Key Person
Life Insurance

Producer Guide

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LIFE INSURANCE

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Key Person Life Insurance

Key person life insurance is a big sales opportunity in the business market. It is based on the likelihood that if a key employee dies, the business will lose profits or experience an increase in expenses. This brochure is designed to help you understand the benefits as well as the disadvantages of key person life insurance and how you can increase your sales in this market.

The Basics

A key employee can either be an owner-employee or a non-owner key employee. If the key employee is an owner, the life insurance coverage can also help protect his/her family's financial position. There are the three main reasons key person life insurance is purchased. Life insurance death benefits can potentially:

(1) Provide the funds to pay off or pay down business debts

(2) Replace profits that may be lost as a result of a key employee's death

(3) Provide funds to recruit, hire and train a suitable replacement.

Key person life insurance may also be used as the funding vehicle for other sales concepts. It can be used to fund both an entity purchase buy-sell arrangement and executive benefits designed to retain and motivate key employees (for example, non-qualified deferred compensation plans, endorsement split dollar plans, death benefit only (DBO) plans, etc.). Those concepts are discussed in depth in other ING Life Companies' producer guides.

How Key Person Life Insurance Works

Key person life insurance is relatively simple to explain and implement. The business purchases a life insurance policy on the life of the key employee and is the policy owner, the premium payor and the beneficiary. If the key employee dies, the policy's death benefits are paid to the business; it may use them to hire a replacement for the key employee or in other ways to promote the business and preserve its financial health.

Legal and Tax Consequences

The business pays the premiums and is not entitled to an income tax deduction for the premium expense. At the key employee's death, the business generally receives the death benefit proceeds income tax free. Proceeds from an insurance policy are generally income tax free (e.g., absent a transfer for value). Any death benefit received by an employer policy owner may be subject to income tax unless the parties have complied with IRC 101(j).

If the corporation is a C corporation, increases in the policy's cash values are included in the corporation's alternative minimum tax (AMT) calculation. At the key employee's death, the death benefits are also included in the company's AMT calculation. Consequently, there is a risk that the life insurance policy could contribute to an AMT problem for C corporations.

The business must have an insurable interest in the employee before a policy may be issued. Check to see if the state where the business is located has adopted statutes or regulations defining the types of employees in which a business has an insurable interest.

Some Potential Advantages of Key Person Life Insurance:

- Provides income tax-free death benefits to replace profits or capital lost because of a key employee's death. Proceeds from an insurance policy are generally income tax free (e.g., absent a transfer for value). Any death benefit received by an employer policy owner may be subject to income tax unless the parties have complied with IRC 101(j).
- Income tax-free death benefits which may be used to recruit, hire and train a successor key employee.
- Customers, creditors and other employees are assured of the stability of the company that it and may be in a financial position to keep its promises.
- Provides an infusion of cash that may keep banks and other lenders from foreclosing on business loans, reducing lines of credit or raising interest rates on outstanding loan balances.
- Can fund an entity purchase buy-sell agreement so the estate of an owner-key employee can convert the business interest into cash.
- Can be used to fund executive benefit programs for owner and non-owner key employees.
- Policy cash values are an asset on the business' balance sheet.

Some Potential Disadvantages of Key Person Life Insurance:

- Premiums are not income tax deductible.
- The coverage doesn't prevent the key employee from leaving the business while alive.
- Death benefits may be subject to the AMT (if the owner is a C corporation).
- The value of a key employee may be difficult to determine.

Selling Key Person Insurance

I. Repayment of Business Debts and Protection from Loan Foreclosures

Fearful Lenders

Businesses often borrow money from banks or obtain credit from firms that sell them equipment, buildings, or operating supplies. Often these loans are secured by valuable business assets. If the business defaults, the lender may take possession of the secured assets and sell them to produce funds to repay the loan. The lender wants access to as many valuable business assets as possible to reduce its risk of loss if the business defaults.

Lenders and creditors can get nervous when an owner or key employee dies. They can be concerned about the business' ability to continue operating profitably without the key person's special skills. If they call the loan or foreclose on any asset pledged as security, the business can be thrown into bankruptcy. The best way to calm lenders' fears and prevent foreclosure is to demonstrate an inflow of income tax-free cash that can act as an emergency fund to replace profits and pay the costs of finding, hiring and training a replacement. If the lender wants to call the loan, the life insurance death benefits can be used to repay it. Proceeds from an insurance policy are generally income tax free (e.g., absent a transfer for value). Any death benefit received by an employer policy owner may be subject to income tax unless the parties have complied with IRC 101(j).

An Owner's Personal Guarantee

When a business borrows money from a bank, a personal guarantee is often required from the owner as a condition to making the loan. These personal guarantees usually allow the bank to accelerate (call) the loan if the owner dies. The personal guarantee can give the bank the ability to collect the remaining loan balance from either the business' assets or from the owner's personal assets.

By signing the guarantee, the owner gives the bank preferred access to his/her personal assets. The guarantee usually doesn't require the bank to seek repayment from the business first or to claim and sell any business assets that may be subject to a security agreement. Instead, the bank may seek repayment from the owner without going through the business at all. If several owners have given personal guarantees, the bank may seek repayment from any of the guarantors in any proportion it wishes. It can collect from any one guarantor and need not take proportional amounts from others.

There are two ways life insurance can help solve the personal guarantee problem:

1. **Key person life insurance on the lives of owners who personally guarantee to pay a business' debt.** The business is the owner and beneficiary of the policy. At the owner's death, the policy death benefits can be used to repay the loan balance. Then the personal guarantee is cancelled.
2. **Personally owned life insurance paid with business funds.** A personal guarantee can be a real threat to a business owner's financial future and that of his/her family. It puts a bank "lien" on the entire estate. Business owners have the right to be compensated for personally guaranteeing to pay a business debt. Some businesses pay a "guarantor's fee" to owners who take on this risk. Such a fee would be fully taxable to the owner.

   The business owner can use the fee to purchase a life insurance policy on him/herself and name the estate or the spouse as the beneficiary. The guarantor's fee can be used to pay the premiums through either a split dollar arrangement or a 162 bonus arrangement.

You can open this discussion with business owners with statements like these:

- *"When your business borrows money, do you sign once or twice? Your personal guarantee may limit your personal investment alternatives and place a lien on your entire estate. Nothing gets settled until the loan is repaid. That means you are putting the bank ahead of your spouse and children in your estate plan. Is that what you wanted to do?"*

- *"When your business borrows money, do you sign once or twice? When you personally guarantee a loan for your business, you are taking on an important financial risk and putting the bank ahead of your family in the distribution of your property. Does your company compensate you for taking on this risk? It may be able to pay you a fee for agreeing to guarantee its loan. It's sometimes called a guarantor's fee. You could use this fee to purchase a life insurance policy that would help repay the loan in the event of your death."*

- *"When you stop, your business stops. How will your banker look at your business if you're not there? A life insurance policy may potentially pay off your business debts if you die unexpectedly."*

- *"I understand you and your partners own this building. Have you taken the necessary precautions to assure that if one of your partners dies, you and the other survivors aren't burdened by paying his/her share of the mortgage? This could present an expensive problem. Life insurance may provide a solution."*

- *"Mr./Ms. Owner, does your business have an outstanding bank loan or line of credit? When you applied for it, you may have found the bank's documents a bit complicated. Did you ask your CPA or attorney to look them over and advise you? When you told the bank that some terms or conditions were too burdensome, did the bank offer to change them or was it a "take it or leave it" deal? Most banks require business owners to personally guarantee that the loan will be repaid. Did you sign a personal guarantee? The bank's guarantee was probably written in "legalese." Was it "translated" in plain English so you could understand what you were really being asked to do? Some owners who personally guarantee bank loans for their businesses have the business pay them a guarantor's fee to compensate them for the additional risk they take on. This fee can be paid in the form of a premium on a life insurance policy large enough to repay the loan if they die. This strategy can keep the bank from going after your personal assets to repay the loan. Does it make sense for you to protect your family in this way?"*

II. Replacing Lost Profits and Unexpected New Expenses

Assets don't make money; people do. Key people often have the intellect, skill and savvy to position business assets so they make a profit. This is the guiding principle of key person insurance. If something happens to a key person and he/she is no longer able to perform, the business potentially loses profits and capital. Businesses insure their things (buildings, machines, and physical assets) against loss, but often forget that what makes profits is the decisions their key people make on how to use business assets. If a key employee dies, the business will not only lose some profits, it may also incur a variety of additional expenses:

- Recruiting expenses
- Travel and relocation expenses
- Training expenses
- Additional salary & benefit expenses.

There are two steps to making the key person life insurance sale. The first step is identifying the business' key people. You must get the owner to tell you whose death will have an adverse financial impact on the business. The second step is determining the value of those key employees so the business can try to quantify the potential loss and decide how much life insurance protection it needs to protect itself.

Identifying the Key Employees

Does the business have some employees who are unusually important to its bottom line? Do some employees have special skills or attributes that can greatly influence profits year after year? Employees who stand out in these areas are probably key people:

- Special contacts/connections
- Sales ability
- Financial expertise
- Management ability
- Product design/innovation
- Leadership skills
- Computer/technical skills
- Ability to get things done.

Some states have adopted statutes or regulations that define who a key employee is for insurable interest purposes. For example, New York has adopted Regulation 180 which lists several classes of key employees. If the employee doesn't fall into one of those classes, the business does not have an insurable interest and a policy cannot be issued. Check the law of the state where the business is located to see if there are any insurable interest restrictions.

Business owners sometimes take their key people for granted. Questions like these can help business owners understand who they depend on most:

- *"Do you have any employees who, if he/she died or was disabled unexpectedly, their replacement would need more than three months to reach the same level of proficiency?"*
- *"Do you have any employees who are engaged in any projects which, if left unfinished, would prove costly to your company? How costly?"*
- *"Do you have any employees who, if they left, their departure would have an adverse impact on your company's credit standing?"*
- *"Aside from yourself, who is your company's Most Valuable Performer (MVP)?"*
- *"If you were to nominate three people from your company to your industry's all-star team, whom would you pick?"*
- *"Which of your employees would be the hardest to replace?"*
- *"Do you insure your PC's for more than your VP's?"*
- *"Do you have "profit" insurance?"*
- *"Do you carry insurance on your trucks? How about on your buildings and machines? Do you carry key person insurance on your president? Who makes the profits around here, the trucks or the president?"*
- *"Your company's most valuable asset is your key employees' ability to produce profits. It's called "intellectual capital." Because of accounting rules, intellectual capital can't be listed on your balance sheet. But it is an important reason your income statements show solid profits. What strategies are you using to protect your intellectual capital from loss?"*
- *"You've probably insured the assets listed on your balance sheet, right? Have you insured the profits on your income statement? Which is more important, your assets or your profits?"*

Key Employee Valuation Worksheet

Part I: Lost Profits

Profits Attributable to Key Employee	$________
# of Years to until Recovered	x________
Total	$________

OR

Revenues Attributable to Key Employee	$________
Profit Margin Percent on Revenues	x________
# of Years to Replace	x________
Total	$________

Part II: Additional Expenses

	Key Employee's Total Comp. & Benefits	Replacement's Total Comp. & Benefits	Difference	
Compensation Differential	________ -	________ =	________	$________
Recruiting, Advertising & Placement Costs				$________
Training Expenses				$________
Increased Interests Costs on Business Loans				$________
Other Costs (Specify)				$________
Total				$________

Total Lost Profits and Total Additional Expenses	$________

The Owner as a Key Person

Owners who work in the business as employees sometimes forget that they are key employees who should be insured to protect the value of the business. They may try to avoid thinking of their own mortality or may not want to purchase insurance on themselves. They may be thinking "I'm not going to die" or "If I die, I won't be here to have to deal with the problems and the loss of value the business will suffer." Remind them that to be able to keep the business viable for their families or for the other employees whose jobs (and therefore their economic livelihoods) come from the business, they need to be insured.

Use this strategy with an owner-employee:

"How much money would you have invested in this business if you weren't in it?"

⇨ *"You're the driving force in your company. You're the 'electricity' that makes it go. While you're running on all cylinders, the company does well and makes a good profit. Do you know what an electrical fuse is? It's very much like you. When it's working, the current is flowing and everything is going fine. Profits are coming in. But when it blows, what happens? Exactly! Everything stops. You're the fuse in your business. What happens when your electrical current stops? That's where I can help you. I can make sure that if your fuse blows, the 'electricity' will keep flowing at your company."*

III. Key Employee Retention-The Companion Sale

Whenever an owner identifies a key employee (other than him/herself), you are positioned to make a second sale. That sale is an executive benefit plan designed to keep the key employee loyal and productive on into the future.

The business will likely suffer the same lost profits and increased expenses regardless of how the key employee leaves. If the key employee dies, the life insurance death benefits can preserve the business' financial strength. But what happens if the key employee leaves voluntarily to join a competitor or to start his/her own business? Then the life insurance policy doesn't pay any death benefits. The key employee can walk away and the business will only have the policy's cash values to offset lost profits and the expenses of replacing the employee.

A business can only protect itself from a key employee's voluntary departure by adopting a plan that gives the key employee strong incentives to stay. An executive benefit plan customized to the key employee's wants and needs can prevent a voluntary departure. In fact, a well-designed executive benefit plan does three things:

1. Formally recognizes the key employee's worth and contribution to the business,
2. Gives the key employee incentives to continue high-level performance, and
3. Recovers the expenses incurred to provide the benefit.

With good planning, the same life insurance policy may be able to fund both an executive benefit plan that keeps the key employee from walking away voluntarily and the death benefit needed to replace the lost profits and increased expenses that occur if the key employee dies. One life insurance policy may be able to do double duty. A non-qualified deferred compensation plan, split dollar life insurance plan, split dollar loan arrangement or a death benefit only (DBO) plan can each be funded by a key person life insurance policy.

Here's what you could say to a business owner:

⇨ *"Do you follow any professional sports? Are you aware of the problems professional sports teams are having in keeping their best players? When their contracts expire, the player files for free agency and makes him/herself available to the highest bidder. When these key players leave, the team often isn't nearly as good and it's under real pressure to find replacements. You've got some 'free agents' on your team. Your top people can work for a variety of companies that need their skills and experience. There is a real market for top-notch people. Have you tied any of your key employees down with long-term contracts? I have some strategies you can use to keep them from jumping to a different team."*

For more information on Key Person Life Insurance,
call your ING Life Companies' representative or
ING Life Sales Support at 1-866-464-7355.

ReliaStar Life Insurance Company
20 Washington Avenue South
Minneapolis, MN 55401

ReliaStar Life Insurance Company of New York
1000 Woodbury Road, Suite 208
Woodbury, NY 11797

Security Life of Denver Insurance Company
1290 Broadway
Denver, CO 80203

Log in to ING for Professionals at
www.inglifeinsurance.com

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140184 09/23/2010

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