WELLS FARGO Advisors

Any Questions?
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Key person life insurance

How does it work?

Key person life insurance is used to protect a business against financial losses or additional expenses resulting from the death of a key employee or owner. Either term or permanent life insurance can be used. The main purpose of this insurance is to provide the business an immediate source of tax-free cash.

Key person life insurance may be needed because the death of a key employee may cause serious financial strain for a closely-held business. For example:

- The business may need cash to recruit, hire, and train a qualified replacement.
- The business may need working capital to pay operating expenses and salaries.
- Revenue could be lost if relationships with suppliers or customers are disrupted.
- Expenses could increase if a key operations manager is lost.
- Lenders could react by increasing borrowing costs or calling loans.
- The business may want additional cash to pay a death benefit to the deceased employee's family.

This strategy is fairly straightforward:

- The business purchases life insurance for each key employee or owner. The business owns the policy and pays the premiums.
- The business is the beneficiary of the policy. If a key employee dies, the business receives death benefits, which are generally income tax free.
- The business can use the proceeds for any business purpose.

Who should be covered?

- Any employee or owner whose death would cause an adverse impact on profits.
- Employees or owners with specialized skills who are not easily replaced.

How much coverage is needed? What type of insurance is appropriate?

There is no "right answer" to this question. Try to estimate a reasonable amount of insurance coverage, based on the amount of cash the business might need if a key employee dies. Here are some ideas you may want to consider:

- One approach is to obtain a death benefit equivalent to one to five times the employee's annual salary and bonus.
- Another approach is to base the coverage on your estimate of the potential revenue loss, or additional cost, the business would incur upon the employee's death.
- The business could acquire an amount of insurance that would allow outstanding loans to be paid off.
- Term life insurance is often appropriate for key person policies. Level premium term protection can be obtained for a finite time, for example, until the key employee's expected retirement age.
- Permanent policies may be used when the business wants to maintain insurance for the employee's entire lifetime (even beyond retirement), or when it is desired to build cash values.

Key concerns and issues include:

- Key person life insurance premiums are not deductible to the business.
- The business may also want to consider insuring against the risk that a key employee becomes disabled. Disability overhead and disability buyout policies are also available.

How the strategy is implemented:

1. Identify key employee(s) or owners.
2. Determine how long you need to provide coverage (for example, until employee's expected retirement age).
3. Determine the amount and type of coverage desired.
4. Select an insurance provider and submit an application for coverage.
5. Once policies are in force, plan to regularly review your business insurance coverage, and perform regular "check-ups" to assess how policies are performing.

How is “key person” insurance different from “buy-sell” insurance?

These terms do not refer to different types of insurance products, but rather to different objectives or reasons for acquiring business life insurance.

- Typically, the proceeds from key person insurance will be used to provide operating funds for use in the business: the business might use them to hire a new employee, defray increased operating costs, or replace lost profits that result from the death of a key employee.
- In contrast, when insurance is purchased to fund a buy-sell agreement, the proceeds will typically be used to buy shares from the heirs of the deceased owner.

These terms are sometimes used interchangeably, but the needs are quite different. If the deceased employee is also an owner, the business may want funds for both of these purposes. It is important to have sufficient cash to buy out heirs of the deceased owner, but the business may also need additional cash for operating purposes.

I’m the sole (100%) owner of my business. Do I need key person insurance on myself?

This is another situation where it’s helpful to focus more on “what you are trying to achieve” and less on the terminology. Is your concern primarily to replace income and protect asset values for a spouse or children? Or to provide operating cash to help the business function without you? Or both of those goals, to some degree?

To the extent that your goal is to provide for your family, the appropriate vehicle might be personal life insurance. For this goal, business-owned life insurance may not be optimal, because even though life insurance proceeds are received income tax free by the business, getting money out of the business usually involves a taxable event: paying compensation, a dividend, or a sale of shares by an owner. In addition, think about the nature of your business and how realistic it is to expect the business to thrive without you. For example, if you are an artist, craftsman, or consultant with highly specialized knowledge, no amount of money can replace you and keep your business going. What you may really need is not cash for the business, but rather cash for your family to replace lost future income.

On the other hand, if you own a widget factory and have a good management team, it may be very realistic to expect that the factory can continue producing widgets profitably—but may need some extra capital to weather the loss of a key manager. In that case, a key person insurance strategy may be quite appropriate. In many cases, it will make sense for a business owner to address both personal and business insurance needs.

Can I also use key person insurance to provide a benefit for the covered employee?

Possibly, but again, this is a very different objective. Remember, to the extent that benefits are going to the employee, they are not providing cash flow to the business. In addition, employee benefits involve a very different set of tax rules, so be sure to talk with your CPA about what costs, if any, are deductible to the business (and when you can deduct them), and what amounts are taxable income to the employee (and when they become taxable).

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