GROOM LAW GROUP

Publications

Innovative Uses of Insurance for Employee Benefits

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SERVICES

We have been working recently on several important innovations to provide employee benefits through insured arrangements. Two involve the use of captive insurance companies and a third involves the use of variable universal life insurance sited in Bermuda (or other offshore location). We believe that these innovations provide valuable planning opportunities.

CAPTIVE INSURANCE

The advantages of using captive insurance include:

- Availability of coverage when the commercial market hardens;
- Cost reductions, primarily for products with significant sales, regulatory and tax costs;
- Ability to tailor a product to meet the company's particular needs; and
- Improved risk and investment asset management.

Two parallel developments promise to expand the use of captive insurance companies to provide employee benefits.

The Liability Captive

Historically, most insurance captives have been formed to deal with property and casualty risks. Generally, for insurance premiums paid to property and casualty captives to be deductible, the captive must insure substantial outside risks. Employee benefits count as outside risks for tax purposes, and thus tend to insulate the captive from IRS attack that the captive does not provide real insurance. However, the use of a liability captive to insure employee benefits has been considered to violate ERISA's prohibited transaction rules. Recently, the DOL issued an exemption to our client, Columbia Energy, that permits its captive to reinsure the parent's long-term disability plan. While the exemption is subject to conditions, its terms could be satisfied by most other captive sponsors. The Columbia Energy exemption has sparked a widespread interest in using existing liability captives to provide employee benefits.

The Pure Benefits Captive

While benefits may be placed in a liability captive to buttress the captive's insurance tax position, some plan sponsors have begun to use captives solely to provide a more effective way of delivering employee benefits, i.e., to provide more benefits to participants at less cost for plan sponsors. The pure benefits captives may be less expensive to operate than a commercial insurer because it does not have the marketing, regulatory and required earnings cost of a commercial insurer. It may also provide possible financial accounting advantages, capital and tax savings.

We recently created the first annuity captive in Vermont for a benefit plan for professional athletes. The plan sponsor believes that this annuity company provides an efficient savings program for players at costs well below those charged for commercial annuities and with superior investment management. We solved numerous Vermont tax and regulatory problems, obtained IRS rulings, provided ERISA and securities law opinions and drafted the necessary documents. The company is now in its second year of successful operation.

We believe that the pure benefits captive has many other possible uses including the funding of foreign and U.S. deferred compensation arrangements, providing annuitized benefits under qualified defined benefit and defined contribution plans, serving as a UBIT shield for certain qualified pension plan investments and sheltering corporate investment income for TOLI's and similar arrangements.

BERMUDA VAL

Subject to some limitations and restrictions, variable universal life insurance offers a tax-efficient way of savings that is roughly comparable to the Roth IRA, but without the Roth IRA income and contribution limits. A strategy adopted by a Bermuda life insurer for wealthy U.S. and foreign clientele appears to be adaptable to U.S. savings and deferred compensation plans. Under this strategy, funds can be saved on a basis that is largely tax-free pursuant to an arrangement that involves annual costs of less than 1% of assets, which is substantially less than costs generally applicable to commercially available contracts. The lower costs are made possible because of elimination of some insurance company level taxes and costs, and lower regulatory expenses in Bermuda. Additionally, this plan may provide a platform for foreign employee compensation (where compliance with U.S. tax rules defining life insurance is not necessary) or for efficient, non-benefit plan, personal savings.

We are currently engaged in discussions with Bermuda insurance providers relating to the use of this arrangement as an efficient way of funding deferred compensation and savings plans for U.S. and foreign based executives.

Can we help you explore these ideas?

Groom Law Group is uniquely capable of addressing all aspects of benefit issues, and we have been at the forefront of dealing with insurance innovations with federal and state regulatory and tax agencies. Please let us know if we can assist you in considering any of the ideas discussed in this memorandum.