KEY PERSON

Have you thought about what you would do if you lost a key employee in your business?

CLIENT PROFILE
Any successful business should consider key person protection. However, look to businesses with any of these characteristics:
> Strong entrepreneurial owners
> Key sales personnel or managers
> Skilled professionals
> Specialty products or services

OVERVIEW
For many business owners, the viability of their business depends on a select few individuals. They may be the owners of the business, or they may be employees with critical technical ability, unique client and sales skills, or a specialized practice. If such a person were to die, the business might suffer:
> Disruptions in management
> Delayed product launches
> Loss of earnings and customers
> Credit issues

Replacing a key person will take time. Whether the vacancy is filled with an existing employee or a new hire, the business must locate, recruit and groom a replacement to fill the gap. Following an unexpected death, a key person protection program offers a death benefit to help keep the business afloat.

THERE ARE MANY APPROACHES TO VALUING A KEY PERSON. THESE CAN RANGE FROM:
> Multiple of salary
> Loss of value to the business
> Cost to replace the key person’s sales profits
> Cost to replace the key person’s contributions to income
HOW DOES IT WORK
1. The business applies for a life insurance policy insuring the key employee.
2. The business is the owner and designated beneficiary of the policy.
3. The business pays the premium directly to the insurance company.
   Premium payments are generally not tax deductible to the business.
4. Upon the death of the employee, the insurance company pays the
   policy death benefit proceeds to the business. Life insurance proceeds are
   generally not subject to income tax (though, larger corporations subject
   to alternative minimum tax (AMT) may realize some additional AMT).*
5. Optionally, the business can give a portion of the proceeds to the
   employee’s beneficiary and/or use cash values to fund a non-qualified
   retirement plan.

EXAMPLE
Cogswell Cogs was a successful manufacturing firm. It had a long-term track
record, loyal clients and widely regarded products. Cogswell was dependent
on a key sales representative, Paul, who worked at Cogswell for nearly 10
years and had a successful record.

Paul passed away. He had recently signed on one of the company’s largest
accounts. The relationship was still new when Paul died and Cogswell was
concerned it would be soon lost. Paul also worked with two additional
accounts that brought in 15 percent of the company’s revenue.

Cogswell held a $1 million key person policy on Paul’s life. The death benefit
from that policy provided Cogswell with the funds it needed at a critical
time, helping tide over and expand the business.
BENEFITS FOR THE EMPLOYER

COST OF REPLACEMENT
>$125,000 was used to recruit, offer a sign-on bonus and relocate a new sales rep, Jeff, who was highly regarded by both the new account and one of Paul’s existing accounts. This allowed Cogswell to maintain its critical relationships.
>$50,000 was allocated to special training and marketing to help Jeff get up to speed more quickly than the average new recruit.

LINE OF CREDIT
>$200,000 was posted as collateral to help keep a creditor from raising the interest on a credit line.

RETENTION DEVICE
>$250,000 was paid to Paul’s widow. If Paul had survived to retirement, the policy values could have been used to fund a non-qualified retirement benefit. Since Paul passed away, a death benefit was paid for his years of service.

BENEFITS FOR THE EMPLOYEE

BONUS
>$250,000 was paid to Paul’s widow as a special bonus for his years of service.

* For federal income tax purposes, life insurance death benefits generally pay income tax free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the “transfer-for-value rule”); arrangements that lack an insurable interest based on state law; and an employerowned policy unless the policy qualifies for an exception under IRC Sec. 101(j).
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