

Sales Strategy

Key Person Insurance



A Way to Protect Against the Unexpected

When taking inventory of their assets, companies include buildings, computer equipment, and phones. In other words, companies value their tangible items — items that can be replaced if lost in a fire or some other type of disaster. One asset that is often overlooked is the human capital of the company. Each business, regardless of its size, has an individual or group of individuals who contribute to its success and without them the business would have a difficult time surviving. Like tangible assets, insurance protection can be purchased for those key employees; instead of property insurance, it would be key person life insurance.

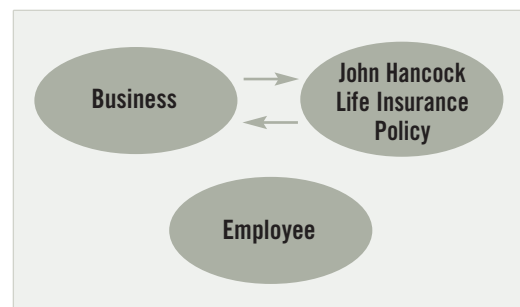
KEY PERSON INSURANCE — WHAT IS IT?

Key person insurance is an insurance policy, either term insurance or permanent insurance, which a business purchases on the life of a key person to help it survive financially if something happens to the employee.

While the main purpose of key person insurance is to provide a death benefit to the business in the event of an unexpected or sudden death of an essential employee, it can also be used as a way to provide the key person with retirement benefits.

HOW DOES IT WORK?

The business buys a life insurance policy on the life of the key executive. The business is the owner and the beneficiary of the policy. The business pays the entire premium and will receive the entire death benefit. The executive does not have any interest in the policy, nor does his family receive any benefit from it when death occurs.



WHY LIFE INSURANCE?

Life insurance can be used by the business to replace the key employee the best they can. They may not be able to replace the niche the employee filled, but at least they will have the funds:

- To keep the business running
- To assure creditors that everything is fine
- To assure customers the business will run as usual
- To cover the expense of finding and training a suitable replacement

HOW TO DETERMINE WHO IS A KEY PERSON.

Some people may argue that all employees are essential to running the company, from the CEO down to the maintenance people, and that they should all have key person insurance policies. However, reality dictates that some individuals are more important to the survival of the operation than others. Key employees can be the business owners, successful sales reps, or individuals whose daily contributions are key to the success of the business. To determine a person's value several factors should be taken into consideration. Some of these factors are:

Business Owners

- **Ability to obtain financial assistance:** If something happens would the business still be able to obtain financial backing?
- **Knowledge of the products and operations:** Does this person have special knowledge about the operations and products?
- **Competition:** Would rival companies have an advantage if this person were gone?
- **Customer Relations:** Is this person the relationship maker?

Non-Business Owners

- **Sales Ability:** Will you be able to meet sales goals without this person?
- **Creativity:** Does this person understand the market and product so well that creativity just happens?
- **Important Contacts:** Does this person have the contacts needed to get results in a crisis situation?

HOW TO DETERMINE THE RIGHT AMOUNT OF INSURANCE COVERAGE.

A typical rule of thumb for deciding the amount of life insurance coverage is five to ten times annual compensation. In addition to the items listed previously, there are other things that should be taken into consideration such as:

- How much will it cost to replace this person?
- How much is the person worth to the bottom line?
- If something happens today, what would it cost the business?
- How much of the company's actual loss are you willing to insure?

Another way to determine how much life insurance coverage is needed is by using the following formula:

1. Estimate the average income over life of the executive.
2. Deduct federal and state income taxes.
3. Determine life expectancy or number of years to retirement.
4. Select a rate of interest at which future earnings will be discounted.

Multiply 1 and 2 by the present value of \$1 per year for the number of years determined in 3, discounted by the rate in 4.

To better understand how key person insurance works, let's look at an example.

EXAMPLE

Facts: Lindsey Webster, age 45, non-smoker preferred, works at Beyond Plants, a small greenhouse in southern Massachusetts, which specializes in the importation of exotic orchids from around the world. The store owner, James Springer, met Lindsey when she was a graduate student studying in Hawaii. He offered Lindsey a job she could not refuse and she has contributed to Beyond Plants' worldwide reputation. James is aware that if something happened to Lindsey his niche in the exotic orchids market would disappear. Not only is Lindsey able to obtain the rarest orchid at a moment's notice, but she is also known as one of the leading specialists in the orchid field around the world. If anyone has a question about orchids or if a problem occurs in the National Botanical Garden, Lindsey is the one they call. For this reason alone, James is purchasing key person insurance on Lindsey.

Here is what it looks like: Since Lindsey is indeed irreplaceable, James decided to value Lindsey by using the rule of thumb of 10 times annual compensation. Between her base salary and her sales commissions, Lindsey makes about \$500,000 a year. Therefore, James is going to purchase a \$5,000,000 policy on Lindsey. James will need to use a large portion of this to recruit and train a team of people to replace Lindsey. By purchasing the life insurance, James can protect his company.

BENEFITS OF KEY PERSON INSURANCE

The purchase of key person insurance benefits both the business and the executive. The business benefits from having a source of income to cover the expenses that occur with the loss of a key person. It can also access the potential cash value of the life insurance policy for cash flow, retirement benefits or other unexpected expenses.

The executive benefits from the knowledge that he or she is essential to the business operations, and the key person plan may be used to fund his or her supplemental retirement income by taking loans and withdrawals from the policy cash value.

TAX IMPLICATIONS

In most instances, a key person life insurance arrangement benefits the corporation. The only involvement the executive has is being the insured. The business does not receive a tax deduction for the life insurance premiums because the corporation has a beneficial interest in the policy. However, the corporation will receive the death benefit proceeds free from income taxes upon the death of the executive. Potential tax issues, such as alternative minimum tax, may arise under limited circumstances if the business is a "C" corporation.

SUMMARY

Key person life insurance is an important way for a corporation to protect itself against the loss of key employees, partners, or owners. Key person life insurance is simple to set up and easy to implement and should be considered by small businesses whose day-to-day and long-term performance may be hurt if something happens to one of their vital employees.

For more information, please contact your local John Hancock Representative or call The Advanced Markets Group at (888) 266-7498, option 3.

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John Hancock Life Insurance Company (U.S.A.), 197 Clarendon Street, Boston, MA 02116.

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