Business Protection

Taxation of key person policies

This communication is for intermediaries only. It mustn't be distributed to, or relied on by, customers.

The information is based on our understanding of current taxation law and HM Revenue & Customs (HMRC) practice, which may change.

Before a company takes out a key person policy, it may be important for it to know whether the policy payments will qualify for corporation tax relief or if the proceeds on a claim will be tax free.

There's no direct legislation covering this subject, but the principles applying were set out in 1944 by the then Chancellor of the Exchequer, Sir John Anderson:

'Treatment for taxation purposes would depend upon the facts of the particular case and it rests with the assessing authorities and the Commissioners on appeal if necessary to determine the liability by reference to these facts. I am, however, advised that the general practice in dealing with insurances by employers on the lives of employees is to treat the premiums as admissible deductions, and any sums received under a policy as trading receipts, if (i) the sole relationship is that of employer and employee, (ii) the insurance is intended to meet loss of profit resulting from the loss of services of the employee and (iii) it is an annual or short-term insurance. Cases of premiums paid by companies to insure the lives of directors are dealt with on similar lines.'

These principles have come to be known as the 'Anderson rules'.

HMRC guidelines

You can find these in HMRC's Business Income Manual at BIM 45525, 45530, and 40751. You can also access them at gov.uk/hmrc-internal-manuals/business-income-manual

General comment on the 'Anderson rules'

The important point here is that the tax treatment of policy payments and proceeds can never be guaranteed. The statement needs to be carefully analysed – **'depend upon the facts of the particular case'**, **'rests with the assessing authorities'** and **'the general practice in dealing with'**. In other words, each case must be looked at on its own merits and will also depend on the local Inspector of Taxes, whose practices will vary between offices.

It's a myth that if tax relief is given on the way in, the proceeds are taxable on the way out and vice versa. In actual fact, each case is determined on its merits – see BIM 40751.

The 'Anderson rules' in detail

The rules need to be examined in detail to determine the tax consequences.

- **'insurances by employers on the lives of employees'** – the policy must be taken out by an employer on the life of an employee. Any other type of policy doesn't meet the condition.
- **'the sole relationship'** – the sole relationship between the company and the insured person must be that of employer and employee, including directors. If the insured person has a significant shareholding in the company (the rule of thumb is 5% or more) then no tax relief may be given. This is because the expense has dual purpose – it's for personal and business benefit.
  The 5% guideline isn't a statutory percentage and the company's tax advisers should negotiate with HMRC if the shareholding is more than 5%. Additionally, no tax relief will be given where a parent or holding company insures a key person of a subsidiary company. This could also lead to problems with insurable interest.

- **'intended to meet loss of profit'** – this must be loss of profits due to the loss of the key person. This rules out any policy that has a surrender value, because part of the policy payment would be for investment purposes. Some whole of life, endowment and possible convertible term policies could have a surrender value. A policy taken out as security for a loan wouldn't be allowed as it's being used for a capital purpose and not to meet loss of profits.
- **'annual or short-term insurance'** – the term of the policy shouldn't be longer than the insured person's usefulness to the company. It's generally recommended that it shouldn't be more than five years.

If all of the above conditions are met then the policy payments will qualify for tax relief and the claim proceeds will normally be taxable.

Tax treatment of policy proceeds

It's worth repeating that whether or not the proceeds from a policy are taxable has nothing to do with whether tax relief was granted on the policy payments.

The tax treatment of the proceeds will be determined on normal taxation principles. This means determining what's capital and what's revenue, which isn't easy in many cases. Hundreds of tax cases have been heard and determined over the years but no distinct dividing line has ever been established. Each case will be determined on its own individual facts and it will be the responsibility of the company's tax advisers to negotiate with HMRC.

Examples

Here we show various scenarios and the suggested tax consequences.

Example one

John Burke is the senior sales executive of Jones Funerals Ltd. He doesn't own any shares in the company but is of enormous importance in terms of his business contacts. The company decides he's a key person and has calculated that if he died tomorrow business profits would be affected by as much as £1 million. The company takes out a life protection policy over a five-year term to cover John for this amount. Four years later John dies and Jones Funerals Ltd receives £1 million cash as policy proceeds, which it uses to find and train a successor for John. It also helps to absorb the immediate loss of profits.

Here's the suggested tax analysis:

- the policy meets all the 'Anderson rules' so the policy payments qualify for tax relief, and
- the policy proceeds are used for revenue purposes as they cover replacement costs and loss of profits, so are taxable.

Example two

We'll use the same scenario as example one, except that after two years John becomes a 40% shareholder in the company.

In this case, the suggested tax analysis is:

- the policy met all the 'Anderson rules' at the start so the policy payments qualify for tax relief, and
- at the point the proceeds are received there's a duality of purpose as John holds a 40% shareholding. So it could probably be argued that the proceeds are of a capital nature and not taxable. HMRC might go back to retrieve tax relief on the policy payments in this scenario.

Example three

Again, we'll use the same scenario as example one, except that after John's death the company uses the £1 million policy proceeds to acquire or buy new business premises.

In this example, the suggested tax analysis is:

- the policy met all the 'Anderson rules' at the start so the policy payments qualify for tax relief, and
- the proceeds aren't used to replace lost profits but to buy new business premises, which is clearly of a capital nature. Again, it could be argued that the proceeds are of a capital nature and so aren't taxable. There's the same possibility, as in example two, that HMRC might try to retrieve tax relief on the policy payments.

Example four

Peter Hare is managing director of Burke (Exhumations) Ltd and has a 30% shareholding in the company. As a condition of a loan made to the company by the Churchyard Bank, the company takes out a life protection policy with a five-year term to cover Peter as security against the loan. Three years later Peter dies and the company receives the policy proceeds, which it uses to reduce the bank loan.

The suggested tax analysis is as follows:

- the policy doesn't meet the 'Anderson rules' so there's no tax relief on the policy payments, and
- the proceeds are used for a capital purpose and should be tax free.

If you need any help with this, please speak to your usual Aegon sales representative or visit our website for more business protection support.