Macbeth

Key Person Cover

The loss of a Key Person within a Company can have a dramatic effect on the profitability and the day to day running of the business. Key Person Assurance is not in itself a product but an application of insurance designed to maintain a company's business profitability.

It aims to provide the replacement costs of an individual whose loss (whether permanent or temporary) could have a significant impact on the company's profits or turnover and which could present itself through loss of:

- Goodwill
- Technical skills/knowledge
- Financial arrangements
- Expansion opportunities or business projects

Why the need for Key Person Protection?

Any business could suffer a financial loss if a key employee was absent for a long period of time. This is in addition to the day-to-day problems that will occur within the company. Examples of how a Key Person Protection Plan could provide funds are:

- Maintain the value of the company
- Enable the company to recruit and train a replacement
- Repay outstanding loans
- Help ward off a takeover
- Pay for temporary staff
- Inject capital when morale is low

Who is a Key Person?

This can be subjective, but is really anyone whose skill, knowledge, leadership or experience contributes to the company's continued financial success.

Assessing the amount of cover required

To place a monetary value on an individual is difficult but that is not what selecting a sum assured for key person assurance is actually about. What is required is a monetary value, which will accurately reflect the impact of the loss of the individual on the company profits.

The following issues could be used to establish the need for cover or a sum assured:

- Decline in turnover, profitability and/or goodwill.
- Length of time to replace and train a replacement and the cost of doing so.
- Current available cash – reserves available to cope with unforeseen losses.
- Effect on the company's credit connections.
- Ability to meet debts.
- Costs involved with cancellation or delay of expansion plans.

Oviously, not all these points will apply to every business and therefore, the approach to calculating financial loss will vary, as will the key individual's value to it.

The most widely used methods are:

Multiple of Salary

A simple and therefore widely used method whereby the key person's salary is multiplied by a given factor, usually somewhere between five and ten times salary. It is particularly relevant where the aim of the plan is to buy replacement cover.

Cash Flow

This method reflects the impact the individual could have on cash flow.

Key person's Remuneration
Total Salary Payroll x Turnover x Recovery Period

Multiple of Profits

Two to three times Average Gross Profit is a common measure.

No method is perfect – an individual's salary for example may not be a true reflection of their actual involvement. However, in establishing a plan, it will be necessary to go through financial underwriting where the level of cover will be assessed to ensure it is reasonable given the company's circumstances.

The involvement of individuals within the company is vital in assessing a potential impact on the business because of their knowledge within it.

How is the cover arranged?

This is normally arranged by the Company taking out a policy in the name of the Company on the life of the employee who they consider to be a key employee within the business.

TAXATION

The corporation tax situation of Key Person plans is not simple, as there is no direct legislation to cover this issue and the final decision on the taxation of both premiums and policy proceeds will lie with the Company's local Inspector of Taxes. For this reason we would always recommend that the company should seek specialist tax advice from their accountants who should consult with the appropriate Inspector of Taxes prior to the cover being put in place.

Will the Company be able to claim the premiums for the key person policy as an allowable trading expense?

As already stated there is no specific legislation covering the tax treatment of premiums for key person assurance.

Generally, premiums are an allowable trading expense if they meet the following conditions:

- The relationship between the business and the life assured is that of employer and employee.
- The policy is intended to meet the loss of profits resulting from the loss of services of the employee.
- The policy is an annual or short-term assurance.

That said, the treatment depends on the facts of each case and clarification should be sought from the Company's own Inspector of Taxes.

How will the proceeds of a key person policy be treated in the hands of the Company?

If the premiums have been allowed as an expense of the business, then any proceeds are likely to be treated as a trading receipt and therefore taxable. If, however, it has been agreed that the premiums are not allowable, then provided the proceeds are to be applied for a capital purpose (e.g. the repayment of a loan), they are unlikely to be treated as a capital receipt and not taxable.

This is not guaranteed and once again the facts of each case will determine the outcome. Unfortunately, the Company's inspector of taxes is unlikely to give advance notice of how the proceeds will be treated and again is an issue to be agreed between your accountant the Inspector of Taxes.

If the business does not claim relief on the premiums of a key person policy, will this ensure the proceeds are free of tax?

No. Treatment of the proceeds will be decided by the local Inspector of Taxes, based on their view of the facts at the time of a claim.