Did you know?

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Key person insurance: what a capital idea!

All businesses should consider the use of life insurance to compensate the business for any financial impact as a result of the loss – through death, disablement or critical illness – of key employees who are responsible for the ongoing success of the business.

Who is a key person?

A key person is an individual whose continued association with a business provides that business with a significant and direct economic gain. Economic gain means more than just profits. It can also include, inter alia, capital injections, cost efficiency, goodwill, access to credit and contacts with suppliers and customers. Business owners will also usually be key people.

What is key person capital insurance?

Key person insurance can compensate the business for the loss of a key person in two different ways: business profitability (revenue purpose) and the capital value of the business (capital purpose). This article focuses on the latter.

Reduction of the capital value of a business

Key person insurance proceeds can be applied to maintain the capital value and stabilise the business. The capital value of a business following the loss of a key person could be reduced in the following ways:

- Credit standing: some businesses can secure credit lines and overdraft facilities more easily than others due to the personal assets of a business owner. Key person capital cover provides the business with an alternative source of funds.
- Goodwill: This intangible is what brings clients to the business, and this will likely suffer due to the loss of a key person's specialised knowledge, business contacts and reputation.
- Business debts: if a business is destabilised and defaults on a loan after the loss of a key person, financial institutions could call in one or more loans to the business.
- Loan accounts: loans by owners to their business may be called in immediately by an outgoing business owner or his/her estate.
- Guarantor protection: Although this does not directly affect the capital value of a business, if directors, for instance, have signed personal guarantees, it means that they secured a loan for the business directly or indirectly using all or some of their personal assets. These guarantees are generally extinguished only when the loan is repaid in full.

Establishing the level of cover

Advisers should ask business owners how much of the business's current capital value and annual capital appreciation, as a percentage, is attributable to the key person. The capital value of the business is often determined by profitability and may include a goodwill component. If profitability or goodwill would be reduced by a certain percentage, this would be one measure of the potential capital loss to the business.

Financiers most commonly secure business loans by having personal guarantees signed by principals. In addition, most financial institutions insist on the joint and several liability of business owners in relation to loans or overdraft facilities, meaning each guarantor is 100 per cent liable for the debt, regardless of his or her share of the business or of individual assets offered as security. Therefore, the full repayment of business debt is attractive to many business owners. In view of this, CommInsure has produced an asset protection calculator (approved by our reinsurer), which provides term life and TPD (total and permanent disability) cover based on a sliding scale, taking into account the total business debt and the number of business owners. Designed for up to four business owners, it provides full debt protection for the first $2 million of a loan and for a sliding percentage of the loan over this amount. You can download the calculator from the CommInsure Adviser site or by emailing InsuranceTech at insurancetech@cba.com.au. In addition to covering external debt, advisers should look at insuring 100 per cent of proprietor loans, i.e. capital injections into the business by individual business owners.

Tax treatment of premiums

The taxation treatment of key person insurance depends on whether the key person policy is for a capital or revenue purpose. It is necessary to establish the intent when the policy was taken out (and any change of purpose during the life of the policy) and the purpose for which the policy proceeds are actually used. The purpose should be recorded via minutes or file notes. Capital purpose insurance premiums are not tax deductible to the business and the death benefit proceeds are not taxable if received by the original beneficial owner. The proceeds of TPD and trauma insurance are subject to capital gains tax (CGT) if received by a company and not taxable if received by the life insured, a spouse (including de facto) or a relative as defined by section 118-37 of the Income Tax Assessment Act (ITAA) 1997.

Policy ownership

Since it is the business that is being protected against the loss of a key person, it makes sense for the entity (company, partnership, trust or individual) to own the policy and pay the premium. The drawback here is that TPD and trauma proceeds paid to a company would attract CGT, so any TPD or trauma sum insured should be grossed up to cover this liability and provide the business with a net amount of proceeds.

As an alternative, clients can consider self-ownership for guarantor protection, which would avoid CGT on the proceeds paid in the case of death, terminal illness, TPD or critical illness. However, it would be essential to implement a mechanism directing those proceeds to the financial institution so as to discharge the debt and release personal guarantees. Another tax-effective alternative is for an insurance trust to own the policies.

For example, let's take the situation of John and Mary, who are unrelated co-directors and equal shareholders in JM Pty Ltd and who have borrowed $600,000 for their business, providing personal guarantees with their family homes as security. They are looking at insurance cover for the debt, and decide they would like to pay of the entire debt in the event of death or TPD and half the debt in the case of critical illness. The first option is to have a policy owned by JM Pty Ltd with John and Mary as lives insured. However, this would require $857,143 of TPD and $428,571 of trauma to cover CGT on the respective proceeds so as to discharge 100 per cent and 50 per cent of the debt respectively. If they attached TPD to term life as a rider, they would also need to gross up the life component as well.

Alternatively, John and Mary can have the trustee of an insurance trust (usually the company itself) as the legal owner of the insurance. The beneficial ownership of the policies would rest with John and Mary, so that insurance proceeds would be free of CGT. Under the terms of the trust agreement, if John were to suffer a TPD, the proceeds could then be directed to the financial institution via Mary (who would become a substitute lender), and provide her with a tax-free loan account in her favour, which she could draw on as required. John would exit the business because of TPD, which would be funded by separate TPD cover (within the same policy) for the value of his share of the business, supported by a buy/sell agreement.

Tax treatment of proceeds

The purpose of key person cover must still apply at time of claim. If the purpose has changed or if the proceeds are used for a different purpose at time of claim, it may affect the deductibility of premiums and the assessment of the insurance proceeds. The proceeds of a policy minuted for capital purpose (and therefore not deductible) might still be assessable at claim time, if the proceeds are applied for a revenue purpose. It is therefore important that there be new records of the purpose at the annual renewal of the policy, because the need may have changed over the previous 12-month period.

Summary

Key person capital insurance can be used to maintain the capital value of the business, including the reduction of debt. Advisers should be able to analyse the capital needs of a business and recommend the appropriate sums insured and relevant ownership structures, whilst understanding the tax implications for businesses.