Financial Services - Insurance Tax Bulletin

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Fifth circuit finds insurance deposits by business not deductible as premiums

In *F.W. Services Inc. v. Commissioner*, the IRS ruled that premium payments held by insurer as deposit against future deductibles that was refundable to a business at the end of a contract cannot be deducted under Section 162(a) as an insurance premium.

F.W. Services Inc. (the "Taxpayer") deducted a $2.5 million insurance deposit on its 2004 income tax return. The payment was made to National Union Fire Co. of Vermont to cover F.W. Service's reimbursement obligations under workers' compensation and employers' liability policies with American Home Assurance Co. Both companies are subsidiaries of American International Group Inc. (AIG).

F.W. Services is a temporary personnel agency that purchased two policies covering workers' compensation and employers' liability from American Home for claims of up to $1 million. However, each policy also contained a “loss reimbursement” endorsement that required F.W. Services to reimburse American Home for each claim. To satisfy that requirement, F.W. Services entered into a contract with National Union that covered its reimbursement obligations.

The National Union contract required F.W. Services to pay an estimated premium of $3.9 million, with the actual premium being determined when the policy ends. The contract stated that, if the final premium was more than F.W. Services' payment, the company would make an additional payment; if it was less, National Union would refund the balance.

At the end of 2004, $2.5 million remained in the National Union loss fund for the payment of the American Home deductibles. On its 2004 tax return, F.W. Services deducted the entire premium it paid to American Home, as well as payments it made to National Union, as business expenses under Section 162(a).

The IRS issued a notice stating that the $2.5M amount that was received by F.W. Services was not deductible as insurance premiums. And thereby, upon further investigation, the Fifth Circuit ruled that the amounts remaining in the National Union Fund were simply not insurance premiums under Section 162(a) as the National Union contract lacked adequate risk distribution.

F.W. Services cited that, under the U.S. Supreme Court's holding in *Helvering v. Le Gierse*, 312 U.S. 531 (1941), the contracts with American Home and National Union must be read together. However, the Court ruled that reading the contracts together does not guarantee that the National Union contract will be interpreted as creating a shift in risk and, therefore, as constituting insurance. The Court ruled that there was inadequate risk shifting between F.W. Services and National Union and, in turn, there was no resulting alteration of risk between F.W. Services and American Home.

As such, the Court ruled that monetary funds paid to insurer and held for reimbursement purposes were not insurance premiums because the insurance contract did not create any shift in risk.

PwC Observation

The Service continues to focus on insurance related issues including the presence of adequate risk shifting and risk distribution.

***For further information**, please feel free to contact Anthony DiGilio at (703) 918-4812 or contact your local insurance tax professional.*

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