

# Limited Warranties and Prepaid Maintenance as Insurance: IRS Treatment and Issues

F&I Reinsurance and Product Conference

by  
**Andrew J. Weill, Esq.**  
Principal  
Weill & Mazer, APC

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## IRS Attitudes About Limited Warranties

- Practitioners are seeing increasing scrutiny and skepticism about limited warranty products
- Issue came to forefront in TAM 201438022
- Efforts to get IRS to re-examine or limit issue have fallen on deaf ears – but we may have turned up some hearing aids
- Expect more challenges in coming years

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## Warranties vs. Insurance

- The issue is incorrectly presented by IRS as a simple bright-line test having to do with separate consideration
  - If the contract is separate from the product, is optional to the purchaser, and can be negotiated out of the deal, that is a service contract
  - If the arrangement is “embedded” into the product price and non-negotiable, it’s a warranty
  
- **But this is wrong!**

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## A “Warranty” Can Be “Insurance”

The issue turns on the extent of coverage

- Does the warranty only cover defects that existed at time of sale? “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.**” Chief Counsel Advice 200628018, citing COUCH ON INSURANCE 3d, §1.20 (1997)

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## AMERCO

- In *AMERCO Inc. v. Commissioner*, subsidiary of AMERCO Group (U-Haul), issued insurance policy providing liability insurance at minimum financial responsibility levels to the lessors of U-Haul trucks.
  - Even though U-Haul customers may have had their own insurance in force, they were required to accept the insurance coverage extended automatically.
  - The cost of the insurance was not disclosed to the lease customers and a separate insurance line item was not included in the lease agreements.
  - As stated by the Tax Court, “The ... cost was included in part of the basic rental fee.” *AMERCO* at 24.
- **Despite the fact that the insurance was not separately negotiated by the lease customers, the Tax Court nevertheless concluded that risk shifting and risk distribution had occurred and that the transaction constituted insurance.**

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## IRS Authority

- CCA 200628018: warranty offered to consumer, liability transferred to manufacturer subsidiary. **No obligation beyond manufacturer's original obligation.** Not insurance.
- GCM 39146 (*Builder's Warranty*): taxpayer assuming builder's liability for inherent defects; not insurance.

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## TAM 201438022

Taxpayer offered certified warranty program in connection with the sale of its used products by retailers to consumers. Two components:

- Typical extended service/warranty agreement (the ESA). Cancelable by either party.
- A “Supplement” which is an extension of the product’s original warranty and results in a higher price to the consumer.
- Without the Supplement, the used product would typically sell for a lower price.
- Supplement is not cancelable.

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## TAM: Difference Between the Products

- The Supplement has language that, by its terms, limits any implied warranty of merchantability and fitness to the duration of the warranty.
- The ESA does not include language limiting any specific warranties, implied or otherwise, and excludes coverage only for failures of the product that are covered by a manufacturer warranty.

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## TAM Analysis

- Found ESA to be insurance – unsurprising.
- Found Supplement not to be insurance because it was warranty.
- IRS rationale: a contract cannot be an insurance contract for federal income tax purposes if it was not separately bargained for and was not sold for a separately stated price.

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## Issues with TAM Analysis

- Ignores important precedents
- Per Chief Counsel Advice 200628018 supra, the focus should have been on whether coverage is provided beyond what was provided under the original manufacturer's warranty
- Finally, the way in which the TAM deals with *AMERCO*...

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## How Does TAM Deal With AMERCO?

- It doesn't. No mention of *AMERCO* in the TAM
- *AMERCO* has been cited by the Service in each significant revenue ruling since 2002
  - Rev. Rul. 2002-89, Rev. Rul. 2002-91, Rev. Rul. 2005-40,22  
Rev. Rul. 2008-8, Rev. Rul. 2009-26, and Rev. Rul. 2014-15
  - *AMERCO* was also cited in at least eight prior memoranda addressing insurance characterization, four of which specifically address the treatment of warranties
  - Cited with approval at least 80 times in other administrative determinations, including 30 letter rulings, 14 chief counsel advice memoranda, 29 field service advice memoranda, and 10 non-docketed service advice reviews

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## Limited Warranty Risk Shifting

Without a Limited Warranty, the consumer is responsible for the cost of a break down

Honey, the car broke down.  
How are we going to pay for this?  
How am I going to get to work until we can pay for repairs?



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## Limited Warranty Risk Shifting

- With a Limited Warranty, the obligor (InsCo) assumes the cost of a break down
- Consumers have fewer worries
- Dealerships build consumer goodwill and possible repair business

Honey, the car broke down. The Limited Warranty says InsCo will pay for the repairs. How soon do you think it can be fixed if we take it back to Dealership?



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## Limited Warranty Premium

- Is there consideration/premium paid? Yes.
- Is it paid by the beneficiary/consumer? No.
- Can it be insurance if the beneficiary/consumer doesn't pay the premium?
  - Employer paid health insurance
  - Parents paying for college age children's auto insurance
  - Life insurance

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## Interactions With IRS

- IRS Exam has taken positions opposing LW in examination
- IRS Appeals has indicated that
  - The party who pays the premium does not have to be the beneficiary of the LW for to be insurance
  - There must be an actuarially determined premium paid to another party

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## Possible Future IRS Reaction

- IRS is particularly worried about ways in which a pure manufacturer's warranty could be turned into insurance, possibly by manufacturer disclaiming warranties and selling protection as insurance.
- Our industry has no reason to want to do this at all – if anything we have a stake in this **not** happening.

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## IRS Concerns Can Be Addressed

- IRS worries of abuse by conversion of manufacturer warranty to insurance can be safeguarded
- IRS should follow CCA precedent – once taxpayer shows the agreement “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”, it is insurance
- “Embedded” is not the relevant concern, as *AMERCO* shows
- Premium does not have to be paid by the beneficiary of the policy for the policy to be insurance

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## Impinging Factors

- *RVI Guaranty*: Major loss for IRS on residual value insurance
- Attitudes toward microcaptives and Notice 2016-66
- Resolution of warranty issues may be tied in the minds of some IRS decision makers

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## Polling Question

What common elements of insurance does a Limited Warranty have?

- A. Premium payment
- B. Written contract
- C. Fortuitous event triggers claims
- D. All of the above

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## IRS Attitudes about Prepaid Maintenance

- IRS: Maintenance contracts do not indemnify for fortuitous loss
- IRS points to agreement stating that it is not insurance
- The key concept is **fortuity** and to what degree

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## Fortuity

- Insurance is designed to cover **unforeseen** or at least **unintentional damages** from risks encountered in life and business
- Insurance protects against **variability of loss**
  - Risk that insured transfers to insurer is the cost of **variability** in losses, not the complete loss from an event, since the insured pays a premium that represents the average cost of the complete loss

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## Fortuity (continued)

It is possible for a prepaid maintenance product to contain elements of **fortuity** and **protection against variability**

- Guards consumer against the risk that the cost of necessary services will rise due to **fortuitous events** such as:
  - Climate conditions
  - Increased labor prices
  - Increased parts and components costs
  - Consumer can **externalize risk of loss** by shifting that risk
  - Absent the maintenance contract, the consumer would bear the entire risk of the associated loss-causing events
  - Maintenance contracts transfer impact of potential loss from insured to insurer

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## Economic Loss is Insurable Risk

*RVI Guaranty* expert:

- “[T]here are many financial risks,” he testified, “that now are commonly insured, such as trade credit insurance, mortgage guaranty insurance, and municipal bond insurance to name a few.” The Court regarded Professor Angelina as a credible witness and found his testimony helpful.

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## Maintenance Agreement Language

- This should not be an issue because of long experience with vehicle service contracts
  - VSCs typically state that they are not an insurance policy
  - Frequently this is language required by state statute
- Despite this language, VSCs accepted as insurance for tax purposes

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## Other Considerations

- In product design, calling these “prepaid maintenance” is likely to lead the IRS to an immediate negative view
  - Terms like “loss mitigation” or “value protection” may be preferable
  - Make sure necessary elements are part of the contract
- *RVI Guaranty* has likely opened the door to properly designed products
- IRS authority is not applicable

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## Can Maintenance Be Insurance?

- The key is to have fortuity as an important component, not incidental
- Consider bundling with other components that are plainly fortuitous
  - The bundling cannot be artificial; it needs to be a legitimate mixture for independent economic reasons
- Consider how to show that the maintenance has a fortuitous component

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## Polling Question

What do you think the future of Prepaid Maintenance is?

- A. It will continue to grow as its own category
- B. It will grow by evolving into bundled products with maintenance as one element
- C. It will remain as a small part of the F&I landscape
- D. It will go away completely

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## Questions



Andrew J. Weill, Esq.  
Principal  
Weill & Mazer, APC  
200 California Street, Suite 400  
San Francisco, CA 94111  
415.421.0730  
[Weill@weillmazer.com](mailto:Weill@weillmazer.com)  
[www.weillmazer.com](http://www.weillmazer.com)

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