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How to Retain Employees With ‘Golden Handcuffs’

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According to the Family Business Alliance, more than 80 percent of all businesses in North America are family businesses.

Despite their overwhelming popularity, too few family-controlled companies explore the unique benefits of captive insurance as a means of increasing tax deductions, better insuring risk, enhancing wealth transfers and preserving capital.

Understanding the Concept

When a business creates a captive insurance company, it essentially sets aside the reserves necessary to cover its own risks.

It does this by designing a policy and collecting premiums through a separate entity that it also owns and controls.

The affiliated company receives a tax deduction on the premiums paid but also gains the ability to invest the premiums through the secondary company, in order to help them grow and meet the demands of claims.

In 2016 the maximum a business can set aside in the form of premium is $1.2 million per captive. In 2017 this limit will rise to $2.2 million. In certain scenarios, a company may benefit from setting up more than one captive, assuming they have enough risk to justify it.

Benefits of Captive Insurance

Captives have benefits for all business owners—not just family-owned companies. A captive allows business owners to insure highly specific risks.

Business owners have much more control over the types of coverage they can secure when a captive issues the policies.

They can insure risks that would normally be uninsurable, or specialized risks that don’t currently enjoy coverage with mainstream companies. A claim that would normally be denied can now be paid for through the captive. Additionally, certain captives may qualify for income tax exclusions on premiums received.

But for family-owned businesses, a properly structured captive can do even more.

With the right structure, a captive can help the business owners enhance wealth transfers, increase retirement benefits and reduce estate taxes—even if those aren't the primary reasons for setting up the captive.

Premiums paid to a captive are either used to pay claims or they become profit to the captive. Those premiums that become profit are essentially tax deferred until the point at which the affiliated business is sold or the owners retire.

Then, the captive can be unwound or terminated and the funds can be used to enhance the owner's exit package. Instead of being taxed at ordinary income rates, they will be taxed at long-term capital gains or dividend rates.

Captives can also remain in place after the first generation of owners leaves the business.

This creates the opportunity to transfer wealth throughout the generations while minimizing tax consequences. Captives may also remain outside the estate, keeping their assets exempt from estate tax consideration and gift tax inclusion.

Ensuring Proper Setup to Avoid IRS Challenge

As discussed, there are many benefits for family businesses to set up their own captive insurance company.

The primary driver for setting up that insurer should be to protect the affiliated business and better manage risk.

The IRS can challenge any captive that it doesn't see as established for the right reasons, which is why it's important to make sure the captive is properly set up.

There are a variety of steps you can take to do this, starting with hiring the right team of advisors to review risks and confirm that insurable interest exists within the company's current structure.

Whether a captive pays claims or not, establishing one ensures the profits that would normally be in an insurance company's pocket will now remain with you and your family.

This will potentially impact generations of wealth planning while still protecting the affiliated business's risks.

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