KEY PERSON INSURANCE

Businesses can often be at risk of being dependent on the expertise of just a few key employees, such as a manager, a leading contributor to the sales force or one who maintains crucial customer relationships. Without the implementation of a sound business plan, the death or disability of a key person could significantly impair the growth or stability of a business.

Key person insurance is an important component of any financial plan and may reduce the impact of the loss of a key employee on a business. If a key employee dies or is unable to work at any time before retirement because of a disability, a key person insurance policy could provide the business with some financial means to manage the loss of the employee and preserve the value of the business.

HOW DOES KEY PERSON INSURANCE WORK?

A key person insurance policy is normally purchased by the employer on behalf of the employee, with the employee's consent, with the intention that the proceeds will be used to maintain the business in case of the death, critical illness, or disability of the key employee. Key person insurance can be structured based on the particular needs and objectives of each individual business.

Typically, key person insurance is purchased by small corporations with active owners. While everyone benefits from such insurance, some thought should be given before deciding who owns the policies, pays the premiums, and collects the benefits. The following scenarios provide a general overview of different key person insurance scenarios and when it may be beneficial to a business.

Scenario 1

- The company is a successful business where all or part of its success depends on a key person (owner or other key person).
- The company wants to ensure that the business will continue to operate if something were to happen to the key person.

In this scenario, the company purchases, owns, and is the beneficiary of a life insurance policy, insuring the life of the key person. Upon the death of the key person, the total death benefit is paid tax-free to the company, who can then use the proceeds in whatever manner required to continue running the business. If the company is a corporation, the difference between the death benefit and the Adjusted Cost Basis (ACB) is paid tax-free to the corporation's Capital Dividend Account. This amount can then be paid to the shareholders as tax-free dividends.

Scenarios 2 and 3 are based on shared ownership between the company and the employee.

Scenario 2

- All or part of the company's success depends on the key person.
- The company wants to ensure that the business will continue to operate if something were to happen to the key person.
- The company wants to attract or retain the key person by providing a savings plan that allows the person to take advantage of the tax-deferred Cash Surrender Value in the universal life policy.
- If the policy is not needed before the key person retires, the face amount of the universal life insurance policy can be transferred to the insured employee to cover the individual's own insurance needs.

In this scenario, a universal life insurance policy can be structured so that the company can own and pay for the insurance coverage (death benefit) component, while the key person can contribute and own the savings component of the policy. When the key person dies, the key person's beneficiary will receive the Cash Surrender Value (CSV) of the policy tax-free and the company will receive the "face amount" of the policy tax-free. If the company is a corporation, the proceeds of the policy will flow through the Capital Dividend Account and can then be paid to the shareholders as tax-free dividends.

Scenario 3

- The company wants to attract or retain a key person by providing low-cost permanent insurance.
- The company wants the tax-free accumulation of the Cash Surrender Value for borrowing while the key person is living or to obtain funds when the individual passes away.

If it is deemed to be more appropriate, the universal life insurance policy can be shared in reverse – the company owns the savings component, while the key person has the rights to the death benefit. The key person pays the annual premiums for the face amount of the policy and the company pays the premiums attributable to the Cash Surrender Value. Upon the death of the key person, the face amount of the policy is paid to the key person's beneficiary tax-free. The Cash Surrender Value is paid out to the company tax-free. If the company is a corporation, the CSV will flow through the Capital Dividend Account and can then be paid to the shareholders as tax-free dividends.

SUMMARY OF KEY PERSON INSURANCE SCENARIOS

	SCENARIO 1	SCENARIO 2		SCENARIO 3	
Owner	Business is the beneficiary of both the face amount and Cash Surrender Value	Key person and the business jointly own the policy		Key person and the business jointly own the policy	
	Death of key person	Death of key person		Death of key person	
Death Benefit	Cash Surrender Value + Face Amount = Death Benefit	Cash Value	Face Amount	Cash Value	Face Amount
Beneficiary	Business	Key person's beneficiary	Business	Business	Key person's beneficiary
Tax Benefit	Excess of death benefit over the Adjusted Cost Basis (ACB) flows into the company's Capital Dividend Account (CDA)		Excess of face amount over the Adjusted Cost Basis flows into the company's Capital Dividend Account	Excess of the Cash Surrender Value (CSV) over the Adjusted Cost Basis flows into the company's Capital Dividend Account	

Key person insurance should be considered an important part of your overall business plan. Determining the type and amount of key person insurance needed depends on your business objectives and the risks associated with the loss of a key person to your company. When considering key person insurance, ask yourself the following questions: who are your key employees and what impact would there be on your business if they were unable to work as a result of an injury or death? **Your CIBC Wood Gundy Investment Advisor, together with an Estate Planning Specialist (Financial Security Advisor in Québec), can work with you to determine the best solutions for your business. Contact your Investment Advisor to discuss if your business can benefit from key person insurance.**