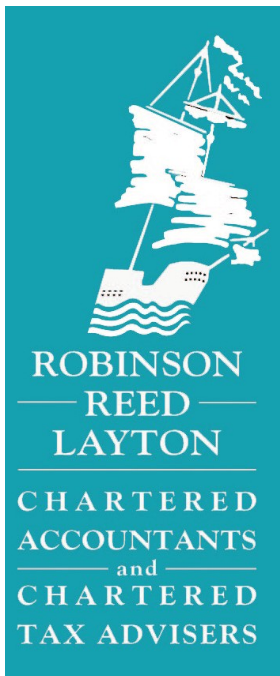

Key Man Insurance For Companies

Many family companies really depend on the skills of a small number of individuals, or even one person who effectively is the company. The death or incapacitating illness of one or more people could seriously damage the company's business.

A related problem is the question of succession. Imagine a company run by three unrelated individuals who also own all the shares. None of them has anyone in their families who would either want, or be able, to take their place if they were to die, so how is their estate to benefit from all their hard work if it is not practical to leave their shareholding to their spouse or their children?

The solution in many cases is to insure the lives of these "Key" individuals. A life insurance policy that pays out in the event of the death of the individual concerned can serve either to fill up the hole in the company's profits that would be caused by their death, giving breathing space to try to find a suitable successor or to enable the company to be wound up as a solvent entity.

Alternatively, a life insurance payout can enable the deceased individual's shares to be purchased at a fair market value so that his family can enjoy the fruits of his labour, without the company or the surviving shareholders having to go seriously into debt to fund the purchase.

These insurance policies are known variously as "key man insurance" or "shareholder protection insurance", and they are quite common in both small family companies and much larger enterprises.

The tax treatment of both the premiums paid and the proceeds if the insurance pays out can be somewhat confusing, particularly as there is no clear legislation on the subject and we have to fall back on general principles and case law to determine how to treat such policies for tax purposes.

I am assuming that the premiums on the policy are to be paid by the company, and that the beneficiary of the policy will also be the company.

When considering whether the company can treat the premiums paid as a deductible expense, the question to answer is whether the payments are "wholly and exclusively" for the benefit of the company's trade.

If the intention is that the insurance payout will be used to fill the hole in the company's income that the death of the key individual would cause, then the premiums are likely to be an allowable expense, in the same way that insuring the company's premises against fire would be.

In this case, there is good case law that suggests that any payment received from the insurer will be taxable income in the company's hands. In the same way that the tax treatment of damages claimed in a legal action is determined by the nature of the loss they are to make good, insurance proceeds that compensate for a loss of profitability are themselves treated as part of the company's profits and taxed accordingly.

The "key man" insured under this sort of policy may or may not be a shareholder, but there is another reason for insuring a life that only applies if the individual insured is a shareholder. In a case where the proceeds of the policy are to be used to enable the company to pay a fair market value for the deceased individual's shares to his estate, the reason for the insurance is not "wholly and exclusively" for the benefit of the company's business – it is at least partly for the benefit of the shareholders and the estate of the deceased shareholder.

In this situation, the premiums paid by the company cannot be claimed as an expense of the business, but by the same token, the insurance proceeds are not a taxable receipt in the company's hands.

These are the two simplest examples of "key man" insurance, but beware – although HMRC broadly agree with the treatment described in this article, they make the point that each case has to be looked at on its individual facts, and it is not as simple as saying "premiums allowable, payout taxable; premiums not allowable, payout not taxable".

This article by James Bailey first appeared in Tax Insider magazine (www.taxinsider.co.uk)