

Key-Executive Insurance: Why, Who, When, and How Much?

- **Who Should Be Covered?**
- **Why Buy Key-Executive Insurance?**
- **How Much Should Be Purchased?**
- **What Will it Cost?**
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- **What Are the Tax Considerations?**
- **Special Needs of Business Owners**
- **What About Split-Dollar Insurance?**
- **Protecting Against Disability**

Here Are the Critical Questions to Consider

- Would the company survive my death? Are there other key employees who are equally important to the company's survival?
- Are my heirs protected and provided for in the event of my death? Is the company protected in the event of the death of a key executive?
- How much coverage is needed to protect against the loss of key people and at what cost?
- What types of insurance policies should I consider (e.g., in some instances, buy-sell insurance may be preferable)? Which policies are most affordable? Which are the best investment?
- What are the tax implications? Are the premiums tax deductible? If not, are the insurance proceeds received tax-free?
- How can I use key-executive life insurance to meet other personal and business needs?
- Do I want the insurance proceeds payable to my spouse or family rather than to the business?

This **Resource Report** answers all of those questions and presents the three principal methods for determining the dollar value of you or another key executive to your business.

Remember: Your life insurance represents significant cash for your family and will most likely be the most liquid component of your estate and the asset on which they rely to pay their living expenses after your death. You want your spouse or other family member, *not the company*, named as the beneficiary. That way, the family receives the proceeds (death benefit) tax-free rather than paying taxes on the company's distribution of the insurance proceeds. Now to our Report on this very important subject.

Key-executive insurance doesn't solve all of your problems when a key person dies but it does alleviate some of the financial pressures that would otherwise occur.

Key-Executive Insurance: Why, Who, and How Much?

Nothing can weaken a healthy company faster or more decisively than the sudden, unexpected absence or death of the owner/president or other key executive. The fact is a company's success often is reliant on one or a few key people. With them, the chances of profitability and growth are increased or even assured. Without them, the company's very survival is in doubt.

You don't like to consider the possibility of your death or the death of one of your key executives. But you should protect against that possibility anyway with key-executive life insurance coverage on essential people.

Few owners realize this insurance can be the main ingredient in the continued success or even the survival of a business after a key person's death. Chances are you're among the many business owners who are not protected against this possibility. Don't be defensive. You've got plenty of company. Statistically, almost 90% of business owners have no "key executive" insurance coverage.

You might be wondering: If so few have the coverage, how can you be sure you really need it? Consider the following possible scenarios.

Disaster #1: As company founder, owner, and president, you become disabled or die — suddenly, unexpectedly. *Result #1:* Your company's operations come to a standstill, its value plummets, and its continued profitability and existence are now in serious doubt. *Result #2:* Without your salary, your family has no other source of income.

Disaster #2: Your top salesman, who accounts for 30% of company sales, dies suddenly and your office manager, who has been with you for 20 years and knows all the details of your business operations and personal business, becomes permanently disabled and dies a short time later. *Result:* Your sales decline immediately, the processing of orders and invoices comes to a halt, and you are spending all your time at the office, trying to get a handle on the sales and administrative tasks previously handled by the now-absent employees. You've begun advertising to fill the positions but replacing both individuals probably will take months, even as long as a year.

Disaster #3: You carry \$300,000 personal life insurance with the company listed as owner and beneficiary. *Result:* In collecting the money from the company at your death, your family has to pay \$120,000 (about 40%) in federal and state income taxes.

Disaster #4: You or your company make an improper sale or transfer of the policy. *Result:* The tax-free status of the life insurance proceeds is voided and the proceeds become taxable income to your beneficiaries/heirs or estate at personal income tax rates up to 35% — that's a \$35,000 potential tax bill for each \$100,000 of life insurance.

This **Resource Report** is designed to show you the real value of key-executive life insurance, help you assess your own need for such coverage, and provide formulas to help you calculate how much coverage your company needs.

Providing for this insurance is easy. The owner or board of directors simply passes a resolution authorizing the business to apply for and become the owner, beneficiary, and premium payer of a life insurance policy on the key employee's life, whether that key employee is you, the owner, or an executive. If that person dies while employed by your company, the business receives the insurance proceeds tax-free since the premiums are *not* tax deductible.

Why Buy Key-Executive Insurance?

The insurance proceeds can solve several problems resulting from the death of you or a key employee, such as:

1. *The business is indemnified for loss of sales and profits.* Some key people may be irreplaceable (you, super salespeople, inventors, etc.). This insurance will help offset the future loss in revenue from that person's death.

2. *A successor can be hired and trained.* Many months may pass before a qualified replacement can be found. In addition, it may take a good year or two to train him/her to the point where he is as competent as his predecessor. The insurance proceeds, in effect, buy time for your company and protect operating capital and cash flow.

3. *Business loans can be paid off.* When the key person dies, particularly

an owner/officer, a lender may have the right to call a loan. The insurance proceeds can fund that payoff.

4. *Credit can be maintained.* At the death of a key person, lenders may become hesitant to lend new money to the business or refinance existing debt. The insurance allows your company to increase available cash and maintain its credit rating by paying its bills in spite of the death.

5. *Stock repurchase.* Common stock owned by the key executive or you can be repurchased with the insurance proceeds. In fact, the repurchase can be structured in advance with a buy-sell agreement, which often is coordinated with the proceeds from key-executive life insurance.

6. *Cashing in.* Many business owners use key-executive insurance as a vehicle for cashing in on part or all of the value of their businesses to support their families after their death. It's especially appropriate if your company is heavily reliant on you and you don't plan to sell the business in the near future.

In these cases, however, the beneficiary of the insurance policy should be the spouse or other family member, not the company. That way, they receive the proceeds (death benefit) tax-free. Also, the amount of insurance coverage should be from 60% to 80% of the company's value. You don't need 100% since the insurance proceeds are received tax-free by the family.

How Much Insurance to Buy?

A good *guesstimate* on how much insurance is needed can be made by the owner with his/her insurance adviser and accountant using one or a combination of the following methods.

Method #1. *Capitalized salary of key person:* Since the executive's salary is presumed to be based on his or her value and contribution to your company, you can use an amount equal to three times that salary to calculate the coverage needed. *Example:* If his salary is \$80,000 a year, \$240,000 life insurance is needed.

Alternate method: If the key executive is a salesperson who generates revenues or commission income, say \$100,000 a year, multiply that figure by two or three years, for a total insurance need of \$200,000 to \$300,000.

Method #2. *Executive's contribution toward earnings or the value of your company:* *First*, average your company's operating profits over the last three years — say \$100,000. *Second*, take the average capital (value) over that period, and figure out the income it would have earned if it had been invested at a reasonable rate of interest — say, \$300,000 average capital (value) invested at 10%, yielding \$30,000 annually. *Third*, estimate the “excess” earnings by subtracting the average profits from the interest earned on capital (\$100,000 less \$30,000 equals \$70,000). *Fourth*, estimate how much of those excess earnings can be attributed to the key executive you want to cover, say, 50% of the \$70,000. *Fifth*, multiply the resulting \$35,000 by the number of years you wish to protect. If it's five years, then \$175,000 of life insurance is needed on that executive's life.

Alternate method: Estimate the value of your company, say \$800,000, and apply a percentage for the key executive's contribution to that value. If it's 25%, you need \$200,000 of life insurance.

Method #3. *Replacement cost:* *First*, figure out how much additional salary is being paid the executive over and above the pay for his routine duties. For example, if his salary is \$80,000 but the routine part of the job accounts for \$20,000, his extra abilities are worth \$60,000. *Second*, estimate how many years it would take to fully train a successor to be as productive as the deceased executive; assume two to three years' salary. *Third*, multiply the above two factors: \$60,000 times three years equals \$180,000 life insurance.

In summary, we have determined the following amounts of life insurance coverage needed to protect your company:

#1. Capitalized Salary	\$240,000
#2. Contribution to Earnings/Value	175,000
#3. Replacement Cost	<u>180,000</u>
Total of Three Methods	<u>\$595,000</u>
Average Life Insurance Needed	<u>\$198,333</u>

Agency fee: To all or the average of the above methods, you can add \$10,000 to \$25,000 for the fee charged by an employment agency to locate a new executive.

No one method is best; consider using a combination or average of the three methods as illustrated on the prior page. Only you can really evaluate the potential loss and effects of a key executive's death or your own death on your company.

What Will It Cost?

Here are the annual premium costs for \$200,000 in coverage for a female and male, age 45, in good health and non-smokers. The term insurance is to age 65 with the right to convert the policy to a permanent (whole life) policy.

	<u>Term</u>	<u>Whole Life</u>
Female Executive	\$400	\$3,200
Male Executive	\$500	\$3,800

Comparison shop: The annual premium quotations are from one of the top 10 life insurance companies and are presented for general information only. The actual premium cost can vary widely and principally depends on many factors, including the age and health of the insured, type and term of policy, projected dividends, and cash values. As usual, get expert advice before buying life insurance; it's a big-dollar commitment over many years. Also, be sure your insurance agent obtains quotes from at least three insurers with comparable illustrations showing the annual premium, projected dividends, guaranteed cash values, and the return rate assumed.

Types of Life Insurance to Consider

For businesses with limited cash flow, renewable term insurance is a good choice because the premiums are much lower than with permanent, variable, or universal policies, so your cash outlay is less. But it is generally recommended that companies switch from term and buy permanent insurance as soon as they can afford to since these policies build cash values over the years. There also are combinations of policies, e.g., permanent life with term insurance, that can be purchased.

With *term insurance*, the premium is usually guaranteed for the term of the policy and can include the right to convert the insurance, usually up to age 65, to a permanent policy. That conversion right is very important. It gives you the flexibility to use the policy for other personal or business needs, e.g., more immediate cash to your family at your death or sufficient liquidity to pay estate

taxes. *Caution:* The annual premium on term insurance policies increases dramatically as you get older and closer to the last date you can convert the policy. To spread out this cost, you can purchase term insurance with *guaranteed* level payments. The annual premium will be higher with level payments but you will have the comfort of lower premiums as you near retirement. Ask your adviser for comparative premium illustrations.

With *cash value policies*, the policy builds cash value each year. As a general rule, after 10 to 15 years, the total premiums paid will approximate the policy's accumulated cash value and dividends paid by the insurer.

Split-dollar insurance: Also ask your insurance agent about split-dollar insurance in which the cash value, which increases each year, belongs to the company but the insurance policy can be kept (purchased) by the executive if he leaves the company. That can be a valuable fringe benefit, particularly if the executive has health problems at the time of departure or needs more life insurance to meet his family's needs. *Reference:* For more information on split-dollar insurance, including some tax cautions, please see page 12.

Taxation of Key-Executive Insurance

If the company is the sole owner and beneficiary of the life insurance, the premiums are not tax deductible [Internal Revenue Code Section 264(a)(1)]. However, at the executive's death, the company receives the life insurance proceeds *tax-free*. In addition, since the executive is receiving no benefit, the premiums aren't taxable as income.

Furthermore, at the key executive's death, the life insurance proceeds aren't included in his or her estate since the company was the policy owner and beneficiary. However, if the key executive was the *sole* or *controlling* stockholder, the insurance proceeds to the company will be taken into account in determining the value of the stock in his estate since the cash proceeds from the insurance policy could increase the company's value. Of course, the loss of an owner's services also will be considered in valuing the stock, usually by applying a discount, say 25%, to the value of the company. *Example:* If the business is worth \$1,500,000 at the owner's death, the value of the 100% ownership position for estate tax purposes would be \$1,125,000 (\$1,500,000 less the \$375,000 discount).

Estate-planning alert: To avoid inclusion of life insurance policies in the value of your estate, consider setting up an insurance trust to own part or all of the insurance policies. You also will want to review the items on the next page with your advisers and *About Split-Dollar Insurance* on page 12.

To assist you in another very important area — protecting your salary on disability — we have included a review of disability insurance on page 14. □

References —

Exhibit 1 — Special Needs of Business Owners, next page

Exhibit 2 — About Split-Dollar Insurance, page 12

Exhibit 3 — Protecting Against Disability, page 14

Special Needs of Business Owners

As the owner of your company, you have special needs and considerations beyond key-executive insurance coverage. *For example:*

1. If there are other stockholders in your company, have you considered a buy-sell agreement funded with life insurance with the proceeds payable directly to your spouse or other family members? This is an excellent way to cash in on your stock and provide for your family at the same time.

2. Have you checked the beneficiaries in your business policies? Do you want the life insurance proceeds going *directly* to your family rather than to the business? Remember, the insurance proceeds are received tax-free and if your company is the beneficiary, you will have problems getting the cash out of the business without paying taxes.

3. What about an insurance trust to own your and/or your spouse's life insurance? The trust reduces the value of your estate by removing the life insurance from it and thus reduces potential federal and state estate taxes payable by your spouse and children.

4. Do the beneficiary designations in your business and personal life insurance policies reflect your present intentions and family status? *Reasons:* Changes in the number of children, death, remarriage, etc. Also, are all the names and addresses of the beneficiaries current and correct?

5. Have you elected any *special* settlement options in any of the insurance policies? *Reason:* You may want to change the method and timing of the payments to your beneficiaries. This is particularly important if you *do not* want a beneficiary to receive a lump-sum payment, e.g., a daughter or son who is still not mature enough to manage money. In that case, you may want the insurance benefits paid over a 5- to 10-year period.

6. Does your *will* need to be revised? It should be fully coordinated with the beneficiary designations in your business and personal life insurance policies so there are no duplications of bequests or beneficiaries among family members. In addition, you can provide directly for a particular person or purpose (e.g., a child's education) by naming the child a beneficiary in a separate life insurance policy.

7. What about naming a business successor for management continuity if you become disabled, die, or retire? You should draft plans now with your advisers for the sale or ownership transfer of your company whether that sale happens while you are alive or after your death. At the least, select an individual who will manage the business, even if only on an interim basis.

8. Adequate disability insurance is also very important. Be sure you're covered. Up to the age of 65, the chances of becoming disabled are many times greater than dying. See page 14 for more information on disability insurance. □

About Split-Dollar Insurance

Split-dollar life insurance is a cash value life insurance policy in which two parties share in paying the premium: the employer and the executive. Structured properly, the company can *recapture* all or most of its premium cost through the policy's cash value build-up over time or through the right to receive part of the life insurance proceeds upon the executive's death.

Benefits: There are no IRS discrimination rules, the life insurance proceeds are received tax-free, and the company gets back all or most of the premiums it paid from the policy's cash value or death benefit.

Some negatives: The premiums are generally not tax deductible by the company and the executive (insured) pays income taxes on the benefit of the life insurance, which income must be reported to the IRS by the executive/company as additional compensation.

Other uses of split-dollar life insurance:

- Fund a buy-sell agreement whereby the company and/or its owners purchase the stock of a deceased owner.
- Fund a deferred compensation plan whereby the executive or his or her heirs collect the deferred salary after retirement or death.
- Provide cash to a deceased executive's family to live on, to support any children, or to pay inheritance taxes.

Your insurance agent will be happy to discuss this life insurance benefit for you only and/or your executives.

Important: The IRS has made major changes in the way split-dollar life insurance is taxed to the executive. The tax consequences depend principally on who is really considered the owner of the policy and whether or not the split-dollar arrangement is, in effect, additional compensation to the executive since he or she

has an *interest* in the policy's cash value and life insurance proceeds. While the issue is complex, it's clear that the cost to the employee of split-dollar policies is substantially higher than in the past. Before entering into any split-dollar arrangement, consult your tax and insurance advisers. If you already have a split-dollar plan in effect, now is the time to review it. □

Protecting Against Disability

Death is not the only possibility you want to protect against. Disability insurance also is important coverage, but it can be very confusing insurance to buy. If you don't already have disability coverage, use the ideas below to choose the best policy. If you currently have coverage, use the ideas as an update to review your current policy with your insurance agent; you may want to make some changes.

Here's the biggest reason to consider disability coverage: Seven out of ten men between the ages of 35 and 65 become disabled and are unable to work for periods of 90 days or more. For women, the statistic is four out of ten.

Costs and terms. The cost for a \$3,000-per-month disability benefit (\$36,000 annually) is relatively low. For 40-year-old executives (Unisex Ratings), the annual premium cost is about \$1,000 for a \$36,000 annual benefit with a 60-day elimination period. For 50- and 60-year-old executives, the cost increases to \$1,400 and \$2,000 a year, respectively.

However, before you buy the disability insurance, you have important decisions to make on the type of policy, level of coverage, and the elimination period, i.e., the length of time you must wait before receiving the benefits. You have a variety of options to choose from.

Here are ideas to discuss with your insurance agent to be sure you're adequately protected on both new and existing policies.

1. The policy you currently own or buy should be *noncancellable* and *guaranteed* renewable. This is very important; you don't want the insurance cancelled when you need it most.

2. Be sure you have sufficient cash reserves to wait out the elimination period. It can be 60, 90, 180 days, etc.

3. Don't rely *solely* on income from sources such as Social Security and other federal or state programs (e.g., veteran's and worker's compensation). Use these programs as a *supplement* to your basic disability insurance.

4. If you want to *lower* your annual cost on an individual policy, consider the following:

- Reduce the monthly benefit amount, but only if you have excess cash to ride out a disability.
- Make the elimination period as long as possible (say, six months to one year). This, again, while it reduces costs, also increases the need for personal resources to ride out the waiting period.

5. *Important questions:* Do I want coverage to protect myself for *any* type of work or just my occupation? And for total or partial disability? What is the definition of disability? Generally, you want the following definition in your policy:

Your inability to perform the substantial and material duties of your *current* occupation.

That's the best definition. Others may define it as: *Your inability to work in an occupation which you can perform based on your past education, training, and experience.* That's more limiting than your *current* occupation.

Another option: Many insurance companies provide benefits based on the decline in earnings due to disability. *Example:* Your monthly income drops from \$6,000 to \$2,500 because of disability. A percentage, usually 66%, of the \$3,500 difference is the monthly disability paid to you. □

About *The Business Library*

This **Report** is part of *The Business Library* (TBL), a collection of 90 Reports and Manuals on subjects of critical importance to business owners, executives, their families, and the professionals who advise them. TBL is produced by an editorial and research staff with an *average experience* of **30** years in helping businesses and individuals manage their finances better.

The company was formed in 1974 by Thomas J. Martin. Martin has written more than 900 articles and advisories and presented *hundreds* of workshops and seminars to *thousands* of business owners and executives on many of the subjects covered in *The Business Library*. He is an Investment Banker and an expert witness in Valuation and Succession Court Cases. He has helped *hundreds* of business owners and executives raise capital, refinance debt, prepare for succession, and value and sell their businesses.

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