Treasury Select Committee
UK Tax Policy and Tax Base Inquiry
Institute for Family Business Response

- Family businesses provide long term stability
- Business Property Relief (BPR) is critical to create level playing field with other firms during transfer of ownership
- Without BPR many profitable businesses would need to be sold, liquidated or indebted

Introduction

Family business is the backbone of the UK economy, and the bedrock of our communities. This response focuses on the impact of certain tax policies and reliefs on family businesses, it highlights those areas which are working effectively, and makes recommendations for areas which are in need of review and reform.

The family business sector in the UK now employs over 12 million people, generating a quarter of GDP and paying £133bn in tax annually. From micro start-ups to worldwide brands, the innovation, agility and resourcefulness of family owned firms is second to none. Family business epitomises long term value creation, defining success over generations. During periods of upheaval, family businesses provide resilience in the UK economy.

Sustainability, custodianship and long termism are the core values which unite family businesses. Alongside the large number of growing entrepreneurial first generation family businesses, many family firms have been operating for hundreds of years and their longevity and enduring success are testament to their innovative and long term outlook. Family firms survive and thrive over generations by taking a long term and sustainable approach, whilst adapting to stay relevant to the modern world. Family firms turnover £1.4 trillion in the UK each year. Growth in the sector helps bring benefits to the whole UK economy, consumers, the exchequer and the millions who work for family firms.

A healthy economy must be a balanced economy, and a thriving family business sector is an essential part of this mix. Their long term outlook rather than a focus on quarterly results, their commitment to local employment and communities, and to investing in sustainable and thriving businesses for the future, make family businesses a vital component of our economy. As such Governments must ensure that legislation supports the family ownership model, and that legislation does not disproportionately impact and disadvantage family ownership over other types of ownership.

The Institute for Family Business is a not-for-profit organisation supporting and promoting the UK family-owned business sector through events, networking, representation, and thought leadership. Our members have a combined turnover of £100bn and employ around half a million people.

Tax and Family Business Transfers

The Committee has asked for views on the efficiency and effectiveness of Capital Gains and Inheritance taxes. Although most often viewed as personal tax issues, both these taxes have a significant impact on how family businesses transfer between generations. We would like to take this opportunity to explain the impact of these, the important role of tax reliefs in supporting business growth, and the necessity of maintaining these tax reliefs.

Family firms exemplify long termism and sustainability in business. Whilst keeping a close eye on performance they don't obsess about quarterly results, rather they look at business decisions over the long term to build businesses which will continue to be successful for generations to come.

Transitions within family firms – be they in the management or ownership of the business – are times of significant opportunity but also provide challenges. Ensuring that these successful businesses are able to plan and continue to thrive after an ownership transition is important not only for the owners, employees and communities which rely on those businesses, but the UK economy as a whole.

This long term outlook ensures they are often able to perform better during periods of economic uncertainty. In order to achieve this they require a stable tax system which supports their ambitions to grow and plan for the long term. This requires a level of clarity and certainty in the regulatory environment in which they are operating now, and how that will look in the future. Core to this is the tax situation around the transfer of ownership between generations of responsible owners.

Business Property Relief

Business Property Relief (BPR) is a crucial relief from inheritance tax (IHT) 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. Some 85,000[1] family SMEs transfer ownership of their business to a new generation each year. BPR affords these firms an option to plan for a stable succession while maintaining ownership stability.

Without BPR, each time ownership of a business passed between generations an IHT liability would be created. This would distort the market by imposing a tax penalty on the transfer of family firms which is not paid by other businesses on transfer. It is extremely unlikely that the family business or the individual beneficiary would have sufficient reserves to meet this cost. Therefore, in order to realise the funds to pay the tax bill the family business would need to be sold, liquidated or indebted.

BPR allows businesses to plan for the future, without having to fear a ruinous IHT bill in the event of the unexpected death of a shareholder. Despite best intentions for planning and preparation, death is often unexpected and sudden. BPR provides a safety net for the owners and employees of family businesses, and the knowledge that they will not be unfairly penalised for an unexpected death.

BPR also plays a key role in ensuring that these small and medium firms can focus on scaling up their businesses. Around 64% of family SMEs are estimated to be first generation businesses[2]. Without BPR these family firms would lose the opportunity to grow under stable ownership and successfully transition to the next generation, as the firms would have to be partially liquidated or sold to fund payment of any IHT charge arising. Therefore, **BPR is a significant pro-growth policy for business**.

[1] Department for Business, Innovation and Skills, 2014 Small Business Survey
[2] Praxity, 2015

BPR is a positive example of how tax reliefs can support business growth. The introduction, and maintenance, of BPR gave business owners the confidence to focus their efforts on building their businesses and competing globally, rather than looking inwards and impeding growth to prevent risking the future of the business after their death. The introduction of BPR took away the disincentive for families to grow their businesses, and subsequently continues to benefit the UK economy as a whole.

Ultimately, without BPR, the death of a major shareholder could lead to the end of an otherwise profitable business. **Consequently BPR is an economically efficient relief, by supporting long term growth in businesses which go on to create employment and make a significant contribution to the UK exchequer.**

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. **BPR is therefore essential to sustaining the family ownership model in the UK and we strongly support the maintenance of this important relief in full.**

<u>Business Hold-Over Relief</u>

Not all transfers of family business occur at death, and many business owners will phase their departure from the company, often passing part of the of the business ownership to the next generation upon retirement. This is both a sensible and efficient part of planning management and ownership succession in a business. For transfers made before death business, owners may be eligible for Hold-Over Relief (HR) from CGT.

Both HR and BPR protect family firms from the danger of having to sell a business to pay a tax bill 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 HR and BPR restrict the use of these reliefs and their potential benefit to family businesses.

HR 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.

There are many legitimate reasons which may see a trading family business taken out of the 80 per cent trading activities, including the impact of economic conditions and natural business cycles. Successful family businesses also often choose to retain profits (to use for future investment in the growth of the business) and diversify risk into investment activity. Such assets including property can provide counterweight to funding riskier investments while enhancing the organisation and the strength of its balance sheet.

Because of the greater burden of the trading criteria for HR 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.

The current test acts as a significant disincentive to family business owners planning and executing a phased and efficient succession plan. **We believe this is an area which the Government should address, by bringing the HR qualifying test in line with the BPR test.**

Bringing the HR qualifying criteria in line with BPR would increase the understanding of the two reliefs, reduce bureaucracy, help ensure smoother succession planning for family businesses and ultimately increase the number of family businesses continuing to thrive for generations to come.

Dividend Taxation

In the July 2015 Budget, the Government removed the Dividend Tax Credit and replaced it with a tax free allowance of £5,000 for all taxpayers. At that time, new tax rates for dividends were also introduced – 7.5% for basic rate taxpayers (previously zero), 32.5% for high rate taxpayers (previously 25%) and 38.1% for additional rate taxpayers (previously 30.56%). Following the announcement of these changes family businesses expressed concerns to us about the impact this could have on their long term stability.

We remain concerned that this added expense could lead to volatility for long term shareholding in family owned firms, by making the realisation of the capital value of the shareholding more attractive in comparison to holding the shares and taking a dividend income.

The long termism and stability of family firms is one of their unique strengths, and this benefits the economy through their long term economic outlook and investment in productivity and employment. Undermining this could damage the firms themselves and the wider economy. There are also concerns about the potential impact on those who own and manage small and micro businesses – the vast majority of which are family firms.

We are also concerned about the effect of these changes on the availability of funding for new investments to support growth in family businesses. If tax rates raise further, some businesses may feel an obligation to shareholders to increased dividend payments to offset the tax loss. This would thereby reduce the resources available to companies to investment.

In the Committee's call for evidence, it references the potential impact of the dividend taxation on businesses which are not 'close companies'. A very large proportion of family firms are close companies. Close shareholdings of responsible and engaged owners make businesses more secure in the long term. Not only do the shareholders uphold strong values, but it enables the business to pursue long term strategies, informed by engaged and insightful owners. This enables investment decisions to be made for the long term benefit of the firm, and the UK economy as a whole.

It is essential that no measures are introduced which would create a disincentive to invest in a close company, or create a tax incentive for family shareholders to divest themselves of their shares in the family business in order to invest in other types of businesses. This would fundamentally undermine the family business ownership model, and the long term stability of the firms themselves.

We recommend the Government continue to review the wider impact of the recent changes to dividend taxation, and monitor the impact on shareholder behaviours.

Conclusion

Inheritance, Capital Gains and Dividend Taxes all have a significant impact on family businesses, and particularly on their ability to invest and grow. Particularly in the wake of the EU referendum family businesses need stability and clarity, and the confidence to make investment decisions which will deliver growth for the long term.

At a time of significant economic uncertainty Business Property Relief and Hold-Over Relief provide family businesses with some of the stability they need to be able to continue to operate and plan for the future. Changes to the BPR regime would harm both investment and employment by family businesses.

We understand that the Government must continue to ensure that tax policy is fit for purpose, and we are supportive of measures to reduce sharp practices. However this must be carefully balanced and researched to avoid potentially disastrous unintended consequences for those acting legitimately.

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