



# KEY PERSON COVER

## What is it?

One of the most valuable assets of a business is its staff, with business success or failure depending on them. Some of these people because of their specialised knowledge, skills or contacts, are vital to the profitability of the business. They are often referred to as 'key persons' as their death or incapacity could result in the financial performance of the business being adversely affected. Such an event could lead to a significant fall in profits, perhaps to the inability to repay loans or meet other obligations and, in extreme cases, to the collapse of the business.

Just as it is necessary to insure a business against the loss of or damage to physical assets, it is also vital to insure against the loss and / or against the serious illness / disability of a key person.

It is usual for the level of cover to be determined in one of three ways

### Payroll-based approach

This is suitable when the recovery period would not exceed five years and the key person's salary and total payroll are fairly stable. It is arrived at by using the following formula:

- Key person salary x sales turnover x expected years to recover
- Total payroll

### Salary-based approach

This is suitable when the aim is to find an equally competent replacement, but does not allow for the key person's contribution to overall turnover. A popular multiple to use is five times the key employee's total remuneration package.

### Profits based approach

This is suitable when there are few (or only one) key persons. Popular multiples are either two times gross profits or five times net profits. Gross profit is taken as total sales less cost of sales. Net profit should be taken before tax.

## Level term assurance

Key person level term assurance policies have a known level of cover that will be paid out in the event of death within a known period of time. Premiums remain level throughout and should the person assured survive the policy term, there will be no benefit. As this type of contract only provides cover in the event of death there is no surrender value, so if you stop paying the premiums at any time, cover will cease.

Level term assurance, written on the life of a key employee enables funds to be made available to the business in the event of that person's death to help in some of the following circumstances:

- Offsetting any reduction in profits
- Prevent the business getting into financial difficulty
- Employ a replacement
- Pay off a loan or overdraft to reduce the business' liabilities

## Critical illness cover

Key person critical illness cover is designed to pay out a lump sum if a key person is unfortunate enough to suffer from any of the specified critical illnesses but survive for a period of time after diagnosis (normally 28 days).

Critical illnesses usually include cancer, heart attack, kidney failure, multiple sclerosis, major organ transplant and strokes. These are known as core conditions and account for the majority of claims. The comprehensiveness of conditions covered varies enormously and details regarding what will and will not be covered will be fully explained in any supporting literature which you should check to ensure it meets your purposes.

It is usual to include cover for permanent total disability within the contract. The definition of permanent total disablement does vary and some insurers define it as the life assured being unable to follow his / her normal occupation as a result of sickness whilst others will define it as the life assured being unable to independently perform three or more Activities of Daily Living as a result of sickness or accident.

Critical illness cover, written on the life of a key employee enables funds to be made available to the business in the event of that person's illness / disability to help in some of the following circumstances:

- Recruitment of a temporary or permanent replacement
- Replace loss of profits arising from the serious illness of a key person
- Tide the business over until the key person is able to return to work
- Pay off a loan or overdraft to reduce the business liabilities
- Contribute to the medical care of the key person or provide financial support for their immediate family

## Eligibility

The minimum age to take out a life assurance contract is 18.

## Taxation

### Tax relief on premiums

Loss of profits is the only type of key person assurance where premiums may be allowed as a trading expense for tax purposes. However, it should be noted that if policy premiums are allowed as a trading expense, then any policy proceeds will generally be taxable. If premiums are not allowed, then the policy proceeds generally escape tax.

In addition to the provision that the insurance must be to cover loss of profits, the following conditions must be met if premiums are to get tax relief:

- The only relationship of the life assured to the company is employee / employer.
- The life assured has no significant shareholding – and is not a member of a family that holds shares – in the company. As a guide, tax relief is usually given without question on a shareholding of up to 5%.
- The policy provides annual or short-term (generally up to five years but potentially longer based on the key person's period of usefulness to the company) life or critical illness protection and does not have an investment element or the option to convert to a policy with an investment element.
- The sum assured must be reasonable.

### Taxation of proceeds

Where all the conditions previously mentioned have been met, any benefits payable under the policy are usually liable to tax as a trading receipt. The level of benefit should be set to take this liability into account.

Where the conditions previously mentioned are not met the policy proceeds are normally regarded as capital receipts and therefore free from tax. Please note that failure to claim relief on the premium, where in fact it was available, does not mean that the benefits will be tax free.

As the tax treatment of each case is considered on its own merits by the HM Revenue and Customs the business must confirm the tax position with its own Inspector of taxes prior to taking out a policy.

All statements concerning the tax treatment of products and their benefits are based on our understanding of current tax law and HM Revenue and Customs' practice. Levels and bases of tax relief are subject to change.

## Risk considerations

There are a number of risk considerations that need to be taken into account. It is important that you are aware of these.

- This contract is designed to provide you with a high level of cover at minimal cost and therefore does not acquire a surrender value at any time
- If for any reason you stop paying premiums, cover will cease
- Failure to disclose any requested or relevant information may adversely affect any future claims
- Payment will not be made for a critical illness claim arising from an excluded cause (For Critical Illness only)
- At the end of the term selected, cover will cease and no further benefit will be payable
- If any relevant information provided, when applying, is not disclosed accurately and honestly, this could result in any cover offered becoming invalid and / or may result in the non-payment of any future claims
- If this policy is to replace any existing policy offering the same type / level of cover, you must not cancel any existing policy until the new policy is in force