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subject: Warranty Claims on New Construction and Product Liability

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Month A =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

A-Year =

B-Year =

C-Year =

ISSUE

Do a tract homebuilder's liabilities arising as a result of breach of warranties provided to purchasers of new homes qualify as product liabilities within the meaning of § 172(f)(4)[1]?

CONCLUSION

A tract homebuilder's liabilities arising as a result of breach of warranties provided to purchasers of new homes do not qualify as product liabilities within the meaning of § 172(f)(4).

FACTS

Taxpayer uses the accrual method of accounting for federal income tax purposes and files consolidated returns for fiscal tax years ending at the end of Month A. Taxpayer is a major homebuilder. Taxpayer incurred large net operating losses (NOLs) for Taxpayer's taxable years ending in Year 1 and Year 2 because of severe weakness in the real estate industry. Taxpayer operates through numerous subsidiaries and is engaged in all facets of real estate acquisition, development, sales, and financing.

Taxpayer obtained substantial federal tax refunds for its taxable years ending in Year 3 and Year 4 by making applications for tentative carryback adjustments based upon assertions that three categories of deductions generated "specified liability losses" (SLL) for Taxpayer's taxable years ending in Year 1 and Year 2. The issue addressed by this Chief Counsel Advice concerns whether deductions that Taxpayer claimed as a result of satisfying certain warranty liabilities incurred with respect to the sale of new homes qualify as deductions attributable to product liability within the meaning of § 172(f).

Taxpayer provides the buyers of its homes a limited A-Year warranty on workmanship and defective materials; a limited B-Year warranty that certain systems such as the septic system, pipes, and electrical system, will satisfy specified performance standards; and a limited C-Year warranty on structural and major construction defects. These warranties are subject to exclusions and limitations on remedies.

Most of the deductions under consideration were for correcting A-Year warranty "deficiencies" in "performance" or "workmanship standards." This warranty covers specified deficiencies in performance standards relating to site work, concrete, masonry, carpentry and framing, interior trim, thermal and moisture protection, siding,

[1] Unless provided otherwise, all section references refer to sections of the Internal Revenue Code of 1986 as applicable to the taxable years under discussion.

roof, doors and windows, finishes, flooring, paint and wall covering, chimney and fireplaces, cabinets and countertops, and appliances and plumbing.

Much of the damages to the homes for which Taxpayer was obligated under the warranties to make repairs or replacements involved such things as (i) water intrusion or leakage (roof, windows and plumbing) that in turn caused collateral damage to drywall, wood floors, and carpets, and (ii) ground settling (that presumably caused damage to floor tiles and cosmetic damage to driveways). Taxpayer did not claim that expenses for correcting deficient conditions, such as the costs of fixing roof leaks or correctly reinstalling windows and fixing leaky pipes, qualified as deductions attributable to product liability. Taxpayer refers to these expenses as “primary damages”. Rather, Taxpayer claimed product liability treatment for expenses for correcting the damages that resulted from the defective conditions, such as the cost of labor and materials for repairing or replacing drywall, carpets and wood floors damaged by water leaks from faulty installation of roof materials, windows and pipes, which Taxpayer categorizes as “secondary damages”. Taxpayer has not substantiated that any of the deficiencies caused an accident or resulted in personal injury.

All or most of the losses were caused by poor workmanship in the installation of the various integral parts and supplies that comprise the homes rather than by inherently defective parts and supplies. There is no evidence, and Taxpayer does not contend that the items fixed (i.e. roof paper and roof tiles) or reinstalled correctly (i.e. windows and pipes) contained latent safety defects of any kind whatsoever. The defective homes did not cause injury to persons or damage to property other than the homes themselves. In most cases, the water intrusions did not render the homes uninhabitable.

LAW AND ANALYSIS

Section 172(a) provides for a deduction equal to the amount of the NOL carryovers and carrybacks to the taxable year. The portion of an NOL that qualifies as a SLL may be carried back 10 years rather than being limited to the normal 3-year carryback period provided in § 172(b)(1)(A)(i).

Section 172(f)(1)(A) defines a SLL in part as the sum of the following amounts to the extent taken into account in computing the NOL for the taxable year:

Any amount allowable as a deduction under § 162 or § 165 which is attributable to -

(1) product liability, or

(2) expenses incurred in the investigation or settlement of, or opposition to,claims against the taxpayer on account of product liability.

Section 172(f)(4) defines product liability as:

(1) liability of the taxpayer for damages on account of physical injury or emotional harm to individuals, or damage to or loss of the use of property, on account of any defect in any product which is manufactured, leased, or sold by the taxpayer, but only if

(2) such injury, harm, or damage arises after the taxpayer has completed or terminated operations with respect to, and has relinquished possession of, such product.

Treas. Reg. § 1.172-13(b)(2)(i) largely echos the definition of product liability provided in the statute. Treas. Reg. § 1.172-13(b)(2)(ii) expands upon that definition by providing that the term "product liability" does not include liabilities arising under warranty theories relating to repair or replacement of the property that are essentially contract liabilities. The regulations further provide, however, that a taxpayer's liability for damage done to *other property* [emphasis supplied] or for harm done to persons that is attributable to a defective product may be product liability regardless of whether the claim sounds in tort or contract. Further, liability incurred as a result of services performed by a taxpayer is not product liability. *Id*. The regulations are consistent with the statute's legislative history.

The law of a particular state is not controlling on whether a claim constitutes "product liability" for federal income tax purposes. It is clear that "liability for injury, harm, or damage due to a defective product … shall be 'product liability' notwithstanding that the liability is not considered product liability under the law of the State in which such liability arose." Treas. Reg. § 1.172-13(b)(2)(iii). The law of "product liability" must be given a uniform interpretation for federal income tax purposes so that taxpayers in similar positions are treated similarly despite differences in the definition of "product liability" under the laws of the various states.

This does not mean that state product liability law has no place in determining the scope of product liability for federal income tax purposes. On the contrary, the legislative history to the Revenue Act of 1978 clearly indicates that Congress intended the federal definition to include damages recoverable under prevalent product liability theories. These theories are necessarily creatures of either state or non-tax federal law. Likewise, the federal tax definition of product liability contains, but does not define, certain terms of art such as "damage to property". The only reasonable inference is that Congress intended such terms to be interpreted as generally understood under state and federal product liability law.

<u>Damages to the Product Itself</u>

Economic damages, also known as pecuniary damages, in the broadest sense include damages that may be objectively determined based on applying known rules of calculation to reasonably objective data. In the context of product liability, courts ascribe a more limited meaning to the term “economic damages” also referred to as economic loss. In that context various courts have defined the term differently. It has been defined as “the loss of the benefit of the user’s bargain, that is, the loss of the service the product was supposed to render, including loss consequent upon the failure of the product to meet the level of performance expected of it in the consumer's business.” 63B Am. Jur. 2d *Product Liability* § 1909 (1997).

Economic damages attributable to a claim that does not involve either personal injury or property damage constitutes a “pure economic loss”. With some exceptions, courts generally have concluded that no valid negligence or strict products liability cause of action exists for the recovery of purely economic losses associated with a product. *Id.* § 1913-14.

A product defect may result in damage only to the product itself. If so the issue arises whether the damage may qualify as property damage for product liability purposes. Some courts view damage to the product itself, no matter how caused, as economic loss recoverable only through contractual remedies. Many courts, however, treat damage to the product itself as property damage in specified circumstances. These courts generally engage in what has been called a risk of harm analysis in determining whether harm a product causes to itself constitutes property damage or economic loss. *Id.* § 1918; *Bellevue South Associates v. HRH Construction Corp*., 579 N.E.2d 195, 199, (N.Y. 1991). This analysis requires considering the nature of the defect, the risk it imposes, and the manner in which the harm occurs. *Bellevue*, *supra*. To constitute property damage, the defect causing the damage must create a serious risk of harm to people or property (safety defect), and generally the damage must manifest itself in an event that falls within the scope of the safety risk presented. *See Russell v. Ford Motor Co*., 575 P.2d 1383, 1387 (Or. 1978).

In East River Steamship Corp. v. Transamerica Delaval, Inc., 476 U.S. 858 (1986), the Supreme Court had to determine, in the context of admiralty law, if liability for damage defective ship propulsion unit turbines caused to themselves qualified as product liability. The Supreme Court noted that lower courts had adopted a variety of approaches in determining if damages to a product itself could be recovered in tort. At one end of the spectrum, under the conservative approach, courts had concluded that such damages were only recoverable through warranty claims rather than tort claims. At the other end of the spectrum, under the minority liberal approach exemplified by S*anto v. A&M Karagheusian, Inc.,* 207 A.2d 305, 312-313 (N.J. 1965)[2] (marred

[2] The New Jersey Supreme Court subsequently largely abandoned this position in *Alloway v. New Hampshire Insurance Co.,* 695 A.2d 264, (N.J. 1997).

carpeting), a manufacturer's duty to make nondefective products encompassed injury to the product itself whether or not the defect created an unreasonable risk of harm. Between these two extremes courts permitted tort recovery for damages to a product itself only under certain circumstances based on the nature of the defect, the type of risk, and the manner in which the damage occurred. These courts generally only allowed recovery in tort for damage to the product itself when the defective product created a situation potentially dangerous to persons or other property, and the loss occurred as a proximate result of that danger and under dangerous circumstance (for example, a safety defect resulting in a sudden and violent accident).

Adopting the conservative approach, the Supreme Court concluded that "[e]ven when the harm to the product itself occurs through an abrupt accident-like event, the resulting loss due to repair costs, decreased value, and lost profits is essentially the failure of the purchaser to receive the benefit of its bargain – traditionally the core concern of contract law. (citing E. FARNSWORTH, CONTRACTS § 12.8, pp. 839-40 (1982)." 476 U.S. at 870. In *East River,* the Supreme Court determined that component parts of a product cannot cause "other property damage" compensable in tort:

> [I]n the traditional "property damage" cases, the defective product damages other property. In this case, there was no damage to "other" property. … "Since all but the very simplest of machines have component parts, [a contrary] holding would require a finding of 'property damage' in virtually every case where a product damages itself. Such a holding would eliminate the distinction between warranty and strict products liability." citing *Northern Power & Engineering Corp. v. Caterpillar Tractor Co.*, 623 P.2d 324, 330 (Alaska 1981) .... Obviously, damage to a product itself has certain attributes of a products-liability claim. But the injury suffered-the failure of the product to function properly-is the essence of a warranty action, through which a contracting party can seek to recoup the benefit of its bargain.

Id. at 867-868.

Treas. Reg. § 1.172-13(b)(3) provides several examples that provide guidance regarding what types of liabilities constitute product liability for purposes of § 172(f). The first two of these examples are set forth below.

Example 1. X, a manufacturer of heating equipment, sells a boiler to A, a homeowner. Subsequent to the sale and installation of the boiler, the boiler explodes due to a defect causing (sic) [and the explosion causes] physical injury to A. A sues X for damages for the injuries sustained in the explosion and is awarded $ 250,000, which X pays. The payment was made on account of product liability.

Example 2. Assume the same facts as in [E]xample (1) and that A also sues under the contract with X to recover for the cost of the boiler and recovers $ 1,000, the boiler's replacement cost. The $ 1,000 payment is not a payment on account of product liability.

Similarly, if X agrees to repair the destroyed boiler, any amount expended by X for such repair is not payment made on account of product liability.

In Example 1, the defect results in an accident that causes physical injury to a person thereby satisfying the physical injury requirement of § 172(f)(4)(A). On the other hand, in Example 2 the damage is only to the product itself, the boiler. Example 2 is consistent with the Supreme Court's decision in *East River* that damage that a product causes to itself does not qualify as property damage for product liability purposes. Being consistent with the Supreme Court's analysis in *East River,* the boiler example constitutes a reasonable administrative interpretation of the statute which courts would certainly uphold pursuant to a *Chevron* analysis.. *See Swallows Holding, Ltd. v. Commissioner*, 515 F.3d 162 (3d Cir. 2008).

Some courts have concluded that buildings do not constitute "products" for product liability purposes. See e.g. *Heller v. Cadral Corp*.,406 N.E.2d 88 (Ill. App. Ct. 1980) (condominiums are not products); *Harris v. Suniga*, 149 P.3d 224 (Or. Ct. App. 2006) (buildings are not "products" for product liability purposes), *aff'd,* 180 P.3d 12 (Or. 2008). However, even if it is appropriate to treat the dwellings at issue as "products" for § 172(f) purposes, the damages at issue do not qualify as product liability for such purposes. This is because the "products" in this case are the completed dwellings, and the damages at issue are damages to the products themselves. Such damages do not constitute property damage under § 172(f)(4) and the regulations thereunder.

The provision and installation of materials involved in the construction of a home may involve many parties. These include the manufacturers of the various materials used in the construction of the home and parties in the supply chain such as wholesalers and retailers. They also include the various subcontractors that work on only a portion of the home as well as the general contractor with the ultimate responsibility for constructing the home. Where a particular element such as a window becomes an integral part of a home, as part of the home's construction, and a defect in that element or the faulty installation of that element results in damages to other parts of the home, the majority of courts that have considered the issue have concluded that such damages constitute damages to the product itself. Most courts have concluded that such damages are recoverable if at all under contract principles rather than as damages to other property recoverable in tort under a product liability claim.

For example, in *Prendiville v. Contemporary Homes, Inc.,* 83 P.3d 1257 (Kan. App. Ct.), *rev. denied,* 278 Kan. 847 (2004), the purchaser of a home brought a negligence action against the contractor who built the home for damages caused to the home by Dryvit exterior stucco which leaked. Correcting the damages from the leaks required expensive repairs not only to the stucco but to other elements of the home such as replacement and installation of windows, interior painting, and calking. The home owner argued that the claim should be allowed because the damages sought were not just for damage to the Dryvit exterior, but for other parts of the house itself. The court rejected the homeowner's argument.

The court concluded that the house constituted an integrated system and that the damages claimed did not constitute damages to "other property." This line of reason has been followed in numerous other cases. See e.g. *Calloway v. City of Reno*, 993 P.2d 1259 (Nev. 2000); (claim against subcontractor for defective framing that resulted in damages to others parts of townhouses not allowed as product liability claim because damages were to integrated structures rather than to other property); *superceded by statute according to Olsen v. Richard*, 89 P.3d 31 (Nev. 2004); *Nastri v. Wood Bros. Homes, Inc.,* 690 P.2d 158 (Ariz. Ct. App. 1984) (various damages to home caused by building on improperly prepared soil not recoverable under a product liability claim, such damages constituted damages to the product itself); *American Towers Owners Ass's v. CCI Mechanical*, 930 P.2d 1182 (Utah 1996) (damages to walls, wall coverings, carpeting, wall hangings, curtains, and other furnishings caused by leaking pipes did not constitute product liability); *Bay Breeze Condominimum Ass's v. Norco Windows,* 651 N.W.2d 738 (Wis. Ct. App. 2002) (damages caused by leaking windows to interior and exterior walls and window casements constituted damage to components of a finished product rather than damage to other property); *Oceanside at Pine Point Condominium Owners Ass's v. Peachtree Doors, Inc.,* 659 A.2d 267 (Me. 1995) (water damage caused by leaking windows constituted damage to the product itself, not damage to other property); *Wilson v. Dryvit Systems.,* 206 F.Supp.2d 749 (E.D N.C. 2002) (damage to sheathing, and rotting of framing, doors, windows, and subflooring caused by defective exterior cladding was not "other property" damage), *aff'd on procedural grounds*, 71 Fed. Appx. 960 (4th Cir. 2003); *Pulte Home Corp. v. Parex, Inc.,* 923 A.2d 971 (Md. Ct. Spec. App. 2007) (damages from water intrusion attributable to stucco product applied to exterior of house did not result in damage to other property), *aff'd on an unrelated issue,* 942 A.2d 722 (Md. 2008); *Casa Clara Condominium Ass's v. Charley Toppino & Sons, Inc. ,* 588 So.2d 631 (Fla. Dist. Ct. App. 1991), *aff'd*, 620 So.2d 1244 (Fla. 1993) (damages to reinforcing steel bars and other damages to a building caused by defective concrete constituted damages to the dwelling rather than damages to other property).

There is some support for the view that damages that one defective component of a building causes to another component of that building results in damage to other property for product liability purposes. For example, in *Stearman v. Centex Homes,* 78 Cal.App. 4th 611 (2000) a contractor built a home on inadequately compacted soil. This caused the slab foundation to move resulting in significant separation between the ceiling and wall joints over the entire length of the house, cracks in the drywall throughout virtually every room in the house, separation and cracks in tile counters in the bathrooms and kitchen, and cracks in the exterior stucco. Without considering any authority from other jurisdictions, the court concluded that the homeowners could recover their damages through a strict liability tort action.

Our position is that the majority view, expressed in *Prendiville* and similar cases, applies in determining what constitutes property damage for purposes of § 172(f)(4). This is especially true under the facts of this case. This case does not involve assertion of a claim against a manufacturer of a component used in the homes or an assertion of

a claim against a subcontractor who may have taken part in the construction of the homes. Rather, the warranty claims at issue were asserted directly against Taxpayer, the seller of the homes and the party with whom the homeowners asserting the claims dealt. The homeowners purchased a complete home from Taxpayer, not individual components of those homes such as windows, roofs, pipes, wallboard, studs, and rafters and other integral components used in the construction of the homes.

As observed in *Casa Clara:*

> Generally, house buyers have little or no interest in how or where the individual components of a house are obtained. They are content to let the builder produce the finished product, i.e., a house. These homeowners bought finished products-dwellings-not the individual components of those dwellings. They bargained for the finished products, not their various components.

620 So.2d at 1247.

Furthermore, although some courts have treated damages to the product itself as property damage when the damage occurred as a result of a accident resulting from a defect in the product which posed an unreasonable risk of harm, the warranty claims at issue in this case did not result from such safety defects. Rather, the claims resulted from qualitative defects that resulted in disappointed expectations regarding the quality of the homes that Taxpayer sold. The warranty claims against Taxpayer constitute classic claims for economic losses and as such do not qualify as product liability claims.

In *In re Harvard Industries, Inc.*568 F.3d 444 (3rd Cir. 2009) the Third Circuit had to determine whether damages attributable to warranty claims arising from defects in manufactured goods that prevented the purchasers of the goods from reselling them qualified as product liability under § 172(f). The primary issue in the case was whether the manufacturer's damages attributable to the customer distributors' inability to sell the goods constituted a loss of use of property within the meaning of § 172(f)(4). However, in reaching its decision, for purposes of § 172(f), the Third Circuit adopted the view expressed in *East River* that damages to a product itself do not give rise to product liability. Noting that the liabilities at issue arose pursuant to contract and warranty liability theories, the Third Circuit concluded that Congress did not intend for liabilities for such damages to qualify as product liability under § 172(f).

The damages at issue arise from warranty claims that Taxpayer's customers asserted against Taxpayer as a result of the failure of the purchased homes, constructed and sold by Taxpayer, to satisfy expectations as to quality. The products were the entire homes, not individual components that became an integral part of the homes during the construction process. Consequently, all the liabilities that Taxpayer satisfied by repairing and replacing components of the homes pursuant to the various warranties provided to the purchasers constituted contractual repair or replacement liabilities within

the meaning of Treas. Reg. § 1.172-13(b)(2)(ii). The regulations specifically provide that such liabilities do not qualify as product liabilities within the meaning of § 172(f).

Finally, we note in passing that although each home giving rise to a claim had one or more deficiencies in construction, Taxpayer has made no assertion that the individual components such as roof materials, windows, and plumbing pipes that were integrated into the composite structure were defective in any manner. Instead, these component items appear to have been improperly installed. Taxpayer made good on its home warranty, a home construction contract, to rectify these issues of poor workmanship. That the real issue was not defective component products but instead poor installation is evidenced by the fact Taxpayer did not seek damages for defective products from the products' manufacturers.

Defect

In addition to not constituting a liability for property damage within the meaning of § 172(f)(4), we are also of the view that the damages in this case are not attributable to a product defect, as contemplated for purposes of § 172(f). To constitute product liability the damages in question must be attributable to a product "defect". As previously noted product defects may be "qualitative" or may constitute "safety" defects. Neither § 172(f)(4) nor the regulations thereunder define the term "defect". The legislative history indicates that Congress intended to craft a federal tax definition of product liability encompassing the kinds of damages recoverable under product liability theories in most states. To effectuate this intent, for federal income tax purposes the definition of defect generally used by most jurisdictions for product liability purposes should apply.

Section 402A of the Restatement (Second) Torts provides for strict liability in tort to one who sells a product in a defective condition *unreasonably dangerous* [emphasis supplied] to the user or consumer or to his property where the defective condition results in physical harm to the ultimate user or consumer or to his property. Likewise, Restatement (Second) Torts § 395 provides:

> A manufacturer who fails to exercise reasonable care in the manufacture of a chattel which, unless carefully made, he should recognize as involving an unreasonable risk of causing physical harm to those who use it for a purpose for which the manufacturer should expect it to be used and to those whom he should expect to be endangered by its probable use, is subject to liability for physical harm caused to them by its lawful use in a manner and for a purpose for which it is supplied.

Other restatement sections provide for liability on product providers other than manufacturers for negligently providing unreasonably dangerous products that cause injury.

Personal injury and/or physical property damage generally constitute the hallmarks of product liability under the laws of most jurisdictions. Although product liability recoveries may be obtained through contract actions for breach of warranty, tort actions constitute the only means of recovery in many situations. To successfully maintain either a strict liability or negligence tort action plaintiffs must establish a safety defect in the product. Although some courts have allowed tort recoveries for damages attributable to qualitative defects, the vast majority limit such recoveries to damages attributable to safety defects. Consequently, for § 172(f) purposes "defect" means a safety defect.

Although some of the defects giving rise to the damages at issue might in a worst case scenario, if left uncorrected for a long enough period, ultimately result in the collapse of some or all of the structure, none of the defects at issue made the homes as delivered to the customers unreasonably dangerous. Therefore, the construction deficiencies in this case did not make the homes defective within the meaning of § 172(f).

For the reasons set forth above the portion of Taxpayer's NOLs attributable to deductions for repairing the homes pursuant to the warranties are not eligible to be carried back 10 taxable years under § 172(b)(1)(C).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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