PKF Littlejohn LLP

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broking business

The newsletter for insurance brokers and MGAs

The NewBro way
The answer to post-Brexit taxes?

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INSURANCE

welcome to our winter issue

Welcome to the latest edition of Broking Business. There is probably no-one in the country who has not felt confused over Brexit at some stage since the 2016 referendum. Even after 31 January, many businesses remain unsure what to expect. An EU:UK Trade Agreement by the end of 2020 should shed more light - assuming there is one. But the feeling is the insurance sector is unlikely to benefit.

So what's the best way to continue serving your EU clients? We explore how to set up a new EU broking company (NewBro) - and how it can reduce your exposure to corporation tax and VAT.

In January the Government announced plans to review the proposed new rules for employment status workers hired via an intermediary. Originally due to be introduced in April, the rules are likely to clamp down on taking on a consultant off-payroll. We help you prepare for this.

What are 'adequate financial resources'? We guide you through the FCA's 2019 consultation paper. How should you assess your resources? And how should your firm manage risk, prevent 'harm' and be covered for a wind-down if needed?

Plus, how is your firm faring with IDD (the Insurance Distribution Directive), introduced in October 2018? It seems the PROD rules may be a sticking point. And we also provide a check list for SM&CR. Are you in line with the specifications?

As ever, we'd like to hear your feedback and ideas for the newsletter.

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SM&CR: it's here

The Senior Managers & Certification Regime (SM&CR) came into effect on 9 December and affects all insurance intermediaries. Samiha Shaikh, Senior Manager at PKF Littlejohn provides a checklist that will keep you in line with the specifications.

The document's key objectives are to define and confirm accountability for senior people in firms (clarifying their responsibilities), and make sure key individuals are well-skilled and capable of performing their roles.

The FCA has taken a proportionate approach, and most firms will need to comply with the core requirements.

SM&CR Check List

Make sure you're where you need to be by reviewing your progress against our SM&CR check list.

By now, you should have:

- ☑ Reviewed your governance framework, confirmed all areas of the business are well accounted for and that there is sound governance in place with no gaps.
- ☑ Confirmed the automatic transition of senior managers from the Approved Persons (the previous regime) and made any submissions, as required to the FCA e.g. for the non-executive chair.
- ☑ Allocated Senior Management Functions (SMFs) and Certified Functions (CFs) to the appropriate individuals (confirming they are fully aware and have agreed their responsibilities).
- ☑ Allocated prescribed responsibilities to Senior Managers, where applicable.
- ☑ Compiled clearly-articulated Statements of Responsibilities detailing what Senior Managers are accountable for.
- ☑ Trained those allocated SMFs and CFs on the conduct rules.
- ☑ Engaged HR, made a plan and prepared the firm for SM&CR 'business as usual' processes.

For Enhanced firms:

- ☑ Additional functions and responsibilities to be allocated for Enhanced firms
- ☑ Requirement to create and maintain Responsibilities Maps
- ☑ Complete and retain up to date handover procedures

Actions for the next 12 months:

- ☑ Have procedures to maintain and review regulatory references and criminal checks for Senior Managers.
- ☑ Senior Managers to be able to demonstrate 'reasonable steps'
- ☑ Conduct the first suite of annual certification checks for Senior Managers and Certified Function holders.
- ☑ Complete firm-wide training on the conduct rules (tailored and specific to staff as required)
- ☑ Set up processes to onboard new Senior Managers and Certified Function holders
  - Employment / onboarding procedures for requesting and checking regulatory references, criminal checks
  - Processes to review and update Statements of Responsibilities
  - Continuous training in conduct rules for firm staff and new starters
  - Ensure all conduct rule breaches are identified, recorded and reported appropriately

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Taxes after Brexit: what you need to know

Even assuming an EU:UK Trade Agreement comes into force on 31 December 2020, the insurance sector is unlikely to benefit. Howard Jones explains why setting up a NewBro is the best solution to keep control of corporation tax and VAT.

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Britain left the EU on 31 January and a transitional period is operating until the end of the year. But there are doubts about how the service sector will be provided for in the future EU-UK Trade Agreement, if there is one at all. Many groups have already introduced measures to be able to continue trading.

From 1 January 2021, only an EU-regulated company and its approved persons may provide insurance services within the EU. To reassure their EU clients of their continued commitment, many UK brokers have set up a new broking company (NewBro) in an EU jurisdiction which is then approved and regulated by its local regulator. From there, NewBro is passported into other EU jurisdictions. The choice of NewBro's location will be influenced by, where the group already has a presence, regulatory environment, the availability of local talent and proximity to clients, carriers or Lloyd's Brussels.

One of the challenges has been satisfying the local regulator while at the same time not incurring significant expense by duplicating staff roles and systems currently working within the group. The ideal would be a light initial presence which expands in line with the business.

Another significant obstacle is how to mitigate tax leakage both on establishing NewBro and when managing the ongoing business.

Corporation tax on transfer of trade

In establishing the operations in NewBro, consider what's being transferred to the company so that it can operate as a regulated broker. This is critical for tax purposes because any business transferred out of, or disposed of from, the UK is subject to an exit charge. When transferred between related parties, it will be valued on an arm's length basis.

As the value of an insurance broker is often the value of its goodwill, which rarely has a base cost for tax purposes, the value of the business transferred would effectively be taxed at the prevailing corporation tax rate of 19% in the UK. Careful planning will help to reduce tax exposure. But the starting point should be to transfer only what is required, and so reduce the value of the disposal. Also, depending on where NewBro is located, there may be some local tax relief for the business transfer.

Implications for VAT

It is important to also look at the impact of VAT on the transfer. Will it be subject to VAT or does it qualify as a Transfer of a Going Concern (TOGC)? Should it meet the TOGC requirements, the transfer would be outside the scope of VAT. But take care to look at the VAT rules from both a UK perspective and from the NewBro country's perspective. Although VAT is a European-based tax, the legislation is interpreted and applied differently between the UK and various EU countries.

Operating structure considerations

In order to manage the cost base, especially in the early years, NewBro may outsource the insurance work back to the UK where it is currently performed. Many NewBros are opening a UK branch to help with outsourcing (called 'back branching'). Services provided between a branch and its head office are usually outside the scope of VAT, as the services are all within the same company. Beware, though, as this is subject to local interpretation of the Skandia case.

But if the UK branch does not have the necessary insurance resource, it will need to acquire it from the existing UK group. You should undertake careful analysis of the services being provided by the group to be confident the correct VAT treatment is applied. Whatever VAT planning you implement in the UK, do also consider carefully its impact on the relationship between the branch and head office.

Unless otherwise agreed, from 1 January 2021 the EU tax directives will no longer have legal effect and, from a structural perspective, withholding tax on dividends and interest may arise - depending on where NewBro is located. Take care when using cross border management charges, as these may be subject to the Reverse Charge for VAT purposes.

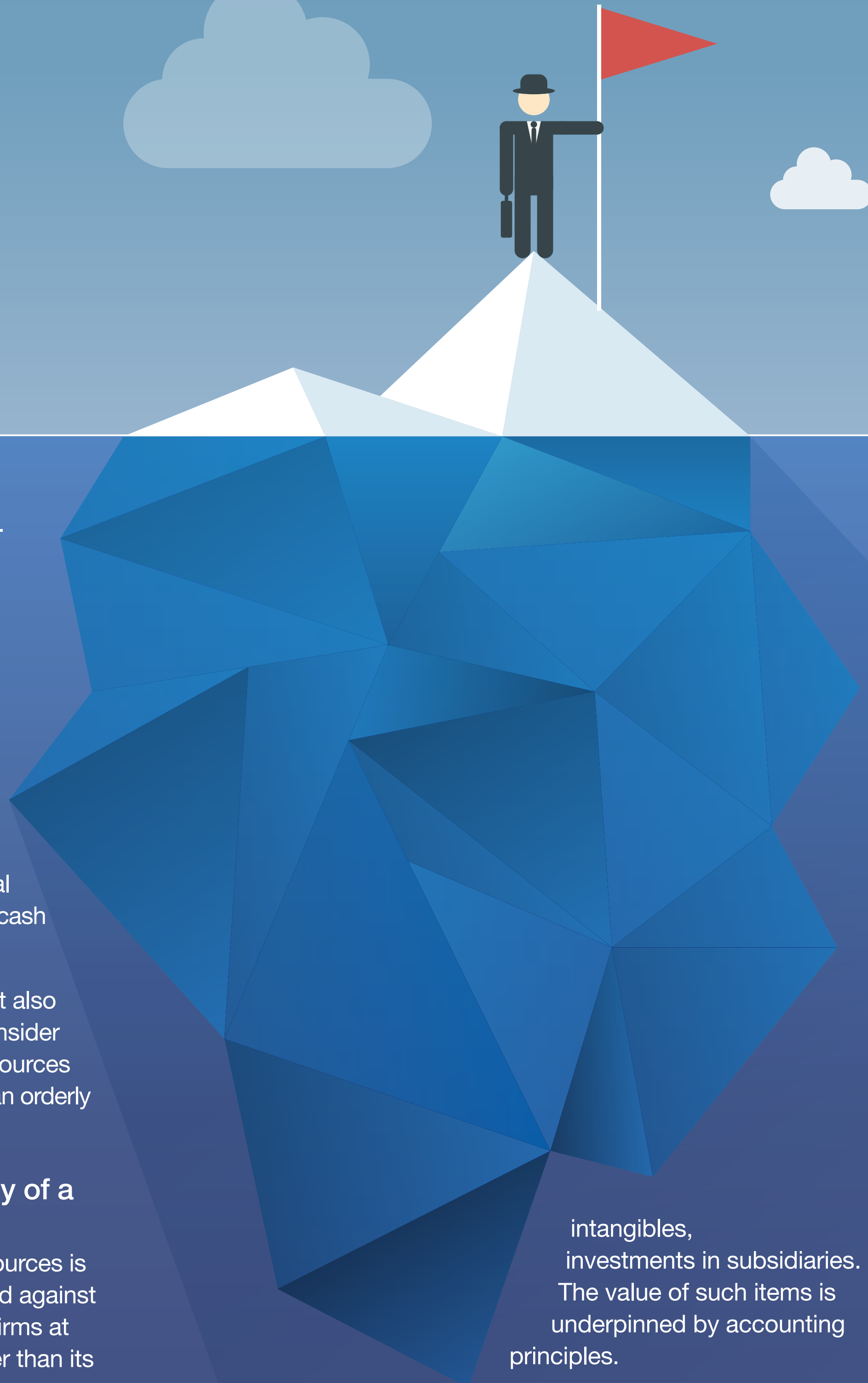
Finally, the allocation of commission or recharge of expenses within the group may be subject to enquiry by any tax administration. It is therefore important to have adequate transfer pricing documentation to support your current position.

Clearly, the tax position is far from straightforward and requires some finessing between the UK and the EU jurisdictions - and also between direct and indirect tax. Your local PKF contact will be able to help you with this process.

For more information, contact Howard Jones.

Why adequate financial resources matter

In June 2019 the FCA published its consultation paper CP19/20 'Assessing Adequate Financial Resources'. It explains the importance of financial resources in helping firms to minimise harm and risk, how to assess these internally and what to expect from the FCA's assessment. Paul Goldwin reports.



The FCA has emphasised that this is not merely an attempt on their part to get firms to overload on financial resources. Rather, it is taking a proportionate and risk-based approach to the supervision of firms.

It expects firms to assess what they perceive to be their adequate financial resources commensurate to the risk of harm to consumers and the complexity of their business. Firms should start with the premise that there must always be enough assets to cover their debts and liabilities. This is based on the Insolvency Act 1986 guideline to 'have sufficient cash-flow to meet liabilities as they fall due' and the balance sheet test of having 'sufficient assets to cover liabilities'.

What is the role of adequate financial resources?

Firms were already required to consider their level of financial resources through two other sets of guidelines: COND 2.4 Appropriate Resources and PRIN 2.1.1 Principle 4 – Financial Prudence. But this new FCA paper is more succinct and provides a steer for the whole life of an organisation.

Why are adequate financial resources so vital? Because they mean firms are not only financially viable, but can also carry out an orderly wind-down, without causing undue harm to consumers or to the integrity of the UK financial system.

The FCA expects a firm to conduct its own assessment and may ask that it is submitted for review to see where it fits in the market.

How should firms go about the assessment?

Firms are expected to assess the risks inherent in their business models and hold financial resources proportionate to the nature, scale and complexity of their activities. They must also understand how changes in operational and economic circumstances might affect these risks.

Sometimes things do go wrong, often through factors outside of the control of the firm. So they must identify the potential sources of harm to consumers and markets, and ensure they have adequate resources to estimate its impact and deal with it.

Similarly, firms should consider the risks that may stop them from putting things right. This means assessing the circumstances leading to financial stress, the potential depletion of financial resources and the inability to convert assets into cash in time to pay for obligations as they fall due.

In order to reduce the impact of failure, firms must also explore recovery options and, if unsuccessful, consider their wind-down choices and how to maintain resources during this process so that they exit the market in an orderly manner.

How does the FCA assess the adequacy of a firm's resources?

In simple terms, the assessment of adequate resources is based on determining how much capital is needed against how much capital is available. The FCA expects firms at all times to have capital which is equal to or higher than its assessment of what is required.

In assessing adequate financial resources, the FCA distinguishes between 'capital' and 'liquid' resources.

- **Capital** refers to the elements of a firm's equity and consists of such items as share capital, retained earnings, subordinated debt less deductions for items such as intangibles, investments in subsidiaries. The value of such items is underpinned by accounting principles.
- **Liquidity**, on the other hand, is less defined by accounting principles. It depends on the ability of the firm to convert different types of available liquid resources into 'cash' to settle debts as they fall due.

To assess how much capital a firm needs to carry requires an overall assessment of the risks to which the firm is exposed.

Expected losses should already be accounted for through provision or impairment of assets. Potential losses depend on the probability of adverse circumstances that will affect the values of the assets and liabilities the firm carries on its balance sheet. The FCA expects firms to have adequate capital to be able to incur losses yet still remain solvent.

How much liquid resources should a firm hold? Enough to be readily convertable into available 'cash' to settle debts on time. But having particular regard to: the ability to monetise liquid assets; having diversified liquid assets; the ability to convert cash to the required currency and having free transferability of funds among entities in order to make these readily available.

How should firms manage risk?

In the FCA's view, a sound risk management framework should help firms to identify, monitor and mitigate potential harm to consumers and markets.

A firm's risk appetite is the maximum level of risk it is willing to take on to generate acceptable returns from its business activities. The FCA expects firms to measure these risks, and ensure they are understood and communicated across the firm.

Firms must have a clear organisational structure and, as part of their controls framework, should consider risk in their day to day activities. They must also have procedures to manage conflicts of interest and a risk function that is adequately resourced and independent. Although business processes can be outsourced to third parties, firms are responsible for any harm caused by the management of outsourced activities.

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"Firms should have a clear and viable business model and strategy to understand how they generate returns and the factors that may affect their ability to continue generating acceptable and sustainable profits."

What causes 'harm' and how can it be prevented?

Harm can be caused by many factors. These include: poor conduct as a result of poor financial management; disruption of markets' proper functioning; disruption to continuity of service; an inability to pay redress or to transfer or return client money and assets.

The regulator requires firms to consider 'what if' scenarios for the activities that they undertake, taking into account that all events may not take place at the same time and that some will be covered by insurance.

Part of this is determining whether the risk undertaken is within or outside their risk appetite and therefore deciding if extra controls are required.

How can the business model help?

Firms should have a clear and viable business model and strategy to understand how they generate returns and the factors that may affect their ability to continue generating acceptable and sustainable profits.

The FCA expects firms to look at:

- 'business as usual' financial projections
- projections under severe but plausible adverse circumstances
- reverse stress testing

What if a wind-down is needed?

Finally, the regulator requires all firms to have a 'wind-down plan'. This aims to reduce the impact of a firm's closure on the market. It should ensure that they have sufficient resources to pay redress if needed, avoid consumer loss, and have prepared plans for continuity of service.

A wind-down plan must be credible, include realistic timetables and assessments of how financial and non-financial resources are maintained while the firm exits the market.

Firms should undertake both a qualitative and quantitative assessment of their wind-down plan.

- **Qualitative assessment** should consider: operational tasks required; risks to continuity of service; the provisions of the client asset resolution pack where client money/assets need to be returned; the level of capital and liquid resources available to carry out the wind-down, mindful that these might have depleted through the actions that led to the firm's failure or closure.
- **Quantitative assessment** should determine the likely wind-down period (often 3-9 months) and the run-off or closure cost financial provision needed for the exercise. Experience shows that although firms may have sufficient capital to be able to carry out the wind-down, often there is a lack of liquid assets for them to operate the wind-down effectively and avoid harm to consumers.

Does your firm have 'adequate financial resources' to meet the FCA's expectations?' For more guidance, please contact Paul Goldwin.

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Compliance Management Services
Insurance compliance. Intelligent solutions.

Nearly 18 months on... where are we with IDD?

Since its introduction in October 2018, the Insurance Distribution Directive (IDD) is proving more difficult to implement that expected. David Allison of Compliance Management Services reports on the sticking points.

After an unprecedented delay of eight months from its original effective date, IDD finally came into force on 1 October 2018. Nearly a year-and-a half on, it might reasonably be expected that firms would have embedded the directive's requirements into 'business as usual'. But the reality, in our experience, is somewhat different.

Insurers and intermediaries alike continue to be challenged by what is arguably the biggest single change to regulation since the introduction of its predecessor, the Insurance Mediation Directive, in 2005. For this reason, the FCA has said it's taking a 'keen interest' in the way firms have risen to the challenge, in the expectation that they have made significant progress in the last year or so. When the FCA takes a keen interest in a topic, you can be sure that it's looking carefully for evidence that firms are complying with the new rules.

Non-compliance is rife

From a conduct perspective, the introduction of an overarching 'customer's best interests' (CBI) rule has been highly significant. Particularly so as it applies to all firms, regardless of their position in the distribution chain. The FCA is already challenging firms' business models and practices against the CBI rule. We have also seen its application featured in the April 2019 thematic work undertaken by the FCA on general insurance distribution chains (TR19/2) and new non-handbook guidance which followed in its wake (FG19/5).

Certain aspects of the IDD have been designed to improve selling standards. While some of the changes have proved challenging (and costly) for many customer-facing intermediaries to implement, we still see instances of non-compliance with the most basic of the new requirements. For example, telling customers about the nature and basis of the firm's remuneration on a contract-specific basis and giving customers the option to receive their documentation in hard copy for no additional charge. More worryingly, some firms have not reviewed their selling standards at all.

Missed or misunderstood?

One of the most commonly discussed areas of IDD compliance is the requirement for all staff involved in insurance distribution activities to undertake a minimum of 15 hours CPD per year. On the face of it, this seems straightforward. But the new rules stipulate which topics must contribute to CPD, a requirement which some may have missed.

A real game-changer for the industry, but much less widely understood, has been the introduction of new Product Oversight and Governance rules (PROD). The PROD rules apply to all product manufacturers and distributors. More than a year on, we find that firms are still trying to get to grips with what the rules mean for them, including their interactions with other parties in the chain. For example, an insurance intermediary with a decision-making role in designing and developing a product must have a documented product approval process for each new or significantly-adapted product before it is brought to market.

Where an intermediary has any form of product manufacturing responsibility, it will sit alongside the insurer as a 'co-manufacturer'. This requires a written agreement between the co-manufacturers that identifies their respective roles and responsibilities in the manufacturing process.

Behind on PROD

The market appears to have been slow in some quarters to get up to speed with PROD requirements. The findings of the recent Lloyd's IDD Thematic Review, conducted by the corporation on its own market, illustrate this point. They are expected to prompt significant activity between managing agents and coverholders, so that the correct documentation and processes are in place.

It is also not often appreciated that intermediaries with no involvement in manufacturing have new responsibilities under PROD. For example, they must have a documented distribution strategy for each product, and review it regularly to keep it valid and always up to date.

The requirements of the IDD are far-reaching and not to be underestimated. Now would be a good time for firms to take stock of the progress they have made in their implementation plans and take actions to address any gaps identified.

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Beware off-payroll tax changes

Many insurance brokers are likely to be affected by new rules for employment status workers hired via an intermediary. The Government is to review these changes, which may delay their scheduled introduction in April. Whichever way, Chris Riley explains how to prepare.

Consultants who provide advice to a business are a feature of all sectors. But for many years governments and HMRC have been concerned that the use of consultants, often off-payroll, is disguising for tax purposes what is truly an employment relationship.

If a business has directly engaged an individual, it has long been understood that where this is an employee relationship (the antiquated 'Servant and Master' term is still used in this context), the employer is required to account for PAYE (sometimes retrospectively) for its UK-based people. But in cases where an intermediary is used, such as a personal service company (PSC), that intermediary is currently responsible under the infamous IR35 rules.

Businesses operating in the insurance market, particularly brokers, often use consultants or other service providers hired through intermediary companies, rather than as employees. It is these relationships which are coming under pressure.

IR35 out of favour

The catch is that the Government doesn't believe IR35 works. It's already tackled the issue with success in the public sector. From April 2017, it moved the payrolling responsibilities for all employment relationships, whether an intermediary is in place or not, to the host employer.

So it's no surprise that the off-payroll working rules will now apply in all sectors from April 2020. Where a business falls within the regime from that date, all its relationships that have hallmarks indicating employment will need to be accounted for under PAYE.

Size matters

It's important to note that in the private sector not all companies will be caught by the legislation. Small businesses are exempt, and will not need to apply the new off-payroll working rules. A business is small if it meets two of the following three criteria – considered on a global consolidated basis.

- Annual turnover less than £10.2million
- Balance sheet total (gross assets) of less than £5.1million
- Less than 50 employees

A year's grace applies for businesses that grow and pass through these thresholds. In other words, the rules come into effect in the second year that a company is considered large. It's likely that HMRC will consider client money reported on a broker's balance sheet as counting towards the balance sheet total, as they do in other areas of tax.

I'm in the rules – how should I start?

If you are an affected organisation engaging an individual via a PSC, you must decide the worker's status and communicate it to both the worker and the person contracted with for the engagement, whether an agency or a PSC. HMRC's check employment status for tax (CEST) online tool is expected to be the primary method used to determine a worker's status.

This decision on status must be made with reasonable care and any disagreements about it resolved within 45 days of notification from the worker.

What if my consultant is caught?

Where the status determination is 'employee', an affected business engaging a consultant or any other worker via a PSC will be responsible for accounting to HMRC for PAYE and NIC due on all engagements, And the same applies where the business has failed to determine the status or not dealt with a status disagreement within the 45-day limit.

It's worth remembering that if you engage a consultant directly, without a PSC in place, these rules have always applied, regardless of the size of your business.

What else should I do now?

If you don't believe you'll qualify as 'small' on the introduction date (currently 6 April 2020), you need to review all current engagements where you have contracted with a PSC. Although the rules will not take effect until April at the earliest, we recommend you confirm these relationships and their tax status as soon as possible, so that all parties can plan for the changes.

From the introduction date, you'll need to hold supporting documents that confirm the status (employee or self-employed) of all engagements via PSCs. You must also have communicated that status to the worker and other required parties in the labour supply chain. Where the status is 'employment', you must account for PAYE and NIC on the payments made to the PSC after the introduction date.

And be aware that working relationships change. If you engage with intermediaries that you conclude aren't captured on the introduction date, then future changes to your working relationships (for example, an intermediary who provides services one day a week becomes more of a full-time engagement) may mean a change to the tax status.

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