

Keyperson Insurance

When running a business, it is vital to consider and plan for events that could adversely affect its success. In particular, it is important to consider the implications to a business of the sudden death or serious illness of a vital employee – a key person in the business.

In this issue of TechTalk, we examine how the company arranges life insurance to protect the company should a key employee die or suffer a serious illness.

Who is the Keyperson and what are the implications?

A Keyperson is an employee whose expertise, knowledge, and contacts are vital to the continued financial success of the company. Their death or serious illness could put the company in a financially unstable position, in a number of ways:

- An interruption of business activity and a consequent reduction in profits.
- Bank loans on which the deceased gave a personal guarantee may be called in.
- The Keyperson or his/her estate may be owed any loans made by him/her to the company.
- Banks and/or suppliers may reduce or withdraw credit facilities over worries about the future profitability of the business.
- The company will lose the individual's expertise and business contacts.
- The company may have to commit resources to find a suitable replacement. This may be a prolonged process where the individual has unique experience and expertise.

Keyperson Insurance assists the survival of the company on death or diagnosis of a serious illness of a 'key' employee by compensating that company for any anticipated financial loss in the event of either of these events.

The purpose of Keyperson Insurance is not to improve the financial situation of the company and increase its value. It is meant to indemnify against loss of profits and repay loans on the death of a key individual.



Setting up Keyperson Insurance

Setting up Keyperson Insurance on the life of a key individual works as follows:

- The decision to set up an insurance policy for the purpose of Keyperson Insurance should be made and minuted at a board meeting. This resolution should clearly show that the intention of the company in setting up the policy is to protect against losses in the event of the death or serious illness of a Keyperson.
- The company takes out a policy on the life of the Keyperson for the amount required to protect against losses. A director of the company signs the proposal form 'For and on behalf of' the company – ideally this should be a different person to the individual covered. The Company's seal should be affixed to the proposal form over the signature of the director.
- On acceptance by the life office, the company pays the premiums and the Keyperson is on cover. A Keyperson financial questionnaire will generally be required by the life office before they will accept the policy.

Quantifying the cover

The amount of cover required on the life of the Keyperson is the estimated potential loss the company would incur if that Keyperson was no longer available.

There are two key areas which need to be addressed by the company, which are (a) the potential loss of profits and (b) what loans may need to be repaid.

(a) Loss of Profits:

- The impact on profits of losing a Keyperson will need to be assessed. There are various approaches to calculating this:
 - Multiple of profits – a general rule would be a maximum of 2 x gross profits, or 5 x net profits.
 - Multiple of remuneration – a maximum of 10 x salary would be allowed for life cover only, it would be 3 to 5 x salary for serious illness cover.
- It is recommended to seek independent professional advice from the company's accountant or financial advisor in assessing the level of cover required.
- The cost of hiring a replacement should also be considered. The longer the recruitment process, the higher the cost to the company.

(b) Loans that may be repaid:

- The sum insured can also cover any loans that the Keyperson has made to the company, which will have to be repaid to his/her personal representative(s).
- Any company loans that the Keyperson has personally guaranteed may have to be repaid and should also be considered.

Payment of Premiums:

The premiums are not necessarily admissible deductions for tax purposes. In order for the premiums to be tax deductible, Revenue have outlined the conditions that must be met, for the premiums to qualify for tax relief:

- The relationship between policy owner and the life insured is that of employer and employee. Revenue have confirmed employee is taken to include director also.
- The employee has no substantial proprietary interest in the business, which would generally mean he/she controls less than 15% of the ordinary shares in the company.
- The insurance policy has been effected for loss of profits only (e.g. not for loss of goodwill or to cover repayment of loans).
- The policy is short-term, i.e. the policy cannot extend beyond the employee's likely period of service with the employer. Revenue clarified that if the premiums are an allowable deduction for tax purposes, the proceeds will be liable to tax. If the premiums are not allowable deductions, the proceeds are not liable to tax. It may be advisable that the company taking out the Keyperson Insurance writes to the Revenue Commissioners to clarify the position regarding the tax treatment. A sample letter which can be used is available on the broker centre.

While the allowability of a premium or the chargeability of a benefit are strictly separate issues, it will usually be the case that, if the premiums are allowable for tax purposes, the benefit is chargeable to tax and, if the premiums are not allowable, the benefit is not chargeable.

Therefore if it is perfectly clear from the circumstances that the sole purpose in effecting the key person insurance policy is capital in nature, i.e. to enable the company to pay off a loan in the event of the death of a key person, then the premium is clearly not deductible for tax purposes.

Therefore the proceeds of the policy payable on death or surrender would, under current Revenue practice and law, be treated for tax purposes as a capital rather than a taxable trading receipt. Section 593 of the TCA 1997, exempts the proceeds of life assurance policies from capital gains tax, where the policy has remained in the beneficial ownership of the Company throughout. No tax liability on the proceeds should therefore arise under current legislation.

The above refers to the payment of policy proceeds in the event of death or disablement of a keyperson.

Here once the proceeds are treated as a capital as opposed to a revenue receipt for the Company the proceeds will be exempt from capital gains tax on death or disablement.

Keyperson & Serious Illness cover

Serious Illness cover can also be incorporated into a Keyperson Insurance arrangement, however there are a few points which would need to be considered.

- Serious Illness cover would be put in place to cover any anticipated loss suffered by a company should the Keyperson suffer a serious illness, as covered by the life insurance company.
- As per the above, there are maximum amounts of cover which would be allowed, i.e, as a multiple of remuneration, a maximum of 3 to 5 x salary for serious illness cover.
- Stand Alone cover is not permitted as this would lead to over-insurance and the expectation would be that there would ever only be one payout. Any policy incorporating serious illness would be set up on an accelerated basis.
- As there would only be one payout, this would lead to the same amount of life cover and serious illness cover being covered by the policy. The following is an example of how serious illness impacts on a policy.

- (a) Company takes out a policy of life and serious illness cover on a Keyperson in the company.
- (b) The Keyperson's remuneration is €50,000 a year, so the maximum cover would be €250,000 life and serious illness, as the maximum serious illness is 5 x remuneration.
- (c) In the duration of the Keyperson's employment, he/she suffers a serious illness and the company makes a successful claim to the insurer.
- (d) €250,000 serious illness claim is paid out and the policy then ceases, nothing is paid out on death.

Keyperson Insurance and Family companies

In many cases, a company may consist of only one person and this may have implications where Keyperson Insurance is applied for.

Where a Keyperson is the sole director in a company, in the event of him/her dying the shares held will pass to their spouse, giving their spouse full control of the company. So in effect the Keyperson Insurance policy is protecting the spouse, rather than the company itself.

In the event of a payout under Keyperson Insurance, the money is paid to the company and if the surviving spouse makes any withdrawal from the company, it will be liable to income tax.

It may be more prudent therefore if the Keyperson takes out personal cover so that in the event of his/her death, the money is paid to his/her estate and the surviving spouse inherits the sum insured tax free.

Steps in setting up Keyperson Insurance

When advising clients on setting up Keyperson Insurance, the following are some suggestions as to how to approach it.

- If the company directors have not already done so, they need to call a board meeting in order to pass a resolution that a policy of life insurance will be taken out on the life of the key person in the company.
- The name of the Keyperson will need to be recorded and the reason for the life cover to be taken out i.e. whether it be to cover any potential loss of profits, repayment of loans or a combination of both. If any legal queries arise, the company solicitor should be consulted.
- If queries about the the level of life cover required arise, the company accountant may be consulted to help determine the monetary value of the Keyperson's contribution to the company.
- The application for Keyperson Insurance is completed with the company as the policy owner.
- The Keyperson is the life insured so the health questions would need to be answered by that Keyperson and the application signed by the Keyperson as life insured.
- A senior figure in the company signs the application 'for and on behalf of' the company. If a company seal is available, this may be used on the application.
- If there are more than two 'Keypersons' in the company, there is the option to take out two single life policies or one dual life policy, owned by the company.

Ensure that all the correct documentation accompanies the application, outlined in the table below.

Life of Another
Application Form
Financial Questionnaire (if applicable)

Conclusion

In the same way as a company insures itself against loss of profits from damage to its plant and machinery, Keyperson Insurance allows a company to protect itself against financial strain in the event of the loss of a person who is key to the business.

Further Information?

If you would like to discuss any issues raised in this article or if you need to discuss any particular case you may have, **contact the TechTalk Team on 01 209 2020 or techsupport@zurich.com**

Zurich Life Assurance plc

Zurich House, Frascati Road, Blackrock, Co. Dublin, A94 X9Y3, Ireland.

Telephone: 01 283 1301 Fax: 01 283 1578 Website: www.zurich.ie

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