Business

KEY PERSON LIFE INSURANCE

Presented for

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KEY PERSON LIFE INSURANCE

The Concept

- Key person life insurance reimburses a business for economic loss when an employee who is critical to the success of the business dies.
- Key employee life insurance is not a specific type of policy, but a way to use life insurance to offset a significant business risk.

The Rationale

A key employee may or may not be an owner; however, key employees:

- Are generally highly paid and responsible for management decisions
- Exert a significant impact on sales and enjoy a special rapport with customers and creditors

A business suffers from a key employee's death in many possible ways:

- A loss of management skill and experience
- Disruption in sales or production
- Missed business opportunities
- Credit difficulties (such as an inability to make payments or a creditor's reluctance to extend credit)
- Increased expenses associated with hiring and training a replacement

The Process

- The business notifies the employee that it intends to purchase a specified amount of life insurance on the employee's life and obtains the employee's written consent.
- The business applies for and is the owner and beneficiary of a policy on the key employee's life.
- One method for determining the amount of insurance is the "contribution to earnings" method. Under this method, the business estimates the key person's contribution to yearly profits and multiplies it by the estimated number of years the employee would have worked. The result can be appropriately discounted to establish a basis for how much life insurance to purchase currently.

- Another method is the “cost to replace experience” method. Here, the business takes the key person’s compensation, subtracts the amount of salary attributable to routine duties, and then multiplies that number by the years required to bring a replacement up to the key employee’s level of experience. Add to this the expenses associated with recruiting and hiring a new employee to determine the appropriate amount of key employee insurance.

The Tax Picture

- Premiums are not tax deductible, as the business is the owner and beneficiary of the policy.
- Proceeds paid to the business are typically excluded from federal income tax when the notice and consent requirements have been met.
- If the proceeds are paid in installments, the interest portion of each installment is taxable to the business.
- Properly structured, the insurance has no tax impact on the key employee unless the employee is also an owner. In this case, when the key employee dies, the value of the deceased owner’s stock and business interests may increase in the estate when the business receives the life insurance proceeds, potentially resulting in greater estate tax.

Other Advantages

- If the key person doesn’t die while employed, the business can use the cash value of the policy to meet other needs.
- The policy demonstrates financial stability to creditors, or the cash value can be used as collateral for a loan.
- For key employees who are owners, the policy could help fund a buy-out of the deceased person’s business interest.
- If the policy isn’t needed to protect the business, the cash value can be used to provide deferred compensation or retirement income for the key employee.

The Bottom Line

Key person life insurance can serve a number of uses benefiting a business, both during the key employee’s life and after a key employee’s death.

KEY PERSON LIFE INSURANCE

SUMMARY

What Is Key Person Life Insurance?

Key person life insurance is designed to protect a business against potential financial loss caused by the death of an employee who is critical to the success and profitability of the business. The business is the owner and beneficiary of the policy.

Who Is a Key Employee?

A key employee is anyone who contributes significantly to the financial success of the business. A key employee (who may or may not be an owner) is anyone who is responsible for management decisions, is highly paid, has a significant impact on sales, or has a special rapport with customers or creditors.

Why Is Key Employee Life Insurance Needed?

A business can suffer from a key employee's death in a number of specific ways. One is the loss of the person's management skill and experience, especially in a business with little management depth. Another is the disruption of business when clients withhold or delay business dealings until the impact of the employee's death becomes known. Credit difficulties can arise, since creditors often remain cautious until they can assess how the key person's death will affect the business. Finally, increased expenses inevitably accompany the hiring and training of a key employee's replacement.

How Does It Work?

The business notifies the employee that it will purchase a specified amount of life insurance on the employee's life, and the key person consents in writing. The business applies for and is the owner and beneficiary of the life insurance policy. If the insured employee dies, the business receives the policy proceeds. Premiums are not deductible, and death proceeds are usually not subject to federal income tax.

Because the business holds all incidents of ownership in the policy, the death proceeds are not included in the insured employee's estate for federal estate tax purposes unless the employee is a sole or controlling shareholder. In this situation, a corporation's incidents of ownership are attributed to the shareholder-employee.

What Are the Benefits?

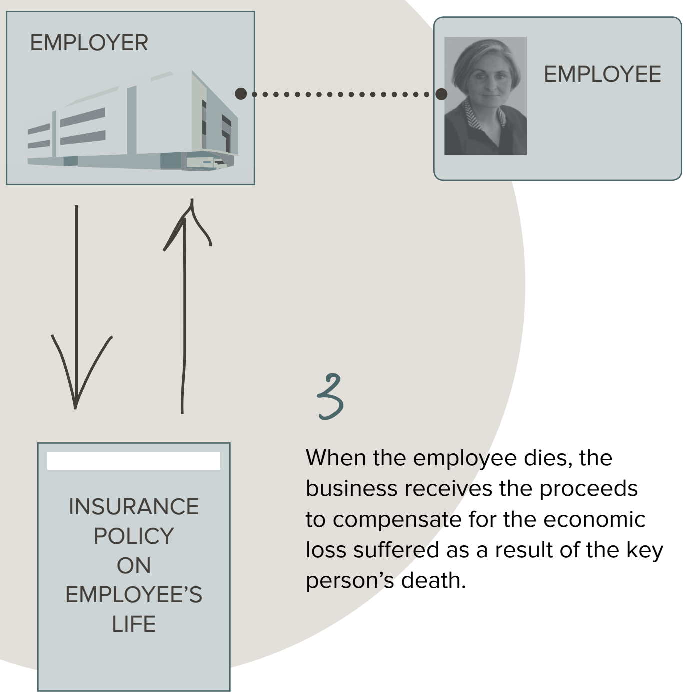
Key person life insurance serves a number of uses benefiting a business, both during the key employee's life and after the employee's death. Death proceeds are generally exempt from federal income tax when the notice and consent requirements have been met.

If the insured employee doesn't die while employed, the policy's cash value is available to the business. Key person life insurance demonstrates financial stability to creditors. If the key employee is an owner of the business, the policy can help fund a buy-out of a business interest when death occurs. If the employee lives, the policy's cash value can be used to provide employee compensation.

KEY PERSON LIFE INSURANCE

1

The employer identifies a key employee whose death would result in financial loss to the business. The business gives notice that it intends to insure the employee's life and obtains the employee's written consent.



2

The employer applies for, owns and is the beneficiary of insurance on the key employee's life. The premiums are not deductible by the employer.

3

When the employee dies, the business receives the proceeds to compensate for the economic loss suffered as a result of the key person's death.

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