Business Protection

Guide To Key Person Protection

For intermediary use only – not for use with your clients

This technical guide details a businesses need for key person protection, suitable solutions, and the impact and tax treatment of applying them.

In this guide we look at the need to make financial provision for the financial loss to a business of a key person. We offer help in identifying who the key people might be, and how to meet the protection needs. This guide also covers the tax treatment when setting up and maintaining suitable solutions.

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1 The Need

The basic need (and basic solution) for key person protection

In every office, shop or factory in the country there is a notice proclaiming that the employer has taken out insurance to cover accidents to employees at work. Every car or lorry owned by a business has to have at least the minimum level of insurance required by law. Most prudent business people will have arranged for insurance on the factory, office buildings, even on the desk at which they work.

But one valuable business asset is often left uninsured. Zurich believes that too few businesses have any insurance to cover the one eventuality that can literally mean the end of the business and the income it provides – the death or illness (including critical illness) of a key person.

Whether the business in question is a partnership, a Limited Liability Partnership, a company, or even a sole trader, it is likely to have an individual, or individuals, crucial to its continued activities and prosperity. Here are a couple of examples:

Example 1 clearly illustrates that a business owner will often be a key person:

John is a successful businessman. He's worked hard to build up his small, but profitable, manufacturing business that is run as a private limited company. It's recently expanded very fast, taking on new staff and installing a new IT package to help with financial management of the company. The bank has been very helpful and provided a temporary overdraft while the expansion takes place. Though he has fellow directors to share the load, John is the main shareholder and still spends long hours doing much of the work himself. He still deals with many of the business's clients on a personal basis.

Why John is a key person

- John's staff rely on him for his experience.
- John is, directly and indirectly, responsible for the majority of the business income.
- His clients trust him to meet their needs.
- His suppliers know that whilst he's around, they will be paid.
- The bank knows that whilst he's around, its money is safe.

So, whilst the business runs as a company, it still has many of the practical characteristics of a sole tradership.

Some potential issues

If John were to die, or suffer a serious illness needing time away from the business, what would happen to the business?

- Staff could leave, fearing their jobs are at risk.
- Valued clients could be lost to rivals.
- Suppliers might require payment in advance.
- The bank could call in the overdraft.
- Revenue and profits would fall.

Potential solution

All this could be prevented if a suitable protection policy, or policies, existed to provide cash at a time when it's most needed. This could enable the bank to be repaid, provide salaries and pay suppliers, replace lost revenue and perhaps even provide a temporary replacement for John (though he may be very difficult to replace!).

This would provide time. Time to build up the business again, or maintain its position and reputation, possibly while a buyer is found.

Example 2 shows that not all key people are business owners:

Sally and Mike are the founders and majority shareholders of a small but successful IT software solutions company, both are married (not to each other) with young families.

While they both fully understand the business of their company, Sally and Mike's background is in IT consulting. The real heart of their business is about helping other companies have the right IT solutions for their business. To be successful, they rely on those solutions being 'fit for purpose' and every client is different.

Both Sally and Mike realise that as well as each other Tom, who is the Technical Director, is also a key contributor to the business' success and well being. Mike and Sally have key person cover on their lives covering death and critical illness. However, the growing importance of Tom to their business has made them realise the prospects for their company would be seriously harmed if, for any reason, Tom was no longer around. As directors, Mike and Sally ensure that Tom's benefits package is sufficient to retain his services – this is within their control. Tom dying or suffering a serious illness however, is not within their control and that's why they need insurance.

Potential issues

- There will be a need to replace Tom.
- Likely to have to pay recruitment and training costs to replace Tom.
- There is likely to be additional costs of disruption through the need to be involved in the recruitment process
- Who does Tom's work while any replacement is getting up to speed? Will they cope, and be capable?
- By how much will profits be depressed, and for how long?

Potential solution

A suitable protection policy, or policies, will provide cash and would mitigate any financial loss caused by Tom's temporary absence, or tide the business over until a replacement is recruited and trained.

Key person protection, through a life assurance, critical illness, income protection policy, or a combination of all three, can provide a cash injection (either as a lump sum or as a flow of income) to the business if a key person dies or suffers a serious illness. Allowing the business to continue trading at a time of considerable uncertainty and financial pressure.

Among other things, the following main needs can be covered:

- Loss of profits suffered until a replacement is found, is in place, and is fully effective.
- Pay for the often substantial costs of recruitment and training of a replacement.
- If absence is due to critical illness, if a return to work is on the cards, pay income to the 'absent' person and also fund the cost of a temporary replacement.

Identifying key people in a business and key person protection needs

A key person is someone whose absence from the business through death, or the suffering of a critical illness or long term disability, would have a serious effect on the future profits of the business. Although the number of key employees will vary from business to business, there will usually be at least one. To give some examples:

Sales person
Without this person the profitability of the business would be affected, new customers would be more difficult to attract, and existing ones might leave.

Technical expert
Without this person products might be defective and not meet the needs of customers, and new product development would be hindered.

Research and development specialist
Without this person the development of new projects could be slow or cease.

Director/Manager (often, but not always, also business owner)
Without this person there would be severe implications on the finance of the business, mostly because this person creates the vision for, and the direction of, the business.

Founder key person protection

In many small companies and partnerships, the founders are the life-blood of the business. They will have set up the business, be its managing director/ partner and chief source of business.

In these circumstances, it is clear that a founder's death will have serious consequences for the business' existence because:

- Most of the goodwill in the business could derive from them.
- Any co-business owners may not be sufficiently competent to take the founder's place. Even joint business owners often have specialist skills and competencies that are hard to replace.

As we outlined in Example 1, the death of the founder (John) could, in the eyes of its clients, mean the death of the business, unless the business has taken steps to avert the problem through the setting up of a properly financed replacement strategy.

Businesses should also consider the consequences of the founder suffering a serious illness because, even if they are ultimately able to return to work, they may need substantial time off to recover or return in a reduced capacity.

Sole traders

Given that, in most cases, there is no distinction between the sole trader and the business, as they're one and the same, cover is determined and established as it would be for personal protection. The financial need is to ensure that funds will become available at the right time, in the right hands.

In summary

So, in conclusion, few business owners – whether shareholding directors, partners or sole traders – like to think of the problems that their untimely death or long-term incapacity could cause. However, it's worth asking these questions in relation to such an absence:

- Who would do everything you do or planned to do?
- Would there be a need to recruit a replacement and how long would it take to do this?
- Would any expansion plans, or ongoing projects, be detrimentally affected?
- Would your staff, customers or bank worry? If so, what could the consequences be?

2 The Solution

The basics needed to establish a solution

One common factor in each of these situations is clear – shortage of money. A business may be well capitalised in terms of assets and possibly (depending on accounting policy) goodwill, but what it may not have is the ability to call on fairly large sums of cash at short notice.

Cash can be raised – by bank borrowing, commercially borrowing from the business owners, selling assets and (for companies) seeking new share capital.

Bank borrowing is the most common (and arguably least disruptive) method. However, borrowing may only be practical where the lender has confidence in the borrower to repay the loan. Confidence will come from the financial strength, present and future, of the business, and the death of a key person in the business could undermine such confidence. Economic conditions can also seriously affect the availability and cost of capital. Interest rates can, for example, make borrowing prohibitively expensive.

Selling assets may be an unattractive solution because:

- Those assets are likely to be used in the profit creation process. Losing them would mean losing their profit-making potential.
- They're being sold because the business has to, rather than because of natural business progression. This can very often result in a poor price. Also, the business could be selling to a competitor, who might wonder about the reason for the sale and this could lead to a loss of confidence on the part of clients.

Securing fresh share capital by a company will mean issuing more shares. Where these are issued to other than the existing business owners, this will result in a dilution of the value of the existing shares. The most likely source of such capital is, however, the existing owners. In this case a loan would usually be seen as a more flexible and straight forward way of introducing funds.

In summary, the need is for the certainty that there will be cash, in the right hands, at the right time. This can be achieved by a protection policy being taken out on the life of the appropriate key person(s).

STEP 1: Calculating the amount of protection needed

How much cover is needed will be different for every business, depending on who they are looking to protect, for how long, their priorities and, of course, affordability.

The exact amount of the sum assured may be difficult to quantify.

- What will be the effect of the key person's absence on production, sales, and most importantly profits?
- For how long will profits be surpressed?
- How long will it take for the replacement to be found?
- How much will it cost to recruit and train a replacement?
- How long will it take for the replacement to be 'up and running' and as effective as the key person?
- What will be the effect on future developments and projects?
- What effect will it have on existing customers and key business contacts, which may in turn effect profits?
- Will any savings be made through the absence of the key person?

There is no single way to calculate the financial value of a key person. However, the cover required under a key person plan should be founded on the amount that is estimated to be needed to replace lost profits, until they are restored to the required level, and to meet any additional costs. Here are four possible methods:

1. Multiple of salary

The first method, most often used for an employee, is to decide on a multiple of the salary, including the value of any benefits in kind, of the key person. The greater the value of the key person, the more serious their loss and the resultant cost of replacing them, the higher the multiple would be.

Perhaps, up to seven times the total remuneration package can be considered for life cover. For critical illness cover perhaps up to five times the total remuneration package could be considered.

However, there are disadvantages in using this method. First, it will not be accurate for a key person who is a shareholder, who might take the bulk of their remuneration in the form of dividends. And it will certainly not be appropriate for a partner who doesn't have a salary. Most important, regardless of the nature of the key person, this method focuses on replacing what the key person received rather than the loss caused by the key person's absence.

2. Multiple of profits

The second method is a multiple of profits, based on the loss of profits caused by the key person's absence. This is usually a more satisfactory measure, though the length of time it takes for profits to fully recover, is difficult to predict.

An underwriter might consider the following maximum multiples:

- 5 x profit for life cover.
- 3 x profit for critical illness cover.

Whether the profit figure used is pre-tax or post-tax will depend on individual circumstances. In most cases recovery will be more gradual and this should be factored when assessing the likely loss. Due attention also needs to be given to one-off costs such as recruitment and their associated costs.

3. Proportion of payroll

Using this method, the key person's contribution to turnover is measured. Their salary is divided by the total payroll, multiplied by turnover, multiplied by the estimated years for the business to recover.

Here's an example:

$$\frac{\text{Salary £100,000}}{\text{Total payroll £2m}} \quad \text{X} \quad \text{Turnover £20m} \quad \text{X} \quad \text{2 years to recover} \quad = \text{£2m}$$

However, as with multiple of salary, this method may not be appropriate where a shareholding director takes a low salary, or is remunerated largely by dividends. It will definitely be inappropriate for a partner.

As mentioned above, the one-off costs, especially those of recruitment, might need to be added to the amount of cover.

- Will an inducement in the form of a 'golden hello' be necessary?
- Will a recruitment agency be needed?
- Will training (and training costs) be needed?
- How much management time (resulting in loss profit/turnover) will be lost due to necessary engagement in the recruitment process?

Such additional costs would need to be factored into assessing the cover level.

Of course any savings secured as a result of the death or critical illness of the key person also need to be factored in, for example the difference between the remuneration package of the key person and that of the replacement.

4. Actual impact method

This method represents a more detailed approach to quantifying the expected financial loss on the death or critical illness of a key person.

This method is based on the loss of revenue (turnover) less any savings (e.g. the salary and/or profit share of the key person, less any payments for a replacement) over the period of expected loss plus any 'one off' costs.

For example, a key person generates revenue of £250,000 a year and has a salary of £75,000. The following is expected:

- 100% of the revenue produced by the key person would be lost in year 1, 75% in year 2 and 50% in year 3 with full recovery from the commencement of year 4. It is assumed that a replacement will have been recruited by the commencement of year 2 (see below).
- A new recruit would be in place at the commencement of year 2 at an initial salary of £75,000 which would rise to £80,000 in year 3. The 'net' salary saving would thus be £75,000 in year 1, £0 in year 2 and a cost of £5,000 in year 3.
- The 'one off' costs of recruitment and additional lost revenue (due to the diversion of management time in the recruitment process) would be £50,000 in year 1.

The following calculation shows how the plan's sum assured could be calculated:

	Loss of Revenue	One-off costs	Savings	"Net" loss
Year 1	£250,000	£50,000	£75,000	£225,000
Year 2	£187,500		£0	£187,500
Year 3	£125,000		-(£5,000)	£130,000
			Total	£542,500

This method should be adopted where it is thought that the circumstances require that a more detailed approach to financial loss assessment is required.

STEP 2: Providing the funds through life assurance

Limited company

As a limited company is a legal entity in its own right, the usual way to set up key person protection is for the company to own the protection policy for its own benefit. That way, any benefits paid, will be paid directly to who needs the money – the company.

The company will apply for a protection policy on a life of another basis – with the company as the policy owner and the key person as the life assured. The company will need to complete a life of another form which gives details of the life to be assured and the organisation to whom the proceeds are payable.

The key person, as the life to be assured, will have to answer questions on the application form relating to their health and will have to consent to the policy being taken out on their life.

By setting the policy up on a life of another basis, no trust arrangement is required.

Where the key person is a business owner, it could be possible to set up a key person policy on an 'own life in business trust' basis. This could potentially give greater flexibility over the use of the sum assured from the policy as these wouldn't be paid to the company. However, this solution would only be suitable if all the owners are key persons and all take out policies under business trusts for each other's benefit.

Partnerships and Limited Liability Partnerships

In England & Wales, a partnership does not have a separate legal identity, unless it's a Limited Liability Partnership (LLP). Therefore, where the key person is an employee, the life assurance policy should be put in place by one or two designated partners on the life of the key person and held in a special Partnership Key person trust for the partners 'for the time being' (in order words as a partnership asset).

In Scotland, a partnership has a separate legal identity and so, a policy could be taken out in the name of the partnership. This is also true for an LLP.

To provide key person cover where the partners themselves are key persons, the special Partnership Key person trust can also be used. However if all the partners are key persons then each partner can take out a protection policy on their own life written in trust (this time using the business trust) for the other partners. If a partner dies or suffers a critical illness, the sum assured from the policy can be paid to the trustees. The benefits then pass to the remaining partners who can make funds available to the partnership usually by lending funds to it. Using a business trust will not be suitable if the cover is required on only one of the partners.

This route can also be adopted by partnerships in Scotland and LLPs if they do not wish to take the life of another route.

Sole trader

Inevitably, the sole trader will be the key person and their death, or even serious illness, could mean the end of the business. It may be that no amount of money can save the business, in which case the most appropriate solution will be for the individual to take out a protection policy on their own life and place it in trust for their dependants.

If the sole trader does have a key employee, as can happen on occasions, then the sole trader would effect a policy in his or her own name, on the life of the key person i.e. on a 'life of another' basis.

Type of plan and period of cover

As explained in the Taxation section, such business is usually written as short-term, level term assurance. Short-term is generally accepted as five years but longer terms and policies with convertibility options can be used.

Underwriting considerations

Medical guidelines for underwriting key person protection are usually the same as for any personal protection policy. It's the financial guidelines and evidence that can differ between business and personal protection. Financial underwriting involves establishing:

- That the level of cover is correctly assessed and is appropriate.
- That the proposer (for example the business) stands to lose from the death or serious illness of the life assured (insurable interest).

A financial questionnaire can help us to establish this. For larger sums assured, independent financial corroborative evidence will also be needed to illustrate the need for the cover, for example, audited accounts and a letter from the company accountant.

3 Taxation

Making the arrangement tax efficient

For most people, minimising the amount of tax payable on a financial transaction, or series of transactions, is a vital part of financial planning. The impact of taxation is important and particularly so in the case of business protection.

Before looking at the tax position on key person protection in more detail, it's worth making some general points:

- The type of policy, its benefits and term can all have an impact on the taxation position of key person assurance.
- Thorough fact-finding of the business' needs will ensure you are recommending a solution to meet their needs and, whilst tax is important, it's not the only factor to consider.
- Decisions made purely for tax reasons at the expense of other commercial questions may not be the right ones. For example, you shouldn't necessarily choose a particular solution solely because it is the most tax efficient.
- Tax rules change. Whilst this shouldn't deter long-term planning, it does reinforce the need to review any arrangements made regularly.
- Tax rules can be complicated. Obtaining competent professional advice is essential.

Tax relief on the payments

One key question is whether the business will obtain any tax relief on the payments it makes to the policy. Obtaining tax relief on the payments can be an important consideration – although if a payment is deductible, the sum assured is likely to be taxable.

However, not every key person protection plan will necessarily benefit from this tax relief, so it's worth knowing the guidelines.

The broad guidelines to obtain tax relief on these type of plans were set down as long ago as 1944 by the then Chancellor of the Exchequer, Sir John Anderson, but the actual decision depends upon the individual local Inspector of Taxes dealing with the business' tax affairs. There are three areas of interest as far as HM Revenue and Customs (HMRC) is concerned, and these are relevant to both life assurance and critical illness policies:

1. **The sole relationship between the insuring party and key person must be that of employee and employer**
   This means that even if the key person is a shareholder then, provided the shareholding is not 'significant', HMRC could regard the relationship as being solely that of employer and employee. What is meant by 'significant' is unclear. As a rule of thumb, a shareholding of less than 5% is likely to be considered insignificant.
2. **The policy must be intended to compensate for loss of profits**
   If the policy can serve more than one purpose, or is being taken out for another reason, for example to repay a loan, then it is unlikely that payments will get tax relief.
3. **The policy must be a short-term or annual insurance**
   On this basis, it is unlikely the payments on a term assurance policy with renewal or conversion options, or a whole of life policy, will qualify for tax relief. HMRC generally regard a term assurance policy as short-term if it has a term of five years or less.

It is important to note that all three tests must be satisfied if tax relief on payments is to be secured. This means that:

- any key person protection policy that is effected on a whole of life basis and,
- any policy on the life of a 'substantial' shareholder,

will not be eligible for tax relief on the payments.

Payments paid under policies on the lives of partners, members of LLPs and sole traders will also not be deductible for the payer as test 1 (above) will not be satisfied.

Please note
Whilst HMRC operate within the context of these fairly simple rules, decisions in individual cases vary a lot. Therefore, it's vital that the proposed tax treatment of the payments should be settled, in writing, as early as possible with the business' local Inspector of Taxes. Draft letters for this purpose are available as part of the Business Protection document library on the Zurich Intermediary website.

Tax on the benefits paid

Broadly speaking, a company will be liable to tax on the policy's sum assured if they were eligible for tax relief on the payments. In such circumstances the entire plan proceeds are subject to tax as if they were a trading receipt. If the payments were not eligible for relief then the sum assured is likely to be treated as a capital receipt and is, therefore, unlikely to be assessable to tax.

For partnerships, members of LLPs and sole traders (where the policies are on the lives of the business owners) as stated above there would be no tax relief on the payments and no tax on the sum assured paid out.

If the life assured under an income protection policy is a key employee, the policy is owned by the business and the benefits are used to protect loss of profits. The proceeds are likely to be taxed as a trading receipt in the hands of the employer. If the benefits are paid on to the employee as sick pay, the payments will, usually, be deductible for the employer but the pay will usually be subject to PAYE and National Insurance.

How the tax is calculated if the sum assured is taxable

If, for example, the policy pays out £100,000, this amount is added to the employer's profits for the tax year in which it is received. The amount of tax that is payable is calculated in the same way as if the company had made additional profits of £100,000 – which, after all, was the reason why the policy was taken out (i.e. to ensure that the company received those 'profits' whatever happened to its key person). Of course, the impact on the tax liability for the year will depend on the extent to which the profits of the company are diminished by the loss of the key person.

If the company anticipates using the funds provided by the protection policy over more than one year it could arrange to have the sum assured paid in instalments. This will mean that only the amount received in a year will be subject to tax in that year.

Tax relief on payments is effectively balanced by the tax on the proceeds. For example, if the payment is £100 and the sum assured £10,000, a company paying corporation tax at 19% (as at April 2018) would effectively pay £81 after tax relief and receive £8,100 in proceeds after tax.

Where it is thought that the sum assured will be subject to tax on receipt, this should be taken into account in deciding the gross sum to be insured. So, in order to insure a larger sum, a larger payment will be necessary. This is important to bear in mind when considering the overall economic outlay necessary for the company.

Chargeable events

'Chargeable events' are a means by which investment profits on life assurance policies are taxed. Prior to March 1989, these were not of great significance to policies owned by companies but have since become more important. Broadly speaking, a 'chargeable event' occurs when the benefits of a plan become payable. The chargeable events are:

- Death, giving rise to a payment of benefits.
- Assignment for money or money's worth.
- Maturity.
- Partial or total surrender.

However, unlike the rules taxing the policy's sum assured as trading receipts, the chargeable event rules only tax 'investment' gains. Moreover, allowance is made for the payments paid when calculating the gains.

In general terms, as long as the surrender or maturity value of a policy does not exceed the payments made, there will be no tax to pay on the proceeds. In most cases, the type of policies used for key person purposes should not pose a problem in this respect; in addition, none of Zurich's current protection policies will ever accrue a cash value. Since 2008 the chargeable event provisions do not apply to corporate policies but the loan relationship rules (potentially resulting in year-on-year taxation for a company) can. However these rules do not apply to pure protection policies.

Capital Gains Tax

In general, life assurance policies are not subject to Capital Gains Tax. As long as the company takes out the policy and does not purchase it from another person, there will be no Capital Gains Tax to pay.

What is key person income protection?

An income protection policy pays income, usually as a (limited) percentage of the key person's salary, in the event of prolonged illness or incapacity. So, it is expected that the key person will return to the business.

Key person income protection is not true key person insurance, as strictly speaking it doesn't replace lost profits. It does, however, provide funds to enable the business to:

- Meet the cost of continuing to pay the sick key employee.
- Pay for a temporary replacement. This is also referred to as 'locum cover'.

It may be possible to provide both income for the key person and locum cover.

What happens if the key person leaves the business?

If the key person leaves, the business may no longer need the policy, although there is nothing to prevent them retaining it and claiming on it in the event of the key person's death. This would be unlikely and if payments were tax deductible they would cease to be, once the key person leaves the business. Alternatively, the company may wish to assign the policy to the key person.

There are two ways in which this can be achieved.

1. The most likely way is the business could give the policy to the key person – perhaps as part of a 'golden handshake'. This could be totally tax-free if the golden handshake is within current HMRC guidelines and limits. Some care has to be taken if the employee is not leaving employment. In such a case, the employee may be subject to income tax on the value of the policy.
2. The employee might buy the policy – maybe because they're no longer able to obtain cover elsewhere because of health problems or simply increased cost.

In either case, it is likely that the subsequent payment of the sum assured could give rise to a liability to Capital Gains Tax. Advice on this is essential before any action is taken.

Finally, a word of caution. Promising the employee that a policy will be assigned to them could be regarded as an Employer Financed Retirement Benefit Scheme. This means that the employee could be liable to tax, so it is best to avoid this kind of agreement. The rules are quite complex so, again, it pays to take advice.

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