Key Person Insurance

ADVISOR COMPANION

BUSINESS PLANNING

Protecting a business against the unexpected

Businesses regularly insure their tangible, physical assets like buildings, machinery, and equipment, but often overlook their most important asset – their people. Each business, regardless of its size, has an individual or group of individuals who contribute to its success. The unexpected death, disability or illness sustained by of one of these "key" people can threaten the success of the company. A key person insurance strategy helps the business insure against financial impact if a key employee in no longer able to contribute.

How it Works

The business owns, pays for, and is the beneficiary of a life insurance policy on the life of the key executive. The business can use the income tax-free death benefit to replace lost profits, recruit and/or retain qualified replacements, or protect the company's credit position. In a traditional key person design, the employee typically has no interest in the policy, nor does his or her family typically receive any benefits from the policy when death occurs.

Once the key employee retires, the company can retain the policy, use the policy to provide the employee with supplemental retirement income, or transfer the policy to the employee for his/her own personal insurance needs as a bonus to the employee.

Employer-owned life insurance must comply with the requirements of §101(j), including obtaining Notice and Consent prior to the issuance of the policy. Please see our BYA on §101(j) for more information.

Who is a "Key" Person?

A key person is anyone in a business whose loss would be significant to the company. This person can be either a business owner or a non-owner employee. Employees who are "key" to the success of a business include individuals with unique leadership ability and expertise; specialized technical/creative skills or knowledge special connections, contacts or influence; or other qualities that set them apart.

LIFE-7744 6/18

Some other factors to consider include:

- **PRODUCTS AND INNOVATION:** Does this person have special knowledge about the company's operations and products? Is he or she engaged in important long-term projects?
- **COMPETITION:** Would a rival company have an advantage if this person were gone?
- **CUSTOMER RELATIONS:** Does this person have unique intra-personal skills and goodwill? Does this person have a proven track record of being critical to generating sales?
- **ABILITY TO OBTAIN FINANCIAL ASSISTANCE:** If this person is no longer with the company, would the business still be able to obtain financial backing? What will happen to existing business debts if this person dies unexpectedly?
- **STATE LAW:** State-specific laws and regulations may have special definitions for who qualifies as a key person for insurable interest purposes.

Key Person Insurance Uses and Benefits

The life insurance death benefit provides the business with an immediate infusion of cash that can be used in a number of ways to keep the business operating smoothly. Consider some ways a key person policy can help protect a business:

- **REPLACE THE KEY EMPLOYEE.** A key employee is often a substantial driver of profit for a business. A life insurance death benefit can be used to help replace these lost profits as well as recruit, hire and train the key employee's replacement.
- **SECURE LOANS.** A lender may be concerned that the death of a key employee/owner may impact the business' ability to repay a loan. A key person life insurance policy can help to enhance a business' credit position by ensuring an influx of cash at the death of the insured.
- **REPAY DEBTS.** Many lenders require an owner make a personal guaranty for a business loan, which allows for a loan to be called under certain conditions, such as at a business owner's death. In such a case, the death benefit can be used to immediately repay the debt.

Determining the value of a key employee

There is no set formula to precisely determine the value of a key employee; rather several factors should be considered that can help to approximate a key person's worth to a company. The approach taken by most carriers' underwriters, including John Hancock, is to look at a multiple of a key employee's total compensation to determine what may be a an appropriate amount of coverage. Compensation can include salary, bonuses, commissions, and other types of employee benefits such as stock options and deferred compensation, if regular and repeating. If the insured has an ownership stake in the business, that should also be taken into consideration. Increased coverage may also be justified based on a percentage of debt that has been personally guaranteed by the key employee.

Term Insurance or Permanent Insurance?

Term insurance is often purchased for key person coverage because the need is for a specified period of time and to minimize cost. Permanent insurance is used when there is a need to provide protection to both the company and the insured or when the business owner wants to build policy cash value for supplemental income needs.

THE JOHN HANCOCK ADVANTAGE:

Our Underwriters generally consider a death benefit of 5-10x compensation, but may consider higher multiples for key employees of well-established businesses.

Case example: A business requests key person coverage on its CEO, who has been in his current role for ten years with a consistent compensation package of approximately $1.2 million a year. Given this fact pattern, the Underwriter may consider a higher multiple than the typical 5-10x of compensation. Consult an Underwriter for more information.*

*A detailed cover letter must be provided, and growth rates/ factors are applied at the Underwriter's discretion.

PLANNING IDEA

Building in a Pre-Retirement Death Benefit

Employers are consistently looking to reward top talent. One way to retain a valued employee is to give the employee a pre-retirement death benefit via an endorsement split dollar agreement. In such a case, the employer retains a portion of the death benefit for its traditional key person planning needs and endorses the remaining death benefit to the key person.

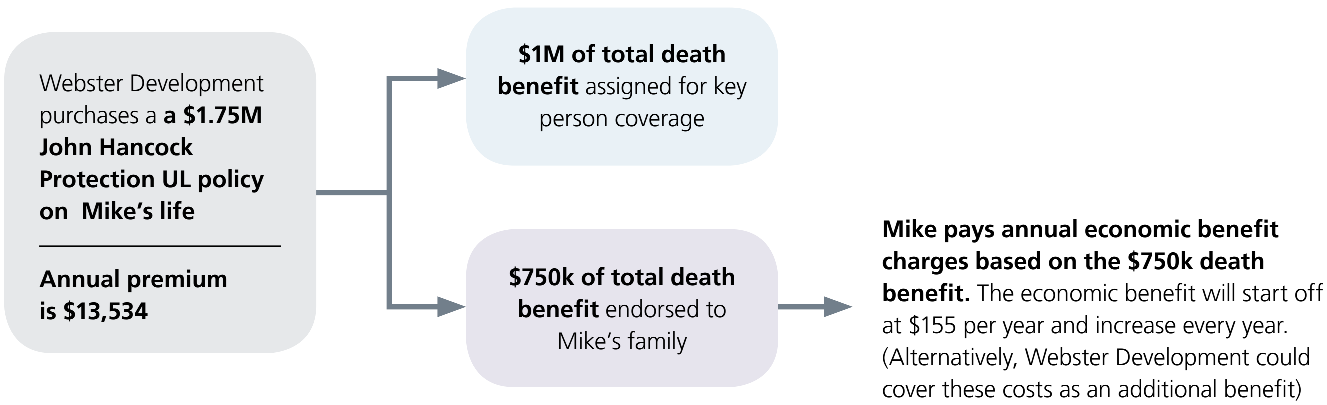
See the hypothetical example on page 4 for more information.

HYPOTHETICAL EXAMPLE

Mike Smith (age 45, Preferred Non Smoker), is a key employee of Webster Development because he knows all of the firm's key contacts, has unique technical skills, and has extensive sales experience which dives growth. Webster would like to create a plan that protects itself from financial loss in the event of Mike's death as well as provide a benefit that gives Mike an incentive to stay with the company on a long-term basis.

With these goals in mind, Webster decides to purchase a John Hancock key person life insurance policy for $1.75M on Mike's life. Webster will allocate $1M (5x Mike's current salary) for coverage, and the remaining $750k will be endorsed to Mike as a pre-retirement death benefit for his family. As part of the split-dollar arrangement, Mike will be required to pay an annual "economic benefit" charge to Webster (alternatively, Webster can pay this amount as a bonus).

How it Works



Why does this plan work?

Not only does the life insurance policy cover the business in the event of Mike's death, but the policy can also be used to cover some of Mike's personal and evolving needs:

During Mike's working years

- The endorsed portion of the policy provides a tax-free death benefit for his family.

At Mike's retirement, Webster has two options:

- Transfer the policy to Mike as a form of a bonus of the policy. Mike will have to recognize ordinary income taxes on the policy ownership transfer.
- Webster can keep the policy on Mike's life as a business asset.

Retirement Options

At the employee's retirement, the employer has several options for what to do with the existing life insurance policy:

1. **RETAIN THE POLICY:** If the business decides to keep the policy, it will continue to be an asset on the business' books. If it is a term policy, the business may want to convert the policy to a permanent policy before the term lapses. For permanent policies, the employer can access cash value as a source of tax-free liquidity.

2. **USE THE POLICY TO FUND A RETIREMENT BENEFIT PLAN:** The business may choose to use the policy to provide the employee with supplemental retirement income or as an informal funding vehicle for a nonqualified deferred compensation plan.

3. **TRANSFER THE POLICY TO THE EMPLOYEE:** Oftentimes a business will decide to transfer the policy to the key employee. The transfer of the policy will be treated as a "bonus" to the employee and the employee will have to take the value of the policy into income. The employee can pay the income tax using out-of-pocket cash or take a distribution from the policy's cash value. The business will take a corresponding income tax deduction, but will have to pay tax on any gain inside of the policy, resulting in a net tax savings based on the basis in the policy. Another option is for the business to "gross-up" the bonus and use business dollars to cover the employee's income tax cost.

Important Considerations

- **NO INCOME TAX DEDUCTION:** Life insurance premiums paid by the business are not deductible.
- **INSURANCE OWNERSHIP:** The business will be the owner of the life insurance policy and the insured typically will not have any personal rights to the policy cash value or death benefit unless separately agreed to.
- **TRANSFER-FOR-VALUE:** If the policy is transferred to the key employee in the future, then the transfer to the insured is an exception to the transfer-for-value rule under §101(a)(2).
- **§101(J) COMPLIANCE:** When life insurance is owned by an employer on the life of an employee, the tax code requires that certain conditions and Notice and Consent requirements be met to keep the death benefit proceeds income tax-free. For more information, please refer to BYA: Understanding Employer-Owned Life Insurance (EOLI) and §101(j).[1]

The John Hancock Advantage

John Hancock has a robust portfolio of products to help with key person coverage. One issue that is a concern for business owners is the financial impact of a key employee who is unable to work due to a serious illness like a heart attack or cancer diagnosis. Although they may survive, recovery can be lengthy, resulting in reduced work hours or an extended absence.

On some permanent products a Critical Illness Benefit rider (CIBR) can be added, which provides a one-time, lump sum, income tax-free benefit to the employer if their key employee is initially diagnosed with a covered critical illness. The benefit is paid from an additional, separate pool of money, preserving the death benefit to meet other protection needs. In addition, there are no restrictions on how the benefit may be spent.

CIBR is an innovative way to protect business-owners from the expenses that may result from a key employee experiencing a critical illness during his/her working years. Adding of the CIBR to a key person life insurance policy can help protect against the financial losses that could result from a key employee needing to take time away. Moreover, the business can use some or all of the benefits received to help the key employee meet expenses incurred as a result of a critical illness. Amounts paid to the key employee may be income tax- free to the extent of otherwise unreimbursed medical expenses.

Things to consider:

- If the life insurance policy with CIBR[2] is owned by the business, **a third-party disclosure will need to be signed,** as it may impact the ability to secure their own critical illness coverage.[2]
- **CIBR maximum issue age is 65**
- **Maximum benefit is $250,000**
- **Premium is not tax deductible**

Pays out upon diagnosis of one of seven covered illnesses: kidney failure, heart attack, coronary artery bypass grafting, certain types of cancer, major organ failure, paralysis, stroke.

Conclusion

A key person life insurance strategy is an important way for a business to protect itself against the loss or extended absence of key. This type of plan is easy to set up and simple to administer and should be considered by any business whose day-to-day operations and long-term success would be jeopardized by something happening to one of its key employees.

For more information on the value of Personal Key Person Insurance, please contact John Hancock's Advanced Markets Group at 888-266-7498 and select Option 3 to reach an AMC, or Option 4 to reach an attorney.

1. Section 101(j) of the IRC imposes income tax on the death benefit of a life insurance contract owned by the employer of the insured unless certain exceptions apply. In addition, the employer must show satisfaction of notice and consent requirements set forth in §101(j). Please see our BYA on §101(j) for more information.

2. John Hancock anticipates that the Critical Illness Benefit paid under this rider will generally be excludable from income under Internal Revenue Code Section 104(a)(3). However, the benefit may not qualify for this exclusion with certain third-party ownership arrangements. The benefit will not be paid for critical illnesses initially diagnosed before the rider effective date or during the waiting period. See the product producer guide for additional details.

For agent use only. This material may not be used with the public.

This material does not constitute tax, legal, investment or accounting advice and is not intended for use by a taxpayer for the purposes of avoiding any IRS penalty. Comments on taxation are based on tax law current as of the time we produced the material.

All information and materials provided by John Hancock are to support the marketing and sale of our products and services, and are not intended to be impartial advice or recommendations. John Hancock and its representatives will receive compensation from such sales or services. Anyone interested in these transactions or topics may want to seek advice based on his or her particular circumstances from independent advisors.

Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are few exceptions such as when a life insurance policy has been transferred for valuable consideration.

Insurance policies and/or associated riders and features may not be available in all states.

Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½.

Insurance products are issued by: John Hancock Life Insurance Company (U.S.A.), Boston, MA 02210 (not licensed in New York) and John Hancock Life Insurance Company of New York, Valhalla, NY 10595.

MLINY060618042

Not valid without all pages.