Protect your business clients' most valued assets

Advanced Markets

Key person producer guide

EQUITABLE

Key person protection

Just as every family has a breadwinner — businesses have key individuals whose management roles, special talents or revenue-generating abilities are critical to a business's success.

Life insurance is often used to protect surviving families. In a business setting, life insurance can also protect the business and its employees after the death of a key person.

In the case of a death, the life insurance proceeds can help offset:

- Declines in sales revenue
- Losses of key clients
- Losses of special talents
- Costs associated with hiring a replacement
- Issues with credit and loans
- Stay bonus payments to selected executives and employees

The life insurance death proceeds can help tide a business over as it recovers from an unexpected loss, and also provide revenue to help recruit, relocate and train a replacement. Inside this Producer's Guide, you will find a hypothetical classic case, profiles of ideal business clients and questions you should ask your clients, as well as questions your clients will most likely ask you.

Typical key person arrangement

During John Doe's working years

Business

Business determines that it has exposure if John Doe dies prematurely. It purchases a life insurance policy to protect itself.

Equitable

Equitable receives premium payments and applies the funds to a life insurance policy. During John Doe's working years, the business, as owner of a permanent policy, has access to all cash surrender values as an asset on its balance sheet.[1]

If there is a death

The death benefit, generally received income tax-free, can possibly help sustain a business and fund a benefit for the surviving family.

If there is not a death

Business

If John Doe lives to retirement, the business can continue to retain the policy, or if cash value life insurance is used, the business can use the cash surrender values for other purposes, including:

- Business expansion
- Securing loans
- Funding a post-retirement benefit plan for John Doe

Equitable

Equitable would pay any cash values requested by the business. The business can also maintain the life insurance policy as a business asset.

1 Loans and withdrawals reduce the policy's cash surrender value and death benefit, and increase the chance a policy may lapse. The client may need to increase premiums in later years to keep the policy from lapsing.

Life insurance and key person protection

Let's look at two successful manufacturing firms, both with long-term track records, loyal clients and widely regarded products. Both were dependent on a successful key sales representative. Peter worked with Acme, Inc. for over 10 years and increased sales each year with the firm. Paul worked at Cogswell Cogs for nearly as long and with an equally successful record. Ironically, both firms lost their key people within weeks of each other. Three years later, Acme is still struggling from the loss, while Cogswell is doing as well as ever. Why did one firm falter while the other succeeded?

Acme, Inc.

Acme was caught off guard when it lost its key salesperson, Peter. He had strong relationships with many of Acme's key accounts, and its other sales reps were not skilled in handling larger high-volume accounts.

Moreover, Acme did not have funds on hand to recruit and hire a replacement. Instead, it struggled with the existing sales staff who were not prepared to handle Peter's former accounts. As a result, Acme found there was reduced attention to both the key accounts and its reps' regular accounts. The result — profits fell.

Acme was ready to introduce a new product line and counted on Peter's relationships to help meet sales numbers. Although the accounts stayed with Acme, reduced attention cost sales from both its existing lines and from the new lines. Acme missed Peter's close, focused attention on the launch and follow-up training. Without him, the sales figures from the new products were a fraction of what Acme hoped to receive from these accounts.

As profits fell, Acme faced difficult issues. Creditors became skeptical of future sales, and one credit line was called. In the face of reduced revenue, Acme struggled to meet its day-to-day expenses. It was forced to cut staff and drop a planned expansion.

Three years after it unexpectedly lost Peter, Acme is still coping with the loss.

Cogswell Cogs

Cogswell also suffered when it lost Paul. He had recently signed on its largest account. The relationship was still new when Paul died, and Cogswell was concerned if it could keep the new account. Paul also worked with two additional accounts that brought in 15% of the company's other revenue.

However, Cogswell held a $1,000,000 key person policy on Paul's life. The death benefit from that policy provided Cogswell with the funds it needed at a critical time. The life insurance death benefit was allocated in a manner that helped tide the business over and also expand.

$125,000 was used to recruit, offer a significant sign-on bonus and to relocate a new sales representative, Jeff, who was highly regarded by both the new account and one of Paul's existing accounts. This allowed Cogswell to maintain its critical accounts.	**$10,000** was allocated to special training to help Jeff get up to speed more quickly than an average new recruit. This included training and meetings with Cogswell's key customers.	**$200,000** was posted as collateral to help keep one of its creditors from raising the rate on a credit line.	**$250,000** was paid to Paul's widow as a special bonus for his years of service.	**$415,000** was held in reserve by Cogswell as a cushion against any possible dips in revenue.

Three years after its unexpected loss, Cogswell is as strong as ever.

This information is for illustrative purposes only. Please evaluate your clients' situations carefully before recommending any financial strategy.

Important note:
Promoters of certain benefit plans may advocate these programs as allowing deductible life insurance premiums as funding for the promised benefits. Some of these plans might contend they can offer the business life insurance benefits for certain business purposes on a deductible basis. Clients should approach these plans with caution. As attractive as the deductions may be, clients will find these programs can be complex, expensive and carry risks, including the possible loss of the tax deductions.

Ideal client

Any successful business should consider key person protection. However, look to these businesses as those likely to need coverage:

Strong entrepreneurial owners	Often a business is dependent on its owner or founder. While the loss of this person will be substantial, businesses frequently will continue in the hands of co-owners, heirs or employees. However, such a loss might trigger credit and cash flow issues, licensing issues (in the case of businesses depending on state contracts or professional skills) or management issues. The death proceeds from life insurance can provide the funds to help tide the business over until it can right itself.
Key sales personnel or managers	The loss of key sales personnel can trigger a loss of revenue or clients. In the case of managers, critical projects or divisions may lose direction. The death proceeds will provide cash until a business can replace these individuals and possibly help recruit a replacement.
Businesses that hire skilled professionals	These individuals have special skills, clients or practices. The loss of these individuals will result in reduced business income until their expertise or niche practice can be replaced. Examples include: physicians, attorneys, architects or engineers, skilled artisans or writers, real estate brokers or business managers with select clients.
Businesses that run specialty products or services	When a business is dependent on a special skill, line or product, or offers services that are key to its operations, the loss of its key people will result in reduced income or trigger credit issues until operations can return to normal.

All these businesses could suffer a loss until these key individuals can be replaced. Replacing them will take time locating, recruiting and grooming a replacement either to take over the role, or carve out a role of their own. The death proceeds from life insurance will provide a business with the necessary cash to stem business losses during this replacement period.

Consider our Long-Term Care Services℠ Rider[2]

In addition to death, the loss of the services of a key person due to impaired health can be just as devastating to a business. The addition of a long-term care rider on a life insurance policy may offer an appropriate solution, making cash available to the business via an acceleration of the death benefit if there is a long-term care event. This allows the business to move ahead with its plans, without waiting for a death to occur.

2 The Long-Term Care Services℠ Rider is available for an additional cost, and does have restrictions and limitations. Be sure to review the product specifications for details.

Questions to ask your clients

1 Who are the most critical employees or consultants to your business?

Virtually no businesses exist without at least one key person. Often it is a founder. Frequently, the business has other key employees that fit the profile. In many cases, you may know the business operations well enough so that you have already identified some key individuals; however, be prepared to ask your business clients:

- Do you have someone with special skills or client relationships?
- Do you have someone with specialized product, information technology (IT) or other expertise?
- If your business is a professional firm (physicians, attorneys, etc.), is someone central to an area in which your firm specializes, such as energy law, cardiology, etc.?

2 What are your plans in the event you lose that person?

Expect that many companies will not have a plan. In many cases, they will try to suffer through the loss and may not have considered that life insurance can help stabilize their businesses. Equitable has several marketing pieces, including client-facing pieces, that emphasize the need for key person protection and the impact losing a key person can have on a business.

Be prepared to ask your clients questions about their financials.

Valuing a key person can be a simple process. Sometimes a company may have a "ballpark" sense as to the amount it would need to spend to replace such a person. More often, you will need to work with a business's CPA or financial officer to gather pieces of information that can be used in valuing the potential loss to the company. Also, work with your underwriters to determine what might be an acceptable death benefit or what items might need to be documented to underwrite higher face amounts.

If your clients say they have a business continuation plan — examine the plan.

This may lead to planning you can do in the event a key person dies. Very often the basic business continuation plans may be underfunded or out of date. From a key person perspective, the successor owner may rotate into a control position from elsewhere in the company. Even though the current control position may be covered, your clients may need to fill a different key slot. They may need to fill the role of the person moving into the control position. You will want to be certain your clients' key person coverage is coordinated with their business continuation plans. Often the business may want to purchase additional insurance as part of the business continuation plan to help facilitate some key person coverage or implement a stay bonus for key affected employees. See Equitable's *Stay Bonus* brochure.

Tax consequences of key person life insurance

Premium payments are not deductible as a businesss expense.

Cash surrender value, an amount up to the business's basis, may be withdrawn from the policy, generally income tax-free,[3] as long as the policy is not a MEC.[4]

Policy loans in excess of basis may be taken without triggering income tax, as long as the policy is not a MEC.

Upon surrender, any gain on the contract is subject to income tax as ordinary income.

Preserving the tax-free benefit special EOLI guidelines

A major attribute of key person insurance is that, properly arranged, the death benefit paid to the business is received income tax-free. Current Internal Revenue Code provisions contain special guidelines and requirements for employer-owned life insurance, including key person coverage.[6] Among these requirements is receiving and maintaining a record of written consent from employees prior to new life insurance coverage. Detailed information and assistance in addressing the special EOLI rules is available with Equitable's educational and support materials for EOLI. One important aspect for employers is obtaining the written "Notice and Consent" from the insured employee prior to policy issue. Equitable has developed sample notice and consent forms for use by our clients.

Recordkeeping required

For tax years after November 13, 2007, IRS guidelines for EOLI include a requirement that employers file an annual report with their tax return, using IRS Form 8925, identifying any life insurance they own on the lives of their employees that was purchased or subject to a material change after August 17, 2006. Information requested includes the number of employees insured, the amount of life insurance and whether they have received valid consent from their employers.[5]

3 The Tax Reform Act of 1986 makes certain withdrawals during a policy's first 15 years partially taxable.

4 For Modified Endowment Contracts (MECs), withdrawals from or loans against policy gains are considered income, and may be subject to a 10% federal income tax penalty. Loans and withdrawals reduce the policy's account value and death benefit, and increase the chance that the policy may lapse. The client may need to increase premiums in later years to keep the policies from lapsing.

5 IRC Section 6039i.

6 IRC 101(j) is effective for employer cases issued or subject to a material change after August 17, 2006.

Frequently asked questions from clients

Why life insurance?

Life insurance offers many planning opportunities, but its most fundamental objective is to provide a death benefit to individuals when they need it most — after the death of a key person.

Some businesses may elect to self-finance (set up a sinking fund) to protect themselves against a loss. They need to weigh what they will do if the loss occurs before they can accumulate sufficient funds. Some businesses may believe they can borrow their way out of such a loss, but few might be able to obtain favorable terms when lenders see the business is vulnerable after the death of a key individual.

Why permanent life insurance?

This is a balancing act for some business clients. Some clients will like and want the lower cost of term insurance. Although term may be an easier sale, many clients should look at permanent life insurance as it can provide the business with certain advantages:

- It builds cash value each year and this becomes a business asset. At some point, the cash value growth may outpace the cost of the premiums.
- The cash value can provide the business with a source of revenue.[7]
- In the event a key person does not die, the policy can be used by the business for other purposes, including expansion, benefits for key executives or collateral for loans.
- The key person plan can be structured to also offer a "golden handcuff" benefit program for select key employees or their families.

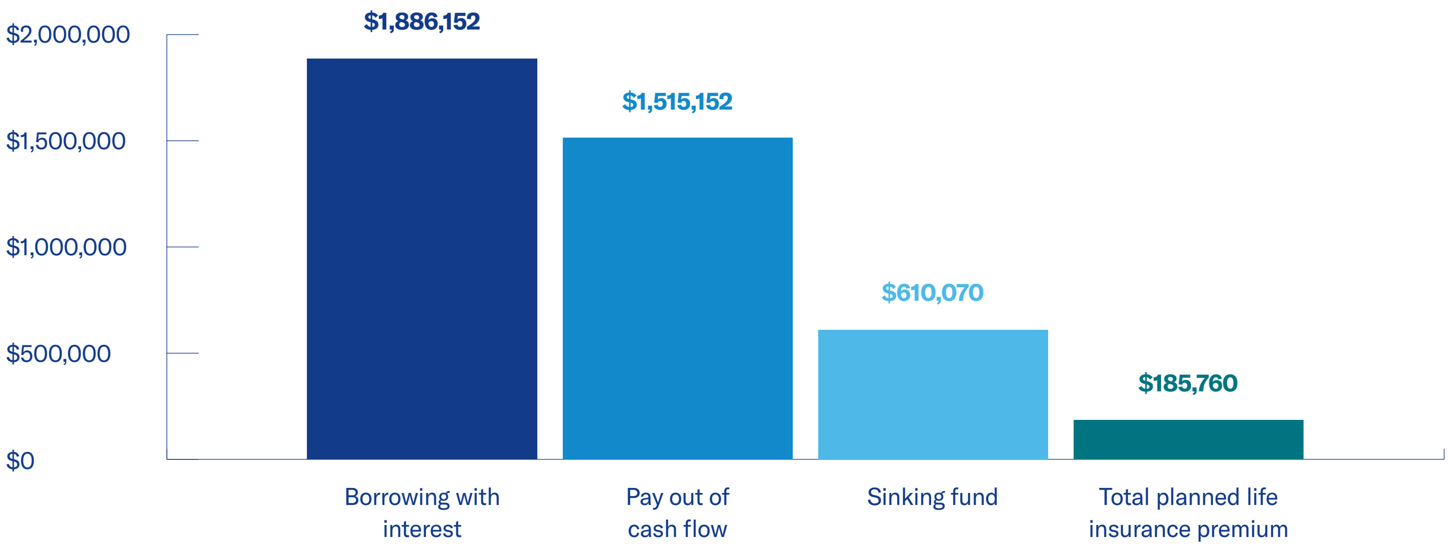
Only life insurance can provide a specified amount at the time most needed and shift the risk from businesses to life insurance carriers.

7 If properly handled, cash values can generally be accessed income tax-free through loans and withdrawals. However, loans and withdrawals will reduce net cash values and death benefits. Excessive loans and withdrawals may cause a policy to fail to maintain its status as life insurance and may trigger inadvertent income taxation.

Important note
The business might also choose to self-fund. However, it always runs the risk that the key person need will appear before the funding is completed. Life insurance partially shifts the risk away from the company, and it may be less expensive. For example, a business looking to self-insure a 45-year-old against a $1,000,000 loss would need to set aside $30,504 per year if it hoped to receive a hypothetical 4.5% after-tax rate of return. After 20 years (when the individual is age 65), the business would have accrued $1,000,000 based on these assumptions. That is a total expense over 20 years of $610,070, but the business has assumed all the risk of loss. Using life insurance, in some situations, allows a business to accomplish the same goal at a fraction of the cost. See the example on the next page.

How can I fund key person coverage?

The chart below illustrates a hypothetical comparison of the key alternatives. This shows what costs a client might incur under each method when addressing a $1,000,000 key person need.



Borrowing $1,886,152	A business that expects to borrow to meet its key person needs risks being denied the financing, since the loan would occur at a time when the business and its management team are under stress. The value presented here is what a business would pay by way of interest and principal if it could receive a 20-year loan at an 8% hypothetical loan rate.
Funding out of cash flow $1,515,152	This is what a business, in a 34% overall average tax bracket, will need to net (after expenses) to meet its key person need.
Sinking fund $610,070	This is what a business would need to set aside each year, between an employee's age 45 and 65, to amass the same amount a $1,000,000 policy will provide. This assumes an annual contribution of $30,504 and an after-tax growth rate of 4.5%.
Life insurance $185,760	This represents the cumulative premiums a business might pay over a 20-year period for a hypothetical universal life insurance policy on a 45-year-old, non-smoking male with a preferred underwriting class.

All these numbers are based on after-tax and after-expense earnings. Depending on a business's tax bracket and expenses against gross income, even more will need to be brought into the company. All these costs will come at a time following the stress of losing a key person. For example, a business in a 34% tax bracket would need to bring in $1,515,152 before taxes if it hoped to net $1,000,000.

The policy premium and death benefit amounts used for this case are intended only to help demonstrate the planning concept discussed and not to promote any specific product. The rates are broadly representative of rates that would apply for a policy of this type and size for the insured's good health and the ages noted in the example. To determine how this approach might work for your client, individual illustrations based on their own individual age and underwriting class, containing both guaranteed charges and guaranteed interest rates, as well as other important information, should be prepared or requested for their review.

How can I value a key person?

There are many approaches to valuing a key person. These can range from:

Multiple of salary	The easiest of all approaches is based on a multiple of the key person's salary and assumes that this will cover the approximate loss of a key person. Although it does not calculate any specific financial loss, it is easy to calculate. A general rule of thumb is 10 times salary, with adjustments for the insured's role and age. This approach is the one most frequently used by underwriting.
Cost to replace the key person's contributions to income or earnings	This method examines gross sales that would be lost and then matches those sales to estimates of sales that would be generated by a replacement. The difference is then present-valued. Additional adjustments may be made for the costs associated with searching for a replacement, hiring, relocation and training costs.
Cost to replace the key person's sales profits	If the key person was not at your client's company, their contributions to its profits would be lost. This method examines those lost profits and then estimates the profits that might be generated by a replacement over a period of time. The difference, the lost profits, are present-valued to determine the value of the key person.
Capitalization of excess earnings	Excess earnings are earnings over what the owner's equity would earn in an ordinary investment. Where the key person has a direct impact on earnings, the loss of a key person could result in a loss of excess earnings. This method is generally used for upper managers who are part of the strategic decision-making team.
Cost to replace experience	Where a key person has special duties or valuable experience, the cost to replace those skills and/or experience is quantified. Typical costs would be the cost of searching for a replacement, hiring, relocation and training costs.
Loss of value to the business	This approach is based on determining the percentage of the business value tied to the key person. If that person were to leave the business, you believe the business would decline in value by that percentage or amount. This method is more commonly used when the loss of the key person would result in a market value drop of 20% or more. For example, if the key person were a company's only salesperson who had a very good rapport with the company's clients, their loss could cause a drop in revenue of 20% or more. Loss of a founder still running the business could be even higher.
Known key person value	This is determined by the business owner's perception of the key employee's worth. This is the most subjective of all methods. Where it varies from other formulas or multiples, it may be heavily scrutinized.

Businesses will sometimes use some or all of the approaches, taking an average of the methods to determine their key person needs. In other cases, they may focus on one approach as providing the targeted amount of life insurance protection.

Is this a qualified valuation?

No. A qualified valuation can be done only by a licensed valuation expert. However, many professionals may be able to offer valuation estimates as a service to clients to help them in their planning. Moreover, for key person purposes, a qualified valuation may not be necessary. Instead, this is to help peg a value to a key person, as opposed to a value for tax or audit purposes. Some business clients might defer to their CPAs; some may defer to their attorneys or other financial advisors. In all cases, clients should consult with their legal and tax advisors.

I have a specialized business. Do the same rules apply to my business as to every other business?

No. Every business has certain idiosyncrasies that call for its valuation to vary from other businesses. For example, with professional practices, certain adjustments might need to be made because of the nature of the practice, the types of services performed and whether or not the client base is steady or not. An example of this might be seen in comparing a dental practice, with a regular client base, to that of a surgeon, whose clients will rarely visit on a regular basis.

Certain adjustments might be made when there is a need for professional licensing or other government approvals. For example, this might be important for medical practices where a key person holds specialized skills and has passed certain medical boards. Similarly, certain businesses might hold government contracts based on the skills of certain individuals.

Finally, the valuation report relies on many financial items from a business. You will want to work closely with the business's financial advisors. Keep in mind, some adjustments might need to be made for accounting purposes. For example, if a business is a cash-basis taxpayer, where income and expenses are deducted as incurred, you might wish to adjust the business income and expenses to more accurately reflect when the services for the income were performed or the expensed items actually utilized.

What do I do with the policy if the employee leaves?

Life insurance is a valuable asset for the business. Many companies will elect to maintain the policy beyond the key person need. They can retain the death benefit for other business planning purposes.

Alternatively, the policy could be cashed in, with its after-tax values used for other business purposes. Some businesses may use the policy values to back an executive benefit retirement plan for the key employee or their family. Other businesses might transfer the policy to the departing key person.

I am a sole proprietor. Do I need key person protection?

Possibly. All types of businesses need protection. This is true of C Corporations, S Corporations, LLCs and partnerships. Emphasize to sole proprietors that they may still need key person protection. The only difference is that they, their families or an irrevocable trust — but not the business — would own this life insurance. What would this insurance do?

- Protect their surviving families
- May offer creditor protection to pay loans transferred to the families
- Protect these clients against the loss of key personnel they employ

What is the importance of an annual review?

Your client's business is constantly evolving. As a result, it is of utmost importance to make certain that adequate life insurance coverage is in place on each key person in the firm. This can best be done by conducting a comprehensive annual review to make certain the coverage in place corresponds with the business's needs.

Why Equitable?

Our dedicated, expert team of Advanced Markets specialists meets the changing needs of clients by offering custom-designed advice and actionable strategies that can proactively help them achieve their desired results — including:

- Strong life insurance portfolio with competitive cash value product options.
- A wide selection of riders to choose from, including the Charitable Legacy Rider®, which offers an additional death benefit to the charity(ies) of your choice at no added cost.
- Strength and stability. For over 161 years, we've been working with clients across generations, building on what's proven and pursuing what's possible.[7]

For more information, please call the Life Sales Desk or visit equitableLIFT.com.

7 The 161-year history and assets management shown apply solely and exclusively to Equitable Financial Life Insurance Company.

Life insurance products are issued by Equitable Financial Life Insurance Company (Equitable Financial) (New York, NY) or Equitable Financial Life Insurance Company of America (Equitable America) and co-distributed by affiliates Equitable Network, LLC (Equitable Network Insurance Agency of California in CA; Equitable Network Insurance Agency of Utah in UT; Equitable Network of Puerto Rico, Inc. in PR) and Equitable Distributors, LLC. For New York state-based (i.e., domiciled) financial professionals, life insurance products are issued by Equitable Financial Life Insurance Company (New York, NY). All companies are affiliated and directly or indirectly owned by Equitable Holdings, Inc., and do not provide tax or legal advice.

Life insurance is medically underwritten, so all candidates should be in reasonably good health. Your clients should not cancel their current coverage until their new coverage is inforce. Surrender charges may be due on an exchange of one contract for another. A change in policy may require an examination. Surrenders may be taxable. Your clients should consult their own tax advisors regarding tax liability on surrenders.

Important notice: The foregoing discussion involves complex tax and legal issues. This discussion is not a legal opinion; it is only meant to provide guidance. Any decisions about whether to implement these ideas should be made by the client in consultation with professional tax and legal counsel.

References to Equitable in this brochure represent both Equitable Financial Life Insurance Company and Equitable Financial Life Insurance Company of America, which are affiliated companies. Overall, Equitable is the brand name of the retirement and protection subsidiaries of Equitable Holdings, Inc., including Equitable Financial Life Insurance Company (NY, NY); Equitable Financial Life Insurance Company of America, an AZ stock company with main administrative headquarters in Jersey City, NJ; and Equitable Distributors, LLC. Equitable Advisors is the brand name of Equitable Advisors, LLC (member FINRA, SIPC) (Equitable Financial Advisors in MI & TN). The obligations of Equitable Financial and Equitable America are backed solely by their claims-paying abilities.

Life Insurance: • Is Not a Deposit of Any Bank • Is Not FDIC • Insured • Is Not Insured by Any Federal Government Agency • Is Not Guaranteed by Any Bank or Savings Association • May Go Down in Value

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