

Key person insurance

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Key person insurance, also commonly called **keyman insurance** and **key man insurance**, is an important form of business insurance. There is no legal definition for "key person insurance". In general, it can be described as an insurance policy taken out by a business to compensate that business for financial losses that would arise from the death or extended incapacity of an important member of the business. To put it simply, Keyman Insurance is a standard life insurance, TPD insurance or trauma

There are four categories of loss for which key person insurance can provide compensation:

1. Losses related to the extended period when a key person is unable to work, to provide temporary personnel and, if necessary to finance the recruitment and training of a replacement.
2. Insurance to protect profits. For example, offsetting lost income from lost sales, losses resulting from the delay or cancellation of any business project that the key person was involved in, loss of opportunity to expand, loss of specialised skills or knowledge.
3. Insurance to protect shareholders or partnership interests. Typically this is insurance to enable shareholdings or partnership interests to be purchased by existing shareholders or partners.
4. Insurance for anyone involved in guaranteeing business loans or banking facilities. The value of insurance coverage is arranged to equal the value of the guarantee.

Who can be a key person?

Key people are individuals whose skills, knowledge, experience or leadership are important to a business' continued financial success. Should something happen to one of these individuals it is likely that their loss will have a detrimental impact on the profitability of the business and will cause financial strain. Examples of a key individual include, but are not limited to: company directors, sales directors, IT specialist, managing directors and heads of product development.

How can you attribute a worth to that person?

Deciding on the sum of money to ensure the key person is dependant on the company and the reason for insuring that individual. It can be to cover a loan or investment amount, or it can be dependant on working out the worth of the person to the company. It is recommended that you 'think about loss of profits, cost of replacement and debts that would need to be covered to keep the company running without that person.'^[1]

Keyman Insurance Policy Ownership

Keyman Insurance policies can be owned in a number of ways depending on the needs of the business. It is common for a business to own the policy with claim proceeds being paid directly to the business. There is no legislative or insurable requirement for a policy to be owned by a specific party or entity and there may be circumstances be it for taxation or policy continuation purposes where policies may be owned and paid for by the insured person directly, or owned by another individual.

Advantages of key man insurance

1. In case of death of a keyman the company is paid money to cope up with the loss.
2. In the USA, any business concern buying keyman insurance for its employee can claim a deduction for the premium paid for the policy as a business expense under Section 37(1) of the Income Tax Act. Tax deductions may also apply in other countries.
3. This policy can be used as either an extra super annuation benefit or an ex-gratia payment to the key employee during the service period. If the company receives the proceeds on maturity, then they may be taxable. (With recent changes in rules, only Term Plan is available under Key Man Insurance. Hence, there will not be any maturity benefit)

4. No need of giving advanced intimation to the income tax authorities.
5. The company can also raise loans on the policy from LIC. (On Term Plan, no loan is available)
6. For the executives earning high salaries, this policy can be given as a hike in salary and saves income tax.
7. It becomes a great help to the business for their tax planning.
8. The directors can also safeguard their immediate family from getting affected by the vagaries of the industry and the various business cycles that the business has to encounter.
9. Key Man Insurance policy helps to improve the retention of key human resources of the business.

Disadvantages of key man insurance

1. The amount on claim or maturity under a keyman insurance policy is not exempt under Section 10 (10D) of the Income Tax Act if the company is paying the premiums unless the policy is assigned to key person who himself/herself pay the premium.
2. If the policy is surrendered then the amount endorsed is taxable in the hands of key man as profit in lieu of salary.

Taxation

The tax treatment for premiums paid for key person insurance and the treatment of monies received from a claim vary among countries. Premiums are generally not tax deductible in the U.S.^[2] In Australia, Keyman Insurance policies are generally not deductible unless used specifically for business revenue protection purposes. Claim proceeds in Australia if used for revenue purposes may be taxable and depending on the ownership of the policy, may trigger a Capital Gains Taxation Event. In the UK the main principles of Key Man Insurance taxation were outlined by the Chancellor of the Exchequer in 1944, Sir John Andersen. The "Andersen Rules" state "Treatment for taxation purposes would depend upon the facts of the particular case and it rests with the assessing authorities and the Commissioners on appeal, if necessary, to determine the liability by reference to these facts. I am, however, advised that the general practice in dealing with insurances on the lives of employees is to treat the premiums as admissible deductions, and any sums received under a policy as trading receipts, if (i) the sole relationship is that of employer and employee; (ii) the insurance is intended to meet loss of profit resulting from the loss of services of the employee; and (iii) it is an annual or short term insurance. Cases of premiums paid by companies to insure the lives of Directors are dealt with on similar lines.^[3]"

References

1. "Key Man Insurance". *Business Protection Expert*. Retrieved 15 February 2016.
2. *IRC Sec. 264(a)*.
3. "Key Man Insurance Taxation". *Business Protection Expert*. Retrieved 20 August 2015.

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