Insurance

Key person insurance

Aon Hewitt Financial Education Series

Key person insurance will protect your business from the loss of individuals whose capital, knowledge, client base or experience are vital to the company's success. This can include a director or specialised employee.

Who is a key person?

Examples of key people include:

- a sales director with valuable contacts which, together with the business they provide, could be lost if he or she died;
- a controlling director who has personally guaranteed loans made to a company by, for example, a bank. In these cases the bank may insist on life insurance as a condition of the loan;
- the founder of a small company who may have built it up from nothing and who still provides most of its impetus. In this case the company may not be able to survive after his or her death;
- a researcher or key employee vital to the development of a new product because of their personal expertise, the loss of which might make it impossible to launch the product;
- an engineer without whose input a particular project may fail;
- a top executive recruited through an expensive 'head hunting' operation, for whom finding a replacement will also be expensive and difficult;
- a highly skilled mechanic who, operating in a small business environment, is largely responsible for attracting and keeping customers.

The loss of a key person can affect the business in two main ways. It can:

- reduce the profitability of a business, and/or
- reduce the capital value of a business.

How does key person insurance work?

In simple terms, the business takes out an insurance policy (e.g. death, total and permanent disablement and trauma cover) on the key person. If a claim is made, the business receives funds to cover the expenses of replacing the key employee (e.g. recruitment and training).

Key person protection may be for:

- a revenue purpose - to protect a business against lost revenue and increased business costs in the event of the loss of a person who makes a significant contribution towards the profitability of the business, and
- a capital purpose - to protect a business through the provision of capital in the event of the loss of a person who makes a significant contribution towards the value of that business.

Examples of revenue purpose	Examples of capital purpose
Recruiting costs	Pay off loans the key person had guaranteed
Training costs	Protect business credit rating
Temporary replacement costs	Pay off shareholder loans
Fall or reduction in sales, profits or revenue	Offset loss of goodwill
Bad debts or receivables	Protect against loss of major supplier

It's important that the business documents the purpose of the insurance in respect of a key person (i.e. either for revenue or capital purposes), via appropriate business minutes. This will affect the tax deductibility of premiums, and also the subsequent taxability of end benefits paid by the insurer.

Determining the amount of insurance cover

How you calculate the worth a key person brings to a business can vary substantially. Much will depend on whether the person is an "arms length" employee or whether they have an actual business ownership interest.

Information such as the remuneration package of the "key person", the value of the business, the likely effect on business profitability as well as the costs of finding a replacement would all need to be considered to calculate the value of a key person to a business.

Review

Over time the purpose of the insurance (i.e. either capital or revenue), and amounts required may also change, so it's important that the insurance is reviewed regularly, and any change documented. It's the purpose of the cover at the time of the last renewal which determines the tax treatment of the premium.