The newsletter for insurance brokers and MGAs

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PKF

Broking Business

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Welcome to our latest issue of Broking Business...

Broker sales/acquisitions have continued apace this year, and owners and acquirers alike were keen to understand how to make the transaction process as smooth as possible at our recent London Broking Breakfast. If you weren't able to join us, you can still listen to the on-demand version here.

In this issue of Broking Business, John Needham and Will Lanyon, Partners in our Transaction Advisory team, explore the most significant themes in the UK broker market over the past 12 months, from M&A activity to market concentration.

As more and more broking entities are being acquired by larger groups, they may need to change their financial reporting framework. Partners James Wilkinson and Satya Beekarry, look at the main accounting considerations for a broker in transition to FRS 101 or IFRS.

The latest regulatory pronouncements are always of interest. The FCA and PRA published their respective consultation papers in September on the proposal to introduce a new regulatory framework on diversity and inclusion (D&I) in the financial sector. Jessica Wills, Partner and Head of our Governance, Risk and Control Assurance team, looks at what this could mean for your business as new regulations come into force.

From a tax perspective, Corporate Tax Parter Tom Golding looks at two common employment tax-related errors that could cause you real problems when it's time to sell the business.

And finally, if your firm is preparing for a CASS 5 audit, our recent conversation with the regulator may provide some crucial guidance.

As always, please contact any of the team to discuss how we can support your business and let us know your thoughts on future topics.

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Top 75 UK Insurance Brokers 2023: Analysis

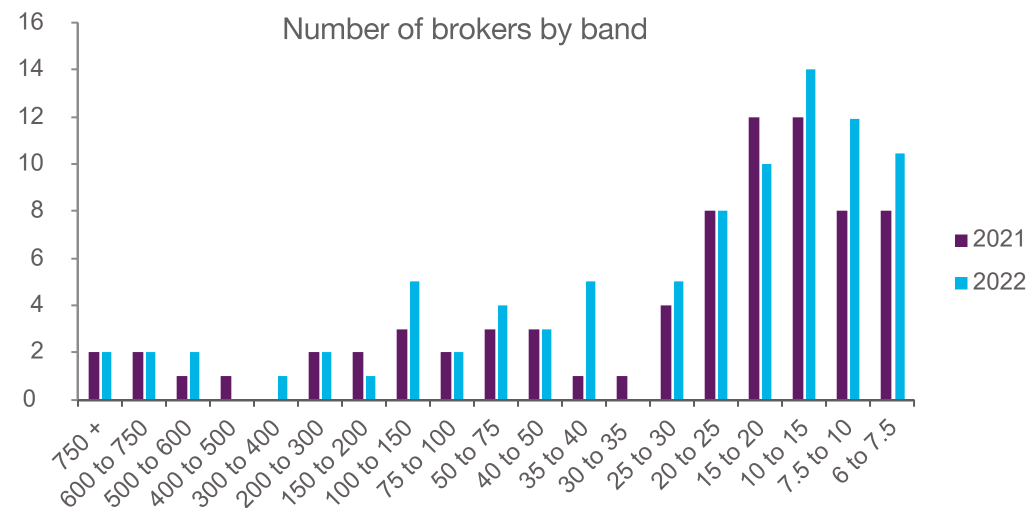
What have been some of the most significant themes in the UK broker market over the past 12 months? John Needham and Will Lanyon explore the impact of some of the main macroeconomic developments on industry trends such as M&A activity and market concentration.

The following article has been taken from our work with Insurance Age in their annual Insurance Age Top 75 feature. The original article can be seen here.

Inflationary pressures being managed

The insurance industry proved adept at dealing with the macroeconomic shock posed by the Covid pandemic back in 2020 – and it appears to have proved equally resilient to the more recent phenomenon of a higher and less certain inflationary environment.

Higher staff costs have been a major area of concern for brokers, like in many professional services sectors, which has lowered the margins of some. However, as a rule, the sector has been able to manage these cost increases by continuing to grow its top line. Premiums have been rising steadily over the past few years due to the hard market conditions, and the surge in inflation during 2022 and early 2023 has added further upward pressure across multiple products and classes.



Outside of personal lines, the rise in premiums does not appear to have resulted in clients shopping around – renewal rates remain robust, particularly at the larger and more complex end of the market. Some firms have exhibited good organic growth through a combination of rate rises, good retention rates and some moderate new business wins.

Interestingly, the rise in interest rates precipitated by higher inflation has provided a boost for brokers with large premium money holdings. These cash balances previously earnt very little interest income, but that is now starting to change. However, for brokers requiring debt funding, the benefit of higher interest income tends to be outweighed by the more expensive cost of borrowing, as we explore below.

Higher interest rates starting to temper deal making

As regular readers of Insurance Age will be aware, merger and acquisition activity in the sector remains at an elevated level.

However, higher interest rates have had an impact on dealmaking at the top end of the market.

The higher cost of borrowing has meant that larger deals are less common than before and are taking longer to complete, with some even being shelved part way through the process. We are also seeing a slow-down in consolidation in the domestic market, although larger groups remain active by focusing their attention on overseas acquisitions.

The price paid by acquirers – as measured by a multiple of the target company's future earnings – is now stabilising after years of growth. These earnings forecasts are being scrutinised more closely than before, with buyers tending to be more conservative about their growth assumptions – they're no longer giving targets the benefit of the doubt in the same way that they did previously. That said, we understand a few larger deals are now starting to emerge, so we will see over the coming months how they progress.

Small deals still going through at a good rate, with the traditional consolidators remaining the most active from an M&A perspective. The most prolific consolidators have still completed a large number of deals in the past year, at a level that is broadly comparable to last year. The valuation multiples for these smaller deals are also holding up well.

The result is that the largest players in the broker market are larger than ever before. The majority of broking revenue is concentrated with the big international brokers, with the largest six operators accounting for over 60% of the industry's total revenue in each of the past two years. The past 12 months also saw some of the large US brokers making significant further entries into the UK.

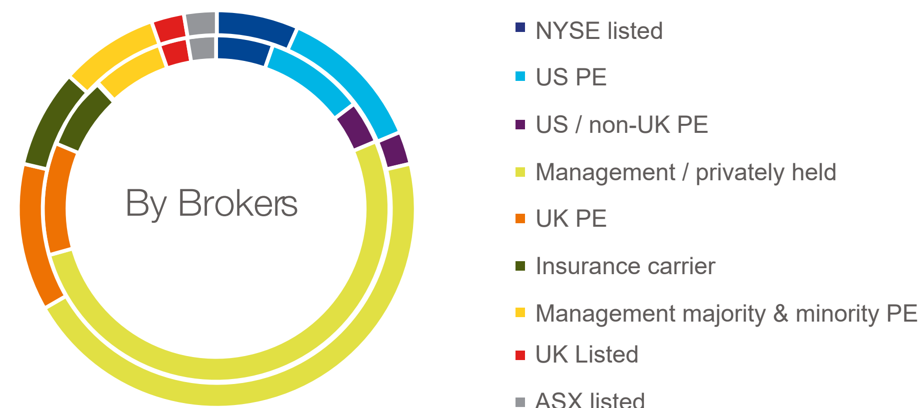
It is worth noting that higher interest rates not only affect those brokers that are currently undertaking debt-financed acquisitions – firms that borrowed to pay for acquisitions in recent years are also likely to be impacted, especially if they are now having to refinance. This will be something to watch over the coming year.

Private ownership model in decline

As well as examining some of the current industry developments, we also wanted to revisit one of the themes that we identified in last year's report – namely the decline of the private ownership model.

We noted last time that just over half of the brokers in our universe were privately owned, making this the most common ownership model – at least for the time being.

Ownership of brokers – by number of brokers

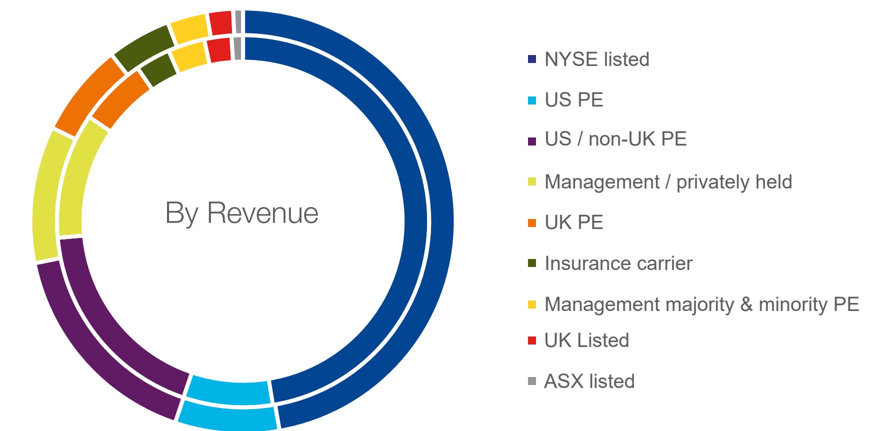


Outer ring = 2022; inner ring = 2021

However, as predicted, the percentage of privately owned brokers has continued to reduce year-on-year – driven by the fact that these brokers generally tend to be smaller, and are a popular acquisition target for the consolidators. We expect their number to continue to decline in the future.

The picture changes significantly when looking at the ownership of brokers by their share of revenue. The large US listed brokers are the most dominant – representing 47% of the total – and this has increased slightly in the past year as Brown & Brown has continued its acquisition-led growth strategy.

Ownership of brokers – by revenue



Outer ring = 2022; inner ring = 2021

As would be expected, the private equity industry is a major player in the UK broker market, owning roughly a third of the brokers by number and by revenue. There has been a significant flurry of PE-backed acquisition activity in recent years; after a slight dip in 2022, activity appears to have rebounded this year, with two new private equity deals recently being announced, Blixt's acquisition of Academy and Apiary's acquisition of Carbon.

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How we have analysed the data provided

- We have been provided data from Insurance Age and Insuramore for UK non-life broking for the top brokers in the UK based on 2021 and 2022 financial results. Information for 2021 and 2022 was for more than 75 brokers but we have capped at the top 75 for both years
- PKF has consolidated brokers where we know of transaction in the last twelve months. If the acquisition occurred in 2022 or 2023 we grouped the balances together in the 2022 numbers but not 2021. Where the acquisition occurred in 2021 or earlier they are included within the new Group's numbers
- The information was less granular than in the prior year and, as such, we have had to make the assumption that the average value of the bandings was the midpoint between the bandings. When grouping entities that have been acquired, we used our market knowledge and estimates of the bandings to ascertain the banding and therefore the midpoint.

Diversity and inclusion: new regulations

The regulators are consulting on proposals for wide-ranging changes to how firms tackle diversity and inclusion (D&I) and their reporting. What will this mean for you?

The FCA and PRA published their respective consultation papers (FCA CP23/20 and PRA CP18/23) in September on the proposal to introduce a new regulatory framework on D&I in the financial sector. Comments on the consultation papers must be in by 18 December. The final regulatory requirements will be set out in a joint policy statement in 2024. In-scope firms, which include insurance intermediaries, will be subject to the new rules 12 months later. The proposals apply differently to firms depending on the number of employees and their SM&CR categorisation. Firms with less than 251 employees will be exempt from many of the requirements, but must meet the minimum standards.

What are the key proposals?

- Integration of non-financial misconduct considerations into staff fitness and propriety assessments, conduct rules and the suitability criteria for firms to operate in the financial sector.
- Reporting annually on average number of employees and data collection.
- Reporting and disclosure of certain D&I data.
- Requirement to establish, implement and maintain a D&I strategy.
- Determining and setting appropriate diversity targets.
- Recognition that a lack of D&I is a non-financial risk.

Non-financial misconduct

The FCA is proposing to explicitly include non-financial misconduct within:

- Conduct rules.
- Fit and proper assessments.
- Suitability guidance on the Threshold Conditions.

Conduct rules

The scope of conduct rules will be expanded to take account of serious instances of bullying, harassment and similar behaviour towards fellow employees, and employees of group companies and contractors. Guidance will also be provided on:

- Types of behaviour that would fall within the expanded scope of conduct rules, and that may breach conduct rules; and
- Conduct that is out of scope because it relates to an employee's personal or private life.

Fit and proper assessments

The FCA proposes to explain in more detail how non-financial misconduct forms part of the Fit and Proper test for Employees and Senior Personnel (FIT) section of the FCA Handbook. Particularly, it will emphasise that bullying and similar misconduct in the workplace is relevant to fitness and propriety, as is equally serious behaviour in a person's personal or private life. This will be supported by examples of non-financial misconduct, such as sexual or racially motivated offences.

Suitability guidance on the Threshold Conditions

To maintain integrity and conduct in UK markets, the guidance on the Suitability Threshold Condition will be extended. It will include offences relating to a person or group's demographic characteristics (such as sexual or racially motivated offences). And it will also encompass tribunal or court findings showing that the firm, or someone connected with the firm (such as a director), has engaged in discriminatory practices.

What firms should consider doing

- Perform a gap analysis between their current processes that support conduct rules and fit and proper assessments, to determine if they need updating to meet the FCA requirements on non-financial misconduct.
- Update policy documents, procedures, codes of conduct and handbooks to reflect the new requirements.
- Develop training materials and deliver training to employees.

D&I strategies

In-scope firms will be required to develop an evidence-based D&I strategy that takes account of their current progress on D&I. This strategy must contain the following, as a minimum:

- D&I objectives and goals.
- Plans for meeting those objectives and goals and measuring progress.
- A summary of arrangements made to identify and manage any obstacles to meeting the objectives and goals.
- Ways to ensure adequate knowledge of the D&I strategy among staff.

Firms will be required to make the D&I strategy easily accessible and free to obtain (for example, through their website). This will facilitate stakeholder engagement and scrutiny on their approach, and progress against stated commitments.

D&I strategies may be reviewed by the FCA as part of its supervisory assessment of how firms are identifying, monitoring and taking steps to address D&I issues.

What firms should consider doing

- Review existing D&I strategies to assess any gaps against the minimum requirements.
- Identify resources needed to develop a D&I strategy and activities and plans for achieving this. It may be worth seeking external advice or support.
- Consider how the firm will make the D&I strategy easily accessible.
- Determine how the D&I strategy will be incorporated into current processes and systems.

Setting targets

Firms must set specific, time-bound diversity targets to address under-representation at both board and firm-wide level. They will be expected to set at least one target for demographic characteristics of the board, the senior leadership, and the employee population as a whole.

Whilst the FCA has provided guidance on compulsory and voluntary demographic characteristics, it will not specify which characteristics the targets must cover nor what those targets should be. Firms must consider the context in which they operate by taking into account available data on the diversity profiles of the UK population and the geographical area in which they carry out regulated activities.

Those based in other countries that carry out operations in the UK would be in-scope. If they do not have a board or senior leadership in the UK, they would not have to set a target for the parts of the business based overseas.

Firms may choose to set inclusion targets voluntarily, in addition to their diversity targets.

They must provide information on:

- Demographic characteristics for which they have set targets, and their inclusion targets (if any).
- The percentage at which each target has been set.
- The year each target was originally set, and the year the firm is aiming to meet it.
- The current level of representation against each target (%).
- The rationale for the targets set.
- Any further details the firm would like the FCA to consider about targets they have set.

What firms should consider doing

- Agree which demographic characteristic target they would like to report on.
- Agree whether to report on inclusion targets and, if so, which one(s).
- Allow sufficient resources and time to implement systems to capture the required data.
- Identify potential difficulties in encouraging employees to provide data, and mitigating factors.
- Make changes to their data collection processes and policies.

Data reporting

Employee numbers must be reported annually by firms of any size, but the proposed data reporting requirements would only apply to firms with more than 250 employees. They will need to:

- Collect and report annually to the regulators in numerical figures, data across a range of demographic characteristics, inclusion metrics and targets, via a regulatory return.
- During the first year, report such data as is practicable and explain the reasons for any gaps and how they will be closed.
- Report data to the FCA and PRA using a single data return.

Data should be reported to the FCA in three categories: board, senior leadership and all employees (including the board and senior leadership).

Limited Scope SM&CR firms are out-of-scope for data reporting requirements.

What firms should consider doing

- Map out the data reporting process - consider whether this will be integrated as part of an existing process or form part of a separate one.
- Allocate ownership for the D&I data reporting process.
- Update HR or other systems if appropriate.
- Clarify responsibilities for reviewing and approving the data to be reported, including the related governance process.

Data disclosure

Firms will need to make public disclosures on D&I data to increase transparency and scrutiny and to facilitate comparisons between firms on D&I performance. This should be done either when they publish annual reports and accounts or, for firms that do not do so, within six months of the end of their financial year.

The rules on disclosure will come into force 12 months after the final rules are published. In the first year they are in force, firms can make their disclosures on a voluntary basis. From the following year onwards, disclosures are mandatory for in-scope firms.

What firms should consider doing

- Allocate ownership of the process for data disclosure (e.g. whether it will be the responsibility of HR or finance).
- Update, if necessary, annual reports and accounts or the financial year end process for incorporating D&I disclosures.
- Clarify the responsibilities for reviewing and approving the data disclosure, including the related governance process. Consider a potential role for the internal audit function to provide assurance over disclosures.

Risk & governance

New guidance will be introduced for large firms to make clear that matters relating to D&I must be considered as a non-financial risk and treated appropriately within the firm's governance structures.

The following responsibilities will remain with the firm's board:

- D&I strategies: Although the FCA will not insist on the frequency of reviews, boards will need to review the D&I strategy regularly enough to ensure it remains appropriate, effective and fit for purpose.
- Setting targets: The board would oversee the targets set and would be expected to explain the rationale for the targets chosen, if need be.

Firms need to consider how a range of relevant functions can contribute to progress on D&I. Risk functions, as well as internal audit functions, will play an important role in managing risk and giving assurance to boards.

What firms should consider doing

- Agree how the board will oversee D&I strategy and targets, including timing and frequency.
- Update board terms of reference to reflect enhanced responsibilities for D&I.
- Consider independent assurance over D&I strategy, data reporting and disclosure.

If you'd like to discuss the FCA and PRA consultation papers and potential impacts on your firm, please contact Jessica Wills or Prianca Hanoomanjee in our Governance, Risk & Control Assurance team.

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IFRS transition: a complex process

Acquisition can often mean a change in reporting requirements. We provide a guide on what to expect and how best to prepare.

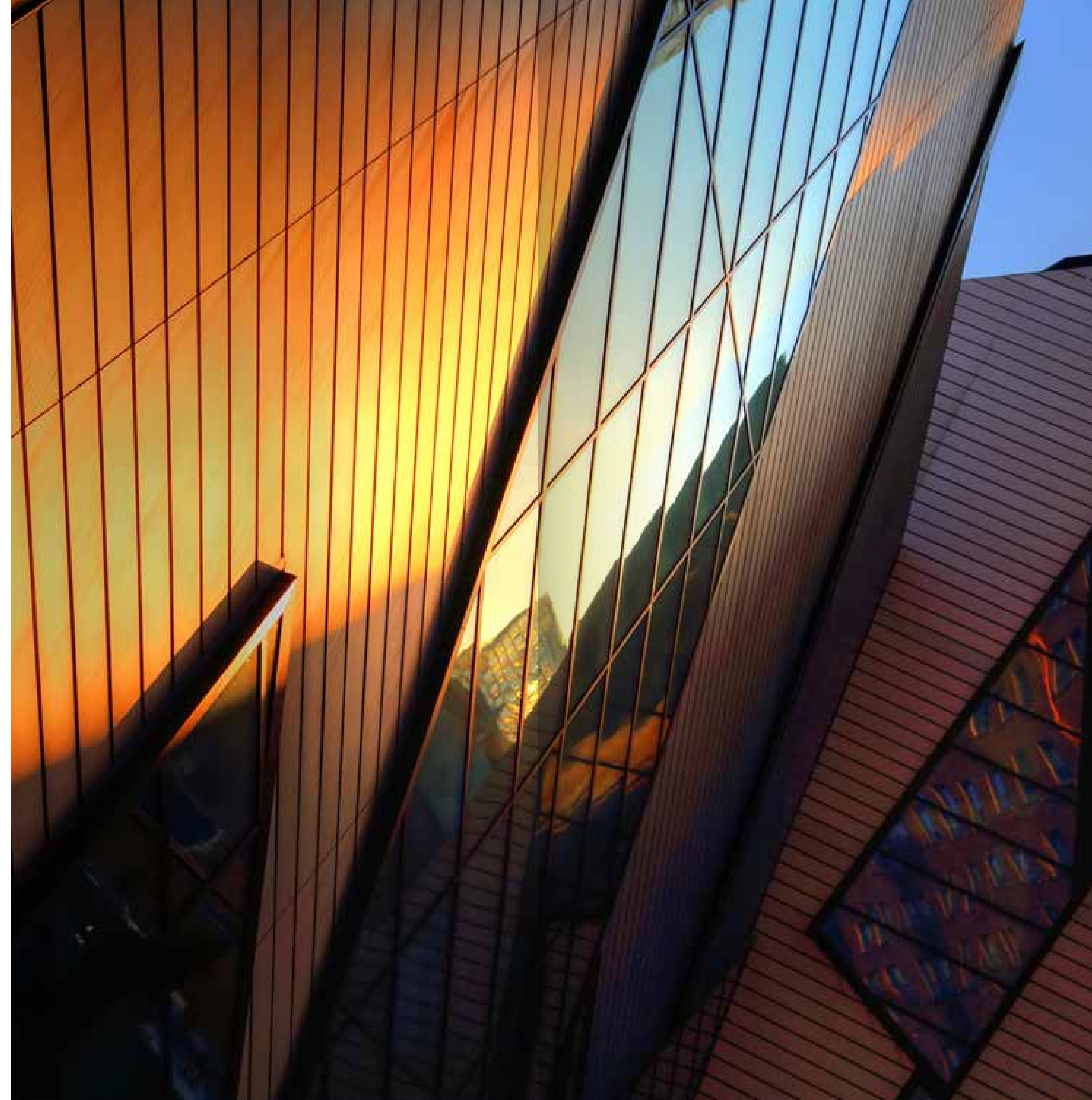
More and more broking entities are being acquired by larger groups. As a result, they may need to change their financial reporting framework from FRS 102 to the recognition and measurement criteria of International Financial Reporting Standards either through FRS 101 (Reduced Disclosure Framework) or full IFRS.

So what does this all mean in practice? And what are the main accounting considerations for a broker in transition to FRS 101 or IFRS?

1) Revenue recognition

IFRS 15 requires a five-step approach to revenue recognition:

1. Identify the contract(s) with customer.
2. Identify the performance obligations in the contract(s).
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations.
5. Recognise revenue when each performance obligation is satisfied.



It's important to review all major customer contracts in detail to understand the potential impact. IFRS 15 has requirements to identify 'distinct' performance obligations. The entity must consider the various services they provide, make an allocation to performance obligations based on the relative stand-alone selling prices, and analyse potential patterns of revenue recognition. They may need to exercise judgement as to what constitutes a distinct performance obligation and the period/pattern over which a customer receives the benefits of these distinct services.

The timing of revenue recognition is also likely to be affected. For example, under FRS 102 most broking entities recognise commission income when policies become effective. But, for certain contracts, IFRS 15 might require recognition when policies are legally bound. And this could be before the effective date of those policies.

There will probably also be an impact on revenue from post placement income and claims management. Arrangements that feature contingencies and trail commissions need particular consideration. This is because IFRS 15 requires entities to recognise revenue when a performance obligation is satisfied, even if the amount of that revenue is uncertain.

- Some entities may be able to recognise revenue earlier. But if the amount of revenue is highly susceptible to factors outside the entity's influence, revenue recognition might be constrained. This could be the case with contingent profit commissions which vary with a carrier's claims experience. At the start of such contracts, the entity may need to constrain revenue recognised. Then, over time, as revenue becomes less susceptible to variation, the entity is able to recognise more revenue.
- IFRS 15 might also lead to earlier recognition of revenue than FRS 102 for certain types of renewal commissions ('trail commissions'). These are where the broker has no additional responsibilities to secure contract renewals or to perform any other activities under the contract. In this case, recognising revenue including commissions relating to expected future renewals may be appropriate.
- The impact of the constraint on variable consideration may be different if it is assessed for an individual contract rather than for a portfolio. It might be hard to prove that the revenue for trail commissions, upon renewal of an individual policy, is unlikely to be subject to significant reversal. But the entity may be able to assess the constraint at the portfolio level instead.
- In many commercial lines of business, the broker might be performing ongoing services (such as claims management and customer care) on top of the original placement. In such cases, recognition of the total commissions, including any renewals, at initial placement would be inappropriate.

2) Lease accounting

IFRS 16 requires most leases to be brought onto the balance sheet. This could have a significant impact on financial statements and key ratios, as it increases the lease liabilities and right of use assets on the balance sheet. It also increases finance expenses and depreciation of the right of use assets and decreases the operating lease rentals in the income statement.

The IFRS 16 definition of what constitutes a lease might also mean that new contracts are identified as leases that were not previously accounted for as such. For example, in group scenarios, working out which entity has the right of use of an asset could mean new leases and sub-leases are needed - resulting in more complexity.

3) IFRS 9 expected credit losses

IFRS 9 includes an expected credit loss (ECL) model which adds to the information an entity must consider when determining its expectations of impairment. Under the ECL model, expectations of future events must be taken into account, leading to earlier recognition of larger impairments. Although all financial instruments are within the scope of IFRS 9, the most likely areas to be impacted for brokers include trade receivables and intercompany debtors.

There are two main ways to apply the ECL model. The general approach involves three stages and includes concepts such as 'significant increase in credit risk', '12-month expected credit losses' and 'lifetime expected credit losses'. But IFRS 9 recognises that implementing these requirements can be complex in practice. So it also allows (and in some cases obliges) entities to apply a simplified approach to trade receivables, contract assets and lease receivables.

The standard requires the application of the simplified approach to trade receivables and contract assets that do not contain a significant financing component. In our view, most brokers should be able to implement this approach. It means there is no need to monitor for significant increases in credit risk, though entities are required to measure lifetime expected credit losses at all times. But impairments are still higher because historical provision rates need to be adjusted to reflect relevant, reasonable and supportable information about future expectations.

4) Other areas of impact

Whilst the three areas above are those which seem to have had the greatest impact for brokers on transition from FRS 102 to IFRS/FRS 101, we have also seen effects on goodwill, intangible assets and deferred tax.

What should you do if a transition is needed?

Financial reporting framework transitions can be time-consuming and, with the increased data requirements of IFRS, may need input from areas of the business other than finance. For example, the identification and key terms of leases may involve procurement and facilities teams. This all means the transition should be planned well in advance of the year end.

It's also important to remember that, given the requirements of IFRS 1, entities must calculate the impact of restatement of the two preceding periods. So, if the transition occurred for a December 2023 year end, entities should also have performed the transition for both December 2022 and December 2021 (effectively the opening balance sheet of 2022). Under FRS 101 there is an exemption to present the opening balance sheet (2022 in the example above) at the date of transition.

Equally vital is that finance teams engage and explain the impacts to a wider group of stakeholders so that the whole business can understand the changes to financial reporting. KPIs and key ratios can be impacted, such as profit margins with potential knock-on impacts on reward schemes and the ability to meet financial covenants and pay dividends.

Lastly, management should engage with their auditors early on to understand what they might require and the information they expect to be considered, and to discuss the impact on timelines and fees.

We can help

Our experienced accounting advisory team can help you with impact assessment, implementation and transition to IFRS or FRS 101. Our enthusiastic and experienced individuals have previously worked on IFRS and FRS 101 transitions (including specific transitions in respect of IFRS 9, 15 and 16) and understand the challenges these accounting changes pose. If you would like further advice, please don't hesitate to contact James Wilkinson or Satya Beekarry.

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CASS 5 compliance: the FCA advises

If your firm is preparing for a CASS 5 audit, our recent conversation with the regulator may provide some crucial guidance.

The FCA meets regularly with us and the other large CASS auditor firms in order to clarify areas of doubt. So what is the current focus, and what are the most common breaches?

Credit write-backs

An increasing concern since COVID, and which the FCA sees as a potential indicator of weak financial resilience, is 'credit write-backs' (CWBs). Are there more incidents in the market than before?

The Regulator takes a strong view on this. It considers CWBs to be a breach of the director's fiduciary duties in protecting client money and also a potential breach of trust law. The FCA would only condone a CWB where there had been express consent from the entity to write off the balance. In such circumstances, it would expect the firm to pay away the monies to charity, rather than keep them for their own account.

Group restructuring

Related to CWBs is the issue of group restructuring – especially where larger private equity-backed groups are aiming to simplify their group structures by applying to the FCA for permission to revoke client money permissions. They typically do this where the business has been transferred to another entity in the group, so that various regulated entities can be de-authorised and closed down.

In such cases, it's sometimes difficult to clear away all client balances and the transferor is left with client money which it cannot easily pay away, possibly because of historic and/or other legacy issues. But the FCA has clarified, as long as there is a 'novation clause' and the firm has properly informed its clients that it intends to move its residual client money to another entity in the group, this scenario would be acceptable.

Is it client money?

So what happens if monies are received in a 'client bank account', but the recipient firm is unclear as to the nature of the receipt and whether it constitutes client money or not? Should the amounts be moved out immediately to prevent possible trust pollution? The FCA says no. It's fine to leave them in the client bank account while the firm investigates, in order to 'protect' the possible client money.

Mystery cheques

Similarly, what about 'cheque banking'? Sometimes a cheque is received which the firm is unclear about. For example, do the funds rightfully belong to the firm or to its clients (and have perhaps been wrongly made out to the firm). Should the cheque be banked or not banked, awaiting the results of enquiries as to its identity?

As above, the FCA would expect the client money to be 'protected' by banking the cheque, pending research by the firm before acting accordingly.

High-interest accounts

In the context of the rise in interest rates, we asked the FCA whether firms could transfer client money to properly designated high-interest client bank accounts.

It confirmed this is not an issue, as long as all consumer duty obligations are met, the firm has considered carefully how long it proposes to tie up the deposit in the 'term' accounts, and is mindful that it must satisfy insurer payment requirements under terms of credit and so on.

Investment products

As well as pure 'money market' accounts, there are now also 'investment' products beginning to appear to invest client money. On these the FCA's chief concern is that there could be a breach, as the firm would be acting as a 'discretionary money manager' for which GI firms do not have the relevant permissions.

If you would like further guidance on issues raised in this article or on CASS 5 compliance in general, please contact Paul Goldwin or Ian Cowan.

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Pre-sale due diligence: don't get caught out

Two common employment tax-related errors could cause you real problems when it's time to sell your business. Here's how to avoid the pitfalls that can threaten a smooth sale.

In our due diligence work for insurance intermediary businesses, we often identify employment tax-related issues. Though not specific to the sector, two in particular are common in small to medium-sized owner managed businesses.

In both cases, if identified as part of due diligence, they could lead to additional liabilities that reduce the consideration paid. It could also mean additional protections and indemnities are included in the purchase agreement. And time would need to be dedicated to rectifying the tax position rather than focussing on getting the deal agreed.

Which costs are business costs?

Business expenses are generally those incurred in the ordinary course of running a business. These can include costs of entertaining, travel and subsistence. But beware, as not all entertaining, travel and subsistence costs are necessarily business costs.

A director shareholder who takes their family on holiday and pays for this using the company bank account is clearly not incurring the cost in the ordinary course of business. This is therefore a private expense of the director.

That may be an extreme example, but what about the director who travels to meet clients and then extends the time travelling and takes their family with them? Or when a business has season tickets at a sporting venue, which are sometimes used to entertain clients but also used by friends and family?

Why does this matter? Because business expenditure is generally not taxable on the employee or office holder, whereas private expenditure is.

How this expenditure is taxable depends on who arranges the supply, and whether the business pays suppliers directly or whether the employee pays for the private expenditure and is then reimbursed by the business.

Ultimately, the private costs must be included as earnings in the company's payroll, with PAYE and NICs deducted, and paid to HMRC or included on a form P11D as a benefit in kind.

Where these costs are identified as part of the due diligence process, we often discover that none have been processed through the payroll or recorded on a P11D.

What's more, there is often a lack of clarity and documentation to show whether these costs do represent business expenses or whether they are privately paid by the business owner and therefore should be reported to HMRC.

We have seen examples where businesses have incurred significant levels of expenditure on travel or entertaining over several years. These amounts have not been reported to HMRC, nor been processed through the payroll. No evidence is provided as part of the due diligence that these represent business expenses.

This means a purchaser could be acquiring a company with potential exposure to considerable liabilities. This would happen if HMRC investigated the position and found that these expenses were private and therefore taxable on the business owner.

Employing family members

Members of a director's or business owner's family can be employed in the business, just like any other employee. But it's important that they are carrying out employment duties and are remunerated at a level that is commensurate with those duties.

Too often it's seen as a way of reducing overall tax liabilities. This is done either by paying part of the director's salary to the family member, even though they do not actively work in the business, or by paying an inflated salary to the family member who performs limited duties for the business or may only work part-time.

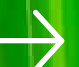
HMRC has anti-avoidance rules which require that a portion of the family member's salary, or all of their salary where the individual is not carrying out any employment duties, is reclassified as earnings of the director.

This, in turn, incurs additional tax liabilities. The director would typically have a higher income and therefore be taxable at a higher marginal rate of tax.

Once again, these kind of issues are usually spotted through the due diligence process. Either it becomes clear that a family member does not work in the business. Or, if they do, they aren't paid a salary that is commensurate with their role or the hours they work each week.

As with any other employee, HMRC expects family members to have an employment contract that clearly sets out their role, working hours and their remuneration.

Again, this would leave a purchaser in the position where the company they are acquiring has a potential exposure to additional PAYE and NIC liabilities.



What should businesses do?

These two situations give rise to significant additional liabilities. They can cause substantial delays in a deal process or, in some circumstances, cause a deal to be paused or fall through completely. This is because the purchaser is not willing to proceed with the transaction until the position has been rectified and the risk removed.

Businesses and business owners must make sure they apply the correct tax treatment to these situations, and that they are compliant with the tax rules. And, from a deal perspective, it's just as important to be able to demonstrate that compliance with clear evidence.

We would suggest that, as far as possible, private expenses are not included within the business but are paid for by the individuals and kept separate from the business.

Similarly, companies should only pay a salary to family members who are employed by the business. The level of that salary should be representative of the work they undertake. Contemporary evidence to support the work that they perform will be invaluable in responding to any challenge.

If you think your business will be going through a sale process in the future, it's often a good idea to engage with your tax advisors in advance and ask them to carry out a review of your tax position. This can help identify any errors or issues at an early stage and, importantly, allows time for these to be fully corrected before the sale starts. This, in turn, leads to a more straightforward due diligence process.

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