An educational guide for business owners

Guardian®

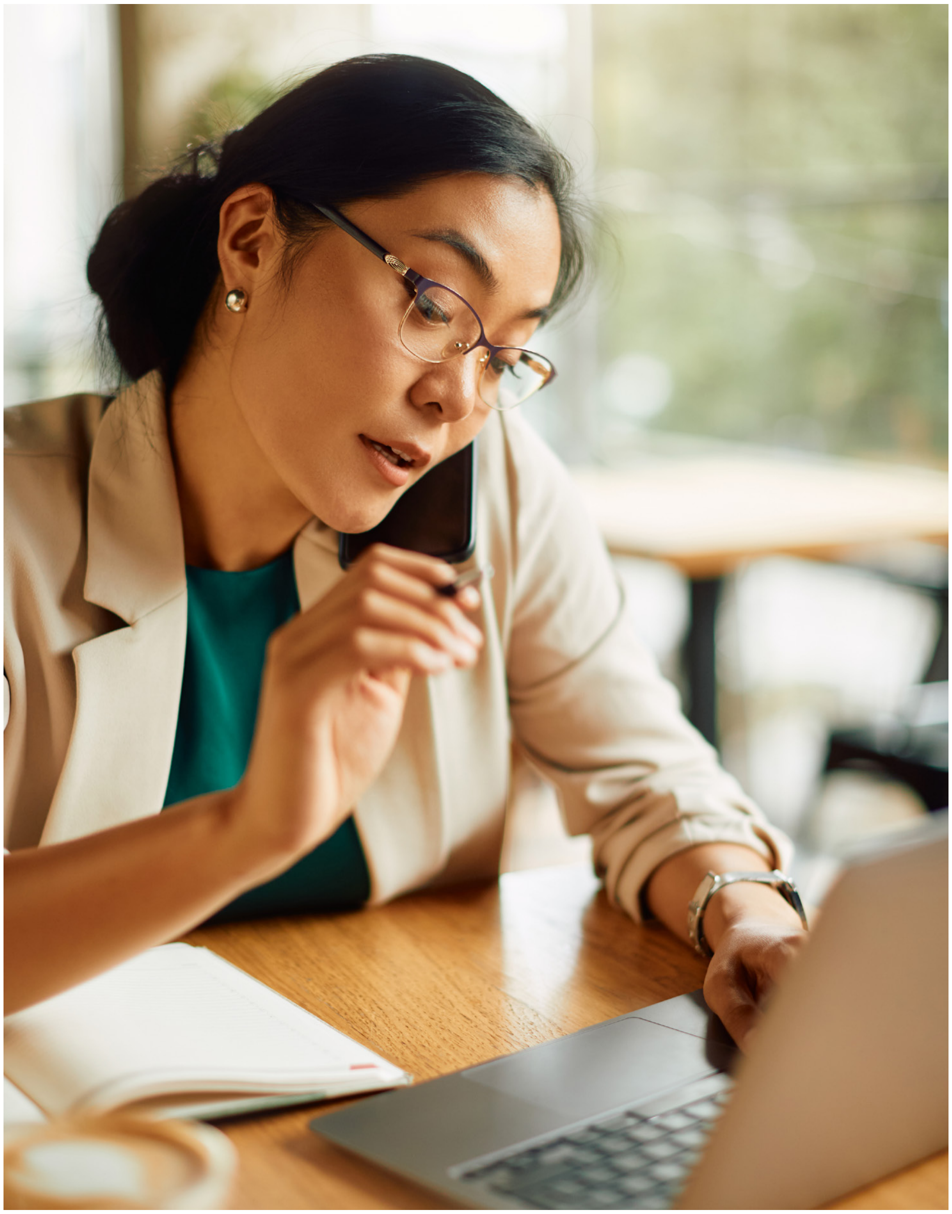
Key person insurance

A strategy to help protect your business

Key employees

If you’re like many business owners, you’ve sacrificed a lot to get where you are today.

But your level of success often means that when it comes to operating your business, you don’t do it all alone. Chances are, there are certain “key” employees that are the lifeblood of your company. These are the individuals you rely on, day in and day out.



What's a key employee?

A key employee is an employee that:

- Has unique management skills, experience and leadership to drive top line growth and manage bottom line expenses
- Possesses valuable relationships with key clients and centers of influence
- Has specialized skills, training or abilities that would make replacing them very difficult, time consuming and expensive

As the business owner, don't forget that you may be one of your company's key employees.

How would the loss of a key employee affect your business?

Have you ever thought how your business would be affected by the death or disability of one of these key employees? For example:

- Could your business still operate on a day-to-day basis?
- Would your business lose profits or experience cash flow difficulties?
- Would you have to find and train a replacement?

These are all important questions to ask. And the answers may expose an area where your business could be at risk — possibly, without your even knowing it.

In this guide, we'll explore one solution that can help you protect your business from the loss of a key employee: key person insurance. It can help you protect your business from the financial fallout that a company can experience when a key employee dies or becomes disabled.

Important reasons to consider key person insurance

Protecting your business against the death or disability of a key employee is a primary reason to purchase key person insurance. But there are other reasons as well:

- **Your business wishes to obtain a loan:** A bank or lending institution may look more favorably upon a business that is applying for a loan if that business has key person insurance in place. The lender may view the business as being more capable of surviving the financial loss of a top performer. And if necessary, the cash value of the key person life insurance policy can be used as collateral for the loan.[1]
- **Your business has a large amount of debt:** Key person insurance can be used to help repay the loan in the event that one of your key executives should die or become disabled.
- **Your key employee is a significant source of sales — or he/she is a "rain maker":** The absence of an employee who generates high sales volumes (whether through death or disability), or who is extremely successful at bringing new clients to a business, can leave a large void in that firm's balance sheet. Key person insurance can help to smooth out your company's cash flow until a replacement can be found.
- **You have a top performer who has talent or skills that would be difficult or expensive to replace:** Key person insurance can help to stabilize your company's cash flow while you conduct a talent search to replace a key employee who has passed away or become totally disabled.

What is key person insurance?

Key person insurance is life or disability insurance on a key employee in a business. Large or small, most businesses have several "key employees," including the owner[2] or partners, the founders and/or one or two employees who are top performers. Key person insurance provides the business with a source of funds when needed most — at the death or disability of a key employee.

Advantages of key person insurance

The advantages of key person insurance are many.

For example, key person insurance:

- Can provide your business with a source of funds exactly when needed — when a key employee dies or becomes disabled.
- Can help your business pay off loans, hire a replacement, and meet financial obligations in the wake of a key executive's death or disability. This can help you keep your business running smoothly, despite the loss you've sustained.
- Is an **asset** of your business. And if your key person insurance is in the form of permanent life insurance, your policy's cash value can provide a source of funds for collateral business uses — such as funding employee benefits obligations and redeeming the business interest of a deceased owner.[3]
- Helps to assure banks, creditors and valued partners that your business will continue uninterrupted in the event of the insured's absence, whether due to death or disability.

How key person insurance works

Business owner determines that the business needs to purchase key person insurance in order to protect its financial interests.

The business is the owner of the policy, which means:

- for life insurance, the business has full access to the policy's cash value for any purpose; and
- the cash value of the policy appears as an asset on the business's balance sheet.

Upon the key employee's retirement

The business may:

- take money from the policy's cash value to fund supplemental retirement income for the key employee;
- transfer the policy to the executive through a bonus; or
- retain the policy as a business asset.

Upon the key employee's death or disability

The insurer will pay the death or disability benefit to the employer as the named beneficiary.

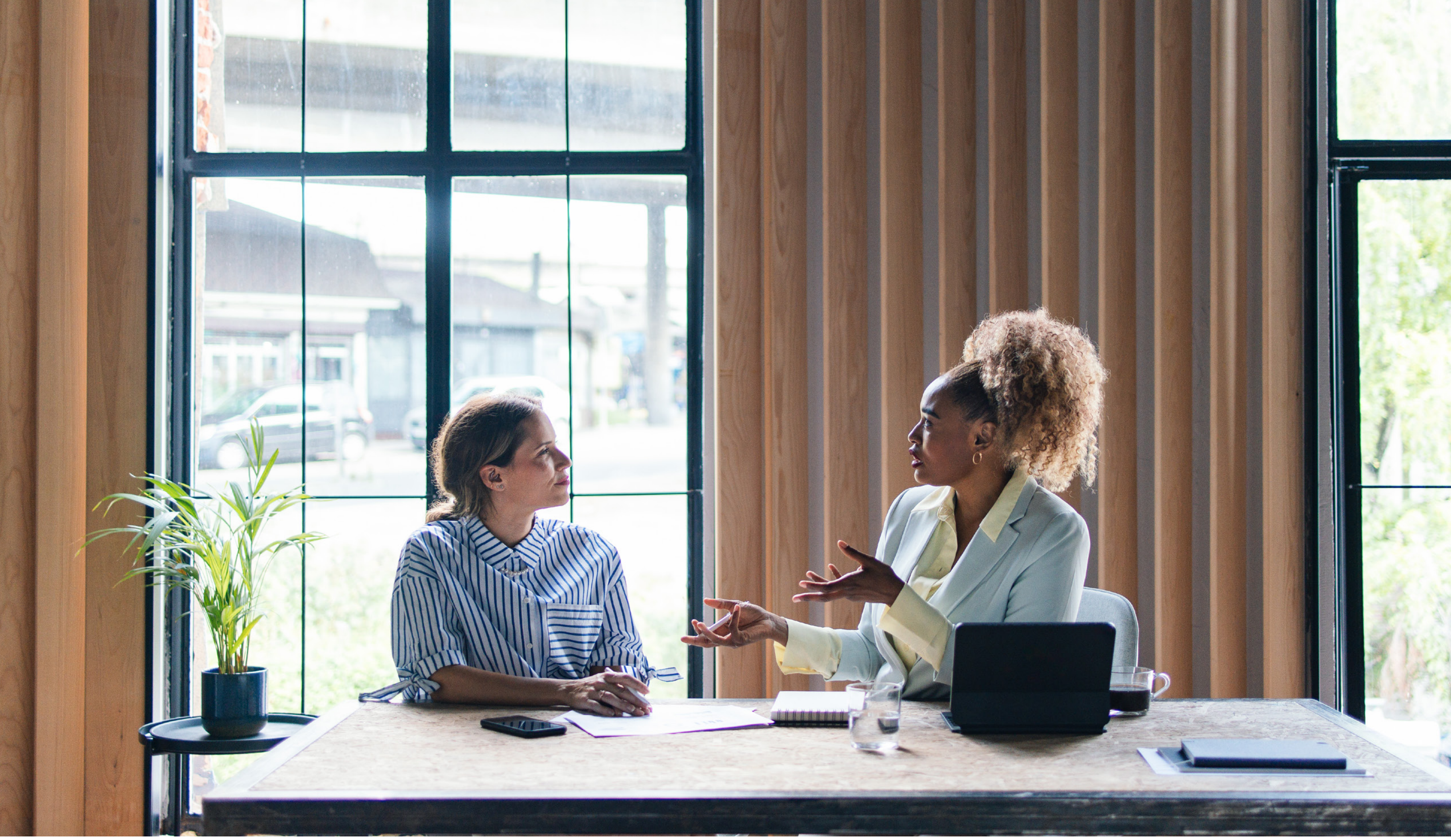
The death or disability benefit can be used to:

- help to meet the business's financial needs in the wake of the loss of the key employee; and/or
- provide a benefit for the key employee's surviving family.

Business owner notifies — and obtains the written consent of — the key employee in order to purchase insurance
on the employee.[4]

Once the policy has been approved, the business pays the initial premium to the insurance company and continues to make premium payments.

The business owner may set up an arrangement with the employee to share some of the death benefit with the key employee's beneficiaries.



How much protection does your business need?[5]

When it comes to key person insurance, there are numerous ways to estimate how much coverage your company may need. For example, you can base the protection level you purchase on:

- A multiple of your key employee's salary
- Your estimation of the key person's contribution to your business
- Your projection of the cost to replace profits lost due to your employee's death or disability
- Capitalization of excess earnings (based on your estimate of the value of the earnings that the insured brought to your business, over and above your business's ordinary investment returns)
- The cost to replace your key person's level of experience
- Potential lost revenues (due to your key employee's death or disability)
- The outstanding loan balance your business wishes to insure (which could be repaid, in whole or in part, with the policy's death or disability benefit)

Benefits and flexibility

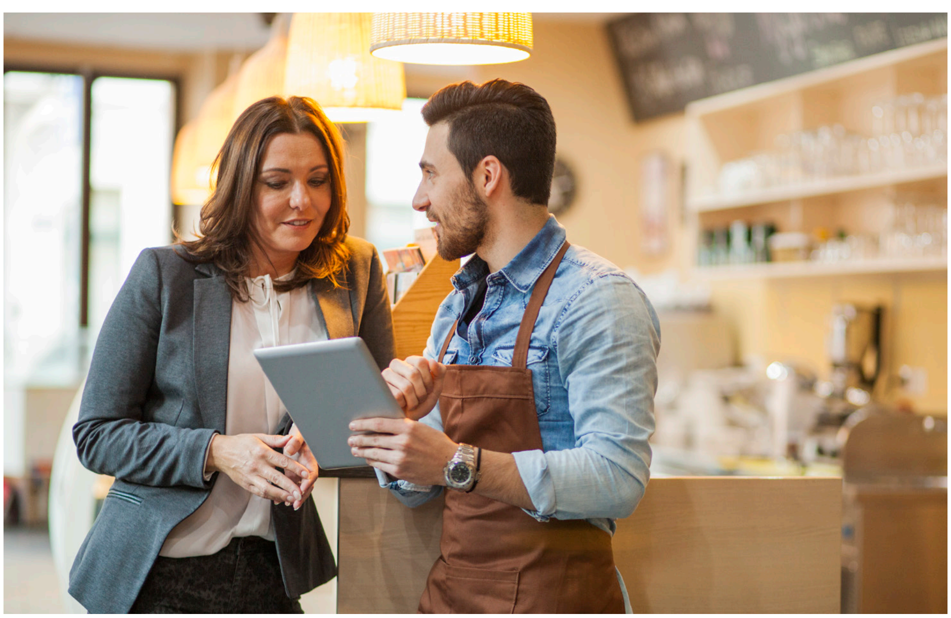
For you and your employees. Give your employees the incentive to **stay** with your business.

The primary purpose of a key person insurance plan is to protect against the death of a key employee. But because employee **retention** is important to business owners today, this type of plan can also be set up to provide valuable incentives to help entice your top performers to stay with your business for years to come.

With this flexible plan, you have the option to offer the key employees you select valuable benefits. For example, you may choose to:

- **Share the life insurance policy with your employee:** You can design your plan to include a pre-retirement split-dollar component, which enables your business to share some of the death benefit with your employee's beneficiaries. This can be done by sharing the cost of the policy with your key executive — or your business can fully fund this benefit as an employee perk.
- **Include retirement income options, such as:**
  - Bonusing the policy at retirement to certain key employees, as an added employee benefit to provide post-retirement insurance and/or supplemental retirement income.[3, 6]
  - Taking loans/withdrawals from the policy on an ad-hoc basis to fund supplemental retirement income for a key executive.[3]

Or, if you prefer, your business can retain the policy as a business asset, which means the policy's cash value will continue to appear as an asset on your company's balance sheet — and your business can access the cash value for any purpose you like. For example, you can fund the purchase of business equipment or other business-related needs. You can also access the policy's cash value to fund your own retirement income.



Key person insurance in action

John Roberts owns Monaco Manufacturing, a small medical device manufacturer. He is concerned because should anything happen to his chief engineer, Felicia Stevenson, his business could suffer greatly. It would take time to find a new engineer as talented and experienced as Felicia, and in the meantime, he would be unable to fulfill any customized orders. John is concerned about the possibility of Felicia's death, as well as the possibility of her becoming disabled.

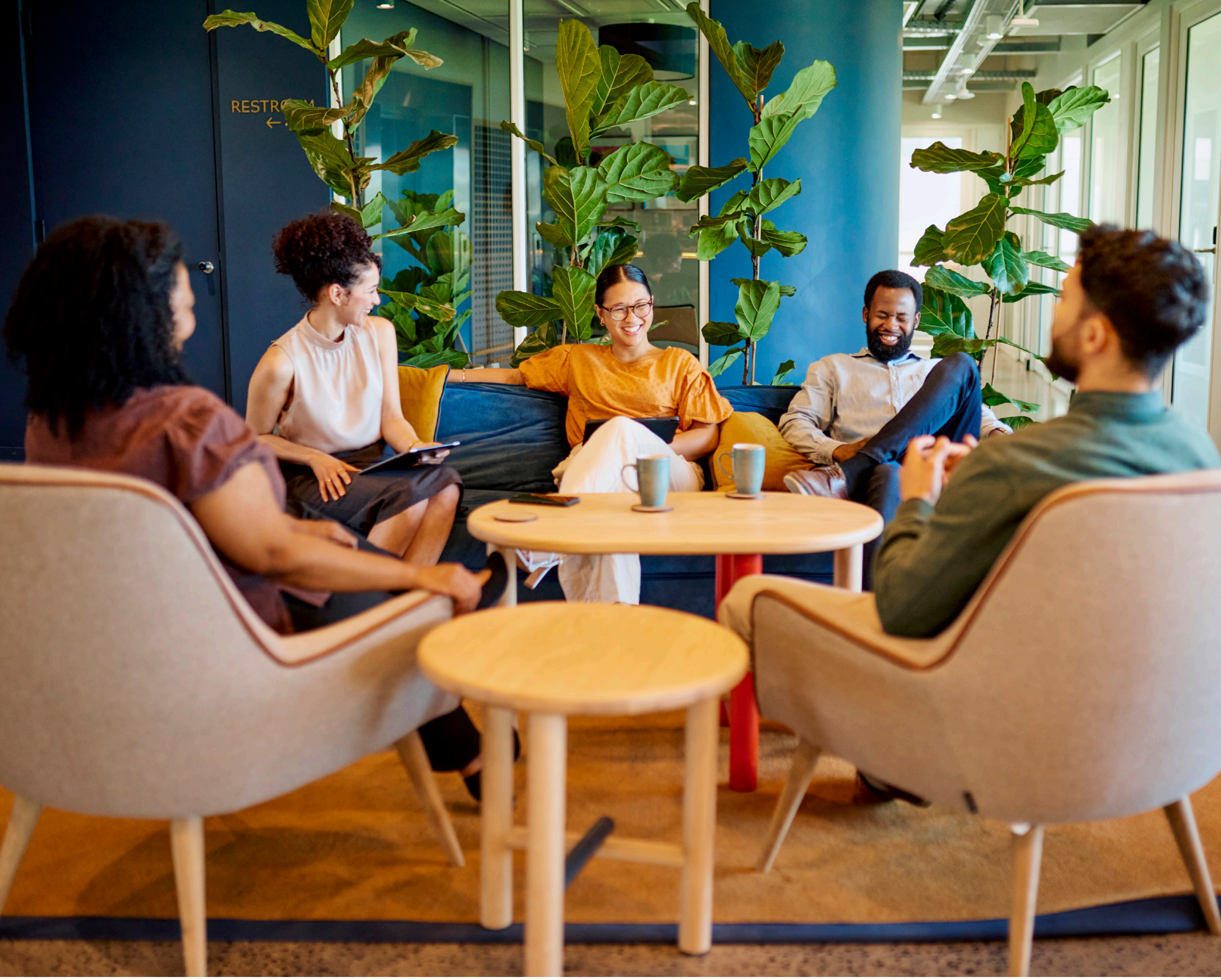
First, John purchases a PayGuard Plus disability income policy on Felicia's life with a maximum potential benefit of $1.425 M and a premium of $3,480.[7] Should Felicia become totally disabled, this policy will pay John's company $25,000 a month for the remaining benefit term (up to five years), or until Felicia can return to work, which ever occurs first.[8] So Monaco Manufacturing will be protected in the event Felicia becomes disabled.

Then, with Felicia's permission, John purchases a $1,500,000 whole life key person policy on Felica's life. The policy has an annual premium of about $30,000. The death benefit will protect Monaco Manufacturing should anything happen to Felicia.

Additionally, by the time Felicia reaches retirement in year 25, the policy will have a cash value of about $765,379. John could use this money to fund an additional retirement benefit for her, or he could even give her the policy outright.

Year	Net Premium	Cumulative Premium	Cash Value	Death Benefit
1	$30,033	$30,033	$525	$1,500,000
5	$30,033	$150,163	$90,878	$1,527,884
10	$30,033	$300,325	$249,960	$1,603,480
15	$30,033	$450,488	$452,397	$1,745,364
20	$0	$480,520	$602,238	$1,733,527
25	$0	$480,520	$765,379	$1,738,182

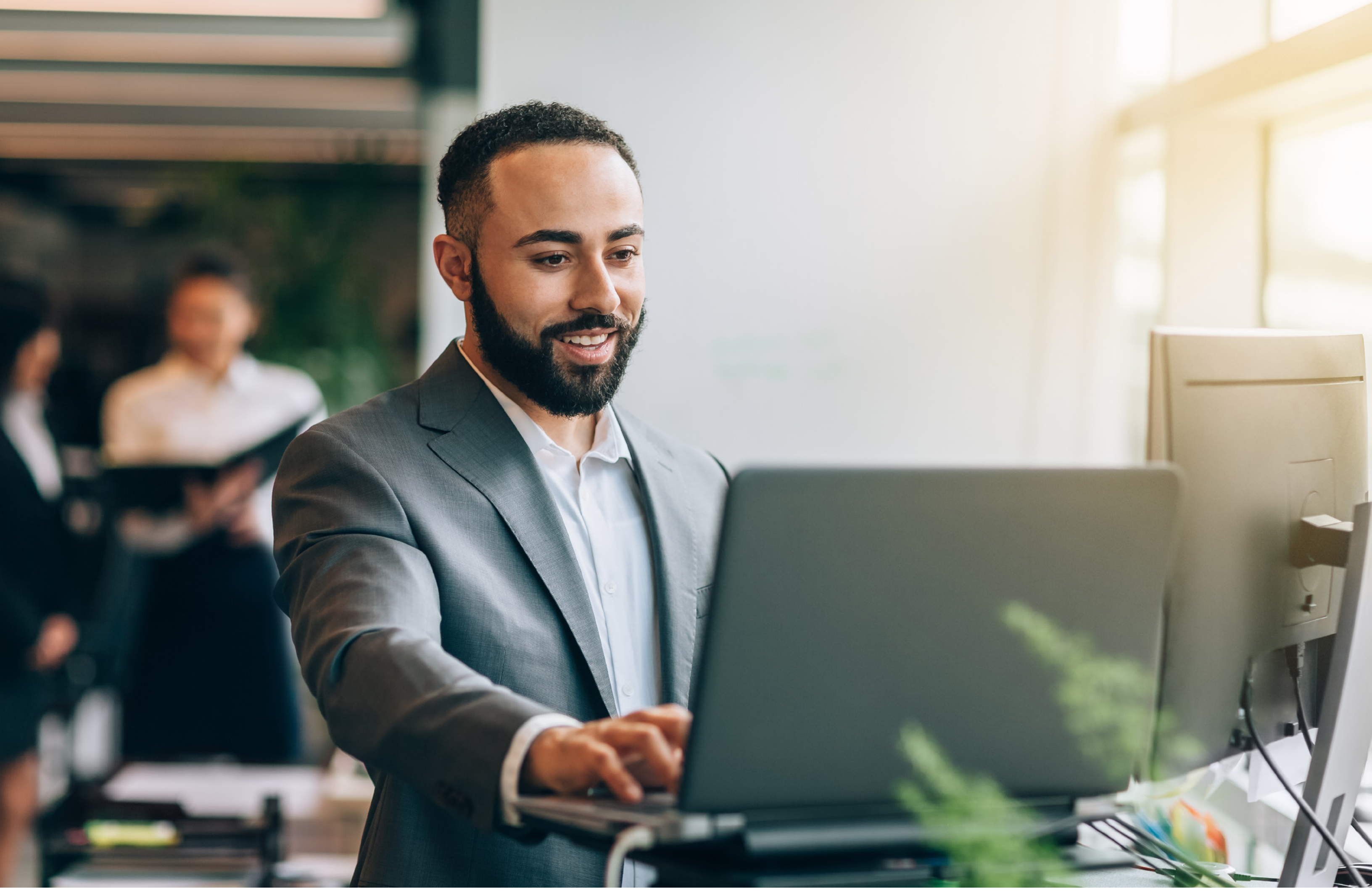
The example shown here is based on a hypothetical policy not available for sale from Guardian. This hypothetical illustration is intended to show, in general terms, how a typical participating whole life insurance policy might work. This illustration reflects a Male/Female Blend, age **42, Preferred NT, Whole Life 99 and Whole Life 95** and Guardian's **2024** dividend scale. A full illustration, showing both guaranteed* and non-guaranteed values, must be provided by a Guardian Financial Representative to an individual applying for a Guardian whole life insurance policy. For any illustration of a Guardian Whole Life product, the values depending on dividends can be more or less than those shown.



Tax considerations[9]

When it comes to key person insurance, there are some important tax considerations to keep in mind:

- Life and disability income insurance premiums are not deductible by your business.
- There are no tax consequences to the employee unless some benefit is paid to the employee or the employee’s estate.
- Insurance proceeds are generally received income tax-free by the business.
- In pass-through entities such as S corporations, Limited Liability Companies (LLCs) and partnerships, the death proceeds increase the basis of the owner’s business interest. Premium payments, policy cash values and policy dividends may also impact an owner’s basis; consult your professional tax advisor.[10]



Can the life insurance policy proceeds be subject to income tax?[11]

- IRC §101(j) stipulates that the death benefit from employer-owned life insurance contracts issued after August 17, 2006 are taxable as ordinary income to the extent the amounts paid under the contract exceed premiums and other amounts paid by the employer.
- However, if certain notice and consent requirements are met before policy issue, and if certain exceptions apply, death benefits have the potential to be income tax-free.
  - Employers purchasing key person insurance should file IRS Form 8925 in order to report:
    - The number of employees the business is covering through key person insurance;
    - The total amount of employer-owned coverage in force; and
    - How many covered employees the business has received consent (for coverage) from.

Get the protection your business needs

Your key employees are critical to the ongoing success of your business. Your Guardian financial professional can help you develop a strategy that can help you protect your business against the loss of these top performers.

Contact your Guardian financial professional to put your strategy in place today.

1 Some whole life polices do not have cash values in the first two years of the policy and don't pay a dividend until the policy's third year. Talk to your financial professional and refer to your individual whole life policy illustration for more information.

2 Disability key person insurance is not available if the partner/owner has more than 5% ownership in the business.

3 Policy benefits are reduced by any outstanding loan or loan interest and/or withdrawals. Dividends, if any, are affected by policy loans and loan interest. Withdrawals above the cost basis may result in taxable ordinary income. If the policy lapses, or is surrendered, any outstanding loans considered gain in the policy may be subject to ordinary income taxes. If the policy is a Modified Endowment Contract (MEC), loans are treated like withdrawals, but as gain first, subject to ordinary income taxes. If the policy owner is under 59½, any taxable withdrawal may also be subject to a 10% federal tax penalty.

4 The Pension Protection Act of 2006 created certain reporting and notice-and-consent rules, and some other technical requirements, for all employer-owned life insurance. Failure to comply could subject part of the life insurance proceeds to income taxation.

5 The amount of desired coverage will be subject to financial underwriting limits.

6 Care should be taken not to create a promise, formal or informal, to give the policy to the executive at retirement. Doing so could inadvertently create a Non-Qualified Deferred Compensation plan which would then be subject to IRC 409A.

7 Premium amount is for illustration purposes only, and is based on generic rates for a female age 40, occupation class 6 with a 90-day elimination period.

8 This hypothetical disability illustration is not a contract or an offer of coverage. It describes certain standard features of our PayGuard Plus contract, which may vary by state. If a policy is issued, its provisions and pricing may differ from what is illustrated here.

9 Guardian, its subsidiaries, agents, and employees do not provide tax, legal, or accounting advice. Consult your tax, legal, or accounting professional regarding your individual situation.

10 Dividends are not guaranteed. They are declared annually by Guardian's Board of Directors.

11 Employer-owned life insurance is received income tax free by the business only if IRC 101(j) is complied with.

All scenarios and names mentioned herein are purely fictional and have been created solely for educational purposes. Any resemblance to existing situations, persons or fictional characters is coincidental. The information presented should not be used as the basis for any specific insurance/investment advice.

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