ART GALLERY COLUMN FOR JULY

IRS code 831(b) captive appeals to both risk, financial specialists

By Dick Goff

The world is conveniently organized into specialties. That's why you can't buy cream puffs at a car dealer or Frisbees at a furniture store – unless one of those is having a really quirky promotional event.

That's why the main stream of financial management comprised of accountants, attorneys and the like has not generally latched onto one of the most valuable risk management concepts: a special kind of captive insurance company that provides for tax-advantaged growth and disbursement of money while also being a significant risk management tool for small businesses.

A captive organized under IRS code 831(b) provides dual financial and risk management benefits for smaller privately owned companies. In our world, think of a self-insured employee healthcare plan or workers' compensation plan funded by specific levels of self-insured risk or high deductibles before any stop-loss or traditional insurance kicks in.

If the self-insured or high deductible risk is insured through an 831(b) captive, premiums paid by the company are immediately deductible up to a maximum level of $1.2 million. That allows the company to cover business risk on a tax-deductible basis while still enjoying the flexibility and lower cost of self-insurance or high deductible plans.

And that's not all, folks. An 831(b) captive is taxed only on its investment income. Under this funding structure the significant advantage is that the captive is able to accumulate surplus from underwriting profits free from tax.

That's the input side of an 831(b) captive: tax deductible premiums paid into it by the company and tax-free growth of underwriting profits. The output side is just as compelling: Annual dividends may be declared to the captive's owner taxed at the prevailing captive gains rate.

For these reasons, an 831(b) captive is an ideal structure to be used for estate planning, company perpetuation, key employee benefit/compensation packages or even balance sheet risk(s) funding. The soft costs associated with the captive's formation are just the nominal price of admission to a long-term tax-advantaged vehicle for growth and transfer of wealth. Plus, those startup costs may be reimbursed by the captive at a later date.

Under these long-range financial management plans the 831(b) captive is better owned by an entity other than the insured's company – a family trust or group of family trusts would be more effective.

Of course, any captive insurance company must pass the IRS litmus tests of risk transfer and risk distribution. As employee benefits or workers' comp plans clearly cover third party risk, they are ideal to insure their SIR or deductible through an 831(b) captive.

Rather than being owned by the actual ERISA or workers' comp trusts, the 831(b) captive would issue a contractual liability policy to the plan sponsor to reimburse its liability for financial obligations to the plans. In some cases a fronting company may be preferred.

Even your most enthusiastic insurance professional would agree that the world would be a better place if all risks were eliminated. But as long as we have to deal with risk, we may as well do it as financially advantageously as possible.

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