Key person insurance

Introduction.

The objective of key person insurance is to compensate a business for loss of profits on the death, critical illness, or disability as a result of sickness or accident of an employee.

As a business owner you will have considered disaster recovery and contingency planning; but have you thought about how the loss of a particular person would impact on the profitability of the company?

The financial impact may include: -

- Loss of new business secured by the key person
- Loss of access to loan finance dependent on the key person
- Necessity to suspend or stop production of certain products on the loss of the key person
- The cost of recruiting and / or training a replacement

There are a number of questions that may be asked in order to identify a key person:

- What would be the financial impact to the business of recruiting and / or training a replacement for the person?
- Does the person have a number of contacts that secure significant amounts of business or help ensure the smooth running of the business?
- Does the person come up with ideas important to the company (research & development)?
- Would the loss of the person affect the financing of the business?
- Does the person bring money into the business?
- Does the person save the business money?
- How would the loss of the person affect business profits until he / she is effectively replaced?

This is likely to include directors, senior managers, research and development specialists and sales staff.

The solution.

Key person insurance is designed to protect your business against loss of profits. As with any insurance it is important that the proceeds are in the right hands at the right time. It is the business that will suffer loss and needs to be insured against it.

The usual way to set up cover is to have the company take out the policy (as plan owner) on the life of the key person. It is possible to arrange life insurance, income protection and critical illness policies in this way.

What about key employees of partnerships?

In England & Wales partnerships are not a separate legal identity from the individual partners. This means that it is not possible for the partnership to own a policy.

A solution to this is to have one or more partners take out an insurance policy and hold it on trust for all the partners in the firm. If the key person is a partner they can take out the policy on their own life and place it in trust for the other partners.

A limited liability partnership (LLP) is able to contract in the business name and so could effect key person cover.

Deciding the amount of cover

There is no set formula for calculating the monetary value of a key person to the business. The financial loss to the company on the death of a key employee will depend on a number of factors including the following: -

- The level of recent and future profits
- The effect on profits if the key person were to die or become disabled
- The cost of recruiting and training a replacement, and the loss of profits during that period
- Loans that could be recalled on the key person's death or disability
- The length of time before the key person is due to retire

There are two approaches that are usually used for determining the level of cover that is needed: -

Multiple of salary

Using this approach, the key person's salary is multiplied by a factor usually between five and ten.

This is a simple way of calculating the cover but it has its drawbacks. The salary alone will not always reflect total earnings, may not accurately reflect someone's real value to the business, and doesn't take any account of the time to go until retirement.

It is usual for employers to substitute the total cost to the employer of an individual rather than just use the salary figure. In other words this could be basic salary, plus potential bonuses, pension contributions, employers National Insurance etc. This helps to protect the employer by calculating the full potential cost of a suitable replacement over the recovery period.

Proportion of profits formula

This formula takes account of the key person's salary, annual profit, and the time it would take to replace them. The formula usually used is as follows: -

[Key person’s salary / total salary roll] X profit* (in the last trading period) X number of years**

*Assuming that profits are expected to increase in the future, care will need to be taken to ensure that the sum insured caters for this. Including an increase option on the policy could do this.

The profit figure can be either the gross or net profit. The net profit is a good reflection of the performance of the business, but will not always allow for some of the fixed expenditure (rent, rates, salaries etc), which still have to be paid after the key person's death. The gross profit can give a better reflection of the business profit lost on their death.

**The number of years is that number necessary to replace the key person; otherwise called the recovery period.

Taxation.

There is no direct legislation concerning the taxation of key person insurance and we still rely on guidance set out in the 1940s by Sir John Anderson (Chancellor of the Exchequer at the time) in what became known as ‘the Anderson principles’.

The principles are that tax relief would be granted on the premium and any policy proceeds would be taxed as a trading receipt provided that: -

- The sole relationship between the life assured and policy owner is that of employer and employee.
- The aim of the cover is to insure against loss of profit due to loss of services of the employee.
- It is an annual or short term insurance.
- If the employee is also a significant shareholder, tax relief is unlikely to be granted on the premiums as the policy is partly for the insured's own benefit.
- The policy should be an annual or short term insurance. Although this has never been defined it is thought that terms of five years would be acceptable. Many policies are written as renewable term insurances to overcome this problem.

If the premiums qualify for tax relief, the general position is that any benefit paid out is likely to be treated as a trading receipt and subject to tax at the appropriate rate (or vice versa where tax relief is not granted).

A business cannot choose not to claim relief on the premiums in the hope that the proceeds might be paid free of tax. The tax position of the premiums and any proceeds is not guaranteed and will very much depend on the individual facts of each case and practice of the local inspector of taxes. It is strongly recommended that the tax treatment of the premiums should be confirmed before inception of the policy.

The tax treatment of any policy proceeds in the event of a claim may not be determined until a claim arises.

The content of this technical note is based on our understanding of current English law, taxation and HM Revenue & Customs practice, which can change at any time.

If you are in any doubt as to the tax position of key person insurance please consult your professional advisers. The tax treatment of a policy and policy proceeds may be at the discretion of HM Revenue & Customs.

If you have any questions or comment in relation to this article, or if you require a quotation or advice on key person insurance for your business please email info@expertfs.co.uk

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