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Key Person Protection Technical Guide

Introduction

The purpose of this guide is to explain how Key Person Protection operates.

This guide aims to answer the most common questions that you may be faced with whilst dealing with this topic.

This guide gives our views and interpretations of HM Revenue & Customs regulations and current practices but we can't guarantee that these will not change.

What is key person protection?

It's simply a company insuring itself against the financial loss it may suffer as a result of the death (or critical illness if chosen) of a 'key' employee. It's not only companies that can effect key person protection. Businesses that take the form of sole traders, partnerships and limited liability partnerships (LLPs) may also have key employees. The majority of this guide, however, is focused on the position for companies.

Who is a 'key' employee?

Key people are the individuals whose skill, knowledge, experience or leadership contribute to the company's continued financial success.

A key person may be one of a number of people within a company, such as the chairman, managing director, marketing manager, computer specialist or sales manager – anyone whose death could lead to a financial loss for the company.

How do we prove an employee is a key person?

In order for a company to insure one of its employees it must show that it stands to suffer a financial loss of profits as a result of the death or critical illness (if chosen) of that employee. This isn't usually difficult and that employee is then regarded as a key person.

So who actually effects the policy?

Arranging key person cover is really very simple. The company is the owner (the grantee) and completes the 'Policy Owner Questionnaire' on the application form. Usually the company Secretary, Chief Executive, General Manager or a Director will sign for and on behalf of the company.

Obviously the key person will have to complete their personal and medical details and also sign the application as the life assured.

The policy proceeds, if payable, will be paid to the company.

Presumably the company pays the premium, so can they claim Corporation Tax relief?

The company will pay the premiums and, in certain circumstances, may be able to claim Corporation Tax relief see 'Taxation' on page 3.

Will the policy proceeds be taxed?

This will depend upon circumstances see 'Taxation' on page 3.

What type of policy should be effected?

This depends on the circumstances involved and the events the company wish to insure the key person against. A life or life and critical illness cover policy could be chosen.

The effect of suffering from a critical or terminal illness can be the same on the company as the death of the key person. Thus life and critical illness cover may be a suitable option.

We recommend that the company thinks about the term, that is the length of the period of cover first of all. Then the risk or risks they wish to be insured against, the sum to be assured, affordability and finally taxation.

So how do you calculate the sum assured?

There are no formal rules for arriving at a sum to be assured and taxation (which will depend upon the type of policy) will be an issue, as will cost.

It's not easy to accurately assess the financial impact on a business of a future event but the company can usually give an estimate.

One rule of thumb that has been used in the past is 10 times the key person's salary but this is rather hit or miss.

A formula which we have found has worked quite well in the past is as follows:-

Key person's salary (p.a.)	Gross profit	Business recovery period	Sum assured
	X of X		=
Total payroll	company		

For example			
£50,000	X £4m	X	4 yrs = £400,000
£2m			

Taxation

Unfortunately, the Corporation Tax situation isn't so simple, since there is no direct legislation on the subject of key person policies. Companies should always consult their inspector of taxes before completion.

The principles were set out as long ago as 1944 by the then Chancellor of the Exchequer, Sir John Anderson, in answer to a Parliamentary question he made the following statement:

"Treatment for taxation purposes would depend upon the facts of the particular case and it rests with the assessing authorities and the Commissioners on appeal, if necessary, to determine the liability by reference to these facts. I am, however, advised that the general practice in dealing with insurances by employers on the lives of employees is to treat the premiums as admissible deductions, and any sums received under a policy as trading receipts, if (i) the sole relationship is that of employer and employee; (ii) the insurance is intended to meet loss of profit resulting from the loss of services of the employee; and (iii) it is an annual or short term insurance. Cases of premiums paid by companies to insure the lives of Directors are dealt with on similar lines."

So provided that:

1. the sole relationship is employer/employee;
2. the cover is for loss of profits; and
3. the policy is a short term assurance,

The company's tax inspector may allow Corporation Tax relief on the premium.

It's thought the tax inspector would not approve term assurance, or whole of life policies longer than five years but might approve critical illness or income protection policies longer than five years.

Where Corporation Tax relief has been given on the premium, the whole policy proceeds will usually be treated as a trading receipt of the company in the year of payment and fully liable to Corporation Tax.

It's not possible to assume that to elect to give up Corporation Tax relief on the premiums would result in tax free policy proceeds. The guidance of the company's tax inspector should be sought. A specimen letter is attached in Appendix 1.

Key person cover shouldn't necessarily be restricted to policies where Corporation Tax relief on premiums may be available. It may be wiser to try and ensure that the policy proceeds are received free of tax. In any event if the sum assured is based on gross profits the fact that it's taxable doesn't matter.

Can key person protection be effected on a controlling director?

Yes, but the company's tax inspector will probably feel that the policy proceeds will be largely for the benefit of the life assured (because he owns a majority of the shares) and it is unlikely he would grant tax relief on premiums.

Are there Inheritance Tax problems?

The only point to look out for is that a cash injection via policy proceeds will boost the value of the shares in that company. If the key person who had just died was also a shareholder the value of their estate would be increased. If the shares were passing to someone other than the spouse or registered civil partner and business relief wasn't fully available any Inheritance Tax liability may be increased.

Underwriting

We have experience and expertise in all aspects of underwriting supported by realistic financial and medical limits. Full details are available on request.

Can the company spend the policy proceeds how it wishes?

Yes, although at outset (in order to establish insurable interest and/or to gain tax approval) the reason for the policy should be apparent. However, when it comes to a claim the company can do what it likes with the money.

The most usual use of the money is however:

- to recruit, train and pay for a replacement;
- to pay for work which has to be contracted out;
- to repay loans;
- to change direction;
- to compensate for lost orders;
- to assure customers, creditors and shareholders of financial security;
- to inject capital when morale is low;
- to help the deceased's dependants;
- to help ward off a takeover;
- to help take over another business;
or
- to pay for temporary staff.

Can a partnership arrange key person cover?

Yes, provided there is an insurable interest. Not all partnerships, however, are the same. An ordinary partnership is not a legal person (except in Scotland). A limited liability partnership (LLP) is a legal person separate from its members. This difference is important to recognise when deciding who should own a key person policy. Corporation tax doesn't come into the picture and the partners should simply be treated as individuals.

Appendix 1

Specimen HM Revenue & Customs letter

Below is a letter which could be used as a guide for companies wishing to find out from the HM Revenue & Customs what the tax position is on a key person policy.

To: H M Inspector of Taxes

Dear Sirs

XYZ COMPANY LIMITED

The above company wishes to effect a key person policy on the life of NAME OF LIFE ASSURED for its own benefit. The type of policy chosen is a Legal & General (NAME OF CONTRACT) and will/will not* acquire a surrender value.

Details of the contract are as follows:

Type of contract:

Sum assured & payable on death/death or earlier terminal illness/death or earlier terminal illness and/or earlier critical illness/total permanent disability*

Other benefits:

Term of policy:

LEVEL Annual/monthly premium: £

(NAME OF LIFE ASSURED) presently holds the position of TITLE within the company.

- The policy is to compensate the above company for the anticipated loss of profits if the service of NAME OF LIFE ASSURED were no longer available.

OR

- The policy is security for a loan/loans*, which will become repayable on the death of NAME OF LIFE ASSURED within the loan period of X years.

I would be grateful if you could confirm in writing whether or not the premiums paid under the above policy will be treated as a business expense for Corporation Tax purposes and whether the policy proceeds will be treated as a trading receipt or a non-taxable item on the capital account.

Yours faithfully

For XYZ COMPANY LIMITED.

* Delete as appropriate

THE ABOVE IS PURELY A DRAFT AND IT IS ESSENTIAL THAT PROFESSIONAL ADVICE IS SOUGHT BEFORE ANY ACTION IS TAKEN.