YOUR GUIDE TO KEY PERSON PROTECTION.

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IMPORTANT NOTES.

This guide has been written to give general information about key person protection and placing business protection policies in trust for key people of partnerships. It is not intended to replace legal advice. If the trust does not meet the key person's needs then they should talk to their legal and financial advisers.

We have based the information in this guide on our understanding of the laws relating to trusts and Inheritance Tax as at 1 March 2017. Although we have made every effort to ensure that the information is accurate, we cannot take legal responsibility for any particular statements.

This guide is based on our understanding of current law and HMRC practice, which can change.

YOUR GUIDE TO KEY PERSON PROTECTION.

WHAT IS KEY PERSON PROTECTION?

It's simply a business insuring itself against the financial loss it may suffer as a result of the death (or critical illness if chosen) of a key person.

WHO IS A KEY PERSON?

A key person is an individual whose skill, knowledge, experience or leadership contributes to the continued financial success of the business.

A key person may be one of a number of people within a business, such as the:

- Chairman.
- Managing director.
- Marketing manager.
- Computer specialist.
- Sales manager.

Anyone whose death could lead to a financial loss for the business through:

- Loss of profits.
- Having to recruit or train a replacement.
- Important personal or business contracts lost due to the key person not being there to maintain a contract.
- Loss of goodwill which could have a direct effect when it comes to raising capital for the business or attracting new investors.
- Customers and suppliers losing confidence in the business.
- Outstanding loans.

HOW DO WE PROVE SOMEONE IS A KEY PERSON?

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

The loss of a key person could lead to the business being unable to repay a loan, which could mean the lender calls in the loan early. This may have a serious effect on any existing loans or any future lending.

WHAT IS A COMPANY?

A limited company is a type of business entity. It is a corporation with shareholders whose liability is limited by their shareholdings. Any personal assets are held separately from the finances and assets of the company.

The company is a legal 'person' able to have debt for which it is liable. It can also own an insurance policy. The company applies for the policy and completes the policy owner questionnaire. Usually the Company Secretary, Chief Executive, General Manager or a Director will sign for and on behalf of the company. In the event of a valid claim the policy proceeds would be payable to the company. As the company is the owner of the policy it would usually pay the premiums.

WHAT IS A PARTNERSHIP?

A partnership is the relationship which exists between persons carrying on a business in common with a view to profit.

The partnership does not have a separate legal identity and each partner would be liable for any trade debts.

It is the partners and not the partnership itself which will own any policy. The partner could take out an own life policy and place it under trust for the other partners. In the event of a valid claim the policy proceeds would be payable to the trustees who would in turn pay the partners as beneficiaries of the trust.

The partnership would usually pay the premiums.

In Scotland a partnership is a separate legal entity and can apply for the policy in its own right.

The partnership applies for the policy and completes the policy owner questionnaire. In the event of a valid claim the policy proceeds would be payable to the partnership. As the partnership is the owner of the policy it would usually pay the premiums.

WHAT IS A LIMITED LIABILITY PARTNERSHIP (LLP)?

The Limited Liability Partnership Act 2000 established a new form of business vehicle. An LLP gives the benefits of a limited liability as for a company, but allows its members the flexibility of organising their internal structure as a partnership. The LLP is a legal entity separate from its members and while the LLP itself is liable for the full extent of its debts, the liability of the members will be limited (except to the extent that the members agree otherwise). Any two or more individuals can incorporate as an LLP.

In short it is a half way house between a company and a partnership.

This business format is becoming increasingly popular among professional practices, such as accountants and solicitors.

An LLP may own an insurance policy directly. The LLP applies for the policy and completes the policy owner questionnaire. In the event of a valid claim the policy proceeds would be payable to the business. As the LLP is the owner of the policy it would usually pay the premiums.

WHAT TYPE OF POLICY SHOULD BE EFFECTED?

This depends on the circumstances involved and the events the business wish to insure the key person against.

You can choose either Life Insurance or Life with Critical Illness Cover.

The effect of being diagnosed with a critical illness can be the same on the business as the death of the key person. Therefore, Life with Critical Illness Cover may be a suitable option.

We recommend that the business think about the length of the period of cover first of all. Then the risk or risks they wish to be insured against, the amount of cover, affordability and finally taxation.

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

SO HOW DO YOU CALCULATE THE AMOUNT OF COVER?

When calculating the appropriate amount of cover needed you should consider the effect of the loss of the key person on the business including whether this would directly impact on the profits, and what the cost of hiring a replacement might be.

There are common formulas which can be used to help identify an appropriate amount:

1. A simple formula is to take a multiple of the key person's earnings. This can often be up to 10 times the key person's earnings for death, with a lower figure considered for critical illness. This takes account of the cost to the business of replacing a key individual and would normally include consideration of the costs involved in finding a suitable person, the expense of required training, and also their earnings whilst they develop in the role.
2. Another method is to calculate the amount of cover based on their contribution to profits, where this is the need to be covered. Common formulas used are:
   - up to 2 x proportion of gross profit directly attributable to key person;
   - up to 5 x proportion of net profit directly attributable to key person;
   - (key person salary/total payroll for business) x gross profit x recovery period (max five years).

In all the above formulas an average of the last two years profit figures would routinely be used.

3. The amount of the loan to be repaid on the death of the key person.

We can offer assistance in calculating the amount of cover with our key person calculator available on our adviser centre.

WHAT HAPPENS IF THE KEY PERSON LEAVES OR RETIRES?

If a key person were to leave or retire before the end of the key person protection policy term, the business could do one of the following:

- Stop paying the premiums and the policy would then lapse.
- Continue paying the premiums until the end of the policy term and in event of a claim, the business would receive a capital sum.
- Assign the policy to the key person who then would become the legal owner of the policy and could then continue paying the premiums.

Where a partner is a key person and the policy is written in trust, the policy would automatically revert to the key person.

The taxation of this can be complicated, for both the company and the life insured. National Insurance, Capital Gains tax may all need consideration. We strongly recommend that you seek specialist advice.

WHAT ARE THE KEY TAXATION EFFECTS FOR COMPANIES AND LIMITED LIABILITY PARTNERSHIPS?

CORPORATION TAX

Where the policy is on the life of an employee the tax treatment of premiums is likely to largely depend on what have become known as the 'Anderson principles' – based on comments made by the former chancellor, Sir John Anderson, in 1944 – along with other related legislation and HMRC guidance.

Essentially, if certain important criteria are met, the tax treatment of a key person policy should be that:

– The company can treat the premiums it pays as allowable business expenses, deductible from the company's profits (potentially reducing its Corporation Tax liability every year it has the policy).

– The company will have to account for any proceeds from the policy as a trading receipt (potentially increasing its Corporation Tax liability in the year of receipt).

The important criteria to be met are that:

a. The policy must be 'short term'. While this is not a defined period, it should not be beyond the period of the employee's usefulness to the company. Premiums on whole of life plans are unlikely to meet this.

b. The policy must cover an expected loss of profits. Where the policy is intended to cover repayment of a loan, the premiums are unlikely to be allowable expenses.

c. The nature of the relationship between the company and the life insured must be that of employer/employee, while the policy and its premiums must be effected wholly and exclusively for business purposes. Where the key person owns an interest in the company, this can lead to complications.

It should be noted that though the Anderson principles give good guidance as to how the local inspector of taxes is likely to consider the tax position, they are not binding in law. Because of this, in each case, we would recommend that the business seek the guidance of the local inspector of taxes directly.

Where the important criteria are not met, and the premium payments are not considered as allowable expenses, the company may or may not still have to account for the policy proceeds on receipt. This will be at the discretion of the local inspector of taxes, however, unlike the position with respect to premiums, it is unlikely that the inspector would give any clear indication about the potential future treatment of proceeds.

It's not right to assume that electing 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. Please visit our adviser centre to download the specimen letter.

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 amount of cover is based on gross profits, the fact that it's taxable doesn't matter.

For an LLP, premiums may be allowable as a business expense if the key person is an employee of the business.

CAN KEY PERSON PROTECTION BE EFFECTED ON A DIRECTOR WITH A SIGNIFICANT SHAREHOLDING?

If the company's tax inspector feels that the policy proceeds will be for the benefit of the life insured (because he has a significant share) and it is unlikely that tax relief would be granted on premiums. A general rule is that where the shareholding is less than 5% tax relief should be available.

ARE THERE INHERITANCE TAX ISSUES?

A cash injection via policy proceeds will tend to increase the value of the business. If the deceased key person 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.

CAPITAL GAINS TAX

A Capital Gains Tax liability may arise, in the event of the sale of an individual's share in the business due to a terminal or critical illness.

There may be other taxation implications but this will depend on your individual circumstances. We strongly recommend that you consult your own legal or tax adviser before proceeding.

TAX AND TRUST INFORMATION FOR PARTNERSHIPS.

WHY USE A TRUST FOR A PARTNERSHIP?

A partnership in England, Wales and Northern Ireland cannot be the owner of a policy because it does not have a seperate legal identity. If the key person is one of the partners, that partner could take out an own life plan, and write it in trust at outset for the other partners.

WHAT IS A TRUSTEE?

A trustee is someone appointed to look after the asset(s) they are putting in trust (for example, their business protection policy). The trustees are the legal owners of the trust assets, and must act for the benefit of the beneficiaries of the trust. In the event of the key person's death, the trustees will need to make a claim for the proceeds and ensure that these are passed to the beneficiaries of the trust.

WHO CAN BE A TRUSTEE?

The partner who is the key person is automatically a trustee and normally the other partners could also be appointed. It is a good idea for them to be resident in the United Kingdom. Solicitors and accountants can act as trustees but they will charge for their services.

CAN ADDITIONAL TRUSTEES BE APPOINTED IN THE FUTURE?

Yes, our trusts allow the appointment of additional trustees at any time.

HOW DO THE TRUSTEES MAKE A CLAIM?

In the event of the key person's death the trustees will need to send the following items

- Partnership Trust (and any subsequent deeds);
- The original policy documentation;
- A death certificate.

TAXATION OF A PARTNERSHIP

There will be no tax relief on the premiums and the amount of cover will not be taxed.

INHERITANCE TAX ISSUES FOR POLICIES PLACED IN TRUST.

Whilst a policy in the Partnership Protection Trust will not form part of the key person's estate for Inheritance Tax, there are some occasions where there is a potential for an Inheritance Tax charge to arise. For example, on each 10 year anniversary of the trust (periodic charge) and when payments are made out of the trust (exit charge).

If a life insurance policy with no surrender value is placed in trust, then provided that the life insured is in good health the value of the policy for Inheritance Tax is likely to be negligible. The maximum charge is 6% of the value of the trust fund in excess of the nil rate band.

APPENDIX 1: SPECIMEN HM REVENUE & CUSTOMS LETTER.

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

To: HM 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 INSURED for its own benefit. The type of policy chosen is a NAME OF CONTRACT and will not acquire a surrender value.

Details of the contract are as follows:

Type of contract:

Amount of cover £ payable on 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 INSURED presently holds the position of TITLE within the company.

NAME OF LIFE INSURED:†

- Owns none of the shares in the company.
- Owns XXX% shares in the company.
- Is a substantial shareholder in the company.
- The policy is to compensate the above company for the anticipated loss of profits if the service of NAME OF LIFE INSURED were no longer available.

OR

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

I would be grateful if you could confirm in writing whether 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

† Select as appropriate

The above is purely a draft and it is essential that professional advice is sought before any action is taken.