



# 180°

A guide to what's hot in the world of captives and ART



Issue 4, Q4 2004

## Employee Benefits in Captives

One of the hottest recent topics in the alternative market has been the use of captives to insure employee welfare benefit plans (e.g. health, disability and life insurance). In this article we summarize the history of benefits in captives and discuss some of the practical issues that must be addressed. The article focuses on structures, which use the Individual Prohibited Transaction Exemption ("PTE"), although we acknowledge that there are alternative structures such as corporate reimbursement that may avoid some of the costs and approval processes.

**ERISA** - The Employee Retirement Income Security Act of 1974 is a federal law that sets minimum standards for most voluntarily established pension and health plans in private industry to provide protection for individuals in these plans. ERISA's fiduciary responsibility provisions and prohibited transaction rules require that plan assets be used solely for the purpose of paying benefits or related expenses and prohibit the plan from engaging in transactions with the employer or parties related to the employer. These prohibited transaction rules would ordinarily prevent employers from insuring or reinsuring their employee benefit plans through captives. However, ERISA authorizes the U.S. Department of Labor ("DOL") to grant two types of exemptions from the prohibited transaction rules:

1. **Class exemption** that may be relied upon by any employer meeting the conditions in the class exemption
2. **Individual exemption** that can be relied upon by only the employer that applied for the individual exemption.

The DOL has granted a class exemption allowing an employer to use its captive to insure or reinsure employee benefits plans if the captive derives no more than 50% of its annual premiums from related business. This requirement has been a major hurdle since most captives focus on related risk and are not interested in exposing risk capital to unrelated business.

**Individual Exemptions** - the Columbia Energy transaction was the first individual exemption allowing the use of a captive for employee benefits without requiring a specific amount of third-party risk. A second individual exemption was granted to Archer Daniels Midland ("ADM"). In both instances, the captive would not have passed the 50% unrelated business requirement in the class exemption. The additional significance of the ADM ruling was that it triggered "EXPRO", an expedited DOL approval process for proposed transactions that are substantially similar to prior transactions. EXPRO allows for approval in as little as 90-120 days compared to approval times in excess of one year for Columbia and ADM.

The individual exemptions came with certain conditions detailing how the transaction must be structured, including:

- the plan will contract only with primary insurers with a rating of A or better from A.M. Best Company;
- the plan pays no more than adequate consideration for the insurance or annuity contracts;

- the formula used to calculate premiums by the primary insurer will be similar to the formulas used by other insurers under similar programs;
- the reinsurance contract must be indemnity insurance so that the primary insurer will not be relieved of liability if the captive does not meet its obligations under the reinsurance contract;
- the captive must be licensed in at least one U.S. state or territory and must have obtained a Certificate of Compliance from the insurance commissioner in the domiciliary state within 18 months before the sale;
- the captive must have undergone a financial examination by the insurance commissioner of its domiciliary state within the five-year period preceding the year of the sale, or by an independent, certified public accountant for its last completed taxable year;
- no commissions are paid in connection with the sale;
- the captive retains an independent fiduciary, at the captive owner's expense, to analyze the reinsurance arrangement and render an opinion that all conditions in the exemption are satisfied; and
- in the initial year of any contract, there will be an immediate and objectively determined benefit to the Plan's participants and beneficiaries in the form of increased benefits.

**Viability of Benefits in Captives** - Now that a framework exists, should captives be looking to fund ERISA benefits? There are both economic and practical issues to consider in this decision:

- **Economic Benefit:** like all captive decisions an evaluation should be made on the cost-benefit of using a captive to fund this exposure, rather than available alternatives. For employee benefits, the captive will need to consider the additional costs imposed by the DOL. These include the costs involved in requiring "A" rated paper, providing increased Plan benefits and retaining an independent fiduciary. The analysis should also consider the economic impact of the improved probability of insurance company tax treatment for all premiums paid to the captive. This is based on an interpretation of Revenue Ruling 92-93, which implies that an employer can use the premiums for employee benefits to satisfy the 30% unrelated business requirement (rule of thumb) to obtain tax deductions for its property and casualty premiums paid to its captive.

### Inside This Issue

Employee Benefits in Captives

Domicile Update: Vermont

SRS News

## Domicile Update: Vermont

Following the recent Vermont Captive Insurance Association (VCIA) annual conference, which attracted over 1,200 attendees, our quarterly domicile review focuses on the largest and most successful onshore domicile to date, Vermont.

There is increasing competition for captive business with more than half of the U.S. States now having captive laws on their books. However Vermont continues to lead the industry in new captive formations. In 2003 Vermont had a net increase of 64 captives or 20 more than its closest global competitor, the Cayman Islands. 2004 is on pace to be another very good year, although not at the 2003 levels. Vermont has surpassed the 700 mark having licensed 27 new captives year-to-date, heading into the historically very busy fourth quarter.

**Regulatory Environment** - The Vermont State Government and Regulatory Authorities have re-affirmed their dedication to the captive industry by taking several actions recently:

- Vermont has amended its Statute to allow captives to form as Limited Liability Companies. This new provision could be beneficial in a number of situations, including where the captive's parent is not a tax payer or where the captive is not deemed an insurance company for tax purposes.
- The captive division now has 24 people dedicated to captive regulation, having added and promoted staff to meet the requirements of the significant growth seen in 2002 and 2003. It has also received budget approval to add two more examiners in 2005.
- Vermont and the VCIA have continued to be leaders on the legislative front, speaking up in favor of continued state regulation of risk retention groups and expansion of the Risk Retention Act. They have also been vocal in defending the benefits and operations of captives with the U.S. Treasury with regards to TRIA and the U.S. Department of Housing and Urban Development.
- The State of Vermont also presented a \$50,000 donation to the newly created International Center for Captive Insurance Education (I.C.C.I.E.).

**Why Vermont?** Vermont is a mature captive domicile and offers several advantages to prospective captive owners

- **Experience and Reputation:** Vermont's experience and reputation is unmatched by any other onshore domicile.
- **Dedicated Staff:** To date, Vermont remains the only onshore domicile with a truly independent and self-sufficient Captive Division. Len Crouse was elevated to the level of Deputy Commissioner in 2003.
- **Infrastructure:** With twelve captive management firms, several legal and accounting firms, banks, investment managers, and consultants with offices in Vermont, the domicile offers a very strong infrastructure dedicated to the captive industry. Unlike Bermuda (Insurance and Reinsurance Market) and the Cayman Islands (Banking and Investments), the infrastructure in place was built for the sole purpose of serving the captive industry.
- **Employee Benefits:** After the creation of the EXPRO approval process by the DOL, there is a greater demand to use captives for insuring ERISA benefits. To date all captives insuring ERISA benefits have done so in Vermont.
- **Stability:** The captive business is an important source of revenue for Vermont. Captives are now contributing as much in premium tax revenues to the State as commercial

## Individual Exemptions

- **Columbia Energy.** Approved 2000. Reinsurance of long-term disability benefits to a Vermont branch of a Bermuda captive.
- **Archer Daniels Midland.** Approved in 2002. Reinsurance of basic and supplemental group life insurance plans to a Vermont captive.

## EXPRO – Successful Applications

- **International Paper.** Approved November 2003. Reinsurance of life insurance benefits to a Vermont Captive.
- **Alcon Laboratories:** Approved August 2004. Reinsurance of long-term disability and life insurance benefits to a Vermont Captive.
- **SCA North America:** Approved July 2004. Reinsurance of long-term disability, accidental death and dismemberment, and basic and supplemental life insurance benefits to a Vermont captive.

## EXPRO – Unsuccessful Applications

- **Whirlpool.** Reinsurance by a captive of life contracts linked to a tax-free trust and not directly to the employee benefits. The DOL deemed this structure to be sufficiently different to Columbia and ADM to deny exemption under EXPRO.

- **Internal Coordination:** the decision to involve the captive in the benefits program usually crosses corporate functions (HR, finance and risk management). Many organizations struggle with the internal politics involved. The human resources department in particular may resist the involvement of the captive as it could be perceived as a loss of control. Engaging all of the departments affected by this potential change is critical to the program's success.
- **Alignment of Interests:** the success of captives in funding employee benefits requires the co-operation of life and health insurers. However, this initiative threatens to remove control of assets from the insurers with a consequent loss of revenue. Insurers will look to maintain margin through increases in related fees such as fronting, reinsurance and claims handling. Under a DOL required structure, it is unrealistic for a captive to expect to hold 100% of the assets and aggressively manage program expenses (e.g. fronting and claims costs). The captive and insurer need to coexist and must share in the risk/reward equation to create a proper alignment of interest that will last. Many of the structures implemented are on a quota share basis reflecting this cooperation.

Anecdotal evidence suggests that there are inefficiencies in how companies procure benefit programs. These programs can benefit from lessons learned on property and casualty including concepts such as unbundling, self-insurance and captives. Placing benefits in a captive is not a panacea and many issues will affect whether insuring or reinsuring benefits through a captive makes sense. The process of analyzing the current approach versus alternative approaches including a captive will invariably lead to a better understanding of the program and the best structure for each particular situation.

- insurers. This despite the fact that the premium tax rate for captives is five times less than the rates for commercial insurers. Successive administrations in Vermont have committed to the captive industry to ensure the continuance and growth of this important revenue stream. As the industry grows the State's commitment to it is only likely to increase.

**Looking Ahead** - Competition from newer domiciles such as South Carolina, D.C. and Arizona, has provided Vermont with the incentive to further promote its captive legislation while remaining true to its roots of strong regulation. For example, the Captive Department has recently launched its newsletter "Captive Comments" to keep the industry aware of the latest changes in the domicile. It remains to be seen if the newer domiciles will maintain their commitment to the captive industry. Vermont has already demonstrated this commitment and we believe it will continue to prosper in both the short and long-term.

## Vermont Captive Fact Sheet

**Applicable Legislation.** Title 8 Vermont Statutes Annotated Chapters 141 and 142, along with supporting regulations.

**Number of Captives.** 701 licensed as of 9/23/04.

### Capitalization & Solvency Requirements

	Minimum Capital & Surplus
Pure Captive	\$250,000
Industrial Insured Captive	\$500,000
Sponsored Captive	\$500,000
Association Captive	\$750,000
Risk Retention Group	\$1,000,000

### Premium Taxes\*

	Direct Tax Rate	Assumed tax Rate
\$0 - \$20 M	0.380%	0.214%
\$20 M - \$40 M	0.285%	0.143%
\$40 M - \$60 M	0.190%	0.048%
Above \$60 M	0.072%	0.024%

\* subject to a minimum of \$7,500 and maximum of \$200,000

### Local Representation Requirement

- Captive Manager must be based in Vermont and approved by the Insurance Department
- Principal place of business in the state must be maintained
- At least one incorporator must be a resident of Vermont
- At least one Board Member must be a resident of Vermont
- One meeting per year must be held in Vermont

### Regulatory Fees

Application Filing and Review Fee	\$3,400
Annual License Fee	\$300
Examination Fee (every 3-5 years)	Varies by Captive

## SRS News

**Client News** – SRS is pleased to welcome the following new captive clients:

- **Bennett International Group**, a privately owned transportation company, has selected SRS to manage its newly formed South Carolina single parent captive.
- **Keystone Indemnity**, which has been writing professional and general liability since 2001, has appointed SRS as its captive manager in Vermont.
- **CHCP Reciprocal RRG**, which started writing medical professional and general liability to its three Connecticut Subscribers in 2003, has appointed SRS as its captive manager in Vermont.

**SRS expands Cayman presence** – effective October 27, 2004 Strategic Risk Solutions (Cayman) Limited was approved as an insurance manager by the Cayman Islands Monetary Authority. SRS has overseen the management of captives in Cayman through a local correspondent for the past two years. With the growth in our captive practice and the importance of Cayman as a domicile for our clients, it was appropriate for SRS to be licensed in Cayman and staff a local office. Graham Lamb, a Director of SRS based in Bermuda, is overseeing the establishment of our Cayman office and the hiring of the local management team. Watch future 180° newsletters for details.

**SRS approved as a captive manager in D.C.** - SRS was approved as a captive manager in the District of Columbia effective September 9, 2004. There has been strong interest in D.C. as a captive domicile, particularly among Associations. Our approval in D.C. allows us to offer more choice for our captive clients and further enhances our ability to act solely in our clients' best interests with regards to domicile selection. Patricia Henderson, a Director of SRS in the Vermont office, will initially oversee captive management activities in the District of Columbia. She will serve as the responsible representative in the domicile.

**Events** – the fourth quarter promises to be a busy time for captive conferences. SRS will be participating in the following events:

- **World Captive Forum**, Nov 15-17: Brady Young, President of SRS, will be presenting on *State of the ART: Developments in Risk Financing*
- **SCCIA 5<sup>th</sup> Annual Educational Conference**, Dec 1-3: SRS will be exhibiting at this conference being held at Charleston Place, Charleston, SC.
- **2004 Cayman Captive Forum**, Dec 7-9: SRS will be exhibiting at this conference being held at the Westin Casuarina Resort.

SRS was also an exhibitor at the recent **ICAP Captive Conference** held in Cambridge, MA from October 4 – 6.

SRS is committed to being the premier provider of captive management and advisory services in the territories in which we operate. SRS is an approved manager of captive insurance companies in Arizona, Bermuda, Cayman Islands, D.C., South Carolina & Vermont. Through a wholly owned subsidiary SRS is also licensed as an insurance broker in Bermuda.

For more information on SRS, visit us at [www.strategicrisks.com](http://www.strategicrisks.com). Contact: [info@strategicrisks.com](mailto:info@strategicrisks.com), Tel: 781 487 9800