SITTERLE HOMES

CAPTIVE INSURANCE RISKS AND REWARDS

WHEN IT ALL COMES CRASHING DOWN

Building Savvy

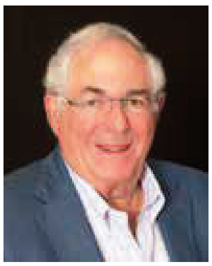
San Antonio | May 2020

JEFF BUELL and FRANK SITTERLE, JR.

PROGRESSIVE BUILDERS LEADING THE WAY

A Homebuilding Industry Publication

CAPTIVE INSURANCE RISKS AND REWARDS



By Steven Bankler, CPA

Captive insurance companies have been used for 70 years to help small businesses cover risks in areas like underwriting, operations, and investments. For that reason, the practice can be particularly beneficial for builders and construction companies. It can also come with significant tax benefits.

But forming a captive insurance company to fund one's own risk is becoming a practice that's so abused, it's been named one of the IRS's dirty dozen tax scams.

Tax law generally allows business owners to create their own captive insurance companies to insure against risks. As the IRS describes it, "the insured business claims deductions for premiums paid for insurance policies. Those amounts are paid, either as insurance premiums or reinsurance premiums, to a captive insurance company owned by the insured or related parties and are used to fund losses incurred by the insured business. Traditional captive insurance typically allows a taxpayer to reduce the total cost of insurance and loss events."

Commercial insurers aren't known to be cost-friendly for builders and construction companies due to their unique risks. Self-funding coverage in a way that's custom-made to fit those special layers of risk can make a lot of sense.

And when a business owner starts or joins a small pool of people to create a small, qualified captive insurance company – often called a micro-captive – they can elect for it to be treated as an exempt organization or to exclude limited amounts of annual net premiums from income. With these elections, the captive insurer pays tax on investment income only. It can be a win-win for builders and construction companies who need supplemental coverage that's notoriously difficult to secure.

But not everyone plays by the rules.

"That's all fine and good if the micro-captive insurer is being set up to cover a real risk and payout based on legitimate claims. But it becomes a problem if those micro-captive arrangements lack the attributes of genuine insurance or, worse, pay claims based on falsified valuations," Shaun Hunley of Thomson Reuters recently pointed out in Accounting Today.

An increasing amount of micro-captives are doing just that, and the IRS is taking notice. The agency has devoted substantial resources to fight what it calls abusive micro-captive insurance tax shelters. Following wins in three recent U.S. Tax Court cases, the IRS sent hundreds of offer settlements to taxpayers currently under exam and new notices to additional taxpayers. Strict reporting requirements are now in place to spot red flags, and those who fail to report arrangements that qualify as captive insurance companies may be slapped with significant penalties.

Captive insurance can be a great way to mitigate risk while receiving tax benefits. But it's a complicated structure to administer — one that requires professional help, both for insurance guidance as well as tax guidance. Seek out that help to cover risk, and reduce taxes the right way.

Steven Bankler has more than 43 years of experience in the accounting industry. Steven's expertise lies in consulting, planning, tax, and asset protection as well as exit strategy services for closely held businesses. He also provides litigation support (both as a testifying expert witness and a consulting expert), business negotiations and estate planning. Visit www.bankler.com for additional tax strategy tips and to learn more about Steven Bankler, CPA, Ltd.