



Concept

- ◆ Key person life insurance helps reimburse a business for economic loss when a key employee dies.
- ◆ The insurance covers the life of an employee who is critical to the success and profitability of the business.
- ◆ Key employee life insurance is not a specific type of policy, but a way to use life insurance to offset a business risk..

Rationale

- ◆ A key employee is generally highly paid, responsible for management decisions, has a significant impact on sales, and has a special rapport with customers and creditors. A key employee may or may not be an owner.
- ◆ A business can suffer from a key employee's death through loss of the person's management skill and experience, disruption in sales or production, missed business opportunities, credit difficulties (such as inability to make payments or a creditor's reluctance to extend credit), and the increased expenses associated with hiring and training a replacement.

Process

- ◆ The business gives the employee notice that it intends to buy life insurance on the employee 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. The business estimates the employee's annual contribution to earnings, multiplies it by the number of years the employee would have worked, and discounts this earnings stream to its present value.

- ◆ Another method is the cost to replace experience method. Here, the business takes the amount of compensation paid to the key person reduced by the salary required to pay someone else to perform the key person's routine duties. The difference between the key person's compensation and the replacement person's salary is then multiplied by the number of years required to bring a replacement to the key employee's level of experience. Finally, the calculated replacement cost is added to any search and hiring costs for the replacement.

Tax picture

- ◆ Premiums are not tax-deductible since the business is the policy owner and beneficiary.
- ◆ Proceeds paid to the business are typically excluded from federal income tax if 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 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 life insurance proceeds.

Other advantages

- ◆ If the insured doesn't die while employed, the business can access the policy's cash value for other purposes.
- ◆ The policy can demonstrate financial stability to creditors, or 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, it can be used to provide deferred compensation funds or retirement income for the key employee.

Bottom line

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

Graphic: Key Person Life Insurance



1. The employer identifies a key employee whose death would result in financial loss to the business. The business gives the employee notice that it intends to buy insurance on the employee 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. If the employee dies, the insurance company pays the policy proceeds to the employer as the policy's beneficiary. These proceeds indemnify the company for the economic loss suffered as a result of the key person's death.



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