Key Person Insurance

Who is the most important person in your business and what is their financial value to your organization?

By Ben Fortier

Ben Fortier
Partner
Deboski & Company

If you are a business owner, you can probably answer the first question rather quickly by responding, "I am." However, the answer to the second question may not come quite as fast. It is difficult to quantify how valuable you are to the business, but that's exactly what key person insurance is all about; it determines how much liquidity would need to be injected into your company to keep things running when you, as the key person, are no longer able to run the business.

A serious illness or death can come unexpectedly. Family members or employees will be left with the responsibility of making sure the business continues, or at the very least, is wound down in an orderly fashion. The odds of their success increases dramatically if there is liquidity available to deal with the financial demands that could put the business in jeopardy. Life insurance and health insurance are common ways to provide that liquidity and often the most effective way of doing so.

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You, as the owner and key person, need to determine how much "key person" insurance you ought to have. A practical approach is to quantify what some of the liquidity needs might be. Let's stop to think about some of the financial stresses that might be evident if someone else is left looking after your business.

Replacing you

This is perhaps one of the most difficult aspects to quantify when considering key person insurance. If you are no longer in your office, how does your work get done? Perhaps for a short period of time others may pick up some of the responsibilities, but it would be unrealistic to suggest the business could run without you for the long haul. Those left in charge of making sure the business continues as an ongoing viable entity will need to secure a permanent replacement.

Filling your position may be achieved through outside hiring or an internal re-positioning. In either case, there will be financial implications to this:

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- The cost of looking for the right person
- The lost opportunity cost until suppliers, customers, and employees become confident of the new environment
- The lost income to your family

Insurance may be used to create a contingency account to look after these costs. A reasonable value to place on this account would be one year's normalized salary, that is monthly draws excluding year-end bonuses.

Bank Loans

If you were no longer coming into work, what planning might be required for those who were left with the responsibility of running your business? Would the business loans be called or reduced? Would additional security be required? These kinds of discussions can be stressful enough at the best of times, but if others are left to negotiate through these talks at a time of your unexpected absence, the added stress could be a costly distraction.

Life insurance or critical illness insurance may provide the solutions; liquidity can be immediately injected into the company and the loans can be reduced or perhaps even paid off completely.

This type of insurance planning provides other benefits

- There may be opportunity for deductibility of premiums
- It opens the door for tax free dividends to be paid to the estate as part of the owner's personal estate planning
- It cleans up the balance sheet if the intent is to sell the business because the owner is no longer around to run it

Equipment and building leases

If part of your cash flow management involves the leasing of equipment, you may want to provide a contingency account to be accessed when a loss of health or death occurs. This type of account usually provides six to twelve months of lease payments. This gives the leasing company and those looking after your business the assurance that these cash flow requirements will be looked after until the company is stabilized from the trauma of your loss.

Tax Liability

In the Canadian Income Tax Act, there is no reference to "estate tax". However, for many Canadians a tax liability is triggered at the time of death. This arises from paragraph 70(5)(a) of the Act which reads that upon death, "a taxpayer is deemed to have disposed of all their assets at proceeds equal to their fair market value immediately before death." Any resulting capital gain must be reported in the taxpayer's final tax return.

Although there is not a tax levied on the value of an estate as in the U.S. and other countries, the deemed disposition rule impacts income tax significantly at the time of death because everything is "deemed to have been sold." For you as a business owner, this can be a huge hidden tax liability that your estate will have to pay. Where will this money come from? Will they have to sell assets or perhaps take out a loan? Any of these options can have damaging effects on the future of the business.

Once you have determined the potential tax consequences to your estate, consider using life insurance as an efficient and tax-effective way to cover the liability.

All in all, if you are the key person behind the success of your business, don't let the value you created be exposed to wealth erosion upon your loss of health or death. Talk to someone about arranging the right kind and right amount of insurance to give those who follow in your footsteps a chance to keep the business going.

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Deboski & Company

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T. 403.668.1491 Website: **deboski.com**

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