

Key Person Protection

by Arthur Childs, Chartered Financial Planner

Introduction

This Guide will be of interest to those of you who are directors or partners in small and medium sized companies or firms.

You are probably already aware from past experience that it is not easy to replace key people at short notice.

An example from a very much larger and highly successful organisation.

Standard Life, Europe's biggest mutual life assurer, announced on 4 January 2005 that it might not be able to appoint a finance director with public company experience until the summer. That would be 12 months after the group said it had instructed head hunters to seek such a person to help prepare for demutualisation in 2006.

This is all the more incredible when you realise that Standard Life had been an efficient and highly successful money manager for more than 175 years and has over 5 million customers. In fact Standard Life's assets under management in 2005 were worth more than the market value of Sainsbury's, Boots, Tesco, Cadbury Schweppes and Marks & Spencer combined.

Even in very much smaller organisations key people are the most difficult and costly business asset to replace quickly.

You, or your bank, may have realised that one or more of your directors or senior staff are such key people that their untimely death or disability could have a devastating effect on the profits of the company.

By insuring the life of a key person against premature death or disability you can safeguard the business against the loss of profits and provide a breathing space during which time the company can be restructured or a suitable replacement found.

Key person protection aims to ensure the continuation of a business by financially compensating a company for the death or disability of one or more of their key employees.

Who is a key person?

Virtually every business has key employees on whom the profits depend. The critical issue to be addressed is 'who are the key people?'

A key person is anyone whose death or disability would have a serious effect on the company's financial status and future profits. The key person need not necessarily be a significant shareholder.

What is the need for such cover?

The problems associated with the loss of a key person will very often fall into one of two areas; principally, loss of profits or loan protection.

The main area of concern is usually the loss of profits that would arise following the death or disability of a key contributor to profit.

Such a person might be a top salesperson, technical expert, or a company director or executive. The damage inflicted on a company very much depends on the individual concerned.

Some situations will affect the company's profitability in the short term, such as an immediate loss of sales, whereas other situations may have greater impact on the long term; for example the loss of a technical expert.

Another important aspect that is sometimes overlooked is the potential impact of insolvency through the death of a key person.

This is of course an extreme situation, but if a company goes into liquidation the directors themselves could be held liable for any outstanding debts.

The test is whether they knew that there was no reasonable prospect that the company could have avoided going into liquidation and they did not take sufficient steps to minimise the potential loss to the creditors.

This could put a director in a vulnerable position where his company moves into financial difficulties as a result of the death of a key person.

Loan protection is another area that may be relevant where key person protection is required as a condition of corporate finance.

How much cover is required?

There is no set formula to calculate the level of benefit required to cover the financial loss.

The amount of cover will depend on how much you think your turnover would be affected if that person were to go home tonight and either not return for many months or not return at all.

How much would it cost to recruit a replacement and how much would it cost and how long would it take before he or she was as productive as their predecessor?

A simple multiple of earnings could be used, or a more complex formula - based on the estimated key person's contribution towards net profit.

Alternatively, the amount of cover could reflect the capital investment tied up in a specific project and the anticipated loss of profits should the project be delayed or abandoned.

What factors should be considered?

Who are the people (or person):

- on whom the main profit stream rests?
- with key sales ability or contacts?
- with specialist technical expertise or knowledge?
- with artistic skills?
- with entrepreneurial skills?
- with ideas?

What might the following cost:

- the loss of profit?
- the loss of personal contacts and goodwill?
- the decline in turnover due to lost orders?
- the loss of specialist knowledge and expertise?
- the delay of planned business expansion or development?
- the effect of a reduction or withdrawal of bank finance and overdrafts?
- the reduction of credit arrangements with suppliers?
- the cost of providing a temporary replacement?
- the time spent recruiting and training a full-time replacement?

How is the cover set up?

The main type of protection cover used is term insurance although it is sometimes appropriate to use flexible whole of life assurance.

Term insurance provides a capital sum on the event of death during a pre-selected term. This is suitable for most key person protection situations as there is invariably a finite period involved such as to the person's normal retirement date.

As its name suggests, flexible whole of life assurance can be continued for as long as it is needed.

This type of protection may be more suitable where the key person is a large shareholder who may remain the driving force of the company well beyond his or her normal retirement age. His or her loss may only be overcome by virtually rebuilding the company.

The premiums are paid by the company and the proceeds would be received by the company, but it is the key person's life that is insured. The period could be either until retirement, or to the end of a particular project or job.

In order to avoid the level of premium becoming prohibitively high it is common to use 5 year renewable term insurance.

This provides guaranteed insurability (ie no further medical questions) for a further 5 year period, or indeed successive 5 year periods, but the premium rate will increase steeply for each new 5 year term.

As a key person may decide to leave the company of their own free will, a 5 year renewable term protection stops the company from paying higher premiums than would be required for a longer term policy.

What types of cover are available?

The risk to the company is through the untimely death or unexpected disability of a key person.

The three types of risk in order of priority that should ideally be covered are therefore as follows:

- Death. Key person life protection is the lowest cost form of key person protection.
- Heart attack, cancer or stroke. Any employee is around 6 times more likely to suffer from this type of life threatening disease rather than die before retirement.

Key person critical illness insurance would provide protection from these and a wide range of other very serious diseases.

- Prolonged disability. It is a fact that over two million people of working age will be off work for at least six months at any time through sickness and disability.

Key person income protection insurance can provide a monthly income to the company so that the cost of employing a replacement for the key person does not unduly put a strain on the company during such a time.

Are the premiums allowable as a business expense?

The taxation of each key person policy is considered by HM Inland Revenue & Customs on its own merits. It is necessary to explain the purpose of the policy to the local Inspector of Taxes in order to establish the tax position in advance.

The main basis for gaining tax relief on the premiums has been established as follows:

- The sole relationship must be of employer and employee. This is relatively clear, but care is needed where a working director is also a substantial shareholder in the company. There is no definitive statement of 'a substantial shareholder', but in practice, if an individual has a holding of more than 20%, the Revenue may disallow relief.
- The insurance must be to meet a loss of profit resulting from the loss of the employee's services. This condition will not be met if the purpose of the plan is loan repayment as this is a capital item.
- Contracts that acquire a surrender value have an investment element and would fail this test. Generally, whole of life policies will not qualify for tax relief on premiums.
- The contract must be of a short term nature. This rule may be interpreted differently by each Inspector. Generally, term insurance of up to ten years may be allowed.
- However, as the local Inspector of Taxes can exercise his discretion, written confirmation should be obtained with regard to how the contract will be viewed for tax purposes.
- Any benefit provided under the policy may be taxed as a trading receipt. If it is clear that this is going to be the case after corresponding with the company's local tax inspector then it is important to gross up the sum assured to allow for the tax that might become payable.

Is the payment of the sum assured taxable?

Generally, if tax relief is allowed on the premiums, then any proceeds of the policy will be treated as a trading receipt.

It is sometimes mistakenly assumed that if tax relief on the premiums is not claimed, then any proceeds receivable will be tax-free. This is not correct. The taxability of policy proceeds is dependent upon the nature of the policy, not on whether a tax deduction is allowed (or claimed) in respect of the premiums.

If the premiums are allowable as trading payments, the proceeds will inevitably be taxable as a trading receipt – but the reverse is not necessarily true.

The sum assured may be paid in instalments

Some product providers will pay the sum assured in annual instalments over 2, 3, 4 or 5 years. This may be a useful option in situations where the sum assured is very large and it would otherwise be expected to be treated as a trading receipt in a single trading year.

A reduction in profits following the loss of a key person would not happen immediately, even though the sum assured would normally be paid shortly after the death or insured critical illness of the key person.

By using the instalment option the payments to the company may more closely match the reduction in profits following the key person's death or disability.

Avoiding a charge to PAYE

If the policy proceeds are not payable to the company, but are payable to the key person's estate or family then the policy is not a key person policy.

As a result the premiums would constitute earnings on behalf of the key person and PAYE liabilities would arise.

Under a true key person policy, there is no PAYE or 'benefit in kind' problem as no benefit accrues to the key person or his family.

Partnerships and sole proprietors

These notes have concentrated on the most common key person situation, where the key person is a director or employee of a limited company.

However, partnerships also need to protect their key employees or partners for the same reasons.

Furthermore, just because a business is owned by a sole proprietor it does not mean that he or she is the only person whose death or disability would cause havoc with the profits of the business.

Letters to the company's Tax Inspector

The following letters should be on the letterhead of the company which has effected the policy.

<p>Draft letter requesting corporation tax relief on the key person protection policy premiums</p> <p>Dear Sir/Madam</p> <p>Key person protection [Name of Company] Limited</p> <p>This company is effecting a policy of life assurance with [name of product provider] on the life of [name of key person] for its own benefit for the sum insured of £[XXX,000]. The premium is £[XXX] per annum.</p> <p>(1) [name of key person] is the [job title or function] of the company. The company is a director controlled company and [name of key person] owns [X% of the shares in the company] [none of the shares in the company] [together with his/her relatives, controls the company].</p> <p>(2) The reason for the policy is [to protect the company from the financial consequences of (name of key person)'s death – because it would lead to a considerable reduction in profits for the company in the years immediately following his/her death] [to cover a loan repayable on the death of (name of key person)] [to cover the reduction in value of the company occasioned by the death of (name of key person)].</p> <p>(3) The policy is [a term insurance which will not acquire a surrender value] [a critical illness insurance which will not acquire a surrender value] [a term insurance including critical illness which will not acquire a surrender value] [a whole of life assurance which will acquire a surrender value].</p> <p>Please confirm that the premium [will] [will not] rank as an allowable deduction for corporation tax purposes.</p> <p>Yours faithfully</p>

<p>Draft letter to be used if corporation tax relief on the key person protection policy premiums is disallowed</p> <p>Dear Sir/Madam</p> <p>Key person protection [Name of Company] Limited</p> <p>We refer to your letter dated [2009] which informed the company that the premiums in respect of the policy effected by the company on the life of [name of key person] will not rank as an allowable deduction for corporation tax purposes.</p> <p>Please confirm that the proceeds of this policy will not be treated as a trading receipt and that, therefore, the company will not be taxed on the proceeds in accordance with the provisions of the Income and Corporation Tax Act 1988 as amended by Schedule 9 of Finance Act 1989.</p> <p>Yours faithfully</p>

Please note that this information does not constitute personal advice and should not be treated as a substitute for specific advice based on your circumstances. If you are in any doubt as to whether Key Person Protection would be suitable for your firm or company, then you should discuss the matter with a suitably qualified independent financial adviser such as ourselves.

Any information given in this Guide relating to income tax legislation is based on our understanding of legislation and practice in force at the date of this Guide. Whilst we believe our interpretation of current law and practice to be correct in these areas, we cannot be responsible for the effects of any future legislation or any change in interpretation or treatment.

For personal advice

If you would like to discuss whether Key Person Protection would be suitable for your firm or company please ask your usual Arch adviser or contact us via one of the following:

Tel: **0845 3700 661**
or **01483 204600** (if local)
Email: **enquiries@arch-fp.co.uk**
Online: **www.arch-fp.co.uk**



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