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Key Person Protection

Technical Guide

INTRODUCTION

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

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

The guide gives Legal & General's views and interpretations of Inland Revenue rules and current practices but we cannot guarantee that these will not change.

WHAT IS KEY PERSON PROTECTION?

It is simply a Company (or an Employer) insuring itself against the financial loss it may suffer as a result of the loss of service of a 'Key' employee as a result of that employee's death (or perhaps illness).

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.

Do all companies have Key People?

The above list is not exhaustive but gives an indication of the type of people who should be insured. Most companies will have a few of these Key People; some may have just one.

Some 97% of companies in the UK employ fewer than 20 employees.* Whilst that may mean most have only a few Key People it also means that the loss of one is much more serious. The effect of the death of a Key Person on a small Company can be disastrous. It is strange that whilst companies will normally insure their physical assets such as the factory, stock and vehicles, few in the UK insure the more valuable and essential assets – the people who run the business.

*Source: Exceed Consultancy, 2005.

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 loss of the employee's service. This is not 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 grantee or life of another section on the application form. Usually the Company Secretary, Chief Executive or General Manager or a Director will sign on behalf of the Company.

Obviously the Key Person will have to complete his/her personal and medical details and also sign the application as the life assured.

The policy proceeds, if payable, will be paid to the Company and can be taken as a lump sum or as capital instalments over two, three or five years. If the capital instalments option is selected at outset and a valid claim is made, the instalments can be commuted to a lump sum.

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" later.

Will the policy proceeds be taxed?

This will depend upon circumstances see "Taxation" later.

What type of policy should be effected?

Obviously this depends on circumstances but your financial adviser can help select one to suit your needs and your budget.

The effect of suffering from a critical, terminal or long term illness can be the same on the Company as the death of the Key Person. Thus Critical Illness Cover may be a suitable option.

We recommend that the Company think 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, finally the sum to be assured, affordability and 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 is 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 of Company	Business Recovery Period	Sum Assured
_____	X	X	=
Total Payroll			

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

TAXATION

Unfortunately, the Corporation Tax situation is not 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 is thought the tax inspector would not approve Term Assurance longer than five years, Convertible Term or Whole of Life plans but might approve short term Critical Illness or Income Protection Insurance.

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 is 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 should not 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 is taxable does not matter.

However for Whole of Life, Convertible or longer Term Assurance, whilst the premiums will not qualify for Corporation Tax relief, the company will only be taxed on the chargeable gain, that is the surrender value immediately prior to death less the premiums paid. (The Company will pay tax at its Corporation Tax rate on any such chargeable gain, with no credit for any tax payable in the life fund.) Term and Convertible Term have no surrender value and the surrender value of a Whole of Life (particularly maximum cover) may well be less than the premiums paid so that, in many instances, no tax will be payable.

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. Thus if the Key Person who had just died was also a shareholder the value of his/her estate would be increased. If the shares were passing to someone other than the spouse and business relief was not fully available any Inheritance Tax liability may be increased.

WHAT ARE THE UNDERWRITING REQUIREMENTS?

Legal & General have experience and expertise in all aspects of underwriting supported by realistic financial and medical limits. Full details of which are available under separate cover.

Can the Company spend 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, when it comes to a claim the company can do what it likes with the money which can be paid as a lump sum or in capital instalments over two, three or five years. If the capital instalments option is selected and a valid claim is made, the sum assured will be paid in instalments over the term specified at outset. Alternatively, the instalments can be commuted to a lump sum, the amount of which will reflect current interest rates at the time of the claim.

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
- to pay for temporary staff

Can a partnership arrange Key Person cover?

Yes, the partners could insure a key employee if they can show insurable interest – which is likely. Of course Corporation Tax does not come into the picture and the partners would simply be treated as individuals.

Appendix 1

Specimen Inland Revenue Letter

Below is a letter which could be used as a guide for companies wishing to find out from the Inland Revenue 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