Key Person Insurance
Protecting Against the Unexpected

The Concerns
When taking inventory of assets, companies include buildings, computer equipment, and phones. In other words, companies value their tangible items – items that can be replaced if lost in a fire or some other type of disaster. One asset that is often overlooked is human capital. Each business, regardless of its size, has an individual or group of individuals who contribute to its success, and without them the business would have a difficult time surviving. Like tangible assets, insurance protection can be purchased for those key employees.

The Solution
You can protect your business from the loss of a key person by implementing a key person insurance plan in which your company purchases and owns a life insurance policy on the life of a key employee. The life insurance policy will provide the company the liquidity needed to help keep the business running in the event of the key employee’s premature death. The plan provides the cash needed to hire a qualified replacement and/or to purchase the additional human capital or assets necessary to keep the business operating. The plan may also help to replace lost profits as a result of the loss.

While the main purpose of key person insurance is to provide a death benefit to the business in the event of an unexpected or sudden death of an essential employee, it can also be used as a way to provide the key person with retirement benefits.

How It Works
The business buys a life insurance policy on the life of the key executive. The business is the owner and the beneficiary of the policy. The business pays the entire premium and will receive the entire death benefit. The executive does not have any interest in the policy, nor does his or her family receive any benefit from it when death occurs.
Why Life Insurance?
Life insurance can be used by the business to replace the key employee. The life insurance provides the company with the funds to:
- Keep the business running
- Assure creditors of a smooth transition
- Assure customers the business will run as usual
- Cover the expense of finding and training a suitable replacement
- Provide the company with a valuable asset on the company’s balance sheet that can be used for unexpected corporate expenses
- Potentially be used by the company to fund supplemental retirement income for the key employee

Determining a Key Person
Some people may argue that every employee is essential to running the company, from the CEO down to the maintenance staff, and that they should all have key person insurance policies. However, reality dictates that some individuals are more important to the survival of the operation than others. Key employees can be the business owners, successful sales reps, or individuals whose daily contributions are key to the success of the business. To determine a person’s value to the company, several factors should be taken into consideration. Some of these factors are:

Business Owners
- Ability to obtain financial assistance: If something happens would the business still be able to obtain financial backing?
- Knowledge of the products and operations: Does this person have special knowledge about the operations and products?
- Competition: Would rival companies have an advantage if this person were gone?
- Customer Relations: Is this person the relationship builder?

Non-Business Owners
- Sales Ability: Is this person critical to generating sales with an established track record?
- Highly Compensated: Is this person among the top 35% of wage earners in the company?
- Important Contacts: Does this person have accounts or contacts that would cause the company to suffer without their continued involvement?

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. In addition to the items listed previously, there are other things that should be taken into consideration such as:
- How much will it cost to replace this person?
- How much is the person worth to the bottom line?
- If something happens today, what would it cost the business?
- How much of the company’s actual loss are you willing to insure?
Benefits

The purchase of key person insurance benefits both the business and the executive. The business benefits from having a source of income to cover the expenses that occur with the loss of a key person. It can also access the potential cash value of the life insurance policy for cash flow, retirement benefits or other unexpected expenses.

The executive benefits from the knowledge that he or she is essential to the business operations, and the key person plan may be used to fund the executive’s supplemental retirement income through policy loans and withdrawals.2

Tax Implications

To protect the income tax-free nature of the death benefit and comply with the provisions of IRC 101(j), the employer will need to provide notice to the key employee and receive consent from the employee as to the amount of insurance the employer plans to require.1

In most instances, a key person life insurance arrangement benefits the corporation. The only involvement the executive has is being the insured. The business does not receive a tax deduction for the life insurance premiums because the corporation has a beneficial interest in the policy. However, the corporation will receive the death benefit proceeds free from income taxes4 upon the death of the executive. Potential tax issues, such as alternative minimum tax, may arise under limited circumstances if the business is a C corporation.5

Summary

Key person life insurance is an important way for a corporation to protect itself against the loss of key employees, partners, or owners. Key person life insurance is simple to set up and easy to implement and should be considered by a small business whose day-to-day and long-term performance may be in jeopardy if something happens to one of its vital employees.

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CASE STUDY

James Webster, age 45, works at Sawyer Builders, a commercial construction business. James’ expertise and contacts have contributed significantly to the company’s success. His annual salary is $100,000. Tom Sawyer, company owner, knows that if something were to happen to James his business would be negatively affected.

Tom purchases a John Hancock Indexed UL policy for $800,000 as Key Person Insurance on James, based on eight times annual compensation. The company can access the policy’s cash values for business purposes, if needed. When James retires at age 65:

1) Tom can transfer the policy to James in the form of a bonus of the policy and the taxes due.
2) Sawyer Builders can keep the policy as a business asset.

### Case Example — Transfer Policy & Employee Takes Withdrawal To Pay Taxes

<table>
<thead>
<tr>
<th>Year</th>
<th>Approximate After-Tax Corporate Annual Outlay</th>
<th>Approximate Taxes Due By Employee on Transfer</th>
<th>Approximate Corporate Tax Deduction if Transferred to Employee</th>
<th>Approximate Withdrawal from Policy to Pay Taxes</th>
<th>Approximate Net Cash Surrender Value</th>
<th>Approximate Net Death Benefit</th>
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* Tax deduction calculation includes tax employer would pay on gain upon transfer, assuming a 35% tax rate for both parties.

The figures used in this case study are hypothetical, for discussion purposes only, are not guaranteed and may not be used to project or predict results. Actual results may be more or less favorable. Specific product and policy elements would be found in a policy illustration provided by an insurer. With any decision regarding the purchase of life insurance, a client would need to determine which type of life insurance product is most suitable for their specific needs. Based on Male, Super Preferred Non Smoker, age 45, 20 annual premiums of approximately $15,000, Massachusetts resident, Return of Premium (ROP) and CVAT. Assumes 100% in John Hancock’s Capped Indexed Account with a current illustrated rate of 6.73%.
1. Please note that caution should be taken if the policy is being set up as a non-qualified deferred compensation agreement. Consult with your tax consultant about the potential issues with setting up a non-qualified deferred compensation plan including accounting for the plan, as well as Section 409A requirements.

2. Loans and withdrawals will reduce the death benefit, 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. 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 59½. Cash value available for loans and withdrawals may be more or less than originally invested.

3. Section 101(j) of the IRC ("COLI Best Practices") imposes income tax on the death benefit of life insurance contracts owned by the employer of the insured unless certain exceptions apply AND notice and consent requirements are met prior to issuance of the contract.

4. 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.

5. Potential for alternative minimum tax may arise in limited circumstances for C corporations. A full tax discussion is beyond the scope of this piece. This piece is intended to provide an overview of key person insurance only. For more information of the tax consequences, please contact your tax consultant.

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