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## Don't Overlook Key Employee Insurance

Our readers often talk to business owners. Many times the conversation is in connection with life insurance on the owner for estate planning purposes, or buy sell planning. Most businesses also have a need for key employee life insurance.

### Who is a Key Employee?

A key employee is anyone who affects the overall success and profitability of the business.

A key employee could be a manager whose judgment and leadership are crucial to the business; a sales representative with knowledge of the product and customers; or any other worker who has unique technical experience or good rapport with customers, creditors, or fellow workers.

### The Need for Key Employee Insurance

The death of a key employee may cause the loss of management skill and experience. This could be particularly traumatic for small companies with only a few managers. Death of a key sales representative could cause the loss of customers loyal to that particular individual, and will affect sales in general. Death of a key employee could hurt the company's credit rating and the ability to obtain credit in the future.

Death of a key employee will cost the business the expense of hiring and training a replacement. The business owner may feel morally obligated to provide a substantial death benefit to the key employee's family.

The premiums on a key employee policy are usually small compared to the death benefit. If a permanent policy is used, the cash values are shown as a business asset on the company books. This may increase the company's credit rating and can be a source of money in a financial crisis.

If the key employee is also an owner, a key employee policy death benefit can be used to fund a buy-out of the deceased owner-employee's interest in the business.

### How Much Key Employee Insurance Should a Business Have?

Determining the amount of key employee insurance is not a precise process; it will depend upon the facts and circumstances of each situation. Here are some broad guidelines.

In the case of sales representatives, product designers and research persons whose loss might directly cause a measurable loss of sales or earnings, advisors recommend using a multiple of lost sales or earnings. For example, suppose a business owner estimates that the loss of a key sales rep would cause a drop in sales of \$100,000 per year for five years, while a new sales rep learned the product and territory. A key person policy of \$500,000 would be in order.

Where key managers or financial officers are involved, the direct impact on sales and earnings may be harder to measure. Many advisors recommend using a multiple of salary in those cases. For instance, if a key manager is making \$100,000 a year and the owner estimates it will take three years to recruit, train, and bring a new manager up-to-speed, a \$300,000 policy would be advisable.

Check with the underwriting manager to get more specific guidelines for your life carrier.

### Tax Aspects of Key Employee Insurance

With key person coverage, the business applies for and is the owner and beneficiary of a policy insuring the key employee's life. The business pays the premiums. The premiums are non-deductible when paid, but the death proceeds are generally tax-free to the business. *(Article continued on next page)*

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In some cases, businesses with over \$5 million per year of revenue may be subject to alternative minimum tax on death proceeds. Also, Section 101(j) of the IRC requires special notice and waiver rules to be followed to preserve the tax free death benefit. Ask your life carrier for the proper forms.

A key employee life insurance policy has no tax effect on the insured employee.

If a cash value policy is surrendered by the employer, the proceeds are tax-free to the extent of premiums paid; any gain will be taxed as ordinary income. Policy loans are available to the employer and are usually tax-free as long as the policy stays in force. Loan interest may be deductible by the loan business on a limited basis.

While key employee insurance seems like a simple idea, it can help a business owner client protect his investment.



## 2007 Charitable Giving Strategy for Seniors

This year is the last one that some of our senior clients will be able to make a tax-favored charitable donation from an IRA.

Prior to 2006, if a person wanted to make a charitable distribution using IRA money, he'd have to take a taxable distribution from the IRA and write a check to the charity. Many taxpayers who did that were unable to claim a full charitable deduction for the money donated, because they didn't itemize their deductions or because they otherwise failed to qualify for the deduction.

In 2007, taxpayers who are older than 70 ½ may donate money to charity directly from their IRA account. The distributions will be tax-free. Taxpayers are allowed to donate up to \$100,000 per year from their IRAs. Since the distribution will not be included in taxable income, individuals will not be able to claim a tax deduction for the charitable contribution.

One other positive result of implementing the strategy is that amounts sent directly to charity also qualify for meeting minimum distribution requirements. Clients ought to seriously consider using IRA money instead of just writing a check if they are:

- Older than 70 ½
- Already supporting a charity with financial contributions
- Facing the prospect of taking otherwise unneeded distributions from an IRA

This special opportunity is scheduled to end this year, so clients ought to make plans now.



# Coverdell Education Savings Account (Formerly Education IRA)

## Contributions

- A maximum of \$2,000 per year into one beneficiary's account. The \$2,000 limit is applied to all contributions made by anyone, on behalf of the particular beneficiary; that is, no multiple gifting by parent, grandparent, etc.
- Contributions may be made at any time during the calendar year and up to the tax filing date (not including extensions) for the current year; for most taxpayers, this is April 15th of the following year.
- Contributions are non-deductible.
- Contributions may only be made on behalf of beneficiaries under age 18, unless the beneficiary is a "special needs" beneficiary.
- Contributions are subject to an income level "phase-out." In the case of joint filers, the maximum allowable contribution phases out between \$190,000 and \$220,000 of modified adjusted income (MAGI). In the case of a single filer, the phase-out is between \$95,000 and \$110,000 of MAGI.
- Excess contributions are subject to a 6% per year penalty.

## Taxation of Distributions

- The account must be distributed prior to the beneficiary's age 30; however, if the beneficiary does not use the money for educational expenses prior to age 30, he or she may change the beneficiary to another family member under age 30.
- Distributions used for "qualified education expenses" of the beneficiary are totally excluded from income.
- "Qualified education expenses" include elementary and secondary expenses in addition to higher education expenses.
- Distributions of gain in the account not used for educational expenses are partly taxable and are included in the gross income of the recipient. Distributions are taxable in direct proportion to the accumulated gain in the account immediately before the distribution.
- Any portion of a distribution includable in income will also be subject to a 10% penalty unless paid on account of the beneficiary's death or disability.

## Coordination with Other Educational Programs

- The account is considered part of the student's assets and is assessed at 35% for federal financial aid purposes.
- Distributions used to pay for education expenses that are used for Hope Credit or Lifetime Learning Credit are not eligible for exclusion from income.

## Estate and Gift Tax Treatment

- Contributions to the account are considered to be a completed gift of present interest from the contributor to the beneficiary.
- Contributions are eligible for the annual gift tax exclusion and generation-skipping transfer tax exclusion.
- The value of the account is not included in a contributor's estate for estate tax purposes.

*In 2007, taxpayers who are older than 70 1/2 may donate money to charity directly from their IRA account.*





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