5 T.C. 374 (1945)

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For a fire and marine insurance company, unearned premium reserves are not part of accumulated earnings and profits for income tax purposes and are therefore not includible in equity invested capital; reinsurance recoverable on unpaid losses and unearned premiums on reinsurance in force are admissible assets for ratio purposes.

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Summary

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Federal Union Insurance Company disputed a deficiency in excess profits tax. The Tax Court addressed two key issues: whether the company's unearned premium reserve should be included in its equity invested capital, and whether reinsurance recoverable on unpaid losses and unearned premiums on reinsurance were admissible assets. The court held that unearned premium reserves are not part of accumulated earnings and profits and thus not includible in equity invested capital. It further held that reinsurance recoverable on unpaid losses and unearned premiums on reinsurance in force are indeed admissible assets for ratio purposes.

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Facts

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Federal Union Insurance Company, an Illinois-based fire and marine insurer, issued policies and reinsured portions of its liabilities. The company maintained reserves for unearned premiums as required by state law. On its 1940 tax returns, the Commissioner of Internal Revenue excluded the unearned premium reserve from the company's equity invested capital and also excluded reinsurance recoverable on unpaid losses and unearned premiums on reinsurance in force from admissible assets.

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Procedural History

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The Commissioner determined a deficiency in Federal Union Insurance Company's excess profits tax for 1940. Federal Union petitioned the Tax Court for a redetermination of the deficiency. The Tax Court addressed whether the unearned premium reserve was part of equity invested capital and whether reinsurance amounts were admissible assets.

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Issue(s)

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1. Whether a fire and marine insurer's unearned premium reserve is a part of its equity invested capital within the meaning of Section 718 of the Internal Revenue Code.

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2. Whether an insurer's reinsurance recoverable on unpaid losses and its unearned premiums on reinsurance in force are admissible assets for ratio purposes under Section 720 of the Internal Revenue Code.

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Holding

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1. No, because the unearned premium reserve is not part of the company's accumulated earnings and profits for income tax purposes and therefore is not includible in equity invested capital.

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2. Yes, because reinsurance recoverable on unpaid losses and unearned premiums on reinsurance in force meet the definition of assets, and Congress did not designate them as inadmissible assets.

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Court's Reasoning

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The court reasoned that unearned premium reserves are mandated by state law to

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protect policyholders, representing premiums for which the insurer's liability has not expired. These reserves are not treated as income until the premiums are earned. Referring to applicable Treasury Regulations, the court noted that the concept of accumulated earnings and profits for excess profits tax is the same as for income tax purposes. The regulations specifically exclude unearned premiums from earnings and profits. The court emphasized the intent of Congress for the income tax and excess profits tax to be interrelated, citing Section 728 of the Internal Revenue Code, which states that terms used in the subchapter should have the same meaning as when used in Chapter 1 (Income Tax). The court also relied on the Ways and Means Committee report, which clarifies that amendments to income tax laws also impact the determination of equity invested capital for excess profits tax purposes. Regarding reinsurance recoverable on unpaid losses and unearned premiums on reinsurance in force, the court determined that these items are indeed assets. The court dismissed the Commissioner's argument that counting unearned premiums on reinsurance in force as an asset leads to a doubling of asset values, stating that Congress defined admissible assets as all assets other than inadmissible assets. Since reinsurance items did not fall within the definition of inadmissible assets, they must be admissible assets. The court noted that

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