Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: 200628018

Release Date: 7/14/2006

CC:FIP:B04:SBFLUM:
POSTN-101395-06

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 831.00-00

date: February 13, 2006

to: Mary Jane Klimkewicz
LMSB:HMT Territory Manager 7

from: Donald J. Drees, Jr.
Senior Technician Reviewer, Branch 4
(Financial Institutions & Products)

---

subject: Notification of Withdrawn Letter Ruling Request

Taxpayer =

Pursuant to § 7.07(2)(a) of Rev. Proc. 2005-1, 2005-1 I.R.B. 1, 26, this is to notify you that Taxpayer has withdrawn a letter ruling request after we reached conclusions adverse to those requested and to provide you our view on an issue raised in the request.

Taxpayer requested a ruling that the express limited warranty provided by Taxpayer to consumers upon the purchase of a product manufactured by Taxpayer is an insurable risk. We concluded that Taxpayer's express limited warranties are not insurable risks for federal income tax purposes.

FACTS:

Taxpayer is a manufacturer of consumer goods which are sold to consumers throughout the United States. Taxpayer routinely provides an express limited warranty to consumers upon the purchase of one of their manufactured products. Such express limited warranty is embedded in the sale of the product; a consumer cannot elect not to purchase the warranty and no separate price is identified to the consumer as the cost of the warranty. Taxpayer provides the express limited warranties as an indivisible part of the price of the products it sells, and the warranties “run” with the product for the stated duration of coverage, without regard to the identity of the consumer/user. The express limited warranty generally includes Taxpayer’s promise to repair or replace any of its purchased products during the specified coverage period should the product suffer mechanical or operational breakdown within the coverage period.

Taxpayer has several subsidiaries, including a subsidiary that sells extended warranties to consumers for products manufactured by Taxpayer. These extended warranties cover mechanical or operational breakdown of a product manufactured by Taxpayer where such breakdown occurs outside of the coverage period specified in Taxpayer’s express limited warranty and is not otherwise covered by any of Taxpayer’s implied warranty obligations. This subsidiary qualifies as an insurance company for federal income tax purposes.

Taxpayer proposed to have its insurance subsidiary indemnify the express limited warranties on Taxpayer’s manufactured products. Taxpayer argued that the express limited warranties it provides to consumers should be considered insurance contracts purchased by the consumers when they buy Taxpayer’s manufactured products. However, the express limited warranty would still be embedded in the purchase price of the product, the consumer would be unable to opt out of purchasing the warranty coverage, the warranty would still “run” with the product, and Taxpayer would still be obligated to repair or replace any of its products that suffer mechanical or operational breakdown during the coverage period.

LAW AND ANALYSIS:

<u>Law</u>

A “warranty”, as that term is used in connection with the sale of goods, is a business arrangement to repair or replace property due to an inherent defect in that property. 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 promises or undertakes to insure 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 Act1, limit a seller's ability to disclaim warranties. White & Summers, Uniform Commercial Code, 5th ed., § 12-1 (2000).

Taxpayer, as do many manufacturers of consumer goods, provides a limited express warranty as part of the package of the product. The main purpose of such a warranty is to eliminate all other express warranties and the implied warranties of quality, merchantability, and fitness for a particular purpose. In lieu of those warranties, a limited express warranty is given which, typically, permits only repair or replacement of the goods for a limited period. Henning & Wallace, The Law of Sales Under the UCC, ¶ 11.07 (1992). Under a limited express warranty, the seller/manufacturer is obligated to repair or replace a defective product if the defect occurs during a specified period of time. The consumer bears no risk related to any defect in the product during this period. Instead, the seller/manufacturer is solely liable for any cost related to the repair or replacement of its product.

Insurance has been defined in various ways. "There is neither a universally accepted definition or concept of 'insurance' nor a [sic] exclusive concept or definition that can be persuasively applied in insurance lawyering." 1 APPLEMAN ON INSURANCE 2d, § 1.3 (2005). While "it seems appropriate that any concept and meaning of insurance be sufficiently broad and flexible to meet the varying and innovative transactions which humankind perpetually produces", care must be used to describe insurance because "overbroad definitions are not useful and may cause many commercial relationships erroneously to constitute insurance." Id.

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). The principal test for determining whether a particular arrangement constitutes "insurance" for federal tax purposes was set out in Helvering v. Le Gierse, 312 U.S. 531 (1941). In that case, the Supreme Court stated that "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." 312 U.S. at 539. But 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

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

state law, AMERCO, Inc. v. Commissioner, 96 T.C. 18, 41 (1991); 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). 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).

It is commonly understood that insurance is the mechanism to manage the risk of loss from fortuitous events. Insurance is not the mechanism to manage losses that are at least substantially certain to occur, i.e., that are not the result of fortuitous events. This principle "embod[ies] the concept that one may not obtain insurance for a loss already in progress, or for a loss that the insured either knows of, planned, intended, or is aware is substantially certain to occur." 43 Am. Jur. 2d *Insurance*, § 479 (2005); see also COUCH, § 102:8.

> Fortuity is another key element in determining what constitutes insurance for purposes of legal classification. It would be foolhardy for insurance companies to sell insurance that would pay for losses strictly within an insured's control…This is the point where the concept of fortuity comes into play. Insurance is designed to cover the unforeseen or at least unintentional damages arising from risks encountered in life and business: injuries and damages caused by negligence and other similar conduct where the insured stands to sustain a real and palpable loss (generally pecuniary) as a result of the event for which the insurance has been purchased.

1 APPLEMAN ON INSURANCE 2d, § 1.3.

Consistent with the requirement of fortuity, for a contract to be deemed insurance for federal income tax purposes, it cannot indemnify a business risk. See, e.g., Rev. Rul. 68-27, 1968-1 C.B. 315.

Analysis

Taxpayer's limited express warranty is not an insurable risk because it is an inseparable part of the merchandise produced and sold. Manufacturers that provide limited express warranties do so, generally, to comply with the UCC, to limit their liability for manufacturing defects, and to further their reputation with consumers. Taxpayer's limited express warranty covers the goods sold for defects that likely existed in the goods at the time of sale. Taxpayer does not separately sell this limited express warranty—the manufacturer's limited express warranty cannot stand on its own. Accordingly, Taxpayer's limited express warranty is not an insurable risk for federal income tax purposes.

Moreover, Taxpayer's limited express warranty lacks fortuity and, therefore, cannot be an insurable risk for federal income tax purposes. Taxpayer has control over the production of its goods. Consequently, there is no fortuity to any loss to Taxpayer due to the malfunctioning of its product.

Furthermore, the cost of the warranty is embedded in the purchase price of the product, the purchaser of the product is unable to opt out of the express warranty coverage, the express warranty "runs" with the product, and the seller/manufacturer of the product is obligated to repair or replace any product that suffers mechanical or operational breakdown during the coverage period. Taxpayer is obligated to provide the product promised in the sales contract. This obligation is a liability of Taxpayer. The consumer faces no risk of loss for any liability covered by the limited express warranty. Therefore, Taxpayer's limited express warranty is a business risk of Taxpayer as manufacturer, for which Taxpayer must make provision in the price of the sold goods. Thus, Taxpayer's limited express warranty is not an insurable risk for federal income tax purposes. See Rev. Rul. 68-27.

We also had concerns with Taxpayer's proposal to have its subsidiary indemnify the limited express warranties. This fact pattern ran afoul of our position that an arrangement with only one insured cannot constitute insurance. See Rev. Rul. 2005-40, 2005-27 I.R.B. 4.

For these reasons, we conclude that Taxpayer's limited express warranty does not constitute an insurable risk for federal income tax purposes.

Please contact CC:FIP:B04 on (202) 622-3970 if you have any questions.

Pursuant to § 6110(k)(3), this document may not be used or cited as precedent.