



IIA'S NEW TASK FORCE CHANGING THE STORY FOR ERCS

Enterprise Risk Captives (ERCs) have been under fire from the Internal Revenue Service for much of the last decade with no indication of a cease fire. To help combat the wrong perceptions held by the IRS, SIIA is moving ahead with a forward-thinking engagement strategy—the creation of a new narrative that talks about needs and success stories. To get this new initiative started, the organization has created the Captive Advocacy Task Force to bring a positive message to the ERC marketplace.

Written by Karrie Hyatt

THE IRS V. ERCS

ERCs are captives that serve small to medium-sized companies and, in most cases, take the 831(b) tax selection made available as part of the US Tax Code. This sector of the captive industry has seen the largest expansion in the last ten years and the IRS suspects that some companies have been using the 831(b) election as a tax dodge for estate planning and wealth transfer purposes.

“Because of the IRS’s undue scrutiny, pressure and aggressive tactics towards ERCs, people are only hearing bad things. And because the ERC captive is a relatively novel idea, some folks have been skeptical of them since their origination ten or fifteen years ago. You hear the crazy stuff about people misusing captives—like buying hurricane insurance in Montana—and things that are clearly not applicable to their business. We know that’s a small minority of cases,” said

Jeffrey K. Simpson, partner with Womble Bond Dickinson (US) LLP.

SIIA has been at the forefront in trying to boost the reputation of ERCs. Their captive committee has been advocating on behalf of ERCs for years and just last year released the Captive Manager Code of Conduct—a document meant to guide captive managers to a high standard of ethical conduct and to help strengthen the reputation of the captive industry.

With this Code, the association hoped to take a proactive approach to answer any lingering questions about the validity and effectiveness of captives.

Yet, the IRS is increasingly focusing on 831(b) captives. “Five years after introducing captive insurance programs to the Dirty Dozen list and four years of collecting information from hundreds of thousands of taxpayers, the IRS has not provided any guidance on properly structured captive insurance programs,” said George M. Belokas, vice president and actuary with GPW and Associates, Inc. “Instead the IRS issued IR 2019-157 in 2019 and IRS Letter 6336 in 2020 indicating the IRS is increasing audit activity to anyone that is reporting their participation in a [ERC] insurance transaction”

Belokas continued, “Captives are being scrutinized based on their tax implications and not by their powerful use as a lifeline to their insured companies and owners providing much needed coverage for risks that are not well managed by the commercial insurance market.”

“Our affiliates and competitors face the same challenges we do. While none of us objects to or opposes proper efforts by the service to ferret out anyone who is not complying with the law, Congress should be taking notice of any government agency that may be undermining the fundamental legislative process embedded in our Constitution,” said Susan M. Euteneuer, general counsel and chief compliance officer for Oxford Risk Management Group.

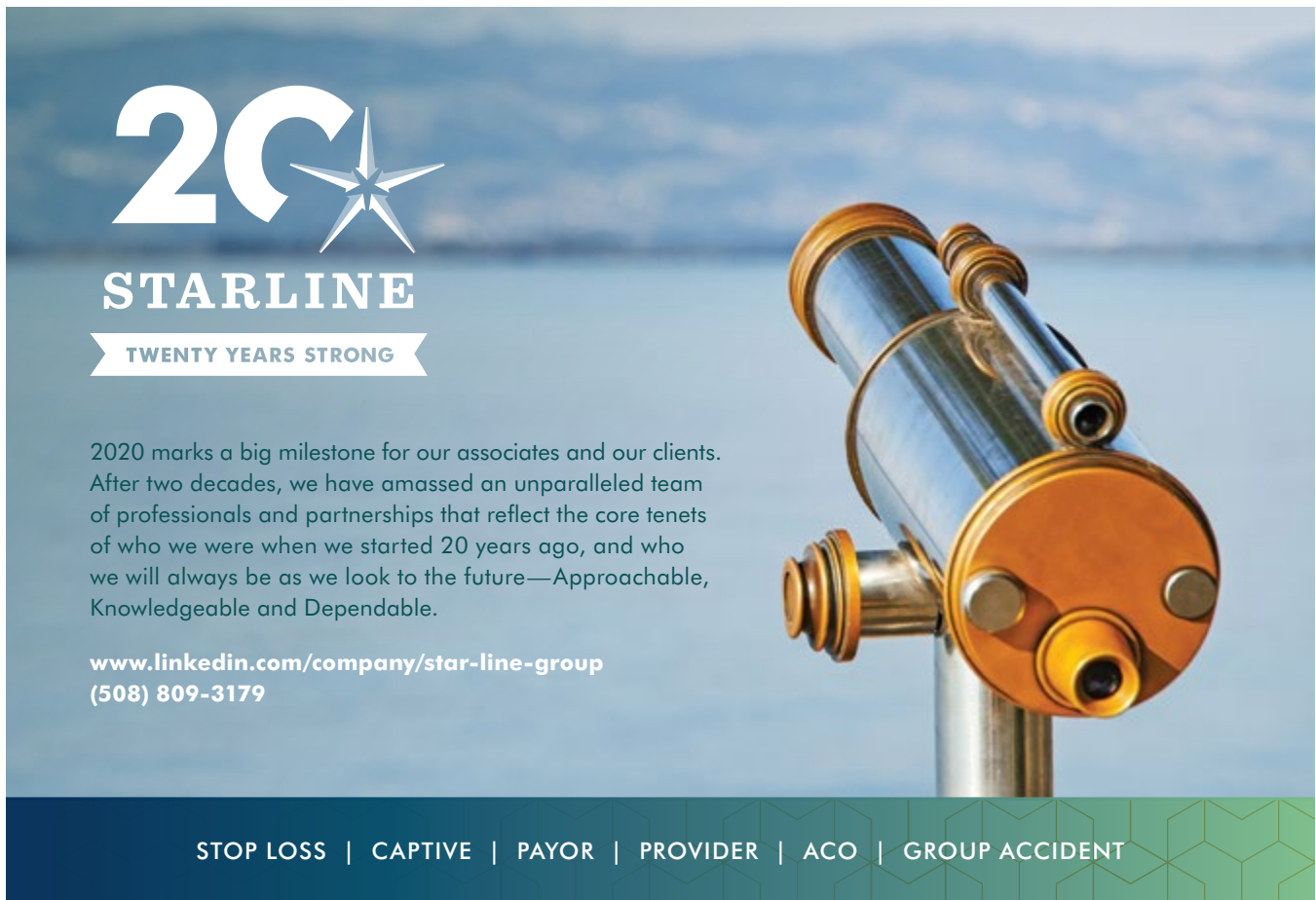



Last September, the IRS, emboldened by three key wins in the US Tax Court, issued a settlement offer to around 200 captives that were then under audit. The captives who received and accepted the offer were required to pay penalties and to concede a substantial portion of the tax benefits that they previously claimed. This offer indicated to much of the ERC community that the IRS had no intention of letting up its pressure on captives.

While the IRS is focusing on smaller 831(b) captives, the pressure they are applying to this segment has ramifications in the larger captive marketplace.

“Unfavorable court decisions in the ERC segment can have an impact on captives universally,” said Simpson. “There are a lot of people and businesses who benefit from these captives and who want to be able to keep doing it. The big story here is about the risk management that ERCs provide their owners, not the tax benefit that the IRS thinks it’s about. It’s a small segment of the industry, but an important one.”

“The IRS has focused its scrutiny on nearly all Captives making a tax election under IRC section 831(b) [of the US Tax Code] which disproportionately impacts captive insurance companies protecting America’s small and medium sized businesses,” said Belokas. However, the IRS’s arguments and actions have far reaching implications for nearly all captives.”

A graphic celebrating Starline's 20th anniversary. It features a large '20' with a starburst graphic, the word 'STARLINE' in a serif font, and a banner that says 'TWENTY YEARS STRONG'. Below this is a paragraph of text and a LinkedIn link. The background is a blue sky over water with a telescope in the foreground. A dark teal bar at the bottom contains the text 'STOP LOSS | CAPTIVE | PAYOR | PROVIDER | ACO | GROUP ACCIDENT' in white.

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TAKING CONTROL OF THE CONVERSATION

In the fall of last year members of SIIA's Captive Committee and general members involved with ERCs decided to form a group that would directly address advocacy for ERCs. According to Simpson, "The Task Force is really about demand. SIIA has been active in the captive space and the ERC space, but [members] who were involved wanted to do more. Then there were people who wanted to get involved. As things got more intense with the IRS, it became evident that we needed to do more, so we formed the Task Force to address the issues and to give people a forum, a channel to advocate for their industry."

The Captive Advocacy Task Force was organized with the intention to take the stories of successful ERCs to the forefront of the conversation with policymakers, regulators, and other interested parties. According to Simpson, "The objective from the outset has been to change the discourse."



"We want to get in front of the bad press about ERCs," said Ryan Work, the vice president of Government Relations with SIIA who is working closely with the Task Force. "We want to take charge of the narrative surrounding legitimate captive structures and to make sure that policymakers are getting the right information."

The vast majority of ERCs are operating within regulatory boundaries and are not abusing tax code section 831(b). According to Belokas, "To ensure the continued operation and stability of America's small and medium-sized businesses, the captive insurance industry needs a strong and unified voice to help change the tide. The Task Force is that voice."

The Captive Advocacy Task Force began the year with several in-person and teleconference meetings. The aim is to create a wholistic message that all parties can use to get their stories out. One of the primary ways that the group intends to take hold of the ERC narrative is to take captive success stories, particularly those told by owners, to policymakers.

It is important that policymakers—especially on Capitol Hill—understand what captives are and how they support business function. "Members of the Captive Advocacy Task Force have volunteered to help educate policymakers regarding what captives are and how they work, to explain some of the challenges the industry has faced, and to make clear the adverse impacts on the national economy if the self-insurance vehicles that Congress legislated into existence are instead drummed out of business," said Euteneuer.

She continued, "Policymakers must determine how to support the IRS in its important mission, while not derailing valuable businesses from obtaining the insurance and financial security they need. It is one of the most important roles of Congress to strike the appropriate balance between these different needs. The Task Force is working to provide policymakers with information to help them in navigating that role."

"The Task Force hopes to educate both Treasury and the IRS on how to identify proper captive insurance structures, change their misguided presumption that most or all captives are abusive, and assist in providing guidance to business owners with captives," said Belokas. "With proper guidance business owners will have the confidence they need to form a captive to protect their business without worrying they may have inadvertently increased their risk of an IRS audit or the fees and penalties that may be imposed to argue their structure."

According to Simpson, if the Task Force can start talking about ERC success stories it will highlight the benefits of these structures while showcasing how they work

when they are structured properly. "As horrible as the coronavirus is for all of us, it might be a good thing for ERCs and captives. It gives ERCs an opportunity to show what they are built for—the kind of low frequency/high severity event that disrupts businesses in uncommon ways like this pandemic has."

"Enterprise risk captives offer insurance for risks that are either unavailable or not commercially feasible with traditional insurance products," said Euteneuer. "The IRS has, through its recent court successes, told three stories of noncompliant captives. Those stories do not begin to scratch the surface of the industry. The benefits of compliant captives in this space are well-illustrated with two current, major challenges with traditional insurance—the hardening market and global COVID-19 issues."

Belokas, through his work with GPW and Associates, relates how their clients have been benefited by insuring through an ERC. "We have a client which relies on a farming operation in Florida that was devastated by Hurricane Michael in October 2018. The amount of loss reimbursed through their captive insurance program was in excess of \$750,000."

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Another client manufactures animal feed supplements in Texas and in 2015-16 experienced a severe shortage of a crucial component necessary to make their supplement. The amount of loss reimbursed through their captive insurance program was in excess of \$400,000.”

“In the absence of a captive insurance program these businesses would have faltered and the over 200 workers they employ could have been left jobless,” continued Belokas. “Individual captive success stories like these are crucial to help change the IRS’s misguided presumption that most or all captives are abusive.”

The original plan had been for Task Force members and ERC owners to participate in a SIIA-sponsored “DC Fly-In” in late March to meet with policymakers. However, due to COVID-19 the event was postponed. According to Euteneuer, “We had planned to meet in-person in Washington, DC and in district offices, so we are now shifting to alternate means of communication. The message is too important to wait until we can meet in person.”

“The many benefits of self-insurance extend well beyond enterprise risk captives,” continued Euteneuer. “The IRS is currently focusing on 831b enterprise risk captives, doubting that any of this is insurance in the commonly accepted sense. No one with a proper captive structure objects to the service looking for actual noncompliance. Rather, we continue to urge that this inquiry be conducted in a manner that comports with the laws as Congress wrote and intended them.”

According to Belokas, “The captive insurance industry is at an impasse. If the uncertainty continues or if policymakers are unwilling to support Captives, then this once powerful tool to protect businesses will be dead. The goals of the Task Force have the greatest opportunity for success with the support of SIIA and its membership.” ■

