INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 831.00-00, 832.00-00
CASE-MIS No.: TAM-123750-13

Taxpayer's Name:

Taxpayer's Address:

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

LEGEND:

TAXPAYER =

TAXPAYER SALES SUB =

TAXPAYER SUB =

BRAND 1 =

BRAND 2 =

DATE =

ISSUE:

Whether Taxpayer Sub's treatment of its participation in Program as the issuance of insurance contracts is proper?

CONCLUSION(S):

The Supplement, which implements the Program, is not an insurance contract by which retail customers who purchase Program Products shift an insurance risk to Taxpayer Sub. Thus, Taxpayer Sub's treatment of its participation in Program as the issuance of insurance contracts is not proper.

FACTS:

Taxpayer offers what it refers to as a "Certified Warranty" program (Program) for its Brand 1 and Brand 2 "used" products[1] ("Program Products") available for sale or lease. The Program is primarily administered through Taxpayer Sales Sub. Under Taxpayer Sales Sub's guidelines, a retailer can enroll a Product in the Program by identifying the specific Product, certifying that the Product passes an inspection, paying a participation fee to Taxpayer Sales Sub, and maintaining certain records regarding the Product. For Program Products, the retailer must follow Taxpayer Sales Sub's marketing instructions.

The Program has two components: a "certified warranty" described in the Supplement and an option to purchase an extended service/warranty agreement (ESA).[2] The Supplement extends the Program Product's original warranty. The sales price of the Program Product that includes the Supplement is typically higher than that for a comparable non-Program Product. The ESA[3] is an optional after-market product that customers purchasing Program Products[4] may buy for a separately stated price. The ESA extends the Supplement on the Program Product.[5]

A Supplement covering a Brand 1 Product transfers to a subsequent non-retail owner of that product. A Supplement covering a Brand 2 Product expires when the customer disposes of the Brand 2 Product. Some ESA plans transfer to subsequent owners; others do not.

Retailers cannot sell or lease a Program Product without the Supplement, even for a lower price, and they cannot sell or lease a non-Program Product with the Supplement, even for a higher price. In fact, guidance provided retailers with regard to Brand 1

[1] Also known as "pre-owned" or "experienced" Product.
[2]The ESA is available for purchase in connection with non-Program Program Products. Taxpayer offers a menu of ESAs with differing benefits for differing prices.
[3] Retailers offer several ESAs. The price for each depends on the benefits it provides.
[4] Customers who buy non-Program Products may also purchase ESAs at a separately stated price.
[5] For non-Program Products, the ESA extends the Product's basic warranty period.

Products caveats that "[the Supplement] is not approved by applicable state agencies as a [service agreement]. Consequently, it cannot be sold to the consumer."

Neither the retailer nor the customer can cancel the Supplement. The ESA is cancellable.

The Brand 1 Supplement provides that, where allowed by law, "[a]ny implied warranty of merchantability or fitness for a particular purpose applicable to this [Product] is limited to the duration of these written warranties". The Brand 2 Supplement provides that, where allowed by law, "[a]ny implied warranty of merchantability or fitness for a particular purpose applicable to this [Product] is limited to the duration of the written warranty." The ESA excludes coverage for any failure of the Product covered by a manufacturer warranty but does not otherwise limit other warranties.

An affiliate of Taxpayer Sales Sub (i.e., Taxpayer Sub) provides coverage under the Supplement and the ESA.

Taxpayer Sales Sub remits the participation fee (less administrative and marketing costs, and profit) paid by the retailer to Taxpayer Sub in exchange for Taxpayer Sub assuming the financial responsibilities under the Supplement.

If the Program Product experiences a mechanical failure or breakdown covered by the Supplement, the customer is expected to return it to the retailer from which the customer purchased it.[6] Taxpayer Sub reimburses the retailer for the costs it incurred for the repair.

Taxpayer Sales Sub must authorize a repair in excess of a specified amount before Taxpayer Sub may authorize a repair and Taxpayer Sales Sub may reverse Taxpayer Sub's denial of a customer's claim.

According to Taxpayer, "[Taxpayer Sub] and [Taxpayer Sales Sub] are co-obligors under the [Supplement] but [Taxpayer Sub] accepts full responsibility"; "[n]otwithstanding that [Taxpayer Sales Sub] does not bear the financial risk under the Program, [Taxpayer Sales Sub] is a named obligor under the [Supplement] to satisfy state laws and to facilitate the administration for the [Supplement]."

Taxpayer argues that "[t]he arrangements between the purchasers and lessors of [Program Products] and [Taxpayer Sub] under the [Program] shift the risk of specified [Program Product] failures from the customers (who would incur these costs in the absence of the [Program]) to [Taxpayer Sub]."

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[6] Taxpayer indicates that its practice is to honor claims under the Supplement if the customer utilizes a different repair facility.

LAW AND ANALYSIS:

a. Law

In Helvering v. Le Gierse, 312 U.S. 531, 540-41(1941), the Supreme Court defined the principal test for determining whether a particular arrangement constitutes "insurance" for federal income tax purposes stating, "historically and commonly insurance involves risk-shifting and risk-distributing" in "a transaction which involve[s] an actual 'insurance risk' at the time the transaction was executed." The Court set the parameters of the arrangement by noting that:

> The two contracts must be considered together. To say they are distinct transactions is to ignore actuality, for it is conceded on all sides and was found as a fact by the Board of Tax Appeals that the 'insurance' policy would not have been issued without the annuity contract.

Cf., F. W. Services, Inc. & Subsidiaries v. Commissioner, T.C. Memo. 2010-28, aff'd per curiam, 459 Fed. Appx. 389 (5th Cir. 2012) (the Tax Court declined to read three contracts as one, but noted that even if it had, the character of the contracts would not change).

In Epmeier v. United States, 199 F.2d 508, 509-10 (7th Cir. 1952), the court described an insurance contract to be generally understood as "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." "[I]nsurance risk requires a fortuitous event or hazard and not a mere timing or investment risk." Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950).

In Situation 1 of Rev. Rul. 2009-26, 2009-2 C.B. 366, the Service considered a ninety percent quota share arrangement between a ceding company with 10,000 policyholders and a reinsurer that had no other business. It concluded that the reinsurance contract between ceding company and reinsurer shifted risk to the reinsurer and distributed risk among the 10,000 policyholders the ceding company insured. Accordingly, to determine risk distribution regarding a reinsurance contract one must "look through" to the source of the risks.

In Rev. Rul. 92-93, 1992-2 C.B. 45, a parent corporation purchased a group-term life insurance policy from its wholly-owned insurance subsidiary. The Service concluded the arrangement was not "self-insurance" because the employees, not the parent corporation, faced the economic risk of loss.

Rev. Rul. 80-95, 1980-1 C.B. 252, describes an arrangement in which a corporation insured its obligation under an employee disability plan with a foreign insurer subject to excise tax under § 4371. The Service found sufficient risk shifting and risk distribution and concluded that, because the employees faced the risk of loss, the arrangement was similar to reinsurance and therefore was a policy of "sickness or accident insurance".

Rev. Rul. 68-27, 1968-1 C.B. 315, holds that providing medical services for illness or disability by staff-model medical clinic for fixed monthly fee involves a normal business risk of an organization engaged in furnishing medical services on a fixed-price basis, rather than an insurance risk.

In a non-tax context, the analysis employed by the court in GAF Corp. v. County School Bd., 629 F.2d 981 (4th Cir. 1980), illustrates the interplay between insurance and a warranty. The court observed that:

> The question whether contracts for sale of goods or for service containing 'guarantees' are insurance contracts or warranties arises in a variety of contexts and is a difficult one because these contracts involve the transfer and distribution of risk, which are two elements of insurance. [citation omitted] … The guarantee must be viewed as a whole in determining whether it constitutes a contract of insurance or a warranty.…The element of risk transference, however, was a relatively unimportant element of the transaction and is incidental to the essential character of the guarantee, which is that of a warranty agreement accompanying the sale of goods. [citation omitted] We think the appropriate rule is that a small element of 'insurance' should not be construed to bring a transaction within the reach of the insurance regulatory laws unless the transaction involves 'one or more of the evils at which the regulatory statutes were aimed' and the elements of risk transfer and distribution give the transaction its distinctive character.…The workmanship guarantee is incidental to the warranty against defects in the products sold. Viewed as a whole under the rule we think proper, the warranty is not a contract of insurance. GAF is, therefore, not an unauthorized insurer and is not amenable to service under the Unauthorized Insurers Process Act.

629 F.2d at 983-84.

BLACK'S LAW DICTIONARY[7] defines "warranty," as that term is used in connection with the sale of goods, as a covenant or promise; an implied warranty of merchantability is a promise that the good is fit for its ordinary purposes.

A "warranty" is further defined as a written statement that promises the good condition of a product and states that the maker is responsible for repairing or replacing the product usually for a certain period of time after its purchase.[8]

The Uniform Commercial Code (U.C.C.) describes two types of warranties -- express and implied. In general, an express warranty is any fact or promise made by the seller to the buyer, any description of the goods, or any sample or model which "becomes" or "is made part of the basis of the bargain". U.C.C. § 2-313. An implied warranty that the goods are merchantable, exists by virtue of the sales contract without any affirmative statement about the product. To be merchantable the goods must be, among other things, "fit for the ordinary purposes for which such goods are used." U.C.C. § 2-314. Another implied warranty provides the circumstances under which the goods will be fit for a particular purpose. U.C.C. § 2-315. Written exclusions or modifications of implied warranties must be conspicuous. U.C.C. § 2-316.

An example of the distinction between a warranty and a service contract is the framework of the Magnuson-Moss Act, 15 U.S.C. § 2301, et seq. As described in regulations, for agreements not subject to that Act, a written warranty must be "part of the basis of the bargain"; that is, it must be conveyed at the time of sale of the consumer product and the consumer must not give any consideration beyond the purchase price of the consumer product in order to benefit from the agreement. 16 C.F.R. § 700.11(b). Conversely, a service contract is an agreement which would meet the definition of a warranty but for its failure to satisfy the basis of the bargain test, e.g., if the consumer must give consideration beyond the purchase price of the consumer product in order to benefit from the agreement. 16 C.F.R. § 700.11(c).

b. Analysis

Taxpayer argues that the proper perspective to determine whether the arrangement is insurance is that of the customer, because it is the customer who faces the risk of loss. Taxpayer posits that "[i]n this case, it is the customer's risk that is being insured, not the [retailer]'s risk or [Taxpayer Sales Sub]'s risk". That is, Taxpayer contends that customers purchasing a Program Product face an "insurable risk" of the mechanical breakdown of the Program Product, and that they transfer this risk to Taxpayer as part of the purchase of the Program Product by the operation of the Supplement. The number of customers is more than sufficiently large to meet the risk distribution requirement.

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[7] (9th ed. 2009)

[8] Merriam-Webster Online: Dictionary and Thesaurus © 2014 Merriam-Webster, Incorporated (http://www.merriam-webster.com/dictionary/warranty.)

The applicable authorities do not support Taxpayer's contention. The context in which the applicable authorities reach the conclusion that an arrangement constitutes insurance for federal income tax purposes involves a separately negotiated contract. Cf. Le Gierse, 312 U.S. at 536 ("The 'insurance' policy would not have been issued without the annuity contract.")

The Supplement contains the Program's promise that, for the specified period, the Program Product will perform and, if it does not, the customer will not incur repair costs. The customer pays no consideration in addition to the price asked for the Program Product for this promise. Inasmuch as the Supplement limits any implied warranties to the duration of the written warranties it provides, the terms of the Supplement echo those described as part of the general legal definition of a "warranty", as that term is applied under the Magnuson-Moss Act and the U.C.C.[9]

Taxpayer acknowledges that enrolling a Branded Product in the Program is a significant selling point because the Supplement protects the customer from incurring the costs of covered repairs. However, this protection cannot be separately bargained for and the retailer cannot offer to remove the Supplement from a Program Product or to add it to a non-Program Product. In this respect, the Supplement echoes a tying arrangement[10] or contract of adhesion.[11]

In contrast, the ESA is separately bargained for, applies after the expiration of any warranties, and does not limit other implied warranties. The ESA does constitute insurance for federal tax purposes.

The contracts that were found to constitute insurance in the various cited cases and revenue rulings are like the ESAs. In contrast, the Supplement is a warranty intertwined with the sale of a good rather than a bargained for contract to shift the risk of an economic loss. Accordingly, Taxpayer Sub's treatment of its participation in Program as the issuance of insurance contracts is not proper because the Supplement, which implements the Program, is not an insurance contract by which retail customers of Program Products shift their insurance risk to Taxpayer Sub.[12]

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[9] Neither the Magnuson-Moss Act nor the U.C.C. are dispositive of the question for federal income tax purposes, but are informative as to the nature of a warranty obligation.

[10] A tying arrangement occurs when, through a contractual or technological requirement, a seller conditions the sale or lease of one product or service on the customer's agreement to take a second product or service. ANTITRUST ENFORCEMENT AND INTELLECTUAL PROPERTY RIGHTS: Promoting Innovation and Competition, ISSUED BY THE U.S. DEPARTMENT OF JUSTICE AND THE FEDERAL TRADE COMMISSION (APRIL 2007), http://www.ftc.gov/sites/default/files/documents/reports/antitrust-enforcement-and-intellectual-property-rights-promoting-innovation-and-competition-report.s.department-justice-and-federal-trade-commission/p040101promotinginnovationandcompetitionrpt0704.pdf.

[11] A standard form contract drafted by one party (usually a business with stronger bargaining power) and signed by the weaker party (usually a consumer in need of goods or services), who must adhere to the contract and therefore does not have the power to negotiate or modify the terms of the contract. Cornell University School of Law, *Legal Information Institute*, http://www.law.cornell.edu/wex/adhesion_contract_contract_of_adhesion.

[12] The Technical Advice request did not ask for an opinion with respect to the federal income tax treatment of any of the ESA products. Therefore, no opinion is expressed about the proper tax treatment of any ESA product

CAVEAT(S):

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.