Unlock the Answers

Key Person Life Insurance

by Mark Weber, JD, MSFS, CLU, ChFC

In times of economic stress, businesses struggle to survive. Perceived risk is reduced by decreasing inventories, shedding employees and cutting operating costs. For a business, the most important asset is its people, particularly those in leadership roles. The sudden death of a key person has the potential to cripple a business's ability to remain solvent.

This article is intended to provide general answers to some of the most common questions regarding key person life insurance. There are exceptions to the answers provided, based on unique situations or a taxpayer's particular fact pattern. However, I believe these questions and answers give the general reader a solid understanding of the basics of key person life insurance.

What is key person life insurance?

Key person life insurance typically refers to insurance that covers the lives of top executives, but is owned by and payable to a business entity.

Why do businesses use key person life insurance?

A business commonly utilizes key person insurance to indemnify against the potential financial loss that could result from the death of one of its top employees. The death proceeds received by the business might be used in one or more of the following ways:

- Redeem the executive's stock
- Replace lost profits
- Repay business creditors
- Hire and train a replacement
- Fund "stay bonuses" to retain other key employees
- Fund executive benefit plans

What is the right amount of insurance a business should own on each key person?

The appropriate amount of key person insurance is unique to each situation. The following factors should be considered when calculating the amount of key person insurance needed:

- What is the likely financial loss caused by the sudden death of the employee?
- How long is the loss likely to last? (Until a replacement can be trained? Until a large loan is repaid? Until retirement? Other?)
- Are financial resources available other than life insurance?
- How much insurance will the insurer issue?

How much does key person insurance cost?

Many factors can influence the cost of key person insurance, including:

- Amount of death benefit purchased
- Age
- Sex
- Health
- Family medical history
- Avocations
- Foreign travel
- Tobacco use
- Type of policy
- Duration of coverage
- Number of executives to be insured

What type of life insurance product should be used?

To determine the best choice, a business owner must answer the following questions:

- How long does the business anticipate needing the coverage?
- Are cash values desired (i.e., to fund lifetime obligations)?
- What amount is budgeted for premiums?
- Is the executive in good health?
- What type of product will the insurer issue?

Key person life insurance typically refers to insurance that covers the lives of top executives, but is owned by and payable to a business entity.

How should the policy be owned and who will be the beneficiary?

In a classic key person life insurance situation, the business owns the policy, pays the premium and is the policy's beneficiary.

How is key person life insurance taxed?

Premiums**—**The Internal Revenue Code expressly provides that no deduction shall be allowed for premiums paid on a life insurance policy if the taxpayer is directly or indirectly a beneficiary under the policy. As long as the business remains the owner and beneficiary, the premiums are not taxable to the insured.

Death Proceeds**—**Under the rules generally applicable to life insurance contracts, the entire lump sum payable to the business at the insured employee's death is exempt from income tax (see below for exceptions to these rules for policies purchased after August 17, 2006 or for policies transferred for valuable consideration). In the case of a C-corporation, a portion of the death proceeds may be subject to tax under the corporate alternative minimum tax.

Cash Values—If a cash value policy is used, the increase in cash value is not taxable income. However, if the policy is surrendered, cash values in excess of the business' cost basis will be treated as ordinary income. (There may be some exceptions to this rule if the policy becomes a Modified Endowment Contract.)

Are there limitations on whom can be insured as a key person?

To be certain that death proceeds will be exempt from income tax, the business must have an "insurable interest" in the employee. In other words, in the event of the employee's demise, the business would suffer a significant, demonstrable financial loss. Insurable interest rules vary from state to state. To be safe, the employee should be a "key" employee, the amount of coverage must be justified by the potential financial loss and the employee is required to give consent in order to be insured.

Are there governmental reporting requirements for businesses that own life insurance on key employees?

Yes. For life insurance policies issued after August 17, 2006, certain requirements must be met or the death proceeds may lose their tax-exempt character. Prior to policy issuance, the employer must notify the employee in writing of the following items:

- The fact that the employer intends to insure the employee's life
- The maximum face amount for which the employee could be insured at the time the policy is issued
- That the business will be the owner and beneficiary of the policy

Following that notification, the employee to be insured must provide written consent to be insured and consent to allow the coverage to continue after the employee terminates employment.

Additionally, the insured must have been an employee at some time during the twelve-month period before his/her death or at the time the contract was issued, and the employee must have been either a director or highly-compensated employee.

The employer must also file an informational return (Form 8925) with the IRS each year, indicating the number of individuals employed by the business, the names of insured key employees, the amount of insurance carried on each insured and confirmation that each insured employee has provided written consent to be insured.

When an employee terminates employment, what can a business do with that person's policy?

A number of options are available to the employer:

- Allow the policy to lapse by discontinuation of premium payments
- Surrender the policy for its cash value
- Transfer the policy from the employer to the employee
- The employer can sell the policy to a third party
- The employer can continue to hold the policy until the employee's death, at which time the death benefit can be collected
- If the policy has an "exchange rider," the employer may be allowed to switch the insurance to another employee

When a large amount of death proceeds is received by the employer, will this cause the accumulated earnings tax to be imposed?

The accumulated earnings tax is a penalty tax imposed when a corporation retains earnings not needed in the business in order to prevent profits from being taxed to its shareholders. In computing the amount of income subject to the tax, a credit is allowed for accumulations to meet reasonable current and anticipated business needs. Consequently, the tax should not be imposed upon income retained for the purchase of life insurance or death proceeds received as a result of an employee's death if the insurance serves a valid business need and is generally related to that need.

Key person life insurance is commonly used by businesses of all sizes to mitigate the financial loss to the business as the result of the death of a key employee. When used appropriately (insuring the right employees for the right amounts) and structured correctly, it can mean the difference between business success and failure following the death of one or more top executives.

To help determine if key person life insurance is appropriate for your business, contact the business succession experts at SilverStone Group.

Source: 2009 Tax Facts (The National Underwriter Company)