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Benefits Captives are Needed Now, and Don't Need a VEBA Trust

By Dick Goff

Funding employee benefit plans through a captive insurance company has always seemed like a good idea to Corporate America but now it is becoming a vital one. Unfunded health care for the fast-growing retired population is the elephant in the corner of the executive suite – it's getting too big to move and too expensive to feed.

The problem exists at the intersection of two powerful trends: ever-increasing health care costs and the ever-growing population of longer-living retirees. Health care for retirees under employer-sponsored self-insured plans is grossly under funded. Fortune magazine reported that post retirement benefits obligations of the Fortune1000 totaled $344 billion and change. Oh, and the bad news: that was for 2001. Ten years hence, you can easily double that figure.

It's no wonder that companies will seek to harness their ultimate liabilities of retiree health care by using captive insurance companies as the funding mechanism on a tax-deductible basis. While tax deductibility is not available through self-funded health plans until claims are paid, pre-tax money can be invested in a captive to hopefully grow in some reasonable approximation of the future liabilities.

Self-insured corporations from the largest down to the middle market may now consider establishing captives to insure retirees' benefits even before addressing the funding of ERISA plans covering their current employees and dependents.

Establishing captives to cover employee benefits began slowly in the U.S. as companies and the government began a tenuous dance that was more like a minuet than a march. The Department of Labor, which has approval over ERISA plans, seemed suspicious of captives for a time but warmed up to the concept as more U.S. states became captive domiciles.

Now the DOL operates its fast-track application process known as EXPRO to provide exemptions from prohibited transactions in less than three months in most cases. The catch is that applying companies must demonstrate that at least two similar companies must already have been approved. That approach would seem to be a curious case of inbreeding, but maybe that's just me.

Largely, the DOL relies on approval and oversight of the captive's licensing authority, the state captive insurance regulator. So a captive's funding arrangements must meet the requirements of both its state of domicile regulator and the DOL.

While this brief paper cannot serve as a complete "how to" of establishing benefits captives, perhaps it can serve to stimulate some further interest in the process among corporate counsel.

As a funding mechanism, a captive serves equally well for a variety of employee benefits including but not limited to health care, voluntary benefits, any form of life insurance, group disability, deferred compensation, defined benefit plans and retiree medical.

Methods of setting up benefits captives have grown more complex in recent years, stemming from the increasing reliance of plans on employee contributions. With ever-spiraling health care costs, plans have migrated from being totally supported by employers to including a mix of employee contributions in various proportions.

There is a widespread perception among some consultants and employers that a Voluntary Employees' Beneficiary Association (VEBA) trust must be established as the vessel that holds both employer and employee contributions. This is not true but perception in many cases has become the reality. Not only does the method become far more complicated than necessary, it also penalizes employers drastically.

Once employer money is comingled with employee contributions and locked up in a VEBA trust it is gone for good, not available to the employer at any time in the future. Rather a captive may follow a strategy of identification and segregation: *Identify* whose money is being held in trust and *segregate* employee contributions from employer contributions for greater corporate flexibility in managing cash flow.

For example the money path for a captive-funded ERISA self-insured medical plan could work like this: the employer still controls the checkbook by deducting the employee's share from payroll and allocating company funds for its share. If the employer formed a fiduciary trust account with JPMorgan Chase or Wells Fargo – just two banks that specialize in these accounts – the employer would just pay the employees' share into the account monthly. No VEBA trust required!

The employer under this scenario would have the option to pay its share in advance by depositing deductible funds into the captive, or pay as they go. Or the captive

could create the employees' fiduciary trust, and then all funds would flow to the captive and the employees' portion would be forwarded to the trust account.

If stop-loss insurance is sought, the employer would buy a policy in excess of its self-insured retention. Or another cell could be added to the captive with the option for the employer to take a portion of stop-loss risk to allow a lower SIR and accelerate tax deductibility.

For ERISA life or disability plans that require a fronting insurer, the employer would pay the premium to the front, which then would reinsure a portion of risk to the captive. The captive would segregate employee from employer's contributions and deposit the employees' portion into the fiduciary trust account.

As claims are paid and benefit checks come into the captive for clearance, the administrator would draw the appropriate percentage of premium from the captive and the captive will draw from the trust account for the actuarially predetermined portion of the claim and from the captive account for the remainder.

A further benefit to employers is that if the plan has a good experience year resulting in excess cash, the employer has options for its portion such as prepayment toward the next year's premiums, increasing benefits or even declaring a dividend with the domicile regulator's permission.

The important concept is that without tying up its money in a VEBA trust, the employer's money will accrue to the employer's benefit. I believe that some major benefits captives have cost their employer-owners millions of dollars in money that has been unnecessarily locked up within a VEBA trust and lost to their use.

This would imply that many more companies would be setting up employee benefits captives if they realize they can still retain the use of their cash.

Here's the point of this expression of opinion where I advise readers that it must not be accepted as legal advice, but only as starting points for their own investigation. But of course you knew that.

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