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Financing the Replacement of a Key Employee

Replacing an employee – particularly a key employee – can be expensive. It is better to prepare ahead of time for this potential cost.

There are a number of methods commonly used to finance the hiring and training of a new key employee.

1. **Pay in cash:** However, most businesses do not keep large amounts of cash sitting idle; the money is typically working in the business. The need to raise cash quickly may result in "distress sales" of valuable assets, at a price below normal market value.

2. **Establish a sinking fund:** However, dollars kept in a savings account represent lost business opportunities. For example, if each $1.00 put into a marketing campaign returns $10.00 in sales and the company has a 15% profit margin, the return on each $1.00 invested in marketing is $1.50. On an annual basis, this would be a 50% return. If the same dollar (along with the profits) were reinvested two or three times a year, with a similar increase, the ultimate return would be many times that earned in a bank account.

   Therefore, a sinking fund may be very costly when one considers the loss of business opportunities.

3. **Borrow the funds:** This option assumes that the loss of a key employee does not seriously damage the firm's credit worthiness. Each dollar borrowed must be repaid, with interest. If the loan were amortized over a 10-year period, at 8% interest, for each $1,000 borrowed the company would repay a total of $1,440.

   Here, too, the business owner must take into account the "opportunity cost" of missed growth and profits, had the money used to repay the loan been reinvested in the company instead.

4. **Life insurance policies:** Many business owners choose life insurance to protect against the loss of a key employee. The premiums are small compared to the lump sum which would have to be quickly raised, either out of earnings or by borrowing, when a death does occur.[1]

If permanent-type policies are used there will also be a cash value build up, which can be available for the business in time of need, regardless of the firm's credit worthiness.

[1] Under the provisions of IRC Sec. 101(j), death proceeds from a life insurance policy owned by an employer on the life of an employee are generally includable in income, unless certain requirements are met. The law was effective for contracts issued after August 17, 2006, except for contracts acquired under an IRC Sec. 1035 Exchange. State or local law may vary. Professional legal and tax guidance are strongly recommended.