Institute for Family Business with UCG

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Rt. Hon George Osborne MP
The Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
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14th October 2014

Dear Chancellor,

Institute for Family Business 2014 Autumn Statement Submission

The IFB with UCG is the voice of family business in the UK. We are an independent, not-for-profit, membership association which aims to raise awareness of the contribution that family businesses make to the UK economy. We also share best practice amongst our members and work to ensure the policy environment supports family businesses in building on their success for future generations.

In the UK family businesses turn over £1.1 trillion annually. Family businesses outnumber others by about two to one – comprising around 3 million businesses. These include companies of all sizes, operating across all sectors and regions, in total employing 9.4 million people.

As HM Government and business leaders look to rebalance the UK economy to build sustainable growth, there are many valuable lessons which can be learnt from family business. Family businesses survive over the generations by taking a long term and sustainable outlook.

There is a desire amongst family businesses to invest and grow. To do this they need reassurance from Government that the sector is understood and supported, and they need a regulatory environment and skilled workforce which matches their ambition. We welcome the trajectory of lower Corporation Tax established by the Coalition Government, and support those measures which support all sectors of the business community as we work together to secure the balanced growth that the economy needs.

The UK Family Business Sector has strong growth ambitions. We believe that this Autumn Statement must focus on supporting business in building on the recent signs of economic growth, rebalancing our economy away from short-termism and over-reliance on unsustainable debt, and providing stability to encourage investment and growth. The recommendations in this submission are also designed to work towards improving UK productivity, which is currently lagging behind economic growth.

We would welcome the opportunity to meet and discuss these issues in more detail. If you need any further information on the recommendations outlined above, please do not hesitate to contact us.

Yours sincerely,

Peter Armitage
Chairman

Summary of IFB with UCG Policy Recommendations

In this submission we have highlighted a number of tax and regulatory simplifications that we believe will reduce the burden on business, increase investment in growth, and support the more sustainable and prudent approach to business that is typical of the family ownership model.

Encouraging Investment

- The connected persons' test for the Enterprise Investment Scheme (EIS) should be removed to promote investment in family start ups.
- The Government should extend the EIS thresholds to support investment in the growth of mid-sized businesses.
- The Treasury should seek to modernise Business Property Relief to better support entrepreneurship and investment in business growth.
- Reintroduce buildings allowance to help stimulate investment in growth.

Ensuring a Stable Environment for Growth

- HM Treasury should consult on introducing a single qualifying test to apply equally for BAHR and BPR. The new single test should be no more stringent than the current test for BPR.
- Government should look at ways it can ease the burden that Quantitative Easing places on family businesses who still maintain final salary pension schemes for their employees.
- Business Property Relief to be maintained in full.

Rebalancing the Economy

- Review the tax treatment of debt versus equity business financing with a view to levelling the playing field for those firms which wish to reinvest in their own business.
- Introduce the same tax deductable treatment for equity financing as currently exists for debt financing.

Planning for the Future

- HM Treasury should review the tax treatment of Trusts so that sensible succession planning can take place over extended periods.
- Introduce an HR investment tax credit to firms who invest in the training and development of employees and apprenticeship schemes to improve the UK skills base and employability.

The Family Business Sector

Family businesses are the backbone of the economy and the bedrock of our communities.

The IFB's Members include some of Britain's best known and well-loved companies and brands including: Clarks, Dyson, Warburtons, JCB, Fullers, Fortnum and Mason, Speedo, Wates, Shepherd Neame, Yorkshire Tea, Aunt Bessie's, Ginsters, Primark, Arnold Clark, Home Bargains and William Grant & Sons.

Family firms in the UK:

- Generate over £1.1trillion turnover, 32 per cent of the private sector, contributing almost £360million to GDP.
- Account for 61 per cent of private sector enterprises in the UK economy – three million businesses
- Account for 39 per cent of private sector employment, providing jobs to 9.4 million people – 500,000 more than in 2010.
- Contribute £102 billion in tax – 15.5 per cent of total government revenues.[1]

By their very nature, family businesses are able to take the long-term view. Our members place a greater priority on stability, sustainability and a preference for long-term growth over short-term profit extraction. They also have respect for, and a long-established commitment to, the communities and environments in which they operate. They also act as incubators for entrepreneurship and future growth. Family firms take a much longer term outlook than non-family companies - long term is usually considered to be a generation in family business planning.

Seventy three per cent (73%) of family businesses are more optimistic than they were last year about their business growing. Whilst eighty eight per cent (88%) of family firms say they are more buoyant this year than last about prospects for growth in the UK economy.

[1] IFB Research Foundation with Oxford Economics, The UK Family Business Sector, 2014

Encouraging Investment

Enterprise Investment and Supporting Entrepreneurship

Recommendations:

- The Connected Persons' Test for the Enterprise Investment Scheme (EIS) should be removed to promote investment in family start ups.
- The Government should extend the EIS thresholds to support investment in the growth of mid-sized businesses.
- Business Property Relief (BPR) rules should be updated to encourage family firms to invest in new enterprises.

Why it matters: A fundamental check on the growth UK businesses is the availability of finance for investment in growth. The EIS has proved highly successful with 76 per cent of business angels reporting they had used the EIS for at least some of their investments.[2] However, the connected persons' test results in an active disincentive for otherwise non-connected family members to invest in start-ups with a family association.

Family businesses are excellent incubators of the entrepreneurial talent. Start-ups are encouraged as incubators of innovation and often seek investment from non-employee family members. It is estimated that 13 per cent of family businesses are start-up spin-offs from an existing family firm[3].

In our view, investment by a family business owner in another family enterprise should attract the same relief as an investment by a family business owner in an enterprise outside the family. Such a tax simplification measure would be a further boost to innovation and enterprise.

The current system results in an active disincentive to invest in family connected businesses and is a barrier to potential investment that would help grow the UK economy. The connected persons' test should be removed to create a level planning field for all investors. HM Treasury should consider lifting this test for a temporary period, in order to encourage increased investment in new businesses. A survey of IFB members found that 27% of respondents said the EIS connected persons rules made them less likely to invest in a start up. Only less than 5% of respondents said they are not actively put off investing by the rule.

The government should also extend the EIS thresholds to support investment in the growth of mid-sized businesses, taking the threshold to 500 employees (the same used for the small firms R&D tax credit) and increasing the investment limit. This will help firms grow further, and move from being mid-sized business to world-leading large firms.

Finally, many family businesses are prevented from taking advantage of the EIS and VCT schemes because of restrictions placed on them by the rules concerning BPR. These should be updated to encourage family firms to invest in new enterprises.

Capital Allowances

Recommendation:

[2] HM Treasury, Financing business growth: The Government's response to financing a private sector recovery, October 2012, P.16, http://www.bis.gov.uk/assets/biscore/corporate/docs/f/10-1242-financing-business-growth-response.pdf

[3] Global Entrepreneurship Monitor, Family Business Specialist Summary, 2006

- Increase the cap on capital allowances to incentivise medium and large enterprises to invest in expanding their operations despite the current economic conditions.
- Reintroduce buildings allowance to help stimulate investment in growth.

Why it matters: The IFB with UCG welcomed the measures announced in the 2012 Autumn Statement to temporarily increase capital allowances from £25,000 to £250,000 for two years. As SMEs aim to grow and increase employment, this measure should be extended beyond its initial two year trial period.

The cap of £250,000 is, however, extremely limiting for those firms that want to make a major investment in their UK operations. Family Businesses make up fifty eight per cent (58%) of UK private sector manufacturing firms and our members tell us that the cap of £250,000 is too low to have the desired effect of increasing incentives to invest in expanding their operations during a financial slowdown. To create a meaningful incentive for medium and large enterprises the government should seek to increase the cap still further when the scheme is extended.

Whilst the economic outlook is improving, productivity is still lagging behind and damaging the UK's global competitiveness. The temporary increase in capital allowances should be extended to further encourage those businesses which are able to invest to do so, and help increase the UK's productivity.

Ensuring a Stable Environment for Growth

Business Asset Holdover Relief (BAHR)

Recommendation:

- HM Treasury should consult on introducing a single qualifying test to apply equally for BAHR and BPR.
- The new single test should be no more stringent than the current test for BPR.

Why it matters: BAHR and BPR both protect family firms from the danger of having to sell a business to pay a tax bill, such as capital gains or Inheritance Tax when no cash disposal is intended or planned. However, to qualify for these reliefs firms must pass different "trading" tests, creating confusion and difficulties for family businesses. The different tests for BAHR and BPR restrict the use of these reliefs and their potential benefit to family businesses.

BAHR is only available if a business contains more than 80 per cent trading activities. 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 per cent trading activities and the application of this test is not always clear.

Simplification would increase the understanding of the two reliefs, reduce bureaucracy and help ensure smoother succession planning for family businesses. Without this change there is the threat that family businesses will fail in greater numbers.

Business Property Relief (BPR)

Recommendation:

- Business Property Relief to be maintained in full and the Treasury seek to modernise the relief to better support entrepreneurship and investment in business growth.

Why it matters: BPR is a crucial relief for family businesses. The IFB with UCG welcomes the Government's support for the family business sector by maintaining this. BPR has a clear objective and purpose – it facilitates the continuity of family business management and ownership between successive generations, allowing businesses to develop a long term approach which focuses on stability and sustainability. It also acts, albeit unintentionally, as a constraint for family firms in restricting how they invest in and fund future growth, and not allowing them to move quickly and be flexible in order to grow.

BPR is an essential component of ensuring family businesses can continue to thrive and be successful for generations to come. In the absence of BPR, the successful and efficient transfer of three million enterprises would be put at risk. Without such a relief the tax implications for any successful business on the transfer of ownership would almost certainly require a sale, liquidation or substantial borrowing. Ultimately, the death of a major shareholder could bring a profitable business to an end.

The IFB with UCG welcomes HM Government's commitment to maintain 100 per cent BPR on inheritance tax, which is a highly significant plank of the Government's policy on business transfer. The Government's policy on BPR has the potential to be a significant magnet for inward investment to the UK from global business as it could create a favourable environment to set up and maintain a family business. The IFB with UCG recommends further improvements to the structure of BPR in order to modernise its operation.

Encouraging and fostering entrepreneurship is a key competitive challenge for the UK economy. Family businesses have a proven track record of entrepreneurial investment. However, the current structure of BPR makes some businesses cautious about investing beyond the core business due to the implications for tax relief that are fundamental to their long-term sustainability. We would encourage the Treasury to examine how BPR could be aligned with such entrepreneurial investments to unlock barriers to innovation.

Family businesses have limited access to broader sources of capital – such as the bond or equity markets. They therefore frequently prefer cash to fund investment in the growth of the business. However, current BPR tax policy acts as a disincentive for family businesses to build and hold cash deposits for future investment purposes. This problem is particularly acute for smaller firms where their relatively small size means they are even more handicapped when attempting to build capital reserves for investment – a distinct disadvantage for family owned companies in the UK looking to grow both at home and internationally. IFB with UCG recommends that the BPR treatment of cash deposits be changed to allow family businesses to build such cash deposits for investment without fear of penalty.

Further improvements would be made to fostering entrepreneurial investments within family businesses if the BPR treatment of minority stakes and joint ventures with third parties were to be specifically addressed to confirm that all such investments, where they are made with the future growth and direction of the firm in mind, qualified for BPR. A specific example where this can be a problem lies with Private Public Partnerships where investment holdings can appear to be out of all proportion with the size of the company.

Pension Schemes

Recommendation:

- Government should work with pensions regulators to change the way in which pension deficits are calculated
- Government should look at ways it can ease the burden Quantitative Easing places of family business who still maintain final salary pension schemes for their employees.

Why it matters: At present, the calculation of deficits for defined benefit pension schemes relies heavily on the use of interest rates linked to Corporate Bond yields. These are less appropriate for family businesses, and, given the exceptionally low bond yields in effect currently, this lead to much larger pension deficits being forecast than are accurate. Even where family businesses are confident that they are able to meet the requirements of their scheme, the calculated deficit can be high. As a result, family firms are forced into a position whereby they are required to find funds to 'plug' the calculated deficit. This damages the contribution that firms can invest in growth. This applies a significant constraint on the ability of family firms to invest in business growth, which would in turn create more employment. This particularly impacts on family firms which do not usually have the same access to capital markets as other ownership models. The IFB with UCG would like to see the Government work with pension regulators and accounting bodies to address this issue.

The IFB with UCG recognises that Quantitative Easing has been a key plank of the Bank of England's strategy to secure economic recovery and growth by maintaining low interest rates. While we broadly support this action, our members are increasingly concerned about the effect the policy is having on final salary pension scheme deficits. Whilst firms may not no longer accept new entrants into final salary schemes, those schemes are still on the company books until the last recipient of the scheme stops claiming.

The Pension Corporation has estimated that the first round of Quantitative Easing (involving £200 billion of gilt purchases) increased pension deficits by £74 billion after netting off equity gains - equivalent to £7.4 billion additional annual payments into pension funds by employers (assuming ten-year recovery programmes and no impact on asset prices). If the Bank of England wishes to continue with this policy the Government must look at ways it can ease the burden it places on family businesses.

Rebalancing the Economy

<u>The tax treatment of debt and equity</u>

Recommendations:

- Review the tax treatment of debt versus equity business financing with a view to levelling the playing field for those firms which wish to reinvest in their own business.
- Introduce the same tax deductable treatment for equity financing as currently exists for debt financing.

Why it matters: Access to finance from the banking sector continues to be a major issue for many UK businesses. Alongside this the Government, and business community, are keen to rebalance the economy away from an overreliance on unsustainable debt dependence. In this environment, those businesses which are able to are turning to other finance streams. The Government must free up access to other forms of finance, and decrease business reliance on bank debt.

The tax treatment of equity financing for business investment, compared to debt financing which is tax deductable, creates a market distortion leading to UK firms significantly favouring debt financing over financing from equity and retained profits. This happens regardless of which may be more appropriate or available. The current system actively penalises the prudent investment model favoured by family firms.

The 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.

The best way to resolve this issue, and to make progress in rebalancing the economy, is to equalise the tax treatment of debt and equity finance by introducing the same tax treatment for equity financing as debt financing. This will allow business to make their investment decisions for commercial reasons and not tax advantage. It would also have the benefit of considerably simplifying the tax code and the overall regulatory burden on businesses.

Planning for the Future

3.2 Trust taxation

Recommendation:

- HM Treasury should review the tax treatment of Trusts so that sensible succession planning can take place over extended periods.

Why it matters: The transfer of management responsibilities between generations tends to be a gradual and ongoing process - taking place as younger generations mature. Trusts have proved an important facilitator in this process and can ensure a smooth transition of management and ownership between generations in a flexible and controlled manner. Trusts are also helpful in cases where ownership is divided between numerous persons or generations.

The IFB with UCG agrees with the policy objective set out in the 2004 consultation document, *Modernising the Taxation of Trust*, for a tax system for trusts which does not provide artificial incentives to set up a trust, but that equally avoids artificial obstacles to using trusts where they would bring significant non-tax benefits.

However the current tax treatment of trusts creates an active financial disadvantage to putting assets into Trust. This, in turn, creates an incentive to gift business assets without the stability and structure offered by a Trust. The result can be that inappropriately gifted assets are in the possession of a child or young adult before they reach an age where responsibility of ownership, management and strategy is more appropriate. The long-term effect of this could undermine the stability and continuation of many UK businesses.

The Government should consider increasing the accumulation period allowed to trusts to allow trustees to make distributions at more appropriate times and not merely because an arbitrary deadline has been crossed. Trusts should also be allowed for the benefit of close family/dependants so that income from BPR assets should be able to go to these connected parties without being aggregated with the settlers’ income – in particular this is penal on spouses who then cannot benefit from appropriately structured trusts during the settlor’s life time.

Increasing Employment and Training

Recommendation:

- Introduce an HR investment tax credit to firms who invest in the training and development of employees and apprenticeship schemes to improve the UK skills base and employability.

Why it matters: Family firms have a strong record of investing in their staff and communities. Investment in training of staff, particularly young people in the early stages of their careers, generates positive externalities – the long term returns accruing to the wider economy exceed the returns to the investing firm alone. Therefore without additional incentives, the levels of training and hiring of younger or inexperienced staff will continue to be below what is optimal for the UK economy.

In the same way Research and Development is recognised for the wider economic benefits it brings, the IFB with UCG would recommend the government introduces a People Capital investment tax credit focused on giving employment tax relief to firms who invest in the training and development of their employees through apprenticeships schemes.

Whilst the outlook for the UK economy has improved, unskilled and youth labour markets are still under pressure and will remain so whilst productivity improvements remain elusive. Whilst family business supports the National Minimum Wage, the IFB with UCG calls for continued restraint in raising the levels of the NMW, to ensure that unskilled (and particularly younger) workers are not priced out of the employment market. Any increase in NMW should be coupled with mechanisms, such as a People Capital investment tax credit, to help industry improve productivity.