Key person protection

Effective and well trained staff, especially those with specialist skills or knowledge, is vital to a business's success. If such an employee were to die or become disabled tomorrow, what would be the cost to that business?

The risk – upon the death or disability of the key person

Losing a key person could mean increased costs for recruiting and up-skilling, a slowdown in turnover and stricter terms from suppliers. In addition this loss could lead to difficulties in raising finance, having to pay back loans, delays in finding a successor and time lost during the settling-in period.

The solution

Key person protection is an arrangement where an employer insures the life of a key employee for the purpose of compensating the business for the loss of income it would suffer in the event of that employee's death or disability. The benefits received upon the death or disability of the key person can then be used to absorb disruptions to the business, protect credit facilities and provide funds to recruit and train a replacement.

Who is the key person in the business?

Anyone who significantly improves or contributes to the profitability and effective management of the business could be considered a "key person". For example: anyone with specialist, expert skills vital to the success in that industry, someone whose presence in the business increases the creditworthiness of the business or someone who builds goodwill for the business, etc.

How to calculate the value of the key person?

In practice, the amount of cover that a business should take out on the life of a key person is usually determined by a combination of the following methods:

- The estimated number of years that it would take for a replacement to reach the key person's present level of profitability, multiplied by the drop in profits as a result of the death or disability of the key person; or
- Itemising the actual costs involved in replacing the key person.

Benefits to the business

On the death or disablement of the key person, the lump sum payment from the life insurance policy will provide cash to ensure that:

- Funds are available for recruiting/training/ development of a replacement;
- The business and its development can continue seamlessly; The creditworthiness of the business is not affected; and
- Premiums may be tax deductible or proceeds may be tax-free.

for your financial wellness

momentum

V 04/2017

Key person protection

Technical information

Income tax implications on premiums paid

If all the requirements of section 11(w)(ii) of the Income Tax Act are met the premiums paid on this policy will be tax deductible. The requirements are as follows:

- The taxpayer (policyholder) is insured against any loss by reason of death, disablement or severe illness of an employee or director; and
- The policy is a risk policy without a cash value; and
- The policy is owned by the taxpayer at the time of paying the premiums; and
- The policy agreement states that section 11(w)(ii) applies to the premiums payable under the policy.

Income tax implications on the proceeds paid

If one of the abovementioned requirements is not complied with, the proceeds will pay out tax-free. An exemption in terms of section 10(1)(gH) will apply.

If all the requirements of section 11(w)(ii) are met, the proceeds will be included in the taxpayer's gross income under paragraph (m) of the gross income definition.

Estate duty implications in respect of the policy proceeds

In terms of section 3(3)(a) of the Estate Duty Act, policies on the life of the deceased owned by a third party will be a deemed asset in the estate of the deceased, for estate duty purposes. However, section 3(3)(ii) provides for an exemption if all the above requirements are met:

- The policy was not effected at the instance of the deceased;
- No premium was paid by the deceased in respect of the policy;
- No amount due under the policy will be payable to the estate of the deceased; and
- No amount will be paid or utilised for the benefit of:
  - any relative of the deceased;
  - any person who is dependent on the deceased;
  - any company that is a family company* in relation to the deceased.

Should the proceeds be subject to estate duty, a deduction against the proceeds will be allowed equal to all premiums, plus 6% interest, if paid by a third party that is entitled to the proceeds.

Note – SARS publishes a guide in respect of the estate duty implications on key person policies in 2008 and this guide suggests that a resolution be passed by the business taking out the key person policy to substantiate the abovementioned requirements.

* A family company is defined as a company other than a quoted company which at any relevant time was controlled or capable of being controlled, directly or indirectly, by way of majority holding or shares or any other interest or in any other manner by the deceased or by the deceased and one or more of his/her relatives.

A relative in relation to a person is defined as the spouse of that person or anybody that is related to him/her or his/her spouse within the third degree or the spouse of anybody so related.