Keys To Key Person Success

Identifying key person cover needs, and avoiding the agony of the failed key person cover proposal.

David Glen

National Technical Manager

March 2019

Contents

The right fundamentals

Purpose of Key Person Cover

- Protects the Business from financial loss that may arise in the event of the loss of the life insured.
- The policy provides funds for the business to overcome the economic/financial effect of the death or disability of a key person.
- The loss covered may be either capital or revenue in nature.
- Level of cover should reflect the likely financial/economic loss from either a capital or revenue perspective.

Types of Key Person Cover

- There is no special type of cover for key person insurance.
- Use conventional life insurance products being death cover, TPD cover or trauma cover.
- Cover used is lump sum cover only.
- Australian life insurance market generally does not offer cover providing compensation in income stream form.

What Is A Key Person?

→ Key person is the life insured.

→ Life insured is the key person who:

- Possesses proven knowledge which cannot be replaced.
- Has hard to replace skills and/or expertise in a specific field
- Performs important tasks or processes in the business not replicated by others.
- Has valuable personal/business contacts and/or relationships vital to the ongoing success of the Business.
- Gives confidence to lenders that business can repay debt.

Key Person Insurance Examples

- Compensation for loss of profits caused by the death or disability of a key employee.
- Compensation for additional expenses following the death /disability of a key person e.g. recruitment costs and temporary executive hire.
- Compensation for loss of goodwill caused by the death/disability of a key employee.
- Compensation for the diminution in value of an investment caused by the death/disability of the key employee.
- Amount to finance the repayment of debt in whole or part to avoid any foreclosure action by banks and other lenders.

Underwriting key person risk

Underwriting Approach

- Important to outline the key person fundamentals in the application.
- Adviser is the field underwriter, and justifies the Client's position.
- Why is the life insured is regarded as a key person?
  - What does the life insured do in the business?
  - What do the other owners in the business and staff do?
  - Sole proprietors are not key persons. The business ceases on proprietor's death
- The estimated amount of the loss
  - How a loss would arise to the Business on death or disability of the key person?
  - What is the basis of the loss calculation?

TAL

Loss Calculation Methodologies

- Replacement cost method. Costs include:
  - replacement salary
  - recruitment costs
  - relocation costs
  - training cost of replacement
  - advertising costs.
- Loss of revenue method.
  - Determination based on the expected reduction in business revenue for the period before a replacement is found and revenue recovers.
- Loss of capital value:
  - Diminution in value of goodwill as a result of death/disability of the key person.
  - Diminution in the value of an investment caused by death/disability of the key person.

Key Person Capital Debt Protection

- Establish the level of debt currently in place and the Life Insured's share thereof.
- Obtain confirmation of the outstanding debt details including:
  - amount,
  - date drawn down,
  - duration
  - purpose.

- Produce external evidence of the debt's existence e.g. loan agreement, signed letter on bank letterhead.

- Calculation method: Current value of debt X percentage ownership share.

- Mismatch: The debt fluctuates, and probably has a term less than the debtor's life expectancy. Underwriter may manage the mismatch with a condition: Claim = the lower of the insured amount, or debt at time of death.

Who should own the policy and pay the premiums?

Policy Ownership

- If the life insured is an employee, the employing entity should own the policy.
- If the policy is protecting an investment, the investor should own the policy.
- If the policy is securing the repayment of debt, the policy should be owned by the debtor entity
- Employee owned policies are not key person policies.
- Be careful if any proclaim proceeds are distributed to equity holders, the proceeds may be taxed as unfranked dividends at the rate of 47%.

Premium Payment Responsibility

- The policy owner should pay the premiums.
- The premium cost is shown as an expense in the profit and loss statement.
- If the premium cost is not deductible for tax purposes, it is shown as an add back in the income tax return.
- No Fringe Benefits Tax Liability as the life insured does not receive any benefit.

Tax and documentation housekeeping

Tax Position Premiums

- Premiums are deductible if they:
  - Replace profits
  - Cover expenses, such as recruitment, training or advertising costs.
  - Purpose needs to be documented.
  - Onus is on the taxpayer to show deductibility.

- Premiums are not deductible if:
  - Compensating for loss of goodwill.
  - Diminution in value of a capital investment.
  - Providing funds to repay debt.
  - The premium is capital in this case. There is generally no deduction for capital expenditure

Tax Position Claims Proceeds

- Claims proceeds are assessable if they:
  - Replace profits
  - Cover expenses, such as recruitment, training or advertising costs.
  - The fact that no deduction has been claimed is irrelevant.
- Claim proceeds are capital if:
  - Compensating for loss of goodwill.
  - Diminution in value of a capital investment.
  - Providing funds to repay debt.
  - Death claim proceeds are exempt from CGT if paid to the original owner of the policy.
  - TPD/ trauma claim proceeds are subject to CGT unless received by the injured/ill person or a relative as defined.
  - Consider grossing up the insured amount by any tax exposure.

TAL

Documentation

- Critical to establish the purpose of the key person cover.
- The purpose needs to be documented comprehensively to avoid ATO query and allegations of breaches of directors' duties.
- Purpose of the cover needs to be documented in the minutes of directors' meeting.
- The purpose should also be documented in the SOA.
- There needs to be consistency between the SOA and the director's meeting minute.
- TAL has documentation templates available.

Engaging clients on key person risk

Opening The Key Person Risk Discussion

- Do not jump to an insurance solution. This approach lacks credibility.
- Create discomfort by alerting the client to key person risk.
- Most SMEs have key person risk. Their wellbeing depends on one or two critical individuals.
- Clients need a catalyst to think about key person risk. See yourself as the catalyst.
- Clients are two engrossed in day to day operational issues to think about key person risk.
- First step is to discuss SME exposure to key person risk and the high probability (Greater than 30%) of a two partner business suffering partner death/disability. Probability increases with more staff/partners.
- Encourage the client to outline the business operations. Put yourself in listening mode.

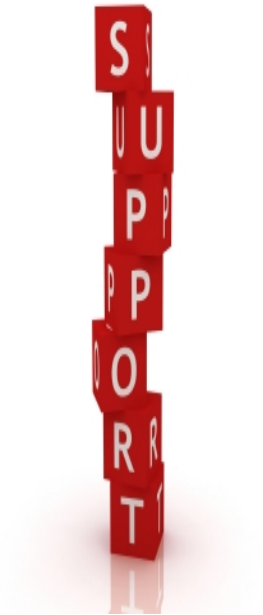
Closing The Discussion

- Prompt the Client to identify those persons whose function is critical to the ongoing wellbeing of the business.
- Raise the question: How do we source a replacement for these roles?
- Suggest a short term replacement strategy e.g. temporary executive hire.
- Move the discussion to long term replacement strategy e.g. junior staff member growing into the role.
- Outline the importance of a pre-planned communication strategy to mitigate damage following key person death/disability.
- Help the client estimate the the potential revenue gap, or damage to the balance sheet in the event of key person death or disability.
- Allow the client to consider gap plugging strategies
- Introduce the notion of key person insurance as a gap plugging strategy.

Key person support materials

Key Person Insurance Support Materials

- Key person revenue minute.
- Key person capital minute.
- Debt protection insurance minute.
- Business Insurance SOA Template in RG90 format.
- AskAnExpert@tal.com.au



Thank you

The information contained in this presentation is general information only and is not intended to be legal, taxation or financial advice.

TAL Australia, it subsidiaries and its representatives have not taken into consideration any individual's personal circumstances, financial needs or objectives.

If any person is intending to act on the information contained in this presentation, consideration should be given to the appropriateness of this general information in the light of that person's own objectives, financial situation or needs before acting on the information. Persons acting on any matter covered in this presentation should seek independent professional advice on the application of that matter to their individual circumstances.

In relation to any financial product referred to in this presentation, a copy of the Product Disclosure Statement should be obtained and read prior to making any decision regarding the acquisition that financial product.