KEY EMPLOYEE COVERAGE

BUSINESS PLANNING

STRATEGY SUMMARY

Small business owners put maximum effort into establishing and running their business, but are they taking the right steps to make sure the business can survive the unexpected death of a key employee? The sudden departure of a key employee could be catastrophic to a company — not because the owner did anything wrong, but because they did not do enough.

IMPACT OF LOSING A KEY EMPLOYEE

When thinking about the continued success of a company, who would be considered a key employee? Is it the employee the owner relies on when they are not in the office? The employee who works best with customers? Or the employee who finds creative ways to finance the business?

Loss of a key employee could have devastating effects on a business, including:

- **Loss of sales due to a lack of manpower or the disappearance of personal relationships**
- **Disruption of production or operations**
- **Significant costs to search for and train a replacement for the key employee**
- **Loss of competitive position or goodwill in the marketplace**

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SAFEGUARDING YOUR CLIENT'S BUSINESS

A life insurance policy, owned and paid for by the business, on the key employee's life can help safeguard your client's business by providing the needed funds to help in the transition after the loss of a key employee.[1]

At the death of the insured, the business can use the federal income tax-free death benefit to find and train a successor and to replace the revenue lost by the untimely death of a key employee. With key employee coverage in place, the company and its owners will benefit from:

Cash reserves available to look for, hire, and train a replacement employee

Liquidity to cover lost revenue during the period before a replacement is hired and able to work at the same level of productivity

Flexibility to change the policy to a form of nonqualified deferred compensation if needs change over time

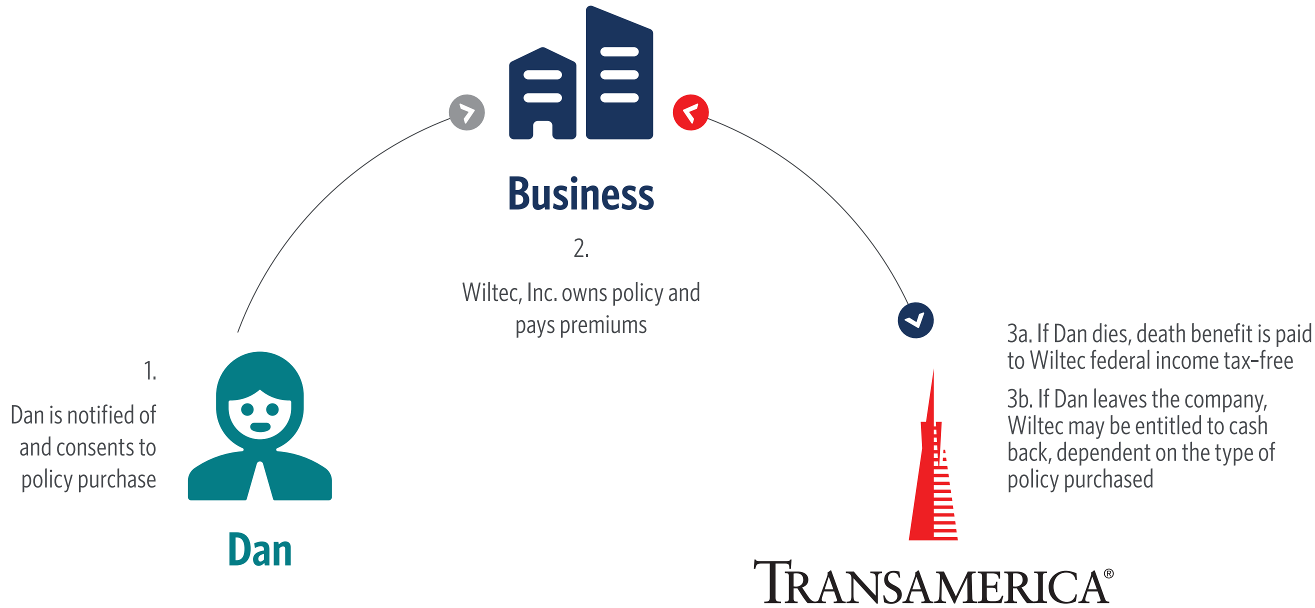
Tax-deferred growth of the policy's cash value and access to the cash value accumulation in the event of financial need, if a cash value policy is purchased

A policy purchased for a key employee need can provide additional benefit as a retention tool. Split-dollar arrangements are often set up with this as a key objective, granting a portion of the coverage for the employee to designate beneficiaries.

Transfer of the policy to the employee may be subject to rules on nonqualified deferred compensation. The employer should consult with their legal and tax counsel for guidance on individual specifics.

[1] For a C corporation, all or a portion of the life insurance proceeds and the annual increase in cash value may be subject to the corporate alternative minimum tax. Moreover, certain situations may result in an exception to the general rule that life insurance proceeds are federal income tax-free under IRC 101(a), including policies transferred for valuable consideration, or corporate- or employer-owned policies that do not fall within the IRC 101(j) exception.

CASE IN POINT: WILTEC, INC.



Mike, Ron and Carol are owners of Wiltec, Inc., a computer software company that specializes in the design of animation graphics for the movie industry. The corporation has been in existence for three years and is valued at $4 million.

Dan is an employee of Wiltec who specializes in advanced graphic design. Dan's expertise gives the company the ability to successfully bid on and win the larger more profitable movie projects. Dan is a highly paid key employee and is provided with a generous benefits package. The owners of Wiltec realize that substantial profits originate from Dan's expertise, and that his premature death would cause financial loss to the firm.

The owners of Wiltec establish a key employee coverage plan funded with life insurance, which provides Wiltec with a number of advantages:

- **Protection from economic loss caused by Dan's death**
- **Funds to recruit and train Dan's replacement**
- **Access to the life insurance cash value for a variety of business needs, such as collateral for a loan or funding of salary continuation plans***
- **The life insurance proceeds are generally free of federal income tax**

*Loans, withdrawals, and death benefit accelerations will reduce the policy value and death benefit. Provided the policy is not and does not become a modified endowment contract (MEC), 1) withdrawals are tax-free to the extent that they do not exceed the policy basis (generally, premiums paid less withdrawals and 2) policy loans are tax free as long as the policy remains in force. If the policy is surrendered or lapses, the amount of the policy loan will be considered a distribution from the policy and will be taxable to the extent that the loan and other distributions on lapse or surrender exceed the policy basis.

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1695929R1 08/21