

Keep calm and carry on

The IRS has made itself quite unpopular in the captives industry with its pronounced distrust of 831(b)s. *US Captive* talks to Amy Lewis from Captive Resources about its view of the recent controversy.



Recent announcements by the Internal Revenue Service (IRS) that it is viewing 831(b) captive insurance companies with additional scrutiny have caused no small amount of worry in the captives industry. However, it's worth remembering that the concept of 831(b)s, or micro captives, remains a sound one.

"We have found that 831(b)s give our clients the chance to further explore alternative risk opportunities and risk management in their respective companies, which allows them the flexibility to better manage some of their insured costs," says Amy Lewis, vice president-finance at independent captive consultant Captive Resources.

"Many of our clients are already interested in or employing alternative insurance arrangements and an 831(b) captive allows them to better manage a broader array of risks. Essentially, they can formalise nearly any self-insurance programme into a small captive.

"An 831(b) captive gives companies the opportunity to insure risks that are often excluded from commercial policies or aren't affordable or available in the commercial market."

Captives can be a key tool in what amounts to a toolbox of financial products, each one unique from the others, and each used for specific purposes. In some cases, Lewis says, Captive Resources' clients have been unable to find adequate or affordable coverage in the commercial markets, and an 831(b) captive has given them the ability to provide coverage for certain operations or activities. To the extent that a business can effectively manage its losses through safety and risk management initiatives, the business is able to retain any resulting profit.

Proper concerns

According to Lewis, the IRS's recent concerns do have some validity.

"In any instance where there's a potential for savings, there are promoters in the market that don't adhere to the tenets of what is expected in forming a legitimate insurance company," she says, adding that based on some of the court cases that have emerged recently, wherein the IRS is arguing that 831(b) captives have been misused, Captive Resources does understand the IRS's frustration

that certain promoters are not respecting the form and function of a true insurance company when they form these captives.

“Despite the fact that there is the potential for abuse, the IRS has stated in publications and in its own lists, that it understands that there are legitimate captives, but that right now, it cannot differentiate between the good ones and the bad ones, so it is going to scrutinise them all,” Lewis says.

She adds that this scrutiny doesn’t mean that the IRS believes that they are all bad, but given the fact that there are clearly instances where people have tried to exploit the use of the 831(b) election and have not respected the form and function of an insurance company, Captive Resources understands why there is some scrutiny.

“However, we still believe micro captives are valid risk management tools when done correctly,” she says firmly. “The stigma surrounding 831(b)s has been created by a limited number of people or promoters in the space that have implemented and managed them incorrectly, either unintentionally or otherwise.

“I believe that the majority of providers make every effort to form and operate these captives in accordance with the law, and will continue to do them well, and those captives will survive scrutiny by the IRS and continue to operate well into the future.”

Effective coverage

As an example of how an 831(b) captive can provide coverage to a business, Lewis recalls cases of Captive Resources clients that had issues with commercial product recall insurance. These clients had product liability issues and remediated them for their customers, as a good company will, regardless of whether existing commercial product recall insurance would cover the losses. In several cases, there were exclusions in the commercial policies that eliminated coverage for those product issues. As a result, these companies opted to form a micro captive to self-insure those risks to ensure future coverage in a more efficient manner.

In certain cases, clients simply did not have a choice to self-insure specific risks, due to the nature of the insurance they required but were unable to obtain.

“We have some clients that have gone into the market and to Lloyd’s to secure coverages unique to their business that they simply had not been able to price,” Lewis says.

“On the Lloyd’s market the price of that coverage was prohibitive. Instead, they formed a micro captive which they found preferable to purely self-insuring because it allowed them to formally fund for the risks, and through strong loss control, to potentially benefit from profits in the micro captive.”

Captive Resources also has clients with land holdings who have had trouble finding pest coverage or wind damage coverage, depending on where they’re located. For them it was simply not practicable to purchase coverage on the commercial market because of the cost, so they have set up micro captives to enjoy the benefits of having a formalised structure, a good claims review process, and the ability to set aside money to pay those future claims.

“I want to convey that in general you are setting up an insurance company, and if you’re willing to go through the steps to properly run that insurance company, the micro captive has a number of very good benefits,” Lewis concludes.

“Companies should not be hesitant to create a micro captive for legitimate reasons. They are excellent risk financing vehicles that when structured properly, with due consideration of risks to be covered, actuarially determined pricing, appropriate domicile, and competent service providers, can be very beneficial to a company.” ■

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