KEY EMPLOYEE LIFE INSURANCE CHECKLIST

The purpose of key employee life insurance coverage is to help indemnify a business for the loss of a key employee's skills and experience in the event of the death of that person. Death benefits or cash values may be used to help recruit and train a replacement, to pay business debt, or to maintain the business's credit and financial standing during a transition of management.[1] The following checklist details the items that are generally needed to properly complete a key employee life insurance arrangement.

STEPS	ACTION REQUIRED	PARTIES INVOLVED
1	Identify key employee(s)	Business owner, licensed financial professional
2	Determine the face amount of life insurance coverage needed on each key employee (proposed insured) and select the type of policy.	Business owner, licensed financial professional
3	Execute a board resolution expressing the business's intention to establish a key employee insurance arrangement and authorizing the payment of stipulated premiums.	Business owner, legal counsel
4	Complete a life insurance application with the key employee as the proposed insured and the business as the owner, beneficiary, and premium payor.	Key employee(s), business owner, licensed financial professional
5	Prior to policy issue, execute employer-owned life insurance notice and consent documentation as required under Internal Revenue Code § 101(j). This documentation should be retained by the business to prove compliance.	Business owner, legal counsel
6	Annually report with the business tax return the data requested for employer-owned life insurance for policies issued after August 17, 2006.	Business owner, business's tax preparer

[1] Life insurance policy cash values are accessed through withdrawals and policy loans. Loan are at interest. Loans and withdrawals cause a reduction in cash values and death benefits, may affect any guarantees against lapse, and may have tax consequences.

5501 Excelsior Boulevard | Minneapolis, MN 55416

IDENTIFYING KEY EMPLOYEES

A key employee can be anyone – an owner or nonowner. What distinguishes someone as "key" is that their loss would severely impact a business until a replacement is found and trained. A key employee could be someone who might influence client relationships, someone whose loss might negatively affect a business's credit or reduce business income, or someone with special skills and talents.

QUANTIFYING THE FACE AMOUNT OF COVERAGE

The amount of insurance coverage should reflect the estimated monetary loss the business would suffer from the death of the key employee. Varied approaches exist to estimate the monetary loss to the business. The method most frequently used to quantify the face amount of coverage is based on either a generic multiple of the key employee's income or a percentage of an existing debt. In the absence of documentation, the general guideline is 5-10 times income or 50-70% of debt (less the existing amount of key person coverage already in force). While it is possible to justify coverage beyond the income multiple or percentage of debt guidelines, realize that additional supporting documentation will need to be provided.

It should be noted that key employees' W-2 compensation is often only a portion of their income. Perks such as stay bonuses, stock options, equity interest in the business, and benefits such as nonqualified plans are also reflective of the individual's value to the business. For key employees who have an ownership interest in the business, also look at the tax structure of the business entity. Distributions in lieu of W-2 income are often made to key employees who have ownership interests in S corporations, or guaranteed payments may be made to owners of partnerships/LLCs. Such payments will be included in an owner's tax return.

In not-for-profit organizations, compensation for key people is often less than what is paid in for-profit businesses. In such case look to other indications of a key person's value to the non-profit. In some cases it may be possible to justify greater amounts by looking at the amount of pledges or grants the key person has developed for the not-for-profit.

In new startup businesses, key employees may have taken a decrease in income at the time they joined the business. In such businesses, it is common for employees to have traded current income for an equity interest in the business. If so, the historical income records may be more reflective of the employees' value. Finally, in startup businesses, personal needs and business needs are often jumbled together. The key person is often the main breadwinner. So, where salary is lacking in a start-up business, you may considering building the insurance need based on personal needs and family protection in order to justify the amounts.

Debt liquidation coverage is frequently intertwined with key person coverage. Where this is the case, clearly describe the terms of the loan including the amount and length. If the debt is a line of credit, indicate the average outstanding debt for the last two to three years. Indicate whether the key person has personally guaranteed the debt and whether the business will experience credit difficulties at the key employee's death.

Key employee life insurance is often required in order to obtain funding for a startup business because venture capitalists want assurance that they can recoup their investment if something happens to a key person. It's not uncommon to see legal agreements where the venture capitalists require insurance equal to the sum loaned. In this regard, don't confuse debt with an equity investment by the venture capitalist.

5501 Excelsior Boulevard | Minneapolis, MN 55416

Generally, insurers will not insure the risk of loss for equity contributions to a business, while they will provide coverage for a loan.

When a case falls outside the guidelines, it is always beneficial to submit a cover letter with documentation that addresses all the important and relevant information.

SELECTION OF A POLICY AND PREMIUM PAYMENT

Careful consideration should be given to the policy choice. Term insurance is often the type of coverage selected when insurance on the key employee is likely to be needed for only a limited period of time. However, key employee insurance is frequently used for multiple purposes, such as to help with the buy-out of a business interest or informal funding of a nonqualified plan. Where this is the situation, a permanent policy may be a better option.

Typically the business is the owner, beneficiary, and premium payor of the policy. Regardless of the type of policy, the premiums are not tax deductible to the business where the business is owner and beneficiary. A decision should be made on where the premium notices and other correspondence relating to the policy(ies) should be sent. This location should be identified in the billing area of the application.

BUSINESS RESOLUTION

The board of directors for the business should adopt a resolution expressing the business's intention to establish a key employee insurance arrangement and authorizing payment of the premium.

NOTICE AND CONSENT REQUIREMENTS FOR EMPLOYER-OWNED CONTRACTS

For employer-owned contracts issued after August 17, 2006, the Internal Revenue Code generally provides that death proceeds will be subject to income tax. However, death proceeds may be received income tax free where specific employee notice and consent requirements are met, and certain safe harbor exceptions apply.[2]

Because key employee life insurance will usually be considered an employer-owned contract, it is critical that prior to policy issue, the business comply with the specific written requirements for employee notice and consent. The employee must also fall within one of the safe harbor exceptions at the time of policy issue, such as being a director, highly compensated employee,[3] or highly compensated individual.[4]

Documentation of compliance may need to be submitted depending on the carrier. Even if the insurance carrier does not require proof of compliance the business owner should retain proof that he/she met both the notice and consent requirement and the requirement that the employee fall within the safe harbor exceptions for as long as the policy is retainedas an employer-owned contract.

POLICY APPLICATION

Generally, the application will name the key employee as the proposed insured, and the business will typically be the owner, beneficiary and premium payor.

[2] The life insurance death benefit is generally received income tax-free under IRC § 101(a).
[3] Highly compensated employees include employees who, during the preceding year, were 5% or more owners of the business or had compensation in excess of a specific amount during the preceding year.
[4] Highly compensated individuals include the five highest-paid officers or individuals who are among the highest paid 35% of all employees.

5501 Excelsior Boulevard | Minneapolis, MN 55416

Specifically:

- *The owner and beneficiary section of the application should contain the complete name of the business, including the full address.*
- *An authorized person of the business must sign as owner on behalf of the business. If the proposed insured is an individual who is authorized to sign on behalf of the company, they may be able to sign as both the proposed insured and again as the owner. When signing on behalf of the business the authorized person will sign their name followed by title and name of the company (e.g., Jane Doe, President of XYZ Company).*
- *The business's federal tax identification number will need to be provided. In the case of a sole proprietorship, the business owner's social security number should be used.*

If you want the premium billing notice sent to a location other than what is provided on the application or if you want duplicate notices, this should be noted in the premium billing section of the application.

To assist the underwriter in quantifying the financial basis for the coverage requested, it is helpful to include a cover letter with an explanation of how the amount of coverage was established and provide the financial documentation that supports the coverage amount (or complete the business insurance financial questionnaire).

ANNUAL TAX REPORTING

Businesses that have employer-owned contracts are required to file Form 8925 with the Internal Revenue Service each year they maintain ownership of a contract. In addition to including information on the amount of employer-owned life insurance in force and the number of employees insured under such contracts, the business must attest that it has obtained valid consent from each insured or, where consent was not obtained, it must indicate the number of insureds from whom it was not obtained.