GODWIN INSURANCE BROKERAGE

Key Person Life Insurance Protects Your Small Business

A small retail business in my community recently shuttered its doors when one of the partners was unexpectedly killed in an automobile accident. Even though the 25-year-old company had survived numerous economic recessions and changes in healthcare regulation, when the owner passed, the bank required the payment of the company's outstanding bank debt, and the company was forced to dissolve.

Hundreds of businesses are affected every day by the unexpected death or disability of a key employee, manager, or owner. In the best cases, the business has prepared for the event and the consequences are not catastrophic. However, for most companies, the loss of a key stakeholder has a devastating effect and can result in layoffs, bankruptcy, or even complete failure. Fortunately, such outcomes can be avoided by the prudent purchase of insurance on "key" members of the business enterprise.

What Is Key Person Insurance?

Everyone faces the possibility of unexpected death or disability. The consequences, however, can radiate beyond immediate family to the business community where the victim lived and worked. The loss of a person can dramatically affect coworkers, customers, vendors, lenders, and business owners, emotionally and financially. The purchase of insurance, in the event of a death or long-term disability, provides cash funds to replace or offset the loss of the victim's earnings until adjustments can be made. Transferring financial risk to others by purchasing insurance is one of the most effective and popular risk management techniques.

Simply defined, key person insurance (or key man insurance) is life or disability insurance purchased to indemnify a company for potential losses arising from the death or extended disability of an indispensable person in the operation of the business. That person may be an employee who possesses unique skills or contacts necessary to run the business, an executive responsible for the day-to-day business operations, or a partner critical to the business's financing. In short, it can be any person essential to a business's success and continuity.

The intent of the insurance is not to provide an extraordinary profit to the insurance owner, but to replace the income that the insured would have brought to the company had their death or disability not occurred.

Who Should Be Considered for Key Person Coverage?

Generally speaking, a business can purchase insurance on any person for whom it has an "insurable interest" at the time the policy is issued. This can be as simple as any relationship in which a policy holder would be financially harmed in the event of the death or disability of the insured.

Examples of businesses or people who might have an insurable interest in another person include:

- An employer and his or her employees
- Business partners or co-guarantors of business obligations
- A bank or lending institution and debtors
- Customers and the makers/providers of a critical product or service
- Vendors and their significant customers

The "key person" must consent and cooperate in obtaining the insurance, although coverage may be required as a matter of employment. Under current IRS rules, the company must notify the employee in writing and obtain the employee's written consent before a life insurance policy is issued, and must also report all corporate-owned life insurance policies to the IRS annually to avoid taxation of the death benefit, or policy proceeds.

Why Do You Need to Purchase Key Person Insurance?

There are major reasons to purchase life or disability insurance on a significant contributor to your company include the following:

1. Maintaining Adequate Revenues
When the missing person is a substantial contributor to the sales and/or cash flow of a business, key person insurance will help ensure that sufficient funds are available until revenues can be replaced. Creditors and employees, even though sympathetic to the problems faced by a company with an unexpected key person loss, cannot usually afford to forgo payment or salaries during the replacement process. Insurance can provide the critical funds until revenues are restored.

2. Funding Recruitment and Training of a Replacement
Finding, hiring, and training a key employee is time-consuming and expensive in the best of times. When the unexpected loss includes lost revenues, production delays and problems, or customer service problems, tensions can rise across the board and the importance of finding the right person who can quickly and smoothly assume the duties of the missing person is even more critical.

3. Protecting Assets and Repaying Debts
Companies often have mortgages on real estate, obligations on facilities and equipment, and short-term financing arrangements that are required to operate the business on a day-to-day basis. The deceased or disabled person is often a key member of management who is responsible for continued sales, production, or financial management, all of which will concern any creditor or lender to the business. Key person insurance demonstrates management foresight and a continued ability to meet contractual obligations in the event of a tragic event; this provides lenders the peace of mind not to collect the entire balance due.

4. Ensuring Cash Flow
Companies in industries such as mortgage and finance depend on a continuous source of short-term loans and financing for revenues. A hiccup in the flow of funds – an inevitable consequence if the key person is essential in the lending relationship – can result in lost market share, declining sales, and unexpected losses. Proceeds from insurance can span the gulf between the loss of the key person and his or her successful replacement.

5. Protecting Existing Equity Owners
Often, the insured individual is also an owner of the business whose family will inherit his or her business interests. Insurance owned by the corporation can provide the necessary funds to pay business obligations to the family or purchase their interests in the event of death or disability to the insured. Without insurance proceeds, the remaining owners may be forced to either liquidate the business or replace funds used to meet the obligations.

6. Supplementing Executive Compensation
Recruiting and retaining experienced executives and critical technological employees is very competitive. Providing an additional death benefit or supplementary retirement funds through corporate-owned insurance can give a company a strategic personnel advantage. For example, limiting the possibility of loans or withdrawal of cash surrender values until retirement can induce an employee to remain with a company despite recruitment efforts by competitors.

7. Meeting Lender Requirements
Banks and lending institutions often require owners to maintain a sufficient amount of insurance to cover their obligations. For example, the Small Business Administration requires all borrowers of SBA-guaranteed loans to acquire life insurance “if the viability of the business is tied to an individual or individuals.”

What Types of Insurance Issued?

- **Long-Term Disability Policies**. The odds of a key employee becoming disabled are significantly greater than the likelihood of death. However, in either instance the company could suffer the same financial consequences with the person's absence. Disability insurance on key employees is available, up to $50,000 monthly, with custom underwriting and design. Companies interested in key person disability should contact a disability insurance specialist to acquire a policy that meets their requirements.
- **Term Life Insurance**. Most companies use term insurance – a death benefit with no accumulating cash value – due to its lower cost and shorter term, thus limiting costs in the event the employee retires or leaves the company.
- **Cash Value Life Insurance**. Some companies use cash value life insurance for key persons who are also owners of the company as a combination of protection in the event of the person's death, as well as a source of the funds (the accumulating cash value in the policy) to acquire the retiring person's equity or settle debts that might be owed to him or her. Companies considering key person cash value insurance should work with a competent tax attorney to avoid unanticipated taxes.

Tax Treatment

The taxation of premiums and proceeds from insurance policies is complex and depends upon the relationship between the insured, the owner or purchaser of the policy, and the beneficiaries, as well as the reasons for the purchase, conditions surrounding the purchase, and the relationship of the insured to the company. The following comments are intended solely for general information and should not be relied upon in the absence of competent advice from a tax professional.

General Rule of Thumb

If insurance premiums are paid with after-tax dollars, insurance proceeds are non-taxable. Conversely, if premiums are deducted prior to taxation, the difference between the total premiums paid and the net proceeds are taxable. In other words, you cannot have your cake and eat it too. If you decide to deduct the premiums (and can meet the conditions for deductibility), consider the impact upon the proceeds you will ultimately receive. In other words, paying taxes on the proceeds may require a greater initial face amount of insurance to meet your business needs.

Generally, premiums paid for the policy are not deductible. However, in certain instances, premiums paid for a key person insurance policy are tax-deductible if certain IRS Requirements are met and the proceeds are used for one of the following:

- To compensate for the loss of profits and revenues of your company
- To hire and train the person who will replace the deceased or disabled employee
- To pay the costs of a temporary replacement until a permanent hire is made
- To pay any debts incurred by the company due to the loss of the key person

Key Person Insurance Is Not an Executive Bonus Plan

Key person insurance is often confused with executive bonus plans where businesses purchase insurance on the lives of key employees as a corporate benefit for the employees. Under Internal Revenue Code 162, employers can purchase life insurance on the lives of employees and deduct the premiums, subsequently or simultaneously transferring ownership of the policy to the employee.

Unlike key person insurance, the *employee* owns the policy, names the beneficiaries, and has all the rights of the policy, including any cash surrender values. The employer has no right to the cash value or the death benefit. Premiums are deductible for the employer and included in the employee's annual W-2 compensation as taxable income.

Final Word

Owning a business is risky. Fickle customers and uncertain suppliers, as well as complicated products and services, are present in every business venture and occupy the bulk of most owners' and managers' attention. As a result, many business owners overlook the value and contribution of key employees and the devastating effects that may arise if they were suddenly gone. However, the financial consequences of losing a key person to unexpected death or disability is a cost that can be mitigated by the purchase of key person insurance.

Are you a business owner or key employee? Does the company or your employer maintain life or disability insurance on you?

