



A Guide to Life Insurance for Small Business

For a small business owner, group life insurance and qualified plans may not be adequate to protect the business from unforeseen risks or provide enough financial security for business owners and their key executives.

NOT FDIC/NCUA INSURED • MAY LOSE VALUE • NO BANK/CREDIT UNION GUARANTEE •
NOT A DEPOSIT • NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY

Why life insurance?

For many small businesses, group life insurance and qualified benefit plans are important components of the company's benefits package. Generally, these types of plans provide a certain level of financial security for employees and their families. However, for a small business owner, group life insurance and qualified plans may not be adequate to protect the business from unforeseen risks or provide enough financial security for business owners and their key executives.

Most small business owners are familiar with managing the multiple risks that face their company. They have probably purchased property and casualty insurance, liability coverage, and workers' compensation coverage but have not protected their most valuable asset—the owner and key employees. The purpose of this guide is to provide education on the financial risks that small business owners face and how life insurance not only can protect against those risks, but also provide additional nonqualified benefits for key executives.

Financial risk and the need for life insurance

There are over five million small businesses in the United States. Only 47% of those businesses, however, have any form of business life insurance.¹ As a result, many fail due to lack of risk management. Here are some potential risks that a business owner needs to consider:

Key person protection

Key person coverage insures the business against the financial loss resulting from the premature death of a key executive. A small business could suffer a disruption in sales, creditor confidence, and customer relationships as a result of the loss. In addition, the business could incur significant expenses for recruiting and training an experienced successor. Life insurance benefits can provide the liquidity needed to replace lost revenue, pay for unexpected expenses, and minimize the impact on operations. These types of plans usually require very little administration.

Business succession

Buy-sell agreements are legal documents that dictate how ownership of a firm will transition upon the death of a co-owner. This agreement ensures that the future of the business will be managed by the desired parties. In many cases, the surviving owners will require funding to buy out the decedent's share of the business. Life insurance is often used as the funding component of the plan. When an owner dies, the surviving co-owners are the beneficiaries of a policy on the decedent's life. The surviving co-owners then can use the life insurance death benefit to fund the buyout of the decedent's share of the business. Buy-sell agreements can be customized based on the business structure of the firm. The most common Buy-sell agreements are:

- **Cross Purchase**—owners purchase coverage on each other
- **Entity**—the business owns coverage on each owner
- **Hybrid**—the business has first right to purchase, then remaining owners

John and his brothers, James and Tom, own a small printing business in their hometown. The business was appraised at about \$3 million. Their attorney recommended that the brothers consider a buy-sell agreement wherein the event that one of the brothers dies prematurely, the other two brothers would have the first option to buy out the decedent's share of the business. This would ensure a smooth ownership transition and provide the decedent's family with the fair value of the deceased's share of the business. The brothers could then purchase cash value life insurance policies and access them to supplement their retirement income or to buy out the other's ownership interest.

1. Based on U.S. Small Business Administration 2006 data.

Nonqualified executive benefits for small business

Most employees are familiar with qualified pension, profit sharing, and 401(k) plans. The reason these plans are considered qualified is because they qualify for special tax treatment. This usually means that contributions to these plans can be deductible to the employer. Although the tax advantages make qualified plans sound attractive, they do have drawbacks. First, they must be offered on a nondiscriminatory basis. That means generally all employees are eligible to participate. As a result, providing benefits through qualified plans can be costly for a small business. Second, most distributions made from qualified retirement plans are subject to tax, which can impact an employee's income at retirement.

In contrast, nonqualified plans offer some advantages over qualified plans. Qualified plan designs can be restrictive, and the benefits to highly compensated employees are limited. As a result, key employees often receive proportionately smaller benefits than those other employees receive. To compensate for this inequity for key employees, employers can incorporate nonqualified plans, which allow contributions for a select group of employees. These plans can help attract, retain, and reward key employees. Nonqualified plans also offer greater flexibility in design and administration. See the chart below to compare qualified and nonqualified plans.

Qualified versus nonqualified plans

	Qualified Plans	Nonqualified Plans
Taxation	Contributions can be deductible for the employer	Contributions are not tax deductible
Discrimination rules	Most employees have to be made eligible	None
Administration costs	Costly to administer	Can be cost efficient
Complexity	Numerous rules and regulations	Minimal rules and regulations
Vesting requirements	Strict vesting rules; no golden handcuffs	No vesting rules
Plan design	Limited flexibility	Flexible
Limits	Caps for highly compensated employees	No caps

Saving for retirement has become more of an individual responsibility and less of a corporate benefit



Nonqualified plans can help supplement an executive retirement plan

Retirement Goal



Nonqualified plan options using life insurance:

Deferred compensation

Saving for retirement has become more of an individual responsibility and less of a corporate benefit. Highly compensated employees are challenged by contribution limits of qualified plans and high income tax rates on current income. Deferred Compensation is an agreement where the employer agrees to pay an employee a benefit in the future. There are multiple variations on how these plans can be structured:

- One method is to allow the executive to defer some current income, thereby avoiding current income taxation. The deferred salary is set aside and is used to pay the premiums on a life insurance policy. In return, the employer promises to generate an income stream for the executive using the policy cash values at retirement or when the employee separates

from the firm. The employee is immediately vested in his/her contributions; however, any matching contribution by the employer may be subject to a vesting schedule. The vesting schedule ensures that executives remain with the firm for a minimum number of years in order to qualify for the employer portion of the benefit. Life insurance is often used because it offers tax-deferred growth of the contributions and tax-favored distributions from the policy. In addition, life insurance offers a self-funding feature that allows the death benefit be used to pay income to the executive's family if the executive dies prior to retirement.

- Another deferred compensation plan is referred to as a supplemental retirement plan, or SERP. It involves the employer committing to making the entire contribution to a deferred compensation plan over and above the executive's salary. Typically a vesting schedule is put in place to "handcuff" the executive to the firm.

Life insurance is also used as the funding vehicle for anticipated retirement income payouts or death benefits for SERPs.

Both of these plans will help a small business recruit, retain, and reward key executives. Cash value life insurance is the most commonly used form of life insurance in deferred compensation plans.

Executive bonus plan

Most people are familiar with cash bonuses; however, incorporating life insurance can fulfill multiple needs for both employers and executives. For the small business owner, an executive bonus plan provides a tax deductible and discriminatory benefit plan that is simple to implement and inexpensive to administer. The executive applies as the owner of the policy on his or her life, and the business pays a bonus to the executive to pay the premium. The cost to the executive is the income that must be paid on the bonus amount. The benefit to the executive is that he or she owns the policy outright and enjoys the full benefits of the policy. Cash value life insurance is typically used in executive bonus plans because it offers both affordable life insurance protection and supplemental retirement income for key executives.

***Planning note:** If the goal of a bonus plan is to tie the executive to the firm, an owner can implement a Restricted Executive Bonus Arrangement, which temporarily restricts the employee's ownership rights in the policy. An endorsement added to the insurance policy restricts access to the cash values until a specific future date. The employer does not own an interest in the insurance policy directly or indirectly.*

Split dollar arrangement

As the name implies, this plan can be structured so that the employer and employee share in the cost of the life insurance coverage. A popular version requires that the executive pay for the smaller "term insurance" cost of the policy,

and the employer contributes remaining premium, helping to build up the cash value of the policy. At some point in the future, the policy is released to the executive (there may be taxable consequences), who can then enjoy the full value of the policy's benefits. In some cases, the employer, upon the executive's departure or death, is reimbursed for contributions made to the policy. Permanent life insurance is the only type of life insurance that will work in a split dollar arrangement.

Estate Planning

For a small business owner, the business may be the largest asset in the estate. If the business owner dies and the estate is liable for any outstanding debts or taxes, the business may have to be sold quickly at a discount to pay off these obligations. Life insurance can provide the liquidity needed to pay off the debt obligations and allow the family to maintain the full value of the business.

***Planning note:** In general, life insurance owned by the insured is includible in the insured's estate at death. This is especially important if you have a substantial estate that could be subject to both federal and state estate taxes. A common strategy to avoid inclusion of the death proceeds in the estate is to have the proposed insured establish an irrevocable life insurance trust. Under this arrangement, an appointed trustee of the irrevocable trust applies for and owns the policy on the insured's life on behalf of the trust. Upon death, the proceeds of the life insurance are received by the trust, income and estate tax free. The trustee is then obligated as a fiduciary to distribute the proceeds according to the provisions of the trust established by the insured. This is a common strategy used in estate planning. Consult a legal professional about drafting trust documents.*

Most people are familiar with cash bonuses; however, incorporating life insurance can solve multiple needs for both employers and executives.

Various types of life insurance for small business

Basically, there are two categories of life insurance: term insurance and permanent insurance. In each of these categories you will find different variations of these products.

Term insurance

Term insurance is the simplest form of life insurance to comprehend. When you purchase term insurance, you are buying pure insurance protection for a specified period of time. You can purchase coverage on an annual basis in which the premium increases each year as you get older, or you can purchase a level premium policy for a stated period of time—say 10 years. As long as the premium is paid and the policy is in force at the time of your death, the insurance company will pay the death benefit amount to your beneficiary free of income tax.

For small business owners, term insurance may be appropriate if the objective of the coverage is pure death benefit protection. Since term insurance does not provide cash values, it would not be applicable for deferred compensation or any supplemental retirement plan where cash accumulation is required to fund the plan.

Permanent insurance

As its name implies, permanent insurance differs from term insurance because it is designed to provide lifetime protection. Unlike term insurance, most permanent policies provide a cash value component that allows for tax-deferred buildup of earnings over time. The policy owner can use these earnings and access them in a tax-advantaged manner through policy loans or partial withdrawals. A small business can access the cash values in order to offer nonqualified executive benefit plans.

There are several variations of permanent plans; we'll cover the most common in the next section.

Whole life insurance

Whole life insurance was the first form of permanent life insurance. The premise of whole life insurance is that you pay a fixed premium for the balance of your lifetime. The premium cost of whole life is generally higher than term insurance. In return, you receive a guaranteed death benefit and a guaranteed level of cash value. In addition, the insurance company can pay dividends, which are a

The key to universal life is that it provides policy owners with the flexibility to adjust the policy premiums and face amounts to meet their changing needs.

portion of the company's surplus and are both distributed to whole life policy owners and/or applied to the cash value of the policy. These dividends accrue on a tax-deferred basis or are applied to other dividend options provided by the company. Access to cash values is usually available through tax-free policy loans.

Universal life insurance

The next generation of permanent life insurance was called universal life. The key to universal life is that it provides policy owners with the flexibility to adjust the policy premiums and face amounts to meet their changing needs. Universal life was the first policy to provide cost transparency. It is referred to as an "unbundled" product because of the open disclosure of insurance

costs and administration expenses. As long as there is enough value in a universal life policy to cover the monthly insurance charges, the policy can remain in force. If not, the owner has to make additional premium payments as needed. Access to cash values is available through tax-free policy loans or withdrawals.

Variable universal life is an alternative version of universal life. Here, the policy owner has the option to determine how the premiums should be allocated into a portfolio of investment choices offered by the insurer. The return credited to the policy cash value is dependent on the performance of the chosen underlying investment portfolios. Variable universal policies do not offer a guaranteed minimum rate of return; the amount in the policy is subject to market performance and could lose value.

Comparison of life insurance options

	Term	Whole Life	Universal Life	Variable Universal Life
Premium Payments	Annually increasing or level for term period	Level for lifetime	Flexible	Flexible
Death Benefit	Level	Level or increased by dividends	Level or increasing flexible	Level or increasing flexible
Cash Values	No cash value	Grows tax deferred	Grows tax deferred	Grows tax deferred
		The greater of the guaranteed rate or nonguaranteed dividends	The greater of the guaranteed fixed rate or credited interest rate	Not guaranteed; dependent on the performance of the underlying portfolios
		Rates set by the insurance company		
Access to Cash	No cash value	Policy loans ¹	Policy loans or partial withdrawals ¹	Policy loans or partial withdrawals ¹

1. Any policy withdrawals, loans and loan interest will reduce policy values and may reduce policy benefits.

Life insurance designed for small business

For small businesses that want to insure multiple executives in a plan, there are flexible underwriting options that may be available. For example, if you have ten or more executives that meet selected criteria, life insurance carriers may issue policies on a guaranteed basis, which does not involve medical requirements. If you have fewer than ten lives to insure, you may be allowed to apply on a simplified issue basis. In this case minimum medical information is gathered.

These multi-life submissions make it much easier to provide life insurance coverage for a group of executives.

These types of policies are ideal for small businesses looking to set up a key person plan, buy-sell arrangement, or executive benefit plan. The financial design in many of these plans can demonstrate minimal impact on the company's financials.

When it comes to life insurance for your small business, Sun Life offers innovative solutions to meet your goals. Our Sun Executive products are designed specifically for small businesses by providing:

- flexible underwriting options, including guaranteed and simplified issue,
- high early cash values,² which minimize the impact to the firm's financials, and
- tax-favored accumulation and income withdrawal features.

So if your goal is to protect your business from unforeseen risks or to implement an executive benefit plan for key employees, talk to a Sun Life representative, who can assist you with developing a Sun Executive life insurance plan to achieve your objectives.

Evaluating insurance companies

Now more than ever, it is critical for a life insurance buyer to understand the financial strength and claims-paying ability of a life insurance company. To assist in you in analyzing each company, a number of independent rating agencies provide a rating system for you to compare companies.

These companies include:

- A.M. Best Company
- Standard and Poor's
- Moody's
- Fitch

You can usually find rating information on the Internet or on the website of the individual companies.

Visit www.sunlife.com to obtain Sun Life Financial rating information.

2. Based on purchase of the enhancement benefit. There are no surrender charges for this product.

Whether your needs are to protect your family's financial security, address your business insurance needs, or transfer your wealth efficiently, a Sun Life Financial representative can help you select the right coverage. For more information, please contact your local Sun Life representative or visit us at www.sunlife.com.



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Variable universal life insurance products are for persons who have a long-term need for life insurance. Variable insurance products are not insured by the FDIC or other government agency and are not deposits or other obligations of, or guaranteed by, any financial institutions. Unit values are subject to investment risk, including possible loss of the principal amount invested, and will fluctuate in value. You may receive more or less than you paid when you access your values. Variable universal life insurance has annual fees and expenses associated with it in addition to life insurance related charges (which differ with the product chosen) including underlying investment charges. Certain charges apply to all products, such as: Premium Expense Charges, Cost of Insurance (COI) Charges, Mortality & Expense (M&E) Charges, Loan Interest Payments, and Flat Extra Charges. Surrender charges may also apply. Additional charges may apply to any optional riders, including Waiver of Monthly Deductions Rider, Payment of Stipulated Amount Rider, Supplemental Insurance Rider, and Surrender Charge.

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MSD 44/1002 (Exp. 06/12)

SLPC 21905 (06/10)

