Key Person Insurance: Another Look, Another Opportunity

Key person insurance — those are relatively small term insurance policies, right? Not so fast — permanent policies may provide more cost-effective and flexible solutions, and key person policies also meet a critical need for your business owner and executive clients.

Key Person Insurance — What Is It?

Key person insurance insures a business against economic losses when a key employee's death could hurt the company's bottom line. Some common ways the corporation may use the death benefits include: replacing lost profits, providing a financial cushion during times of uncertainty and lower productivity, and having cash to find and attract a replacement. Lenders may also insist on key person insurance before extending credit in some cases.

The business is the owner, premium payer and beneficiary of a life insurance policy on the key person's life. A popular method to determine the coverage amount needed is a multiple of the employee's gross income, based upon how many years it would take the business to hire a replacement and bring that new person up to the same productivity level.

The Benefits of Cash Value Life Insurance

Producers often present a level term product for key person solutions. However, this may not be the most cost effective solution. Why? Under § 264, premiums paid by the company are not a deductible expense when the business benefits either directly or indirectly. Remember the "golden rule" of business expenditures — **if you can't get a tax deduction, make sure you get cost recovery!** A properly-designed cash value life insurance policy can provide cost recovery regardless of the reason and time the key person stops working for the company.

If the key person retires or leaves for any reason, the company can surrender the policy and take the cash value as cost recovery. The older the policy, the more cash it can provide when a long-time key employee leaves. Some carriers also offer high early cash value riders[1] that could maximize cost recovery in case of early departure.

If the employee dies while still working, the death benefits are paid to the business tax-free and are treated as an addition to corporate surplus. With certain riders, the policy may even provide the company with additional funds in case the key person leaves due to disability.

Flexible Alternatives to Surrendering the Policy

As a key person prepares to turn over the reins to a successor, the company could use the policy for other purposes instead of surrendering it:

1. Transfer the policy as an additional benefit (taxable as compensation to the employee, deductible to the company) or sell it to the insured. (See Rev. Proc 2005-25.)
2. If the key person is a partner or shareholder, the policy can also be used to fund a buy-sell agreement. Care must be taken to maintain tax-free death benefits under the transfer-for-value rule, but with the right planning this can be accomplished for any corporate structure.
3. Use the policy to informally fund deferred compensation arrangements. (Note that § 409A requirements may apply.) Withdrawals and loans from cash value can fund promised benefits in retirement.

Caution: § 101(j) Applies!

Tax code § 101(j) was enacted in 2006 in reaction against "janitor insurance," but the disclosure and consent requirements apply to all corporate-owned life insurance policies. Be sure to have the § 101(j)-required documents signed by the key person before the policy is issued, or the death benefits will become taxable!

For further information on this topic and other advanced concepts, please contact your GPAgency Brokerage Manager.

[1] Policy riders are available at an additional cost and may not be available for all products. Terms and conditions apply.