Institute for Family Business

IFB SUBMISSION TO THE OFFICE OF TAX SIMPLIFICATION

Contents

1. Introduction

1.1 Tax Simplification and the Family Business sector

The IFB welcomes the opportunity to make a submission to the Office of Tax Simplification. The Institute for Family Business (IFB) is an independent, not-for-profit, politically neutral, membership association supporting the UK family-owned business sector through Representation, Education and Research.

The IFB believes that simple tax rules play a key role both in creating a tax system that is fair for all and in creating a tax environment which is internationally competitive. The IFB welcomes HM Government's commitment to tax simplification as evidenced by the establishment of the OTS and through the principles set out in the 'Draft Protocol on Announcements Outside Scheduled Fiscal Events'.[1] The IFB sees the Protocol as an acknowledgement that simplification is not merely a workstream. What is needed is a strategy for tax simplification that is incorporated into the process of generating tax policy itself.

[1] In particular, the protocol set out several areas relevant to simplification; it is important that consultations are conducted at the stage of a tax policy change when the overall principle and objectives are being considered and the introduction of a specific tax impact assessment in place of the current government-wide impact assessment.

Certainty regarding the meaning of tax provisions and liability to tax and the ability to resolve queries quickly are important issues for any efficient tax system. Lack of certainty arises largely because of complexity in the tax system. Guidance has been used to provide a semblance of certainty, but the precise status of guidance notes is sufficiently unclear that they introduce an additional layer of uncertainty into the UK tax system, with damaging consequences. Clear and well drafted legislation would remove the need for most HMRC 'Guidance', but where it is necessary it should be subject to the same public consultation procedures as legislation.

Recommendation: There should be full and adequate consultation on draft guidance. Once implemented any guidance should be legally binding.

1.2 IFB's general principles on tax system reform

First that many tax reliefs are not reliefs, but provide for a deferral of tax charges until a gain is crystallised or income is received. These reliefs, which holdover or defer tax charges, are very important for family businesses.

In short, by deeming a taxable payment to have been made tax is not levied based on an ability to pay. The IFB seeks to identify the areas of the tax system where such rules could be simplified or reformed to further help the family business sector.

The IFB believes that a clear set of principles should apply when considering taxation policy in relation to the corporate sector generally and family business in particular:

· All companies should make a fair contribution to the fiscal needs of the UK.
· Tax should be charged based on the ability to pay. Managing succession in family firms requires a unique set of policies to enable business continuity during generational transitions (see sections 2, 3 and 4).
· The tax system should avoid complexity. The avoidance of complexity is particularly important with respect to SME family firms. The compliance costs that the tax system imposes on family businesses are a drain on resources that would otherwise be available for investment (see section 3). IFB members regularly highlight the time that tax complexity takes up for senior management. This should be reduced so that more time can be directed towards growth opportunities.

· Market distortions caused by the tax system should be minimised. The tax system should promote a balanced approach to risk encouraging businesses not to take on excessive leverage.

2. Business Property Relief

2.1 BPR's importance to the family business sector

Business Property Relief (BPR) is a crucial relief from inheritance tax which facilitates the transfer of family management and ownership between generations, allowing a long term approach which focuses on the stability and sustainability of the business. In the absence of BPR, such an approach would not be possible as the inheritance tax which any successful business attracted 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 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.

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 of Trade and Industry, as was, published 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 solely, down to the relief for business property for inheritance tax[2].

A number of 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 the taxation of inheritance. During recent years, the Member

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

States Austria, Portugal and Sweden have abolished their inheritance tax system. Cyprus, Estonia, Latvia, Malta, Romania, Slovakia also do not have an inheritance tax or estate tax[3].

Recommendation: BPR from inheritance tax is crucial and should be maintained in full.

2.2 BPR and Joint Ventures

Family businesses often use Joint Ventures (JVs) in order to expand into new areas of business. This is particularly true when expanding into new international markets.

The current legislation limits the ability of family businesses to establish JVs in two ways; the 50% test applying to unquoted securities and the holding company relief test.

The legislation can mean that BPR would be lost on assets falling foul of the tests. This can mean that a JV has to be designed around the legislation so that it is majority controlled for instance. However, in many cases it is not possible to do so – perhaps the family business cannot raise enough capital to have a significant enough shareholding for instance, or perhaps the other party would not agree to having a minority stake. This would likely prevent the JV, and therefore the expansion of the business, because family businesses cannot jeopardize their BPR status (see 2.1). These limitations can place family firms at a competitive disadvantage to non-family firms when it comes to making investments of this nature. The limitations can stifle investment by family firms in joint ventures thus hindering economic growth.

BPR could be simplified by altering these restrictions on the relief. In particular, consideration might be given to equivalent provsions for those that used to apply for business asset taper relief that were included as paras 23-24 of Sch 7, TCGA 1992 – these essentially 'look through' a joint venture company and allow its trading activity to be attributed to qualifying corporate shareholders.

Recommendation: Legislation should be introduced to reduce the impact of the holding and control tests in the BPR rules.

[3] Lyons, T. et al, *Capital taxes in Europe*, (London 2010)

3. Family Business Trusts

3.1 Introduction

Trusts, an English law concept, are a flexible means of catering for a variety of demands for the protection of families in a range of aspects of their personal, financial and commercial lives. Most mainland EU countries have some equivalent form – typically a foundation or *usufrucht*.

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 stability in the management and ownership, particularly during times of generational transition.

Several studies including a paper published by the Financial Services Authority have showed that younger people are not very financially capable and that financial capability clearly improves with age.[4]

3.2 Principles of trust taxation

In its 2004 consultation document *Modernising the Taxation of Trusts* 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. Trust taxation is inevitably complicated but should avoid tax obstacles to good business planning.

The key aspects of trust taxation that are relevant to family businesses relate to provisions introduced in the Finance Act 2006 and are set out below in 4.2.

[4] "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.

3.3 How are trusts taxed?

The key concept is the "relevant property" regime. This regime applies and always did apply to discretionary trusts but now applies (following the 2006 changes) broadly to all trusts. The main consequence of the FA 2006 changes is that transfers of assets into trusts are now chargeable and not "potentially exempt". Relevant property is subject now to a number of IHT charges:

- *10-yearly charge* This charge as its name suggests is levied every 10-years after the foundation of the trust. The charge is 6% and is levied on the value of the trust assets at that time. The trustees pay the liability.
- Exit charge - The exit charge applies as and when the trustees appoint trust capital to one or more beneficiaries or a beneficiary becomes absolutely entitled to trust capital. The rate applicable depends on the length of time between the date the exit charge arises and the date of the immediately preceding 10-year charge. The charge is 0.6% per year from the immediately preceding 10 year charge up to a maximum of 6%.
- Exit charge before the First 10—year Charge -It may be that prior to the first 10-year anniversary following the setting up of the trust that an exit charge arises. To ascertain the rate of the charge a complex methodology is used. The charge is an attempt to levy a charge equivalent to the exit charge outlined above.
- Qualifying interest in possession trusts - For the discretionary trust nothing changed in 2006. For the interest in possession trust created in lifetime after 2006 the regime applicable to the discretionary trust now applies.

The decision to create a lifetime discretionary trust or interest in possession trust is now tax neutral. However, the decision to do so when compared to an outright gift to an individual is not tax neutral. It is more costly to create a trust than give an outright gift thus undermining the ability of business families to use this form of ownership planning.

3.4 The problem for family businesses

The problems for family businesses are not purely about the tax to be paid because the BPR regime applies to settled property (eg. trusts) and therefore the tax liability of any inheritance is reduced or extinguished by relief for the majority of family businesses. The problem with this tax regime is that the compliance costs are large and incurred many times.

The system works as follows:

In the case of business property the tax treatment depends on the kind of trust used. In the case of a *discretionary trust* BPR reduces the amount of inheritance tax charged on the trusts' 10 yearly anniversaries and on any exit charges. Lifetime Interest in Possession trusts created after 22 March 2006 are treated as a discretionary trust.

The problem is largely not one therefore of the effective rate of tax due which is reduced by the business assets in the trust. The problem is one of administrative burden. This is particularly the case where previously owned property is involved for the purposes of Schedule 15 FA 2003 and where property is treated as subject to a reservation for the purposes of section 102 FA 1986.

It costs six figure sums to review the tax status of a trust involving family business assets. Given that under the new regime this has to be done for tax purposes every decade compliance costs have increased dramatically.

Recommendation: To create a road map for legislation which creates a "family business trust" which exempts business assets settled in such a trust from the relevant provisions thus making trusts and outright ownership tax neutral. The legislation should aim for simplicity to reduce compliance costs.

4. Business Asset Holdover Relief and Business Property Relief

4.1 Introduction

Business Asset Holdover Relief (BAHR) and Business Property Relief (BPR) are both of strategic importance to the family business sector, however they interact poorly so that one restricts the use of the other reducing their impact.

BPR for IHT is a crucial relief for unquoted companies and family businesses. It is considered a major plank of Government policy in fostering entrepreneurial activity supported by a dynamic family business sector making a strong contribution to growth and employment. Unfortunately the complexity of the tax system in the area of capital taxes has had the effect that in many cases the effectiveness of the relief can be limited.

Holdover relief is also crucial for family businesses and for the revenue base. Where taxes extract liquidity and assets from businesses their short-term tax revenues might be more than outbalanced by long-term revenue losses resulting from the discontinuation of businesses.[5]

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 BPR and BAHR. However, to qualify for these reliefs businesses must pass a "trading" test. Different tests apply for different reliefs creating confusion and difficulties for family businesses. This paper sketches the issues involved in changes.

The tests applied for BPR and BAHR substantially differ. Unless it can be shown that a business does not to a 'substantial'[i] extent contain non- trading activities (an 80% threshold), BAHR will not be available. In contrast the BPR position, which refers to a business being 'wholly or mainly' trading, effectively imposes the requirement that in order for BPR to apply to shares in an unquoted trading company, the company must undertake at least 50% trading activities.

4.2 Areas for exploration

The BAHR position

Schedule 7 TCGA 1992 provides that if the assets transferred are shares, assets which are not business assets, and are included within the chargeable assets of the company disposed of or, in the case of a holding company, of the trading group disposed of, and the transferring shareholder has, or within the previous 12 months has been, either:-

- an individual exercising 5% or more of the voting rights; or
- has exercised 25% or more of the company's voting rights

Further reference must be made to the precise nature of the assets held by the company in the calculation of the amount of the gift which will benefit from BAHR.

Where shareholders in companies of the type listed above exceed the permitted control requirements, Holdover Relief is restricted by the extent the group or company holds any 'non-business' chargeable assets , strictly speaking the held-over gain is reduced by multiplying it by a

[5] ee EU Commission Communication on the Transfer of Business, 14 March 2006.

fraction the denominator of which is the then market value of all of the company's chargeable assets and the numerator of which is the then market value of the company's business assets.

The test applied in determining the status of an asset for these purposes means there must be a disposal made otherwise than at arms length by an individual and for which a claim for relief under s 165 TCGA 1992 is made; the disposal must be of an asset within the categories listed below, namely:

- an asset or an interest in an asset which has been used for the purposes of a trade, profession or vocation carried on by the transferor, or his personal company, or a member of a trading group of which the holding company is the transferor's personal company; or

- shares or securities of a trading company or of the holding company of a trading group, where:

  (1) the shares or securities are not listed on a recognised stock exchange; or

  (2) the trading company or holding company is the transferor's personal company.

<u>The BPR position</u>

The excepted assets hurdle must also be overcome if BPR is to apply without restriction. This will apply where assets which are the subject of an IHT transfer have not been used wholly, or mainly for business purposes, or are not required for such use in the next two years. Where this is the case BPR will be restricted to that part of the business which reflects the value of the assets which have been used for business purposes. This bears a strong resemblance to the anti-avoidance rules of Sch 7 TCGA 1992 set out above but is not an identical test.

Where, despite not having been used in the previous two years the assets are required for future use they may not fall within the excepted assets restriction (s 122(2) IHTA 1984). *Barclays v CIR* [SC 3107/97] outlines indications as to what constitutes 'future use' for these purposes. Cash which is not set aside for a defined project within the short term is unlikely to be considered a business asset required for future use. Working capital however and short term fluctuations are not likely to be excluded, and also assets held to support income in a recession are permitted under this head, and further guidelines as to the approach taken by HMRC in determining whether assets such as cash in bank and building society accounts may benefit from relief are set out at para 25352 - IHT Manual.

Differences between BPR and Holdover relief

In these circumstances the wide scope of BPR's "wholly or mainly" test is negated by the BAHR rules. This happens because although the control tests are similar the proportion of the company's activity being 'trading' is much more stringent for one test than the other. This causes extreme difficulty for companies looking to plan for a transfer of assets to be made.

It is also onerous for those contemplating gifts of business assets to carry out four parallel and discrete tests of a company's activities before they can establish whether unrestricted holdover relief is available on gifts of shares in trading companies (ie the 50 % wholly or mainly test for BPR, the excepted assets test for BPR, the 80% test for BAHR and in some cases the business chargeable assets test for shareholders where individuals hold more than 5% or trustees 25% of voting rights).

Policy Objectives

In considering whether simplification would be appropriate it is important to consider the question - do "trading" activities mean the same thing in the different tests? The "trading tests" in the legislation, such as they are defined, serve slightly different purposes.

When BAHR shared the 'wholly or mainly' test with BPR the control tests were logical. When BAHR 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.

In effect, this restricts the usefulness of BPR because if a family business wants to secure BAHR then it must satisfy the stricter test.

Recommendation: To have a single qualifying test that applies equally for BAHR and BPR. A new single test should be no more stringent than the "wholly or mainly" test for BPR.

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