

**FREQUENTLY ASKED QUESTIONS:****BUSINESS CONTINUATION WITH KEY PERSON LIFE INSURANCE**

**When should a business and its owners consider buying insurance on its key employees? How is a key person's value to the business determined? What are the primary tax considerations?**

A key person can be either an owner or an employee. What distinguishes someone as a key person is that their death would severely impact the business until a replacement could be found and trained. Many businesses, especially those that are small or medium sized, depend on the skills and talents of one or more key individuals for their growth and continued success. In fact, some companies could not survive if a key employee suddenly died.

When the present and future of a business is dependent on the specialized skills, knowledge, or influence of a person or persons, the business should seriously consider acquiring insurance to help cover its potential loss at the death of such an employee. Such insurance coverage is usually referred to as key person life insurance.

Under most circumstances, the business should be the owner, premium payer, and beneficiary of the policy purchased on a key employee. The goal is to have an influx of cash at the death of a key person in order to help stabilize the business until a new comparable employee can be found, hired, and trained. Not only does key person coverage ensure that there will be cash available to help hire a replacement or to pay down loans, it also helps to instill confidence in employees and creditors that the business will continue. Employees will be less likely to leave, and lenders will be less likely to call in a loan.

**When should a business and its owners consider buying insurance on its key employees?**

The following are examples of common situations where a business should consider purchasing insurance on its key employees:

**The business needs to secure a loan.** Many banks and venture capital groups insist on key person insurance for one or more members of the management team when lending to a new business or venture. The lender may ask that it be named beneficiary on the life insurance policy. However, a better approach may be to have the business be the beneficiary with a collateral assignment of the death benefit to the lender.

That way, as the loan principal is reduced, the lender will get that portion of the death benefit equal to the debt with the balance going to the business. If the lender is named beneficiary of the entire amount, it may receive a death benefit larger than the current amount of debt owed to the lender.

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**The business is carrying a large debt load.** Even if the lender does not require life insurance on key executives in order for a business to obtain a loan, it may be wise for the business to consider insuring those key executives. That way, if one of the key executives dies, all or a portion of the loan can be paid off at the death of the executive.

**An individual brings in more than their share of sales or clients to a business.** Sales organizations often have one or two key sales people who generate a large share of a company's sales. If one of these sales people were to die, it could seriously affect the profitability of the business.

A well-known attorney who attracts major corporate clients or major cases to a law firm is another example of a key person contributing more than their fair share to a successful business.

**A key person has a unique talent that would be difficult to replace.** Often, a business has an individual employee who brings a unique talent or perspective to a business that helps set that business apart from its competitors and contributes immensely to its success. As stated earlier, it could be a person who has the talent and creativity to develop new and profitable products. Or it could be a person who has a unique ability to motivate sales people. Individuals with different but complementary talents often join forces to start a business. One could be a financial whiz and able to obtain major financing while the other is equally talented in marketing. The business would likely suffer greatly if either of these individuals died. Key person life insurance—in addition to life insurance to fund a buy-sell agreement—could be important to the future of the business.

**A larger company buys out a smaller successful business.** The larger company often recognizes the founder(s) of the smaller company or another key person within that company as being a key element to the continued success of the company after the acquisition. The retention of key customers of the smaller company and/or the retention of employees may depend on the figurehead of the smaller company remaining. If that person were to die, it could mean the loss of a customer base or a mass exodus of employees. Key person life insurance can help mitigate the loss associated with such an event.

There are certainly other situations where the purchase of key person life insurance is worth considering. For example, a key person could be a top sales person or sales trainer; an engineer, scientist, or programmer who is responsible for the development of new products; a person who has many industry contacts that help bring in business; or an individual whose financial expertise is the key to the business's ability to borrow money. The loss of any of these individuals could be devastating to a business. The bottom line is, any employee whose death could negatively affect the viability and/or profitability of a business is a candidate for key person insurance.

Once a key employee is identified, the next step is to assess the impact their death would have on the business in order to determine the face amount of insurance coverage needed to help protect the business.

## **How is a key person's value to the business determined, and how much insurance should be bought?**

The amount of insurance coverage should reflect the estimated monetary loss the business would suffer from the death of the key employee. It is difficult to set up a definite formula whereby the value of an employee to their company can be easily determined. Varied approaches exist to estimate the monetary loss to the business. In absence of documentation, the method most frequently used by underwriters to determine whether the face amount requested makes sense is based on either a generic multiple of the key employee's income or a percentage of an existing debt.

For key employees, W-2 compensation is often only a portion of their income. Perks such as retention bonuses, stock options, and benefits such as nonqualified plans can often be included. When the key employee has an ownership interest in a business, distributions by S corporations and guaranteed payments by partnerships or LLCs may be included. In a new startup business, key employees often take a decrease in income in return for an interest in the business. When this is the case, historical income records may be more reflective of their value. Often, coverage equal to five to ten times income can be justified.

If the purpose of the key person coverage is in part to cover a business loan, the amount of the loan is a major factor in determining the amount that will be issued. Another determining factor is whether the key employee has personally guaranteed the debt. Generally, coverage is limited to 60% – 70% of the outstanding debt.

Coverage can be justified beyond the normal income multiple or percentage of debt guidelines, but documentation that supports the coverage requested needs to be provided. In this respect, documentation such as tax returns and a detailed bio reflecting experience, education, specific talents, and skills should be included, along with a discussion of how the amount requested was determined in a cover letter.

## **What are the primary tax considerations?**

The Internal Revenue Code (IRC) provides that no deduction is allowed for premiums paid on a life insurance policy covering the life of an officer, an employee, or any person financially interested in the business where the business is directly or indirectly a beneficiary of the policy.<sup>1</sup> Since a business is usually the owner and beneficiary of a key person life insurance policy, the premiums paid by the business are generally not deductible. Furthermore, the premiums paid by the business are generally not taxable income to the employee.

In general, life insurance proceeds paid by reason of the death of the insured are exempt from income tax under IRC §101(a). However, there are situations where the death proceeds from a key person policy might be subject to income tax.

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<sup>1</sup> IRC §264(a)(1).

One situation where the proceeds could be subject to income tax is under IRC §101(j). This section provides that death proceeds from employer-owned life insurance contracts issued after August 17, 2006, will be taxed as ordinary income to the extent the amounts paid under the contract exceed premiums and other amounts paid by the employer. At first glance, this provision seems to negatively impact key person life insurance. Fortunately, the rules also provide that, if certain notice and consent requirements are met before policy issue, and if certain exceptions apply, death benefits can still pass income tax-free.

One of the exceptions provides that death benefits will not be taxable if the insured qualifies as a director or is a *highly compensated employee* or a *highly compensated individual* at the time the policy is issued. The term “highly compensated employee” is defined as an employee who was a 5 percent owner of the business at any time during the preceding year or who received compensation in excess of a specific amount during the preceding year (\$130,000 in 2021 and \$130,000 in 2020), indexed for inflation in future years). The term “highly compensated individual” is defined as an individual who was one of the five highest-paid officers or individuals who are among the highest-paid 35 percent of all employees.

Normally, a key employee will qualify as either a highly compensated employee or a highly compensated individual under this exception. In light of the reporting rules, it is important to maintain documentation that proves you have met the notice and consent requirements in a timely manner.

Finally, a key person life insurance policy may have estate tax consequences when the insured is also an owner in the business. This can occur since the gross estate of a business owner includes the value of their interest in the business. Life insurance proceeds paid at the business owner’s death and received by the business are taken into account in valuing their business interest.<sup>2</sup> However, it should be noted that the proceeds do not necessarily increase the value of the business on a dollar-for-dollar basis since the business has also lost the value of its key employee.

## Summary

The continued success of a business depends on its key people. Key person life insurance is an important risk management tool. The annual premium cost for a key person policy is a small price to pay in comparison with the potential loss that a company could suffer at the death of a key person.

<sup>2</sup> Treas. Reg. §20.2031-2(f).

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