

Institute for Family Business Submission to HM Treasury – October 2009

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Part 1 - Introduction

The Institute for Family Business is an independent, not-for-profit, politically neutral, membership association which supports the UK family-owned business sector through Advocacy, Education and Research. The IFB membership accounts for approximately £35 Billion in turnover.

Studies have consistently demonstrated the importance of the family business sector. Research on the UK family business sector conducted for the IFB by Capital Economics¹ estimates that:

- Family firms account for **65% of private sector enterprises** in the UK economy - 3 million businesses
- Family firms account for over 40% of private sector employment, providing jobs to 9.5 million people – **one job in three throughout the UK**
- Family businesses account for **£73bn per annum in UK tax receipts**

¹ "The UK Family Business Sector", (London, 2008)

The evidence not only highlights the size and importance of family businesses to the UK economy but also the contribution the sector makes to the diversity of UK plc. The overwhelming emphasis of successful family businesses is on sustainable, long-term investment and employment practices. There is also a strong commitment to entrepreneurship that promotes innovation and renewal and an acknowledgement that social responsibility through engagement with key stakeholders is important.

The core values that define the family business sector can be summarised as:

- **Stewardship:** responsible management of entrusted resources
- **Entrepreneurship:** providing a crucial breeding ground for entrepreneurship and innovation
- **Social Responsibility:** generating benefits for all key stakeholders

This submission discusses the application of Government tax policy and accounting rules within this tripartite context. The IFB contends that supporting this approach, all the more prescient in the wake of the financial crisis, should be at the heart of Government policy. The IFB submission demonstrates why HM Government should be concerned, in particular, by issues relating to the family business sector, and with family firms accounting for over 30% of GDP why firms with this type of ownership are of importance to our economy.

The following are main themes relating to problems in the tax system facing the family business sector:

- Problems can arise when gifts or transfers of shares (on death) are made or when they are settled on trust because no liquidity is produced but a tax charge can result. In this regard Business Property Relief for IHT (BPR) is critical as it prevents a liquidity crisis arising in a business as a result of a change of ownership within the family.
- The IFB has highlighted examples of where the tax system could be simplified without creating opportunities for avoidance. Simplification is particularly important with respect to SME family firms who support 80% of the jobs in the family business sector.
- There is a presumption in the tax code - with the EIS and substantial donor rules- that transactions are not at arms length, particularly when involving family members. The IFB argues that this is both damaging to business by discouraging new business investment and by placing barriers in the way of increasing family philanthropy.
- The corporation tax regime encourages firms to favour debt funding that has led to some over-leveraging of companies. There is an imbalance with respect to the relative taxation of equity or patient capital that is treated less advantageously than debt.

We set out below our key policy recommendations to enhance the environment for family firms in the UK. Through sustaining policies that enable family businesses to develop in terms of stewardship, entrepreneurship and innovation family firms will be able to make a positive contribution to strengthening the private sector and creating greater employment.

Part 2 – Stewardship

Family business stewardship means actively and responsibly managing entrusted resources including a long term approach to growth and investment, which has positive knock-on effects for the economy as a whole. In today's uncertain economic climate, many family firm owners continue to ensure continuity of their business activity through succession to the next generation. With 3 million family firms in the UK it is estimated that 100,000 businesses potentially face a generational transition each year. It is important that family businesses have the option in terms of succession planning to choose an orderly transition between generations. It is the IFB's view that the tax system should not give rise to situations where unfunded tax charges are placed on family businesses, when ownership is retained in family hands. As will be demonstrated certain IHT and CGT charges cause particular problems to family businesses because the owners wealth is tied up in the business so there is no liquidity to fund the payment of taxation.

2.1 Business Property Relief for IHT

Business Property Relief is a crucial relief from inheritance tax which facilitates the transfer of family management and business ownership between generations, allowing a long term approach which focuses on the stability and sustainability of the business. In the absence of such relief, this approach would not be possible as the inheritance tax which any successful business would attract would almost certainly require a sale, liquidation or substantial borrowing. The death of a major shareholder could bring a profitable business to an end.

A recent German study found that the UK had a supportive environment for family business. The report stated that, that the UK had the most competitive environment for family business of 14 major countries. This is in large part, but by no means only due to the relief for business property for inheritance tax². The relief was introduced as a 50% business property relief (BPR) in 1987, increased to 100% in 1992, which exempted the transfer of most business properties from inheritance tax.

Case Study: An SME family business A & Sons is owned by a father (Mr A) and one of his sons (Mr B). Mr A falls ill and decides that his other son (Mr C), who works in the business, should be given ownership of half of Mr A's shares worth £2 million, while Mr B will be given the other half. Unfortunately, Mr A dies within 7 years of the gift being made so the transfer is chargeable. This means that Mr B and Mr C each face an IHT charge of £400,000. Their assets are all tied up in the company which is growing steadily thus requiring investment and the directors have retained the profits in the business. The sons have no way of financing the tax charge. BPR means that they do not face such a charge.

² "Competitiveness Report for Family Enterprises,"(Stiftung Familienunternehmen, 2008)

Policy options

Abolition of the relief could potentially raise the Government extra revenue. However, it would in effect prevent family businesses from being transferred through generations. This would either have the effect of closing businesses or meaning that they would have to be sold, to fund a tax liability, which would mean they were no longer family owned (see case study above). Equally limiting the relief would create the same liquidity problems as abolishing the relief and could have exactly the same effects. Both these options would seriously damage the family business sector's long term existence.

Given that BPR relief³ is vital to the continued long term existence of the family business sector in the UK maintaining the relief would satisfy the policy aims of enabling family businesses to continue to exist as family owned enterprises with all the accompanying benefits outlined in the introduction to this submission.

Recommendation 1: Maintain 100% BPR relief on IHT

2.2 BPR Clearance mechanism

The IFB urges HMRC to continue the operation of its clearance mechanism for Business Property Relief which has been an excellent pilot innovation by Government in helping taxpayers to comply with their obligations.

Anecdotal evidence from IFB members suggests that the relief has already been useful and in a recent survey of our membership 5% of companies had already used the clearance mechanism – a significant proportion given that the scheme has only run for a short period of time.

Recommendation 2: Continue operation of BPR clearance mechanism

2.3 Trusts and holdover relief

Holdover relief and the capital gains tax regime contribute significantly to the competitiveness of UK family businesses. The IFB appreciates the efforts of HM Treasury and HMRC to ensure the effective operation of the scheme. However, we are concerned about two points. The treatment of trusts reduces the options for a family business looking to plan for succession. It also creates a liability to tax for which there is no liquidity to meet because actual gains have not crystallised. Secondly, the rules around BATR and holdover relief are not presently aligned but could be in order to simplify the tax system.

³ BPR cost £130 million in 2008-09.

Trusts are a useful mechanism for transferring part of the business to future generations using trusts to separate ownership and control. The absence of holdover relief makes the use of trusts impractically expensive thus making the stewardship of family businesses more problematic. It is the IFB's submission that holdover relief should be granted on a transfer of a business to a trust, notwithstanding that it would otherwise be a settlor interested trust. The current legislation prevents holdover relief if the settlor, his spouse, civil partner, child (or stepchild) under 18 can benefit at all under the settlement (section 169F TCGA 1992). This legislation therefore prevents good succession planning.

Family business proprietors may not wish to dispose of their business in one fell swoop and to retire from it immediately. Indeed, it is very often the case that, if they did so, the retirement would have deleterious consequences for the business itself. The transfer of a business to the next generation will often be most successful where it takes place over time, operating as both incentive and reward, in tandem with the increased responsibilities and input of the younger generation. The current restrictions on capital gains tax holdover relief make this extremely difficult unless the business already happens to be held on trust.

Recommendation 3: Connected person rules for CGT should be altered so that trusts can be used for the continuation of the family business.

2.4 Business asset taper relief, BPR and holdover relief

Tax simplification is important where it can be delivered without creating avoidance opportunities or uncertainty through the use of new terms.

The rules concerning business asset taper relief (BATR), BPR and holdover relief are somewhat piecemeal in their approach to overlapping issues and create complexity where the tax law could be made more coherent.

Recommendation 4: The tax laws relating to BATR, BPR and holdover relief should be simplified.

2.5 Accumulation & maintenance trusts (“A&Ms”) and interest in possession trusts (“IIPs”)

The rules on accumulation & maintenance trusts (“A&Ms”) and interest in possession trusts (“IIPs”) were amended in 2006. The tax regime for these trusts have been aligned with the more heavily taxed inheritance tax regime that applies to general discretionary trusts, subject to certain exemptions and transitional provisions. This means that they are taxed in a different way than previously which is hampering prudential planning by families and family businesses. Moreover, the age limit for

distributions to beneficiaries has come down from 25 to 18. We do not feel it is appropriate in all cases to make large distributions to family members until age 25 by which point young adults should have acquired a growing sense of stewardship and responsible ownership. As a tax charge kicks in earlier (at 18 rather than 25), under the post-2006 regime, the tax system now encourages families to give money to a young person who may act irresponsibly.

Recommendation 5: The IFB calls for HM Treasury to formally assess the impact of these changes to the tax regime for trusts and report to Parliament.

Part 3 - Entrepreneurship

Family businesses are a driving force for entrepreneurship in the UK economy. Family businesses constitute the majority of the SME sector where a high proportion of new business start up activity and innovation occur. Existing family businesses and their owners have been identified as key sources of early stage entrepreneurial activity⁴. It is critical that finance can flow to these young businesses and help ensure that they do not succumb to the problems encountered in the “equity gap”.

3.1 EIS rules

A key incentive for investment into early stage businesses is the Enterprise Investment Scheme (EIS). EIS and venture capital rules discriminate against family businesses raising capital from relatives and this makes it harder for family firms to raise early stage capital. Inherent in EIS is a presumption that investment by family members is not at arms length.

EIS income tax deferral only applies where individual investors are not connected to the company that they are investing in. Whilst the definition excludes siblings it does include partners, directors or employees. This discriminates against active business participation by related investors, typical in family businesses.

Recommendation 6: To allow family members relief on EIS investments through a “commerciality test”

3.2 BPR and expansion into new lines of business

The treatment of growth in the IHT business property relief legislation places barriers in the way of sensible corporate planning by limiting the relief where expansion into a new line of business either vertically or in parallel with an existing trade through associated companies and joint ventures takes place. Businesses develop associated companies and JV's for good reasons such as to diversify risk

⁴ <http://www.ifb.org.uk/media/6672/gemreport-familybusinessspecialistsummary.pdf>

by embarking on a new strategic direction. This legislation either prevents businesses from expanding in this way or the limitation of the relief creates a potential tax liability which results in liquidity problems putting family firms at a competitive disadvantage against non-family companies.

Recommendation 7: Introduce a provision to look through the holding in the associated or Joint Venture Company.

3.3 Corporation Tax

The recent financial turmoil has highlighted the issue of the amount of debt that is healthy for the economy to bear; the state's debt, consumer debt and corporate debt are all under the spotlight. While corporate Britain as a whole is not considered to be over burdened with debt, overleveraging is a practice that has become prominent in certain parts of the business sector. The family business sector generally tends to shy away from high amounts of debt preferring to fund growth and investment through retained earnings. A more conservative financial approach in terms of balance sheet funding has been shown to be advantageous during times of recession; firms with low debt are able to more readily adjust to tougher trading conditions, while continuing a strategy of long-term growth and investment and thereby securing jobs.⁵

The present corporation tax system is imbalanced when it comes to the treatment of debt and equity, strongly favouring the former which is a deductible expense for corporation tax purposes. Patient capital that family firms reinvest in companies is treated less advantageously in tax terms than debt.

Recommendation 8: HM Treasury should engage in consultation with relevant organisations to consider re-balancing the corporation tax regime to take a more balanced approach towards debt and equity funding

Part 4 - Social Responsibility & Family Philanthropy

Companies and their owners are committed to supporting other stakeholders through socially responsible behaviour that can include giving programmes. Recent research by the IFB suggests that family owners and their companies engage strongly in philanthropy. The same research suggested that extra incentives from the Government were not considered important by IFB members and that family businesses will continue to be actively engaged in their communities as employers and maintain socially responsible practices⁶.

⁵ Poutziouris, P. "The UK Family Business PLC Economy" (London, 2005)

⁶ <http://www.ifb.org.uk/media/32594/natphilanthropists%20final.pdf>

4.1 Substantial Donor Rules – s.54 Finance Act 2006

A particular problem area, of which Ministers are already aware, is Section 54 Finance Act 2006 relating to the Substantial Donor Rules. The problems have been well documented but in essence the legislation is complex, confusing and excessively onerous in its implementation. Section 54 was introduced to prevent the abuse of tax reliefs on large donations to charity. The statute defined a substantial donor as a person or business who gets tax breaks on gifts to a charity of at least £25,000 over a period of 12 months or £100,000 (now amended to £150,000) over six years. “Connected persons” include – but are not limited to – spouses, a range of relatives and business partners. Identifying a substantial donor creates new accounting problems for the charity but also requires the charity to ask intrusive questions of generous people. If a donation falls foul of the rules the charity will lose charitable tax reliefs – possibly many years down the track.

Recommendation 9: To create a purpose test for substantial donors to replace the existing rules.

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