

Understanding key person insurance

Client Fact Sheet - July 2012



The importance of key person insurance

The most valuable resource of any business is its staff and in particular its key people.

In your business a key person may be the business owner, an employee, or a supplier to the business. A key person is anyone whose absence, or loss, from the business would have a significant negative impact on the business.

Loss of key staff can affect every aspect of your business – revenue, profit, goodwill and ultimately the value of your business.

Key person insurance can protect your business in the event that an important employee (or other key person) leaves the business as a result of disability, trauma or death.

Key person insurance provides an amount of money for revenue purposes, such as protection against reduced sales or profit, or a capital purpose such as paying off a loan.

You may have other avenues open to you, to address the absence of a key person, such as additional borrowing, capital injections from shareholders or selling assets. But how realistic are these and could they be done quickly to provide the much needed funds?

Key person insurance policies can be effected quickly, meaning your business can continue operating and maintain its value.

Types of insurance

There are three types of risks that can be covered by key person insurance. You can take out cover for the death, total and permanent disablement (TPD) and trauma of a key person.

As everyone's circumstances are different you should speak to your financial adviser about what types of cover are suitable for your business, and how the insurance package should be structured.

Ownership of the policy

Key person insurance is often owned by the business, as the business is generally the entity that will require the proceeds of the policy.

In some circumstances key person insurance may be owned by a lender to the business, or the guarantor of business debt.

You should discuss ownership options, and their implications, with your financial adviser and accountant.

Tax considerations

If you take out key person insurance for a revenue purpose, such as replacing a fall in business income or an increase in business expenses, then your insurance premiums are tax deductible. On the flipside, the insurance proceeds are taxable. You can claim a tax deduction for expenses incurred by the business, and this may offset the tax payable on the insurance proceeds.

If you take out key person insurance for a capital purpose, such as to repay debt or compensate for loss of goodwill, then your insurance premiums are not tax deductible. The proceeds of the insurance policy may also be taxable under the capital gains tax (CGT) provisions.

Your accountant or tax consultant can advise you on the tax implications of key person insurance for your business.

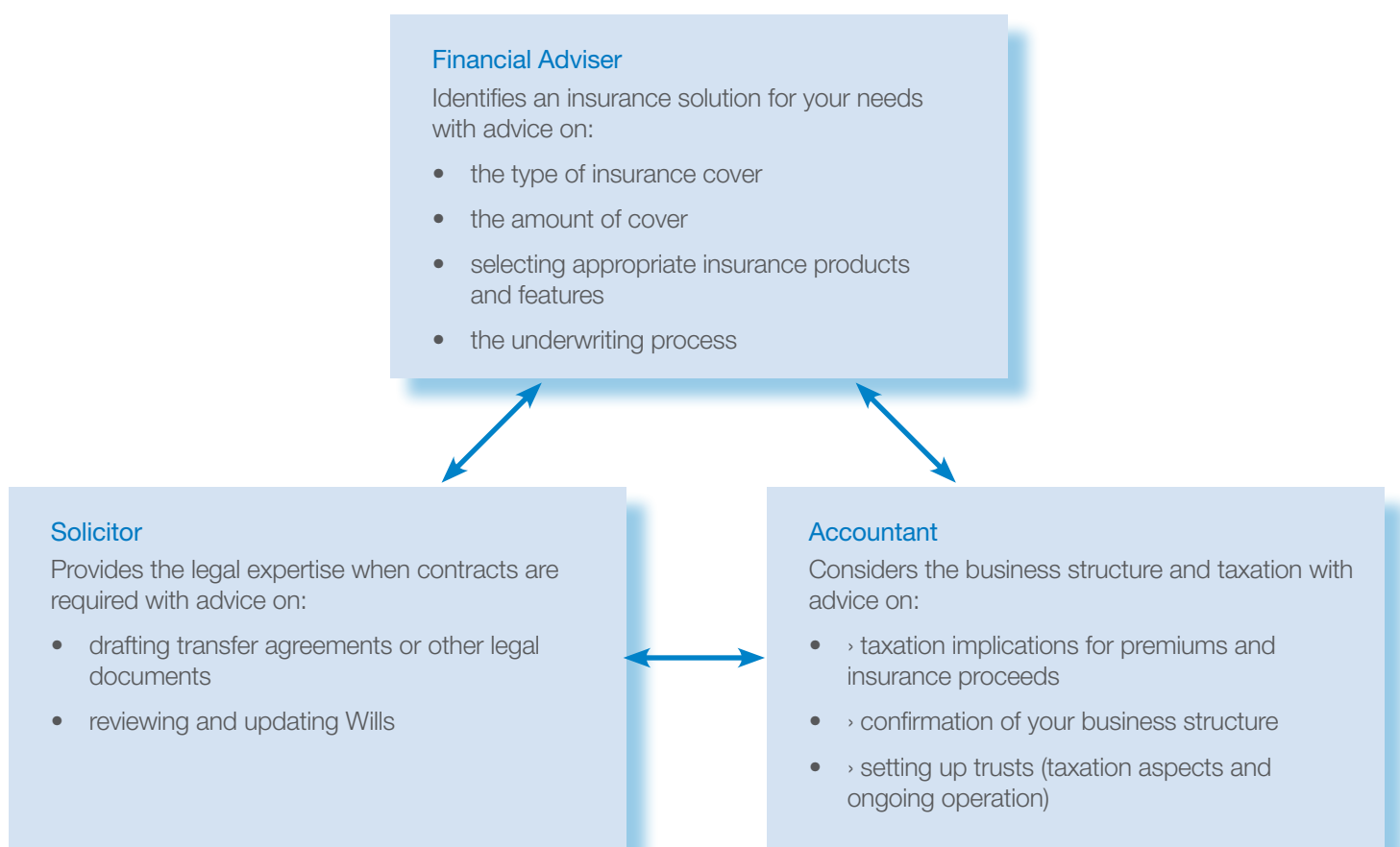
You and your professional advisers

You don't need to make decisions about key person insurance on your own.

Designing an effective key person insurance package requires your financial adviser, accountant and solicitor to work together.

Each professional brings their own unique skill sets.

The functions of your advisers and the expertise they provide are shown below.



Case study

Protecting a business for loss of revenue

Gary owned a successful and growing architectural firm. He had a reputation for innovative designs and was well regarded in his profession.

Gary recognised that his value to the business came from his focus on designs, so he employed Andrew as a professional manager to meet the needs of his growing business.

Andrew dealt with the employment arrangements of staff, office renovations, marketing, client billing and other back office Functions. He helped reduce the practice's expenses and increase its profit. Gary saw that Andrew was a key person to his business, so took out life and trauma insurance for him.

When Andrew suffered a heart attack a year after he joined the firm, his insurance policy was effected, and the business received the insurance proceeds. This helped Gary's firm maintain its profitability until Andrew was able to resume work.

Case study

Protecting business debts

Wendy's business needed to buy premises to cater for its expanding needs. Wendy obtained a business loan to purchase a commercial strata unit. Wendy backed the loan with a personal guarantee, a mortgage over the unit and her home. A condition of the loan was that it must be repaid in the event of Wendy's death or disablement.

Wendy realised that should she become critically ill (or die) she (or her estate) would need to sell the property, the business or the family home – and in a hurry – in order to repay the loan. Wendy took out key person insurance for the capital purpose of paying off the loan.

Three years after taking out the insurance Wendy suffered a stroke. The insurance paid out the loan, leaving Wendy with a valuable business to sell and a wholly owned commercial property to rent. The money from both will provide support in her recovery.

Key person insurance – a checklist for business owners

- ✓ Identify the key person(s) in your business.
- ✓ Estimate how long it would take to replace the key person(s).
- ✓ Specify the type and amount of loss to the business if the key person(s) died, suffered total and permanent disablement or a trauma. Your financial adviser and accountant will be able to help you estimate potential loss.
- ✓ With the help of your financial adviser examine the types of insurance required - life, TPD or trauma. Are all three required or just one or two?
- ✓ Discuss policy ownership options with your financial adviser and accountant. The default owner is generally the business, as it is affected by the key person's absence.
- ✓ Confirm with your accountant the tax treatment of the insurance premiums and insurance proceeds.
- ✓ Speak to your solicitor to determine if a legal agreement is required to transfer the insurance proceeds.
- ✓ Consult with your financial adviser and accountant about your personal insurance and buy/sell insurance needs.

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