Key Person Insurance

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Key Person Insurance

1. Business purchases life insurance policy on key employee
2. Life insurance company issues policy covering key employee
3. At death of key employee, income-tax free death benefit paid to business

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The advantages of this strategy

• Life insurance lets you reduce, or even eliminate, some of the risk your business may face following the death of a key employee.
• The costs, expenses, and potential loss of revenue resulting from the death of a key employee are no longer unexpected or unmanageable.
• Funds become available to hire and train a new employee.
• The plan is completely selective – cover only those employees you feel are most important to the ongoing success of your business.
• Life insurance benefits are received income-tax free by the business.
How does Key Person Insurance work?

• Insurance policy on the life of a key employee
• Owned by a corporation
• Death benefit is payable to the corporation
• Premiums are paid by the corporation
• Company cannot take a tax deduction for the premiums
• Employee has no personal interest in the value or benefits of the policy
Who are considered Key Persons?

• For small business owners and those in the early stages of business
  – Owner
  – Co-Owner

• As the business grows, others often evolve
  – Employees with considerable technical knowledge
  – Experienced professionals
  – Top sales producers
Benefits of key person insurance to the company

• Death benefit provides immediate source of cash to continue the operation of the business itself

• Can provide security for creditors during a period of change

• Helps in attracting and retaining employees – knowing there is a plan to continue the company if the owner dies prematurely
Impact on losing a Key Person

• Profitability, stability and progress of a business
  – Lenders may cut back credit
  – Creditors may press for immediate payment
  – Debtors may delay making payments
  – Employees and customers may lose confidence
  – Competitors may take advantage of the situation
Potential costs associated with losing a Key Person

- Costs of hiring, contracting and training an interim replacement
- Costs for searching, interviewing and ultimately training a permanent replacement
- Loss of productivity or revenue
- Reduction or retraction of lines of credit from suppliers or lenders
- Calls of business loans
- Increase in debt servicing charges
Determining the value of a key person

- Contribution to Profits method
- Replacement Cost method
- Multiple of Compensation method
## Business Protection/Key Person fact finder

### Key employee data

Please identify all key employees.

<table>
<thead>
<tr>
<th>Key employee</th>
<th>Key employee 2</th>
<th>Key employee 3</th>
<th>Key employee 4</th>
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</thead>
<tbody>
<tr>
<td>Name</td>
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<td>Title</td>
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<td>Gender</td>
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<td>Own (Yes or No)</td>
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<td>Date of birth</td>
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<td>Annual compensation</td>
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<tr>
<td>Number of years needed to hire and train replacement</td>
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<tr>
<td>Costs involved in marketing, hiring and training replacement</td>
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<tr>
<td>Estimated cost to replace key employee using replacement cost method after 5, 10, 15 Years</td>
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</table>
What type of product to use?

- Term
- Whole Life
- Universal Life
Illustrated Presentation

Protecting Your Business

When the financial soundness of your business is threatened by the death of a key person.

There is a financial tool that can help protect your business against the loss of a key employee.

- Permanent Life Insurance
  - Income-tax free death benefit
  - Tax-deferred cash value

How it works:
- Determine the financial impact the loss of a key employee will have on your business.
- At the death of the key employee your company receives an income-tax free death benefit that can be used to cover business costs while searching for and hiring a successor.
- Your company also has access to tax-deferred policy values that can be:
  - Used to meet business cash needs or
  - Seen as a form of loan protection for creditors or as collateral for securing future loans.

Life Insurance – helping protect your business against the unexpected death of a key employee

Employer
Annual Outlay
$3,553

Assumes Client’s Death At Age 65
$425,000
Death Benefit

OR

In Year 23
$103,099
Projected Cash Value

- Recruit and hire replacement
- Keep credit lines open
- Use for business cash needs
- Supplement key employee retirement
- Replace lost profits
- Collateral for securing future loans

A strategy to help:
- Reduce the risk your business will face following the death of a key employee.
- Cover costs, expenses and potential loss of revenue.
- Provide funds to recruit, hire and train a new employee.

Protect your business today against the future loss of a key employee

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Executive Bonus Plans
Section 162 Plans
Benefiting the key employee

• Key Person Insurance protects the company

• What if the company wants to provide an additional benefit to a key employee?

• There are lots of options
Ways to benefit a key employee

• Qualified Plans
  – Defined Contribution Plans
  – Defined Benefit Plans

• Non-Qualified Plans
  – 162 / Executive Bonus Plans
  – Split Dollar Plans
  – Section 79 Plans
  – Deferred Compensation / Salary Continuation Plans
  – ESOP
What is an Executive Bonus Plan?

• A plan that allows an employer to provide personally owned life insurance as a tax deductible fringe benefit for owners and select key employees.
Why the Executive Bonus Plan?

• Easy to explain
• Easy to establish
• Allows for discrimination
• Does not need IRS approval
• Benefits can be individually customized
• Appropriate for all business forms
  – Exception is a business owner of an S corporation, partnership or LLC.
Executive Bonus

Business pays tax-deductible bonus to the key employee.

Bonus

Key employee pays tax on bonus

Key employee uses bonus as life insurance premium, and buys a policy on his/her life; employee has full ownership rights, including access to policy cash values.

Cash Value

Life insurance company pays tax free benefits to employee’s beneficiary at death.

Death Benefit

Beneficiary
Benefits to the company

• Assists with recruiting, retaining and rewarding key employees
• Can be implemented with a qualified plan in place or used on its own
• Allows maximum flexibility in plan design
• Terms of the plan can remain confidential
• Can change, suspend or discontinue plan without penalty tax
• Bonus amount is tax-deductible
  – As long as total compensation is “reasonable”
• Restrictive endorsement can limit employees’ access to cash values

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Benefits to the Employee

• If the employer grosses up the bonus, additional benefit does not reduce current income

• Portable

• Employee gets to name the beneficiary

• Policy cash value grows income tax-deferred

• Employee has access to the cash values
  – Subject to any restrictive endorsements

• Cash value may be used to supplement retirement income*

* Policy loans and withdrawals reduce the policy’s cash value and death benefit and may result in a taxable event
Are there any disadvantages?

• To the employer:
  – Does not provide key person protection
  – No requirement for the employee to stay
  – No cost recovery for employer
  – Employer has no access to cash value
  – Executive may not use the policy for its intended use

• To the employee:
  – They may have to pay income tax on the bonus amount
  – Death benefit may be included in their taxable estate
How to move forward with a plan

1. Employer determines who will be covered under the plan and draft a corporate resolution stating the requirements
2. Add any restrictive endorsements (optional)
3. Company pays a tax deductible bonus to the employee
4. Employee purchases a life insurance policy with the bonused dollars
5. At retirement, employee can access policy values to supplement retirement income*
6. At death, the life insurance policy pays an income-tax free benefit to employee’s beneficiary

* Policy loans and withdrawals reduce the policy’s cash value and death benefit and may result in a taxable event