Leveraged Planning® Solutions & Key-Person Life Insurance

How your clients can fund a key-person life insurance policy without sacrificing valuable corporate capital

THE SIGNIFICANCE OF A KEY EMPLOYEE

Who are the key employees in your client's business? Certainly your owner-employee client is at least one of the firm's MVPs, but it's very likely that he or she is not alone.

A key employee is an individual who holds special training, knowledge, experience or talent that allows him or her to generate revenues for the company, drive profits, establish a reputation or otherwise play a substantial role in the success of the business.

HOW KEY-PERSON LIFE INSURANCE HELPS YOUR CLIENTS

Whenever an employee passes away, it creates a hardship on a business. No matter what role the employee played, they were likely a necessary part of the team and their now-empty spot must be filled.

But when a key-person passes away, a business could face significant delays, losses and negative word-of-mouth in the community and online. It may be completely unable to fulfill orders or to service contracts and there may be no other employees able to pick up the slack, making it impossible for business to go on as usual.

A company owning a key-person life insurance policy receives a death benefit after a key-employee passes away. That death benefit can work toward:

- Offsetting the costs associated with the loss
- Paying for training and recruiting expenses
- Funding business continuation after the loss
- Stemming client losses through outsourcing, hiring or special training for existing employees

A key-person life insurance policy can be purchased on either a non-owner employee or an owner-employee. You may think these polices are useful only if the key-employee passes away—but that's not entirely correct. Not only does the presence of the policy calm investors and customers with the knowledge that the business can and will remain stable, but the cash values growing in the policy can be included in the assets on the company's balance sheet.

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Premium FInancing and Key-Person Insurance

The premium for a properly designed key-person life insurance policy can be aggressive because the death benefit must be large enough to help your client's business deal with the total costs related to the key-employee's death and replacement. If you select a death benefit that adequately covers the potential expenses and losses and ensures that the business is able to preserve its financial security, it can be difficult for a business owner to free up the capital needed to pay that premium, especially if there are multiple key-employees who should be covered.

Through premium financing your client may secure the policy without personal or business collateral as the policy itself secures all – or a portion of - the loan. In addition, consulting with a tax professional can help your client determine if their loan interest payments can be considered a tax-favorable business expense.

Now that you have the perfect solution for helping your clients easily obtain and fund their key-person life insurance needs, let's take a closer look at the process of policy design.

Identifying a Key-Person

Before they can secure the insurance, your clients must recognize which of their personnel would be considered key employees. While everyone on staff is valuable, there needs to be an especially compelling reason for one to be insured through a key-person policy in order for an insurable interest to exist between the insured and the beneficiary. Without that, the policy won't be issued.

Some states have specific regulations that outline who may be considered a key employee. In general, the underlying theme will be that the staff member is very difficult to replace. If your client's state does not have any regulations then any of the following may be considered as a factor in who could be considered key:

- Specialized knowledge that the business relies on
- Unique, specialized skills (including creative or technical)
- Exclusive contacts, connections or agreements that the company utilizes
- Leadership role within the company
- Industry expertise that isn't easy to replace or retrain
- The unique ability to create revenues for the business

Valuing a Key-Person

How do you put a price tag on a talent, skill, or intellectual capacity? You can't, exactly, and that's what makes it so challenging to find the appropriate death benefit for a key-person policy.

Determining a number doesn't have to mean picking something random; it's just about finding an effective way to estimate the potential losses. The business must consider two factors: the profits they'll lose and the expenses they'll face. Some of the expenses they can consider include:

- Costs to recruit and hire a replacement, including relocation fees, bonuses, training and additional salary or benefits

ADDITIONAL NOTES REGARDING KEY-PERSON INSURANCE

- A key-person insurance policy doesn't just provide protection for the business, but also for the owner's family in two ways: 1) When the policy is taken out on the owner-employee, it can help the family take the necessary time to learn how to continue the business in the owner's absence. 2) Using a split-dollar agreement, the policy may be designed to pay a percentage of benefits directly to the owner's family.
- Death benefits may be tax free unless the corporation is a C-corp (in which case the company's alternative minimum taxes may be affected), or the owner-employee was the beneficiary and it is an equity split dollar agreement with owner and business sharing responsibilities, benefits and cash surrender value.
- Key-person insurance policies should be used only to fund the potential business losses and expenses caused by the death of the insured. If the death benefit includes any amount that was previously loaned to the covered employee, the benefits could be taxable.
- Key employees should be informed in writing that they are being insured. Not only will this help to secure underwriting information but it will also comply with the COLI Best Practices Act and help ensure tax-free benefits.
- Key-person insurance only covers the death or, in some cases, the terminal illness or dismemberment of the key employee. Should they leave to join another company, no benefits would be paid.

Valuing a Key-Person (cont'd)

- Costs to recruit and hire a replacement, including relocation fees, bonuses, training and additional salary or benefits
- Customers and other valuable relationships lost during the employment gap
- Outsourcing work in the interim
- Press releases and marketing to get the word out about contingency plans or the incoming replacement
- Business or industry-specific costs

To give your client a firm idea of the total potential death benefit, ask them to estimate the above costs, add those numbers together, then determine the amount of profit the business earns through the key employee each year. They should multiply the profit by the number of years they think it will take to replace the employee, then combine that number with the expense total to arrive at a suggested death benefit. The owner can then decide whether to add an additional percentage for a cushion to cover any unanticipated costs.

Premium Financing for Your Client's Key-Person Policy

With GFD's Leveraged Planning® solutions, your clients can fund their key-person policies without having to free up capital that's already working for them elsewhere. After determining which staff members qualify as key-employees, then finding an acceptable value for the costs associated with losing that employee, your clients can complete a preliminary GFD loan application. When they send the application to us, they will be asked to supply certain documents, including (but not limited to):

- Tax returns (both business and personal)
- Articles of incorporation
- Other items (please see GFD's complete list of required documents)

Our Financial Services Managers can help you if you have questions about any collateral needs for your client's loan although often, for key-person policies, the collateral may simply be the underlying policy.

ESTABLISHING THE TERMS OF THE LOAN

Your clients have a great deal of flexibility when designing their premium-financed loan. They can choose from many different interest rate structures, including:

- Variable LIBOR or Prime-based rates
- Fixed interest rates
- Other rates structures may be available – please contact a GFD Financial Services Manager to learn about other options

Additionally, no upfront funds are necessary when applying. Loan origination fees, if any, can also be financed.

* All clients must confer with their financial and tax advisors on deductibility or tax treatment matters. Global Financial Distributors(GFD) does not provide tax advice.

ADDITIONAL OPTIONS

Your client has many options when it comes to future premium payments and benefits within the policy. They can decide to structure the loan so that the cash values growing within the financed policy are accessible to pay future premium payments or to make interest and principal payments on the loan, essentially allowing the policy to fund itself. They may also decide to add additional coverage options to the policy, such as a terminal illness/accelerated benefit rider or accidental death and dismemberment benefits.

It's not easy to insure the intangible. With key-person insurance for your client's business, you can help them protect the value of the intellectual capital, creative capital, or highly-skilled labor capabilities of the employees who keep their business moving forward year after year.

Call us today for more information about implementing a Leveraged Planning® solution for your clients.

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Contact Your Financial Services Representative with questions or for more information.