



Boston – Hartford Actuarial Clubs Joint Meeting

Using a Captive to Fund Employee Benefits

November 29, 2007

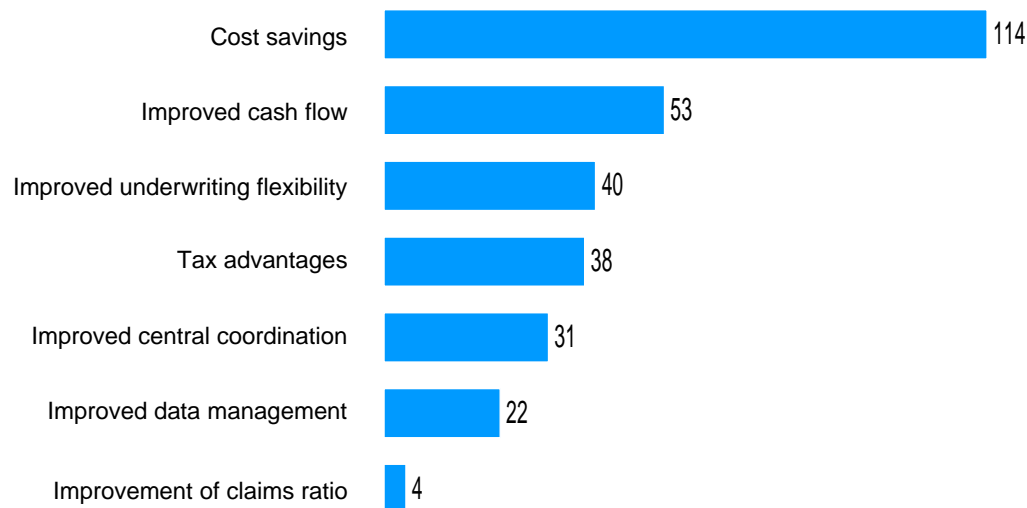
Outline

- Reasons for using a captive
- Benefit plans that can be financed with captive insurance
- Illustrative transaction structure
- Tax issues
- Pros and cons of captive financing

Reasons for using a captive

Survey Results

Three Main Reasons for Financing Employee Benefits Via the Captive (Scores Based on Ranking 1, 2, 3)



Source: Towers Perrin Survey, January 2005

Realized Advantages

- The most common reasons given are to save on costs and to increase cash flow
- Towers Perrin's view is that control is the key reason
- The ability to tailor benefit designs (e.g. for internationally mobile employees)
- Tax advantage is also ranked high as incentive for a captive structure

Benefit plans that can be financed with captive insurance

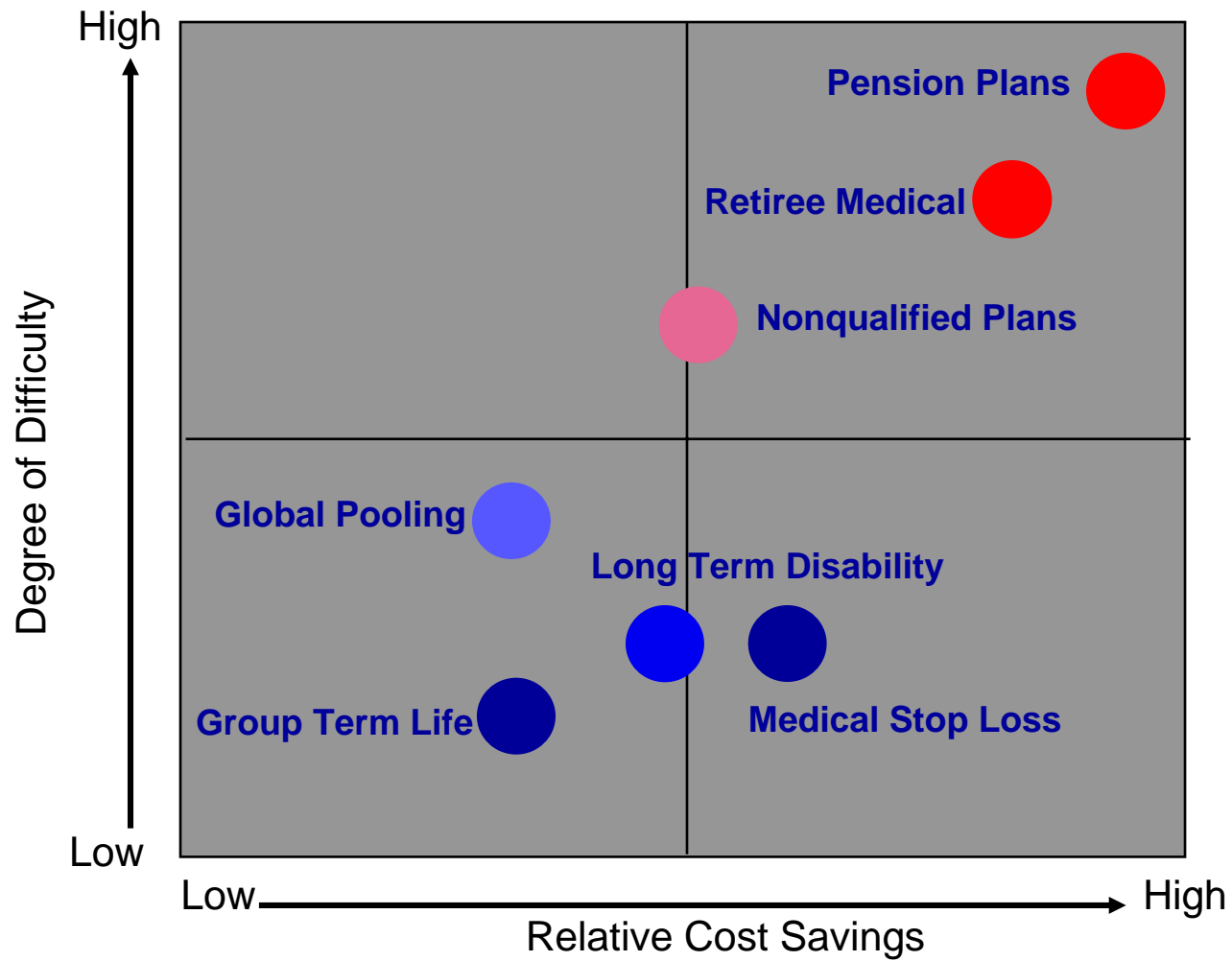
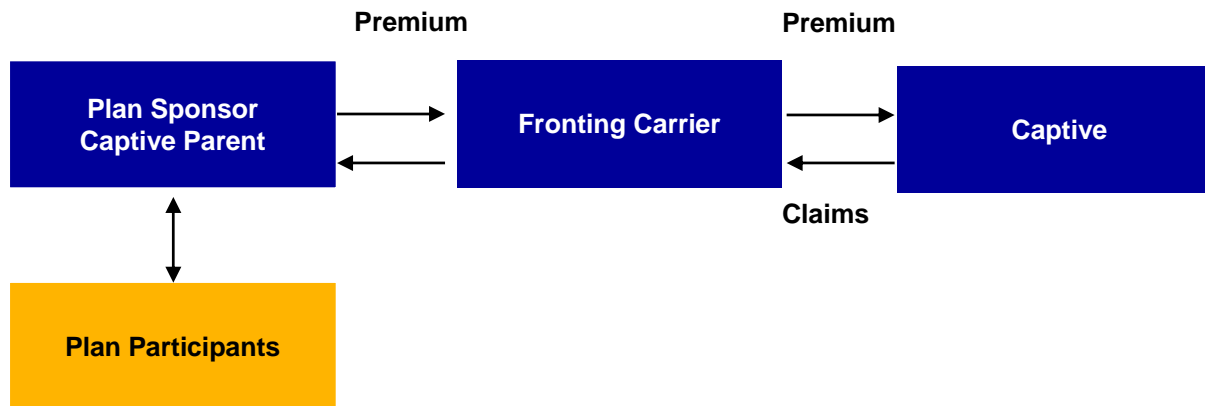


Illustration of a captive transaction structure Group term life

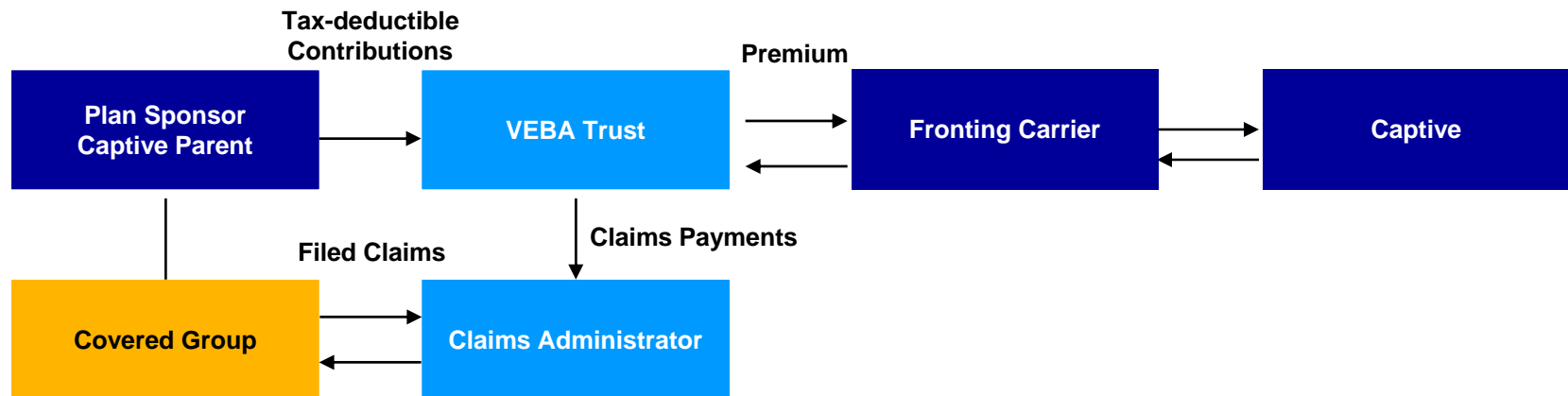
- A group insurance policy is issued to the plan by the fronting carrier and reinsured to the captive



Sponsor View	Carrier View
<ul style="list-style-type: none"> ■ Assets remain in corporate group ■ Lower insurance expenses ■ Tax-deductible claims reserves ■ Need Dept. of Labor exemption 	<ul style="list-style-type: none"> ■ “ASO” type transaction ■ Credit risk of the captive requires collateral ■ Joint discussions on rates and reserves ■ Greater reporting requirements

Illustration of a captive transaction structure Postretirement medical

- An insurance policy is issued to the trust by the fronting carrier and reinsured to the captive



Advantages

- Accelerates tax deductions with no UBIT
- Assets remain in corporate group
- Lower insurance expenses
- Tax-deductible claims reserves
- Captive regulation permits more flexible investment strategy

Disadvantages

- Need Dept. of Labor exemption
- Need to partner with insurance carrier
- Added expenses
- Working capital partially trapped

Key tax issues for benefit captives

- Whether the captive is an insurance company for US tax purposes
 - 50% unrelated risk was established as the “safe harbor” for tax deductibility of related-party premiums in Rev. Rul. 2002-89
 - Benefits insurance may be considered third-party as it covers the risks of the employee rather than risks of the employer, and claims are payable to the employee (Rev. Rul. 92-93)
- Whether the captive is a life or non-life insurance company
 - An insurer is taxed as a life company if 50% or more of its reserves are life & health reserves (Section 816(a))
 - Life companies file separate, non-consolidated tax returns for the first five years as member of an affiliated group (Treas. Reg. 1.1502-47(d))
- Whether reserves qualify as life insurance reserves
 - Life reserves are tax deductible (Section 807(d))
 - Life reserves allow provision for interest (using an applicable federal discount rate) which offsets otherwise taxable investment income, known as “inside buildup”

Impact on the income statement

- Revenue
 - Captive premium receipts
 - Captive investment income
- Tax-deductible expenses
 - Plan contributions for postretirement plans up to the allocable Section 419(A) limit. If the “Wells Fargo decision” is applied, the deduction is based on amount equal to the all of the unfunded retiree obligation plus amortization of the active employee obligation
 - Premiums paid to insurers (except those from VEBA trusts)
 - Reserves established by captive
- Plan accounting
 - For postretirement benefit plans, interest earned on plan assets reduces plan interest expense, e.g., if the plan’s expected return on plan assets (“EROA”) is 7%, a \$100 million contribution results in \$7.0 million of annual investment income for the plan
 - If insurance assets are held in a captive’s “general account” they are not “plan assets”

Pros and cons of using captive for health and welfare plans

Employee Benefits	Pros	Cons
U.S. Health & Welfare		
<ul style="list-style-type: none"> ■ Group Term Life 	<ul style="list-style-type: none"> ■ Known procedure for obtaining Prohibited Transaction Exemption from the DOL ■ Relatively easy to implement 	<ul style="list-style-type: none"> ■ Low savings potential ■ Cash flow may be limited ■ Assumption of mortality risk ■ Reinsurance for catastrophe losses can be costly
<ul style="list-style-type: none"> ■ Long Term Disability 	<ul style="list-style-type: none"> ■ Same as above ■ Consolidation of cash ■ Accelerated deductions versus book self-insurance ■ No greater risk assumption than at present 	<ul style="list-style-type: none"> ■ Potentially low savings versus pay-as-you go
<ul style="list-style-type: none"> ■ Retiree Medical 	<ul style="list-style-type: none"> ■ Significant acceleration of tax deductions and cash consolidation 	<ul style="list-style-type: none"> ■ Individual exemption may be required for the DOL, which could take time ■ Complex implementation

Pros and cons of using captive for pension plans

	Pros	Cons
Pensions		
<ul style="list-style-type: none"> ■ U.S. 	<ul style="list-style-type: none"> ■ Regulatory settlement ■ Not settled for FAS 87 ■ Enhanced control <ul style="list-style-type: none"> ■ May provide greater degree of investment freedom ■ Avoids trapped surplus 	<ul style="list-style-type: none"> ■ Individual exemption required from DOL ■ Risk location moves, but remains unchanged ■ Complex implementation
<ul style="list-style-type: none"> ■ Non-U.S. 	<ul style="list-style-type: none"> ■ Regulatory settlement ■ Not settled for FAS 87 ■ Enhanced control <ul style="list-style-type: none"> ■ Greater investment freedom ■ Cash consolidation of plans ■ Avoids trapped surplus ■ No regulatory exemptions needed 	<ul style="list-style-type: none"> ■ Complex implementation ■ Approval required from relevant fiduciary group, e.g. trustee, works council, or participants council

Profile of companies that use captive insurance for benefits

- Captive used for property-casualty risks
- Seeks captive premium growth for risk diversification and third-party business
- Can demonstrate cost savings with captive transaction
- Can recover expense of funding in product rates
- Life and AD&D premium > \$5,000,000
- Disability premium > \$5,000,000
- Active medical:
 - Facing sharply increased commercial rates for stop loss
 - Can tolerate P&L volatility from large claims at highest corporate level
- Retiree medical:
 - Accumulated Postretirement Benefit Obligation (APBO) > \$50,000,000
 - Large non-union retiree population
 - Wants to demonstrate funded status on financial statements
 - Has sufficient cash available to pre-fund benefit plans

Benefit plans that can be financed with insurance

EMPLOYEE BENEFIT PLAN	STANDARD FINANCING	PAYORS	MAJOR RISK TYPES	COMMENTS/ CAPTIVE HISTORY
Group Term Life (GTL) <ul style="list-style-type: none"> ■ Basic ■ Voluntary (Supplemental & Dependent) 	Fully Insured in order to provide tax-free death benefits	<ul style="list-style-type: none"> ■ ER for basic ■ EE for voluntary 	<ul style="list-style-type: none"> ■ Mortality 	<ul style="list-style-type: none"> ■ All but one of the DOL PTE approvals ■ Reinsurance of multinational pools ■ Fairly predictable for large populations
Accidental Death and Dismemberment (AD&D) <ul style="list-style-type: none"> ■ Basic ■ Voluntary 	Fully insured	<ul style="list-style-type: none"> ■ ER for basic ■ EE for voluntary 	<ul style="list-style-type: none"> ■ Mortality ■ Accident 	<ul style="list-style-type: none"> ■ Generally included with GTL ■ Reinsurance of multinational pools ■ Low frequency/ high severity
Disability <ul style="list-style-type: none"> ■ Basic ■ Voluntary 	Often self-insured	<ul style="list-style-type: none"> ■ ER for basic ■ EE for voluntary 	<ul style="list-style-type: none"> ■ Accident & Health ■ Morbidity/ longevity ■ Medical costs ■ Interest rate 	<ul style="list-style-type: none"> ■ 3-4 of the 9 DOL PTE approvals ■ Reinsurance of multinational pools ■ "Long tail"
Active Employee Medical	<ul style="list-style-type: none"> ■ Self-insured ■ Stop loss protection 	ER-EE co-pay	<ul style="list-style-type: none"> ■ Accident & Health ■ Morbidity ■ Medical costs 	<ul style="list-style-type: none"> ■ Excess insurance for ER-paid portion ■ Reinsurance of multinational pools ■ "Short tail"
Retiree Medical	<ul style="list-style-type: none"> ■ Unfunded, or ■ Partially funded in VEBA trusts 	ER-EE co-pay	<ul style="list-style-type: none"> ■ Accident & Health ■ Morbidity/ longevity ■ Medical costs ■ Interest rate ■ Inflation 	<ul style="list-style-type: none"> ■ A few commercial insurers ■ A group captive ■ Manufacturing company owning a licensed insurer ■ "Long tail"
Non-qualified plans <ul style="list-style-type: none"> ■ Executive life and AD&D ■ Deferred compensation ■ Salary continuation 	Unfunded, trust contributions or life insurance (TOLI/COLI)	ER-EE co-pay	<ul style="list-style-type: none"> ■ Mortality (life) ■ Longevity (income replacement) ■ Interest rate 	<ul style="list-style-type: none"> ■ Some commercial insurers ■ Privately-held companies ■ Non US owned captives
Pension Plans	Pension trusts	ER	<ul style="list-style-type: none"> ■ Longevity ■ Interest rate ■ Inflation 	<ul style="list-style-type: none"> ■ Several pending transactions