INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-139131-07

Taxpayer's Name:
Taxpayer's Address:
Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =
Company C =
Reimbursement Policies =

Number B =
Country A =
Year 1 =
Year 2 =

ISSUE:

Whether a manufacturer's original product warranty risks covered by the Reimbursement Policies purchased by Taxpayer constitute insurable risks for federal tax purposes?

CONCLUSION:

The Reimbursement Policies purchased by Taxpayer to cover a manufacturer's warranty risks do not constitute insurable risks for federal tax purposes.

FACTS:

Taxpayer is a multi-line retailer that offers a wide array of merchandise and related services. Taxpayer's retail offerings include a large assortment of products. These products are generally subject to a manufacturer's warranty. The consumers of these products automatically receive the manufacturer's warranty as part of the original product sales transaction. No separate amount is charged for these manufacturer's warranties. The consumers of the products may not opt to purchase the product without the manufacturer's warranty.

The products sold by Taxpayer include major national brands (Manufacturer Branded Products) as well as exclusive Taxpayer brands (Taxpayer Branded Products). The Taxpayer Branded Products are produced by various manufacturers. Taxpayer enters into supply agreements with manufacturers for both the Manufacturer Branded Products and the Taxpayer Branded Products. These supply agreements typically include provisions for pricing, warranties, product quality, and service recourse.

For Taxpayer Branded products, Taxpayer generally agrees, in exchange for lower product costs, to repair or replace such products subject to certain provisions as set forth in the supply agreements. There are Number B such supply agreements. The manufacturer is required to include a manufacturer's warranty with the product identifying Taxpayer as the party responsible for services promised in the warranty. The manufacturer agrees to pay Taxpayer for service calls in excess of a target level. In addition, for Taxpayer Branded Products, the manufacturer agrees to reimburse Taxpayer if the total service calls for any product category in any calendar year exceeds the product category target for such calendar year. In the case of any catastrophic failure, or a Taxpayer Branded Product recall or rework, the agreements require that a manufacturer reimburse Taxpayer for all of Taxpayer's costs, including all labor, travel and other service costs, incurred in connection with servicing the products that are subject to a catastrophic failure. A consumer normally contacts Taxpayer to handle any problems with respect to a Taxpayer Branded Product during the manufacturer's warranty period.

Taxpayer represents that prior to Year 1, Taxpayer incurred warranty repair costs for Taxpayer Branded Products. Taxpayer reported the estimated liability for the warranty repair cost as an expense reserve in Taxpayer's audited consolidated financial statements each year. The reserve was non-deductible for federal tax purposes. During Year 1, Taxpayer entered into Reimbursement Policies with Company C, a wholly-owned subsidiary of Taxpayer, domiciled in Country A and incorporated in Year 2. Company C has elected to be taxed as a domestic corporation under section 953(d). Company C has been included in the consolidated annual US federal income tax returns of its parent, Taxpayer, since Year 2.

In general, Reimbursement Policies with Company C reimburse Taxpayer for warranty expenses incurred in connection with its service obligations under manufacturer's warranty agreements for Taxpayer Branded Products sold by Taxpayer. The Reimbursement Policies exclude any liability to Taxpayer for expenses under any manufacturer's warranty agreements if the manufacturer retains all liability for such warranty expenses. The Reimbursement Policies also exclude any liabilities Taxpayer incurs under an extended warranty sold by Taxpayer to the consumer. The Reimbursement Policies provide that Taxpayer maintain control of the management of all claims under the policy. The Reimbursement Policies require that Taxpayer submit monthly claim reports to Company C. In addition, at the end of the policy period, Taxpayer is required to provide Company C with an Annual Paid Claim Report. The Annual Paid Claim report contains Taxpayer's actual paid claim data for the policy period. After a comparison is made of the actual, annual claim costs to the sum of all monthly estimated claim amounts for the policy period, an annual adjustment is computed. The Reimbursement Policies are subject to claim audits.

LAW and ANALYSIS

Warranty Defined.

With regard to commercial sales, "warranty" has been defined as:

> [A] statement or representation made by seller of goods, contemporaneously with and as part of contract of sale, though collateral to express object of sale, having reference to character quality, or title of goods, and by which seller promise or undertakes to ensure that certain facts are or shall be as he represents them… A statement of fact respecting the quality or character of goods sold, made by the seller to induce the sale, and relied on by the buyer. Black's Law Dictionary, Abridged 6th Ed. (1991), 1095-96.

The Uniform Commercial Code (UCC) provides sellers with the ability to limit liability that would otherwise arise from implied warranties. But the seller does not have unlimited power to avoid liability. Courts do not generally favor disclaimers. Both the UCC and federal law, such as the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act[1], limit a seller's ability to disclaim warranties. White & Summers, Uniform Commercial Code, 5th ed., § 12-1 (2000).

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1 Act of 1975, Pub.L.No. 93-637, 88 Stat. 2183, 15 U.S.C.A. §§ 2301 et seq. (1982).

A written warranty is specifically defined as: "any written affirmation of fact or written promise made in connection with the sale of a consumer product by a supplier to a buyer." 15 U.S.C.S. § 2301(6)(A) (2000).

Insurance Defined.

Neither the Code nor the regulations thereunder define the terms "insurance" or "insurance contract." The Supreme Court of the United States has explained that in order for an arrangement to constitute insurance for federal tax purposes, both risk shifting and risk distribution must be present. Helvering v. LeGierse, 312 U.S. 531, 539 (1941). The risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F. 2d 1190, 1193 (7th Cir.1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-291 (2d Cir.1950), and must not be merely an investment or business risk. LeGierse, 312 U.S. at 542.

An insurance contract is generally understood to be "a contract, whereby, for an adequate consideration, one party undertakes to indemnify another against loss arising from certain specified contingencies or perils . . . [I]t is contractual security against possible anticipated loss." Epmeier v. United States, 199 F. 2d 508, 509-10 (7th Cir. 1952). Risk shifting and risk distribution, the principal tests for determining whether a particular arrangement constitutes "insurance" for federal tax purposes and set out in Helvering v. Le Gierse, requires that the risk shifting and risk distribution occur in "a transaction which involve[s] an actual 'insurance risk' at the time the transaction was executed." 312 U.S. at 539.

Risk shifting and risk distribution are not the only required aspects of an insurance contract. An insurance contract must also fall within the "commonly accepted sense" of insurance. The "commonly accepted sense" of insurance derives from all of the facts surrounding each case, with emphasis on comparing the implementation of the arrangement with that of known insurance. Court opinions identify several nonexclusive factors bearing on this, such as the treatment of an arrangement under the applicable state law, AMERCO, Inc. v. Commissioner, 96 T.C. 18, 41 (1991), aff'd 979 F. 2d 162 (9th Cir. 1992); the adequacy of the insurer's capitalization and utilization of premiums priced at arm's length, The Harper Group v. Commissioner, 96 T.C. 45, 60 (1991), aff'd 979 F.2d 1341 (9th Cir. 1992); separately maintained funds to pay claims, Ocean Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714, 728 (1991), aff'd per curiam, 988 F.2d 1134 (Fed. Cir. 1993); and the language of the operative agreements and the method of resolving claims, Kidde Indus. Inc. v. United States, 49 Fed. Cl. 42, 51-52 (1997).

Non-tax insurance treatises further confirm that arrangements entered into to manage losses that are at least substantially certain to occur, or that are not the result of fortuitous events, do not constitute insurance. See e.g., Couch on Insurance 3d, (1997) ¶102:8 (losses that exist at the time of the insurance agreement, or that are so probable or imminent that there is insufficient "risk" being transferred between the insured and insurer, are not proper subjects of insurance); 1 Appleman on Insurance 2d ¶ 1.4 ("The fortuity principle is central to the notion of what constitutes insurance. The insurer will not and should not be asked to provide coverage for a loss that is reasonably certain or expected to occur within the policy period."); 43 Am. Jur. 2d.Insurance, ¶ 479 (2005).

One treatise describes an insurable risk as having four elements, among them that the loss must be fortuitous or accidental. It is explained that for an event to be fortuitous,

> [i]t must not be something that is certain to happen. If the insurance company knows that an event in the future is inevitable, it also knows that it must collect a premium equal to the certain loss that it must pay, plus an additional amount for the expenses of administering the operation. Emmet J. Vaughn, Fundamentals of Risk and Insurance 29 (3d Ed. 1982).

The Tax Court has described "insurance risk" as:

> Basic to any insurance transaction must be risk. An insured faces some hazard; and insurer accepts a premium and agrees to perform some act if or when the loss event occurs. If no risk exists, then insurance cannot be present. "[I]nsurance risk" is required; investment risk is insufficient. If parties structure an apparent insurance transaction so as to effectively eliminate the effect of insurance risk therein, insurance cannot be present. [LeGierse] illustrates these points.
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> AMERCO, Inc., 96 T.C. at 38-39.

Warranty and Insurance Distinguished.

It is the Service's position that a manufacturer's warranty is a written guarantee that if anything fails with a product due to faulty design or manufacture, which the manufacturer has control of, the manufacturer will repair or replace an item. In essence, it guarantees the integrity of the item. Insurance does not guarantee the integrity of an item. Insurance indemnifies a policyholder against a loss caused by an outside peril. For federal tax purposes, for an arrangement to constitute insurance the insured must have an insurable risk, the risk must be shifted and distributed, it must be insurance in the commonly accepted sense, and loss must be fortuitous or accidental.

A warranty that covers the goods sold for defects that likely existed in the goods at the time of sale is not insurance in the commonly accepted sense. A warranty that goes materially beyond the goods, or beyond defects in the goods, to compensate for losses due to causes unrelated to the general merchantability of the goods can be an insurance contract. Couch On Insurance 3d, § 1: 20 (1997).

The Supreme Court addressed what constitutes "the business of insurance" for purposes of section 2(b) of the McCarran-Ferguson Act, 59 Stat. 34, as amended, 61 Stat. 448, 15 U.S.C. ¶1012(b) in Group Life & Health Ins.. Co. v. Royal Drug Co., 440 U.S. 205 (1979). The Court concluded that agreements between Blue Shield of Texas and three pharmacies for the provision of prescription drugs to Blue Shield policyholders did not constitute "the business of insurance" within the meaning of the McCarran-Ferguson Act, noting that "[t]he primary elements of an insurance contract are the spreading and underwriting of a policyholder's risk." The Court considered the legislative history of the Act, quoting approvingly from one of the early House Reports, as follows: "The theory of insurance is the distribution of risk according to hazard, experience, and the laws of averages. These factors are not within the control of insuring companies in the sense that the producer or manufacturer may contract cost factors." 440 U.S. at 220-21. (quoting H.R. Rep. No. 873, 78th Cong. Ist. Sess., 8-9 (1943)).

In Griffin Systems, Inc. v. Washburn, 505 N.E.2d 1121 (Ill 1981), the court analyzed the differences between a warranty, a service contract, and insurance in determining whether a company which offers to repair or replace certain auto parts on recently purchased automobiles was acting as an insurance company. The court reasoned at 1124:

> An analysis of the cases set forth above reveals that a warranty and a service contract have many of the same features. Nonetheless, the distinguishing feature which sets them apart from an insurance policy is the fact that the respective companies manufacture or sell the products which they agreed to repair or replace. No third parties are involved, nor is there a risk accepted which the company, because of its expertise, is unaware of. Through a warranty or service contract, a company simply guarantees that its own product will perform adequately for a period of time.

The Reimbursement Policies are not insurance for federal tax purposes.

The Service has determined that a manufacturer's warranty is not insurance for federal tax purposes. There is no outside force at work when something goes wrong with the product. There is no fire or other accident. The manufacturer has control over the manufacturing process. Anything that goes wrong is attributable to actions, or lack of actions, of the manufacturer. When a manufacturer enters into a retail sales contract with a customer and exchanges its product for cash, the manufacturer is promising, whether explicitly or implicitly, that the product works, and that if it does not the manufacturer will stand behind its product and fix it or otherwise satisfy its part of the retail sales bargain. A manufacturer's warranty is part of, or is carried by, the product to the retail customer. It is not a separate item that exists away from the product.

In this case, Taxpayer sells Taxpayer Branded Products. Under the arrangements that permit Taxpayer to sell these products, Taxpayer is stepping into the shoes of the manufacturer when it sells these products. Taxpayer becomes the manufacturer and any purported Taxpayer warranty must be treated as a manufacturer's warranty. Consequently the Reimbursement Policies are not insurance. Furthermore, any risk that Taxpayer will pay out more in repairs than the amount factored into the price of the product for repair cost is a business risk.

Taxpayer claims that its risk is more than a business risk and that fortuity exists. We disagree. Rev. Rul. 68-27, 1968-1 C.B. 315, holds that a medical services contract does not constitute an insurance contract because the predominant portion of the issuer's expenses were not of a type "other than that which it incurs in providing the medical services through a salaried staff of physicians, nurses, and the technicians." The contract provided for indemnification of the costs for needed services the issuer was unable to provide. "[A]lthough an element of risk exists, it is predominantly a normal business risk of an organization engaged in furnishing medical services on a fixed-price basis, rather than an insurance risk."

Taxpayer's financial arrangement is not unlike the arrangement described in Rev. Rul. 68-27. Taxpayer has taken the place of the manufacturer with respect to liability for product integrity. Pursuant to Taxpayer's supply agreements, Taxpayer negotiates a lower product cost for Taxpayer Branded Products as an offset to the repair costs it incurs pursuant to the manufacturer's product warranties for which Taxpayer is liable. The supply agreements require certain standards to be met by the manufacturers of the products, and seek to improve the quality, features, and value of the product. Additionally, the supply agreements provide for reimbursements to Taxpayer for repair costs which exceed a certain target rate. This demonstrates Taxpayer's control over the integrity of the products its sells under Taxpayer's name, and that Taxpayer is *de facto* the manufacturer. Consumers expect to look to Taxpayer to remedy any repairs or failures. Moreover, Taxpayer's supply agreement is clear that the Taxpayer's warranty is the only consumer warranty applicable.

Taxpayer contends that the offering of the Reimbursement Policies by Company C (a third party) qualifies this arrangement as insurance because such coverage is not incidental to a product sale. Citing to Griffin Systems, Riffe v. Home Finders Assoc, Inc., 517 S.E.2d 313 (W.Va. 1999); and Electronic Realty Associates, Inc. v. Lennon, 404 N.Y.S.2d 283 (1978), as well as statements by the National Association of

Insurance Commissioners, as authority, Taxpayer asserts that state insurance regulators expressly distinguish a warranty provided by a manufacturer or retailer from a warranty provided by a third party. These cases, however, are not determinative. We do not find that the insertion of a third party creates insurance for federal tax purposes. The warranty that is provided to the consumer is not provided by Company C (the third party). Company C is not in privity with the consumer. Company C merely indemnifies Taxpayer. Moreover, if the underlying risk (i.e., liability under a manufacturer's warranty) cannot be the subject of insurance, a third party's contract to assume that risk cannot establish an insurance contract under federal tax law.

Risk covered by a manufacturer's warranty is not the same risk covered by an extended warranty sold to the consumer of a manufacturer's product.

Taxpayer asserts that the risks covered by the Reimbursement Policies are the same as those covered in an extended warranty, and since an extended warranty qualifies as insurance for federal tax purposes, a manufacturer's warranty should also qualify as insurance for federal tax purposes. We find Taxpayer's assertion meritless. A manufacturer's warranty guarantees to the consumer that the product will operate as designed. Because a warranty covers the product sold for defects that likely existed at the time of sale, and a manufacturer has the ability to control the manufacturing process, there is no fortuity. A manufacturer maintains statistics to determine the likelihood of, and to minimize, design flaws in the effort to manage losses that predictably could occur, all to the financial benefit of a manufacturer. Thus, manufacturer's warranty does not represent an outside peril to the manufacturer.

An extended warranty, sold to a consumer of a product, indemnifies the consumer for losses that the consumer may incur beyond those covered by the manufacturer's warranty. The losses incurred subsequent to the term of the manufacturer's original warranty represent a fortuitous event to the consumer (i.e., one that is not in the control of the insured). If a consumer does not obtain an extended warranty, the consumer would be liable for the cost to repair or replace the product due to a malfunction that is outside of the consumer's control. An extended warranty provides indemnification to the consumer for this risk.

CAVEAT

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent