

IT'S ALL ABOUT THE PEOPLE, PEOPLE

How Key Person Life Insurance Can Protect Your Capital and Revenue

By JAMES COTIS, Principal – Logical Insurance Brokers

In the 2019 Winter edition of Across Borders Magazine we discussed the oftentimes overlooked concept of Business Succession Planning.

We highlighted the need for SMEs to make sure they have the right structures in place (that is life insurance and Buy/Sell agreements) to protect both themselves as shareholders and the business itself in the event of a shareholder involuntarily needing to exit the business due to their death or severe illness/disablement.

In this edition, we'll discuss the concepts surrounding business continuity and stabilisation using **Key Person Life Insurance** (also known as *Key Man* insurance).

The Human Asset is Your Greatest Asset

Most SMEs take out insurance cover to protect *tangible* assets such as plant, equipment, vehicles and buildings. However, it is an undeniable fact that the greatest asset to a business is the intellectual capital and personal effort by people, and in particular, *key personnel*. It is this *human* asset that - through initiative, drive, skill, specialist knowledge and ingenuity - can actively generate profits for the business.

Whilst it isn't the most pleasant aspect of business planning to think about, it is important to consider how your business would cope if one (or more) of your key people were to suddenly pass away, be diagnosed with a terminal illness or become unable to fulfil their role in the business due to suffering a severe disability.

Could you easily find replacement team members with equal knowledge, experience and aptitude who could pick up right where your key employees left off?

Therefore, we suggest SMEs carefully consider crucial questions like:

- Would your business' financiers become anxious and decide to call in loans?
- Would your business cope in the short term where internal reorganisation can cause remaining staff to take on extra duties? The extra pressure put on those people may prevent them from performing to their usual standard.
- Would the remaining staff feel insecure about their future and the future of the business?
- Would your customers and suppliers have the same misgivings?
- Would the business be able to keep operating?
- Would the surviving business owners or partners be able to cope financially?

This type of destabilisation can have a profoundly negative effect on business revenues, which may threaten the continuity of the business and have a financially damaging knock on effect for the surviving business owners/partners.

For this reason, it is vital that SME's have both short-term and long-term stabilisation plans in place.

Who is a Key Person?

Before we begin talking about insurances to help with this stabilisation, let us first try to define the term **key person**.

A **key person** is someone whose knowledge, skills and experience are crucial to the success of your business. For example, in relation to SMEs this may be the founders/directors of the business. These could also be people who have personally guaranteed loans for the business.

For a larger business, a **key person** may be someone whose absence would reduce the profitability of the business, such as a sales manager or a highly skilled employee.

Think of a person whose continued association with an SME provides it with a significant and direct economic gain. Economic gain can, among other things, include cost savings, capital injections, goodwill, access to credit and access to customers. For example, an employee who is directly responsible for bringing in sales or who holds key technical expertise on which your business relies.

As much as an SME tries to share skills, knowledge and information within their business, there will probably be some people who are key to the SME's success. It might be a Director or the CEO, whose vision made it a success in the first place. It might be a star salesperson, or someone within the IT area who knows the system backwards. It could even be someone who doesn't create any revenue but does a fantastic job of boosting the SME's reputation or



perhaps running the administration and back office systems.

How does Key Person Life Insurance work?

From a big picture perspective, **Key Person Life Insurance** is designed to help recover from the loss of a key member of the SME.

The insurance mechanism is fairly simple and straightforward:

1. The SME purchases a life insurance policy on the life of the director/employee (or several key individuals within the organisation, if needed), with the company being named as the beneficiary and owner of the policy.
2. If something tragic were to happen to the director/employee (or employees) which is covered by the policy, a lump sum benefit would be paid to the SME to help with hiring and training of new employee(s) or retiring debt so the business can get back on stable ground.

Typically, **Key Person Life Insurance**

policies cover death, total and permanent disability (TPD), and trauma/critical illness.

What cover does Key Person Life Insurance provide?

Key Person Life Insurance can compensate the SME for loss in two different categories:

1. Business profitability (Revenue Purpose)

For many SMEs, medium term income loss can have long term financial consequences for both the business and its shareholders.

The majority of income can usually be attributed to the skills, actions or relationships of a few key persons within the business. The loss of one of these key persons would cause a reduction in revenue.

It is therefore important to consider insuring these key persons against the business losses.

Key Person Life Insurance proceeds

can be used to:

- Replace the revenue the key person would have generated;
- Pay for the costs of temporary replacements until a full-time replacement can be recruited, including temporary overtime costs;
- Pay the extra costs incurred in locating and attracting suitable replacement(s);
- Pay incentive bonuses (to entice the right person into the role);
- Compensate for falls in revenue/sales/profit.

2. The capital value of the business (Capital Purpose)

Losing a **key person** can also adversely affect the *capital value* of the business. These effects can be far reaching and can impact:

- Goodwill: A **key person** may have specialised knowledge, unique skills, high quality business contacts or even a

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reputation for excellence;

- **Credit Standing:** For example, credit lines can be secured more easily because one director has sufficient personal assets to secure the debt. Should that director die, access or maintenance of lines of credit and overdraft facilities may prove difficult;
- **Loan accounts:** The loss of a **key person** who has loaned money to the business may mean that the loan must be repaid to the key person or their estate immediately;
- **Other debts:** If the business is destabilised and defaults on a loan, the financier could call in one or more loans made to the business.

Capital Purpose **Key Person Life Insurance** aims to ensure that the business can repay debts on the loss of a **key person**, thereby easing the financial burden of the SME at a crucial point in time. This will give the SME some breathing space to stabilise and maintain the capital value of the business.

Taxation Implications

It is important to consider both the Income Tax and Capital Gains Tax treatment of **Key Person Life Insurance**. Where term life insurance is utilised, then the tax treatment depends on whether the purpose of the insurance is for *revenue* or *capital*.

Revenue Purpose insurance premiums are generally tax deductible to the SME, however, the claim proceeds are tax assessable.

Capital Purpose insurance premiums are generally not tax deductible to the SME, however, the claim proceeds are not assessable if the benefit is a death benefit and the recipient was the original owner of the policy or did not pay consideration to acquire it.

It is important to note that if there was a change of purpose or the insurance proceeds were used for a different purpose at the time of the claim, it may affect the deductibility of past premiums and the accessibility of the insurance proceeds.

Therefore, we recommend that specialist

taxation & legal advice is sought prior to embarking upon a course of action.

Live Case Study

Note: All names of persons and businesses have been changed for this case study.

Readers of the Winter 2019 edition Across Borders Magazine will recall that Fred, George and Peter were all directors and equal shareholders of Fabulous Freight Forwarders Pty Ltd, valued at \$6 million.

During Logical's meeting with Fred, George and Peter, we learned that the business had a \$2,000,000 loan facility which was used to fund the acquisition of other aligned businesses and provide operating capital as required. The facility was secured through each director's family home, plus director's guarantees. Although the facility was not fully utilised at the time, it frequently reached its limit.

Logical also learned that the directors had complementary skill sets. George was the managing director who has the expertise, ingenuity and ability to allow the business to run smoothly, operate within budget and establish a strong market presence. Fred was responsible for the sales efforts, having unique contacts and methods which provided the business with a competitive edge. Steve had specialist knowledge which enabled the business to win contracts. This effectively meant that all three directors were key people.

Fred, George and Peter decided that their immediate need was to provide maximum protection in relation to the loan facility, so Logical recommended the need for Key Person Life Insurance (Capital Purpose) for \$2,000,000 each to extinguish the debt.

Logical gathered relevant information required to provide a detailed report to each of them. Logical then assisted them apply and successfully complete their insurance arrangements.

In addition, Fred, George and Peter realised they had several other key people within their business, and they agreed to review that situation over the ensuing six months. However, they quickly recognised and identified one other **key person** within the business,

the National Information Technology manager who built and maintained their unique cargo/freight and warehouse management software systems.

They understood that they didn't have the IT expertise to maintain and enhance these systems, which could lead to a loss of competitive advantage should their IT manager die or suffer a severe illness/disability.

Following careful consideration, it was agreed that there was a need for **Key Person Life Insurance** in relation to the IT manager. In consultation with Logical it was decided that a Revenue Purpose amount of \$1,000,000 would be required.

Fred, George and Peter were relieved that they had removed another key risk from their business.



Who we are

James and the team at Logical Financial Management Australia Pty Ltd (ABN: 23 103 138 305) provide specialist risk management, insurance and financial planning solutions to the logistics industry. Logical is delighted to be associated with the Freight and Trade Alliance (FTA) and is proud to be their appointed insurance adviser since its inception in 2012. James is also a regular presenter at FTA professional development events.

If you would like more information about how careful business succession planning can help protect the value of your business, please feel free to contact James on 02 9328-3322, email jamesc@FTAlliance.com.au or visit the Logical Financial Management website at www.logicalfinancial.com.au.

