



Key person insurance makes financial sense

In this issue of Wealth Management Alert we look at two aspects of business protection: key person loss of profits protection and key person loan protection.

1. Key person loss of profits protection

This aims to ensure that the business has sufficient funds to tide it over the critical illness or death of a key individual. For a director or key employee of a company, the company effects the policy and must demonstrate its insurable interest for the amount of cover proposed.

In the case of partnerships (except in Scotland), the policy is usually effected by the individual and written in trust for the benefit of the partnership. The amount of cover required is usually calculated:

- as a multiple of salary, eg, 5 -10 times salary
- using a proportion of profits formula
- as a multiple of profits, eg, 2 x gross profit or 5 x net profit.

It won't happen to us!

- 81% of businesses employ someone whose loss would seriously impact the profitability and even the survival of the business.
- 67% of these businesses have no insurance to protect the reduction in profits that the loss of this person could result in or the cost of replacing that person. In fact, businesses are more likely to insure their photocopier against breakdown (29%) than they are to insure a key person against death (15%) or critical illness (13%).
- 59% of UK businesses which do not have key person insurance believe their business would not survive the loss of a key person.

*Source Scottish Widows Business Protection Report 2009.

Tax issues

Tax relief is generally available if the sole relationship is that of employer and employee and if the insurance is intended to cover profit lost as a result of losing the services of the employee due to death or critical illness.

Generally, if the employee is a director and has more than a 5% holding in the company, no tax relief will be given on life cover premiums.

Where a company is the owner of the policy, premiums are charged through the company's profit and loss account. The company should highlight to HMRC that the premiums have been paid and state if corporation tax relief has been claimed or not. The tax office then decides whether to allow the company's claim for a reduction. Generally, if tax relief is available on the premiums, the proceeds will be taxable on the company as a trading receipt. Where tax relief is not available, the proceeds will normally not be taxable.

How key person loss of profits insurance works in practice

A Gordon Ltd has a key employee, Steven, who has been responsible for much of their success over the last few years. Steven earns £125,000 a year and the company's payroll is £1.25 million a year. The company wants to protect itself again loss of profit should Steven die. Directors estimate that it would take two years to recover from his loss. The company's gross profit last year was £2 million. The company's accountant has indicated that tax relief should be available on the premiums. Cover required, using the proportion of profits formula is:

$$\frac{125,000 \times 2,000,000 \times 2}{1,250,000} = \text{£}400,000$$

This amount is then increased to allow for Corporation Tax at 28% (level correct October 2010):

$$\text{£}400,000 / (1.28\%) = \text{£}555,555.$$

Once the policy is set up the accountant writes to HMRC and obtains guidance on the tax treatment of the premiums and the proceeds in the event of a claim.

Continued on next page

Continued from previous page

2. Key person loan protection

Directors and partners may have made loans to the company by making cash injections or leaving salary or dividends in the business. The company may have effected a bank loan. Where insurance is being taken out to cover these loans, the sum assured would be the amount of the outstanding loan account or bank loan.

Taxation and underwriting

As loan protection does not insure against loss of profits, tax relief is not normally available. This generally means that the proceeds are not taxed.

Underwriters normally require supporting evidence to demonstrate the level of cover requested, and this may include company accounts, business plans and a description of the key person's duties, loan agreements and additional financial questions. Medical evidence is usually required as well.

Why take out key person loss of profits and loan protection?

- The vast majority of businesses have a key person the loss of whom would seriously impact the profitability or even the survival of the business.
- The money could be used to train and recruit a replacement for the key person. Recruiting well-trained and qualified staff is both expensive and time-consuming.
- Key person insurance can be considered money well spent, when taking into account the actual cost to the business should a key person die and the difficulties this could cause,
- The money can be used to repay a company debt or overdraft, offering peace of mind to the company's bank.

Questions that help determine whether a business needs key person insurance:

- If a key member of the business were to die or suffer from a critical illness and be unable to work for a long period of time would the business still be operating 12 months later?
- How many employees does the business have? The fewer the number of employees, the more a business will rely on one or two key people.
- If one or more of the top sales team were lost would the sales fall significantly?
- Do the sales people have invaluable contacts?
- Does the business have debt or loan obligations that need to be insured?
- Do any of the directors or partners have personal guarantees that could be called in by the banks should they die or suffer a critical illness?

We thank Scottish Widows for its input into this article.

Business protection insurance needs to reflect the precise needs and priorities of each business and individuals within that business. And of course the cover must represent good value for money.

LighthouseCarrwood advisers are experienced in working with accountants to advise clients on business protection issues and would be pleased to help your clients ensure that neither they, their families nor their business suffers financially should the worst happen to them or one of their colleagues.

LighthouseCarrwood is one of the UK's leading providers of financial planning services to professional practices. We would be delighted to work with you to help your clients reduce their tax liabilities. To discuss how we could work with your firm in a way that suits you and benefits your clients and your business, please contact:

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