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# **The Rules of Insuring Employee Benefits in Captives**

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In 1993, in response to the publication of the Internal Revenue Service's (IRS) Revenue Ruling 92-93, 1992-2 C.B. 45, the state of Vermont enacted legislation that would allow captive insurance companies to write employee benefit plan business. Soon thereafter, Hawaii enacted a similar provision to amend its captive insurance company law. And interest continues to grow.

In August 2001, RM described the benefits of such arrangements. This year, we dig into the details of insuring employee benefit plan benefits with a captive insurer.

There are three categories of legal issues to consider: federal income tax issues, state insurance regulatory constraints and prohibited transaction considerations under the Employee Retirement Income Security Act of 1974 (ERISA). The U.S. Department of Labor's (DOL's) evolving interpretations of ERISA have spurred more contentious issues and provide for more dramatic changes in the future. We will examine these in detail.

### **ERISA Regulation of Captive-Insured Programs**

ERISA was passed with the aim of addressing deficiencies and irregularities in the funding and operation of pension plans, thus protecting employees and their beneficiaries. Among its protections, ERISA requires that pension and welfare plans be administered in the best interest of the employees. It prohibits many transactions between plans and persons and entities with certain relationships to the plans, known as parties in interest. Because the reinsurance of plan benefits with a captive may be viewed as involving the transfer of plan assets, i.e., premium, to an affiliate of the employer it raises questions under the prohibited transaction provisions of ERISA. In general, ERISA's prohibited trans-

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action provisions bar the reinsurance of employee benefit plan risks with the captive that is a party in interest with the plan.

When evaluating how ERISA may affect a captive-insured benefits program, three fundamental points must be examined:

Is the risk that the captive intends to reinsure that of an employee benefits plan?

If so, is the reinsurance transaction a prohibited transaction?

If so, is there a basis for an administrative exemption?

#### **Definition of a Benefit Plan**

ERISA defines employee benefit plans as both pension benefit plans and welfare benefit plans, including medical coverage, life insurance, disability and similar programs.

Certain voluntary group or group-type insurance programs (e.g., employee pay-all, group term life insurance) are not considered employee welfare benefit plans if they meet a number of requirements. These include that the employer “receives no consideration in the form of cash or otherwise in connection with the program, other than reasonable compensation, excluding any profit, for administrative services actually rendered in connection with payroll deductions.”

In one case addressing such a benefit plan, the DOL held that a voluntary program involving life insurance policies issued to the employees of Ashland Oil Inc. was not a welfare plan covered by ERISA. The policies were issued by Ashland’s wholly owned domestic subsidiary, Integon Life Insurance Corporation. The DOL took the opposite position, however, when an offshore captive sought to reinsure a voluntary benefits program. It found that the reinsurance arrangement constituted excessive employer involvement. In informal discussions, the DOL stated that it would be contrary to normal business practices in the Ashland situation to require it to seek out a competitor of Integon. No such factor is involved in a captive reinsurance arrangement. Therefore, the situation is distinguishable. Thus, a voluntary benefit program that reinsures benefits with a captive is likely to be treated as an ERISA plan.

#### **Federal Income Tax Issues**

In the early 1990s, the U.S. Tax Court and the U.S. Court of Claims rendered four decisions that held that a parent corporation and its operating affiliates may, for tax purposes, deduct premiums paid to a wholly-owned insurance affiliate for property/casualty coverage. Three requirements must be met:

1. Presence of insurance risk
2. The transaction conforms to traditional concepts of insurance
3. The transaction involves both risk transfer and risk distribution

The last requirement has garnered the most attention and debate, mostly over how much unrelated business an insurance affiliate must write to qualify its transactions as risk transfer and distribution. This amount has ranged from approximately 30 percent in a decision on an arrangement by the Harper Group, to approximately 99 percent in a decision regarding an arrangement made by Sears, Roebuck and Co.

In another ruling, Rev. Rul. 92-93, 1992-2 C.B. 45, the IRS shed additional light on what qualifies as unrelated risk. It held that the insurance of certain employee benefits by an insurer wholly-owned by the employer that maintains the plans is deductible for federal income tax purposes. The ruling characterized the risk as the employees’, rather than the employer’s.

In Rev. Rul. 2001-31, 2001-26 I.R.B. 1348, the IRS abandoned its so-called economic family theory. The IRS indicated it would follow *Humana, Inc. v. Commissioner* (1989) and *Kidde Indus., Inc. v. United States*, (1997), and allow deductions for premiums paid to a sister company (subject to a review of circumstances, e.g., whether there are parental guarantees of the captive’s obligation to a fronting company). Thus, in some circumstances, unrelated business may no longer be critical to the deduction of premiums—at least to the extent that such premiums are paid by, and relate to, an affiliate and not a parent.

#### **Prohibited Transactions**

ERISA prohibits any direct or indirect transfer of plan assets (by a plan fiduciary) between a plan and a party in interest to that plan. The key to determining if the payment of premiums to a captive insurer is a prohibited transaction is establishing if the captive insurer is a party in interest. A party in interest to a plan includes, but is not limited to, the following entities: an employer with any employees covered by the plan; and a corporation with respect to which 50 percent or more of the combined voting power of all voting stock or the total value of all stock is owned by the employer.

The DOL has stated in the commentary to a class prohibited transaction exemption that the purchase of insurance from an unrelated insurer, where that insurer is expected to reinsure the risk with a party in interest, is not covered by the class exemption (which covers only direct insurance transactions).

**Administrative Exemptions**

In addition to certain statutory exemptions (none of which applies to the issue at hand) ERISA Section 408(a) authorizes the DOL to grant administrative exemptions to certain transactions that otherwise would be prohibited by ERISA. The exemption must be administratively feasible, in the interest of the plan and its participants and beneficiaries, and must protect the rights of participants and beneficiaries.

Administrative exemptions may be class exemptions, which apply generally to a variety of transactions involving unrelated plans, or individual exemptions, which apply to a specific plan and transaction.

The major difference between class exemptions and individual exemptions is in the review process. Whereas class exemptions are excluded from this process, individual exemption requests are subject to potentially lengthy and difficult reviews.

**Prohibited Transaction Exemption 79-41**

The DOL has promulgated a class exemption—PTE 79-41—covering transactions in which a plan directly insures coverage with an affiliate of the plan sponsor, i.e., the employer. That exemption, however, does not cover reinsurance transactions and therefore does not apply to the reinsurance of an employee benefits program with a captive.

The DOL has, however, granted several individual exemptions for transactions involving the reinsurance of benefits with a captive. In granting these individual exemptions, the DOL has generally looked to seven requirements under PTE 79-41:

1. The insurer must be a party in interest to the plan because of a 50 percent or more of stock or partnership affiliation with the employer/sponsor.
2. The insurer must be licensed to sell insurance in at least one state, Puerto Rico or the U.S. Virgin Islands.
3. The insurer must have obtained a certificate of compliance from the commissioner of its domiciliary state either eighteen months prior to the date of the transaction or when such certificates were last available, if earlier.

**State Insurance Regulatory Issues**

Captives are generally not licensed to write business in all of the states in which employees are located, which makes insuring a benefits program through a captive all the more complicated. If a captive is to be used the insurance must be placed based on direct placement statutes, industrial insured statutes or established case law, depending on the requirements of individual states.

Such placements may not even be viable in all states, which is particularly troublesome for employers with employees across the country. Furthermore, many employers already use licensed carriers to provide insurance or perform administrative services to which their employees have become accustomed. Accordingly, in considering this issue, most employers have expected to include a licensed company as the primary writer of the benefits coverage.

4. The insurer must have undergone a financial examination by the insurance commissioner of its domiciliary state within five years of the transaction or undergone an examination for its last completed year by an independent, certified public accountant.
5. The plan may pay no more than adequate consideration—fair market value—for the insurance contract.
6. No commission may be paid with respect to the sale of the contract.
7. For each taxable year, the gross premiums for all plans (and their employers) with respect to which the insurer is a party in interest, may not exceed 50 percent of the gross premiums received for all lines of business during that year. (The 50 percent test.)

Because several of these requirements are inapplicable to captives and PTE 79-41 applies only to direct insurance, PTE 79-41 does not in and of itself provide a solution if the employer wishes to utilize a licensed carrier as the initial insurer and administrative provider and reinsure with the captive. Accordingly, an individual exemption is the appropriate means to secure relief from ERISA's prohibited transaction provisions in this case.

**Evolution of the Fifty Percent Test**

Efforts by various companies to secure individual relief for reinsurance transactions using PTE 79-41 have yielded inconsistent results, mostly because of the DOL's changing position on the 50 percent test.

For example, in 1985 the DOL exempted a life insurance program insured by Provident Life & Accident Insurance Company of Chattanooga, Tennessee, and reinsured 50 percent with the U.S. Virgin Island branch of Burlington Industries' Bermuda-based captive, Insuratex Ltd. Insuratex's application represented that it complied with all of the conditions set forth in PTE 79-41, except that it had involved a reinsurance transaction, rather than a direct insurance transaction. The DOL granted the exemption even

though virtually all of Insuratex's business was related to Burlington because, in applying the 50 percent test, the DOL considered Burlington's own nonplan business in the denominator only and not in the numerator of the equation.

A few years later, however, the DOL's interpretation of the 50 percent test changed. When CSX Industries, which maintained a Vermont captive, approached the DOL in the early nineties for an exemption that was virtually identical to the Insuratex exemption (and appeared to satisfy all of the conditions of PTE 79-41), the DOL issued an adverse ruling.

The DOL sought to apply a new, more restrictive interpretation of the 50 percent test: all of the employer's risk would be considered part of the numerator along with the benefit plan risks for which exemption was sought. According to the DOL's new interpretation, the 50 percent test required that more than half of the risk insured in a captive be unrelated to the employer that owned it. Because most of CSX Insurance Company's risk was related to CSX Industries, it could not obtain a prohibited transaction exemption simply by making the representations set forth in the Insuratex application.

After numerous informal discussions between CSX and the DOL about conditions that could serve as a substitute for the reinterpreted 50 percent test, CSX decided not to pursue the issue.

In subsequent favorable exemptions (Zion's Bancorporation, First Security Corporation and Union Carbide) the captive had more than 50 percent unrelated business. With Zion and First Security, the banks insured their plan with a company that reinsured with a bank-owned reinsurer, which was formed to reinsure a book of credit, life and disability business for its customers.

In yet another approach to the 50 percent test, the DOL granted Columbia Energy Group a prohibited transaction exemption for the proposed reinsurance of certain disability programs with the Vermont branch of its Bermuda-domiciled captive. Columbia did not have 50 percent of business unrelated to its own operations prior to the proposed reinsurance program.

In this case, in lieu of the 50 percent test, the DOL required that the company maintaining the plan retain an independent fiduciary, at its own expense, to analyze the transaction and render an opinion on whether all of the exemption requirements had been satisfied. In addition, the DOL imposed a number of other requirements:

- In the initial year of the contract, there must be an immediate and objectively determined benefit to the plan's participants and beneficiaries in the form of increased benefits.
- In subsequent years, the formula used to calculate premiums by the insurer (or any successor insurer) must be similar to those used by other insurers that provide comparable long-term disability coverage under similar programs. The premium charge calculated in accordance with the formula must be reasonable and comparable to that charged by insurers and competitors with the same or better rating providing the same coverage under comparable programs.
- The plan can only contract with insurers that have an A rating or better from A.M. Best Company.
- The reinsurance arrangement between the insurer and the reinsurer (captive) must be indemnity insurance only.

For the first time, it was possible to secure a private exemption for captives without any unrelated business.

#### **On the Fast Track**

In January 2002, Decatur, Illinois-based Archer Daniels Midland Company submitted an individual prohibited transaction exemption request with similar conditions as those approved in the Columbia Energy exemption. If the DOL approves this exemption, future applicants will be able to take advantage of the DOL's expedited exemption procedure, Ex-Pro.

Ex-Pro provides for an expedited review of prohibited transaction exemption requests where the applicant proposes a transaction that is "substantially similar" to at least two individual exemptions approved by the DOL within the previous five years. (On March 20, 2002, the DOL proposed an amendment to Ex-Pro that would allow the applicant to propose a transaction that is "substantially similar" to one individual exemption granted within the previous ten years and one transaction that received final authorization under Ex-Pro within the previous five years.)

Ex-Pro provides for tentative authorization of the proposed transaction generally no later than forty-five days after the DOL acknowledges receipt of the application, and for final authorization, as early as thirty days after notice of the proposed exemption is distributed to interested persons.

So when the next individual exemption is approved, it may be much easier for employers to use a captive to reinsure an employee benefits program.