

Key Person Protection

Protecting your business against the unforeseeable loss of human capital

Business owners generally understand the need to protect their business against unforeseeable risks that may have a significant impact on their ability to do business. Still, a number of business owners fail to protect one of the most important assets of their business: their key persons.

Who are Key Persons?

For small business owners and those in the early stages of business, identifying key persons is quite simple. Usually it's the owner or co-owner of the business. However, as the business grows in size and cash flow, other key persons will evolve. These individuals will have considerable technical knowledge, experience and expertise in the particular nature and relationships of the business, thus making them invaluable to the business.

How the loss of a Key Person impacts a business

The loss of the owner and other key persons can significantly impact the profitability, stability and progress of a business. During the disruption that may result from their demise, employees and customers may lose confidence in management, creditors may demand for payment, other key employees may be enticed to look for other career opportunities, and lenders may be less willing to provide credit. Key persons, particularly in small businesses are not readily replaced, and the delays in recovering from their loss can be catastrophic.

Assessing potential losses

Assessing the potential losses associated with the departure of a key person is specific to the size and nature of the business. These losses might include:

- The costs associated with hiring, contracting, and training an interim replacement.
- The costs incurred searching, interviewing and ultimately training a permanent replacement.
- The loss of productivity or revenue.
- The reduction or retraction of credit lines from lenders and suppliers.
- The calling in and retiring of business loans.
- The increase in debt servicing charges.

Protecting against loss

Most businesses have difficulty retaining their key person risk, as they simply do not have the cash flow or available credit to endure the losses and credit retrenchment. Consequently, many businesses choose to transfer this risk through the purchase of life, disability or critical illness insurance.

KEY PERSON LIFE INSURANCE

This involves the purchase of an insurance policy on the life of the key person. In the event of the key person's death, the insurance policy proceeds provides the much needed cash infusion of capital to keep the company going, and it funds the expense of searching for and training a competent replacement. Key person life insurance provides cash to buy time for the business to

recover from the loss of the deceased. **Life insurance premiums paid by a business for key person insurance protection are not deductible for tax purposes.**

Supplementary benefits of key person life insurance are:

1. The cost of key person insurance is low in relation to the value to the business in the event of the death of a key person.
2. In the case of a private corporation that receives insurance proceeds as a consequence of death, the excess of the proceeds over the adjusted cost base of the policy credits the capital dividend account of the corporation and permits the payment of tax-free capital dividends, to the extent of any balance in the capital dividend account. (*The capital dividend account is a notional corporate account where untaxed gains can be distributed to shareholders or owners tax-free*).
3. It improves the ability of the business to attract and retain executive talent, particularly if a reverse split dollar arrangement is employed. This strategy involves the use of a permanent life insurance policy. Under this arrangement, the key person would control the cash values of the policy, and thus would be responsible for paying the savings portion of the insurance premiums. The company would control the death benefit portion of the policy to fund its key person requirements, and its premium commitments would likely be tied to the equivalent of term insurance rates for comparable coverage (**see Split Dollar Insurance Arrangements article**).

KEY PERSON DISABILITY INSURANCE

Disability insurance is an insurance policy that covers an individual's ability to produce income. Most policies include coverage for residual disability, which means that the disabled individual can still perform the material and substantial duties of their occupation; presumptive disability, which means that the individual has suffered loss of sight, speech, hearing or any two limbs; and recurrent disability, which means that the individual has recovered from one disability, and then another one occurs.

Key person disability insurance can be utilized in two ways:

1. To provide salary continuation to the key person in the event of disability; or
2. To provide the business owner with an income stream to cover office salaries and expenses during the period of disability, usually for a finite time.

KEY PERSON CRITICAL ILLNESS INSURANCE

Critical illness insurance covers the risk of the insured person suffering from long-term ailments. These long-term ailments do not necessarily render them disabled but nonetheless affect their productivity or their desire to work to the same extent as they did prior to becoming ill. Death does not need to occur for a payout to be made by the insurance company.

Key person critical illness will pay a lump sum, or in some cases provide an income stream to the business to help cover losses created by the absence or lower productivity of a key person.

If you have any questions or require clarification on any of the issues discussed in this document, do not hesitate to discuss these with us.



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