THE NORTHWESTERN MUTUAL LIFE INSURANCE COMPANY (NORTHWESTERN MUTUAL)

KEY PERSON LIFE

in brief

22-3886 (0318)

Northwestern Mutual®

Key Person Life Insurance

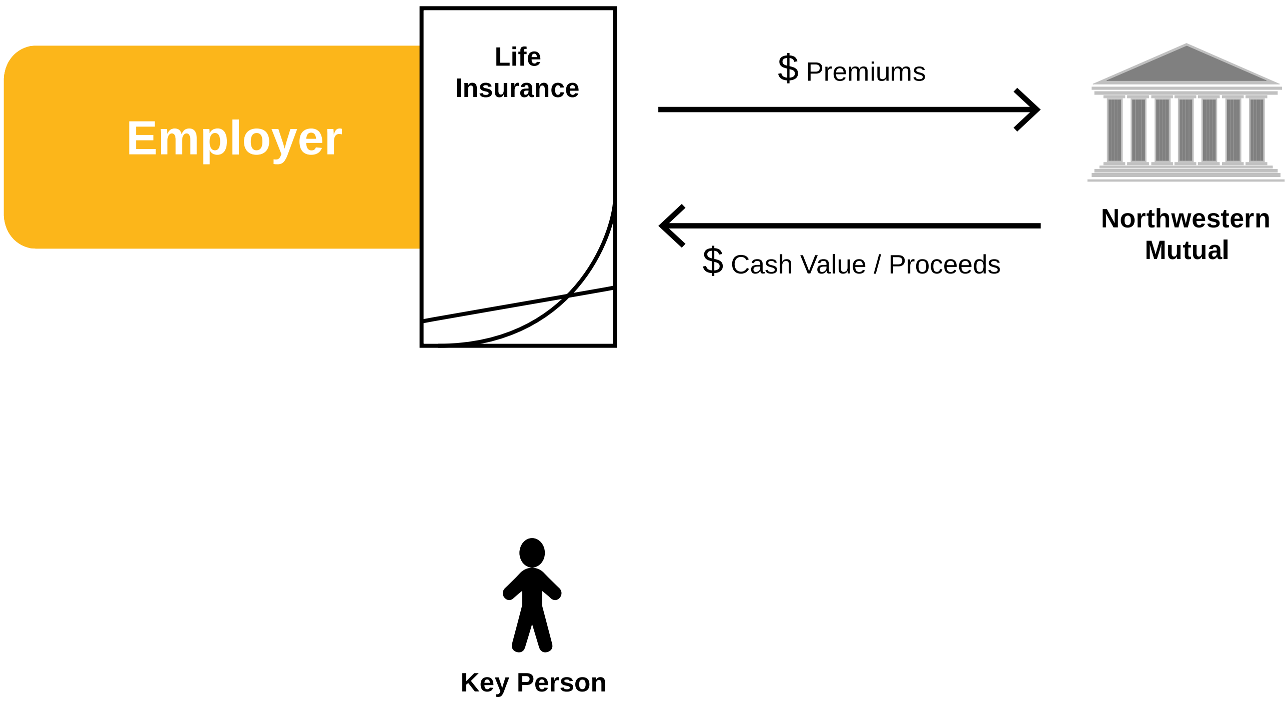
Key person life insurance is life insurance that a business owns on its valued and skilled employees to partially indemnify the business for the loss sustained upon the death of the key person.

KEY PERSON LIFE INSURANCE USES

- In its strictest sense, “key person insurance” benefits the employer for the loss of the key person, but does not directly benefit the key person. The life insurance can be used to:
  - help strengthen the credit of the business and provide cash for emergency needs
  - indemnify the business for loss of a key person
  - provide cash to pay outstanding obligations
  - provide cash to hire a new employee to take over key person’s duties
- Sometimes the term “key person insurance” is used in a broader manner to describe any situation where an employer owns life insurance on an employee, such as to:
  - informally fund executive benefits for the key person employee
  - redeem stock owned by key person

How It Works

KEY PERSON LIFE FOR INDEMNIFICATION



- Employer applies for and is owner and beneficiary of a life insurance policy insuring the key person.
- During the key person's lifetime, the policy can help enhance the Employer's credit and provide cash for emergency needs.
- Upon the key person's death, Employer is indemnified for the loss of the key person.

Federal Tax Consequences

TO THE KEY PERSON / EMPLOYEE

- Because the key person is not provided any economic benefit by the Employer's ownership of a policy, the key person is not income taxed on the premium.
- Because the insured/key person generally will have no incidents of ownership in the Employer-owned policy, its death proceeds will not be included in the key person's gross estate. See Internal Revenue Code (I.R.C.) § 2042.
- If the insured/key person is an owner of the business, the death proceeds could increase the value of his or her proportionate ownership of the business for federal estate tax purposes. I.R.C. § 2031. This increase in value might be offset by the fact that the loss of the key person could simultaneously reduce the value of the business. See Revenue Ruling 59-60 and *Newell v. Comm'r*, 66 F.2d 102 (7th Cir. 1933).

TO THE EMPLOYER

- The premiums paid by the Employer are not deductible. I.R.C. § 264.
- The policy death proceeds received by the Employer generally are not income taxed. I.R.C. § 101. To receive this tax-free treatment for death proceeds, the Employer must comply with various eligibility and notice/consent requirements before the policy is issued. I.R.C. § 101(j).
- Taxation of the policy's gain (cash value exceeding total premiums) is generally deferred until the policy is lapsed, surrendered, or distributions from the policy exceed the premiums paid by the employer. I.R.C. § 72.
- Amounts borrowed from the policy generally are not treated as distributions (neither tax-free return of premium, nor from taxable gain) unless the policy lapses or is surrendered. I.R.C. § 72.
- If the policy is a Modified Endowment Contract (MEC), however, policy distributions are taxed as first coming from any taxable gain and then as a tax-free return of premiums. Amounts borrowed from the policy are treated as distributions and are subject to the same gain-first tax rules. Also, the taxable portion of any MEC distribution is potentially subject to an additional 10% penalty tax. I.R.C. §§ 72 and 7702A.
- The purchase of key person life insurance might be considered a reasonable business need and could be helpful in avoiding the corporate accumulated earnings tax. See *Emeloid Co. v. Commissioner*, 189 F.2d 230 (3rd Cir. 1951) and *Motor Fuel Carriers, Inc.*, 559 F.2d 1348 (5th Cir. 1977). But see, *Novelart Mfg. Co. v. Comm'r*, 434 F.2d 1011 (6th Cir. 1970).

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Northwestern Mutual is the marketing name for The Northwestern Mutual Life Insurance Company (NM), Milwaukee, WI (life and disability insurance, annuities, and life insurance with long-term care benefits) and its subsidiaries.

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