Key Person Insurance

CLIENT SNAPSHOT

Protecting one of your company's most important assets – its key people

Ensuring that your company's assets are protected is a key component of running a successful business. This means insuring tangible assets like inventory, buildings, and machinery, as well as protecting your intellectual property and brand. But when you think about what makes your business run smoothly day in and day out, the first thing that comes to your mind likely isn't the equipment you use or even the goods or services you provide, but rather the key individuals whose knowledge and contributions to your company are invaluable.

Ask yourself – if something were to happen to one of these key players, how would that affect your company's short and long-term success and viability?

- **Is this individual a substantial driver of profit?** Does he/she directly influence or generate sales?
- **Does this person have unique skills or expertise** that would be difficult to replace?
- **Does he or she have special contacts and/or goodwill** that would harm the business if he or she was no longer at the company? Is he/she a key relationship builder?
- **Would the absence of this key player** affect the company's ability to secure a loan or make existing lenders call on a debt?

If you answered yes to any of the above questions, a key person life insurance may be a viable solution to insure against the loss of a key employee and protect your company on a long-term basis.

89.4% of U.S. businesses have 20 or fewer employees,[1] meaning many businesses rely on just a small number of players to keep the business running.

How many of your employees are integral to your company's success?

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How it Works

Key person is a strategy where a life insurance policy is purchased and owned by your business on the life of a key employee to protect the business in case of the insured's death. A key person policy can insure the life of a non-owner executive or the life of an owner of the business. It can be either term insurance or permanent insurance (e.g., universal life, indexed universal life, variable universal life).

TODAY:

- **Your business buys a life insurance policy on the life of a key person.** The key person can be a non-owner employee or an owner of the business, including you.
- **The business pays all of the policy premium,** owns the policy, and is named the beneficiary of the death benefit.
- The life insurance policy is an **asset of the business**.
- **The insured may have decision making responsibility over the insurance policy as a business asset,** but has no direct personal rights to the policy.
- It may be possible to use the policy to provide **personal insurance protection** to the insured's family as a pre-retirement death benefit. This requires a separate agreement and the policy must be permanent insurance.

BEFORE RETIREMENT:

- **If the key person dies before retirement,** the income-tax free death benefit received by your business may be used to replace lost profits, recruit and/or retain qualified replacements, or protect the company's credit position.[2]
- **If the insured is also a business owner,** the death benefit could be used to buy-out the insured's business interests from his/her estate.

AT RETIREMENT:

- **When the insured retires,** your business can retain the policy as business asset and use it for any business purpose.
- Alternatively, your business may **decide to "bonus" the policy out to the insured** to use for his/her own personal insurance needs.

Key Person Insurance Uses and Benefits

A key person plan is simple to implement and the death benefit provides your business with an immediate infusion of cash that can be used in a number of different ways to keep the business operating smoothly.

Key person life insurance can provide valuable protection to your business **at the death of the insured:**

- Keeps the business operating seamlessly
- Protects goodwill and/or replaces lost profits
- Covers the expense of finding and training a suitable replacement
- Assures creditors of a smooth transition
- Assures customers that the business will continue to run as usual

Key person *permanent* life insurance also provides valuable benefits to your business **during lifetime:**

- A valuable business asset that can be used for unexpected business expenses via policy cash value.
- Long-term planning options – you can decide in the future whether to keep the policy for business purposes or to transfer it to the insured for personal purposes

Determining the Right Amount of Coverage

A typical rule of thumb for deciding the amount of life insurance coverage is five to ten times annual compensation. On a case-by-case basis, additional coverage may be permissible for key employees of well established businesses. "Compensation" includes all types of income, including W2 or 1099 wages, commissions, bonuses, as well as other types of employee benefits like retirement benefit plans, stock options and elective deferral plans. Any ownership stake that the insured has can also be a factor.

Choosing the Right Product – Term or Permanent Insurance

If cash flow is a concern, term insurance if often a lower cost solution to cover the loss of a key person. Although term insurance provides helpful death benefit protection, a permanent policy may offer more long-term options and flexibility. Permanent policies are often used when there is a desire to offer life insurance protection coverage during the insured's working years to the insured's family as a pre-retirement death benefit in addition to the key person benefits.[3] A permanent policy may also be more desirable if the business anticipates that it will bonus the life insurance policy to the insured in the future (such as at retirement).

Consider some of the advantages of permanent insurance:

- **Your business may be able to take loans and withdrawals** from the policy's potential cash value accumulation to cover business expenses
- **Upon the key person's retirement,** your business could use the potential policy cash value to provide retirement income to the key person/insured
- **The policy can be transferred to the insured at retirement as an added benefit.** In this case, the employee would recognize income and your business would receive a corresponding tax deduction.[4]

Did you know John Hancock has a robust portfolio of term and permanent products?
In addition, John Hancock has a Critical Illness Benefit rider which can provide an additional benefit to cover losses associated with a key person experiencing a covered critical illness. For more information please talk to your advisor about these options.

Important Considerations

- **NO INCOME TAX DEDUCTION:** Life insurance premiums paid by the business are not deductible.
- **INSURANCE OWNERSHIP:** The business will be the owner of a life insurance policy on the key employee's life. The employee will have no direct access to the policy cash value unless the policy is later bonused to him/her.
- **§101(j) COMPLIANCE:** When life insurance is owned by an employer on the life of an employee, the tax code requires that certain conditions and Notice and Consent requirements be met to keep the death benefit proceeds income tax-free. Consult your tax/legal advisors for more information.
- **TRANSFER-FOR-VALUE:** If the policy is transferred to the key employee at retirement, a transfer to the insured is an exception to the transfer-for-value rule under §101(a)(2).

Conclusion

Key person life insurance is an important way for you to protect your business against the financial impact of the death of a key executive. Key person life insurance is easy to set up and simple to administer. Using permanent life insurance may provide other valuable benefits to the business or to the insured during lifetime at your discretion.

Contact your advisor for more information on how a key person insurance plan can help your business.

1. Small Business & Entrepreneurship Council. Facts & Data on Small Business and Entrepreneurship. http://sbecouncil.org/about-us/facts-and-data/.

2. Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are a few exceptions, such as when a life insurance policy has been transferred for valuable consideration or the requirements of §101(j) have not been complied with.

3. If a pre-retirement death benefit is incorporated into the plan, a separate split-dollar agreement will be required. Please consult your advisor for more information.

4. Note that although the business will be able to take an income tax deduction, it will have to pay tax on any gain inside of the policy, resulting in a net tax savings approximately equal to the basis in the policy.

Insurance policies and/or associated riders and features may not be available in all states. Some riders may have additional fees and expenses associated with them.

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Loans and withdrawals will reduce the death benefit and the cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Withdrawals in excess of the cost basis (premiums paid) will be subject to tax and certain withdrawals within the first 15 years may be subject to recapture tax. Additionally, policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age $59^{1/2}$. Withdrawals are available after the first policy year.

Insurance products are issued by: John Hancock Life Insurance Company (U.S.A.), Boston, MA 02210 (not licensed in New York) and John Hancock Life Insurance Company of New York, Valhalla, NY 10595.

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