

KEY PERSON LIFE INSURANCE

Protect your business
against the loss of a key person





If a key person in your company died today,
would it adversely affect your business profits?

Who is a key person?

Successful businesses are built on a variety of assets: equipment, inventory, real estate, accounts receivable, cash, goodwill, and most importantly, *key people*. The death of a key person could have a devastating effect on the future of your business.

Without question, *you* and your fellow business-owners are the most valuable key assets of your business.

Certainly, your involvement and guidance are crucial to its success. Additionally, a key person would be anyone who contributes significantly to its success and whose death would result in a tangible loss.

Key person insurance helps to indemnify your business for the death of a key person and the loss of that individual's skill and expertise.



A key person generally has the following characteristics:

- Vision to plan the direction of the business
- Decision-making power
- High-level salary
- Ability to implement plans
- Financial leverage representing a source of business capital
- Special or unique talents

Challenges created by a key person's death

When a key person dies, the challenges surviving businessowners face go beyond the emotional toll of the loss. There are several areas that need to be addressed soon after the key person's death.

- **Disruption of management:** Suddenly another employee must assume the management duties of the deceased key person. The death may disrupt operations, particularly if your firm is in a period of growth or change.
- **Reduction in earnings:** An income decrease or an expense increase, or both, may follow the death of a key person. Company earnings may suffer until your business adjusts to the shock and disruption.
- **Impairment of credit:** Creditors questioning the future of your business may press for immediate debt payment and adopt a wait-and-see attitude about further credit. The credit restriction may hit your business when it is most vulnerable – after the loss of a key person.
- **Replacement of the key person:** When a key person dies, his or her knowledge, experience, reputation and judgment – qualities that made that person invaluable to your company – are lost. Now, in addition to the expense of finding, hiring and training a new person, your company may have to absorb the costs of mistakes the replacement will inevitably make while learning the new position.
- **Loss of confidence:** Employee morale and loyalty may be weakened as business stability is questioned. Customers and suppliers may start to look elsewhere for their business needs.

Measuring the value of a key person

When placing a value on a person's skills and talents, no set rule exists for determining how much coverage is needed. The important thing is to arrive at a reasonable and practical amount of life insurance coverage for your company's needs. Several methods are commonly used to measure the value of a key person.

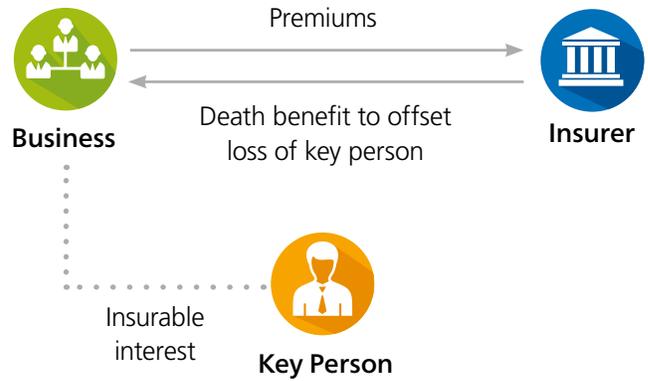
- **Capitalization of salary** measures the value of the key person to the business by multiplying annual salary by a capitalization factor (ranging from 1 to 10, depending on the type of business). This method recognizes that the key person's salary does not represent his or her entire value to your business.
- **Contribution to earnings** measures the key person's effect on, and contribution to, the earnings of your company. By analyzing financial figures, including book value and net income, valuation can be placed on a particular key person.
- **Replacement cost** estimates the cost to replace the key person by focusing on various factors such as the existence of an understudy, time required to train a replacement, availability of persons with similar qualifications and salary considerations.
- **One year's profit** looks at key person insurance as replacing your company's profit for one year. Essentially, this gives you a year to find and train a replacement and get things up and running again.
- **Present value of projected loss in earnings** estimates the loss of earnings for as many years as the death of the key person could be expected to affect your profits. These annual losses then would be adjusted for present value.



With the loss of a key person, your business may lose the judgment, skill, experience and reputation upon which your profits depend.

How a key person life insurance plan works

1. The business sets a value and then purchases insurance on the key person's life.
2. The business pays the premiums and is both owner and beneficiary of the policy.
3. When the key person dies, life insurance proceeds are paid to the business.
4. The business uses the proceeds to offset losses in sales, productivity, credit, morale and/or replacement cost.



Establishing a key person life insurance plan

Ownership of the life insurance

Your business is the owner, premium payer and beneficiary of a key person life insurance policy. A board of directors' resolution authorizing the key person policy is recommended. The key person has no rights in the policy. Under a separate agreement, the key person could receive the policy outright or be given the right to purchase the policy at a later date if your business no longer needs or wants the policy.

Policy selection

You have flexibility when it comes to choosing the type of life insurance policy to purchase for key person coverage. While term life insurance is attractive because of its low premiums, permanent life insurance will have a favorable impact on your company's balance sheet. Permanent cash value life insurance offers the additional benefit of having money set aside and available for expansion or emergencies.

By adding an optional *Waiver of Premium for Total Disability Rider* to a permanent life insurance policy, your business further protects itself by limiting the financial burden it would bear during the disability of a key person. The business is relieved of the burden of premium payments while the key person is disabled and is ensured that the cash value continues to build.

Further, an optional *Business Exchange Rider* provides flexibility when the original key person terminates employment with your business. Instead of starting over with an entirely new policy, the cash value in the policy can be transferred to a new policy on the replacement key person. This rider makes it possible to use one policy to help fund one individual after another, although each new insured needs to satisfy underwriting requirements.

Accounting treatment

Generally, your business carries the cash surrender value of a key person policy on its balance sheet as a non-current asset. Upon receipt of the death proceeds, the gain may be reflected as a special entry for nonrecurring amounts, or it may be carried directly to retained earnings. If term life insurance is used, premiums are charged as a current (nondeductible) expense that should be charged against income, not retained earnings. Please consult your accounting professional for more information on accounting treatment of a key person insurance policy.

Understanding tax implications

Premium payments

Key person premiums are not deductible because the business itself owns the policy and is the beneficiary. The federal tax code denies a deduction for premiums paid on a policy when the taxpayer (your business) is a beneficiary under the policy. There are no income tax consequences to the key person under this type of arrangement.

Insurance proceeds

Generally, key person life insurance proceeds enjoy complete income tax-free status. Key person policies are not included in the key person's estate since the company is both the owner and beneficiary of the policy. To the extent that the key person owns all or part of the business, the policy proceeds may increase the estate tax value of the business.

To ensure that death proceeds are received income tax free, it is recommended that the employer obtain proper notice and consent from the key person before the life insurance policy is issued.

Accumulated earnings tax

The federal tax code imposes a penalty tax for accumulating excessive earnings inside a C corporation instead of distributing the earnings to the shareholders. Corporations are permitted to accumulate up to \$250,000 (\$150,000 for personal service corporations) without incurring the penalty tax.

Accumulations in excess of this amount can still avoid the penalty tax if they are accumulated to satisfy the reasonable business needs of the corporation, both currently and those that are reasonably anticipated for the future. Key person life insurance, bought to reasonably indemnify the corporation, will not create an accumulated earnings tax problem.

Consult your company's tax professionals regarding more information on the tax treatment of a key person insurance policy.



Frequently asked questions

Q: Why does my business need key person insurance when I could start a sinking fund?

A: A sinking fund, an account accumulated regularly and used to redeem debt or finance purchases, can be established for the purpose of indemnifying the business for the loss of the key person. However, key person life insurance is the only sinking fund that is completed automatically when the key person dies. With a sinking fund, you can't be sure that the person will live long enough for sufficient funds to accumulate. If your key person dies next year, or any time in the early years of your sinking fund, you may have only the amount contributed to the fund.

Q: If a sinking fund isn't adequate, why can't my business make up the difference from current cash flow?

A: The death of a key person may cause serious damage to your company's earnings. It may not make good business sense to use 100 percent dollars from cash flow and run the risk of depleting your surplus. Using life insurance brings the benefit of paying premiums over time rather than the full cost to cover the loss of a key person.

Q: Why can't my company just borrow the money to tide it over if the unexpected happens?

A: A bank loan may be a possibility, assuming economic conditions are right when you need the money. A bank, however, may not be as generous with a company forced to borrow to absorb the financial shock of a key person's death. But more importantly, think about the wisdom of borrowing. If you borrow the money, you will have to pay 100 cents on the dollar, plus interest. With key person life insurance, you pay an annual amount equal to a small percentage of the total death benefit.

Q: Business conditions are too uncertain right now. My company really can't afford key person insurance. Why can't I just wait until everything settles down?

A: In a growing, successful business, the pace rarely settles down. Uncertainty of what lies ahead for your business will always exist.

Key person life insurance is vital to the continued success of your business, because it can protect against some future uncertainties. Providing cash indemnification in the event of a key person's death, while also accumulating emergency cash reserve funds with permanent insurance, will make your business stronger.

Q: Why buy key person insurance if my business can't deduct the insurance premiums?

A: It's true that premiums are not deductible, but the much larger death proceeds (as compared to the premium payments) are generally income tax-free to your company. Consult a tax professional for guidance.

Why Ohio National?

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