Key Person

Businesses regularly insure their tangible, physical assets like buildings, machinery, and equipment, but often overlook their most important asset — their people. Every business, regardless of its size, has an individual or group of individuals who are fundamental to its success. Unexpected death, disability or illness sustained by of one of these "key" people can threaten the success of the company. Key person insurance insures the business against the financial impact should a key employee no longer be able to contribute.

WHO IS A KEY PERSON?

A key person is anyone in a business whose loss would significantly impact the company. This person can be either a business owner or a non-owner employee. Employees who are "key" to the success of a business include individuals with unique leadership ability and expertise; specialized technical or creative skills or knowledge; special connections, contacts or influence; or other qualities that set them apart.

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Some other factors to consider include:

Products and Innovation – Does this person have special knowledge about the company's operations and products? Are they engaged in important long-term projects?

Competition – Would a rival company have an advantage if this person were gone?

Customer Relations – Does this person have unique intra-personal skills and goodwill? Does this person have a proven track record of being critical to generating sales?

Ability to Obtain Financing – If this person is no longer with the company, would the business still be able to obtain financial backing? What will happen to existing business debts if this person dies unexpectedly?

State Law – State-specific laws and regulations may have special definitions for who qualifies as a key person for insurable interest purposes.

HOW DOES IT WORK?

The business owns, pays for, and is the beneficiary of a life insurance policy on the life of the key employee. The business can use the income tax-free death benefit to replace lost profits, recruit and/or retain qualified replacements, or protect the company's credit position. In a traditional key person design, the employee typically has no interest in the policy, nor does his or her family typically receive any benefits from the policy when death occurs.

HOW IS THE VALUE OF A KEY EMPLOYEE DETERMINED?

There is no set formula to precisely determine the value of a key employee. Rather, several factors should be considered to approximate a key person's worth to a company. The approach taken by most carriers' underwriters is to look at multiple times – usually five to ten – a key employee's total compensation to determine what may be an appropriate amount of coverage. Compensation can include salary, bonuses, commissions and other types of employee benefits such as stock options and deferred compensation, if regular and repeating. If the insured has an ownership stake in the business, that should also be taken into consideration. Increased coverage may also be justified based on a percentage of debt that has been personally guaranteed by the key employee.

BENEFITS TO THE BUSINESS

At the death of the insured, key person insurance provides an infusion of cash to keep the business operating smoothly by addressing any business ramifications:

- Protecting goodwill or replacing lost profits
- Covering the expense of finding and training a suitable replacement
- Assuring creditors of a smooth transition
- Assuring customers that the business will to continue to operate as usual

During the lifetime of the insured, key person insurance provides options, as well:

- An asset that can be used for unexpected business expenses via policy cash value
- At the retirement of the insured, the company has the option to either:
  - Retain the policy for business purposes such as a buy/sell or to provide the employee with supplemental retirement income or as an informal funding vehicle for a nonqualified deferred compensation plan
  - Transfer the policy to the employee as a reward – via a bonus – for their services

CONSIDERATIONS

- Life insurance premiums paid by the business are not deductible.
- The business will be the owner of the life insurance policy and the insured typically will not have any personal rights to the policy cash value or death benefit unless those rights are agreed to separately.
- If the policy is transferred to the key employee in the future, then the transfer to the insured is an exception to the transfer-for-value rule under §101(a)(2).
- When life insurance is owned by an employer on the life of an employee, §101(j) requires that certain conditions and notice and consent requirements be met to keep the death benefit proceeds income tax- free.*

Employer-owned life insurance must comply with the requirements of §101(j), including notice and consent requirements, prior to the issuance of the policy.

THE BOTTOM LINE

A key person life insurance strategy is an important way for a business to protect itself against the loss or extended absence of key employees. This type of plan is easy to set up and simple to administer and should be considered by any business whose day-to-day operations and long-term success would be jeopardized if something happened to one of its key employees.

*IRC §101(j) subjects death benefits on employer-owned life insurance (EOLI) policies to income taxation to the extent they exceed the employer's basis in the policy, unless (1) a valid exception applies and (2) notice and consent requirements are satisfied. Prior to the issuance of the policy, the employer must notify the employee/proposed insured of the following: that the employer intends to insure his life; the maximum amount for which he or she could be insured; and that the employer will be the beneficiary of the death proceeds. Thereafter, the employee must provide written consent to being insured.

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