



## Disability Insurance Coverage on a Key Employee

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### What is it?

Key person disability insurance can protect your business in the event that a key employee becomes disabled, and as a result, the business suffers a financial loss. A key person disability policy will pay short-term benefits to the business until the key employee recovers from their disability, or until they can be replaced.

#### *Who is a key person?*

A key employee is an employee whose unique skills and talents contribute greatly to the financial success of your business. However, a key employee insured by this type of policy is usually not an owner of the business, although the key employee may own a minority interest in the business (less than 50%). If you are the majority owner, you may be allowed to buy coverage, but you can

only cover a percentage of your salary, and key person coverage will probably be added as a rider to your individual disability policy. Your family members will also normally be excluded from coverage under key employee insurance.

As a business owner, you protect your business in the event you become disabled by buying a business overhead expense insurance policy.

*How does a business lose money when a key person becomes disabled?*

Your business can lose money when a key person becomes disabled and is unable to work. First, any income generated by the key person will decrease (e.g., if the key person is the primary salesperson for the business's products). At the same time, your business expenses will increase, because you may have to hire a temporary employee or hire a permanent replacement. In addition, your company's cash flow may decrease if customers are lost because the company can't handle the increased workflow, or because other employees are lost due to concerns over the company's future.

## **When can it be used?**

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*Key employee coverage should be used as one component of a business protection plan*

Purchasing disability coverage on a key employee is one of several ways you can protect your business against financial loss in the event that you or one of your employees becomes disabled. Both your personal income and the personal income of your employees can be protected by group and individual disability income policies. You can also purchase an overhead expense policy that will pay the operating expenses of the business if you become disabled. In addition, disability insurance can also be used to fund a buy-sell agreement, if your business must be sold due to an owner's disability. However, key employee disability coverage can add another layer of protection for a business by paying benefits to the business when it suffers a financial loss because an important employee becomes disabled.

*Key employee coverage is normally sold to small to medium-sized businesses*

Most key employee policies are sold to small to medium-sized businesses because it's likely that a single key employee contributes greatly to the business's bottom line. If you own a large company that is more easily able to absorb the financial losses caused by losing a key employee, you may be unable to buy coverage.

## **Common policy coverage and provisions**

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*Amount of benefits paid to the business*

Monthly benefits paid to the business usually equal 100% of the key person's monthly salary, up to a maximum limit (often \$10,000 per month). However, some insurance companies limit benefits to 50% of the key person's salary. A business receiving benefits can use them to keep the business running and to cover the expense of finding a replacement employee.

*Example(s): Frank works as a sales representative for Industrial Engines and brings the company 70% of its business.*

*Fortunately, when Frank is disabled, the company begins receiving benefits after a 60-day waiting period. The monthly benefits the company receives total \$9,000, the amount Frank earns monthly at the company. It uses the money to offset the financial loss that results because Frank is no longer selling the company's product and to pay an agency to find a temporary sales representative who can work until Frank is able to return to his job.*

#### *Elimination period*

All disability policies begin paying benefits after the elimination period, or waiting period, has been satisfied. Key employee policies offer elimination periods ranging from 30 to 180 days, with 60- or 90-day elimination periods most common, since this is the most cost-effective choice for most businesses.

#### *Benefit period*

A business may receive benefits for six, 12 or 18 months, depending upon the policy. This should give the business adequate time to replace the key employee or to allow for the key employee to recover and return to work.

#### *Renewability*

Key person disability insurance is normally a noncancelable policy as long as the key employee continues to work full time for the company (unless totally disabled), and they own less than 50% of the company (the percentage may vary). Under a noncancelable contract, the premiums and coverage under the policy are guaranteed and cannot be changed until the insured employee reaches age 65.

#### *Definition of disability*

Disability under a key employee policy is usually defined as the inability of the employee to perform the normal duties of their own occupation due to injury or sickness. This is a total, own-occupation definition of disability.

#### *Personnel replacement coverage*

Personnel replacement expense coverage pays for the cost of finding and hiring a replacement for the key employee. Benefits are usually payable after the disability has continued for six months. The business will be compensated only for the actual expenses incurred, including the salary paid to a replacement employee during the first three months of employment, employment agency fees and advertising costs. Although this may be included in the base policy coverage, it is often available as an optional benefit at an additional premium.

### *Waiver of premium*

This provision states that once the elimination period has been satisfied, the insurance company will pay the policy premiums as long as the disability lasts or until the benefit period ends.

## **Strengths**

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### *Protects a business from suffering financially when a key person becomes disabled*

The loss of one employee who is an important figure in the company can devastate the company financially. Key person disability insurance can protect a business if a key employee is disabled by providing benefits to the company on a short-term basis, until the employee recovers or a new employee is hired. This can ensure that the business remains profitable.

### *When used in conjunction with a disability buyout policy, can ensure the business continues to thrive even if the insured cannot return to work*

If the key person is a co-owner of the business, buying a key person policy, as well as a disability policy to fund a buy-sell agreement, can ensure that the business can survive the short-term disability of a minority owner. The key person policy would pay benefits to the business until it was clear that the disabled co-owner would be unable to return; then the disability buyout policy would finance the sale of the key person's ownership interest.

## **Tradeoffs**

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### *Limited disability coverage*

Before a key person disability policy can be underwritten, you'll have to prove that the insured individual is critical to your company's financial success, and that their skills and talents are unique. Picking a good candidate might be difficult (the individual must be insurable), and you may only be able to afford to insure one key person in your organization. This means that key person coverage may provide your company with only limited protection against disability.

## **Tax considerations**

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### *Premiums are not tax deductible*

The premiums paid by a business for a key employee insurance policy are not considered tax-deductible business expenses by the Internal Revenue Service (IRS) if the business is the recipient of the benefits. Instead, they are considered a capital investment.

### *Benefits are normally not taxable*

Benefits received by a business from a key employee disability insurance policy are generally not considered taxable income to the business.

## **Questions and answers**

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*If the disabled employee terminates their employment with the company, is the key person policy convertible?*

Some policies will allow a business to transfer the policy to another key person or will allow the insured individual to buy the policy from the company as an individual disability income insurance policy.

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