



FINANCIAL SERVICES

- Insurance Tax Bulletin

PRICEWATERHOUSECOOPERS 

Vehicle Service Contracts Qualify as Insurance

August 8, 2007

Alert Number: 07-49

In PLR 200730001, the IRS ruled that vehicle service contracts (VSC) are insurance contracts for federal tax purposes, and a company that issues and administers the contracts will be taxed as an insurance company under section 831, as long as more than half its business during the tax year consists of issuing contracts.

Taxpayer is a corporation that is not regulated as an insurance company under the laws of State. Taxpayer represents that its sole business activity is the issuance and administration of VSCs for pre-owned vehicles. The VSCs indemnify the contract holder against economic loss for certain expenses to repair a vehicle that has had a mechanical breakdown, provided the expenses are not covered by either the manufacturer or a dealer's warranty. In addition, the VSCs may offer limited coverage for a portion of the costs of roadside assistance that are necessitated by a mechanical breakdown. The VSCs do not cover a contract holder's expenses for preventative or routine maintenance, and they limit the amount payable per repair to the cash value of the vehicle at the time of the repair. Taxpayer does not perform any repair services, instead, Taxpayer pays the contract holder for any necessary repairs based upon the coverage terms of the VSC after the repairs have been made and the claim has been closed. Taxpayer is the obligor on all of the VSCs it issues. In states that require that companies that sell VSCs to obtain insurance from a licensed insurance company, Taxpayer has entered into a contractual liability protection policy with Insurance Company to insure its performance under the VSCs. Under the policy, Taxpayer's obligations are indemnified by the licensed insurance company, but Taxpayer remains liable to the contract holder.

Section 831(c) defines the term "insurance company," as having the same meaning as that term is given under section 816(a). Section 816(a) provides that the term "insurance company" means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Section 1.801-3(a)(1) provides that it is the character of the business actually done in the taxable year that determines whether the company is taxable as an insurance company under the Internal Revenue Code. See, *Bowers v. Lawyers Mortgage Co.*, 285 U.S. 182, 188 (1932). In *Helvering v. Le Gierse*, 312 U.S. 531, 539 (1941), the Supreme Court stated that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing." The "commonly accepted sense" of insurance derives from all the facts surrounding each case.

The IRS concluded that Taxpayer's VSCs are insurance contracts for federal income tax purposes. Moreover, the IRS found that more than half of Taxpayer's business is issuing VSCs that are insurance contracts for federal income tax purposes. Therefore, Taxpayer will qualify as an "insurance company." The VSCs are aleatory contracts under which Taxpayer, for a fixed price, is obligated to indemnify the contract holder for certain economic losses, which are not covered by the manufacturer or a dealer's warranty, that result from the vehicle's mechanical breakdown. Thus, during the contract period, the contract holder has limited its loss for covered risks to the payment of the contract purchase price. In this way, each contract holder has shifted its risk of economic loss to the Taxpayer. By issuing VSCs to a large number of contract holders, Taxpayer has assumed numerous, independent, and homogeneous risks. In this way, Taxpayer has distributed the risk of loss under the VSCs so as to make the average loss more predictable.

PwC Observes: There is a long history within the IRS that warranty contracts are insurance contracts. Once again, the IRS takes a look at the issue of risk shifting, risk distribution and the 'business of insurance' to determine whether a company is an insurance company for federal tax purposes.

For additional information please call Anthony DiGilio at (202) 414-1702 or contact your local insurance tax professional. Please visit us at: <http://www.pwc.com/us/insurance/tax>

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