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# Life Insurance Coverage on a Key Employee





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## What is key employee life insurance?

### *Insurance coverage on certain employees or owners*

Key employee life insurance is coverage on the life of an employee who has special skills and makes a significant contribution to the business. Executives and certain managers may be considered key employees, as are certain shareholders who actively participate in the ongoing success of the business. This type of policy used to be referred to as key-man insurance, but the language has recently been modified.

### *Protects business from losses arising from death of key person*

The primary purpose for this type of life insurance is to protect the business against financial loss if a key person dies. Typically, the business owns the policy, pays the premiums, and is the beneficiary of the key employee life insurance policy. Since the business owns the life insurance covering the key person, it has control of the policy. Policy cash values and death benefits may be used by the business for any purpose. Policy loans may be taken by the business, or the policy may be surrendered.

Without life insurance coverage on a key employee, there may be serious losses to the business. Key employee policy proceeds are often used by a business to cover the following cash needs that can result after the death of a covered key employee:

- Expenses related to recruiting and training a new employee to take the place of a key employee
- Losses that may occur as a result of mistakes or delays when a less capable or inexperienced employee tries to fill the role of a key employee
- Business operating expenses
- Loans that may become due upon the death of the key person
- Customer and employee assurances that the business will still operate in spite of the loss of the key person

### *Death benefits not subject to federal income tax*

For contracts entered into before August 17, 2006, the general rules applicable to life insurance indicates that the death benefit is received income-tax free by the beneficiary. There are exceptions and situations where the death benefit, in fact, may be taxable as income. Consult with your tax advisor or financial professional for more information.

For life insurance contracts entered into after August 17, 2006, the death benefit on an employer-owned life insurance policy is not taxable to the employee if certain, specific requirements are met before the issuance of the policy. First, there must be proper notice and consent by the employee to be insured. Then, an exception must apply for the death benefit to be received income-tax free. One exception is that the insured is an employee of the policy owner-employer any time in the 12 month before death, or that the employee is either a more than 10 percent owner of the business, or highly compensated, or in the top 35 percent of all employees ranked by pay. Or the death benefit must be paid to qualifying members of the insured's family or a named beneficiary (other than the employer), or the proceeds must be used by the employer to buy the insured's interest in the business from qualifying family members of the employee.

Also, in the case of a C corporation, insurance proceeds may expose a company to or increase an existing liability to the alternative minimum tax (AMT) . When benefits are paid to the estate of the insured, they may be subject to estate tax.

## Valuing a key employee's worth

Putting a dollar value on a key employee's economic worth may be difficult. What would happen if the key employee died today? Would it be difficult to replace the key employee quickly because of special talents? How much specialized knowledge does the key person possess? These are just a few of the questions that need to be answered. While there are no particular rules or formulas that an employer may use to put a dollar value on a human life, there are several costs to consider and several possible methods to use in valuing the replacement of a key employee.

### *Key employee's worth in contribution to profits*



A concern for the business is how much a key employee is worth in terms of company profits. Even if not directly responsible for sales revenues, the employee may maintain a key customer account or be a key to the production or operations process. Assuming it can be determined how much a key employee contributes to profits each year, the employer could take that amount and multiply it by a factor. One possible multiple is the number of years or the measure of time it would take to recruit and train a replacement. Multiplying the time period by the profit level would yield an appropriate level of insurance coverage.

### **Key employee's current salary**

The employer could use a multiple of salary. Here, the employer determines how much life insurance is needed by multiplying the key employee's salary by the number of years it might take a newly hired employee to reach the same skill level. The rule of thumb is for the employer to use 3 to 10 times the key employee's salary. The employer may also want to periodically review and increase the multiple as the key employee's value (and salary) increases.

### **Cost of replacing the key employee**

There are replacement costs in terms of both time and money--if you recruit the replacement yourself, you are spending valuable time, and if you use a recruitment firm, there are hard dollar expenses in the form of recruiting fees. Attracting and hiring an equally qualified replacement may require a higher level of salary and fringe benefits than the key employee was receiving. In some cases, it may take more than one person to replace a key employee. The estimate for cost of replacement could be the policy death benefit used for the key person life insurance policy.

### **Key employee's excess salary**

Some key employees receive excess salary. Excess salary is that portion of the key employee's salary that is above what would be paid to a non-key employee who performs routine job duties. The excess amount is multiplied by the number of years it would take to recruit and train a replacement. That amount is then used as the death benefit amount of the life insurance bought by the employer to cover the key employee.

## **Key employee life insurance in a sole proprietorship**

Life insurance on a sole proprietor is technically not considered key employee life insurance. By definition, a sole proprietorship terminates when the owner dies. Any losses or financial obligations at the death of the sole proprietor become the responsibility of the estate, not the business. Life insurance coverage on the sole proprietor can be used to cover these financial responsibilities. Life insurance owned by a sole proprietor that covers the life of a key employee is called key employee life insurance.

## **Key employee life insurance in a partnership**

Who should own the life insurance policy insuring the key employee in a partnership? Let's assume that the key employee to be insured is also a partner in a firm with four partners. Each partner may want to own and pay for the key employee life insurance policy insuring the key employee.

**Example(s):** *If each partner owns and pays the premium for a life insurance policy insuring a key partner or employee, at the death of the insured, each partner would receive the proceeds of the policy. If the policy is owned and paid for by the partnership, then the partnership would receive the proceeds. Where the partnership is owner and beneficiary of the policy, the surviving partners can enjoy the benefits of the life insurance policy where a special allocation has been made, so long as there is economic substance to the allocation.*

## **Key employee life insurance in an S corporation**

There are immediate tax consequences when an S corporation buys life insurance on a key employee. There is no tax deduction because the corporation is the beneficiary of the life insurance policy. Because premiums are not deductible, the taxable income passing through to the shareholders is not reduced by the amount of the premium. If the corporation surrenders the life insurance policy, any gain would be taxed as ordinary income to the shareholders. The gain is the cash value paid to the corporation minus the net premiums paid.

## **Key employee life insurance in a C corporation**

Corporate-owned life insurance on a key employee can have multiple uses. It may be used to cover the loss (and subsequent



replacement) of a key employee who has special talents or makes significant contributions to the business. Adequate amounts of key employee life insurance should also be considered as part of a corporate risk-management program. Key employee life insurance can provide funds at the death of a key employee when the corporation is deciding whether the business is to be continued, sold or liquidated.

Typically, the corporation is the owner and beneficiary of the life insurance policy. The total amount of premiums paid is small compared to the amount of cash that may be needed at the death of a key employee, if loans must suddenly be repaid, for instance. Death proceeds in excess of replacement costs or other expenses may be used as a salary continuation plan for the survivors of the key employee or other corporate purposes. If the key employee does not die and lives to retirement, the policy's cash value may be used to fund a nonqualified deferred compensation plan .

## **Key employee life insurance in a limited liability company (LLC) or a limited liability partnership (LLP)**

Limited liability companies offer owners the limited liability of C corporations in conjunction with the tax and management advantages of partnerships. They are less restrictive than S corporations.

Key employee life insurance is probably one of the most important types of insurance a business should consider. If the key employee life insurance plan is established properly, the business may receive the financial resources needed for the success of the business. If there is no key employee life insurance plan in place, the business may not successfully recover from the loss of a key employee.

## **Key employee life insurance in a professional corporation (PC)**

Losses may be severe when the principal of a professional corporation (PC) dies. A professional corporation is dependent on the performance of the personal services of doctors, lawyers or other licensed professionals. Typically, at the death of a principal, income and profits decrease and expenses rise. The same situation can occur when the PC employs a key employee of the same licensed profession who has special talent and has made a significant contribution to the business.

When an insured key employee dies, the life insurance death proceeds are paid directly to the business. The money may be used to replace the key employee and continue the business. If the business is sold, the funds are available for legal expenses. If the business is liquidated, the proceeds can be used for any ensuing business and legal expenses. The death proceeds may be made available for the family members of the key employee to offset economic losses.

## **How is group carve-out used with key employees?**

Under a group carve-out plan an employer removes or carves out one or more highly compensated employees from the life insurance coverage provided by a group term life insurance policy. The carved-out employees are then provided life insurance coverage through individual policies. These policies may be bought through a split dollar arrangement , a death benefit only arrangement or an executive bonus plan. The appropriate owner and beneficiary for the policy will vary with the type of plan. Because the coverage is under an individual policy, these policies are portable--the employee may be able to assume ownership (and premium payment) of the policy if he or she leaves the company. Under a carve-out arrangement the business does not get a tax deduction for policy premiums paid. The premiums for group life insurance are tax deductible for the business.

## **Tax considerations and key employee life insurance**

The following is a list of tax considerations you should be aware of when considering key employee life insurance. You should consult your tax advisor to evaluate the tax implications of key employee life insurance in your specific situation.

- Premiums paid on key employee life insurance policies are not tax deductible.
- Premiums paid by the business on a policy it owns covering a key employee will not be taxed to the employee as long as he or she did not hold incidents of ownership in the policy. However, if the policy underlies a split dollar arrangement, the employee will be taxed on the value of the economic benefits provided by the policy (less any amount the employee has paid into the policy).
- If the business sells the key employee life insurance policy to the employee, the employer will realize a taxable gain if the cash surrender value of the life insurance policy is greater than its net premium costs.



- Death proceeds are generally not taxable to the beneficiary. A notable exception occurs when a C corporation is the beneficiary. Here, the death proceeds may increase the corporation's liability for the alternative minimum tax (AMT) .
- Policy proceeds received by a corporation that are later distributed to the shareholders may be considered taxable dividends to the shareholders.
- The cash value buildup in a policy owned by a C corporation (carried as an asset on the books) may increase the corporation's liability for the alternative minimum tax (AMT) .
- The transfer-for-value rule may apply when a business takes over an existing life insurance policy on a key employee instead of buying a new policy. Application of the transfer-for-value rule may subject the business to income tax on part or all of the insurance proceeds.
- Matured or surrendered policies are subject to taxation. Amounts in excess of the policy's cost basis are subject to taxation as ordinary income. If the business elects to receive the proceeds as annuity installments each payment will be partially taxable.
- Death proceeds payable to the business should not affect the estate taxes of a key employee who dies holding no ownership interest in the business.
- Estate, gift and generation-skipping transfer taxes may be affected for a key employee who dies while holding an ownership interest in the business. The receipt of the death benefit by the business tends to increase the value of the shares held by the estate. When properly structured, the proceeds received and the increase in the value of the stock should offset each other.
- Any death proceeds from a key employee life insurance policy that insures a partner in a partnership and is paid to a beneficiary other than the partnership may have to be included in the gross estate of the partner. The partner is considered to have incidents of ownership possessed by the partnership.

**Caution:** *This list is not all inclusive. For answers to specific questions regarding your situation, please consult additional resources or your insurance agent.*

## IMPORTANT DISCLOSURES

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