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INTERNAL REVENUE SERVICE NATIONAL OFFICE STRATEGIC ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, LMSB:NR, AREA 4

FROM: LON B. SMITH
Associate Chief Counsel (Financial Institutions and Products)
CC:FIP

SUBJECT:

EIN

This memorandum responds to your request for advice in the above-referenced case. Specifically, you ask two questions. First, what are the litigation hazards in arguing that an original manufacturer's warranty cannot be the subject of insurance for income tax purposes, and that premiums for such insurance are therefore not presently deductible? Second, if an original manufacturer's warranty can be the subject of insurance, what additional facts should be developed in this case to determine whether the purported insurance arrangements should nevertheless be challenged?

We have read the facts and considered the analysis set forth in your request for advice. The following paragraphs summarize our thoughts on the litigation hazards and factual development of this case.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The facts in this case and relevant legal authorities are set forth in your incoming request and will not be repeated here.

Issue 1

Your proposed analysis would not treat the seller's liability under an original warranty as insurance, due to the insured's (the builder/seller's) control of the risk, the nature of the liability as arising from breach of an initial sales contract. Your conclusion is that such policies do not insure against any outside peril, personal injury, property

damage, or consequential damages. We are skeptical whether this position would prevail in litigation[redacted] Insuring a seller's liability under an original warranty is not unlike a manufacturer insuring against a number of recognized insurance risks such as products liability, or a physician or other professional insuring against malpractice liability. If you advance a position in litigation that the original warranty is so much within the control of the builder/seller that the transaction lacks fortuity or is merely a business risk (and not the proper subject matter of insurance), you should expect to take on a number of hazards. Specifically, you would have to distinguish various lines of existing insurance business from the original warranty situation. The following paragraphs attempt to do so.

In response to the hazard that original warranties are like product liability insurance, you might direct a court's attention to Aetna Casualty & Surety Co. v. Monsanto Co., (Fla.App. 1 Dist.), 487 So.2d 398 (1986) (defective products not covered) and its reference to the majority rule of Weedo v. Stone-E-Brick, Inc., 81 N.J. 233, 405 A.2d 788 (1979). In Weedo, the Supreme Court of New Jersey states the majority rule on the injury to product exclusion, holding that the exclusion precludes coverage for costs of correcting a product defect. Under Weedo, defects in products are "business risks" as opposed to insurable occurrences involving personal injury or property damage to others as a result of the insured's product. [redacted] In Federal Insurance Company v. P.A.T. Homes, Inc., (Ariz. Sup. Ct.) 547 P.2d 1050 (1976), the Arizona Supreme Court concluded that a contractor could recover from a subcontractor's insurer under a provision in the subcontractor's comprehensive general liability policy that provided coverage if the subcontractor to failed to do its construction in a workmanlike manner. If necessary, it might be possible to distinguish Federal Insurance Company from the present situation on the grounds that only a small portion of a comprehensive general liability policy was under consideration by the Arizona Supreme Court and that the issue of whether the provision was insurance was not squarely raised. The decision might be rationalized as a case where an ambiguity in the language of an insurance contract was construed against the insurer who drafted it and in favor of the insured.

There is also a hazard that the builder/seller will analogize an original warranty to the coverage that a physician receives under a traditional medical malpractice policy. Under such a policy the physician is also in a position to exert control over the risk that is assumed by an insurance company. The builder/seller could urge that just as the medical malpractice policy protects the physician against liability arising out of the performance of his professional services, so also does the warranty corporation's contract protect the builder/seller against liability arising out of the performance of its services. One possible answer to such an argument would distinguish the risk assumed under the medical malpractice policy from the risk associated with a warranty contract, as follows. Under a medical malpractice policy, the insurance company

typically agrees to pay on behalf of the insured amounts which the insured becomes legally obligated to pay as damages because of injury arising out of malpractice, error, or mistake in rendering or failing to render professional services. We understand, however, that the typical malpractice policy excludes from coverage liability assumed by the insured under an agreement guaranteeing the result of any treatment.

A third possible hazard is that the tax law has recognized home warranties as insurance elsewhere, as in Buyers Home Warranty Company v. Commissioner, T.C. Memo. 1998-98. Buyers Home Warranty Company addressed whether, as part of the Technical Advice process, the Service waived the requirement that the taxpayer secure permission to change its method of accounting. The underlying technical advice (LTR) and the Tax Court Memorandum decision involved a taxpayer that sold "home warranty contracts" through realtor and escrow companies to purchasers and sellers of previously owned residential properties. The taxpayer was unrelated to any builder or real estate company and its sole business consisted of selling the "home warranty contracts." In the Technical Advice Memorandum, the Service concluded the "home warranty contracts" were insurance contracts for purposes of § 832. A distinction is that the homes in that case were previously owned, and the warranty was directed largely to systems and appliances. In the present case, the homes are new, and the systems and appliances presumably are under warranty from their original manufacturers. Thus, the warranty at issue in the present case is directed primarily to the workmanship of the builder/seller's construction.

As new lines of business are accepted insurance by the states, we would anticipate additional hazards of trying to distinguish warranty coverage from the coverage offered by these lines.

Issue 2

Notwithstanding our concerns with respect to Issue 1, we believe this case presents a variety of anomalous facts that deserve further development and could serve as the basis for challenging the treatment of these transactions as insurance.

First, you may wish to develop facts

Third, many of the factors cited in your submission would cause us to question whether there is insurance in the commonly accepted sense. See AMERCO & Subsidiaries v. Commissioner, 96 T.C. 18, 42, aff'd. 979 F.2d 162 (9th Cir. 1992).

Fourth,

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Fifth, you may wish to consider

See Rev. Rul. 84-79, 1984-1 C.B. 190; Alumax, Inc. v. Commissioner, 165 F.3d 822 (11th Cir. 1999). The rules provided in the Code for determining whether an insurance company qualifies for the election to be taxed only on its investment income under § 831(b) are straightforward. In determining whether a corporation's net written premiums exceed the $1,200,000 threshold, the corporation is considered to receive the net written premiums of all members of the controlled group. Section 831(b)(2)(B)(i). Controlled group is defined as in § 1563(a) except that more than 50 percent is substituted for at least 80 percent. Section 831(b)(2)(B)(ii).

Please call William Sullivan at (202) 622-3970 if you have any further questions. With respect to the last item dealing with controlled group concerns under § 1563(a), you may also contact William F. Barry of the Office of the Associate Chief Counsel (Corporate) at (202) 622-8012 .

Associate Chief Counsel
(Financial Institutions & Products)

By: /S/
MARK SMITH
Chief, CC:FIP:4