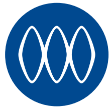
A MILLIMAN GLOBAL FIRM



Milliman USA
Consultants and Actuaries

Benefits Perspectives
Current Issues in Employee Benefits

SUMMER 2002

• Catching Up to Retirement
• Benefits and the Middle-Age Boom
• A Tax Incentive to Save for Retirement

A Captivating Proposal for Employee Benefits

by Charles M. Waldron

Funding employee benefit programs via a captive insurance company can provide an employer significant advantages. Doing so not only can increase an employer's benefit cost controls, but also offers potential tax savings, spreads risks for the captive, and could potentially increase benefits for plan participants. The Department of Labor's (DOL) granting of a prohibited transaction exemption (PTE) for one employer and a pending application of a second, along with the DOL's recent streamlining of the PTE process, will pave the way for other employers to pursue funding of their employee benefit programs through their captive insurance subsidiaries.

This article provides information on the DOL's PTE process and explains how an employer—including one that self-insures benefits—may reap the advantages of using its wholly owned captive insurance company to fund its benefit programs.

ERISA, PTEs, and Captives

The Employee Retirement Income Security Act (ERISA), the federal law governing employee benefits, prohibits transactions between an employee benefit plan and a party in interest with respect to the plan. A transaction between or among subsidiaries of a parent company and its plan is prohibited. Thus, a transaction that allows an employer's captive insurance subsidiary to participate in the coverage of the qualified plan's liabilities would be considered a prohibited transaction that could result in the loss of the plan's qualified status.

Fortunately, ERISA provides that the DOL may approve exemptions to a prohibited transaction.

With regard to use of captive insurance for funding of employee benefits, some background is in order.

What is a captive insurance company? A captive insurance company is an insurance company formed as a subsidiary of the parent company (i.e., the employer with the benefits program to be funded through the captive insurer). In general, the captive insurer is restricted to writing insurance coverage for the parent and related companies. Traditionally, the coverage written by captives has been primarily casualty risks (e.g., auto, fire, general liability, and workers' compensation). Qualified employee benefits coverage (life, health, disability, and retirement) was not considered viable because of ERISA's prohibited transaction rules. And although nonqualified plans can be insured through the captive, few employers have done so.

What restrictions did the DOL place on use of captives for employee benefits? The DOL granted the first PTE for the use of a captive insurance company to Columbia Energy Corp. two years ago. Before then, for employee benefits to be part of a captive insurance program, 50% of the premiums paid to the captive company had to come from what the DOL referred to as "unrelated" exposures. For the DOL, calculating unrelated exposures required the parent company to exclude its own property, liability, and workers' compensation risks. Thus, if an employer put $10 million in employee benefits premiums and $20 million in property/casualty premiums into its captive insurance company, then it had $30 million in related premiums. Such an employer then had to find insurance risks/exposures amounting to an additional $30 million worth of unrelated premiums in order to put the $10 million of premiums for employee benefits in its captive insurance company. Unrelated premiums could include large catastrophic exposures or exposures with unknown loss potential, either due to lack of historical data or a lack of knowledge or sophistication on the part of the captive. The sheer magnitude of the 50% threshold usually made use of the captive insurance arrangement for employee benefits a nonstarter; and even if it could be achieved, the risk of significant underwriting losses was not worth the trouble.

Columbia Energy's PTE

In October 2000, the DOL granted Columbia Energy Corp. an individual PTE (PTE 2000-48) for the company's financial transaction involving its long-term disability plan covering employees and Columbia Insurance Corporation, Ltd., its wholly owned captive insurance company. The PTE eliminated the 50% threshold and adopted other safeguards designed to protect employee benefit plan participants:

- An employer is no longer required to produce any unrelated premiums. The sample employer described above does not have to find $30 million of premiums in other exposures to fund the employee benefits program through the captive. Consequently, in contrast to the DOL's prior position, the employee benefit plans are better protected because they will not be exposed to risks outside of the scope and control of the parent. Therefore, the benefits are more likely to be paid.

- The captive insurance company must be a US-domiciled captive or branch captive.

- Annual reviews of the captive insurer's reserves must be conducted by an independent firm of actuaries and reported to appropriate regulatory authorities.

- The captive insurance company must undergo an examination by an independent certified public accounting firm.

An employer must improve the benefits offered to participants in the plan. Beginning in the initial year of the transaction, there must be an immediate benefit to the plan's participants and beneficiaries in the form of increased benefits or lower employee contributions as a result of the transaction. The DOL has not indicated how much larger the benefits—or how much lower the employee contributions—must be, but presumably, the improvements should be material.

Independent Fiduciary Requirement

In granting a PTE along the lines of Columbia Energy Corp.'s, the DOL also requires that an independent fiduciary, representing the participants and beneficiaries of the plan, be appointed. The independent fiduciary must annually review the transaction and certify that certain specific requirements are met. This additional check-and-balance serves as another layer of protection to plan participants, allowing the DOL to remain involved in monitoring the arrangement and to take early enforcement action if necessary.

To be considered independent, the DOL requires that a fiduciary and any entity affiliated with the fiduciary (employer, spouse, subsidiary, partner, etc.) not be an officer, director, employee, or partner of any party to the transaction. The fiduciary and any affiliate of the fiduciary also may not derive more than 5% of their revenue from any party to the transaction.

The independent fiduciary must report on specific items; among them, the fiduciary must certify that:

- the formula used to calculate premiums for the plan is similar to formulae used by other insurers providing coverage under similar programs; and

- the premium charge calculated under the formula is reasonable and within the range charged by the marketplace providing similar coverage under comparable programs.

These two certifications require the independent fiduciary to have the expertise to review the pricing of the benefits placed in the captive. Furthermore, the independent fiduciary must have a working knowledge of the insurance marketplace to be able to certify that the premiums are reasonable and within the range that other direct writers might charge. Some arrangements involving the captive will require the independent fiduciary also to have additional knowledge of both the self-funding of employee benefit plans and the reinsurance market available for the benefits.

Potential Tax Savings and Costs

The captive arrangement potentially offers the parent company an improved tax position. The IRS has issued little guidance in this area, but what it has published appears helpful and employers would be wise to seek advice from a tax professional.

Although the DOL defines the parent's property/casualty premiums and employee benefits premiums as *related*, the IRS apparently considers employee benefits as an exposure *unrelated* to the parent's scope of operations. Many companies that seek tax deductions for all of their captive insurance premiums and reserves try to achieve at least a 30% ratio of unrelated premiums. This ratio is an unofficial barometer in determining an amount of unrelated premiums needed for the deductibility of premiums and loss reserves.

Using the earlier example, a $30 million program consisting of $20 million of property/casualty premiums and $10 million of employee benefits would be considered by the DOL as 0% unrelated, but by the IRS as 33% unrelated. This would exceed the 30% threshold often assumed needed for IRS purposes. With the new DOL exemption rules, the addition of the employee benefits might create a tax deduction for the property/casualty premiums and reserves that were otherwise not

deductible before. Will the IRS take exception to this? Time will tell. Meanwhile, what might the tax benefit be worth?

If an employer structures its benefits and captive arrangements appropriately and is able to obtain a PTE along the lines of the one granted to Columbia Energy Corp., it is likely to incur some costs but also achieve some federal tax benefits. The additional costs—from improving plan benefits, new administrative requirements (e.g., fiduciary opinions and legal costs), and higher captive premium taxes—might be offset by tangible and intangible savings or benefits, including possible accelerated tax deductions, potential increased control over employee benefits costs (e.g., integrated disability benefits), and expected improved employee relations and morale (e.g., lower employee contributions or increased benefits).

Using the example above of an employer with $20 million in property/casualty premiums and $10 million in employee benefits, what is the potential savings if the incremental costs (legal, fiduciary, and premium taxes) are $600,000 ($390,000 after-tax cost, at an assumed 35% tax rate) based on the following:

- Plan benefits increase by $500,000 (after tax, $325,000);
- Annual administrative costs increase by $60,000 (after tax, $39,000);
- Illustrative state premium tax of 0.4% on the $10 million of employee benefits is $40,000 (after tax, $26,000);
- There is an existing captive insurance program; and
- Captive premiums are currently not deducted for federal tax purposes.

Milliman's research on the benefit of accelerated tax deductions indicates that, for a typical block of casualty lines (workers' compensation, general liability, and auto liability), the annual benefit is about 3.0% of the underlying premium. In this illustrative case, using $20 million in premium, the benefit is $600,000. Subtracting out the incremental costs of approximately $390,000 (after taxes), the net annual benefit of accelerated tax deductions to the corporation would be about $210,000 or approximately 1% of the captive's property/casualty premiums. This gain ignores any potential savings generated by increased efficiencies/control of costs. It focuses solely on federal taxes.

Looking Ahead

The DOL is now reviewing an application for a PTE from Archer Daniels Midland Co. (ADM) to fund improved basic and supplemental life insurance plans for employees through its captive insurance company. ADM's application for the PTE indicates that the arrangement is structured similar to the one granted to Columbia Energy Corp.

If the DOL grants the PTE to ADM, other employers contemplating such approaches will likely seek similar rulings. Moreover, they may find the DOL's PTE application process significantly streamlined. Effective July 3, 2002, the DOL modified its PTE process (PTE 96-62) to expedite consideration of routine transactions involving terms, conditions, and circumstances that are substantially similar to those described in two individual exemptions granted within the past 60 months. Being able to cite Columbia Energy Corp.'s PTE and, when granted, ADM's PTE, should facilitate other employers' applications.

Conclusion

The DOL's grant of a PTE to Columbia Energy and the pending application for ADM is a positive event for many employers. It may provide a powerful incentive to make employee benefits part of a captive insurance company program. How the IRS will view the matter remains to be seen, and many employers are cautiously optimistic about a favorable outcome. The potential for substantial savings at the corporate level exists, but participants in ERISA plans also significantly benefit.

For many employers' captives and benefit plans, the DOL's requirements are already being performed on an ongoing basis and present little or no additional costs. For other employers that self-fund their benefit plans, the requirement for an independent actuarial review of the reserves may present some new tasks and costs for the plan, but there still are compelling reasons—expense savings, risk spreading, and coordinated risk management—to consider the captive approach. And for the many employers with existing offshore captives, either a branch captive must be established or the domicile of the offshore captive must be transferred to the US to have a chance at obtaining a PTE along the lines discussed.

As a rule of thumb, an employer will need at least $1 million worth of insurance premiums to make its captive arrangement viable. But smaller employers could consider *sponsored* or *leased* captives, which involve several businesses in a shared captive arrangement—a discussion of which is beyond the scope of this article. Setting up a captive insurance company solely to fund qualified employee benefits may not be financially viable. However, the use of a captive insurance company for all of a company's business and financial risks could prove worthwhile and provide the catalyst to cash in on the advantages of including the qualified employee benefits programs in the captive.

Chuck Waldron is a consulting actuary in Milliman's Hartford office and is the independent fiduciary for both Columbia Energy Corp. and ADM. This article was peer reviewed by Joel Chansky, a consulting actuary in Milliman's Boston office.