

key person and loan protection

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You will find that the success of almost all small and medium-sized businesses is dependent on a few people who make a significant contribution.

These key people can include the owners, senior directors, sales people, production managers, research and development staff or other people with specialist skills or knowledge.

Often a person's value to the business is reflected in their remuneration package. When you are trying to identify the key people this can be a good place to start, although this may not always be the case.

Whatever the key person does, their loss could have disastrous consequences for the business. Some of the problems the business may face are:

- Loss of profits.
- The need to recruit or train a replacement.
- Loss of important personal or business contacts.
- Difficulties in meeting existing loan repayments.
- Loss of confidence from suppliers and customers.
- Difficulties in raising new finance for new developments.
- Loss of detailed knowledge of the businesses processes and systems.
- Having to repay a loan the key person has made to the business.
- Loss of goodwill.

Having the right protection in place can help to ease all of these problems. Bright Grey's Business Protection Menu is **designed to provide a cash injection** if the key person dies or suffers a critical illness. It can also provide a regular income for the business if the key person is temporarily disabled and unable to work.

It can't stop the unthinkable from happening, but it can make dealing with the consequences a little easier.

Source

¹ Office for National Statistics, October 2009.

99.3%

of business enterprises in 2008 were classed as small, having 0 to 49 employees.¹

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calculating the cover

There are no hard and fast rules when assessing the financial value of a key person. Each key person must be dealt with on their own merits.

There are several options available to guide you in assessing a reasonable amount of cover, and these are outlined below.

Multiple of profits

As one of the main objectives of key person cover is to protect the profitability of the business, looking at profit is a sensible first step.

The normal multiples would be as follows, although higher multiples may be justified for a rapidly expanding business:

- 2 x gross profit, or
- 5 x net profit.

However, these would be the upper limits on the business as a whole. So where there is more than one key person, cover would need to be apportioned according to each person's contribution.

Multiple of salary

A multiple of gross salary including benefits in kind can give a useful guide to the amount needed to recruit a replacement. Between 7 and 10 x gross salary may be considered. While this could be a useful guide for non-shareholding employees, care needs to be taken with shareholders who may be taking a reduced salary to build the business or taking dividends for tax reasons.

Proportion of salary roll

This method covers the key person's contribution to turnover. In a similar way to the multiple of salary route, a shareholding key person may show salary that is artificially low so care needs to be taken. The formula used would be:

**Key person's salary x turnover x years
to recruit and train a replacement**

Total salaries

Loan security

Any outstanding business loans will need to be covered (apportioned between the relevant key people as appropriate). As well as the lender usually requiring this cover, many directors may have given personal guarantees and/or used their own residential home as security, so there is the added need to ensure that dependants are protected.

Directors may well have made loans to the company themselves either by making a cash injection or leaving salary, bonus or dividends in the business. These are known as director loan accounts. On death they become repayable to the estate of the deceased key person and therefore need to be included in the sum assured. On critical illness the repayment of such a loan would give the director much needed personal financial security.

In a partnership there may be similar loan accounts owed to individual partners and these need to be covered in the same way.

Special circumstances

Business start-up

When a company starts up it requires working capital. This can be at risk until profit flows have stabilised. So it is sensible to cover the key person's proportion of this risk.

Management buyout

A management buyout will often be financed by a bank or venture capitalist. This could be through a loan or equity finance. Either way the providers of the finance will want to protect their investment by covering the proportion each key person is liable for. As with any loan there is also the question of any personal security that has been offered and the need to protect dependants.

These guidelines should help advisers work out the appropriate level of cover. But all businesses are different and their needs will be particular to their own circumstances.

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how to set up the cover

Each type of business needs a different solution.

Limited companies

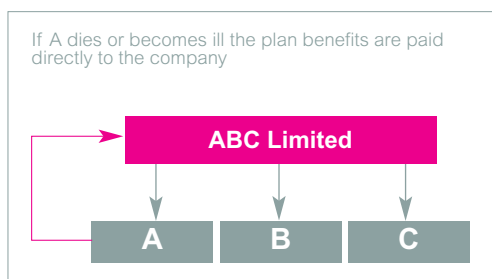
There are 2 solutions that can be considered for key person and loan protection for companies.

Life of another

The company takes out a 'life of another' plan on the key person. The Bright Grey Business Protection Menu allows you to combine Life Cover, Critical Illness Cover and Life or Critical Illness Cover into one plan that suits each company's particular needs. Then, if the key person suffers a critical illness or dies, the benefits would be paid directly to the company. These funds can be used to meet the company's financial needs while it reorganises or recruits a replacement. In the case of a critical illness claim it is possible the key person will return to work, so the funds could be used to pay for a temporary replacement or replace lost profits (see chart below).

Key Person Income Cover for Sickness could also be taken out. This provides a regular payment if the key person is absent through illness or an accident for any length of time. The income can be used to compensate for loss of revenue, to fund loan repayments, to pay a temporary replacement or to fund sick pay for the key person. Key Person Income Cover for Sickness differs from Personal Income Cover for Sickness in that the cover limits are higher.

Key Person Income Cover for Sickness can cover up to 75% of the gross profit that would be lost if the key person was no longer there. Income Cover for Sickness will only cover 50% of the key person's salary. And as the cover is to finance the short-term loss of profit caused by the loss of a key person the maximum payment period is 5 years. It is therefore not suitable as a long-term salary replacement vehicle.



Own life in trust

If the key person is a shareholding director they can take out a plan on their own life, written under a Bright Grey business trust for all of the other shareholders. Should the key person die or suffer a critical illness the other shareholders will receive the benefits provided by the plan, through the trustees.

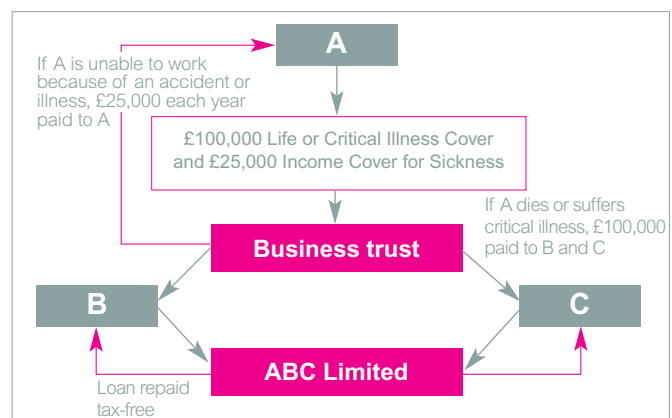
The shareholders can then lend the benefits to the company to offset the potential loss of revenue while they reorganise or recruit a replacement. This is done by creating or increasing directors' loan accounts.

The key advantage of this method is the extra flexibility it offers as the other directors can choose when the money is loaned and how much of it they use. Because the money has only been loaned to the company, once the business is back on its feet again it can be withdrawn at any time without any tax liability.

The downside of this is the cost because the premiums have to be met from post-tax income. Or if the company pays, the premiums would be treated as income in the hands of the shareholders. There is more detail about the tax treatment within the taxation section on page 21.

Each shareholder could also take out Income Cover for Sickness to protect their income if they are unable to work because of illness or an accident. The Bright Grey business trust makes sure that this cover is always payable for their benefit rather than the other shareholders (see chart below).

Key Person Income Cover for Sickness should not be taken out using this method as the benefits would be payable to the ill shareholder instead of the company. If Key Person Income Cover for Sickness is needed, this should always be applied for as a life-of-another plan.



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Partnerships

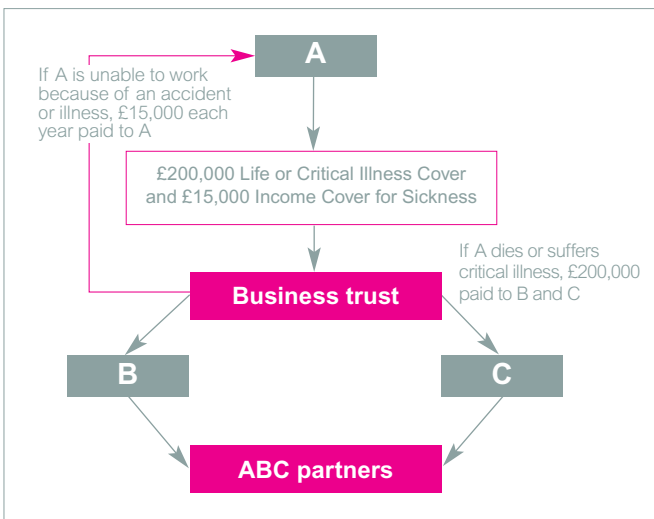
Partnerships in England, Wales and Northern Ireland do not have a separate legal entity. This means they cannot enter into a contract in the same way a limited company can, so a different approach is needed.

There are 2 different key person needs affecting partnerships.

A partner

Each partner takes out a plan on their own life which is written under the Bright Grey business trust for their co-partners. If one of the partners suffers a critical illness or dies, the plan benefits are paid, through the trustees, to the remaining partners. They can then be invested in the firm once the future of the deceased or ill partner's share has been decided (see chart below).

Each partner could also take out Income Cover for Sickness to protect their income if they are unable to work because of illness or an accident. The Bright Grey business trust makes sure that this cover is always payable for their benefit rather than to the other partners.



An employee

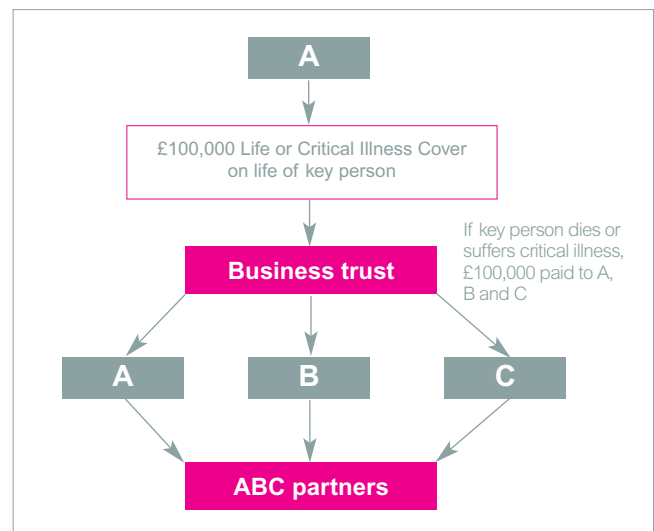
If the key person is not a partner, but is employed by the partnership, then one or more of the partners needs to take out a life-of-another plan on the key person written under trust for all of the partners. If the key person suffers a critical illness or dies, the partners will receive the benefits provided by the plan, through the trustees.

Alternatively if there are only 2 or 3 partners, each partner could take out a life-of-another plan on the life of the key person. The amount of cover for each would be their proportion of the overall loss the partnership would suffer following the loss of the key person.

These funds can then be used to meet the firm's financial responsibilities while it reorganises or recruits a replacement. In the case of a critical illness claim it is possible the key person will return to work, so the funds could be used to pay for a temporary replacement, or replace lost profits (see chart below).

Key Person Income Cover for Sickness could also be taken out in the same way to provide a regular payment if the key person is absent through illness or an accident for any length of time. This income can be used to compensate for loss of revenue, to pay a temporary replacement or to fund sick pay for the key person.

In Scotland a partnership is a separate legal entity and can take out the plan itself.



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Sole traders

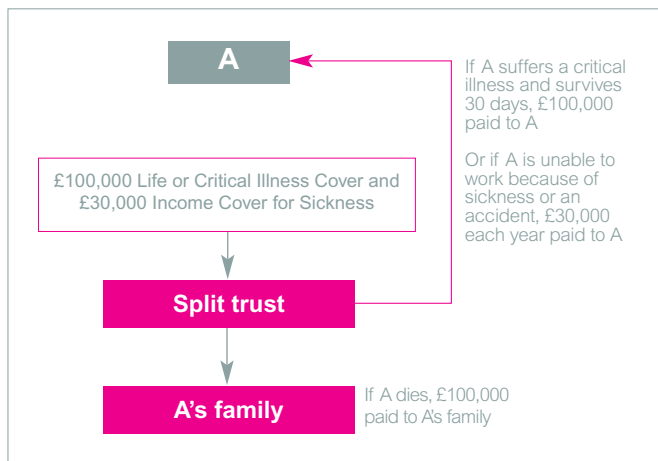
There are 2 key person situations a sole trader may need to protect against.

The sole trader

The solution for a sole trader is to take out a plan on their own life with both Critical Illness Cover and Life Cover. The plan is written under a Bright Grey split trust with their family as the beneficiaries. If the sole trader suffers a critical illness the plan will pay them the benefits if they survive the illness by 30 days. The sole trader can then meet the financial responsibilities of the business, change their lifestyle if necessary and safeguard the future of their family.

In the event of the sole trader's death the plan will pay the benefits to their family allowing them to meet the financial responsibilities of the business and safeguard their future financial wellbeing. If the family decide to continue the business after the sole trader's death, the benefits from the plan can help considerably.

Income Cover for Sickness could also be taken out to provide a regular payment if the sole trader was unable to work through illness for any length of time. This income could be used to compensate for lost profit or to pay a temporary replacement (see chart below).

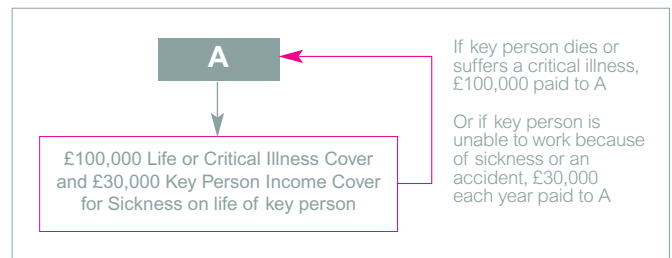


An employee

In addition to being a key person, the sole trader may employ someone who is also key to the success of the business. The loss of this person could have the same impact on a sole trader as it could on any other business.

The solution for the sole trader is to take out a 'life-of-another' plan on the key person. In the event of the key person suffering a critical illness, dying or being unable to work due to long-term illness, the sole trader will receive the benefits of the plan. These funds can then be used to meet the sole trader's financial responsibilities while they reorganise or recruit a replacement. In the case of a critical illness claim it is possible the key person will return to work, so the funds could be used to pay a temporary replacement or replace lost profits.

Key Person Income Cover for Sickness could also be taken out to provide a regular payment if the key person is absent through illness for any length of time. This income can be used to compensate for loss of revenue, to pay a temporary replacement or to fund sick pay for the key person.



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Limited liability partnerships (LLP)

A partnership created under the Limited Liability Partnership Act 2000 is effectively halfway between a limited company and a partnership, while the taxation of the individual partners is similar to a traditional partnership. Their individual liability is limited to the amount they have subscribed to the partnership.

In a similar way to a limited company, a limited liability partnership has its own legal persona and can contract in its own name. Therefore it can take out policies for Life Cover, Critical Illness Cover, Life or Critical Illness Cover and Key Person Income Cover for Sickness on the life of the key person or member in the same way a limited company can.

This business format is becoming increasingly common, especially among professional practices such as accountants and solicitors.

other considerations

Board/partners'/members' resolution

Before taking out the cover the business should record its intentions in the minutes of a board, members or partners meeting. Suggested wording is shown below but this should be amended to suit each client's requirements.

Company resolution

'RESOLVED THAT the company shall effect a protection plan on the life of <name of key person> for the amount of <amount of cover> payable on death <or diagnosis of a critical illness>.

The plan is being taken out solely for the purpose of protecting the company against the financial loss to the company likely to arise in the event of <his/her> death <or being diagnosed with a critical illness> while in the service of the company and is not intended for the benefit of <key person name> or <his/her> family.'

Members' resolution

'RESOLVED THAT <the limited liability partnership>("the LLP"), shall effect a protection plan on the life of <name of key person> for the amount of <amount of cover> payable on death <or diagnosis of a critical illness>.

or

'RESOLVED THAT <name of key person> shall effect a protection plan on <his/her> life for the amount of <amount of cover> payable on death <or diagnosis of critical illness>. The plan shall immediately be placed under trust for the benefit of the present members of <name of LLP>("the LLP") other than <name of key person>

and

'The plan is being taken out solely for the purpose of protecting the LLP against the financial loss to the LLP likely to arise in the event of <his/her> death <or being diagnosed with a critical illness> while in the service of the LLP and is not intended for the benefit of <name of key person> or <his/her> family.'

Partners' resolution

'RESOLVED THAT <name of key person> shall effect a protection plan on <his/her> life for the amount of <amount of cover> payable on death <or diagnosis of a critical illness>. The plan shall immediately be placed under trust for the benefit of the present partners in the firm of <name of partnership> other than <name of key person>.

The plan is being taken out solely for the purpose of protecting the firm against the financial loss to the firm likely to arise in the event of <his/her> death <or being diagnosed with a critical illness> while in the service of the firm and is not intended for the benefit of <name of key person> or <his/her> family.'

Confirmation of tax position

General guidance on the tax position of key person protection plans is given later in this guide. But the actual treatment is dependent on the specific circumstances of each business. Your client should therefore attempt to get written confirmation from their local Inspector of Taxes as to how any plan they take out will be treated for tax purposes. A draft letter to HM Revenue and Customs is included within the taxation section on page 28.