Key Person Life Insurance

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 business is a C corporation, proceeds it receives as the beneficiary could be subject to the corporate alternative minimum tax (AMT).
- The inside buildup (in excess of the cost of insurance) is included in the AMT calculation.
- 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.

What is key person life insurance?

Key person life insurance covers the life of an employee who is critical to the success and profitability of a business. The policy is purchased by the business, which is also the beneficiary, to help reimburse the business for economic loss when a key employee dies.

Who is a key employee?

A key employee is one who contributes significantly to the financial success of the business. The employee—who may or may not be one of the owners—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 it needed?

Businesses can suffer from a key employee's death in specific ways. One is the loss of the person's management skill and experience, especially in a business that doesn't have a lot of management depth. Another is the disruption of business when clients withhold or delay their business until the impact of the employee's death becomes known. Also, credit difficulties often arise, with creditors exercising caution until they can assess how the key person's death affects the business. Finally, the business typically experiences increased expenses associated with hiring and training a key employee's replacement.

How does it work?

The business gives the employee notice that it intends to buy insurance on the employee and obtains the employee's written consent. The business applies for and is the owner and beneficiary of a life insurance policy covering the key employee. If the insured employee dies, the business receives the policy proceeds. Premiums aren't deductible, but death proceeds are generally federal income tax-free to the business if the policy is structured correctly.

Because the business holds all incidents of ownership in the policy, the death proceeds aren't includible in the insured employee's gross 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.

The two basic ways to determine the amount of key employee insurance are the contribution to earnings method and the cost to replace experience method. The first uses a formula based on the loss of earnings that would result from the death. The second uses a formula based on the employee's compensation and the number of years required to develop a replacement's skill levels.

What are the benefits?

Death proceeds are generally exempt from federal income tax if the notice and consent requirements have been met. However, C corporations may be subject to the corporate alternative minimum tax on part of the death proceeds. If the insured employee doesn't die while employed, the policy's cash value is available to the business. The policy typically demonstrates financial stability to creditors. If the key employee is an owner of the business, the policy can help fund a buy-out of his or her 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 demonstrably serves a number of uses benefiting a business—both during the key employee's life and after the employee's death.

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