BUSINESS CONTINUATION - KEY PERSON INSURANCE

The departure of an individual who plays a substantial role in enhancing a company's profitability or stability can have a substantial effect on the company's continuous earnings and credit standing.

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Key person insurance safeguards a business by offering a one-time payment that can substitute for business income or capital in the event of a significant incident, such as the disability or death of a vital individual.

Benefits of business expenses insurance

The insurance payouts preserve the continued sustainability of the business and contribute to upholding the business's worth by supplying a lump sum that can be utilised for the following purposes:

- Offsetting a decline in revenue during the business's restructuring or while a replacement is sought.
- Meeting the expenses associated with locating and training a fitting replacement.
- Minimising or repaying debts.
- Safeguarding a personal or business asset used as collateral for a loan.

How it works

The success of businesses isn't primarily driven by tangible assets like land, buildings, machinery, inventory, or working capital. Rather, it hinges on the expertise of the individuals who utilise these assets effectively.

Key individuals represent the most invaluable asset a business can possess. Their departure, particularly if it occurs unexpectedly due to factors such as death, disability, critical illness, or injury, can disrupt not only their family's life but also the business and the lives of everyone involved in it.

Contingency plans for key individuals are created to supply the business with financial resources to mitigate the economic repercussions stemming from the disability or demise of a key figure. These funds can also be employed in conjunction with a business succession strategy, ensuring that the business can remain healthy even if a proprietor or key individual is unable to continue their role within the company. While this approach can help ensure the ongoing viability of the business for remaining owners, it should be noted that it doesn't replace the necessity for insurance to fund a Business Succession Agreement.

Who is a key person?

A key person is an individual who possesses the following characteristics:

- They are effective at accomplishing tasks. This person could hold positions like a manager, director, company secretary/chief financial officer, accountant, supervisor, foreman, or technical specialist.
- They cultivate goodwill. Their personal attributes and qualities instill trust, attract customers, and foster a loyal clientele. Goodwill elevates the business's worth and is crucial for sustained success.
- They enhance the business's creditworthiness. Their competence and efficiency often bolster the credit that suppliers and bankers are willing to extend to the business.
- They contribute to revenue, either directly through sales and client account management or indirectly through technical expertise that would be challenging to replace if they were to leave involuntarily.

What is the business impact?

The absence of a key individual can have significant repercussions on a business. Here are some examples:

- Revenue Impact: Revenues may decline, expenses may rise, and profits may be adversely affected. This could result in an immediate loss of income because existing contracts may go unfulfilled, and new contracts may be difficult to secure until a replacement is found.
- Time and Cost of Replacement: Finding a suitable replacement can be time-consuming and costly, and it may take months for the new person to become fully effective. During this transition period, business momentum can wane, and profitability may decrease, potentially giving competitors an opportunity to gain an advantage.
- Productivity and Cash Flow: Other members of the business may become distracted, leading to reduced productivity and increased pressure on cash flow.
- Liquidity and Credit Issues: Liquidity and credit can be adversely affected. Creditors may demand payment quickly, debtors may delay payments, and lenders may be hesitant to extend credit to a business that has lost a key person.
- Impact on Goodwill and Credit: Goodwill and credit are closely intertwined; the loss of one often leads to the decline of the other. Businesses frequently require immediate cash for financial stability.
- Obligations to Key Person: Proprietors may feel obligated to continue compensating the key person, especially if they are a proprietor themselves or a highly valued employee.

To safeguard the business in the short term, it is advisable to have insurance coverage for key personnel to provide sufficient funding to offset the loss in revenue or the impact on the business's profit and loss account. This coverage may encompass:

- Compensation for the reduction in revenue or profits.
- Provision for the costs associated with recruiting and training a replacement.
- Additional ongoing business expenses, such as outstanding projects and general overhead.
- This insurance provides the company with the financial flexibility needed to restructure for the future without the strain resulting from reduced revenue due to the absence of a key person due to factors like death, disability, critical illness, or injury.
- Furthermore, businesses may choose to safeguard their balance sheet by ensuring they have adequate funds to cover capital costs or losses, such as:
- Compensation for the loss of goodwill.
- Funds for debt repayment.
- Costs associated with preserving the business's capital rating and capital structure.

Insurance Policy Ownership

Key person insurance coverage can take on either a revenue-oriented or capital-oriented nature, and the intended purpose of the coverage has implications for policy ownership and related taxation considerations.

KEY PERSON REVENUE

If the objective of the insurance policy is to safeguard the revenue stream of an entity, it is typically owned by that entity. The premiums paid for this policy are usually tax-deductible for the entity, and any claims proceeds received are considered assessable income.

KEY PERSON CAPITAL

In cases where the insurance policy serves a capital purpose, such as repaying a business debt or offsetting the loss of goodwill, the policy is typically owned by the entity that bears the debt or the loss (e.g., goodwill). Premiums for this type of policy are generally not tax-deductible, and the claims proceeds are not typically assessable from an income tax perspective.

However, it's important to note that there might be Capital Gains Tax (CGT) implications that should be taken into account. Life insurance policies, including Total and Permanent Disability (TPD) and Trauma policies, are considered CGT assets, and when a claim is paid out, it is viewed as a disposal of the asset. To receive the claims proceeds CGT-free, the policy owner must satisfy the relevant CGT exemption criteria.

LIFE INSURANCE

To qualify for the CGT exemption for Life Insurance, the policy owner must either be the original owner of the contract or have acquired the rights to the contract for no consideration. This ensures that any claims proceeds received do not trigger Capital Gains Tax liabilities.

Key Considerations

- The tax treatment of premiums and claims proceeds for key person insurance hinges on the business structure and the intended purpose for holding the insurance. It is crucial to document the purposes of the policies in the business meeting minutes and review and record this information annually.
- Before implementing key person insurance, it's advisable to consult with and obtain confirmation from your solicitor and/or accountant regarding the ownership of the policies. They can provide guidance on the most suitable ownership structure based on your business's needs and objectives.
- Always make sure to thoroughly read and understand the Product Disclosure Statement (PDS) and the policy document for the insurance policy you select. Keep these documents in a secure location for reference and easy access when needed. This helps ensure you are well-informed about the terms and conditions of your insurance coverage.

References

You may wish to refer to the following websites for further information about key person insurance:

- www.moneysmart.gov.au
- www.ato.gov.au