Key-person Insurance – How to treat for corporation tax purposes

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Advice that adds up

The issue of tax deductibility of key-person insurance premiums and the taxability of key-person insurance proceeds has been (and still remains) open to debate and there are numerous tax cases which have attempted to give an answer one way or another.

Before automatically assuming that the premiums are allowable or not (or the proceeds are taxable or not), enquiries into who is the beneficiary, their relationship to the company, and the exact reasons for the policies will be extremely important in order to determine the correct treatment for corporation tax purposes.

Key-person insurance premiums

Premiums paid under a key-person policy, to compensate the company for the loss of profits arising under a "key" director's death, may be allowed. If a deduction is taken, HMRC will likely seek to tax any proceeds paid out under the policy as a trading receipt (but see more on this below). HMRC's Business Income Manual states that premiums will be allowable provided:

a. the sole relationship is that of employer and employee;
b. the insurance is intended to meet the loss of trading income arising from the loss of the employee's services;
c. the policy is a short-term temporary assurance (long-term temporary assurances are allowable if they expire before the expected retirement date, i.e. they do not extend beyond the period of the employee's usefulness to the company).

HMRC are likely to challenge a deduction where the premium relates to a policy taken out for a director where he or she, or members of his or her family, hold a substantial shareholding interest in the company. Arguably, the fact that the shareholders might indirectly benefit should not be relevant, although HMRC would have grounds for disallowing the premium if it was shown that the policy was taken out to protect the shareholders rather than the company's trade. Provided the purpose is to protect the company from loss of profits, the premiums may be deductible even if the shareholders might also benefit.

However, this approach was not followed in Beauty Consultants Ltd v HMIT (2002) Sp C 321. The Special Commissioners held that no relief was available for premiums on a policy taken out to pay the salary of a manager if one of the company's two shareholder-directors died. Although the policy would make up additional trading expenditure (of the manager's salary), it was found that the shareholders would also benefit since the value of their shares would be maintained – this was considered to be a "subconscious purpose" although there was no direct evidence that this was a factor in paying the premiums.

In addition, HMRC will disallow premiums where the policy is required to provide collateral security on a loan taken out by the company. HMRC's argument is that the premium represents a capital cost of the borrowing.

Parliamentary statements in 1944 indicate that if the key-man insurance premium is not allowable (as a matter of law), any proceeds received under the policy would not be taxed as a trading receipt (Hansard, 27 July 1944 and 1 August 1944, Vol. 402, Cols 890, 1162). However, given that these statements were made over 50 years ago, their authority is perhaps less persuasive now. The Hansard statement does not go as far as to suggest that the proceeds will be tax-free if no trading deduction is actually claimed, so it is not sufficient to merely disallow the premiums in the hope that insurance receipts are non-taxable.

Key-person insurance proceeds

The treatment of key-person insurance proceeds, as a general rule, follows that of the premiums. If the premiums cannot be deducted, the receipts under that policy are not taxed as trading income.

However, HMRC take the view that the proceeds may represent a trading receipt even though the premiums are not allowed (Simpson (HMIT) v John Reynolds & Co. (Insurances) Ltd (1975) 49 TC 693, IR Commrs v William's Executors (1994) 26 TC 23 and Keir & Cawder Ltd v IR Commrs (1958) 38 TC 23). These cases provide clear authority for taxing the proceeds of a key-person insurance policy. The basic principle applied is that receipts to compensate for the loss of (trading) profits are generally trading income.

In William's Executors, a company took out an extra policy on the life of a director who was also a 35% shareholder. The evidence given before the Commissioners indicated that one of the reasons for taking out the insurance was that the company's business would suffer in the event of the director's death. Thus, as the purpose of the policy was to compensate for the loss of profits by reason of the director's death, the proceeds were trading receipts. It was also found that the director's family would not get much for his shares and that the object of the insurance was not to cover any temporary loss. Unfortunately, that evidence did not help and the Revenue won the case. This was a unanimous decision of the House of Lords and therefore carries substantial weight.

However, it can be argued that the proceeds should not be taxable where the purpose of the policy is to provide funds for the company to purchase the deceased shareholder's shares (normally at their "fair" market value). This can be distinguished from the above cases, since the purpose would not be to "fill" a loss of trading income.

Thus, in Greycon Ltd v Klaentschi (HMIT) (2003) Sp C 372, the Special Commissioner placed more emphasis on the directors' purpose in taking out the policy rather than inevitable "hole in profits" analysis. It was held that the proceeds from the whole of life policies taken out on the life of a "key" director shareholder were not a taxable trading receipt but that of a "non-taxable" capital nature.

Conclusion

The key (pun intended), therefore, is to be mindful of the particular facts and circumstances in each case. Quite often there is no clear-cut answer and due care is advised when preparing the corporation tax computations of a company that pays key-person insurance premiums.

Ultimately, as much of the HMRC guidance in this area has not been legislated, the treatment of premiums paid and proceeds received is at the discretion of the local tax office and it would be up to the taxpayer to defend the position taken should HMRC ever enquire.

We would therefore recommend that, before you prepare your corporation tax computations, you look carefully at the terms of the policy, who is covered, what their relationship is to the company, as well as keeping hold of evidence detailing the reasoning for taking out the policy in the first place.

If you would like further advice on the above, please contact Nikhil Oza: nikhiloza@lubbockfine.co.uk

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