

## Success Strategy Key Person Insurance

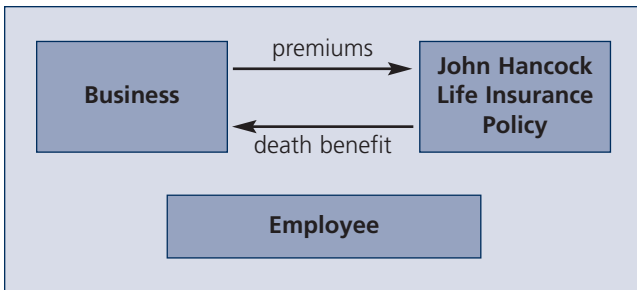


You may be concerned about protecting your business from the premature death of a key employee whose knowledge and contribution to your company are invaluable. The loss of such a key person may result in not only a loss in sales but also a potential loss of important contacts and goodwill. Your company's credit position may also be compromised. The solution to this problem is to establish a key person insurance plan.

### WHAT IS KEY PERSON INSURANCE?

Key person insurance is an insurance policy taken out by a corporation on the life of a key employee to protect the business in case of a sudden death. The key employee can be anyone in the business whose loss would be significant to the company or could result in a loss of business. This could be the owner, a partner, or an employee whose knowledge and contributions to the company are invaluable.

### HOW DOES IT WORK?



The corporation buys a life insurance policy on the life of the key employee, and the business is the owner and the beneficiary of the policy. The business will pay the entire premium and at the death of the employee, the business will receive the entire death benefit. This income tax-free death benefit may be used to replace lost profits, recruit and/or retain qualified replacements, or protect the company's credit position. The employee does not have any interest in the policy, nor does his or her family typically receive any benefits from the policy when death occurs.

### BENEFITS OF KEY PERSON INSURANCE

Key person life insurance is simple to implement. It does not need IRS approval and may include many people. With key person life insurance, the business has death benefit protection in case of a sudden and unexpected death, and is able to access the potential cash values of the life insurance policies for cash flow, retirement benefits, or for unanticipated expenses.<sup>1</sup>

### TAX IMPLICATIONS<sup>2</sup>

A key person life insurance arrangement, in most situations, benefits the business and the only involvement that the executive has is being the insured. The business does not receive an income tax deduction on the premium, but it will receive the death benefit free from income taxes upon the death of the insured. However, potential for alternative minimum tax may arise in limited circumstances if the business is a C corporation.<sup>2</sup>

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.

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1. Withdrawals and loans from life insurance policies which are classified as modified endowment contracts may be subject to tax at the time the withdrawal loan is made. A federal tax penalty of 10% may also apply if the withdrawal or loan is made prior to age 59½. Withdrawals and loans also have the effect of reducing the death benefit and cash surrender value and may cause the policy to lapse. Lapse of a life insurance policy may cause adverse tax consequences.
2. 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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