Key employee insurance – it can save your business

Many business owners operate their business without considering the financial impact of losing a key employee. Imagine, as a business owner, getting a phone call in the middle of the night because a key employee has died. Naturally, your first concern is for the family. But, consider the impact this will have on the business.

Who is a key person/employee?

A key person is someone who a business finds very important to their business. The loss of the key person would drastically impact the daily operations of the business. A key person or employee to a business may include, but are not limited to, the business owner, a top sales person, a technical expert, a manager of operations or client service, or an individual with supplier relations. For each business, it is expected that the role of a key employee will be different.

Losing a key employee

The loss of a key employee could result in many negative impacts including, but not limited to:

- The business may not have an immediate replacement for this individual. The absence of a replacement may impact the overall perception of customers, suppliers and employees in the areas of service, quality, relationships, etc.
- The business's existing customers may become impatient during the recovery period. This may result in lower revenues as the customers wait for service, orders, expertise, etc.
- New potential clients may shy away from the business during the recovery period as they may be wary of the uncertainty that may exist.
- The business may have increased costs associated with having to replace that employee. These costs could include recruitment and incentives to attract the right person.
- As a result of the above lost revenue and increased costs, creditors may lose confidence in the business and may want to collect outstanding debts or shorten payment terms.
- Existing employees of the business may decide to pursue other career opportunities outside of this corporation due to the uncertainty of their jobs and confusion that may occur during the recovery period.

Employers who value long-term planning may have identified the costs associated with the loss of key employees. As a result, they may have made arrangements to place funds in a separate account as a reserve to cover these costs. The savings required may be very high and the funds in this account will likely be taxed at the highest corporate tax rate. What many employers may not realize, however, is that there is an alternative to this savings plan.

Purchasing a life insurance policy for the business

As an alternative, the business could choose to purchase a life insurance policy to provide the necessary funding in the event of the loss of a key employee. The business would be the owner and beneficiary of the policy.

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On the death of the insured key person, the policy would pay a tax-free death benefit to the business. This benefit could then be used to compensate for the decline in revenues and to fund increased costs incurred by the business. Specifically, the injection of cash into the business:

- Will allow the business to pay for the costs associated with replacing the key employee.
    - If the corporation can replace the key employee quickly, customers will not feel the full impact of the loss of the key employee and revenues may continue.
- Could be used to pay suppliers or creditors in the event payment terms are tightened.
- Provides employees with a sense of reassurance that the business has enough funds to stay afloat and recover from the loss of the key employee.

Corporate funded life insurance has additional benefits associated to it beyond receiving the necessary funds exactly when needed (on the death of the key employee). Private corporations are eligible to receive a credit to the capital dividend account (CDA) equal to the net death benefit proceeds of the life insurance policy less the adjusted cost basis. At an appropriate time, the private corporation may elect to pay out a capital dividend up to the amount of the CDA, tax-free to shareholders.

Having insurance on a key employee is only one of many reasons why business owners should consider incorporating life insurance as a part of their business planning. For additional information, please contact your financial security advisor.

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