PENSIONS
INVESTMENTS
LIFE INSURANCE

Irish Life

KEYPERSON COVER

AN ADVISER GUIDE

Life Advisory Services

For Financial Adviser use only

CONTENTS

This document provides an outline of the taxation issues to be considered when you are putting together a business protection arrangement for your clients and is based on our understanding of current legislation and Revenue practice.

In all cases we would recommend that business owners obtain professional legal and tax advice to ensure that any arrangement they put in place is appropriate to their personal and corporate circumstances.

1. THE LOSS OF KEY PERSONNEL

1.1 MANAGEMENT EXPERTISE

Management expertise, experience and contacts are often the most important assets of a business. It is the difference in the quality of management expertise that explains why some businesses prosper while others fail.

1.2 THE LOSS OF KEY PERSONNEL

Statistics show that over 90% of business failures result from management breakdown. In many such cases it is likely that failure results from the sudden loss of key personnel.

The sudden death or serious illness of a key person could give rise to a number of immediate financial pressures for the company:

- **the 'calling in' of company loans**, in particular any to which the 'key person' had given a personal guarantee
- **a costly interruption in business**
- **a loss of business contacts**
- **extra resources may have to be committed** to the recruitment and replacement of the key individual.

2. THE SOLUTION

2.1 KEYPERSON COVER

Keyperson cover is life assurance effected by an employer on the life of a key employee, who may also be a shareholder or director, to protect the company against the financial consequences of that individual's sudden death or serious illness.

Keyperson cover is designed to protect the value of the company's human assets in much the same way as fire insurance protects a company's physical assets.

Keyperson cover can provide an immediate lump sum payment to the company. The company would use these funds in any way it chooses:

- **repayment of bank loans,** particularly any to which the key individual has given a personal guarantee.
- **repayment of any loans the key person may have made to the company.**
- **recruitment of a successor.**
- **investment in the business.**

2.2 WHO IS A KEYPERSON?

A keyperson is any 'key' employee or director on whom the business depends for its continued success, or existence, and on whose death or serious illness the business could suffer a financial loss.

2.3 AMOUNT OF COVER

In determining the appropriate amount of keyperson cover an insurable value must be put on the potential financial loss the company would suffer on the death or serious illness of a key individual.

In assessing the amount of cover two important factors to consider are:

- **Loan Repayment,** any loans personally guaranteed by a "keyperson" or any loans made by him or her to the company.
- **Loss of profits cover.** The death or serious illness of a key individual could jeopardise the trading position and profitability of the company.

The cover required is the estimated financial loss that the business would suffer plus the costs of replacing the key individual.

Other than in the case of loan cover, estimating the financial loss can be extremely difficult. The level of cover is normally related to either the person's salary or to the company's profitability.

Typical maximum cover levels should **not exceed 10 times salary, or if the calculation is in relation to profit then the keypersons percentage contribution to profit to a maximum of twice gross profit or 2.5 times net profit (i.e. profit after expenses but before tax).**

3. TAXATION IMPLICATIONS

The most important point to consider in relation to the taxation of key person contracts is **whether the proceeds payable on death or serious illness will be liable to tax.**

3.1 PLAN PROCEEDS PAYABLE ON DEATH OR SERIOUS ILLNESS

The purpose of the plan is to protect the company financially in the event of the death or serious illness of a key person, so the company needs to know, if they affect cover of €100,000, will they actually end up with €100,000 or €100,000 less Corporation tax.

The **purpose for which the plan is taken out,** whether to cover a "Capital" or "Revenue" type loss, is **the main consideration in** establishing whether or not the proceeds will be taxed.

If the purpose of the plan is to protect a company loan then the proceeds are likely to be treated as a capital receipt for the company and thus not subject to Corporation Tax. The proceeds of a company owned plan, paid out on death or disablement, are exempt from Capital Gains Tax. **So no tax liability arises for the company.**

If the **plan is to protect "loss of profit"** (if the profits were earned they would be subject to Corporation Tax) or other "revenue items" such as replacement costs then the proceeds are likely to be treated as a "revenue receipt" and **subject to Corporation Tax.**

Where the cover is required for two different purposes i.e. loan cover and loss of profits cover, we would recommend two separate plans should be taken out.

3.2 TAX DEDUCTION FOR PREMIUMS

Generally speaking keyperson cover premiums are 'not' admissible deductions for Corporation Tax purposes. However the Revenue Commissioners have outlined the circumstances in which such premiums may qualify as admissible deductions:

a) the sole relationship is that of employer and employee,

b) the employee has no substantial proprietary interest in the business,

c) the insurance is intended to meet **loss of profit** resulting from the loss of the services of the employee as distinct from loss of goodwill or other capital loss, and

d) the plan is a short term insurance, providing only for a sum to be paid in the event of death.

Therefore premiums on keyperson cover life assurance plans which do not meet all of the above requirements are not admissible deductions for Corporation Tax purposes.

On this basis, keyperson cover life assurance premiums for plans taken out to repay loans or other outstanding debts are not admissible deductions for Corporation Tax purposes.

REASON FOR COVER	BENEFITS	PREMIUM
Loss of Profit / Replacement Costs	Yes - Taxable	Tax deductible - if the 4 conditions across are met
Loan Repayment / Share Purchase	No – Not taxable	Not tax deductible

More details on the Revenue interpretation of conditions (a) to (d) above are set out in Appendix I.

3.3 BOARD RESOLUTION

We recommend that the company pass a board resolution recording their intention to affect keyperson cover. The resolution should cover the purpose for which the plan is being taken out.

Sample

"That the company shall effect a life assurance plan on the life of Mr X in the sum of €XXX,XXX. The purpose of this insurance is to (meeting the financial loss which the company is likely to suffer) / (protect company borrowing which may be repayable) in the event of his death whilst in the service of the Company

Mr Y is hereby authorised to complete all necessary documentation on behalf of the company and it is hereby declared that the proceeds of this insurance are intended for the protection of the Company itself and are not for the benefit of Mr X or his family."

APPENDIX I

REVENUE CLARIFICATION ON TAX DEDUCTION FOR PREMIUMS ON KEYPERSON INSURANCE POLICIES

The following is an extract from a circular issued by the Superintending Inspector of Taxes, dated July 1986, with regard to the admissibility of keyman insurance premiums as an allowable deduction for Corporation tax purposes.

"..the term 'Keyman' may be applied to a range of policies not all of which may give rise to admissible tax deductions and the allowability or otherwise of premiums paid will be determined by reference to the terms and purposes of the policy, rather than any description which the Insurance Company may give it. In applying the conditions (a), (b), (c), (d) '(see Section 3.2)' the following guidelines are followed:

(a) "Employee" is taken as including a Director.

(b) A person who directly or indirectly, owns or is able to control more than 15% of the ordinary share capital of a company is regarded as having a substantial proprietary interest in the company.

(c) The policy must be for a fixed term with no surrender value and no endowment or other investment content; it must not contain provisions whereby benefits could be paid to any person other than the employer.

(d) The insurance must be related to loss of profits only and it will be necessary to satisfy the Inspector of Taxes that the contingency insured against will genuinely have an adverse effect on the employers business.

Premiums on policies taken out to cover loans or other outstanding debts which would become repayable on the death of an employee are not admissible deductions...."

We advise that your client seeks professional tax and legal advice as the information given is a guideline only and does not take into account your client's particular circumstances.