

# Key Employee Life Insurance

## *What Is Key Employee Life Insurance?*

Nearly every business has key employees who are critical to the overall success and profitability of the business. Key employee life insurance is insurance on the life of a key employee, purchased to reimburse an employer for the economic loss caused by the death of the employee. As such, key employee life insurance is not a specific type of life insurance policy; rather, it is an effective way for a business entity to use life insurance.

## *Typical Key Employees*

A key employee is anyone in whom the business is deemed to have an insurable interest, usually based upon a substantial impact on the financial success of a business. Smaller companies tend to have a greater need for key employee insurance since they do not have a pool of employees from which to select a replacement if a key employee dies. Further, the success of a smaller business can be directly attributed to the vital contributions of a few individuals. In general, a key employee can be anyone who--

- is responsible for management decisions,
- is highly paid,
- has a significant impact on sales, or
- has a special rapport with customers and creditors.

## *The Purpose of Key Employee Life Insurance*

The purpose of key employee insurance is to help protect a business from economic losses that can occur when a key employee dies.

### Losses from a Key Employee's Death

A business can typically suffer in four ways if a key employee dies:

1. The death may cause a loss of management skill and experience. This can be particularly devastating for companies without management depth.
2. There may be a disruption in sales or business production. When a key employee's talents are vital to these areas, the business is certain to suffer. And if clients recognize the key employee as vital to the business operations, they may delay orders or refrain from doing business until they find out how the organization will respond to this loss.
3. The business may experience credit difficulties. A drop in business income may make it more difficult to make credit payments. In addition, creditors may hesitate to extend loans or favorable credit terms to a business that has lost a key employee, particularly if that employee's talents or resources were factors that encouraged the creditor to extend loans or special terms in the past.
4. Losses also surface from expenses associated with hiring and training a replacement for the key employee. Even if the company can promote from within, business losses may continue to accrue until the replacement becomes thoroughly familiar with the job.

## ***Advantages of Key Employee Life Insurance***

It is clear that there are serious financial consequences when a key employee dies. Here are the advantages businesses enjoy when key employee life insurance is in place:

1. The employer receives needed funds which can be used to help meet financial obligations and train a replacement if the key employee dies.
2. Death proceeds are exempt from the regular income tax, but may be subject to the corporate alternative minimum tax.
3. While the policy is in force and the employee is alive, the cash value of a permanent policy is available for use in a variety of ways.\*

\*Withdrawals and loans will affect policy values and death benefits and may have tax consequences.

## ***How Key Employee Insurance Works***

Key employee life insurance is one of the simplest of the business life insurance programs to implement. The business applies for the policy on the life of a key employee. If the business is a corporation, the board of directors must adopt a resolution authorizing the purchase of the policy. The resolution should mention that the policy is being purchased to protect the corporation from loss it could suffer if the key employee died.

The employer applies for, owns and is the beneficiary of insurance on the key employee's life.

If the employee dies, policy proceeds are paid to the employer to use as it wishes.

The business pays all of the premiums and is the policyowner and beneficiary. All incidents of ownership should belong to the business. If the insured has any of these incidents of ownership, the policy proceeds will be included in his or her estate for federal estate tax purposes.

## ***Key Person Valuation***

There are two basic ways to determine the amount of key-person insurance:

- contribution to earnings
- cost to replace experience

### **Contribution to Earnings Method**

The employer estimates the loss of annual earnings that would be caused by the employee's death and then multiplies that annual loss by a certain number of years (limited by insurance company underwriting guidelines). This figure is then multiplied by the present value factor for \$1 per year, where the period is measured by the remaining working years, and a reasonable rate of interest is used to discount future earnings. [Click here for an example.](#)

### **Cost to Replace Experience Method**

The economic value of the key person is determined by subtracting from the key person's compensation the salary that would be required to pay someone else to perform the employee's routine duties. This difference is then multiplied by the number of years it will take to recruit, train, and bring a replacement up to the employee's level of experience. [Click here for an example.](#)

## **Funding Alternatives**

Key employee insurance, of course, utilizes a life insurance policy as a funding instrument. Some business owners may be tempted to consider funding alternatives. These alternatives, however, have their drawbacks as discussed following.

### ***A Regular Savings Fund***

A company can set aside funds on a periodic basis with the hope there will be enough money on hand if a key employee dies unexpectedly. The drawbacks to such a plan:

1. current obligations may require the business to use the funds rather than set them aside
2. the funds can be easily withdrawn to deal with a more immediate problem
3. there is no guarantee the business will have enough time to develop a substantial and before a key employee dies.

### ***Periodic Investments***

As funding to cover losses incurred as a result of the death of a key employee, making periodic investments has the same drawbacks as a regular savings fund. More than this, there is no guarantee the value of the investment fund will not fall at the very time the business has the greatest need for cash.

### ***Life Insurance--The Preferred Funding Instrument***

Life insurance is generally the preferred funding instrument to cover losses incurred as a result of the death of a key employee because--subject to the continued claims-paying ability of the insurer--it can guarantee a specific amount of money precisely when the money is most needed. While term insurance may be used, cash value life insurance is usually preferred because it can provide additional benefits for the business.

## **Tax Aspects for Employer**

### **Premiums**

Section 264 of the Internal Revenue Code states that there is no deduction for premiums paid by a taxpayer on any insurance policy, or endowment or annuity contract (other than annuity contracts used to fund specified retirement vehicles or held by persons who are not natural persons) when the taxpayer is directly or indirectly a beneficiary under the policy. When a business is the beneficiary under a key employee policy (which is most often the case), the premiums are not tax-deductible.

### **Policy Loans**

Interest paid or accrued by a business after October 13, 1995, on loans against policies that cover employees of a business, or persons financially interested in the business, is nondeductible. A limited exception is available for key-person policies. For this purpose, key persons are defined as officers and 20%-or-greater owners. However, the number of key persons covered by this exemption cannot exceed the greater of--

- five persons, or
- the lesser of 5% of total officers and employees, or 20 individuals.

For such key persons the deduction for policy loan interest is allowed but only to the extent that--

the total policy indebtedness for any key person does not exceed \$50,000, and interest paid or accrued for a month does not exceed the Moody's Corporate Bond Yield--Monthly Average Corporates rate for that month.

### **Inside Buildup**

The increase in cash value of a life insurance contract is generally exempt from the federal income tax, even for corporations (not so in the case of annuity contracts!). However, the corporate alternative minimum tax may reach the increase in cash value of the policy for a particular tax year. This increase is added to "adjusted current earnings" for the year, and is one of the many factors which determine whether the corporation will be subject to the alternative minimum tax.

### **Death Proceeds**

While premiums are not tax-deductible, death proceeds from the policy are generally exempt from the federal income tax. If these proceeds are received in installments rather than as a lump sum, the part of each installment that represents interest is, however, taxable as income.

It should also be noted that proceeds received by a corporation may be subject to the corporate alternative minimum tax if the corporation is subject to this tax. There are many other factors which affect whether a C corporation will ultimately be subject to the alternative minimum tax.

[Click here to refresh your memory of the corporate alternative minimum tax, especially as it applies to life insurance policies. \(Then click on the "Back" button above to return here if you wish.\)](#)

If the proceeds are income tax-free, this can have a dramatic effect on a business. [Click here for an example.](#)

### **Distributions of Proceeds by the Company**

Although the proceeds of a key employee insurance policy are usually exempt from the federal income tax (but perhaps not the corporate alternative minimum tax), they lose their exempt character if distributed to some third party. The tax consequences may vary depending on what kind of distribution is made and to whom. For example, if the proceeds are later distributed by a corporation as dividends to its shareholders, the dividends will usually be taxable as ordinary income to the shareholders.

### **Policy Surrender**

There may be a good reason to surrender a policy while the key employee is still alive; for example, perhaps the employee is no longer "key" because he or she left the company. In such a case, the business will have a taxable gain to the extent the surrender proceeds exceed the net premium paid. (Net premium equals gross premium minus dividends, withdrawals, and loans.) Nonetheless, if the net premium paid exceeds the surrender proceeds, the loss is not tax-deductible by the business.

### **Tax Effect on the Employee**

In a properly structured key employee insurance arrangement, all incidents of ownership are in the business. This means that premiums paid for the policy are not taxable as income to the employee.

Further, the proceeds paid at the employee's death are not included in the employee's

estate for estate tax purposes. Keep in mind, however, that if the employee has any incidents of ownership--such as the right to change the beneficiary or obtain a policy loan--the proceeds become a part of his or her gross estate.

If the deceased employee was also an owner of the business, the proceeds paid to the company may increase the value of the deceased owner's business interest. This value, of course, is included in the insured's estate. On the other hand, even after the proceeds become a business asset, the loss of the key employee's services may cause the total value of the business to be less than it was before the key employee's death.

### ***Other Uses of Key Employee Insurance***

The major value of key employee insurance is, of course, when the key employee dies. But when a cash-value life insurance policy is used, both the employer and employee can benefit in additional ways.

#### **For the Employer**

The increasing cash and loan values of the policy can provide the business with a source of funds which are available regardless of the general credit conditions in the economy. While there are good reasons not to disturb the cash value of the policy, the funds are there if and when they are needed, and the business can borrow at the rate specified in the policy; however, the policy values and the death benefit will be reduced by outstanding loans and interest. There may also be tax consequences.

Another use of key employee insurance is in the credit area. A key employee life insurance can be used to show that the business is on sound financial footing. Creditors may be more apt to extend credit if the business has protected itself against losses that might occur at a key employee's death. Further, the policy can serve as collateral for a loan. If the key employee is also an owner, the key employee policy can also be used to help fund a buy-out of the deceased's business interest or a partial redemption under Section 303. The business (or the surviving owners, depending on how the business and the buy-sell agreement are arranged) can use the policy proceeds to purchase all or a portion (Section 303) of the deceased key employee's share of the business.

#### **For the Employee**

Key employee life insurance can also be used to help provide funds for a deferred compensation agreement. If the employee dies before retirement, proceeds can be used to pay any income due the key employee's family. And if the key employee lives to retirement, policy cash values can be used to help provide supplemental retirement income.

#### **Keying in on Key Employees**

Key employee life insurance is one of those rare sales concepts that is both compelling and simple. A policy written on the life of a key employee can benefit the business, the employee, and even the employee's family. Look for key employees in both small and midsize businesses, and be prepared to illustrate this exciting way to put life insurance to work for the business.

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