THE TEAM WITH THE BEST PLAYERS WINS…….Jack Welch

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"The More You Know About the Past, the Better Prepared You are for the Future" – Theodore Roosevelt

By Ronald M. Roth, SVP Strategic Planning

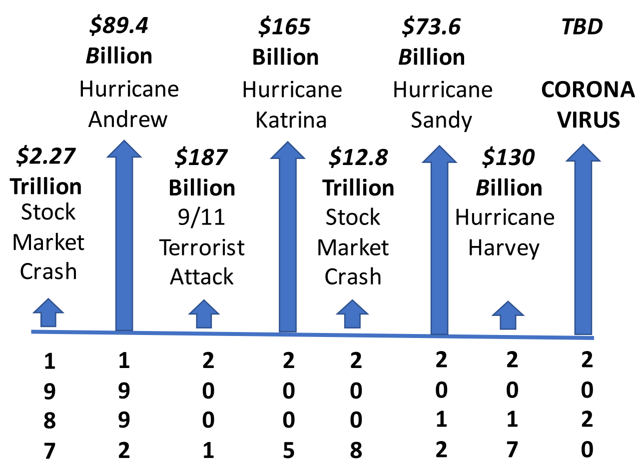
Since 2015 the IRS has waged an all-out war on 831(b) Captive Insurance Companies. Their attacks have included listing these transactions on their "Dirty Dozen" list, conducting large scale promoter audits, and utilizing aggressive publicity campaigns in an attempt to scare taxpayers into avoiding such transactions.

Have there been abuses of this section of the tax code? Absolutely… but this is not unique to Section 831(b) as there are abuses in many areas of inappropriate tax planning. The major problem is that it seems that the IRS has a short memory and has forgotten why ***Section 831(b) was enacted in the first place – to help small to medium sized businesses protect against losses not covered by the underlying commercial insurance programs***.

As a result of the recent coronavirus pandemic and ensuing financial devastation, many if not most businesses will suffer. This is a reminder that businesses need to be prepared for disasters. This is nothing new. Since Section 831(b) was implemented as part of President Reagan's tax reform in 1986, there have periodically been major events in the United States and the world that have caused financial ruin to many businesses. A look back at these will remind us why captive insurance companies are necessary to help protect business, their owners, and their employees.

1986 was an important year in the history of captive insurance companies. Congress enacted section 831(b) of the Internal Revenue Code, which allowed insurance premiums paid by a business to be 100% deductible to the sponsoring business while *not* being considered income to the captive upon receipt of premiums. This permitted a captive receiving premiums of $1.2 million ($2.4M now) or less in annual premiums to exempt the premium received from their underwriting income when calculating income for taxation. Congress's rationale was that it should encourage smaller companies to create the necessary insurance coverage to protect their enterprise. While commercial insurance is a prudent component of sound business development, it represents a cost that frequently limits the growth of smaller businesses. IRC section 831(b) allowed midsized businesses to grow their balance sheets more quickly to support the risk of their owners and resulted in a rapid growth of captive insurance companies among mid-sized businesses. This legislation showed its necessity in very short order as the following year our country experienced a stock market crash that wreaked havoc on the financial markets and subsequently on businesses and business owners. ***Those that had captive insurance companies were able to look to them for some relief through claims related to business interruption, loss of key customers, and other provisions that exist in captive insurance portfolios***. These risks are generally not insurable through commercial carriers due to either their prohibitive cost or generally not being available in the commercial insurance market.

The following are the major disasters our country has encountered since 1986 and the corresponding financial cost to our economy:



Although it's hard to quantify how much of these losses were covered by captive insurance companies, suffice it to say the owners of these captives did have a way to mitigate more of their losses compared to those with only commercial coverage.

This is especially true in a pandemic or stock market crash. These disasters generally include no physical losses, thereby making claims against commercial coverage almost impossible. In the commercial insurance market, business interruption insurance is intended to protect a business against the loss of income related to disasters and other emergencies, and is most commonly triggered when "direct physical loss of or damage to" insured property occurs during natural disasters, such as fires, hurricanes, floods, earthquakes, etc. When there is no underlying physical loss, most policies will not provide for coverage due to losses from the interruption of the business. Further, most do not consider communicable disease (in the case of the Coronavirus) as a physical loss to the business itself. Similarly, losses due to supply chain interruption and other associated risks may also fail to provide coverage in a pandemic or other disaster that does not cause an underlying physical loss.

Although we are only in the early stages of the economic devastation that our country will face due to the Corona-virus pandemic, captive insurance company managers and facilitators have been bombarded with inquiries from business owners, with a related captive insurance company, as to how much coverage will be available to them through their captive. This will most certainly depend upon several factors including which of the following risks commonly insured by captive insurance companies they have included in their specific captive:

1. Business Interruption - with no requirement that a physical loss be incurred.
2. Loss of Key Employee – again with no underlying requirement for the reasons behind such losses.
3. Supply Chain Interruption
4. Loss of Key Customer Revenue

What is clear is that these business owners and their employees will benefit from the foresight and choice to utilize a captive in their risk management planning. It is also clear that any tax advantages they enjoyed from premium payments to their captive will be an ancillary benefit to having significant additional insurance coverage during a time of economic disaster and great need.

Finally, ***it is clear that the IRS has lost sight of the reason that Section 831(b) was created and the positive impact that these captives can have on the business environment especially during times of crisis and devastation***. Since 1986, there have been no less than eight disasters causing trillions upon trillions of dollars in economic loss. On average, that's one every 4.25 years. The Coronavirus pandemic is just the most recent and certainly will not be the last. It should serve as a reminder to the Service that 831(b) captive insurance companies provide a significant benefit to businesses and protects business owners *and* their employees. The attempts of the Service to condemn the entire industry due to the abuses of a few is an ill-conceived approach to a market that protects and serves the business community.

Call Independent Captive Associates, LLC to learn how to get started.

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