Key person life insurance can help business owners

Life insurance to offset financial loss

Business owners recognize the benefit of insuring their firm's valuable assets, such as office equipment and inventory, to cover property loss. Such assets, however, may not be as valuable as key persons.

Consider a top salesperson who is unsurpassed at bringing in new business or an expert manager who handles the day-to-day operation of the business. Key persons are a business's most valuable resource. Their energy, expertise and hard work enable the business to be successful in today's highly competitive marketplace. If a key person dies suddenly, profits could be impacted and there might be considerable costs incurred in recruiting, hiring and training a suitable replacement.

Life insurance should be part of a business continuity strategy. It can provide the business with tax-free funds when needed to help:

- Find and train a new person to assume the key person's role
- Assure customers that the business will continue as a viable entity
- Assure creditors that funds will be available to meet commitments
- Offset expected reductions in sales revenue (after-tax)
- Pay a death benefit in recognition of the deceased employee's service to the surviving spouse, other family members or the estate (up to $10,000 may be received tax-free)

A key person is anyone associated with the business whose special skills make a major contribution to the bottom line. Some examples include the active business owner(s), employees who have strong relationships with valued customers, and any employee who has specialized knowledge and expertise that can't easily be replaced.

Determining the amount of coverage

Calculating the potential financial impact of the loss of a key person's services to a business may not be easy, and no set formula or rule can be used for all business situations. In many cases, the amount of key person insurance is established in a somewhat arbitrary fashion. Some questions that may be considered when determining a reasonable coverage amount can include:

- What costs would need to be incurred to replace the person in question?
- What amount of the firm's net annual profits does the person generate or contribute to, and how long would these profits be affected if the person died?
- How much would it cost the business if this person died today?
- How much would it cost for temporary or contract help while finding a replacement?
- What proportion of the business's probable total loss is the business able and willing to insure?
- How much debt would have to be repaid to lenders if the person died?

Using the "contributions to profits" method, the business should project the amount of profits that might be lost as a result of the death of the key person. For example, assume the business determined that pre-tax profits would decrease by $500,000 over a three-year period and no further losses would be incurred after the third year following the death of the key person. The company may then decide that replacement of 50 per cent of the projected after-tax loss would achieve an appropriate management of its risk. With an assumed corporate tax rate of 36 per cent, the company could insure the key person for $160,000, which in this example represents a 50 per cent reduction in after-tax profit to be expected in the three years after death [$500,000 x (1-.36) x .50]. *

Policy structured for corporate protection

To implement key person life insurance in a corporate context, the corporation is the applicant for the life insurance coverage to be arranged on the life of the key person, and the named owner and beneficiary of any policy that is issued.

The premium is a non-deductible expenditure by the corporation and the life insurance proceeds are non-taxable when received.

Private corporations

For private corporations, another benefit of a key person life insurance policy is the life insurance death proceeds create a credit to the corporation's capital dividend account, equal to the proceeds less the adjusted cost basis of the life insurance policy. The capital dividend credit can then be used to pay tax-free capital dividends to the shareholder(s).

Professional advice

When considering key person life insurance, clients should always consult with all their professional advisors to help assess the risk involved and the appropriate amount of coverage to be applied for.

This article provides information of a general nature only and is not intended to provide legal or tax advice. The information is current to the best of our knowledge as of June 2008, but laws and interpretations may change. Clients are encouraged to consult with their own professional tax and legal advisors about their particular circumstances.

**This example is not complete without the issuing company's life insurance illustration including the cover page, reduced example and product features pages having the same date.*