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Employee Retirement Benefits and Captive Insurance

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Many accounting firms encourage their profitable business clients to develop retirement plans. A well-designed retirement plan will be able to provide future security for both employees and employers. This is a critical component in today's business world, especially as life expectancy is expanding and both employers and employees are seeking peace of mind for the future.

Retirement planning has always served as an important employee benefit program.
The original ERISA tax laws enacted in 1974 have undergone numerous technical corrections over the last forty-six (46) years. This has resulted in inequities, today, that seriously hamper the accumulation of retirement assets for a wide group of people. These technical corrections have resulted in Defined Benefit plans disappearing at an alarming rate in favor of Defined Contribution plans.

Defined Benefit plans are retirement plans designed to create guaranteed retirement income. The contributions and growth are reviewed annually by certified actuaries to ensure a future monthly retirement income amount. Adjustments are made utilizing certain IRS/actuarial guidelines in order to meet these future commitments.

Defined Contribution plans, unlike Defined Benefit plans, are retirement plans where there are no future guaranteed benefits. The future retirement benefits vary with the contributions made and the investment returns achieved. Defined Contribution plans are easier to administer, less costly and simpler for the participants to understand. However, they lack the certainty, at retirement, provided by a Defined Benefit plan.

In addition to this major shift from a benefit formula to a contribution formula, the last forty-six years have seen other changes. Combined, these changes have resulted in inequality and discrimination of benefits between employees and employers.

1. Discrimination against the high wage earners and the leaders of many mid-market businesses in America is a direct result of the adjustments made to equalize contributions between highly compensated employees and lower compensated employees. Nondiscrimination testing is required for qualified retirement plans to ensure that benefits under the plan do not discriminate in favor of officers, owners, shareholders, or any other employee classified as highly compensated. Moreover, the contribution limits on the Defined Contribution plans have not increased along with life expectancy. Most highly compensated individuals, if they were able to contribute, would want the ability to make a larger contribution.

2. The shift away from Defined Benefit plans has caused discrimination against the high wage earners and the leaders of most mid-market business in America. Most employees and middle management are no longer receiving Defined Benefit contributions. These employees are being encouraged to fund their own retirement benefits through salary reduction plans. Due to the rising future retirement needs, the accumulation in most retirement plans has not kept up with the assets necessary to fund future retirement goals. It appears that the same employees who were to benefit from the original law are now ill prepared for retirement. In fact, the average 401(k) balance at Fidelity, which holds 16.2 million 401(k) accounts and is consistently ranked as the largest defined contribution record-keeper, was $103,700 as of March 2019. The average account balance by age was as follows:

    Age 20-29, Average 401(k) balance - $11,800
    Age 30-39, Average 401(k) balance - $42,400
    Age 40-49, Average 401(k) balance - $102,700
    Age 50-59, Average 401(k) balance - $174,100
    Age 60-69, Average 401(k) balance - $195,500

401(k) balances begin to fall as more people start tapping their 401(k) accounts. The average balance for those 70 years and older is $187,100 – an inadequate amount to secure surety for the future! This is going to be more acute as a result of the Coronavirus. Future contributions and benefits are in jeopardy. Actuaries will struggle to design retirement plans that adequately compensate both the leaders in business as well as the people who are instrumental in assisting the management teams in developing profitable businesses. Neither the highly compensated nor the rank and file have the security which ERISA was created to provide.

This situation is a direct result of more than 18 modifications (that we can count) made in the laws governing retirement planning which date back to the Employee Retirement Income Security Act (ERISA) of 1974, plus a worldwide pandemic which will alter future incomes and benefits.

ERISA Sets the Guidelines for all Private Retirement Plans
ERISA was enacted to create uniform standards and to provide equality to all retirement plan participants. Since ERISA's inception there have been many changes made. In addition to the regulatory changes, our society has evolved. There has been a shifting of accountability from corporate retirement planning to individual employee responsibility. Over the years the growth of 401(k) plans have taken center stage. In addition to private retirement planning, our country also utilizes the "Social Security" system as a support program for retirees over and above the personal/business retirement programs.

The shift to **Defined Contribution** retirement planning and the secondary system of Social Security skews the benefits against high income wage owners. The maximum 401(k) annual contribution is $19,000 for 2019 and Social Security contributions stop being deducted at $132,000 of salary. The increased income of the higher paid employees results in a lower percentage of income at retirement. Fewer and fewer Defined Benefit Retirement Plans are being created each year. In addition, due to increased longevity, the Social Security system has become strained. A solution must be implemented to remedy these inequities without resorting to more legislation.

Today, because of the sophistication of the financial marketplace, the authors believe there are alternative programs that currently exist which can improve these overall results. Retirement planning for mid-market businesses can be more effective by utilizing multiple unrelated strategies. By broadening our way of thinking, we believe it is possible to change this outcome by combining unrelated strategies. Moreover, we believe that it is possible to also provide pandemic protection going forward.

The utilization of a **Captive Insurance Company** is a method of leveraging the insurance premiums paid by a business for their company's P&C insurance and at the same time accumulating capital which can be used to supplement retirement benefits. It is a technique wherein businesses form their own stand-alone insurance subsidiary to finance reserves by setting aside assets to cover losses in a formal structure. This is all done under the guidance of an appropriate State Insurance Department. In addition to enhancing, supplementing and managing commercial insurance risk, Captives result in a substantial method of accumulating assets. These accumulated assets make a business stronger and more resilient. A Captive is a legally formed alternative and can do anything a commercial insurance company can do. They can be custom designed and are lifelines during a pandemic.

A Captive Insurance Company is not a commercial insurance company. It is a private insurance company licensed and regulated under the Department of Insurance (DOI) to insure the risk of a specific company or group of companies. Significant factors in forming a Captive Insurance Company include:

- Captive Insurance Companies must be established as "C" corporations.
- Captive Insurance Companies must maintain adequate collateral as well as reserves to pay claims.
- Captive Insurance Companies must issue properly priced insurance policies
- Captive Insurance Companies must undergo an annual certified audit

- Captive Insurance Companies can be grouped into three major insurance types. (1) Group Captive Insurance Companies (2) Large Captive Insurance companies, also known as 831(a) Captives and (3) Small Captive Insurance companies, also known as 831(b) Captives.
- Captive Insurance Companies provide Asset Protection
- Captive Insurance Companies can create customized insurance coverage

Simply put, Captive Insurance Companies give a business the opportunity to capture their unused insurance premiums as profit while providing business protection.

Ordinary businesses cannot take a deduction for reserves that they have set aside for future uninsured claims unless paid to a legitimate insurance company. Many business owners unknowingly self-insure a tremendous amount of business risk, such as malpractice deductibles, professional liability, accounts receivable, administrative actions, loss of professional license and business interruption, etc.

With a properly structured Captive, insurance can create substantial tax deductions resulting in significant tax savings and the accumulation of assets to fund employee benefits that are similar to a retirement plan but have greater flexibility. Because the business owner has control of his insurance company, policies can be custom designed. This flexibility allows the Captive to meet the specific needs in terms of the scope of coverage, level of risks, deductibles, premiums and dealing with unique programs such as the Coronavirus.

Control of a Captive Insurance Company also allows for the control of the claims process. Too frequently, with third party insurance companies, the insurance claims process can be irritating at best and can disintegrate into litigation. With a Captive Insurance Company, the "parent" or related businesses will benefit from good claims experiences while the surplus of the insurance company will be controlled by its shareholders. Without a Captive Insurance Company, premiums paid to a commercial insurance company are always lost.

It is a fact that the overhead of commercial insurance companies account for 35 to 40 percent of insurance premiums charged to each policyholder. Writing insurance directly through a Captive Insurance Company can significantly reduce these costs. In addition, a Captive can offer direct access to the third-party reinsurance market and related wholesale pricing, which is often considerably less than would otherwise be available to most employers utilizing commercial coverage.

Most business people do understand the need for business insurance to protect what they have created. However, most business people dislike paying insurance premiums.

We believe it's time to utilize a Captive Insurance program along with an unrelated strategy; a Defined Contribution Retirement Plan – to improve and maximize retirement benefits for all people building a business. This plan assists stockholders and rank and file employees to enhance retirement benefits. By doing this we can also create a successful strategy to address insurance issues that plague today's businesses and at the same time assist employees and employers in the area of retirement.

It seems obvious that if 90% of Fortune 500 businesses are using Captive Insurance Companies then the majority of mid-market companies should also be reviewing the use of Captive Insurance Companies. It is time to recognize that paying P&C insurance premiums into a Captive Insurance Company is a tax-deductible event just like making a contribution to a Retirement Plan. It is also time to realize the cash reserves of Captive Insurance Companies are a reliable source of future retirement income.

What Else Does This Strategy Offer?

Additional benefits derived from a Captive/401(k) strategy are less subtle. Captives are not subject to the 59-1/2 or 70-1/2 age limitations or excess accumulation penalties that are inherent with ERISA retirement plans. In addition, Captives allow adjustable contributions each year. With respect to oversight and control, retirement plans are overseen by the federal government and the Captive Insurance Companies are overseen by state insurance departments.

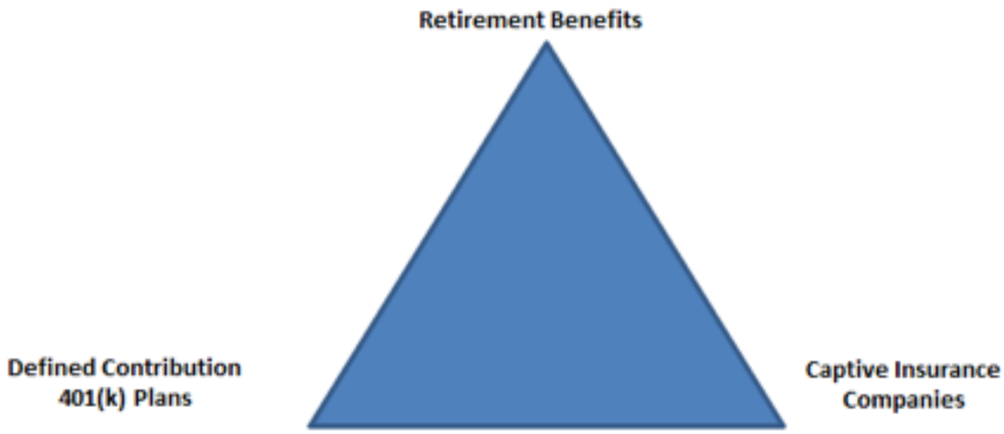
When a business uses a Captive, it is also possible to operate a Defined Contribution retirement plan simultaneously. This creates a new paradigm. In fact, after combining a traditional 401(k) plan with a Captive Insurance program, we can provide a retirement program that is more effective for both the employees and the employer.

When the business owners of a Captive Insurance Company take distributions prior to 59-1/2 for needed business reasons without a penalty, they pay tax at capital gains rates as opposed to having to withdraw assets from their pension accounts, pay ordinary income tax rates and a possible 10% tax penalty. In addition, there would be no mandatory distribution penalty when assets remain in the Captive past the ERISA RMD point.

The companion 401(k) distributions for the employees would still be subject to a 10 percent tax penalty on loan prior to age 59 ½. (A loan may be made from the 401(k) plan on behalf of any employee of up to $50,000 or 50 percent of the vested accrued benefit whichever is less). In addition, ERISA exceptions exist today. These exceptions include, among other scenarios, first time home ownership and chronic illness. There is no mandatory distribution at age 70-1/2 if employees remain working for the employer. However, the employees would still maintain the ability to roll over their accounts to an

IRA. The intent of Congress to allow employees to accumulate assets on a tax-deductible basis and grow on a tax-free basis would be achieved through the 401(k) plan. The strength of this two-prong plan is that it can be used by businesses that have a large employee work force and total payroll which exceeds the total income of the principles. Under these circumstances the principles/shareholders would be limited in making their own contributions into the 401(k) plan.

Building a retirement pyramid using a Defined Contribution plan [401(k)] alongside a risk management vehicle creates maximum flexibility, asset protection and strengthens a business while creating a more flexible retirement scenario.



The ability to develop future security, add additional risk management protection to a business, and provide assets to both workers and owners, without one group becoming disenfranchised, is a goal that is achievable by employing this strategy.

EXAMPLE

A mid-market manufacturing firm was paying $5 million in P&C insurance premiums each year and allocating $600,000 toward their company retirement plan. Under this scenario, the owner had calculated that at retirement (10 years), he would accumulate approximately 3 million dollars in his retirement account. Each year, $250,000 was set aside for the owner from the $600,000 being put in the retirement plan. Under the retirement plan design, $350,000 each year was being awarded to the remaining employees. No benefit accrued to either the employees or employer from the P&C premiums being paid to the commercial insurance company. Over the next 10 years the business would spend $50 million in P&C insurance premiums. All the P&C insurance premiums paid less the claims refunded ($6 million) were lost.

$44 million was profit to the commercial insurance company. Using the same budget funds could be re-allocated between the current commercial insurance company, a newly created Captive Insurance Company, and the company Retirement plan. This new design allocated $1.1 million dollars of expenses to the Captive Insurance Company, $3.9 million dollars would be spent with the Commercial Insurance Company and the same $600,000 would continue to be contributed to the retirement plan. **The result of this redesign is significantly different than utilizing only a 401(k) plan.**

$13 million dollars will accumulate in assets within the captive and another 2.1 million dollars will accumulate in the retirement plan over the 10-year period for the owner. Due to the reallocation of the insurance premiums, the owner also increased the total benefits in the retirement plan for the employees as an offset. By increasing the allocation to the employees 401(k) accounts, the future retirement benefits of the employees were more secure. For the owner, this planning added a $13 million increase in assets for their retirement plus enhanced P&C coverage, plus building greater benefits for the employees. A superior outcome for both employees and employers.

Today building adequate retirement income is mandatory to retain better employees and stronger businesses. If this can be accomplished by re-allocating assets currently being spent and not adding any new dollars into the planning, greater efficiency is achieved.

During the last year, Captive Insurance Companies have taken on even more significance as a result of the recent Coronavirus outbreak. "Employees are finding that Captive Insurance Companies are becoming a life-line." (Source: New York Times 3/20/2020

This option needs to be reviewed in our ever-changing new environment. The base of our economic growth as a country is dependent on a strong work force and this option addresses that problem. We are in a New Normal.

About the Author

Joseph W. Tucciarone is a true visionary and "Rocket Scientist", a graduate mechanical engineer with a minor in nuclear engineering, Joe started his professional career as the Assistant Spacecraft Test Manager at Kennedy Space Center. After leaving the space industry and for the past 35 years, Joe has applied his mathematical and analytical skills developing one of the premier ERISA Qualified Retirement Planning firms in the United States. Joe complemented this extensive pension experience by serving on the Board of Directors of GAMA International and building one of the largest insurance agencies in America. Joe's commitment to and belief that accountants are indeed the "most trusted" advisors in America, led him to create the National Network of Accountants (NNA) in 1992 and subsequently develop Independent Captive Associates (ICA). He believes both companies are tools for accountants and business owners to provide professional solutions to the business issues. Under Joe's leadership, the NNA has recently been selected by the State of Connecticut to develop a state wide program to design, enhance, protect and provide growth opportunities for both the accounting and business community within the state. He believes that research, analytical thought and professional cooperation create efficient business solutions. His current book on Amazon. "Captive Insurance Companies....a Game Changer", (First and Second Editions) provides insight and education to many business owners and professionals across America today. He continues to innovate and differentiate himself today as a national speaker, writer and industry expert, featured in several renowned financial publications such as The Wall Street Journal, CBS Marketwatch, The CPA Journal, Practical Accountant, CPA Wealth Provider and Accounting Today.

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