

YOUR GUIDE TO KEY PERSON PROTECTION.




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INTRODUCTION.



The purpose of this guide is to explain how key person protection operates.

This guide aims to answer the most common questions that you may be faced with whilst dealing with this topic.

▶ YOUR GUIDE TO KEY PERSON PROTECTION.

WHAT IS KEY PERSON PROTECTION?

It's simply a business insuring itself against the financial loss it may suffer as a result of the death (or critical illness if chosen) of a key person.

WHO IS A KEY PERSON?

A key person is an individual whose skill, knowledge, experience or leadership contributes to the continued financial success of the business.

A key person may be one of a number of people within a business, such as the:

- Chairman
- Managing director
- Marketing manager
- Computer specialist
- Sales manager

Anyone whose death could lead to a financial loss for the business through:

- Loss of profits.
- Having to recruit or train a replacement.
- Important personal or business contracts lost due to the key person not being there to maintain a contract.
- Loss of goodwill which could have a direct effect when it comes to raising capital for the business or attracting new investors.
- Customers and suppliers losing confidence in the business.

HOW DO WE PROVE AN EMPLOYEE IS A KEY PERSON?

In order for a business to insure one of its employees it must show that it stands to suffer a financial loss of profits as a result of the death, terminal or critical illness (if chosen) of that employee. This isn't usually difficult and that employee is then regarded as a key person.

KEY PERSON LOAN PROTECTION

The loss of a key person could lead to the business being unable to repay a loan, which could mean the lender calls in the loan early. This may have a serious effect on any existing loans or any future lending.

WHAT IS A COMPANY?

A limited company is a type of business entity. It is a corporation with shareholders whose liability is limited by their shareholdings. Any personal assets are held separately from the finances and assets of the company.

WHAT IS A PARTNERSHIP?

A partnership is the relationship which exists between persons carrying on a business in common with a view to profit.

The partnership does not have a separate legal identity and each partner would be liable for any trade debts.

In Scotland a partnership is a separate legal entity and can apply for the policy in its own right.

WHAT IS A LIMITED LIABILITY PARTNERSHIP (LLP)?

The Limited Liability Partnership Act 2000 established a new form of business vehicle. A LLP gives the benefits of a limited liability as for a company, but allows its members the flexibility of organising their internal structure as a partnership. The LLP is a legal entity separate from its members and while the LLP itself is liable for the full extent of its debts, the liability of the members will be limited (except to the extent that the members agree otherwise). Any two or more individuals can incorporate as a LLP.

In short it is a half way house between a company and a partnership.

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

WHAT IS A SOLE TRADER?

A sole trader is an incorporated business owned by one person, which may or may not have employees.

Sole traders can simply trade under their own names ('Jack Johns Flag Emporium') or they can devise a name for their business ('Jack's Flag Emporium').

SO WHO ACTUALLY EFFECTS THE POLICY?

A company

The company is the owner and completes the application and the policy owner questionnaire. Usually the Company Secretary, Chief Executive, General Manager or a Director will sign for and on behalf of the company. In the event of a valid claim the policy proceeds would be payable to the company.

A LLP

The LLP is the owner and completes the application and the policy owner questionnaire. In event of a valid claim the policy proceeds would be payable to the business.

A partnership

The partner could take out an own life policy and place it under trust for the other partners. In the event of a valid claim the policy proceeds would be payable to the trustees who would in turn pay the partners as beneficiaries of the trust.

A partnership in Scotland

The partnership would be the owner and completes the application and the policy owner questionnaire. The other partners would sign on behalf of the partnership. In the event of a claim the policy proceeds would be payable to the partnership.

An employee of a partnership

If the key person is not a partner, but is employed by the partnership, then one or more of the partners could take out a life of another policy on the key person, written under trust for all the partners.

A sole trader

The sole trader would apply for a policy on his own life and then place the policy in trust using a Legal & General Protection Gift Trust. In the event of a claim the trustees could use the sum assured for the family who could then use the money to meet any financial responsibilities of the business and give support to the family's future.

An employee of a sole trader

The sole trader could effect a policy on the key employee on a life of another basis. In the event of a claim the policy proceeds would be payable to the sole trader.

The key person will have to complete their personal and medical details and also sign the application as the life assured.

WHO PAYS THE PREMIUMS?

Where a company, LLP or Scottish partnership is the owner of the life policy it pays the premiums.

Where the policy is for a partnership, the partnership would normally pay the premiums.

Where the policy is for a sole trader, the sole trader as the owner of the policy would pay the premiums.

WHAT TYPE OF POLICY SHOULD BE EFFECTED?

This depends on the circumstances involved and the events the business wish to insure the key person against.

A life policy or life and critical illness policy could be chosen.

The effect of suffering from a critical illness can be the same on the business as the death of the key person. Thus life and critical illness cover may be a suitable option.

We recommend that the business think about the term, that is the length of the period of cover first of all. Then the risk or risks they wish to be insured against, the sum to be assured, affordability and finally taxation.

SO HOW DO YOU CALCULATE THE SUM ASSURED?

There are no formal rules for arriving at a sum to be assured and taxation (which will depend upon the type of policy) will be an issue, as will cost.

It's not easy to accurately assess the financial impact on a business of a future event but the company can usually be given an estimate.

When calculating the appropriate amount of cover needed you should consider the effect of the loss of the key person on the business including whether this would directly impact on the profits or is the cost of hiring a replacement a bigger concern.

There are common formulas used to help identify an appropriate amount detailed below:

- 1 The cost of replacing a key individual to the business would normally include consideration of the costs involved in finding a suitable person, the expense of required training, and also their earnings whilst they develop in the role. A simple formula for life cover is a multiple of up to 10 times the key persons earnings with a lower figure considered for critical illness contracts.
- 2 Where the need for key person cover is to cover the profits of the business consideration needs to be given to whether their contribution is to gross or net profits of the business. An estimation of their contribution to profit is required and common formulas used are:
 - up to 2 x proportion of gross profit directly attributable to key person;
 - up to 5 x proportion of net profit directly attributable to key person;
 - (key person salary/total payroll for business) x gross profit x recovery period (max five years).

In all the above formulas an average of the last two years profit figures would routinely be used.

We can offer assistance in calculating the sum assured with our key person calculator available on our website.

WHAT HAPPENS IF THE KEY PERSON LEAVES OR RETIRES FROM A COMPANY, SCOTTISH PARTNERSHIP OR LLP?

If a key person were to leave or retire from a company, Scottish partnership or LLP before the end of the key person protection policy term. The business could do one of the following:

- Stop paying the premiums and the policy would then lapse.
- Continue paying the premiums until the end of the policy term and in event of a claim, the business would receive a capital sum.
- Assign the policy to the key person who then would become the legal owner of the policy and could then continue paying the premiums.

WHAT HAPPENS WHEN THE KEY PERSON IS A PARTNER WHO LEAVES OR RETIRES FROM A PARTNERSHIP?

The policy would automatically revert to the key person.

WHAT HAPPENS IF THE KEY PERSON IS AN EMPLOYEE OF A PARTNERSHIP OR A SOLE TRADER WHO LEAVES OR RETIRES?

If a key person were to leave or retire from the employment of a partnership or sole trader the trustees, as the legal owners of the policy, could do one of the following:

- Stop paying the premiums and the policy would then lapse.
- Continue paying the premiums until the end of the policy term. In the event of a valid claim, the trustees would receive the policy proceeds for the benefit of the beneficiaries of the trust.
- The beneficiaries could assign their beneficial interest to the employee. The trustees could then assign the policy to the employee so he becomes the legal owner of the policy. He may then wish to place the policy in trust for his own beneficiaries.

▶ WHAT ARE THE TAXATION EFFECTS?

Unfortunately, the Corporation Tax situation isn't so simple, since there is no direct legislation on the subject of key person policies. Companies should always consult their inspector of taxes before completion.

The principles were set out as long ago as 1944 by the then Chancellor of the Exchequer, Sir John Anderson. In answer to a Parliamentary question he made the following statement:

"Treatment for taxation purposes would depend upon the facts of the particular case and it rests with the assessing authorities and the Commissioners on appeal, if necessary, to determine the liability by reference to these facts. I am, however, advised that the general practice in dealing with insurances by employers on the lives of employees is to treat the premiums as admissible deductions, and any sums received under a policy as trading receipts, if (i) the sole relationship is that of employer and employee; (ii) the insurance is intended to meet loss of profit resulting from the loss of services of the employee; and (iii) it is an annual or short-term insurance. Cases of premiums paid by companies to insure the lives of Directors are dealt with on similar lines."

So provided that:

- 1 the sole relationship is employer/employee;
- 2 the cover is for loss of profits; and
- 3 the policy is a short-term assurance.

The company's tax inspector may allow Corporation Tax relief on the premium.

It's thought the tax inspector would not approve term assurance or Whole of Life policies longer than five years.

Where Corporation Tax relief has been given on the premium, the whole policy proceeds will usually be treated as a trading receipt of the company in the year of payment and fully liable to Corporation Tax.

It's not right to assume that electing to give up Corporation Tax relief on the premiums would result in tax free policy proceeds. The guidance of the company's tax inspector should be sought. A specimen letter is attached in Appendix 1. Please visit our website to download the specimen letter.

Key person cover shouldn't necessarily be restricted to policies where Corporation Tax relief on premiums may be available. It may be wiser to try and ensure that the policy proceeds are received free of tax. In any event if the sum assured is based on gross profits the fact that it's taxable doesn't matter.

TAXATION OF A PARTNERSHIP

In England and Wales, a partnership does not have a separate legal identity. Unless the partnership is in Scotland, where the partnership could own the life policy. The partnership would normally pay the premiums and tax relief as a business expense might be available.

If Her Majesty's Revenue & Customs agreed that premiums were a business expense, in event of a claim, the sum assured would more than likely be treated as a trading receipt.

CAN KEY PERSON PROTECTION BE EFFECTED ON A CONTROLLING DIRECTOR?

Yes, but the company's tax inspector will probably feel that the policy proceeds will be largely for the benefit of the life assured (because he owns a majority of the shares) and it is unlikely he would grant tax relief on premiums.

ARE THERE INHERITANCE TAX ISSUES?

A cash injection via policy proceeds will increase the value of the shares in the business. If the deceased key person was also a shareholder, the value of their estate would be increased. If the shares were passing to someone other than the spouse or registered civil partner, and business relief wasn't fully available, any Inheritance Tax liability may be increased.

CAPITAL GAINS TAX

A Capital Gains Tax liability may arise, in the event of the sale of an individual's share in the business due to a terminal or critical illness.

INCOME TAX

An Income Tax liability may arise from the potential reversion of the trust fund to a partner or sole trader. Where the business is a partnership, this could happen if the partner should resign or retire or otherwise cease to be partner, or the partnership should be dissolved other than as a result of the death of the partner. This is also known as Pre-Owned Asset Tax (POAT).

This would not apply to Companies or LLPs as the policies are not subject to a trust.

We strongly recommend that you consult your own legal or tax adviser before proceeding.

▶ TRUST INFORMATION FOR PARTNERSHIPS AND SOLE TRADERS.

WHY USE A TRUST?

A trust is a way of transferring the policy (the asset) for the benefit of either the other partners or the sole trader or the sole trader's family (the beneficiaries) without giving them full access to and control over it. The trust will also specify who you want to look after and control the asset (the trustees).

WHO IS A BENEFICIARY?

Where the business is a partnership, the beneficiaries would be the other partners in the partnership. Where a Legal & General Protection Gift Trust is used, it would depend on the type of trust used but normally it would be either the sole trader or their family.

WHAT IS A TRUSTEE?

A trustee is someone appointed to look after the asset(s) they are putting in trust (for example, their Legal & General business protection policy). The trustees are the legal owners of the trust assets. They must keep to the conditions of the trust, and act for the benefit of the beneficiaries of the trust. When the trust asset is a life assurance policy, in the event of the key person's death, the trustees will need to make a claim for the proceeds and ensure that these are passed to (or used for) the beneficiaries of the trust.

WHO CAN BE APPOINTED AS A TRUSTEE?

Normally the other partners or the sole trader's family could be appointed as the trustees. It is a good idea for them to be resident in the United Kingdom. Solicitors and accountants can act as trustees but they will charge for their services.

CAN THE KEY PERSON BE A TRUSTEE?

Yes, the key person can be appointed as a trustee.

CAN ADDITIONAL TRUSTEES BE APPOINTED IN THE FUTURE?

Yes, our trusts allow the appointment of additional trustees at any time. After the key person dies, the trustees will have the power to appoint additional trustees.

HOW MANY TRUSTEES SHOULD BE APPOINTED?

It is a good idea to have at least two trustees at any time. For this reason, it is normally sensible to appoint at least two additional trustees.

WHAT HAPPENS IF A TRUSTEE DIES?

If a trustee dies, the remaining trustees can still carry on but a replacement could be appointed. If the trustee was the last surviving trustee, their legal personal representatives will have the power to appoint additional trustees or take over as trustees themselves.

WHAT HAPPENS IF A TRUSTEE NO LONGER WANTS TO BE A TRUSTEE?

A trustee can retire from the trust with the consent of the other trustees, provided that there are at least two trustees following the retirement.

HOW DO THE TRUSTEES MAKE A CLAIM?

In the event of the key person's death the trustees will need to send the following items to Legal & General's Life Claims Department:

- Partnership Trust or Protection Gift Trust (and any subsequent deeds);
- The original policy document;
- An official death certificate.

THE ADDRESS TO SEND THESE ITEMS TO IS:

Legal & General Life Claims Department
City Park
The Droveaway
Hove, East Sussex BN3 7PY

Once the claim is accepted, the trustees will be paid by direct credit.

▶ INHERITANCE TAX ISSUES FOR POLICIES PLACED IN TRUST.

Periodic charge

An Inheritance Tax liability may arise on each 10 year anniversary of the creation of the trust. The charge is based on the value of the property in the trust, which is referred to as "relevant property". The value of the relevant property will be the value of the policy. The maximum rate of tax that can be charged on the relevant property is currently 6% of the assets over the nil rate band, less any chargeable transfers made in the seven years preceding the creation of the trust. A periodic charge may become payable where the key person dies and the value of the policy proceeds exceeds their available nil rate band.

Exit charge

An Inheritance Tax liability may arise where capital leaves the trust. For example, a charge may arise where the trustees pay the policy proceeds to a beneficiary following a claim. Different calculations are done depending on whether the distribution of capital occurs before or after the first 10 year anniversary of the trust.

Where an exit occurs during the first 10 years, the calculation is based on the values at the creation of the trust. Where the exit occurs between 10 year anniversaries, the calculation is based on the values at the previous 10 year anniversary. In either case, the rate of tax upon which the exit charge is based is a maximum of 6%.

QUICK CHECKLIST FOR THE PARTNERSHIP PROTECTION TRUST

Before sending the trust to Legal & General, have you

1. Dated the trust?
2. Completed the Settlor's details?
3. Completed the Additional Trustees details?
4. Inserted the name of the Partnership?
5. Completed the details of the application?
6. Crossed through mistakes (rather than using correction fluid) and have all parties initialled any changes?
7. Signed the trust and had those signatures witnessed?

Please note for sole traders using a Protection Gift Trust, please refer to the relevant Protection Gift Trust Technical and Completion Guide.

IMPORTANT NOTES.

We have written this guide to give general information about key person protection and placing business protection policies in trust for key people of partnerships and/or sole traders. It is not intended to replace legal advice. If the trust does not meet the key person's needs then they should talk to their legal and financial advisers.

We have based the information in this guide on our understanding of the laws relating to trusts and inheritance tax at the time of publication. Although we have made every effort to ensure that the information is accurate, we cannot take legal responsibility for any particular statements.

This guide is based on our understanding of current law and HMRC practice, which can change.

In preparing this guide we have assumed that only Legal & General's Partnership Trust or Protection Gift Trust is to be used in conjunction with Legal & General's business protection policies. We can also provide director's share and limited liability partnership share trust forms. The information in this guide does not apply to family protection. Legal & General have separate literature for family protection. Please see your financial adviser for more details.

▶ APPENDIX 1 SPECIMEN HM REVENUE & CUSTOMS LETTER.

Below is a letter which could be used as a guide for companies wishing to find out the tax position on a key person policy from the HM Revenue & Customs.

To: HM Inspector of Taxes

Dear Sirs

XYZ COMPANY LIMITED

The above company wishes to effect a key person policy on the life of **NAME OF LIFE ASSURED** for its own benefit. The type of policy chosen is a Legal & General **NAME OF CONTRACT** and will not acquire a surrender value.

Details of the contract are as follows:

Type of contract:

Sum assured £ payable on **death/death** or earlier terminal illness/death or earlier terminal illness and/or earlier critical illness/total permanent disability.*

Other benefits:

Term of policy:

LEVEL Annual/monthly premium: £

NAME OF LIFE ASSURED presently holds the position of **TITLE** within the company.

NAME OF LIFE ASSURED:†

- Owns none of the shares in the company.
- Owns **XXX**% shares in the company.
- Is a substantial shareholder in the company.
- The policy is to compensate the above company for the anticipated loss of profits if the service of **NAME OF LIFE ASSURED** were no longer available.

OR

- The policy is security for a loan/loans*, which will become repayable on the death of **NAME OF LIFE ASSURED** within the loan period of **X** years.

I would be grateful if you could confirm in writing whether the premiums paid under the above policy will be treated as a business expense for Corporation Tax purposes and whether the policy proceeds will be treated as a trading receipt or a non-taxable item on the capital account.

Yours faithfully

For XYZ COMPANY LIMITED

* Delete as appropriate

† Select as appropriate



The above is purely a draft and it is essential that professional advice is sought before any action is taken.



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