

► RETIREE LIFE BUYOUT

A Risk Financing Solution
for Retiree Life Insurance



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The Prudential Insurance Company of America (Prudential)
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INTRODUCTION

Employer-provided life insurance benefits plans have changed over the past several years. Fewer employers offer a plan design that provides post-retirement life insurance. Reasons driving this change include employers wanting to decrease their liability and the cost of funding these benefits. Nonetheless, many employers have legacy liabilities or grandfathered employees to whom post-retirement life benefits are owed.

The Prudential Insurance Company of America (Prudential) offers employers several solutions to address their retiree life insurance liability, including our Insurance Continuation Fund (ICF) and Insurance Continuation Fund with Stop Loss. An ICF allows the employer to pre-fund the cost of the retiree benefit during the employee's working years. The objective of an ICF is to accumulate sufficient contributions so that each employee's retiree benefit is fully funded by the time he or she retires.

An ICF with Stop Loss is used when Prudential agrees to "buy out" the postretirement benefit liability for an employer's existing retiree life insurance plan in exchange for a lump sum premium payment. This product gives employers relief from their liabilities for a distinct group of retirees. Products like ICF with Stop Loss are commonly known in the industry as Retiree Life Buyouts. While both products are viable options for addressing retiree life insurance liabilities, this white paper will focus on Retiree Life Buyouts.

Why Is a Retiree Life Buyout So Important?

The Financial Accounting Standards Board (FASB) is a private, not-for-profit organization whose primary purpose is to develop generally accepted accounting principles (GAAP) within the United States.

In 1990, FASB issued its Statement of Financial Accounting Standards (FAS) No. 106 (ASC 715),¹ Employers' Accounting for Postretirement Benefits Other Than Pensions. Statement 106 required employers to begin accruing, in 1993, the projected cost of postretirement benefits during an employee's working career.

This shift from cash-based accounting to accrual-based accounting created large liabilities for employers providing employer-paid retiree insurance benefits.

Cash-based accounting recognizes income when money is received, and recognizes expense when money is paid out.

Accrual-based accounting recognizes income when goods are shipped or services are rendered, and recognizes expense when it is incurred.

Key Facts Related to FAS Statement 106 (ASC 715):

- ▶ Postretirement benefits include life and medical benefits.
- ▶ An employer's liability for these benefits is incurred as employee service is rendered, not just when the employee retires.
- ▶ The company's total liability is the actuarial present value of the benefits expected to be paid for plan participants. It is not the premium amount or total volume for the retiree population.
- ▶ Employers report their "net liability" (total liability minus amounts that have been funded with restricted plan assets).
- ▶ These non-pension, postretirement benefit plan liabilities are usually disclosed in the footnotes of an annual report as an Accumulated Postretirement Benefit Obligation (APBO).

What Is Accelerating the Need for Retiree Life Buyouts?

There are some key trends and considerations in the marketplace that increase employers' concerns around their FAS 106 (ASC 715) liability:

- ▶ **The Retiree Population Is Growing**—By 2030, there will be about 74.1 million persons age 65 and over, more than twice their number in 2000.² With more retirees in the population, employers face increasing postretirement liabilities.

It was widely reported in the media that on October 15, 2007, the first Baby Boomer, Kathleen Casey-Kirschling, filed for early retirement and started collecting Social Security benefits. According to the U.S. Census Bureau, Kathleen is among an estimated 76.4 million Americans born between 1946 and 1964 (the Baby Boom generation).³

- ▶ **Volatility of Corporate Earnings Influence Stock Prices**—Wall Street likes to see steady earnings from quarter to quarter. Stock prices are influenced by earnings announcements and future projected earnings.

When an employer carries a large postretirement life liability on its balance sheet, it takes on a certain amount of volatility in its earnings. Simply defined, earnings (or net income) is revenue minus expenses. Investment income can fluctuate, and insurance expenses are impacted by changes in claims experience.

- ▶ **Employers Have Incentive to Remove Liabilities During Mergers and Acquisitions (M&A)**—During an acquisition, a buyer gains ownership control of a target company, often by purchasing shares of the company. Ownership control of the company in turn conveys effective control over the assets of the company. But because the company is acquired intact as an ongoing business, this transaction carries with it all the liabilities accrued by that business, including its postretirement liability. The buyer has an incentive to remove those liabilities to improve future earnings and risk.

- ▶ **The Debt to Equity Ratio** is a measure of a company's financial leverage calculated by dividing its total liabilities by shareholders' equity. A high debt to equity ratio generally means that a company has been aggressive in financing its growth with debt. Lenders consider a business that carries a large debt load to be a credit risk, which means the company will have to pay much higher interest rates to finance its capital activities.

What Are the Key Elements of a Retiree Life Buyout?

A Retiree Life Buyout offers many valuable features, including:

- ▶ **Client Transfer of FAS 106 (ASC 715) Liability**—The employer pays Prudential a lump sum premium payment. In exchange, Prudential agrees to honor the retiree life benefit obligations of a distinct group of retirees.
- ▶ **Stop Loss Caps the Employer's Obligation**—The buyout premium payment includes a Stop Loss component, which guarantees the employer that they will not have to contribute any additional money to Prudential for the distinct group of retirees.
- ▶ **A Contract Rider Establishes the Buyout**—Contractually, the buyout is established with a rider to the group life contract. The retirees' coverage continues under the group term life policy and is subject to the normal policy provisions.
- ▶ **Life Record Keeping and Customer Service is Handled by Prudential**—Once the Retiree Life Buyout is purchased, Prudential's Record Keeping Services takes over the life record keeping, including maintenance of beneficiary designations, preparation of death claims, and handling of benefit inquiries through a convenient toll-free number.
- ▶ **Periodic Sweeps to Buy Out Additional Liabilities**—In addition to buying out a distinct group of retirees, Prudential can also accommodate a periodic "sweep" of retirees. As additional employees reach retirement age, Prudential can buy out their liability for the appropriate lump sum premium. The rider would be amended each time Prudential buys out new lives.

What Are the Advantages of a Retiree Life Buyout?

With a Retiree Life Buyout employers can:

- ▶ **Reduce Long-Term Liabilities**—By removing the FAS 106 (ASC 715) liability on a distinct group of retirees from the balance sheet, the employer lowers its long-term liabilities. This is very helpful to corporations trying to improve their debt-to-equity ratio and to companies trying to reduce their liabilities in anticipation of a merger or an acquisition.

- ▶ **Transfer Mortality Risk**—When the liability is transferred, the employer is no longer responsible for paying premiums on the distinct group of retirees. This reduces its insurance expense.

The mortality risk is also removed on the distinct group of retirees. The employer is no longer subject to premium increases due to poor claims experience on the retiree block of business. If the employer has a combined active and retiree rate, removing the retirees could improve the composite rate.

- ▶ **Remove Investment Risk**—Some employers handle the FAS 106 (ASC 715) liability by creating a plan asset that has been segregated and restricted to pay retiree term life premiums upon retirement. Plan assets may include tax-advantaged vehicles like a Voluntary Employees' Beneficiary Association (VEBA) Trust or an Insurance Continuation Fund that are used to offset reported liabilities on the employer's balance sheet.

If the investment returns are low on the plan asset and the fund is depleted, the employer is required to add additional contributions to pay for the retiree benefits.

With a Retiree Life Buyout, the investment risk is transferred to Prudential. If the fund reserve under the buyout is insufficient to pay term premium under the group life plan, then Prudential is responsible for future premium payments and will not ask the employer for additional premium.

- ▶ **Reduce Administrative Work**—Life record keeping is included in a Retiree Life Buyout. Prudential will relieve the employer's Human Resources department of the burden of maintaining retiree life records, making beneficiary changes, filing claims, and answering death benefit questions. The employer is still responsible for W-2 reporting for imputed income on amounts over \$50,000 and for ERISA 5500 reporting.
- ▶ **Transfer All or Part of the Liability**—The employer has the option to buy out the full retiree population at once or buy out portions of the population at different times.
- ▶ **Accelerate a Tax Deduction**—Employers' premium contributions for the retiree life benefits are tax deductible each year. During a buyout, employers are paying the premium for the full benefit versus what is due on a yearly basis. This allows them to deduct premiums sooner. Employers are allowed to take a tax deduction on premium associated with benefit amounts up to the Deficit Reduction Act (DEFRA) limit, which is \$50,000.

Prudential does not provide tax, legal, actuarial, or accounting advice. Therefore, the employer should consult its own tax, accounting, and/or actuarial advisor regarding the tax implications and/or FAS 106 (ASC 715) accounting implications of the retiree life liability transfer arrangements they enter into with Prudential.

When purchasing a Retiree Life Buyout, employers are transferring the obligation and funding of retiree life benefits to one of the largest financial services companies in the United States. Life insurance and investing are among our core competencies. Prudential has more than \$1.8 trillion in group life insurance coverage⁴ and solid financial strength ratings.

What Is DEFRA and Are There Other Tax Implications?

The Deficit Reduction Act of 1984 places certain restrictions on the amounts an employer can deduct for the funding of retiree life coverage. The amount of post-retirement life insurance that can be funded on a tax-advantaged basis is restricted to \$50,000 per employee in most cases. This limit does not apply to collectively bargained plans, employee-funded plans, some tax-exempt entities, individuals who are permanently disabled, or individuals grandfathered under DEFRA. Other restrictions are that the plan must be non-discriminatory, and separate reporting is required for key employees.

What Are the Imputed Income Implications?

Employer contributions would not generate taxable income for the retirees provided that the coverage amount for any retiree does not exceed \$50,000. Coverage amounts in excess of \$50,000 for any retiree would cause imputed income to that retiree.

Imputed income is the term the IRS applies to the value of any benefit or service that should be considered income for the purposes of calculating an individual's federal taxes.

The imputed income to the retiree would be calculated as the annual cost of providing the excess insurance coverage. Upon request, Prudential can provide information to the employer for use in their imputed income calculations.

One approach is to treat the entire benefit amount (below and above \$50,000) as term insurance. As a result, a retiree's taxable income is limited to the imputed income based on the value of each year's term life premium on amounts over \$50,000, rather than the value of the entire single premium deposited on behalf of the retiree.

It is possible that the employer could be taxed on any earnings on funds held by Prudential to support face amounts in excess of \$50,000 under the contract as deemed unrelated income. Alternative interpretations are possible.

What Information Is Necessary for Prudential to Provide a Retiree Life Buyout Quote?

- ▶ **Proposed Effective Date**—The date the employer wants Prudential to take on the retiree life liability on the distinct group of retirees.
- ▶ **Situs State**—The state where the contract is signed.
- ▶ **Census**—A list that includes the retiree's name, gender, date of birth, salary or benefit amount, and reduction schedule, as well as key employees (IRC 416(i)). Individuals who have retired due to disability should not be included in the census, since these individuals are not generally covered under a retiree life buyout.
- ▶ **Plan Design**—For each class of retirees including reduction formulas and termination provisions.
- ▶ **Commission Percentage**—If any.
- ▶ **Inforce Term Life Insurance Carrier**—Which carrier is currently insuring the distinct group of retirees?

A Prudential Group Insurance Sales Representative will work with employers throughout the proposal process. When evaluating retiree life buyout quotes, it is critical to make sure that the correct number of employees and insurance volumes are being quoted.

Once Prudential has confirmation from the employer, we will provide the final list of retirees to our Life Claims, Contracts, and Record Keeping Services areas. Prudential will send the employer a contract (which includes the ICF buyout rider) and a retiree certificate in PDF format. The ICF buyout rider includes a list with each retiree's name and amount of insurance. Each retiree will receive a welcome letter, along with a Group Life Beneficiary Designation/Change Form.

What Retiree Life Product Alternatives Do Employers Have?

Employer-paid retiree life insurance creates a FAS 106 (ASC 715) liability on an employer's balance sheet. Two options that don't create a FAS 106 (ASC 715) liability are Prudential's Group Universal Life (GUL) and Voluntary Retiree Reducing Term (VRRT) Life Insurance.

Unlike group term life insurance plans, which often end or reduce at retirement, Prudential's GUL Insurance can be continued at the full coverage amount up to age 100. If the cash value is sufficient to purchase paid-up insurance, the reduced paid-up coverage amount can continue for life with no further premiums due.

Regardless of changes in health, GUL coverage will remain in force as long as premiums are paid or cash value is sufficient to pay any monthly charges. Participants can continue their GUL coverage if their employment ends, they retire, or they become disabled.

Another option is Prudential's VRRT, which is paid entirely by the retiree and is administered by Prudential. It is a unique offering that provides a level-cost retiree life benefit, because coverage reduces as the retiree ages. Since GUL and VRRT are employee-paid, they do not generate FAS 106 (ASC 715) liability for the employer.

Where Do Employers Go to Obtain More Information About Retiree Life Buyouts?

For more information, contact your Prudential Representative. He or she will orchestrate internal resources within Prudential to meet your funding needs, including working closely with our Advanced Markets Group.

Our Advanced Markets Group is unique in the industry. It is a special unit with resources and expertise to provide funding and complex product solutions tailored to each client's unique requirements.

The specific products that fall within the Advanced Markets Group include cash value life products, international benefits, retiree funding alternatives, captive reinsurance, and alternate funding mechanisms. This focus supports the complexity of these products and helps employers successfully manage their welfare benefit liabilities.

¹ Accounting Standards Codification (ASC) Topic 715, Compensation Retirement Benefits. Prudential does not provide tax, legal, actuarial, or accounting advice. Therefore, the employer should consult its own tax, legal, accounting, and/or actuarial advisor about the tax implications and/or FAS 106 (ASC 715) accounting implications of the retiree life liability transfer arrangements they enter into with Prudential.

² U.S. Census Bureau, 2014 National Population Projections Tables, Table 3. <https://www.census.gov/data/tables/2014/demo/popproj/2014-summary-tables.html>

³ Source: "The Baby Boom Cohort in the United States: 2012 to 2060 —Population Estimates and Projections." U.S. Census Bureau, May 2014

⁴ 2015 Statutory Annual Statement of Prudential Excerpts (Blue Book), Exhibit of Life Insurance. Client counts and lives covered are based upon number of contracts and certificates in force.

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