



### PROTECTING AGAINST THE UNEXPECTED

When taking inventory of 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.

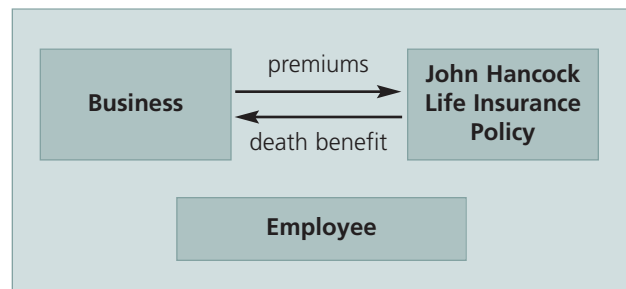
#### KEY PERSON INSURANCE — WHAT IS IT?

You can protect your business from the loss of a key person by implementing a key person insurance plan in which your company purchases and owns a life insurance policy on the life of a key employee. The life insurance policy will provide the company the liquidity needed to keep the business running in the event of the key employee's premature death. The plan provides the cash needed to hire a qualified replacement and/or to purchase the additional human capital or assets necessary to keep the business operating. The plan may also help to replace lost profits as a result of the loss.

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 life insurance provides the company with the funds to:

- keep the business running
- assure creditors of a smooth transition
- assure customers the business will run as usual
- cover the expense of finding and training a suitable replacement
- provide the company with a valuable asset on the company's balance sheet that can be used for unexpected corporate expenses
- potentially be used by the company to fund supplemental retirement income for the key employee

## 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 to the company, 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.

### CASE STUDY: LINDSEY WEBSTER

**Facts:** Lindsey Webster, age 45, works at Sawyer Builders, a construction company in Massachusetts. Sawyer Builders has a stellar reputation in commercial building, and Lindsey's expertise and contacts have contributed significantly to the company's business. James Sawyer, the owner of Sawyer Builders, knows that if something happened to Lindsey his business would be affected.

**Key Person Coverage:** James decided to purchase key person insurance on Lindsey by using the rule of thumb of 10 times annual compensation. Lindsey's total annual compensation is \$500,000 a year. Sawyer Builders is going to purchase a John Hancock Accumulation UL policy on Lindsey, with a \$52,153 annual premium for 20 years. By using the Accumulation UL policy, James will be able to access its potential cash values for business purposes or to fund supplemental retirement income for Lindsey.

When Lindsey retires in year 21, Sawyer Builders can transfer ownership of the policy to her, since it will no longer be needed as a key person policy. The chart below shows that the company will own the policy for 20 years and then will transfer the policy ownership to Lindsey in year 21, for supplemental retirement income and other liquidity needs. In year 21, the projected policy cash value will be \$1,278,876, and the company will pay a bonus of \$688,625 to Lindsey to cover the income tax due on the policy transfer, resulting in a total transfer to her of \$1,967,501. The company will get a tax deduction of \$1,967,501, which will offset the cost of the policy transfer.

Year	After-Tax Corporate Annual Outlay	Corporate Tax Deduction	Transfer to Employee at Retirement	Employee Outlay	Policy Death Benefit
1	\$52,153	\$0	\$0	\$0	\$5,000,000
10	\$52,153	\$0	\$0	\$0	\$5,000,000
20	\$52,153	\$0	\$0	\$0	\$5,000,000
21	\$1,278,876	\$1,967,501	\$1,967,501	\$688,625	\$5,000,000

This is a supplemental illustration authorized for distribution only when preceded or accompanied by a basic illustration from the issuer. Benefits and values may not be guaranteed; the assumptions on which they are based are subject to change by the insurer. Actual results may be more or less favorable. Refer to the basic illustration for guaranteed elements and other important information. Based on Female, Preferred Non Smoker, age 45, twenty-pay policy, Massachusetts resident.

### 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 the executive's supplemental retirement income through policy loans and withdrawals.

### 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.<sup>1</sup>

## 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 a small business whose day-to-day and long-term performance may be in jeopardy if something happens to one of its vital employees.



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1. Potential for alternative minimum tax may arise in limited circumstances for C corporations. A full tax discussion is beyond the scope of this piece. This piece is intended to provide an overview of key person insurance only. For more information of the tax consequences, please contact your tax consultant.

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