Employee Protection and Tax Deductibility Issues when Insuring Employee Benefits through a Captive Insurance Company

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Abstract: Two recent Department of Labor (DOL) decisions have cleared the way for captive insurance subsidiaries to insure the employee benefits of their parent firms. This paper examines whether using captives for this purpose is beneficial for employees and whether employee benefit premiums should be tax deductible in this case. We conclude that under the DOL’s conditions, the practice is advantageous for employees. Furthermore, we conclude that unless outside risk and outside premiums are added to the pooling arrangement, there’s no basis for permitting premiums to be tax deductible. The analysis suggests the Internal Revenue Service’s treatment of employee benefit risk as “outside risk” when insured by the parent company’s captive insurer is incorrect. [Key words: captive insurance company, employee benefits, tax deduction]

INTRODUCTION

A captive insurance company is a subsidiary created by a parent company for the purpose of insuring the parent company’s loss exposures. Captive insurance companies have been used traditionally as a means of insuring the property and liability loss exposures of their parent companies. While captive insurers are also in a position to write the employee benefit coverages of parent firms, the Employee Retirement Income Security Act of 1974 (ERISA) generally precludes this practice.¹

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Under ERISA, employers are forbidden to transact employee benefit business with a “party-in-interest” of the employee benefit plan. This prohibition is designed to protect employees by requiring employee benefit dealings to be “arms-length transactions,” transferring employee benefit risk outside the same economic family. The Department of Labor places additional restrictions on the use of captive insurance companies to write the employee benefit coverages of parent firms, including a rigorous (at least 50 percent) “outside business” requirement.

International companies and organizations with employee benefit plans exempt from ERISA standards have explored the use of captives to write employee benefit coverages. In 1999, for example, Toronto-based R.J. Reynolds International, which has operations in 170 countries, established a captive insurer to write employee benefit coverages.

Using captives to insure the employee benefit coverages of U.S.-based companies is more problematic, however, given legal and tax restrictions. The possibility of using a captive insurer for this purpose received greater attention recently when a Virginia-based gas company, Columbia Energy Group (CEG), was granted a “prohibited transaction exemption” by the Department of Labor (DOL). This exemption, granted in 2000, cleared the way for CEG to use its captive insurance company to reinsure its group long-term disability income risk. Following the CEG precedent, Illinois-based Archer-Daniels-Midland (ADM) filed a request with the DOL for permission to use a Vermont branch of its offshore captive to reinsure life insurance coverage for as many as 15,000 employees. In March, 2003, the DOL published notice of a proposed exemption for ADM. In May, 2003, ADM’s exemption was formally approved.

A well-documented phenomenon in commercial insurance markets is the “underwriting cycle.” Insurance markets alternate between periods of loose underwriting standards with low premiums (a “soft market”), and tight underwriting standards with high premiums (a “hard market”). Plunging investment returns and large losses (e.g., hurricanes, earthquakes, and, most notably, 9-11 claims) have helped to create a hard insurance market at the present time. The hard market is sure to foster captive insurer formation, as alternative risk sharing/transfer arrangements are considered. A desire for organizations to more effectively utilize their assets (including so-called “sleeping assets”), and the precedents established in the CEG and ADM decisions, should increase interest in insuring employee benefits through captive insurers in the future. Derick White, Assistant Director of Captive Insurance for the Vermont Department of Banking, Insurance, Securities and Health Care Administration, said of the CEG decision, “It’s going to open the floodgates” for using...
captives to insure benefits. That statement was made prior to approval of the ADM request.

In addition to increased interest in using captives to insure employee benefits, the recent ADM decision is important for another reason. Prohibited transaction exemption applicants qualify for a “fast track” review, in which a decision is reached in 45 days or less, if the applicant can show that the DOL has granted exemptions in two “substantially similar” cases within the previous five years. As ADM’s application was patterned after CEG’s approved request, the two exemptions appear to be “substantially similar.”

The purpose of this paper is to examine the use of captive insurance companies to write the employee benefit coverages of parent firms from an employee-protection perspective and from a premium deductibility perspective. The recent Enron and WorldCom fiascoes raise concerns about companies’ ability to meet their employee benefit obligations, such as post-retirement health care benefits. Thousands of Enron employees lost their retirement benefits because of the collapse of Enron. Therefore, we would like to examine whether the use of captives to write employee benefit coverages is beneficial for employees. Another issue that has not been addressed adequately is the tax deductibility of employee benefit premiums paid to a parent firm’s captive insurance company. This issue is important because, as authorities—e.g., Derick White—have suggested, one of the overriding reasons for using a captive to write employee benefit risk is tax deductibility. Should employee benefit premiums paid to a single-parent captive insurer be considered a tax deductible business expense? Specifically, we investigate to what extent and in which cases premiums paid for employee benefit coverages should be considered tax deductible for the parent firm.

Some of the major results are provided here. First, we believe that using captive insurers to write the employee benefits of parent companies does not increase the risk for employees, provided two important conditions are satisfied. These conditions, which were part of the Department of Labor’s guidelines in the CEG and ADM cases, are critical. First, only a top-rated insurer (rated “A” or higher by the A.M. Best Company) can insure the risk. Second, this insurer is irrevocably liable for the benefits if the captive insurance company defaults. We believe the employees will benefit from this type of transaction as long as the current DOL guidelines are maintained.

Second, our analysis suggests the current IRS ruling that the employer can unconditionally treat employee benefit risk as outside risk is incorrect. We believe only fully contributory employee benefit plan risk should be treated as outside risk. Third, it should be noted that one cannot treat
employee benefits risk as outside risk unless the benefits are fully contributory group insurance benefits. In other words, employees have to pay 100 percent of the cost for the risk to be considered “outside risk.” Even if the captive insurer satisfies the prohibited transaction exemption conditions imposed by the DOL, unless outside risk and fair outside premiums are added to the pooling arrangement, there is no reduction of risk and no basis for allowing premium payments to be tax deductible.

The rest of the paper is organized as follows. For background on the prohibited transaction exemption process, a brief review of the CEG case is provided in the following section. Then the advantages and disadvantages of using a captive to insure employee benefits are discussed. Next, we analyze the tax deductibility issue. The results are summarized and conclusions are offered in the final section.

**THE COLUMBIA ENERGY GROUP (CEG) CASE**

Columbia Energy Group (CEG) is a Herndon, Virginia, natural gas and energy services company. CEG sought to use its captive insurer to reinsure its long-term disability income employee benefit risk. Under a fronting arrangement, 8 CEG would insure the long-term disability risk with Employers Insurance Company of Wausau, a unit of Liberty Mutual Insurance Company. Then Employers of Wausau would reinsure the risk with a Vermont-licensed branch of CEG’s Bermuda-based captive insurance company.

In addition to ERISA restrictions, the Department of Labor imposes other limitations upon the use of captives to write employee benefits risk. The most significant restriction requires that, at minimum, the captive insurer must write 50 percent non-parent (third-party) business to be eligible to write the parent firm’s employee benefit coverages. This restriction is problematic for most companies that have a captive insurer, because often the captive is used exclusively to write parent-company risk. In the case of CEG, almost all of the risk underwritten by the captive was parent-company risk.

Nevertheless, CEG applied to the DOL for a prohibited transaction exemption (PTE), which would permit use of its captive to reinsure its long-term disability income risk. Preliminary approval of CEG’s request was given in August of 2000, with formal approval granted in October of 2000. In approving the request, the DOL set forth a number of conditions that CEG must satisfy:
—Provide an immediate and objectively determined benefit (enhancement) to the long-term disability income plan covering CEG employees.

—Use only a top-rated insurer (rated “A” or higher by the A.M. Best Company) to insure the risk. In addition, this insurer is irrevocably liable for the benefits if the captive insurance company defaults.

—Use a formula to determine the premium for long-term disability insurance that is “similar to formulae used by other insurers providing comparable long-term disability coverage under similar programs.”

—Use an independent fiduciary each year to determine that all conditions of the prohibited transaction exemption are being satisfied.

—Reinsure the risk through a captive that is licensed domestically.

CEG’s plan to reinsure its long-term disability employee benefit through its captive insurer satisfied all of the DOL’s prohibited transaction exemption requirements. Anticipating the “enhancement” requirement, CEG increased the benefit payable under the group long-term disability plan. Previously, long-term disabled employees received replacement income equal to 30 percent of salary up to the Social Security maximum taxable wage base plus 60 percent of salary in excess of the Social Security wage base. For 2000 and beyond, the long-term disability benefit is a flat 60 percent of salary. In addition, a more liberal definition of disability was adopted, thus increasing the availability of long-term disability benefits to workers. CEG enlisted consultants from Milliman & Robertson to attest that the actuarial requirements imposed by the DOL were met. The domestic insurer employed in the fronting arrangement (Employer’s of Wausau) is a subsidiary of Liberty Mutual, a company that received an “A+” rating from the A.M. Best Company. The final condition is that the captive must be licensed domestically. Seeing employee benefit captives as a potential growth area, the Vermont legislature passed a law allowing offshore captives to create branch captives in Vermont. CEG’s Bermuda-based captive has established a branch in Vermont, and this subsidiary is licensed in the state. Therefore, all of the requirements were satisfied.

While CEG and, more recently, ADM have been given the green light to use their captive insurers to reinsure employee benefit risk, two important questions about such arrangements have not been addressed. First, is insuring employee benefits through a subsidiary of the parent company in the best interests of employees? Second, should parent companies be permitted to take a tax deduction for employee benefit insurance
premiums paid to their captive insurers if captives are insuring or reinsuring this risk?

**IS USING A CAPTIVE TO INSURE EMPLOYEE BENEFITS BENEFICIAL FOR EMPLOYEES?**

**Does Risk Increase for Employees?**

There are two possible ways in which the use of a captive to insure employee benefits will increase the risk for employees. First, many captives are not well funded in terms of equity capital. Often captives are established off-shore and are not well financed. Indeed, many captives choose to maintain only the minimum capital required, which may not be sufficient to pay large losses. Second, parent-captive transactions are not arms-length, thus, the premium charged by the captive may not be sufficient for the risk that is insured. Therefore, insuring employee benefits through a captive insurer may present a higher risk of default because of inadequate premiums and, consequently, inadequate reserves.

In the CEG and ADM cases, both of these issues were addressed by the Department of Labor. The prohibited transaction exemptions require that a top-rated insurer (rated “A” or higher by the A.M. Best Company) be used to insure the employee benefit risk. In addition, this fronting insurer is irrevocably liable for the benefits if the captive insurance company defaults. With these requirements, employees are protected even if the captive becomes insolvent. In addition, the premiums charged by the captive will be determined by “formulae used by other insurers providing comparable … coverage under similar programs.” Thus, the default risk attributable to insufficient premiums is eliminated. Finally, CEG and ADM must insure the risk through a fronting company that is licensed domestically. This transaction means that the policyholders of the captive are protected by a state guaranty fund if the domestic insurer becomes insolvent. In summary, the risk of employee benefits does not increase for employees when a parent company uses a captive to insure employee benefits under the DOL’s guidelines in the CEG and ADM cases.

**Other Issues**

It seems that the guidelines imposed by the DOL actually improve the welfare of employees in two additional ways. First, the DOL requires CEG and ADM to use an independent fiduciary each year to determine that all conditions of the prohibited transaction exemption are being satisfied. Having an independent, outside fiduciary monitoring the agreement is
beneficial for employees compared to the purchase of insurance from a conventional insurer. More importantly, the DOL required CEG and ADM to “enhance” the employee benefit as a condition of granting the prohibited transaction exemption. CEG complied with this condition by increasing the disability benefit payable and relaxing eligibility requirements. ADM complied by increasing the amount of life insurance coverage provided to employees.

In summary, we believe it is advantageous for employees if a firm insures its employee benefit risk through an A-rated (or higher) fronting company, and the fronting company reinsures the risk with the firm’s captive insurer following the DOL guidelines. The employees are protected from the captive’s default risk and enjoy additional benefits such as higher coverage limits and greater access to benefits.

**SHOULD EMPLOYEE BENEFIT PREMIUMS PAID TO A CAPTIVE INSURER BE TAX DEDUCTIBLE?**

Recently, the Internal Revenue Service has decided to drop the “economic family theory,” which had been used by the IRS in addressing the premium deductibility issue for captives in various courts. The ruling (Revenue Ruling 2001-31) overturned the old ruling (Revenue Ruling 77-316). The reason the IRS dropped the “economic family theory” is that “[n]o court, in addressing a captive insurance transaction, has fully accepted the economic family theory” (see Ruling 2001-31). While the IRS stopped using the economic family theory, this change does not mean that the IRS will not challenge companies concerning premium deductibility. In fact, the IRS stated that it will address captive insurance transactions issues “on a case-by-case basis.” In this section, we examine the tax deductibility issue on the basis of economic and financial theories.

**Outside Risk (or Unrelated Risk?) and Risk Reduction**

To examine the issue of deductibility of employee benefit premiums paid to captive insurers, we first consider tax deductible expenses in general. The Internal Revenue Service (IRS) allows a tax deduction for all ordinary and necessary expenses paid or incurred in carrying on a trade or business (Internal Revenue Code 162 (a) 1954 and U.S. Treasury Regulation 1.162-1(a)). Property and liability insurance premiums paid to a private insurer are tax deductible because they are an ordinary and necessary business expense. Similarly, premiums for employee benefit coverages paid by the firm to an unaffiliated private insurer also are tax deductible. Thus group life and health insurance premiums paid by an employer to a
private insurer are tax deductible. The deduction also would be permitted if the benefit risk was insured by an unaffiliated captive insurer, as risk is transferred to the insurer. On the other hand, premiums including employee benefits, paid by the parent to a wholly-owned captive subsidiary which does not write outside risk, should not be tax deductible because there is no risk shifting or risk pooling. Recent tax court rulings indicate that insurance premiums paid to a company’s captive insurer are tax deductible if the captive writes at least 30 percent “outside risk.” Interestingly, an IRS ruling in late 1992 permits employers to consider their own employee benefit premiums as “outside risk” for the purposes of satisfying the 30 percent requirement.

It is well known that utilizing a pooling arrangement results in risk reduction. Specifically, the standard deviation of the average loss is reduced when more risks are added to the pool. When the number of risks in the pool becomes very large, the standard deviation of the average loss approaches zero. This result, the law of large numbers, is a fundamental principle in insurance operations. If Columbia Energy Group’s captive does not underwrite outside business, the number of exposure units insured by the captive will not be as large as it would be for any private insurance company. Thus CEG’s captive faces a relatively high standard deviation or risk with regard to the coverage written. CEG will require a substantial premium per-unit of exposure in order to remain financially viable with respect to the long-term disability exposure. For example, if a plant burned down and many workers were injured, or if a group of highly compensated employees were injured away from work, losses could be quite large. The captive insurer that wrote the risk might not be able to pay the losses in either case.

Han and Lai (1991) and Lai and Witt (1995) developed a theoretical model and showed that the addition of outside risk is essential for there to be risk reduction. In addition, the debate in certain captive insurer court cases (AMERCO, 1991; Harper, 1991; Sears, 1991; for example) focused on “risk spreading.” More importantly, the issue of whether the captive insurer underwrote a relatively large amount of unrelated risk was a key factor in these cases. For example, the court stated that “the relatively large number of unrelated insureds [that] comprise approximately 30 percent of Rampart’s business … constitute a sufficient pool of insureds to provide risk distribution” (Harper, 1991, p. 24). It is apparent that both Han and Lai (1991) and the courts believe that it is possible to reduce risk or spread risk when risks are added and pooled with parent-specific risk.

The confusion seems to come from the interpretation of the phrases “third-party” and “unrelated risk.” Specifically, the debate in the literature and the court decisions focuses on whether the captive will write third-
party risk, which adds both additional risk and additional premiums to the captive pool; or whether the captive will write the parent firm’s employee benefit coverages only, which adds additional risk but not additional premiums, as it is the parent that pays the premiums, not the employees. In other words, the issue is not whether the risk is related to the company’s operations, but rather, whether additional outside risks and outside premiums are added to the captive pool. One of the reasons that the IRS granted CEG’s proposal and ADM’s request may be that the IRS treats employee benefit risk as “unrelated risk.” This appears to the stance adopted in Revenue Ruling 92-93. We assume this stance was adopted because the IRS believes that employee benefit risk (e.g., long-term disability in the CEG case and death of a worker in the ADM case) is unrelated to the companies’ operating risk. While it is true that long-term disability and death of an employee are unrelated to a firm’s operating risk, we do not believe that the IRS correctly interpreted “unrelated risk”—in the context of prior court decisions and Han and Lai (1991). Specifically, Han and Lai and the courts meant “outside risk” when the phrase “unrelated risk” was used. Risk reduction or risk spreading is possible only when outside risk is added to the pool. When there is no outside risk involved, it means that no additional premiums are collected and added to the pool, and thus there is no risk spreading or risk distribution. If there is no risk spreading, risk distribution, or risk reduction, then there is no basis for the tax deductibility of employee benefit premiums paid to a captive insurer.

We believe the current IRS ruling based on the concept of “unrelated risk” is incorrect. For example, a firm’s product liability risk is unrelated to most of the firm’s other risk exposures, such as its building and business personal property risk exposures. That does not mean that the premiums for product liability insurance paid by the parent to a captive are tax deductible. In addition, one may argue that employee benefit risk, such as life insurance risk, comes from third parties—employees. Thus, employee benefit risk is not only unrelated risk, but also outside risk. Again, if a third party (the employee) does not pay the market premium, then the parent bears additional risk without being compensated by additional premiums. In this case, the risk will increase but the premiums received by the captive will remain the same; thus, the premiums should not be tax deductible. Consider a firm that has a captive that writes 30 percent outside risk, but the captive does not collect premiums for the outside risk. Are the premiums paid by the parent to the captive deductible according to the 30 percent ruling? The answer is obvious—the IRS would never allow the premiums to be deductible in such a case.

In summary, without additional premiums, the firm insuring employee benefit risks through its captive increases its risk. In other words,
the risk faced by CEG and ADM will increase if CEG and ADM reinsure their employee benefit risk through their own captive insurers, and the premiums paid by CEG and ADM should not be tax deductible. It should be noted that the DOL requires a “50 percent outside risk” condition for using a captive to insure employee benefit. The reason that we base our analysis on “30 percent outside risk” is that companies (including CEG and ADM) have requested an exemption from the “50 percent outside risk” requirement. Furthermore, the requests have been approved by the DOL.

Is There Risk Reduction?

Han and Lai (1991) also developed a theoretical model to calculate the degree of risk reduction to determine to what extent premiums paid to captives by parent companies should be tax deductible. Specifically, they assumed that insurance risks are homogeneous and are identically and independently distributed. They argued that the greater the reduction of parent-specific risk as compared to parent-total risk (relative risk), the greater the tax deductibility of premiums paid to a captive insurer. Han and Lai define parent-specific risk as the pure risk associated with the parent, while parent-total risk includes both parent-specific risk and outside risk. Note that parent-total risk is the same as captive risk because all of the risk the captive bears is also borne by the parent company as long as there is only one parent associated with the captive. If a captive does not write outside risk, then parent-specific risk is the same as the parent-total risk. The tax deductibility issue for the employee benefits under three scenarios is examined in the following section.

Case I—A Fully Contributory Group Insurance Benefit

In Case I, we assume that the employer makes a group insurance benefit available, but employees pay 100 percent of the cost. The premiums are paid to a fronting insurance company and the fronting company reinsures all of the risk with the parent company’s captive insurer. The employee benefit risk can be treated as outside risk because the risk is not related to the parent-specific risk and employees pay 100 percent of the cost. Note that there is no tax deductibility issue regarding the employee benefit premiums in this case because the parent company does not pay any of the premium. Furthermore, such voluntary plans in which employees fund the benefit are exempt from the provisions of ERISA if certain conditions are met.

However, an interesting scenario emerges in the case of fully contributory employee benefits. Recall that premiums paid by a parent firm to a captive insurer for parent-specific risk may be tax deductible if the captive writes enough (30 per cent or more) non-parent, outside risk. For example,
if the captive writes all of the parent-specific risk and some outside risk, which accounts only for about 25 percent of parent-total risk before accepting the employee benefit risk, then the premiums paid by the parent to the captive are not tax deductible. In this case, there is risk reduction, but the magnitude of reduction is not sufficient. The IRS permits premiums paid to a captive insurer to be tax deductible if the captive writes “significant” outside (unrelated) risk. Under present tax court rulings, “significant” means 30 percent or more outside (unrelated) risk must be written by the captive. In other words, it is the court’s contention that premiums paid to the captive are tax deductible when the outside risk is at least 30 percent of the parent-total risk. If both the newly added employee benefit risk (e.g., 5 percent) and the existing outside risk (e.g., 25 percent) account for at least 30 percent of the parent-total risk, then the premiums for the parent-specific risk become tax deductible as a consequence of insuring the employee benefit risk.

Case II—A Noncontributory Group Insurance Benefit

If employers pay 100 percent of a group insurance employee benefit premium (Case II), then whether the premiums paid to the captive are tax deductible depends on whether the captive writes sufficient outside risk. Under present law (circa Revenue Ruling 92-93), employee benefit risk can be considered “outside” risk and can count toward helping the employer to meet the 30 percent standard.

We disagree with treating employer-paid employee benefit premiums as “outside” risk. If the parent company pays 100 percent of the premium, then the employee benefit risk is part of the parent-specific risk. If the other outside risk accounts for 30 percent or more of parent-total risk (including the newly added employee benefit risk), then the premium for parent-specific risk (including the newly added employee benefit risk) paid by the parent should be tax deductible.13 Interestingly, if employer-paid employee benefit premiums were not treated as “outside” risk, it might prevent the parent company from deducting premiums for other parent-specific risk. For example, if the outside risk before the captive writes the new employee benefit risk is 30 percent, then the parent-specific risk is tax deductible. However, the outside risk relative to parent-total risk becomes less than 30 percent when the new employee-benefit risk is added to parent-total risk. Under this scenario, the premiums (including that of the employee benefits and other parent-specific risk) are not tax deductible.

The CEG case is instructive. Here, the parent-specific risk involved is CEG’s long-term disability risk, which is not transferred outside the economic family. CEG plans to use Employer’s Insurance Company of Wausau as a primary insurer and, in turn, to reinsure the business with CEG’s
captive. In other words, CEG will transfer its parent-specific risk (long-term disability) to Employer’s of Wausau, and Employer’s of Wausau will, in turn, transfer the risk back to CEG by reinsuring the risk with CEG’s captive. Therefore, the parent-specific risk involved is not transferred outside the economic family and there is no risk reduction. In addition, since CEG’s captive does not underwrite outside risks and is wholly owned by CEG, the parent-specific risk for CEG will remain the same. Since there is no reduction of relative risk, there should be no tax deduction, according to Han and Lai (1991). In fact, the proposed insurance and reinsurance agreement is very similar to the landmark Carnation case (71 TC 400 (1978)). The analysis of Han and Lai (1991) suggests that the premiums paid to Carnation’s captive are not tax deductible (as the court ruled), and their results are consistent with other tax court rulings.

Case III—A Contributory Group Insurance Benefit

In the third case, contributory group insurance benefits, both the employer and the employee pay a portion of the cost of the coverage. Perhaps the employer offers group long-term disability insurance or group life insurance and agrees to pay half of the premium, with the employee paying the other half. In this case, premiums paid by the employer are not tax deductible because the premiums paid by the employees do not totally reflect the additional risk borne by the parent, even though the third-party risk and third-party premiums are being added to the pool insured by the captive. Han and Lai (1991) argue that relative risk is an appropriate risk measure when one examines the tax deductibility issue. Specifically, they argue that when an outside risk is added to the captive, the total risk of the captive increases but the relative risk decreases because additional premiums that reflect the cost of insurance are also added to the pool. In the case of a contributory group insurance benefit, the total risk of the captive (or the parent) increases after additional employee-benefit risk is insured by the captive but the relative risk does not necessarily decrease because less than the fair premium is added to the pool.

Default Risk and Earnings Volatility

The analysis up to this point suggests that CEG’s and ADM’s reinsurance arrangements do not create a tax deductible expense, if we consider only the outside risk issue. However, one of the main features of the prohibited transaction exemption granted by the Department of Labor complicates the tax deductibility issue. The prohibited transaction exemption requires that “[t]here would be a licensed, well capitalized “A”-rated fronting insurance company that would be irrevocably liable to the plan
for benefits, even if the captive were to default on the reinsurance agreement.”

This requirement may give the impression that premiums are tax deductible in these cases. In arguing for CEG’s prohibited transaction exemption, Kathryn Westover (2001) noted, “Columbia Energy has gone in to make the case, which we believe is solid, that the captive does not have to write third-party business to be financially sound.” Ms. Westover is Chief Operating Officer of Strategic Risk Solutions, a company that specializes in captive formation and management. While her statement may be true in certain circumstances, it needs to be interpreted carefully, especially in the context of insurance premium deductibility.

One of the conditions imposed by the DOL in granting the prohibited transaction exemptions is that the fronting insurer is irrevocably liable for benefit payments if the captive defaults. This provision ensures that the risk is shifted to the fronting insurance company. In essence, the fronting insurance company will pay benefits to the employees if the captive defaults. In the CEG case, the employees of CEG are guaranteed to receive benefits because CEG shifts the default risk of the captive to an “A”-rated insurance company. It should be noted that even though employee benefit risk is shifted to the fronting company in the case of the captive’s default, the risk of the captive and therefore the risk of the parent have not been reduced because CEG still bears the uncertainty of long-term disability risk. In other words, we believe that premiums for employee benefits should not be tax deductible when there is no risk reduction.

It should be noted that there are circumstances in which premiums paid by the employer to a captive insurer for employee benefits should be tax deductible. For example, assume that an employer offers a contributory group insurance plan (e.g., group life insurance or group property and liability insurance) and writes the coverage through its captive insurer. Perhaps the employer pays half of the cost of the benefit, and the employee pays the other half. In this case, premiums paid by the employer may be tax deductible because third-party risk and third-party premiums are being added to the pool insured by the captive. However, one more condition must be fulfilled for the premium to be tax deductible. Even if the 50 percent outside business rule for employee benefits is waived as part of the prohibited transaction exemption, the IRS permits premiums paid to a captive insurer to be tax deductible only if the captive writes “significant” outside (unrelated) risk. Under present tax court rulings, “significant” means 30 percent or more outside (unrelated) risk must be written by the captive.
Self-Insurance (Self-Funding) vs. Insuring through a Captive Insurer

Previously, we considered insuring through a captive insurance company versus using conventional private insurance. We concluded that using a captive insurer does not reduce the parent company’s risk, and therefore premiums paid to the captive should not be tax deductible. Using conventional private insurance provides an immediate tax deduction, while deductibility (in practice) if a captive is employed is unclear at best. If the employer uses self-insurance (self-funding), employee benefit costs are deductible when paid. In this section, we examine some additional characteristics of self-insurance versus using a captive insurer to write employee benefit coverages.

As the prohibited transaction exemptions granted in the CEG and ADM cases are likely to serve as precedents in future cases, some key features of the exemptions should be considered when examining the self-funding alternative. First, the exemptions require the fronting insurer to be financially sound (“A” rating or higher from the A.M. Best Company) and to be responsible for losses if the captive insurer goes bankrupt. As discussed previously, these features protect employees against loss in case the captive defaults. Thus, using a captive to insure employee benefits under the DOL’s conditions in the CEG and ADM cases is superior to self-insurance with regard to this characteristic.

The prohibited transaction exemption also requires that a fiduciary be appointed to review whether the transaction is based on a fair market price and whether insuring the plan through a captive is in the best interests of employees. We believe this requirement prevents mispricing of coverages, as the risk is insured first with the fronting company, and the rate can easily be compared to rates charged other employers. In addition, the fiduciary is required to constantly monitor the arrangement. The monitoring requirement will also assure that the captive (i.e., the parent firm) will reserve expected losses properly. Using a captive to insure employee benefits appears superior with regard to this characteristic compared to self-insured plans, which are not required to establish appropriate reserves based on expected future claims and are not monitored by an outside fiduciary.

SUMMARY AND CONCLUSIONS

The Department of Labor’s approval of requests by Columbia Energy Group and Archer-Daniels-Midland to reinsure employee benefit risk through each company’s captive insurer is likely to increase interest in this practice. The commercial property and liability insurance market is cur-
rently hard, businesses desire more effective deployment of their assets, and the approval of ADM’s request establishes a precedent that opens the door for fast-track consideration of future prohibited transaction exemption requests.

We believe that using captive insurers to write the employee benefits of parent companies does not increase the risk for employees, provided two important conditions are satisfied. These conditions, which were part of the Department of Labor’s guidelines in the CEG and ADM cases, are critical. First, only a top-rated insurer (rated “A” or higher by the A.M. Best Company) can insure the risk. Second, this insurer is irrevocably liable for the benefits if the captive insurance company defaults. We believe the employees will benefit from this type of transaction as long as the current DOL guidelines are maintained.

While captive insurance companies appear well-positioned to write the employee benefit coverages of their parent firms, the tax deductibility issue remains in question. It should be noted that one cannot treat employee benefit risk as outside risk unless it is fully contributory group insurance risk. In other words, employees have to pay 100 percent of the cost for the risk to be “outside risk.” Even if captive insurers satisfy the prohibited transaction exemption conditions imposed by the DOL in the CEG and ADM cases, unless outside risk and fair outside premiums are added to the pooling arrangement, there is no reduction of risk and no basis for allowing the premium payments to be tax deductible. If the DOL relents on its “50 percent outside risk” condition for using a captive to insure benefit risk, the IRS still requires at least 30 percent of a captive’s business to be “outside unrelated risk” for the deduction to be approved.

Our analysis also suggests the current IRS ruling that the employer can unconditionally treat employee benefit risk as outside risk is incorrect. We believe only fully contributory group insurance risk should be treated as outside risk.

**NOTES**

1 Voluntary group coverages in which employees pay the entire cost of coverage are exempt and not considered “employee welfare benefit plans” if certain conditions are met (Wright and Kamen, 2002).

2 See Geisel (2000).

5 The only major difference in the two cases is the type of employee benefit—disability insurance in the CEG case and life insurance in the ADM case.
6 The tax deductibility issue has been widely debated and discussed in tax courts and academic journals (see, for example, Smith (1986), Bradley and Taten (1988), Kafka (1989), Joffe and Brandt (1991), and Sax (1992)).
7 Derick White was Assistant Director of Captive Insurance with the Vermont Department of Banking, Insurance, Securities, and Health Care Administration when he made this comment in 2000.
8 In a fronting arrangement, premiums are paid to one insurer, which then reinsures the risk with another insurer. States require that certain insurance coverages (e.g., workers compensation and auto liability) be written by U.S.-based companies. A company with a captive insurer domiciled in the Caribbean could insure the risk with a domestic insurer (the “front”), which would then reinsure the risk with the captive. Such an agreement satisfies the “domestic” requirement while permitting the captive to ultimately insure this risk.
9 An important point because under Vermont law, captive insurance companies do not participate in state guaranty funds.
11 Revenue Rule 92-93 permits companies insuring employee benefits with their captive to consider the premiums as “outside business,” according to John Woyke of Towers Perrins. See Otis (1993) for a discussion of this revenue ruling.
12 In the case of a work-related disability, workers compensation would be the primary source of disability income benefits. Most group short-term disability income plans exclude occupational disability. In contrast, most group long-term disability income plans cover both occupational and nonoccupational disability. For a long-term employment-related disability, workers compensation would be the primary source of benefits, with group long-term disability income benefits secondary. Group long-term disability income plans commonly include an integration provision to take into consideration other sources of recovery, such as workers compensation and Social Security disability benefits. In the case of non-occupational disability, the group long-term disability income plan would be the primary source of benefits.
13 Of course, the 50 percent “outside business” requirement must be met or this condition must be waived for there to be tax deductibility.

REFERENCES


