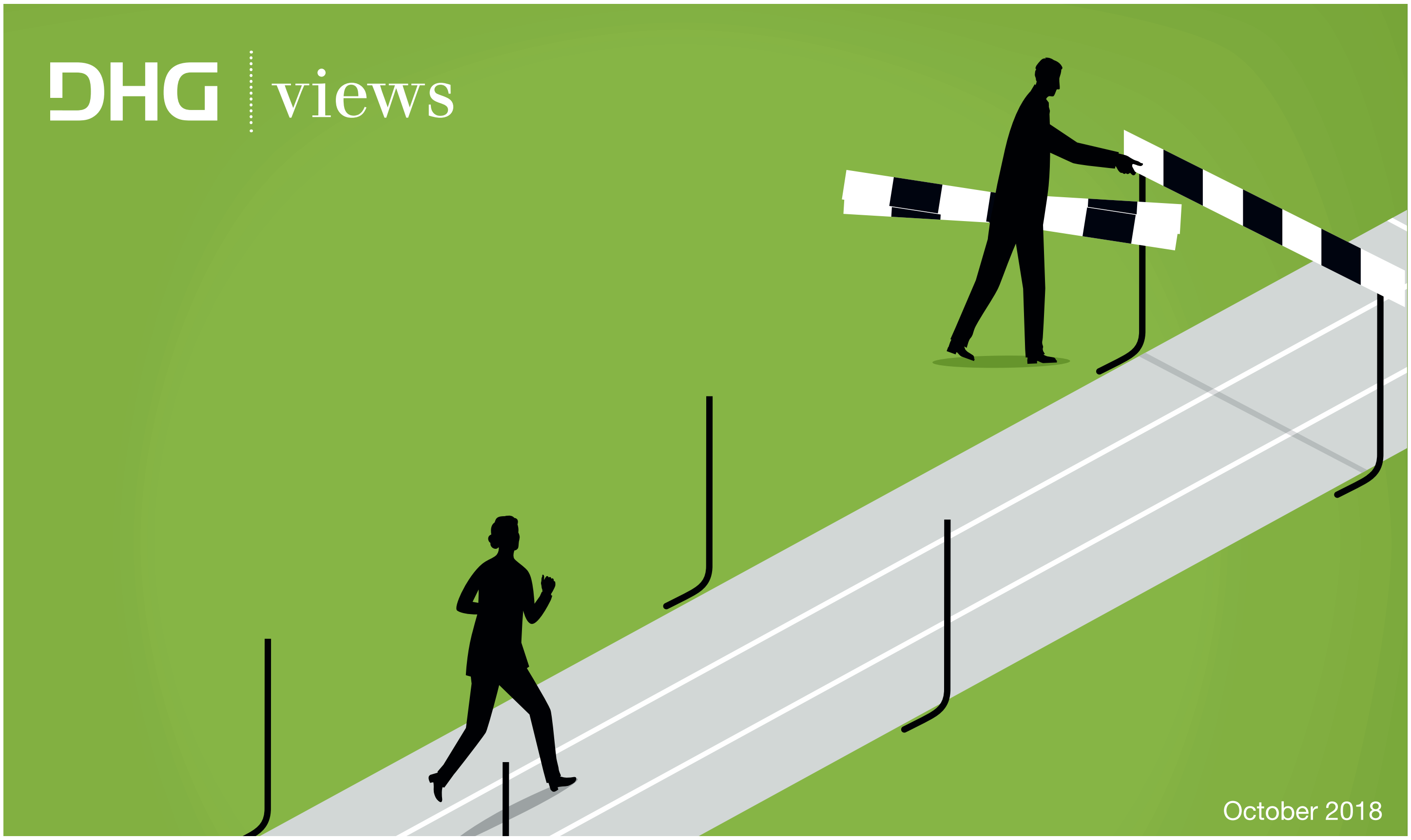


# Federal Income Tax Considerations – Service Contract Providers

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**Over the years, there has been uncertainty for entities that provide automobile service contracts as to their tax status for federal income tax purposes. Normally, these service contract providers do not meet the traditional definition of an insurance company from a regulatory standpoint, creating some uncertainty as to their proper tax status. Fortunately for business owners and tax practitioners alike, the Internal Revenue Service (IRS) has addressed this issue, providing us with tangible guidelines in the form of published rulings.**

The analysis of whether an entity is an insurance company for federal income tax purposes is multi-faceted, but arguably begins with the following question: is the underlying contract an "insurance" contract for federal income tax purposes, as opposed to state regulatory purposes? Once this question is answered, there are other numerical and factual tests that must be considered in determining whether the entity is an insurance company for federal income tax purposes.

The IRS has issued a number of Private Letter Rulings (PLRs) which conclude that a contract providing protection to a vehicle purchaser or lessee, covering the economic loss associated with the cost of repairs due to mechanical breakdown, meets the definition of an insurance contract for federal income tax purposes. The IRS has also ruled that a company issuing these contracts (the obligor) is an insurance company for federal income tax purposes, provided that at the end of each taxable year, more than 50 percent of the company's business is the issuing of such contracts.

Service contract providers that meet the above criteria should adopt insurance company filing status for tax purposes and use a Form 1120-PC (U.S. Property and Casualty Insurance Company Income Tax Return) to report their business operating results for federal income tax purposes. Several of the key provisions of being properly classified as an insurance company for federal income tax return purposes include:

- Acquisition costs related to the issuance of new contract (service contracts) sales are deducted as incurred – these costs typically represent a significant portion of the revenue of a contract.

- Revenue from the sale of new contracts is deferred and recognized over the term of the contract – insurance revenue recognition relates to the period in which policy premiums are earned.
- 20 percent of the deferred revenue is subject to tax in the year issued (written) – the current taxation of a portion of the "unearned" premium is a partial offset to the immediate deductibility of acquisition costs.
- Loss reserves for incurred losses and unknown incurred (incurred but not reported, or "IBNR") can be established and deducted for federal income tax purposes when identified – these loss reserves must be actuarially determined and are subject to required time-value discounting concepts.

## Illustration of a Typical Contract

The dealer selling the contract collects the contract price (gross "premium") from the contract holder but forwards an amount to the company issuing the contract net of the commission retained by the dealer. The IRS has determined that the gross contract price under IRC Section 832 is the amount that a purchaser (consumer) pays for the contract (i.e., the gross "premium"), and that the issuer of the contract is entitled to a deduction under IRC Section 832(b)(6) for the commission retained by the person (i.e., dealer) who sold the contract. The significant impact of this ruling methodology on the calculation of taxable income is illustrated as follows:

*Example:* On July 1, an auto dealer sells an extended service contract that will provide coverage for 60 months for $1,500. The dealer is entitled to retain commission of $750. The dealer collects $1,500 from the purchaser of the contract and forwards $750 to the obligor.

*Illustration of taxable income as computed by the "insurance" company (for federal income tax purposes)*

| | Year 1 "Gross" Approach | Year 1 "Net" Approach |
|---|---|---|
| Contract price (Gross "premiums" written) | $1,500 | $750 |
| Unearned premium EOY (54/60 * GPW) | 1,350 | 675 |
| 80% of unearned premiums | 1,080 | 540 |
| Earned premiums | 420 | 210 |
| Less commission | 750 | 0 |
| Net taxable income (loss) | (330) | 210 |

The variation between the two approaches is a timing difference that will reverse over the life of the contract. The gross approach can produce an immediate tax loss if the contract period is multiple years and the commission expense is significant, which historically is the case with these types of contracts. Under such circumstances the company may generate tax losses for several years, especially if contract revenue is increasing year after year as the business operations expand. Because the "gross" approach is a favorable accounting method for tax purposes, service contract providers should review how they currently account for contracts where they receive contract revenue net of a dealer commission. Companies that are using the "net" approach may wish to consider changing their accounting method to a "gross" approach by filing a Form 3115 for a change in accounting method. The use of the "gross" approach would require the service contract provider to collect data for the dealer contract sales price. Any contemplated change in accounting method should be accompanied by a detailed analysis of the anticipated tax impact to the change.

## Summary

Automobile service contract providers employ a variety of accounting and tax approaches that may not accurately reflect either the "gross" or "net" approach described in the above illustration. Since the position taken by the IRS in published rulings is acceptable, and since it allows for proper classification as an insurance company for federal income tax purposes, service contract providers should examine their current methodology to determine if a change would be advantageous.

The advent of tax reform in 2017 will result in several changes in the economic analysis of the tax cost to automobile service contract providers. Notably, the reduction in the corporate tax rate from a graduated maximum of 35% to a flat 21% rate will result in significant tax savings for entities that are producing taxable income. Said differently, for entities employing the Gross method that are no longer producing increases in the volume of new business written, the current tax cost of recognizing deferred revenue will be less burdensome.

Also expected for all service contract providers is an impact from the acceleration of taxable income due to changes in the tax discounting methodology for Property & Casualty insurers. Tax Reform will produce deeper discounts at the outset – as mentioned above, this is a timing difference and its overall impact should be muted for service contract providers.

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