

# Questions Board Members Should Be Asking About Key Person Life Insurance That Is More Than Five Years Old.

## **Summary:**

In the event of the death or disability of a key employee would your business be as successful as it is today? Key person life and disability insurance are designed to help you and your company prepare for the unexpected.

The purpose of this paper is not to make recommendations, but rather ask the important questions that will allow Boards to make informed decisions with regards to their company's Key Person insurance assets.

## **What is Key Person Insurance?**

Key Person Insurance is a life or disability insurance policy purchased by an employer on the life of a critical employee to help protect the business from the financial loss resulting from that employee's death or disability. Policy proceeds can be used to recruit, hire, and train a replacement. Key Person insurance also provides a cash cushion to help creditors, employees, and shareholders remain comfortable about the business's long-term stability and viability.

## **How was the amount of Key Person coverage determined?**

Is it a fixed amount? Is it formulaic and tied to some financial target? It depends on what the business stands to lose at the death or disability of the key person. There are a number of valuation methods utilized in assessing this loss. They include:

- Loss of Business Value
- Loss of Excess Earnings
- Cost to Replace Experience
- Cost to Replace Contributions
- Cost to Replace Lost Sales Profits
- Multiple of Salary

## **Is the amount of Key Person coverage still appropriate?**

Economic conditions, employment contracts, etc. make it prudent to review these arrangements to ensure they're still performing as expected and will provide the desired liquidity, protection, and cash flow.

## **Is there a written agreement or company policy detailing the purpose of the insurance?**

It's important there is a clear purpose for the use of the funds in writing.

## **Is there a need for Key Person disability protection?**

The probability of disability is much higher than the probability of death. Would the company suffer financially from the extended disability of a Key Person? If so, there are Key Person disability policies designed to pay a lump sum amount to the company.

**Are the correct people insured?**

Key Person insurance should be considered on any senior level executive whose death or disability could potentially create a financial hardship for the company.

**Is the policy structured so the benefit will be received tax-free by the company?**

The business should pay the premiums and be the owner and beneficiary of the policy. The premiums are a non-deductible business expense. The benefit will be taxable income if the company deducts the premiums.

**Are you compliant with IRC § 101(j)?**

IRC § 101(j) applies to any employer-owned life insurance policies issued or materially changed after August 17, 2006. Failure to comply could cause the death benefit to be taxable. There are two basic requirements: (a) Notice and Consent and (b) Employee Status.

a. Notice and Consent

Notice: The employer must provide written notification to the employee that the employer:

- (1) Intends to insure the employee's life
- (2) The maximum face amount for which the employee could be insured at the time the contract was issued, and
- (3) That the employer will be a beneficiary of any proceeds payable upon the death of the employee.

Consent: The employer must secure written consent from the employee prior to issue.

b. Employee Status

At the time of application, the insured must have one of the following titles in order for the death benefit to remain tax free:

- (1) Director
- (2) Highly Compensated Employee
- (3) Highly Compensated Individual

**What is the current health of the insured(s)?**

Has the executive's health declined (or improved) since the policy was issued? If the insured's health has improved (lost weight, quit smoking, etc.) the company may save money by reapplying for a better rating. If the insured's health has declined it is important to review the guarantee period, conversion features, etc.

**What are the convertibility options/rights of the insurance policy?**

If the Key Person life insurance is term, the ability to convert it to a permanent policy without proof of insurability could be a very valuable feature. Some policies are convertible for the full premium guarantee period. Some policies may only be convertible for the first 5 or 10 years.

### **How long is the policy needed?**

Is the policy designed to provide coverage for the anticipated length of time the coverage is needed? Most Key Person policies are term insurance. There are situations when the coverage is needed for longer periods of time, or where the policy can also be used as a “golden handcuff” when permanent insurance is more suitable.

### **What should you do with the policy when the executive retires or leaves the company?**

Many term policies are allowed to lapse when the executive retires or leaves the company. There may be substantial value in the policy to both the company and/or executive. If the executive would have trouble purchasing new insurance due to age or health impairments, the company may consider retaining the policy as a company asset or selling the policy in the secondary market. The company could also transfer (gift/sell) the policy to the insured. It is very important to be aware of “Transfer for Value” considerations.



Seth J. Buckley, CFP®, CLU®, ChFC®, MSFS, AEP®, TEP

Seth J. Buckley is President of Buckley Financial an independent life insurance brokerage and consulting firm specializing in the structuring and administration of life insurance portfolios for affluent families and businesses. He can be reached at [seth@buckley-financial.com](mailto:seth@buckley-financial.com)

Securities Offered Through ValMark Securities, Inc. Member FINRA, SIPC

Investment Advisory Services Offered Through ValMark Advisers, Inc. a SEC Registered Investment Advisor 130 Springside Drive, Akron, Ohio 44333-2431 1-800-765-5201

Buckley Financial is a separate entity from ValMark Securities, Inc. and ValMark Advisers, Inc.