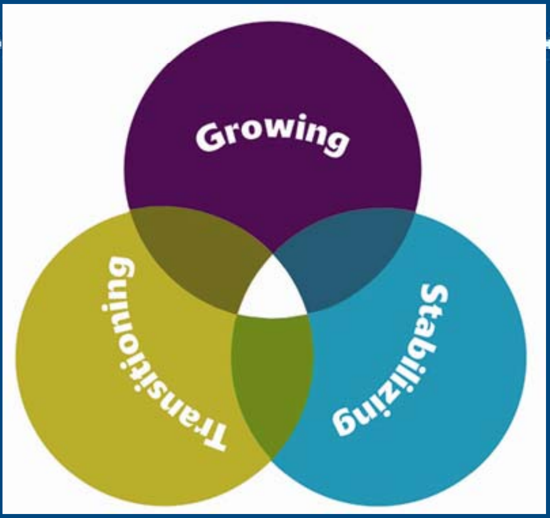
INDIVIDUAL LIFE INSURANCE

Key Person Coverage

Helping to Continue a Business by Protecting Its Most Valuable Contributors Through Life Insurance



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Did you know that…

- Over 95% of business failures are due to management weaknesses.
- Key persons, especially business owners, are critical to the success of many businesses.
- Employees do not adjust to change and loss particularly well.
- Family members may not be able to deal with the loss of a key person and allow the business to thrive.

Source: Dun and Bradstreet, Monthly Business Failure Report 1997-2005, December 2005

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Who Do You Know Who Is:

- Owner of a closely-held business who cares about what happens to the business
- Someone who has a need for life insurance
- Between the ages of 45- and 75-years old
- Willing to potentially use company or personal money to protect the business
- Willing to take the time to plan for business succession
- Willing to take the time to determine the value to the business of his or her employees and their functions
- Willing to protect against the loss of a key employee

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The Small Business Opportunity

- It is important to note that many small businesses are required by lenders to carry key person life insurance coverage.
- Investors often ask for key person life insurance coverage on business principals.
- If lenders and investors consider insuring key persons, why shouldn't the business owner?

Questions to Ask a Business Owner

- Are you interested in helping to ensure the continuation of your business after the death or disability of a key employee?
- Do you know who your key employees are?
- Do you know what they are worth to your business?
- Are you interested in a way to help provide financial security for your employees' families?

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Who are Key Persons?

- In order to determine who are key persons:
  - What functions are key to the business?
  - Who performs those functions?
  - Is the person who performs the function the right person to perform it?
  - Can the function be replaced?
  - Can the person be replaced?

Valuing a Key Person

1. What function does the individual do that is difficult to replace or requires additional expertise?
2. Is the key person replaceable?
3. What percentage of revenue does the key person generate directly? Indirectly?
4. What proportion of the firm's current net profit is attributable to the key employee?
5. How long will it take for a new person to reach the efficiency of the key individual?

Valuing a Key Person

6. How much will it cost to locate and situate a replacement?
7. Will the new employee demand more salary?
8. How much will it cost to train the new person?
9. What mistakes is a replacement likely to make during the break-in period?
10. How much are those mistakes likely to cost the company?

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Valuing a Key Person

11. Is the employee engaged in any projects that, if left unfinished at death or disability, would prove costly to the business? If so, how costly?
12. Would a potentially profitable project have to be abandoned or would a productive department have to be closed?
13. Would the employee's death result in the loss of clientele or personnel attracted to the business because of his or her personality, social contacts, unique skills, talents or managerial ability?
14. What effect would the key employee's death have on the firm's credit standing?
15. What proportion of the business' actual key person loss is it willing to self-insure, if any?

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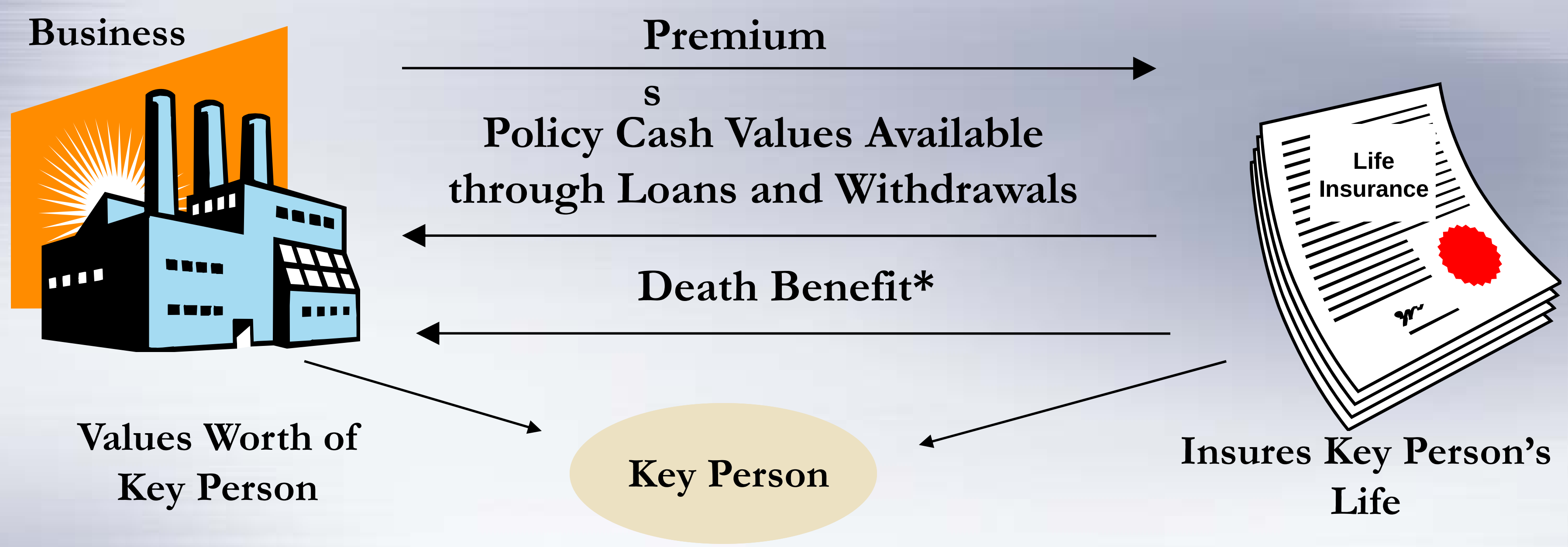
How it Works



***The death benefit of an Employer-owned life insurance policy as defined in Section 101(j) of the IRC may not be fully tax-free.**

Both loans and withdrawals from a permanent life insurance policy may be subject to penalties and fees and, along with any accrued loan interest, will reduce the policy's Account Value and Death Benefit. Depending upon the performance of a VUL policy's investment choices, the Account Value may be worth more or less than the original amount invested in the policy. Assuming a policy is not a Modified Endowment Contract (MEC), loans are free from current Federal taxation and withdrawals are taxed only to the extent that they exceed the policyowner's basis in the policy. Distributions from MECs are subject to Federal income tax to the extent of the gain in the policy and taxable distributions are subject to a 10% additional tax, with certain exceptions.

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Case Study – Key Person Coverage

- Widget Enterprises is a small closely-held business owned by John Morgan.
- John is concerned about threats to his business, including the loss of key individuals.
- Bobby Hart is Widget's top salesperson and also a key client manager.
  - Bobby earns $200,000 per year.
  - Bobby is married to the key client's daughter.
- Widget's key client orders $5,000,000 worth of materials yearly.
- John wants to insure that if Bobby dies the business will continue and Bobby's wife will be financially secure.

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Case Study – Key Person Coverage

- Widget would purchase a $5,000,000 contract on the life of Bobby Hart. In accordance with Section 101(j) of the IRC, Widget provides appropriate written notice to Bobby and obtains consent from Bobby to insure his life. In addition, Widget confirms that Bobby is a “highly compensated” employee within the meaning of Section 101(j) of the IRC.
- John agrees that if Bobby dies prior to age 65 (retirement) Widget would pay a salary continuation benefit to his widow of $200,000 a year for 10 years.
- The remaining $3,000,000 of death benefit would be used to hire and pay a new key account manager to replace Bobby.

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Key Person Strategy Using Universal Life Insurance

- universal life insurance offers death benefit protection with the potential for greater accumulation through equity-based investment options.
- universal life insurance policies contain fees and expenses, including cost of insurance, administrative fees and premium loads, surrender charges and other charges or fees that will impact policy values. The underlying funds also have fund operating expenses. The investment return and principal value will fluctuate so that when redeemed, may be worth more or less than their original cost.

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Key Person Strategy Using Universal Life Insurance

- Stag Protector II from the Hartford universal life insurance can beused in the key person strategy.
  - Bobby is a 45-year-old male, Preferred Non Nicotine.
  - Widget Manufacturing is the owner, premium payer and beneficiary of policy with death benefit of $5,000,000.
  - Premiums of $50,000 per year for 20 years (until Bobby is 65)
  - If Bobby dies, the company receives the $5,000,000 death benefit and will use $2,000,000 of that amount to continue paying Bobby's $200,000 salary to his widow.
  - The company could bonus the policy to Bobby when he reaches age 65. Would be taxable to Bobby.

Guarantees are based on the claims-paying ability of the issuing company and do not apply to any investment option.

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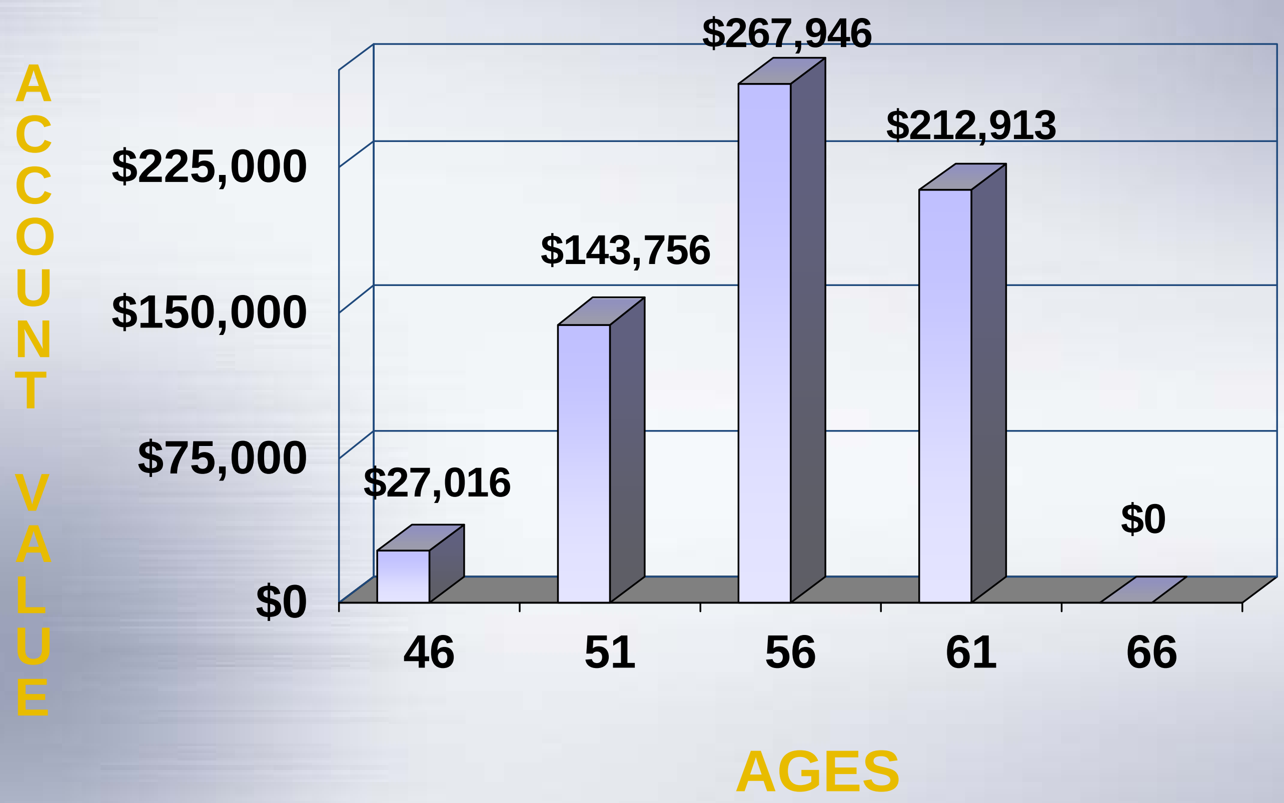
Key Person Strategy Using Universal Life Insurance

This chart shows the effect on the policy at 0% hypothetical rate of return. The policy would provide a $5,000,000 death benefit until the policy lapsed at age 72. Additional premium would be required to continue the policy (1).



1 Based on a Hartford Stag Protector II Universal Life policy, male, Preferred Non-Nicotine, Level Death Benefit, annual premiums to endow at age 100. issued in the state of Connecticut, assuming a 0% hypothetical rate of return and maximum charges. Premium is $50,000 for 20 years.

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Employer Owned Life Insurance

Internal Revenue Code Section 101(j) (IRC Section 101(j)) states:

- Death benefits from an "employer-owned life insurance contract" are subject to federal income tax in excess of premiums and other amounts paid,
- Unless the notice and consent requirements of section 101(j)(4) are satisfied and an exception under section 101(j)(2) applies.

An "employer-owned life insurance contract" is a contract that:

i. is owned by a person engaged in a trade or business ("policyholder") under which the policyholder (or a related person) is directly or indirectly a beneficiary under the contract, and

ii. covers the life of an insured who is an employee with respect to the trade or business of the policyholder. For these purposes, the term "employee" means all employees, including officers and highly compensated employees, as well as directors.

Notice and consent is generally satisfied if, <u>before the contract is issued</u>, the employee

i. is notified in writing that the policyholder intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract was issued,

ii. provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment, and

iii. is informed in writing that the policyholder (or a related party) will be a beneficiary of any proceeds payable upon the death of the employee.

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Employer Owned Life Insurance

After the notice and consent requirements have been met, the death benefit of an employer-owned life insurance contract *will not be taxable provided that:*

(A) (i) the insured was an employee, with respect to the policyholder at any time during the 12-month period before the insured's death, *or*

(ii) the insured is, at the time the contract is issued—

1. **a director,**
2. **a highly compensated employee within the meaning of Section 414(q) (without regard to paragraph (1)(B)(ii) thereof), or**
3. **a highly compensated individual within the meaning of Section 105(h)(5), except that "35 percent" shall be substituted for "25 percent" in subparagraph (C) thereof.**

(B) the death proceeds paid to insured's heirs as contemplated under IRC Section 101(j) (2)(B).

(C) the death proceeds are used to purchase an equity (or capital or profits) interest in the applicable policyholder from certain of the insured' heirs

Section 6039(I) also imposes annual reporting and record keeping requirements on employers that own one or more employer-owned life insurance contracts.

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