KEY PERSON

OVERVIEW

For many business owner clients, the viability of their business depends on a select few key individuals with critical skills, knowledge, creativity, or experience that would be difficult to replace. Key employees possess unique managerial skills and experience which help the company to be successful. They may also have relationships with clients that help generate a large portion of the company’s revenue. The death of a key person could mean the death of the business itself. If such a person were to die, the business might suffer:

- Disruptions in management
- Delayed product launches or production
- Impaired supplier or customer relations
- Loss of earnings and customers
- Unexpected costs in recruiting, hiring and training a replacement
- Loss of position in the marketplace
- Weakened credit standing
- Adverse effects on the financial stability or value of the business
- Disruption of business when clients withhold or delay purchases until the impact of the employee’s death becomes known.

When Considering What To Do...

- To protect your business if you or another key person were no longer there to help keep the business running, the question is
- "Without such a program, what impact would the loss of that person have on your business, including earnings, client retention, market position, bank-extended loans and credit lines?"

While it is certain that the death of a key person will result in a financial loss to your business, the amount of that loss is not certain. What is the financial value of your key people?

A Key Person Protection program offers the business death benefit protection to help keep the business afloat following an unexpected death. Key Person Insurance makes sense for protecting businesses in the future. Any person considered irreplaceable in the short term is a good candidate for key person insurance.

THE SITUATION

Several years ago, James expanded his business, CDC Construction, to attract more lucrative projects. He hired Sarah, an architect with a great local reputation. The move paid off—Sarah brought in new clients and landed projects that had a big impact on profits. She is now a key factor in CDC’s success. It would be difficult and expensive for James to replace her.

THE SOLUTION

James chose key person insurance to protect his business from financial loss if Sarah dies. James estimates the dollar value of Sarah’s contribution and the cost of replacing her, including:

- Lost profits
- Costs of recruiting and retaining a replacement
- Protecting the company's position in the marketplace

CDC then purchases life insurance on Sarah, giving her notice and receiving her consent, and pays the premiums. CDC is the owner and the beneficiary of the life insurance policy, which means that the policy cash value is an asset of CDC and that Sarah and her family have no interest in the policy. Now James has options to protect CDC’s future.

If Sarah dies, the business receives the policy death benefit tax free, ensuring the CDC will have working capital and funds to survive any financial loss and to recruit a successor. If Sarah stays until retirement, the life insurance case values can be used to:

- Provide cash flow
- Provide executive benefits to Sarah
- Cover expenses, including the cost of recruiting for Sarah’s replacement
The business gives notice to the key employee that insurance will be purchased on the employee’s life and receives consent from the employee.

- Insurance death proceeds are generally received income tax free [IRC Section 101(a)]. For employer-owned contracts issued after August 17, 2006, death proceeds will be subject to income tax. However, where specific employee notice and consent requirements are met and certain exceptions apply, death proceeds can be received income tax free [IRC Section 101(j)].

- The business purchases a life insurance policy on the key person’s life. The business is the owner, premium payer, and beneficiary on the policy. The premiums are not tax deductible.

- During the life of the key employee, a cash value policy can provide the business with a reserve that can be accessed through loans or withdrawals. Loans and withdrawals reduce cash values and death benefits, may affect any guarantee against policy lapse, and may have tax consequences. At the retirement or termination of the key employee’s employment, the business has the option of maintaining or surrendering the policy.

- When the key employee dies, the policy pays a death benefit to the business. The proceeds can be used to help recruit, hire, and train a successor or may be used to help meet financial obligations. If the key person insurance is on an owner, it may be used to fund the redemption of a deceased owner’s business interest.

Key person life insurance serves a number of uses benefiting a business both during the key employee’s life and after his or her death.

- Death proceeds are usually income tax-free to the business
- Indemnifies the business against the potential loss of profit and reduction in business value
- Provides cash required to attract, train, and compensate a qualified replacement
- Strengthens and protects the credit position of your business now and into the future
- Enhances confidence of investors
- Enhances confidence and security felt by employees about the company’s financial security
- Enables the business to purchase the insured’s ownership interest at death or retirement
- Provides funds to offset the loss in value if the business has to be liquidated
- Creates a policy case value that is reflected as an asset on the company’s balance sheet and is available for unexpected business emergencies and/or opportunities
- Provides policy cash values to fund executive benefit programs
  - Fund supplemental retirement income program for the insured
  - Fund salary continuation for a surviving spouse or employee’s heirs
  - Could help fund a buy-out of the deceased person’s business interest for key employees who are owners
- No IRS approval needed
THE CONSIDERATIONS

1. Premiums are not tax-deductible since the business is the policy owner and the beneficiary
2. Annual premium payments are not taxable to the insured employee(s)
3. Insurance death proceeds are generally received income tax-free [IRC §101(a)]
   - For employer-owned contracts issued after August 17, 2006, death proceeds will be subject to income tax
   - However, where specific employee notice and consent requirements are met, and certain exceptions apply, death proceeds can be received income tax-free [IRC §101(j)]
4. In an S corporation, limited liability company or partnership, death proceeds increases the basis of the owners
5. The inside buildup (in excess of the cost of insurance) is included in the AMT calculation
   - In a C corporation, death proceeds and annual cash value increases may be subject to alternative minimum tax (AMT)
   - Certain small corporations are exempt from AMT
6. The death proceeds increase the company’s net worth, but do not necessarily increase the value of the deceased owner’s interest for estate tax purposes where the proceeds represent his or her value to the company
   - Properly structured, the insurance has no tax impact on the key employee unless the employee is also one of the business owners
   - In this case, the value of the deceased owner’s stock or other business interest in his or her estate may be increased when the business receives the live insurance proceeds
7. If the proceeds are paid in installments, the interest portion of each installment is taxable to the business

SAMPLE DOCUMENT

A sample generic Acknowledgment and Consent to Employer-Owned Life Insurance form appears below. Please be aware that this form has not been adapted to the specific circumstances or objectives of an individual employer. We strongly urge you to consult with your attorney to understand the application of these rules to your situation prior to completing an employer-owned life insurance transaction.

A Sample Generic Form Applicable to Employer-Owned Life Insurance

Proposed Insured Name: _______________________________________________________________
Employer/Applicable Policyholder Name: _________________________________________________
Employer/Applicable Policyholder Address: _______________________________________________

Employee Acknowledgment and Consent

The employer/applicable policyholder has given me notice that it intends to purchase a life insurance policy or policies on my life.
I understand and consent to the following:
• I will be the insured under the policy(ies)
• The employer/applicable policyholder will own the policy
• The employer/applicable policyholder may, directly or indirectly, be a beneficiary of the policy(ies) and may receive proceeds payable on my death
• The employer/applicable policyholder, or its successors, may continue to be the owner and/or may be a beneficiary of the policy even after my employment terminates
• $_________ is the maximum face amount for which I may be insured by the employer/applicable policyholder at time of issue.

__________________________________  __________________
Signature of Proposed Insured    Date

Employee Status
At time of policy issue, the insured was (check one of the following):
____ Director of the business
____ 5% or greater owner
____ A highly compensated employee or individual with compensation of _________________

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