Key Person Insurance
Toolkit

Questions and Answers

What is Key Person Insurance?

Key Person Insurance is a life 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. Policy proceeds can be used to recruit, hire, and train a replacement. They can be utilized for loan repayment to satisfy a completion bond on a project, or generally to maintain credit. Basically, Key Person Insurance is coverage that can provide a business a cash cushion in the event of an untimely death of a key employee and can help creditors, employees, and shareholders remain comfortable about the business' long-term stability and viability.

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Who is a Key Person?

A key person is any employee whose death would adversely impact either the day-to-day operations of the business or its long term profitability, or both. Examples of key persons include:

- Owners whose loss would seriously jeopardize credit availability
- Top salesperson or client driver
- The intellectual property employee
- A nonprofit's "rainmaker"

How is the amount of Key Person coverage determined?

It depends on what the business stands to lose at the death 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

It may be best to focus on the Multiple of Salary method to substantiate the amount of coverage being applied for. In the absence of a cover letter explaining one of the other methods and financial documentation to justify it, underwriters regularly default to the Multiple of Salary method.

How is the policy structured?

The business is the owner, pays the premiums, and is the beneficiary.

Are the premiums tax deductible to the business?

No, although Key Person coverage does appear to be a business expense that would normally be deductible, IRC Section 264(a)(1) expressly provides that no deduction shall be allowed for premiums paid on any life insurance policy or contract. Where IRC Section 264(a)(1) applies, the premiums are not deductible even though they would otherwise be deductible as an ordinary and necessary business expense.

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Is the death benefit received income tax free by the business?

Yes, death proceeds are not subject to federal income tax as long as the Notice and Consent requirements of Section 101(j) are met. These requirements are discussed in detail in the final question below. Also, if the business purchased or received the Key Person policy in a Transfer-for-Value transaction that does not fall under one of the exceptions to the Transfer-for-Value rule, then the policy's death benefit, less the sum of any consideration paid for the policy plus any additional premiums paid by the business, will be taxable. The exceptions to the Transfer-for-Value rule in the context of business transactions are as follows:

- If the sale or other transfer for value is to the insured.[1]
- If the sale or other transfer for value is to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is an officer or shareholder.[2]
- The life insurance policy is transferred as part of a tax-free reorganization.[3]

Can the Key Person's personal beneficiaries share in the death benefit?

Yes, a portion of the death benefit can be endorsed over to the Key Persons for them to designate their own personal beneficiaries. The Key Person must recognize imputed income due to the economic benefit associated with the right to name a beneficiary. This is currently measured by the annual renewable term rates found in Table 2001[4] multiplied by the amount of coverage going to the Key Person's beneficiary.

Are there any other tax considerations associated with a Key Person contract?

Yes, if a business is organized as a C corporation and a cash value policy is used, the increases in cash value of the policy for a particular tax year may be subject to the Alternative Minimum Tax (AMT) and the Accumulated Earnings Tax (AET). The policy's cash value increase is added to the business' "adjusted current earnings" for the tax year, and is one of the many factors that can determine whether the corporation will be subject to either the AMT or AET. In addition, death proceeds received by a corporation may be exposed to both the AMT and AET if the corporation is subject to either. However, in due course numerous other things affect whether AMT or AET will be an issue for a C corporation.

Can the policy be distributed to the employee at some point?

Yes; however, it is critical that there is no predetermined decision to do so and doing so may have potential Section 409A implications that are discussed in the next question. Further, the Key Person must recognize the Fair Market Value (FMV) of the policy as income in the year of distribution. Determining the FMV of a policy incorporates many factors (e.g. the type of policy, how long it has been force, among others) and ultimately it is up to the taxpayers and their advisors as to the amount they report as the FMV. Your Advanced Markets Director is available to discuss the FMV computation in greater detail and IRS Form 712 can be submitted to a carrier for analysis of the policy value.

How does the American Jobs Creation Act of 2004 affect Key Person arrangements?

The American Jobs Creation Act of 2004 created IRC Section 409A. There is concern that §409A, which generally deals with the federal income taxation of nonqualified deferred compensation plans, may be broad enough in its scope to reach Key Person arrangements. The concern is when an arrangement terminates and the policy is rolled out to the employee – is that a form of deferred compensation and consequently subject to the rules of §409A? There appears to be one avenue of hope for avoiding the application of §409A to Key Person. The IRS guidance [Notice 2005-1, Q.-3(c)] says that the definition of a nonqualified deferred compensation plan does not include a "death benefit plan" that provides death benefits as defined in Reg. §31.3121(v)(2)-1(b)(4)(iv)(C). The question here, then, is whether a particular Key Person arrangement meets the fairly narrow definition of death benefits in the cited regulation. This will require a legal interpretation by the client's attorney.

How does the Pension Protection Act of 2006 affect Key Person arrangements?

The Pension Protection Act of 2006 added income inclusion rules and exceptions with regard to company-owned life insurance and, since in all Key Person agreements the employer is both owner and beneficiary, it definitely applies. IRC Sec. 101 was amended by adding subsection (j). This new rule provides that the death proceeds will be income except to the extent of premiums and other amounts paid by the employer for the contract. The excess proceeds would be ordinary income to the company.

There are exceptions to the income inclusion rule if the notice and consent requirements, which follow, are met. There are three elements to the employee notice and consent requirements that must be met before the policy is issued:

- The employee must be notified in writing that the employer intends to insure the employee's life. The notice must state the maximum face amount for which the employee could be insured at the time the policy is issued.
- The employee provides written consent to being insured under the policy and that the insurance may continue after the insured terminates employment.
- The employee must be informed in writing that the employer will be directly or indirectly a beneficiary of any proceeds payable on the death of the employee. Further requirements beyond the scope of this discussion also apply,[5] however, if adequate notice, consent and employment requirements are met, the policy benefits can be received tax-free.

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[1] IRC Sec. 101(a)(2)(B).
[2] Ibid.
[3] IRC Sec. 351(a) and Sec. 368(c).
[4] Although the IRS has not formally adopted Table 2001 as the benchmark for this measurement, most practitioners as well as the majority of life insurance carriers recommend their use until IRS publishes further guidance.
[5] The insured must be an employee of the company during the 12-months prior to their death; or a director or highly compensated employee of the company at the time the policy was issued. IRC Sections 1.414(q) and 105(h) apply.

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