

Key man insurance

(Lecture P1222 – 16.20 minutes)

There are two aspects when we are looking at key man insurance taken out by a company to insure the life of a key employee or director. The first is the deductibility of the premiums for the company. The second is the potential benefit in kind on the individual whose life is insured.

Whose name is the policy in?

The first issue to consider is the practical side of things.

Who has taken out the policy, who is insured and who will receive the money in the event of a pay-out? Only then can we start to consider the purpose of taking out the policy and what the tax impact is. It is also true to say that the impact of getting the paperwork right is not always acknowledged which means that mistakes are made.

This was demonstrated in the case of *Macleod and Mitchell Contractors Ltd v R&C Commrs* where HMRC were trying to tax the value of premiums paid by the employer on insurance contracts that had been erroneously taken out in the name of the employee. The Upper Tribunal agreed that there was evidence that there had been a mistake and that HMRC were wrong in taxing the premiums but the First Tier Tribunal had not been so forgiving. This case will be considered further below.

The tax impacts

This will be considered assuming that there is a company involved although the basic questions are the same.

The main difference would be that an insurance policy taken out for the proprietor of an unincorporated business would always be disallowed as private expenditure but no benefit issues arise.

There are two issues to consider.

1. Are the premiums allowable for the company?
2. Do any tax implications arise for the person whose life is insured?

Are premiums allowable?

The HMRC guidance at Business Income Manual para.45525 is fairly clear on the conditions that have to be met for premiums on insurance policies to be deductible (but of course, this is HMRC's view, rather than the legislation which would simply require the expenditure to be wholly and exclusively incurred for the purpose of the trade).

The Manual states that the sole purpose of taking out the insurance must be the trade purpose of meeting a loss of trading income that may result from loss of the services of the key person.

BIM45530 lists some non-trade purposes for its inspectors to look for including where:

- benefits under the policy exceed sick pay arrangements, or other employee benefits, typically offered to employees of equivalent status in similar concerns;
- the key person is a major shareholder in the trader such that a purpose of the trader entering into the policy is to protect the value of its shares;
- there is an investment purpose; for example, where the policy has a surrender value. A policy has a surrender value where a cash payment will be made to the policyholder if the policy is terminated prior to maturity. Whole life and endowment policies are most likely to have a surrender value;
- the term of the policy extends beyond the period of the employee's usefulness to the company; or
- the policy is taken out as a condition of securing long-term finance.

Some of these issues were considered in the case of *Beauty Consultants v Inspector of Taxes*, which is a Special Commissioners case from 2002. It was found that the premiums were not paid wholly and exclusively for the purposes of the company's trade for a variety of reasons:

The first two policies were on the life of each of A and B, the two directors of the company, and were taken out a number of years before the company was formed. The policies related to the directors' ownership of their private residence – the only connection between the company and these policies was that the bank lending to the company had a second charge on the house.

The third policy was in the name of the director and linked to a first charge on the property used as business premises and meant that the directors' preference shares would be repaid on the sale of the business premises. The policy monies were in excess of the secured debt and would belong to the directors so the Special Commissioners could not identify any benefit to the company or its trade in paying the premiums.

The fourth policy was taken out by another company of which A and B were shareholders and directors but had been assigned to *Beauty Consultants Ltd* at the time A and B became involved in that business so it was found the policy had a dual purpose as the policy benefitted the directors by improving the value of their shares.

The upside to disallowing the premiums is that HMRC acknowledge that the receipt is not going to be a trading receipt for the company and so might not be taxable. However, the Business Income Manual does state that 'no assurance can be given that any future receipt will be excluded from trading income even though the premiums are not allowable'. What is not in dispute is that if premiums are allowable, then the receipt will be taxed.

There is a 2003 case involving a company called *Greycon Ltd* where proceeds from a series of key man insurance policies was found to be capital in nature. The intention of the company in taking out the policies was to fill the hole in the profits arising from the director's death but they were taken out as part of an agreement with an investor and as a condition of that agreement. The immediate and conscious purpose was to obtain the benefits of that agreement which were of a capital nature unconnected with any potential loss of profits.

The policy monies were not, therefore, part of the trading profits. HMRC do not accept that this is a precedent for treating all key man insurance policy proceeds as capital in nature.

Is this taxable on the employee?

There are various different possibilities here and again, it is not straightforward.

If the policy is taken out by the individual and any receipt paid directly to him (or his estate), then the payment of premiums by the employer is the meeting of the pecuniary liability of their employee. This is taxable as remuneration under s62 ITEPA 2003.

If the policy is taken out by the employer and any receipt is to be paid to the individual (or his estate) then it is a benefit in kind which would need to be reported as such with the relevant tax consequences arising from that.

The receipt by the individual in that situation should not itself be taxable.

If the policy does not allow for payment to the individual directly, then it may be that no benefit in kind would have arisen as the receipt would have been intended to be retained by the company. However, if the intention is for the money to be used in a particular way, such as repurchase of shares, then you would need to consider again whether a benefit does arise to the employee but then it may be a case of proving the intention at the time the policy was taken out. If the company has some discretion over what it is going to use the money for, then it may be difficult for HMRC to assume that there is a benefit charge on the employee.

This leads us on to the question of what happens if money is paid out of the company following receipt of the proceeds. Once again, it will depend on how it is paid out.

Payments under transactions such as purchase of own shares would be considered on their own merits as to whether capital treatment would apply. This is something that is seen commonly when a person has died; the insurance pay-out is allowing the shares to be repurchased from the estate.

If the payment is made under a critical illness policy and is then paid out to the employee, then HMRC would probably want to tax it as employment income. There is an exemption from employment income where compensation is paid on termination of an employment due to injury or disability. This can be following a period of physical or mental deterioration but note that ageing is not a disability. This is why payments can normally be paid out to employees under these types of policies without any tax being paid. It does have to be the sole reason that the money is being paid out but given the nature of critical illness policies (there has to be good evidence of the ill health) then normally that is not an issue but if the insurance policy is excessive compared to any put in place for comparable employees, then there might be more of an argument.

A payment which is not paid out due to termination of employment due to injury or disability but is being paid on termination could be taxed as a payment under an unapproved retirement benefit scheme as it is paid 'on or in anticipation of retirement' so would be taxed as employment income even if it cannot be shown to be normal remuneration.

Of course we might then have an argument about whether that payment is wholly and exclusively for the purposes of the trade, and whether a deduction would be allowed for the company. It would be hoped in this situation that the receipt is taxable but there is a deduction for the amount paid out to the employee. This risk is increased if no BIK has been declared on the policy but the amount paid out is excessive.

Other thoughts

This issue often arises when a company is about to encash a policy of this type and have not really ever thought about what the tax implications would be in that case. I have had a couple of cases in the past where we have got HMRC to accept that we could disallow premiums retrospectively so that a receipt under a key man policy was not taxable. In both cases the money was then used to repurchase shares from the estate of a deceased shareholder. But those cases were probably 15 years ago (if not more!) and it was a different regime then and we were talking about five years' premiums at most in each case.

However, the case referred to at the beginning is a good example of the Courts being more realistic about these situations. In that case, the taxpayer was the sole director and shareholder of the company, which had paid insurance premiums relating to life insurance, critical illness and income protection policies which were all in the name of the taxpayer. The issue for the appeal was whether the premiums should be treated as earnings for the taxpayer.

When the taxpayer took out the insurance policies he had intended them to be in the name of the company and had left the details to a financial advisor. However, the taxpayer confirmed that he had received copies of the final policies which clearly stated that they were in his name. The error did not come to light until copies of the policies were requested by HMRC in a PAYE audit in 2013.

The Tribunal concluded that, although the intention was to take out the policies in the name of the company, they were actually taken out in the name of the taxpayer. Therefore, as the payment of the premiums counted as money's worth under s62 (2)(b) ITEPA 2003, the amounts were earnings from employment and subject to income tax and NIC. The appeal was therefore dismissed. The taxpayer appealed.

The first question was whether the transactions in question had conferred a profit or benefit upon the taxpayer that had derived 'from' his employment. It was held that the First-tier Tribunal had erred in law in that it had failed to focus correctly on the critical questions, namely whether there had been any real benefit to the taxpayer from the payment of the premiums and, if there was, whether it had arisen from his employment.

On the facts found both questions ought to have been to be answered in the negative. The First-tier Tribunal had misdirected itself in treating MMCL's intention as an irrelevant consideration. It was well established that the purpose of an employer in granting a benefit to an employee was an important factor in determining whether it was properly to be regarded as a reward or return for the employee's services. The First-tier Tribunal had further erred in failing to take proper account of the fact that the taxpayer had been a fiduciary and that, as soon as he became aware that he was the policyholder, he had an obligation to account to MMCL for the policies and any proceeds and to assign the policies to MMCL if and when it demanded it.

The second question was whether the continued payment of premiums until the assignation were earnings chargeable to income tax and NIC. MMCL had not intended to bestow the benefit of those payments on the taxpayer as a reward or return for his services as an employee or officeholder.

On the contrary, the intention from the inception of the policies until the assignation had always been that MMCL would be the beneficiary of the policies and of the policy premiums.

The discovery of the error had not altered that. The assignation had been a mechanism to confer title to the policies upon MMCL to reflect what had always been the parties' objective. The continued premium payments had been made in order to provide the benefit of insurance cover to MMCL, just as they had been before the error had been discovered. They were not a reward, return or remuneration for the taxpayer's services to the company nor were they earnings from his office or employment.

The appeal was allowed.

Contributed by Ros Martin