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REINSURING EMPLOYEE BENEFITS THROUGH CAPTIVE INSURERS

A U.S. entity may now reinsure employee benefits through a domestic captive insurance company, provided certain conditions are satisfied. These conditions are outlined in the long awaited final prohibited transaction exemption (PTE) issued to the Archer Daniels Midland Co. (ADM), which follows a similar exemption issued to Columbia Energy. To do so, the U.S. entity must obtain a PTE from the Department of Labor (DOL), which may now be done on the DOL's "fast-track" review process. By establishing a captive insurer, or funding employee benefits through an existing captive insurer, companies can take advantage of certain tax deductions, customize coverage and control investment of the reserves held by the captive insurer.

In the final PTE issued to ADM on May 5, 2003, the DOL permits the reinsurance of life insurance benefits for employees through ADM's domestic captive insurer. The final PTE that the DOL issued to Columbia Energy in 2000 allowed the reinsurance of long term disability benefits through a Vermont branch of Columbia's Bermuda captive insurer. These two exemptions pave the way for other companies seeking a PTE for funding employee benefits through their captive insurers to take advantage of the DOL's "fast-track" review process.

The "fast-track" review process means the DOL must rule on a PTE application within 45 days of the request when the applicant cites two substantially similar exemptions, and these two exemptions are substantially similar. Indeed, ADM apparently modeled its exemption after Columbia's to assure approval. Each applicant agreed to the following conditions relating to the transactions:

- The captive will be licensed to sell insurance or conduct reinsurance operations in the United States.
- The insurance commissioner for the state of incorporation of the captive will have examined the financials of the captive within the five years before the reinsurance transaction.
- The benefit plans will pay no more than adequate consideration for the employee benefit insurance contracts.
- The benefit plans will pay no commissions associated with the direct sale of the employee benefit insurance contracts or the reinsurance of those benefits.
- In the initial year of the contract with the captive insurer, the plan will provide increased benefits that are immediate and objectively determined (*e.g.*, Columbia reduced the waiting period for long term disability benefits and ADM increased the maximum amount of life insurance coverage available under the plan).
- In subsequent years, the formula used by the insurer to calculate premiums must be similar to those used by insurers providing similar coverage and the premiums must be reasonable as compared to those charged by insurers with the same rating.
- The benefit plans will only contract with insurers with a rating of A or better from A.M. Best Company and the reinsurance will be indemnity insurance only (*e.g.*, the primary insurer will remain liable even if the captive defaults on its reinsurance obligations).

- The captive insurer will retain an independent fiduciary that meets certain requirements outlined in the PTEs, at the applicants' expense to oversee the transaction and ensure that these conditions are satisfied.

Use of a captive to reinsure employee benefits or other coverage has its advantages. Under certain conditions, the parent may benefit from accelerated tax deductions for any advance funding of employee benefits (*i.e.*, retiree benefits). Funding employee benefits through a captive could also be considered third party business for the captive, which may result in tax deductions for the parent company for premiums paid to the captive for other coverage. (Generally, a captive would need to derive at least 30 percent of its premiums from third party business for the parent to receive such a deduction.) For example, if the commercial market premiums for property and casualty coverage seem excessive, the parent could move some or all of its property and casualty coverage to the captive insurer. Reinsuring employee benefits through the captive insurer would increase the likelihood that the parent could deduct the property and casualty premiums paid to the captive, as well as the premiums for the employee benefits coverage.

If you would like to discuss the ADM and Columbia Energy PTEs in more detail, please contact any member of our Alternative Risk Financing and Captive Group or Mike Friedman (313-465-7388) or Nicole Bogard (313-465-7398) of our Employee Benefits Department. Our Alternative Risk Financing and Captive Group consist of the following: William O. Hochkammer (313-465-7414), William M. Cassetta (313-465-7348), Jeffrey A. Hyman (313-465-7422), Julie E. Robertson (313-465-7520), Zachary Fryer (313-465-7450) and Michael Domanski (313-465-7352).

New Member of Alternative Risk Financing and Captive Group

We are pleased to announce the addition of Michael Domanski as a new member to our Alternative Risk Financing and Captive Group. Mike, who has joined our firm as a partner, has come to us from KPMG LLP where he specialized in international tax compliance and planning matters. He received his J.D., magna cum laude, in 1996 from Detroit College of Law at Michigan State University and his LL.M., in 1997 from New York University School of Law. His practice is focused on international tax and captive insurance matters.