

# Key Person Insurance

## Business Succession Planning

### Looking after your business



HEALTHIER, LONGER,  
BETTER LIVES

## ‘The greatest asset a business has is its people’

Every company has invaluable employees they'd like to keep forever. Unfortunately, sometimes life circumstances such as injury or illness takes them away earlier than expected. Just as it is prudent to insure business assets against loss, it is also prudent to insure specialists or skilled people who contribute significantly to the ongoing success of the business.

Key person insurance protects your business by not leaving it financially vulnerable if key employees were to suffer an injury or illness or pass away, by providing a timely injection of funds to minimise the financial impact to your business.

### Who is a key person?

A key person may be a business owner, partner, director, sales person, or key employee that generates significant profits.

A key person is also someone whose sudden absence from management or day to day operations could cause financial loss to the business. If you are in a partnership or run a small to medium-sized company, there may be other key people who may need to be considered.

In addition, there will be employees whose skill set gives the business a competitive advantage. These employees may also be considered key people. Ideally, all key people identified should be covered, according to the scale and current risk status of your business.

### Here are some examples of the different key people in a business

- **Specialist Skills:** a business in its formative stage may place reliance on the skills and abilities of one or a few individuals, such as a restaurant chef, medical practitioner or a sole accountant.

- **Operations:** a business considering major changes or mergers may be more vulnerable to the loss of specialist skills, particularly those on which the business is dependent for the changes or merger.
- **Resources:** a smaller business may be dependent, throughout its life, on several people merging or pooling their resources, existing networks and complementary skills and/or expertise to the company or partnership.
- **Brand:** the founder or head of the business, who is closely linked with its image and success in the minds of the general public, suppliers, distributors, customers and other stakeholders.

### How does key person insurance work?

Key person insurance can be used to cover the costs of replacing the key person, associated expenses and / or income.

Here's how the funds can be used to keep your business going:

- Recruiting and training new employees
- Replacing lost profit
- Holding market share and protecting your brand
- Meeting existing contractual commitments
- Maintaining customer confidence with minimal disruptions
- Maintaining supplier confidence by continuing to meet financial obligations.

## How much cover is enough?

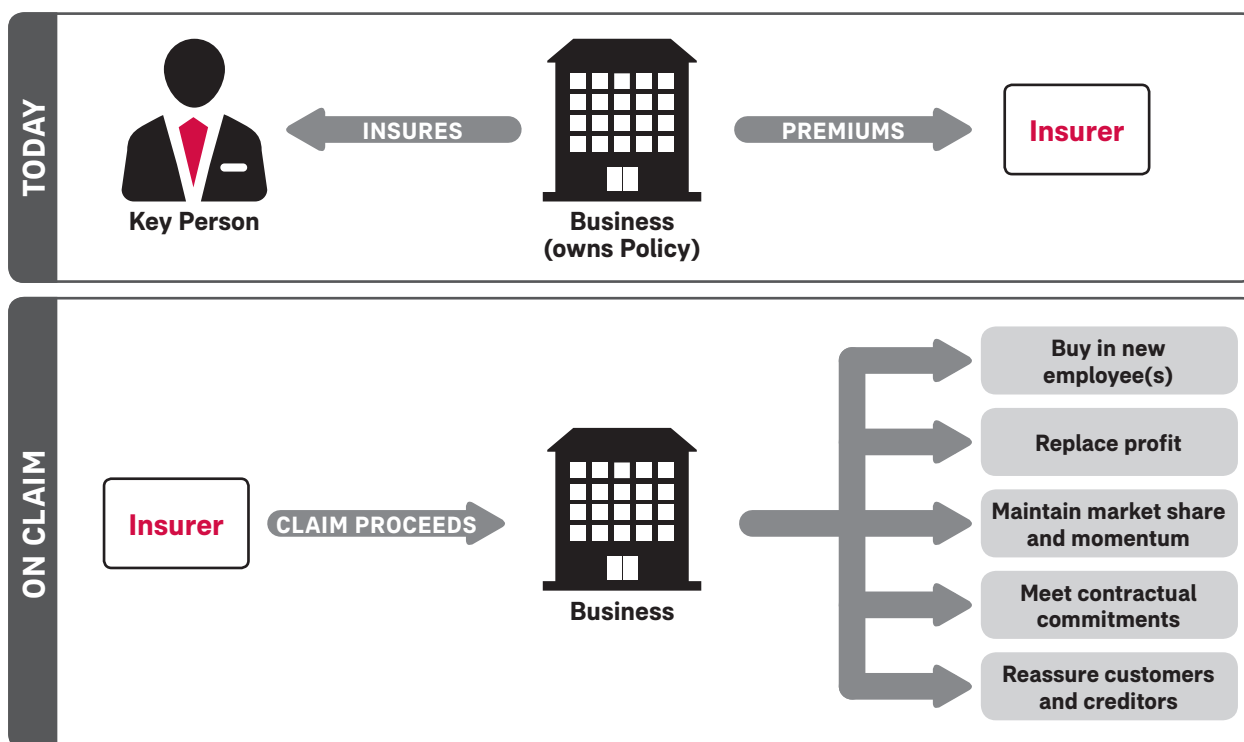
There is no one formula to calculate the value of a key person but you should consider the impact to both the business capital and revenue when calculating the sum insured.

### Capital replacement

Capital essentially refers to business balance sheet items. Calculations of the sum insured may include debt repayment and replacing lost value which may occur from the loss of the key person, for example the cost of goodwill required to rebuild and maintain client relationships.

### Revenue replacement

Calculation of the sum insured may include multiples of the key person's remuneration, multiples of gross/net revenue generated by the key person, or costs associated with replacing the key person.



## Who owns the policy?

As a general rule, the business would arrange and own any policy purchased for key person purposes.

### Life insurance versus key person cover?

The difference between key person insurance and normal life insurance is simply the ownership structure of the policy. The basic definitions and benefits provided are the same with the key difference being the policy is paid for and owned by the business to help in providing funds to cover the business costs of finding a suitable replacement.

## Tax treatment of the policy

If the policy was taken out for 'capital replacement' then the premiums paid on the policy will not be deductible for tax purposes. In addition, no income tax will be payable on proceeds in the event of a death claim. However if the policy is a TPD or trauma policy, Capital Gains Tax (CGT) may be payable on the claim proceeds.

If the policy was taken out for 'revenue replacement', then premiums paid on the policy will be tax deductible and proceeds paid on death will be assessable as is the case for usual business revenue and expense items.

**Because the tax consequences will vary for different types of insurance used for key person protection, it's important to consult a tax adviser for guidance in respect your needs.**



### Case Study

Frank and Larry enter into a business relationship together in website development. Frank is the brains of the partnership and has a great vision for the future of the business. Larry enjoys the sales side of the business.

Frank and Larry employ George to be their website programmer. He has the skills they need to build the websites for the new clients that Larry sells to. George's skills are very important to the business as he is the only one who has the skills to create the websites with the creative flair their customers have come to know. George's programming skills are second to none and Frank and Larry agree that they can attribute about \$150,000 of the annual revenue to George's work.

One year later, George is in a boating accident and becomes permanently disabled. George's disablement impacts the business significantly as he is the only one who has the skills to write web programs and new business sales suffer as a result. In addition to this their existing clients are concerned about the future quality of their websites and a number of larger clients don't renew their contracts, resulting in a loss to the company's revenue by 20% the following year.

With the business revenue already in decline, they don't have the funds to find a new replacement with the same amount of experience and knowledge that George had.

This situation could have had a different ending. If Larry and Frank had purchased key person insurance to cover George for \$150,000 they would have had the funds to find a replacement with the right skills and knowledge allowing them to continue their high quality website designs as well as receiving funds to help them with the decline in business revenue.

**Speak to your financial adviser to find out how Business Insurance can help protect your business.**

#### **Don't forget about you and your family**

Disability or death can also impact your personal life, especially if banks and creditors try to claim family assets to pay for business debt.

**Think about steps you can take to protect your family's financial security with insurance policies that can protect you for:**

- Treatment for illness
- Current debts
- Future expenses/income requirements
- Keeping family assets safe