BUSINESS CONTINUATION - KEY PERSON INSURANCE

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The loss of a person who makes a significant contribution towards the profitability or stability of the business can significantly impact on the ongoing earnings and credit status of a business.

Key person insurance protects a business by providing a lump sum that can replace business revenue or business capital if a 'trigger' event such as disability or death affects a key person.

BENEFITS

The insurance proceeds protect the ongoing viability of the business and help to maintain the business's value by providing a lump sum that can be used to:

- offset a reduction in revenue while the business restructures or a replacement is found
- cover the costs associated with finding and training a suitable replacement
- reduce or repay debts
- protect a personal or business asset used as loan security.

HOW IT WORKS

Businesses are not made successful by tangible assets, such as land, buildings, plant, equipment, stock or working capital. Rather, success depends upon the expertise of the people who put these things to work.

Key people are the most valuable asset a business can have. Their departure (especially if unexpected, e.g. due to death, disablement, or critical illness or injury) could cause havoc not only to that person's family, but also to the business and to the lives of all who remain involved in the business.

Key person contingency strategies are designed to provide the business with money to offset the financial loss resulting from the disability or death of a key person.

This money may also be used in conjunction with a business succession plan to ensure that the business remains healthy if a proprietor/key person is unable to remain in the business. This may help to ensure the remaining business owners continue to have a viable business, but does not replace insurance needed to fund a Business Succession Agreement.

WHO IS A KEY PERSON?

A key person is someone who:

- Gets things done. They might be a manager, director, company secretary/chief financial officer, accountant, supervisor, foreman or technical specialist.
- Builds goodwill. Their human attributes and qualities inspire confidence, attract custom and build clientele. Goodwill enhances the value of the business and is vital to continued success.
- Improves the credit standing of the business. The confidence and goodwill built up by their skill and efficiency often enhances the credit extended to a business by suppliers and bankers alike.
- Contributes to revenue either directly via sales and client account management or indirectly via technical skills which would be difficult to replace if they involuntarily departed.

WHAT IS THE BUSINESS IMPACT?

The loss of a key person can affect the business. For example:

- Revenue may fall, expenses increase and profits be impacted upon. This may result in immediate loss of revenue as existing contracts may not be able to be satisfied nor new contracts sought until a replacement is found.
- It will take time and money to find a replacement and perhaps months for the new person to become fully effective. In the meantime, momentum flags and profitability may fall. It becomes an opportune time for competitors to grasp an advantage.
- Others in the business may have their attention diverted, causing a decrease in productivity and downward pressure on cash flow.
- Liquidity and credit can be affected. Creditors can be quick to press for payment, debtors slow to pay and lenders reluctant to advance to a business after the loss of a key person.
- Goodwill and credit are closely linked; one tends to follow the other. Cash is often urgently needed for the financial stability of the business.
- The proprietors may feel bound to continue to pay the key person given that they are either a proprietor or at least a valued employee.

To protect the business in the short term, key personnel should be insured to provide sufficient funding to cover the loss in **revenue** or impact on the business' profit and loss account. This could include, but is not limited to:

- Compensation for a reduction in revenue or profits
- Provision for the associated costs of recruiting and training a replacement
- Additional continuing expenses of the business, such as outstanding projects and general overheads.

This will provide the company with some breathing space to restructure for the future, without the financial strain resulting from a reduction in revenue, following their absence due to death, disablement, critical illness or injury.

In addition, the business may wish to protect the balance sheet of the business by providing sufficient funds to cover **capital** costs or losses such as:

- reimbursement for loss of goodwill
- funds for repayment of debt
- costs associated with protecting the capital rating and capital structure of the business.

INSURANCE POLICY OWNERSHIP

Key person cover can be either revenue (e.g. protecting the income stream of the entity) or capital (e.g. repaying a business debt, offsetting the loss of goodwill) in nature. The purpose of cover has implications as to policy ownership and the related taxation implications.

KEY PERSON REVENUE

If the purpose of the insurance policy is to protect the revenue stream of an entity, that entity would typically own the relevant insurance policy. The associated premium will be tax deductible to the entity and the claims proceeds will constitute assessable income.

KEY PERSON CAPITAL

If the purpose of the insurance policy is capital in nature (e.g. repaying a business debt, offsetting the loss of goodwill), the policy would typically be owned by the entity that owns the debt, or suffer the loss (goodwill etc.). The associated premium will not be tax deductible, and the claims proceeds not assessable from an income tax perspective.

There may however be Capital Gains Tax (CGT) implications that need to be considered. Life insurance policies (including TPD and Trauma) are CGT assets where the payment of the claim proceeds constitute the disposal of the asset. In order for the claims proceeds to be received by the policy owner CGT free, the policy owner must meet the relevant CGT exemption applicable.

LIFE INSURANCE

To meet the CGT exemption for Life Insurance, the policy owner must be the original owner of the contract or acquired the rights for no consideration.

WHAT YOU NEED TO CONSIDER

- The taxation treatment of the premium and proceeds will depend on the business structure and the purpose for owning key person insurance, so it is important that details about the purpose of the policies are documented in the business minutes and reviewed and recorded each year.
- The ownership of the policies should be discussed with and confirmed by your solicitor and/ or accountant before implementation.
- You should always carefully read the Product Disclosure Statement (PDS) and policy document for your selected insurance policy and keep these documents in a safe place.

REFERENCES

You may wish to refer to the following websites for further information about key person insurance

- www.ato.gov.au
- www.moneysmart.gov.au

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