KEEPING YOUR BUSINESS HIGH & DRY

Duncan FINANCIAL GROUP

Most businesses thrive on the ingenuity and dynamism of a few key people. In order to retain their best employees, business owners often devise attractive benefit packages that make it harder for the competition to lure away key employees. Unfortunately though, even the best benefit packages cannot protect a small business from the sudden death of a key person. Imagine what a severe impact such an event could have on the future of your business.

Businesses often use key person insurance as a safety net. They buy a life insurance policy on the life of a valuable team member, so the death proceeds potentially may be used to get the business back on its feet. With key person insurance, the premiums are not a deductible expense. The company owns and pays for the policy, and also receives the proceeds income tax free (although there may be alternative minimum tax (AMT) consequences for a business organized as a C corporation). But, how do you actually evaluate and protect a key employee's contributions to your company's success?

QUANTIFYING SUCCESS

One of the most common methods for determining the amount of insurance needed is the "multiple" approach, which simply uses a multiple of the key person's total annual income including bonuses and deferred compensation. This approach is identical to the "rule of thumb" formula often used to determine life insurance needs for family protection (e.g., five to seven times annual salary). The result is an estimate that may, or may not, relate to actual needs. However, this method's popularity perhaps underscores the difficulty business owners face in quantifying a key employee's real value.

A more sophisticated method is the "business profits" approach, which is similar to the needs-based approach used to determine family life insurance needs.

This method tries to quantify the portion of the business's net profit that is directly attributable to the efforts of the key person, and multiplies that amount by the number of years estimated for a replacement to become as productive as the person insured. For example, if the annual estimate of net profit attributable to the key employee is $250,000, and it is estimated that it would take five years to hire and train a replacement, the policy's face value under this method would be $1.25 million.

A third approach determines the "present value" of the profit contributions of the key employee over a specified number of years. In this case, the face amount of the policy is discounted because the assumption is: Since the money will not be spent all at once, lump sum insurance proceeds can be invested at a reasonable rate to accrue over the years. To give a simple example, using anticipated profit contributions of $250,000 over the next five years and a discount rate of 8%, the policy's face value would be about $1 million. (You may wish to consult with your insurer's underwriter regarding their specific valuation method.)

Regardless of which approach may be deemed appropriate, key person insurance is vital to help safeguard your business from the possible loss of your most valuable assets—the key people who help ensure your company's future success. In addition to providing the cash to recruit, hire, and train replacements, key person insurance can help replace lost profits so that the success of your business may continue uninterrupted.