ART GALLERY

by Dick Goff

Enterprise Risk Captive Smells Better Than 831(b)

"What's in a name?" the poet asked, pointing out that by any other name a rose would smell as sweet. But not if we called it a 328, I don't think. The great product names linger in our minds with positive reference while numeric names are mostly just a product filing system.

Positive identity is the goal of every name, and that's why SIIA has put forth the name Enterprise Risk Captive (ERC) as an alternative to such captives being identified principally by their relationship to Internal Revenue Code Section 831(b).

SIIA member Jeff Simpson was quoted in the organization's June announcement that the new name is a first step to reframing the narrative of the 831(b) type of captive so that they are not simply defined by their tax election status. The new name highlights the purpose and function of these types of captives instead of focusing on their tax status. Simpson chairs the SIIA ART Committee's ERC Working Group.

For those who haven't kept up with this fast-growing captive structure – some say the fastest-growing in the self-insurance universe – the ERC is an ideal structure for owners of small to mid-size businesses. They can pay premiums of up to $1.2 million annually to insure certain business risks with their underwriting profits accruing for the benefit of the enterprise or for purposes of wealth accumulation or estate planning.

To be sure, ERCs must pass the same IRS litmus test as all captive insurance companies: they must insure legitimate risks and distribute and receive significant portions of risk to and from third parties. So, you wouldn't pass muster insuring your Denver factory against tsunami damages and assume all the risk yourself. No, the risks must be genuine. The requirement of third-party risk distribution is often accomplished through pooling structures in which each member holds a portion of all other members' risks.

ERCs require a specific identity because of features that are unique to their type, according to Simpson, who cites SIIA's list of ERC features:

- Manage risks generally not addressed by commercial insurance programs.
- Insure risks of low frequency and high severity.
- Issue first party, reimbursement types of policies.
- Take the 831(b) election.
- Frequently owned in a manner that facilitates wealth transfer or estate planning.

Even though ERCs must abide by the letter of IRS rules, there has been some grumbling that they abuse the spirit of the law as a simple tax dodge dressed up in accountants' pinstripes.

"ERCs are growing rapidly and there are intense opinions coming from all sides, with a great deal more dialogue about possible abuses than actual instances of abuses," Simpson says. "An institution needs to step into the void and provide an objective resource on how to form and manage ERCs properly. We think that institutional leadership can be provided by SIIA."

Simpson was instrumental in organizing a SIIA webinar last month to which state insurance regulators were invited to learn about and discuss the ERC concept, and cites that as an early initiative in the organization's assumption of the industry leadership role. "Our purpose was to help regulators better understand this type of captives and focus on ways they can manage them more efficiently and constructively," he explained.

Two educational sessions on this subject are scheduled for SIIA's National Conference in October: "Enterprise Risk Captive Case Study Profiles" and "Enterprise Risk Captives Crossfire – Let the Debate Begin."

In establishing the 831(b) election that is so helpful to ERCs, Congress apparently was acknowledging the vast importance of the small-to-middle market of American family-owned businesses. A statistical profile indicates that over 80 percent of U.S. businesses are family firms and that most individual wealth is concentrated in these enterprises. Along the way, family businesses are a main driver of the U.S. economy, accounting for approximately 60 percent of the country's employment and approximately 50 percent of U.S. GDP.

It's not just the self-insurance industry that is talking about ERCs. The American Bar Association within recent years has started a committee on captive insurance and has sponsored webinars on multi-disciplinary practices embracing risk management and tax-advantaged wealth management strategies.

Simpson, an attorney with Gordon, Fournaris and Mammarella in Wilmington, Delaware, sees SIIA as the ideal institutional voice for ERCs in helping to prevent the kinds of abuse that could potentially lead to adverse changes in the Internal Revenue Code.

"We've got to help assure that abusive practices don't occur by avarice or ignorance," he says. "Thankfully, my experience is that most participants in this space are careful to build legitimate risk management structures. Successful ERCs have good loss ratios and their professional service providers help them annually react and adjust to experience by either lowering premiums or increasing coverage where appropriate. That kind of annual review and adjustment is exactly what should happen."

Almost every owner of a family business can find significant risk management and financial benefits from looking at these types of captives. And isn't it so much better now that they're named Enterprise Risk Captives than just robot-sounding 831(b)s? ■

Readers who wish to comment on this column or write their own article are invited to contact Editor Gretchen Grote at ggrote@sipconline.net. Dick Goff is managing member of The Taft Companies LLC, a captive insurance management firm at dick@taftcos.com.