Key Person Insurance – Fact Sheet

What is a Key Person?

A Key Person is an individual whose skills, knowledge and experience are vitally important to the success of a business. In the event of the loss of a key person this could cause the business severe financial problems, a Key Person is likely to be difficult to replace.

What is Key Person cover?

This is the name given to life assurance policy taken out by a business and owned by the business, on the life of a Key Person to protect the businesses future profits and ensure continuity should the Key Person die or become seriously ill.

Types of Policy?

The choice of policy will be largely influenced by the specific needs of the business, cost and tax implications. Typically, the need for cover will be identified as short-term assurance plan which will be the most popular solution. A serious illness of a Key Person could cause as many problems as their death; therefore, critical illness cover may often be added to the plan.

Calculating the amount of cover?

The sum assured under a Key Person cover policy should reflect the potential loss of profits that are expected to occur in the event of Key Person's death. A simple way method is to take the Key Person's salary and multiply it by a factor of up to ten; this is not an accurate measure but gives a broad basis of calculation. Other methods are based on multiples of business profits.

How would the cover be set up for companies?

The purpose of Key Person cover is to ensure that funds are made available to a business on the death or serious illness of the Key Individuals. For companies, it is the company itself who should be the applicant for the cover (the plan owners). The Key Person is the life assured on the plan. Therefore, the company would own the policy and pay all premiums and as they are the plan owners a trust is not required. An authorised official of the company, such as the Managing Director or Company Secretary, would make the applicant's declaration.

Partnerships and Key Person's cover?

Limited Liability Partnerships (LLPs) and Scottish partnerships are legal entities in their own right and can therefore take out policies on the lives of key individuals, in the same way as companies. Partnerships under English law do not have a separate legal entity and cannot affect a life policy. If a partnership has a key employee, who is not a partner, a Key Person policy can be taken out jointly by all the partners authorised to act on behalf of the partnership.

The policy would need to be held under trust for all partners, this would accommodate any future changes in the partnership.

If the key person of an English law partnership is a partner, the above routes could be considered or alternatively the partner could take out an own life policy under a suitable trust for the other partners.

Sole Traders and Key Person's cover?

A sole trader may take out a policy on the life of a key employee.

What about tax?

If certain criteria are met such as the Anderson Rules (see below), it is possible for a business to receive tax relief on premiums under a Key Person policy. The relief is obtained by treating the premiums as an allowable business expense, which means that they can be offset against business profits for corporation tax purposes. The taxation treatment of any policy proceeds (i.e. payment of life cover or critical illness benefit) will often depend on whether the premiums were tax deductible. Usually, if tax relief has been allowed on the premiums then any proceeds received are treated as

trading receipts and charged to corporation tax. Conversely, if premiums are not tax deductible the any proceeds are typically free of tax.
If a business is eligible for tax relief on premiums, it cannot elect to waive this right to receive tax-free benefits.

It is strongly advised that a business should confirm with its local inspector of Taxes to confirm the likely tax treatment, of any proposed Key Person cover.

Tax Treatment - The Anderson Rules?

These are a set of principles that formed part of a statement made in 1944 by Sir John Anderson, Chancellor or the Exchequer. The principles form the basis on which a local Inspector of Taxes will generally decide whether Key Person cover premiums qualify as an allowable business expense. There are three conditions that have to be met:

• The sole relationship between the business and Key Person must be that of employer and employee. Relief will not be allowed if the Key Person has a significant stake in the business.

• The life policy is intended to meet loss of profits resulting from the loss if the Key Person's services.

• The policy is a short-term assurance (although 'short-term' is not defined, most tax inspectors will allow relief for terms of up to 5 years).

Assignment of a policy to the Key Person?

A business can agree to pass the legal ownership of a Key Person policy to the Key Person. This situation may occur for instance if the Key Person was to be leaving the business or there was no longer a need for the plan from the business perspective. It can be achieved my making an assignment of ownership to the Key Person.

The business should seek tax advice before proceeding with this type of assignment as this is a complex area that could involve implications of corporation tax, income tax, CGT and national insurance.

Important Information

This factsheet is based upon our understanding of current regulation, law, tax, and other legislation at the release date and may be subject to change in the future. Whilst every care has been taken to ensure the accuracy of this information, My Mortgage & Protection Experts can accept no responsibility for any actions taken because of this information.