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DOL Proposes Exemption for Pension "De-Risking" with Captive Insurer

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Earlier this month, the Department of Labor proposed a significant prohibited transaction exemption that would allow a plan sponsor's captive insurer to reinsure pension annuity risks. Proposed Exemption From Certain Prohibited Transaction Restrictions Involving Memorial Sloan Kettering Cancer Center (MSKCC) or the Applicant Located in New York, New York, 89 Fed. Reg. 56422 (July 9, 2024). While DOL has issued a long line of exemptions for captive insurance involving group life, disability, and other welfare benefits, this is the first proposed exemption covering pension risks – which typically are more complex and involve large dollar amounts.

In this alert, we briefly review the key benefits of captive insurance, the pattern of DOL exemptions for group welfare benefit captives, and the key conditions of the new proposal involving pension annuity risks.

Key Benefits of Captives

Properly structured, a captive insurance company can provide significant financial and administration benefits to a plan sponsor compared with the use of traditional group insurance policies. In addition, a captive insurance company can, through the shifting of certain risks to the captive insurance company, result in reduced ongoing benefit costs and/or increased benefits for a plan sponsor's employees. Longstanding IRS rulings allow the plan sponsor to deduct the premium payments as business expenses. And they treat the risks of insuring the sponsor's own employees as equivalent to insuring third-party risks for purposes of recognizing the captive insurer as providing "insurance" for federal tax purposes. Rev. Rul. 92-93, 1992-2 CB 45.

Need for DOL Prohibited Transaction Exemption

As an affiliate of the plan sponsor, the captive insurer will be an ERISA "party in interest" with respect to the plan. Accordingly, premium payments to the captive would be prohibited transactions – and may be deemed to involve "self-dealing" – which normally will require an application to DOL for a prohibited transaction exemption. In considering these proposals over the years, DOL has established a series of requirements to grant relief, including the use of an independent fiduciary to confirm the following points –

- the insurer is licensed to underwrite the proposed risks;
- the captive's reserves for the past two years had been reviewed by an independent firm;
- the captive had undergone an examination by an independent certified public accountant for its last complete taxable year;
- the proposed transaction would confer an immediate benefit on the plan's participants in the form of lower cost for employee contributions, enhanced benefits, or both;
- the premiums charged under the program were reasonable and within the range of rates charged by competitors for similar coverage under comparable programs;
- the plan did not pay any commissions with respect to the reinsurance transaction; and
- that the reinsurance agreement was "indemnity reinsurance," leaving the fronting insurer liable for the risk if the reinsuring captive was unable or unwilling to pay.

Prohibited Transaction Exemption for Columbia Energy Group, 65 Fed. Reg. 60452 (Oct. 11, 2000).

Memorial Sloan Kettering Cancer Center ("MSKCC") Captive Proposal

On July 9, DOL issued a proposed exemption that would allow the captive owned by MSKCC to reinsure annuity benefits under its pension plan. A fronting insurer would issue the group annuity contract that satisfies the "safest available" annuity criteria established by DOL Interpretive Bulletin 95-1. An independent fiduciary would select the fronting insurer through a competitive bidding process. The complex proposed transaction involves a "buy-in" phase and a "buy-out" phase, both of which are described in detail in the proposal.

Consistent with DOL practice in granting captive exemptions for welfare benefits, the MSKCC proposal requires the plan sponsor to provide participants with a "meaningful benefit enhancement that must exceed 50 percent of the total financial benefit MSKCC derives from the Reinsurance Arrangement." Accordingly, MSKCC represented that it would provide increased benefits of $64,440,000 to participants and beneficiaries because MSKCC expects to derive total financial benefits of $126,444,000 over the term of the arrangement.

In addition to this financial commitment, the proposed PTE would require substantial oversight by the independent fiduciary, payment of all costs by the captive (and not the plan), the use of a collateral account based on Vermont law requirements, and numerous other protections. Comments and requests for a hearing must be submitted by August 23. If DOL grants the exemption, it would take effect on the date prescribed by DOL.

Observations

The proposed MSKCC exemption represents the most significant development in the evolution of captive benefit arrangements in many years. For major plan sponsors that have or are considering the use of captive insurers, the transaction could offer substantial financial advantages with resulting additional benefits for retirees. Although a plan sponsor may not rely on the MSKCC exemption, it provides a beneficial template to follow in requesting the plan sponsor's own exemption from the DOL if it decides to add utilizing a captive insurance company to their derisking toolkit.

Groom has considerable experience working with clients on captive insurance arrangements—including securing DOL prohibited transaction exemptions—as well as advising on pension risk transfer "de-risking" transactions of all types.