



Key Person Insurance

“Protect your business from the loss of a key person with life insurance payable to the business.”

We offer you this concept piece to help you understand how life insurance can be used to help provide funds to help indemnify a business for the loss of a key employee. This material contains references to concepts that have legal, accounting and tax implications. It is not intended as legal, accounting or tax advice. Consult your own attorney and/or tax advisor for advice regarding your particular situation. Accordingly, any information in this document cannot be used by any taxpayer for purposes of avoiding penalties under the Internal Revenue Code.

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Do you identify with the following?

You are a business owner with a key employee who:

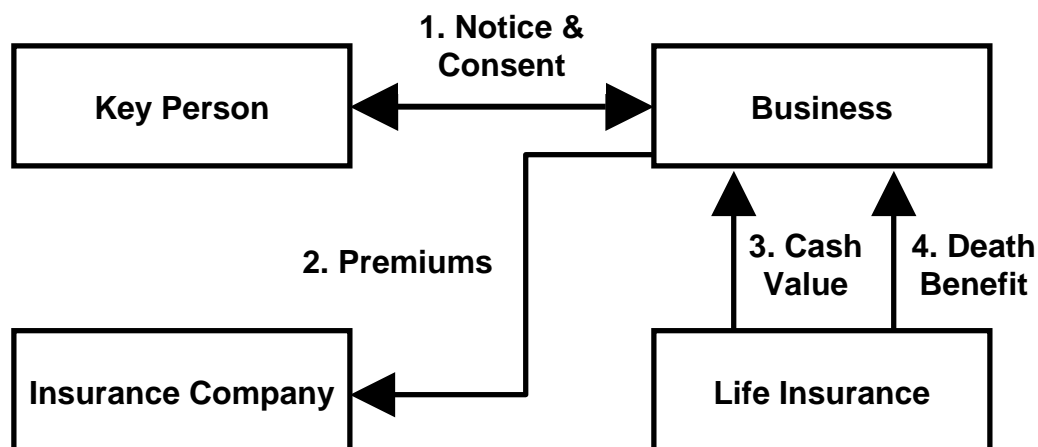
- ◆ Has unique managerial skills and experience, which helps the company to be successful
- ◆ Has relationships with clients that help generate a large portion of the company's revenue
- ◆ Possesses skills that would be difficult to replace

Your business would lose revenue and/or experience increased expenses upon the death of this key employee due to:

- ◆ Disrupted client relationships
- ◆ Lost skills
- ◆ Weakening of the company's credit rating
- ◆ Recruiting, hiring, and training expenses

If so, you may want to consider insuring the life(lives) of your key employee(s).

A Key Person Life Insurance Structure



1. The business gives notice to the key employee that insurance will be purchased on the employee's life and receives consent from the employee.¹
2. The business purchases a life insurance policy on the key person's life. The business is the owner, premium payer, and beneficiary of the policy. The premiums are not tax deductible.
3. During the life of the key employee, a cash value policy can provide the business with a reserve that can be accessed through loans or withdrawals. Loans and withdrawals reduce cash values and death benefits, may affect any guarantee against policy lapse, and may have tax consequences. At the retirement or termination of the key employee's employment, the business has the option of maintaining or surrendering the policy, or may transfer the policy to the insured-employee.
4. When the key employee dies, the policy pays a death benefit to the business. The proceeds can be used to help recruit, hire, and train a successor or may be used to help meet financial obligations. If the key person insurance is on an owner, it may be used to fund the redemption of a deceased owner's business interest.

¹ Insurance death proceeds are generally received income tax-free [IRC § 101(a)]. For employer-owned contracts issued after August 17, 2006, death proceeds will be subject to income tax. However, where specific employee notice and consent requirements are met, and certain exceptions apply, death proceeds can be received income tax-free [IRC § 101(j)].

Benefits to the Business:

- ◆ Key person life insurance proceeds provide a financial cushion that can help indemnify the business for the loss of a key employee. The business receives proceeds that can be used to help meet financial obligations and recruit, hire, and train a replacement.
- ◆ Having key person insurance in force helps to strengthen the credit rating of a company because it inspires confidence in the suppliers and creditors that the company will be able to meet its obligations at the death of a key employee.
- ◆ The existence of insurance coverage on key employees may give potential investors confidence in the company when they might otherwise have been concerned about the financial loss to the company if the key employee were to die.
- ◆ Key person insurance can give other employees a feeling of security and confidence in the continuation of the business even after the death of a key employee.
- ◆ Cash values, if any, are reflected as an asset on the company's balance sheet. The cash values provide a reserve that can be accessed on a tax-favored basis through policy loans and/or withdrawals. Withdrawals and loans will cause a reduction in cash values and death benefits, may affect any policy guarantees against lapse, and may have tax consequences.
- ◆ Key person insurance has valuable collateral uses:
 - ◆ The coverage may be used to help informally fund a deferred compensation arrangement when cash value life insurance is used.
 - ◆ Proceeds may be used by the employer to finance the continuance of a key person's salary to the surviving spouse or other beneficiaries.
 - ◆ Proceeds may be used to redeem the stock of a deceased owner.

Tax Considerations:

- ◆ Premiums are not tax-deductible.
- ◆ Annual premium payments are not taxable to the insured employee(s).
- ◆ Insurance death proceeds are generally received income tax-free [IRC § 101(a)]. For employer-owned contracts issued after August 17, 2006, death proceeds will be subject to income tax. However, where specific employee notice and consent requirements are met, and certain exceptions apply, death proceeds can be received income tax-free [IRC § 101(j)].
- ◆ In an S corporation, limited liability company, or partnership, death proceeds increase the basis of the owners.
- ◆ In a C corporation, death proceeds and annual cash value increases may be subject to alternative minimum tax (AMT). Certain small corporations are exempt from AMT.
- ◆ The death proceeds increase the company's net worth, but do not necessarily increase the value of the deceased owner's interest for estate tax purposes where the proceeds represent his or her value to the company.