Institute for
Family Business

Institute for Family Business (IFB) Autumn Submission to HM Treasury

October 2011

The IFB welcomes the opportunity to make a submission to HM Treasury and would be grateful to discuss at an early stage the tax issues raised in this document. This autumn submission follows the last submission by the IFB in October 2010[1], and responses that were made during the course of 2011 on related issues particularly to the Office of Tax Simplification[2].

This submission contains the following:

1) Introduction
   i. The family business sector
   ii. Taxation principles

2) Policy Recommendations
   i. Business Property Relief
   ii. BAHR control test and BPR
   iii. Trust taxation
   iv. The treatment of finance for growth
   v. EIS connected persons rules

1. Introduction

<u>1.1 The family business sector</u> The IFB is an independent, not-for-profit, politically neutral, membership association which supports the UK family-owned business sector through Representation, Education, and Research. The IFB membership accounts for 215 medium and large sized family firms with more than £40 billion in turnover.

Studies have consistently demonstrated the importance of the UK family business sector. New research on the UK family business sector conducted for the IFB Research Foundation by Oxford Economics[3] estimates that:

- Family firms account for 66% of private sector enterprises in the UK economy – 3 million businesses.
- Family firms account for more than 40% of private sector employment, providing jobs to 9.2 million people.

[1] http://ifb.org.uk/media/44016/ifb%20autumn%20submission%20to%20hm%20treasury%202010.pdf
[2] http://www.ifb.org.uk/media/119541/ots_ifb_submission.pdf
[3] *The UK Family Business Sector*, Oxford Economics, publication pending November 2011.

- Family firms generate over £1.1 trillion turnover or 35% of the private sector contributing almost a quarter of total GDP.
- Family businesses account for £81.7 billion per annum in UK tax receipts or 14% of Government receipts[4]

The family business sector is a strategic pillar of our national economy. The sector broadly characterises itself by the long-term approach it takes to **stewardship**, carefully managing resources, and as a breeding ground for **entrepreneurship**

Family firms face particular issues especially around business transfer. Government estimates show that more than 172,000 businesses in the UK each year are exposed to the risk of business transfer failure, either closing or becoming less effective[5]. A failed process of succession to the next generation is a key cause of ownership transfer failure.

Enabling family firms to plan for and manage ownership transfer supports the retention and growth of economic capital such as knowledge, key relationships, and other intangible assets retaining jobs and promoting economic growth. Public policy in the area of business transfers is therefore of paramount importance.

More successful business transfers will have immediate beneficial effects for the UK's economy. Existing companies conserve on average five jobs whereas a start-up generates on average two jobs.

<u>1.2 The IFB believes that some key principles should apply in considering the tax regime in relation to family business:</u>

- Develop a balanced economy where diversity of ownership type is encouraged
- Achieve greater certainty regarding stability of the tax regime to encourage investment
- Reduce complexity easing the burden of tax compliance
- Encourage owners to pursue a balanced approach to risk
- Market distortions caused by the tax system should be minimised.

The tax regime generally should promote policies that support entrepreneurship and stewardship.

[4] *The UK Family Business Sector*, Oxford Economics, publication pending November 2011.
[5] UK Government Report *Passing the baton – encouraging successful business transfers* (2004).

2. Policy recommendations

The IFB recommends the following:

- **Recommendation 1: Business Property Relief for inheritance tax is a crucial relief and should be maintained in full.**
- **Recommendation 2: HM Treasury consults on simplifying the control test used in holdover relief qualification.**
- **Recommendation 3: Holdover relief connected persons rules are altered so that sensible succession planning using trusts can take place.**
- **Recommendation 4: A review of business finance is carried out by HM Treasury in order to foster growth.**
- **Recommendation 5: The connected persons tests for EIS should be removed to promote family start-ups.**

2.1. Business Property Relief

BPR is a crucial relief from inheritance tax that facilitates the transfer of family management and ownership of the businesses between generations; allowing a long term approach which focuses on stability and sustainability. 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.

The IFB welcomes HM Government's commitment to maintain 100% BPR on inheritance tax, which is a highly significant plank of the Government's policy on business transfer. 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. BPR means that when inheriting a share of the family business and successfully continuing the business the next generation of owners does not face a tax charge which they do not have the liquidity to fund. This policy has been highly successful and other countries in the EU have adopted a similar strategy.

PriceWaterhouseCoopers conduct an annual survey of family business, encompassing thousands of businesses. The most recent PwC survey[6] showed that succession is becoming a larger issue as the "baby-boomer" generation reaches retirement age over the next few years. Of the thousands of family firms leaving a generation's control each year many of those proprietors will be owners of small businesses. In fact, over half of all SME's are family firms according to HM Government data[7]. BPR affords these firms an option to plan for a stable succession while maintaining ownership stability.

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[6] http://www.pwc.com/gx/en/pwc-family-business-survey

[7] *The UK Family Business Sector*, Oxford Economics, publication pending November 2011.

Furthermore, there are approximately 100,000 non-micro family owned SMEs that could grow to become medium and large sized businesses. Promoting medium-sized business (MSBs) is a national economic priority and family firms make up an important share of this segment of the economy. If BPR was removed family firms would lose the opportunity to grow under stable ownership as the firms would have to be partially liquidated or sold to fund payment of any tax charge arising on the death of an owner. Therefore, BPR is a significant pro-growth policy for business.

The relief has a significant impact, given the obvious potential difficulties of passing a business down generations it is not difficult to imagine that an inheritance tax charge would make the transition of business ownership unviable. The Department for Business Innovation and Skills publishes an annual survey of small firms. This found that 77% of family firms in the SME sector are controlled by the first generation, 10% by the second generation, and 6% by the first and second generation. A third of family firms tend to be passed onto the second generation and one tenth reach the third generation, the rest being either sold or closed down.

A recent German study found that the UK had a supportive environment for family business. The report stated 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, down to BPR for inheritance tax.[8] However, a number of European Member States have lowered their tax rates on inheritance. Examples include Denmark in 1995, Italy in 2002, Finland and Greece in 2008, and the Netherlands in 2010. Furthermore, several Member States have abolished taxation of inheritance. During recent years, the Member States Austria, Portugal and Sweden have abolished their inheritance tax system. Cyprus, Estonia, Latvia, Malta, Romania, Slovakia do not have an inheritance tax or estate tax.[9] The Swedish IHT repeal was motivated largely by the wish to encourage more owner managers to consider retaining their firm in family ownership, and continuing to invest in growing the business- rather being faced during the succession process with a "forced sale". This policy was ultimately designed to combat what has been described as a "bar-bell" economy where there are insufficient MSBs in a private sector that becomes polarized around firms at opposite ends of the spectrum in terms of size. In the case of Germany there is a particularly robust MSB segment that is strongly populated by family firms- these companies are commonly referred to as the "Mittelstand".

Recommendation 1: Business Property Relief for inheritance tax is a crucial relief and should be maintained in full.

<u>2.2 BAHR Control Test and BPR</u>

As noted above, Business Property Relief for IHT is a crucial relief for privately owned family businesses. It is considered a major plank of Government policy in fostering entrepreneurial activity supported by a

[8] "Competitiveness Report for Family Enterprises,"(Stiftung Familienunternehmen, 2008)
[9] Lyons, T. et al, *Capital taxes in Europe*, (London 2010)

family business sector making a strong contribution to growth and employment. Unfortunately the complexity of the capital tax system restricts the effectiveness of the relief. Businesses who qualify for BPR also seek to qualify for holdover relief on gifts of shares but the complexity of the system hinders this sort of best practice planning for business transfer.

A charge to tax such as capital gains or inheritance tax can cause extreme problems particularly if no liquidity is created by the disposal that triggers the charge. Family businesses are, therefore, extremely cautious in ensuring that they qualify for Business Property Relief (BPR) and holdover relief. Without holdover relief a gift could result in a CGT liability, with little or no disposal proceeds from which to pay it. It is therefore of crucial importance for gifts of assets to qualify for holdover relief. To qualify for these reliefs businesses must pass a "trading" test. The holdover relief test has several components which cause difficulties. This section sketches the issues involved and proposes amendments.

To qualify for holdover relief companies in which shares or securities are being transferred have to pass a three pronged test. The key aspect of this onerous test is that if there are non-business assets amongst the assets of the business (i.e. it is a hybrid trading company with some investment assets) the transferor of the assets must have only a small amount of control of the business. This limited control is restricted to being under 5% of the voting rights or under 25% of the voting rights if they have been exercisable in the past 12 months.

If the control test is failed then holdover relief is restricted so that relief is denied on investment assets on the balance sheet.

The restriction is calculated by working out the market value at the point of the disposal of all company/group chargeable assets and allowing relief only on the percentage that business chargeable assets comprise of total chargeable assets. HMRC make clear in guidance that all assets which, if sold, could give rise to a gain are to be considered as chargeable assets for these purposes even if the assets concerned are currently standing at a loss.

It is also onerous for those contemplating gifts of business assets to carry out two discrete tests (i.e. whether the firm is trading and then whether the control requirements are met) regarding a company's activities before they can establish whether unrestricted holdover relief is available on gifts of shares in trading companies.

Historically when holdover relief shared the 'wholly or mainly' test with BPR the control tests were logical. When holdover relief was reformed it was expected that the control reforms may also have been realigned because neither the, now obsolete, taper relief 'trading' test or the Substantial Shareholdings Exemption test, both of which use the stricter 'substantial' hurdle, had a control element. It is unclear, given the adoption of the stricter 'substantial' test, for holdover relief, what the policy aim of this further hurdle is.

This is significant for successful family businesses which choose to retain profits and diversify risk into investment activity, as this can have a substantial impact on the availability of crucial holdover relief. Many firms' owners decide to invest the company's resources, for prudent financial reasons, in assets that are less risky. Such assets including property can provide counterweight to funding riskier investments while enhancing the organisation and the strength of its balance sheet. This can mean that gifts of shares are not made according to a family business succession plan but are made for tax reasons sometimes hindering owners transmitting shares during their lifetime.

Recommendation 2: HM Treasury consults on simplifying the control test used in holdover relief qualification.

2.3 Trust taxation

The transfer of management responsibilities between generations tends to be a gradual and ongoing process - taking place as younger generations mature, which trusts can facilitate. Trusts also enable the economic benefits of a family business to be shared among numerous persons and generations, at the same time ensuring that the ownership of the business is not unduly fractured. Trusts can promote stability in terms of management and ownership. They also are a mechanism to plan forward especially in terms of ownership transition. In a recent IFB poll trusts were confirmed as an ownership structure that remains popular, with 60% of members using trusts.

In its 2004 consultation document, *Modernising the Taxation of Trusts*[10] HM government sets out its objectives as being a tax system for trusts which does not provide artificial incentives to set up a trust, but equally, avoids artificial obstacles to using trusts where they would bring significant non-tax benefits. The IFB wholly supports this aim. The trust taxation regime is inevitably complicated but should avoid tax obstacles to good succession planning.

The IFB has sought to provide a practical proposal for trusts which would make them more useful for family business and would remove distortions.

Practical steps for trusts

The problem is largely not one of the effective rate of tax due which is reduced by the business assets in the trust because of BPR. However, family businesses have told the IFB that the current tax regime encourages early outright gifts of family business assets rather than settling them on trust. This clearly runs against the Government's policy intentions as set out in the *Modernisation of the Taxation of Trusts* consultation in 2004 that stated that the tax treatment of trusts should be neutral and should not create artificial incentives.

Any gift which is not at arm's length is deemed to be for a consideration equal to the market value of the asset at that date. This affects family businesses who are trying to plan for succession in their

[10] http://www.hmrc.gov.uk/trusts/trust-modernisation.htm

business. Several studies including a paper published by the Financial Services Authority have showed that a person's financial capability improves with age.[11]

Therefore it would be ideal if it were straightforward to use trusts for succession planning. This would include settling family business assets on trust when the next generation in the family is not yet ready to takeover ownership of the company. However, the decision to settle assets on trust for beneficiaries who are currently children is not tax neutral: instead, it is penalized by the tax system.

A disposal is always deemed to not be at arm's length if it is to a connected party. Such a connection makes the trust a settlor interested trust which means that any such gift would not qualify for business assets holdover relief. If it was made through a trust, to be distributed only when the child is more mature, the gift would be chargeable on the capital gain. Whereas if the gift was made outright (i.e. not through a trust) to a minor child the gift would qualify for both holdover relief and BPR.

Recommendation 3: Holdover relief connected persons rules are altered so that sensible succession planning using trusts can take place.

2.4. The tax treatment of finance for growth

The current tax system skews financing towards debt funding and away from equity finance and retention of profits yet it is also not the case that this would be the only or major reason to reform the treatment of financing methods. The problem now is the need for investment for growth and the fact that new investment is hard to come by and carries additional cost.

Improving the strength of the balance sheet is important for business. A recent study by the University of Nottingham and Leeds[12] commissioned by the IFB Research Foundation shows that conservative balance sheets are a feature of many family businesses. Among small, medium and large firms family businesses retain a higher proportion of profits than non-family firms, creating strong balance sheets[13].

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[11] "Somewhat ironically, whilst the need to plan ahead is perhaps greatest in early adulthood, financial capability in terms of planning ahead clearly improves with age": Financial Services Authority, *Levels of Financial Capability in the UK: Results of a baseline survey, March* 2006, page 76. Young people aged 18 to 20 had a factor score of just 27 out of 100, while those aged 20-29 had a higher factor score of 40.

[12] UK family businesses: industrial and geographical context, governance and performance (London, 2010)

[13] Family businesses' access to internal finance is likely to have been significantly constrained during the credit crunch because of the depth of the recession, which adversely affected corporate profitability. For example, according to ONS data, gross operating surplus for private non-financial corporations (PNFCs) fell by 11.7% in 2009, the largest fall in post-war UK history.

Analysis of accounting data shows how the availability of internal finance changed for family businesses. Between 2008 and 2009, the median ratio of retained earnings to total assets fell from 21.4% to 19.3% for small family firms and from 18.0% to 16.0% for medium-sized family firms. This compared favourably to non-family firms where the equivalent figures were 14.2% to 12.3% and 8.3% to 6.4%. This suggests that family firms benefited, on average, While much of the debate concerning finance and taxation has been related to whether debt interest should be allowed to be deducted, it is clear that the tax system not only skews investment decisions in this way it also skews behavior against investment through retention of profits or equity finance.

If a firm uses debt-financing corporation tax does not have a negative impact on financing options. Before tax the decision to use equity financing is also tax neutral. However, corporation tax raises the cost of equity capital creating a significant disincentive for growth.

The recent Mirrlees Review conducted by the Institute for Fiscal Studies says that “Some corporate investment that would otherwise be viable is likely to be deterred by a standard corporate income tax.” At a time when growth is critical for the UK economy as a whole it is important to examine the details of how growth finance is treated by the tax system. HM Treasury should also look at international comparisons such as Belgium where equity deductibility is possible[14].

<u>Hypothetical example:</u>

If a firm wants to invest in its own growth it can raise the finance to do so in two key ways. The first is to borrow the money. The second is to retain profits. In the case that the firm is making a sizeable profit the following apply:

Debt finance

If a firm chooses to use debt it would be in the following position. It raises £1 million at an interest rate of 5%. It makes a return of 10% equaling £100,000. However, the firm would have to pay the 5% interest payment to its creditors for the loan costing the firm £50,000. Yet the cost of the interest payment is deductible for tax. This means that £50,000 interest paid is deducted for corporation tax leaving a taxable profit of £50,000. This is taxed at 25% which equals a cost of £12,500. So the firm makes a profit of £100,000 - £12,500, totaling £87,500 after tax. This leaves it with an after-tax return on investment of 8.75%.

Retention of profits

If the firm instead chooses to retain profits to utilise for investment, rather than distribute reserves through dividends, they would be in the following position. If the firm reinvests £1million and makes a 10% return on that investment, totaling £100,000, it then pays corporation tax of £25’000 on the profit. It therefore makes £1,075,000 after tax which is an after-tax rate of return of 7.5%.

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from a more cautious approach in the run-up to the crisis. On the other hand, the median ratio of retained profits to total assets for large family firms increased from 25.7% to 27.0% between 2008 and 2009, with a similar pattern for non-family firms. This indicates that large firms were able to strengthen their balance sheet during the recession − despite the squeeze on profits.

[14] http://www.feb.ugent.be/nl/Ondz/wp/Papers/wp_10_640.pdf

The return is lower for the firm that chooses to finance its activity through retention of profits, as is demonstrated in the example below. In effect the tax treatment is raising the cost of capital for certain forms of growth finance. In the example in Year 1 the after-tax return on investment (ROI) is 8.75% when using debt finance but only 7.5% if using retained profits despite the pre-tax rate of return being the same.

Source of Finance	Initial investment	Interest rate	1st Year ROI	After-tax ROI/Investment value following 1st Year
Debt	£1,000,000	5%	10%	8.75% / £1,087,500
Retention of profits	£1,000,000	N/A	10%	7.5% / £1,075,000

Recommendation 4: A review of business finance is carried out by HM Treasury in order to foster growth.

2.5. EIS connected persons rules

As set out previously by the IFB in its Autumn Submission to HM Treasury in 2010 the IFB is principally concerned with the connected persons rules in relation to tax-advantaged schemes for venture capital investment.

Growth in family businesses often comes about as a result of investment by family members who are or are not involved as employees of a family business. Start-ups are encouraged as incubators of innovation and seek family investment from non-employee family members. In a report for the IFB by Capital Economics[15]it was shown that 13% of family businesses were start-up spin offs. In a recent survey of IFB members one in five report that they invest in family start ups.

The EIS and the proposed BASIS rules hinder investment in fledgling family companies. This is because both schemes distort the market for venture capital for those connected persons. The tax deductions offered mean that a venture capital investment that does not qualify by virtue of the investor being connected to the company will have to radically outperform such a tax-advantaged investment. This is clearly in contravention of Section 1.3 of the EU Commission's Guidelines on Risk Capital.

The policy rationale given to the IFB by HM Treasury is that the market failure caused by information asymmetries does not apply to family members. It is unclear why this is thought to be the case. There are separate rules where family members are connected to the company by virtue of working in the

[15] http://www.ifb.org.uk/media/7404/uk_fb_sector_report.pdf

business. It is unclear why family members who are not working in the business should have more information than other investors.

Whilst the IFB supports HM Treasury's endeavor to fill the equity gap for SMEs it believes the restrictions imposed on connected parties should be reformed so that kinship is not taken into account or so that any such connected persons rules are targeted specifically against avoidance. In the IFB member survey 38% indicated they would increase investment or begin investment in family start ups if connected party restrictions to EIS relief were lifted.

Hypothetical example:

Mr Eyre invests £150,000 into an EIS investment in June 2003. In June 2010 he sells the shares for £200,000. HIs tax position is as follows:

- EIS relief is at 20% so Mr Eyre's investment cost is £120,000.
- As the sale was after three years of owning the shares the gain is exempt from CGT.

The return on investment is 33%. However after the income tax relief the gain is effectively £80,000. That leaves Mr. Eyre with an effective return of 53%.

In 2003 Mr Eyre also invested £150,000 in the business of his son Jack. His son was taking a small salary from the start-up and owned 40% of the shares with voting rights. Mr Eyre is therefore a connected person for the purposes of ITA 2007 s170. The firm performed well and in the 2010 tax year Mr Eyre sold his shares for £200,000.

- His investment cost is £150,000 as he does not qualify for EIS income tax relief.
- His gain is chargeable at 28% (£14,000), he therefore makes £36,000 over 7 years.
- The return on investment is therefore reduced to 24%.

By virtue of the EIS relief the performance of a family business has to be significantly higher than that of a non-family business to attract an investment from a family member. In this case the financial return had to be almost doubled just to achieve parity.

Recommendation 5: the connected persons tests for EIS should be removed to promote family start ups.

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