

CAPTIVE INSURANCE COMPANY REPORTS

Abuse of 831(b): The ERC Image Problem

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No segment of the captive insurance marketplace is as misunderstood as the segment that takes the election under Internal Revenue Code (IRC) 831(b). Whether you call them minis, micros, small captives, or enterprise risk captives, and whether you think abuse is rampant or hysterically overblown, the simple fact is that this segment has a serious image problem.

For purposes of this article, let's call them enterprise risk captives (ERCs). Even though our friends at *CICR* make fun of us for this name (*CICR comment*: and others), we think it's important to get away from labeling these captives by a Code section. We also think innocuous labels like micro or small captive don't do enough to articulate the risk management purpose of these captives. We recognize that ERC is not a perfect name, but we do think it's better than any of the current alternatives. (*CICR comment*: We agree!)

Problem of Perception

ERCs have an image problem. But the problem is not that the Internal Revenue Service (IRS) doesn't trust ERCs; the IRS doesn't trust anything about any captive. The problem is that much of the captive industry doesn't trust ERCs. The industry frets that ERCs are a tax-driven sham that will draw the ire of the IRS and others, ultimately ruining captives for us all. To be fair to the industry, ERCs are new, and new is different, and different always takes some getting used to. So, it's no surprise if the industry is a little cautious of ERCs.

And ERC practitioners haven't done much to help their own cause. A reader of online forums, blog posts, and other ERC-related promotional materials could easily conclude every service provider in the ERC market seems to think he's the only one doing it right, and all the others are doomed to prison. To be fair, service providers need to distinguish themselves from one another to compete. But the unfortunate result has been ridiculous public battles that do nothing but diminish the credibility of all involved. Worse, they reinforce the fears of the industry.

The obvious question, then, is why should the industry trust and support ERCs in light of the way things have gone so far? The industry could reasonably argue that ERC service providers have made their own bed and played into the hands of the IRS, so ERCs do not merit industry support. But, the fact is that ERCs actually are important, ERC service providers really are well meaning, ERC abuses really are few, and marginalizing a material segment of the industry is a dangerous idea. ERCs need and deserve industry support, and the route to that support is interaction and understanding.

The Argument for ERCs

ERCs have become an important captive structure in that they are now a means by which middle market, privately held enterprises are being introduced to captives. ERC service providers are helping their privately held business clients manage risks in new and exciting ways. They help business owners appreciate that they can do more to manage risk than just buying workers comp, auto, and general liability coverage. Those business owners are now recognizing a much broader array of risks, considering the financial implications of those risks, funding in advance instead of crossing their fingers, and using pools to dilute the impact of large losses. All of this is good.

Our experience has been that ERC practitioners are competent, professional, and diligent insurance professionals, just like the rest of the captive industry. Actually, many participants in the ERC market are people you have known for years as thoughtful, reputable captive practitioners—and they still are. But the vast majority of those who are new to the captive insurance market, having come in through the ERC door, are acting responsibly too. They join the right associations, they attend the right conferences, and they earn the right credentials. They conduct themselves professionally and competently, earning the confidence and respect of peers, clients, and regulators.

An example is the ERC community's thoughtful response to the recent Senate Finance Committee (SFC) proposal to amend 831(b). A group of ERC practitioners, working under the auspices of the Self-Insurance Institute of America (SIIA), is engaged in a dialogue with the SFC to develop an 831(b) amendment that protects the election and allows for the expansion long sought by Senator **Chzuck Grassley**, but eliminates incentive for certain abuses identified by the IRS. In the interest of full disclosure, **Jeff Simpson**, coauthor of this article, chairs the SIIA committee working on this project. An important feature of the group is that it consists of ERC captive managers from a variety of organizations. Some are institutional, some are small consultancies, some are from insurance backgrounds, and some are not. But all agree that the opportunity to engage responsibly with legislators, and maybe the IRS, to untether ERCs from perceived abuse is critical for the long-run health, not just of ERCs, but of the captive insurance industry as a whole.

The perceived abuse being addressed by the SFC is estate planning using ERCs. Although the practice is entirely legal, the debate is about whether it should be. Credit the SIIA group for concluding that the risk management objectives of ERCs are more than enough without the added benefit of estate planning and proposing amendment language on that basis to the SFC. It is difficult to believe the group could have reached that conclusion if its members were more interested in the allegedly abusive opportunity. What's more, the National Association of Insurance Commissioners (NAIC) has also proposed language to the SFC that, with a few minor changes, generally tracks the SIIA proposal. So, the ERC community appears to be on the same page as the regulators, which ought to be a good sign to the industry.

Meanwhile, actual abusive practices in the ERC space are considerably less common than media hype and aggressive IRS scrutiny would lead you to believe. We have certainly seen a few abusive structures. But, we declined to be

a party to those transactions, and the vast majority of ERC service providers have as well. More importantly, wherever possible, we try to educate ERC owners and service providers when we see actually or potentially abusive features in their transactions. With only a few exceptions, we have found them to be responsive. And those who are not responsive, we have noticed, whether from ignorance or disposition, are being policed. Peer ERC service providers, other advisers, and regulators have all begun to assume roles to address abuses.

Cooperation Is Key

While all of this is happening, we believe the captive insurance industry is better served by welcoming ERCs into the mainstream than by marginalizing them. While the captive industry might, in order to protect itself from something it doesn't fully understand, be tempted to kick ERCs and ERC service providers to the curb, doing so would open the door to the domino effect. It would give the IRS a significant and material victory in its decades-long quest to conquer captive insurance. And that big victory would surely be interpreted as a success for the heavy-handed, scorched-earth tactics they are using to pursue alleged ERC abusers. Rest assured, if the IRS thinks those methods work, it will use those methods to target other areas of captive insurance, and anyone else working in captives could find themselves in the crosshairs.

We are all better served by working to understand ERC design and application and recognizing that ERCs are different, but different is not necessarily bad. Much of what passes for alleged abuse, in our view, is just failure to recognize differences in application. If ERCs are a novel concept in that they help privately held, middle-market companies cover risks that they have not historically covered, is it not reasonable that some of those risks would be different

than what the industry has traditionally seen? Correspondingly, if these businesses are just beginning to address these risks, is it a surprise that they do not always have the necessary internal processes to identify and report losses covered by their captive policies? Similarly, if the pools used for ERC coverages are addressing risks that have not been pooled before, should we expect that these new pools would have loss ratios that correspond with the loss ratios of pools that cover different kinds of risk? We could go on and on.

The point is that ERCs are not necessarily bad or abusive because they are different. They are simply different. The challenge is not to try to make ERCs fit the ideal model of some other type of captive. The challenge is to figure out what should be the ideal model for an ERC. And figuring that out will take time, data, thoughtful policy debate, and engagement between ERC practitioners and traditional captive practitioners. The infrastructure for this engagement is only now being assembled, and the dialogue is just getting underway. The objective should not be to do away with ERCs, it should be to recognize the value that drives their popularity and understand how they should be ideally designed and operated.

Conclusion

As **Ben Franklin** purportedly said, "We must all hang together or we will surely all hang separately." Rather than allowing the ERC image problem to fracture the industry, the captive insurance community should welcome and engage ERC owners and service providers. Recognize and support the constructive efforts of the many positive actors in the ERC community and help them identify and eliminate abusive practices and abusive practitioners. You will find the ERC community is happy to work with you as it works out its image problem.

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