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Key Employee Life and Disability Insurance

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You've got a great group working for you now, and business is good. You know that much of that success is due to one or two key people with both skills and personalities that are hard to match. Suppose they were injured and out of work for a while, or suppose they died? Would your business survive? Key employee life and disability insurance coverage can help make sure that it does.

When bad things happen to good people

Your key employees are those special people with such unique skills and talents that they contribute greatly to the financial success of your business. If a key employee were disabled and out of work, or were to die, your business would suffer a financial loss. Here are some possibilities:

- While the employee is out of work, the revenue that he or she generates may substantially decrease
- You'll incur unexpected expenses recruiting and training a temporary or permanent replacement
- Less capable or inexperienced employees trying to fill in can make mistakes or cause delays that cost you money
- If a key person dies, a business loan may come due
- Customers or even other employees may look elsewhere, concerned for the future of the business after the loss of a key employee

Key employee life and disability insurance policies can help soften the impact of these blows. Generally speaking, these policies are sold to small or medium-size businesses; it's in those operations that a single person can make the most difference to the bottom line. If you own a large company that's better able to absorb the financial losses caused by losing a key employee, you may have difficulty buying the coverage you desire.

If death does you part--key employee life insurance

Typically, your business purchases a life insurance policy on a key employee, pays the premiums, and is the beneficiary in the event of the employee's death. As the owner of the policy, the business may surrender it, borrow against it, and use either the cash value or death benefits as the business sees fit.

In determining how much insurance you'll need, putting a dollar value on a key employee's economic worth may be difficult. Although there are no rules or formulas to follow, several possible methods to determine the insurance amount may be used. The appropriate level of coverage might be the cost of recruiting and training an adequate replacement. Alternatively, the insurance amount might be the key employee's annual salary times the number of years a newly hired replacement might take to reach a similar skill level. Finally, you might consider the key employee's value in terms of company profits; the level of insurance coverage might then be tied to any anticipated profit loss.

The premiums you pay for key employee life insurance are not a tax-deductible business expense for federal income tax purposes, since your business is the recipient of the benefits. For the most part, the death benefits your company receives as the beneficiary of the policy aren't considered to be taxable income. However, if your business is a C corporation, the death benefits may increase the corporation's liability for the alternative minimum tax. You should consult a tax professional for information on your circumstances.

Riding out the hurt--key employee disability insurance

The death of a key employee isn't the only threat to your business. Suppose a key employee is injured or becomes ill, and is out of work for an extended period? Disability insurance on such a key employee is another way you can protect your business against any resultant financial loss.

A critical part of key employee disability insurance policies is the definition of disability. Usually, these policies define disability as the inability of the employee to perform his or her normal job duties due to injury or illness. As with life insurance, your business buys a disability insurance policy on the employee, pays the premiums, and is named as the beneficiary. When the employee is disabled, the insurance coverage pays monthly disability benefits to your business. These benefits can equal a certain percentage of the key person's monthly salary, up to either a maximum monthly limit or 100 percent of that salary. The benefits may be used to pay the operating expenses of the business and to cover the expense of finding a temporary or permanent replacement for the key employee.

The policies typically offer elimination periods (i.e., the waiting period between the disability and when the benefits begin) ranging from 30 to 180 days. Depending on the policy, your business may receive the benefits for 6 to 18 months--long enough to allow the key employee to return to work or to allow the company to replace the key employee. The policy is normally a noncancelable contract, guaranteeing the premiums and the coverage amount. A waiver of premium option can be an important part of these policies. This option provides that, once the elimination period has been satisfied, the insurance company will pay the premiums as long as the disability lasts or until the benefit period ends.

Sometimes included in the base disability policy coverage (or available as an optional benefit for an additional premium) is personnel replacement expense coverage that pays for the cost of finding and hiring a replacement for the key employee. These benefits are usually payable after the key employee's disability has lasted at least 6 months. Your business will be compensated for actual replacement expenses incurred, including advertising costs, employment agency fees, and the first 3 months of the new employee's salary.

As with key employee life insurance, the premiums you pay for the key employee disability policy are not a tax-deductible business expense. As a result, the benefits your business receives are not generally considered taxable income.

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