



Taxability and Tax Deductibility of Insurance Payments



By Randy Paulikens

CPA/ABV, DABFA

Shareholder

WithumSmith+Brown

Certified Public Accountants
and Consultants

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Having Your Cake and Eating It Too

Those of you reading this article may have already taken a significant step toward securing your financial future and independence by doing one of the following:

- You have set up a business and are looking to maximize your cash flow (i.e. profits).
- You have recently set up a business and are looking to understand the myriad of things necessary to be successful.
- You are considering setting up a small business and are researching the benefits and risks of taking the plunge.

In establishing a new business there are many things that need to be done, many bills to pay, many people to meet and many decisions to be made. Some people believe that owning a business will create wealth and ultimately lead to a life of leisure. We hope that you are successful in these aspirations and the owners of this website are there to help you.

Recently, we reviewed a new program developed by the Friedlander Group designed to help small business owners.

This proprietary program effectively allows business owners to “have their cake and eat it too” by legitimately adding a business vehicle (with restrictions) to a personal automobile policy. What this means is that the insurance carrier will allow (again with restrictions) business-owned vehicles to be insured on the cheaper personal policy. This immediately saves the cost of the commercial insurance premium over the personal premium as well as make it tax deductible for the business portion of the use. In essence, you have the best of both worlds. You have the most inexpensive (in relative terms) business automobile coverage, and the titling of the assets matches the economic reality so that the risk of the carrier denying the claim (since the coverage does not match the risk) is avoided completely.

Not all carriers offer this program; actually most don't. As an accountant, I have never seen it before. In fact, it is just being rolled out in Fall of 2006. We must stress that proper disclosure to your agent and the carrier is necessary to make sure that the coverage is done properly. Also the tax deductions available are for the business use only, and proper documentation is necessary.

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Background

Now that I have your attention, one of the single most important areas that you as a business owners MUST be concerned with is taxes. There are sales taxes, income taxes, use taxes, payroll taxes, excise taxes, etc., etc. Ignoring tax issues does not make them go away; rather it can make your business or even your home go away. One purpose of this article is to make you aware that avoiding taxes will only make them worse. The main purpose of this article is to provide you with information to illustrate certain benefits that the tax code provides you and that with the appropriate documentation you are entitled to take advantage of.

You may have friends who own businesses who brag about all the personal and semi-personal expenses they “write off on the business.” One of the single most expensive costs you have is transportation, and one of the first things many business owners ask is, “Can I write my car off on the business?”

In general, the Internal Revenue code allows a deduction for all reasonable and necessary costs and expenses incurred in the production of income. The key is the proper documentation for such expenses. Without proper substantiation, there is a risk that upon audit these expenses will be disallowed by the IRS.

For this article, we will be limiting our discussion to automobile insurance. In the past it was not uncommon for a business owner to pay for a vehicle using her

or his business, recording it as an asset of the corporation and taking depreciation deductions as appropriate for the business portion of the use of that vehicle. The corporation would pay for the insurance and appropriately deduct that expenditure as well. Since the vehicle was owned by a commercial enterprise, the appropriate insurance policy would be a commercial policy. There is nothing wrong or incorrect about this arrangement.

The problem that arises concerns commercial automobile insurance, which is almost universally much more expensive than private personal automobile insurance. A price difference of 50% is not uncommon. Thus, while there may be a benefit (real or perceived) by having the corporation take out and pay for the policy, the economics make that policy more expensive thus negating the tax benefit.

Some small businesses had the company pay for the vehicle with the title remaining with the owner as an individual. The accountant may not be aware of this arrangement since rarely do accountants review the titles to the fixed assets. In fact, in small write-up and tax preparation, review or analysis of the underlying documents is not required of the preparer.

At this point, the business owner insures the vehicle as part of his or her personal automobile insurance policies to enjoy the lower rates than a comparable commercial policy. The owner then has the



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corporation pay for the insurance. In practical terms this arrangement has the business recording an asset and taking deductions for an asset that it does not own. Depending on the outcome of an audit, the business may still receive some deductions, but more likely the individual may recognize income since they are in effect renting the car to the business. This income might also be subject to self-employment taxes, and since we are talking audit here—penalties and interest may also be incurred. Even if the final economics do not result in a significant tax issue, assuming the business use rules are followed, there is the expense of the audit and the unpleasantness of the entire process. Believe it or not, this could be the least of your problems.

CRASH—this is where the problem begins—when there is a claim. Despite the fact that the premiums were paid, coverage by the carrier may be denied since the carrier was insuring a commercial vehicle risk on a personal automobile policy. If the vehicle was titled in the business name, yet insured on a personal policy, it may be deemed that no insurable interest existed so no coverage was in effect. If a claim is denied, the savings realized by using personal insurance for a commercial policy do not seem like much of a bargain after all.

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It is critical that honest, factual discussions with your insurance advisor, financial advisor and legal advisor be undertaken on issues such as this, since taxes, deductibility, etc. are highly case-

specific. However, if the Friedlander Group program seems appropriate for your situation, and it adequately covers you and the Tax Man, then this program may save you a significant amount of money while avoiding undue exposure to risk.

One final item with numbers, to the extent that a person can legitimately use pre-tax dollars for expenses, the savings can exceed 30% to as much as 45% of the amount moved from post-tax to pre-tax. This is as compared to incurring the same expenditure that was ineligible for a tax deduction. For example, suppose that you have a \$100 expense that would qualify as a business deduction, then the after-tax cost could be as low as \$60, (assuming a 40% tax rate) since your tax bill would be reduced by \$40. This is the same type of example used when people discuss the “after-tax cost” of your mortgage payment.

Randy Paulikens, CPA/ABV, DABFA, is a shareholder at WithumSmith+Brown, Certified Public Accountants and Consultants, and can be reached at the firm's Red Bank office, 732.842.3113, rpaulikens@withum.com.