HM Treasury Consultation: Financing Growth in Innovative Firms
Institute for Family Business Response

Summary

- Family business embodies long term investment and patient capital.
- The tax environment must continue to support long term family business investment.
- Policymakers must be mindful of the unintended consequences of changes introduced to stimulate investment in other areas of the economy.
- Family firms require investment options which do not require them to give up equity in the business.
- Business Property Relief (BPR) is a crucial relief for family businesses, and also a positive example of how tax reliefs can support business growth.

About the Institute for Family Business

The Institute for Family Business (IFB) is the UK's family business organisation, supporting and promoting the UK family-owned business sector through representation, thought leadership, analysis, events and networking.

We work closely with family firms to support them in growing enterprises for generations to come. A central part of our work is to provide educational resources and knowledge-sharing designed to support business owners and those who work in family business. We aim to champion best practice within the family business community and help others to learn from these examples.

About Family Business

Family business is the backbone of our economy, and the bedrock of our communities. In the UK, family firms generate a quarter of GDP and employ over twelve million people. By their very nature, family businesses take a long term view, build on long-term stewardship of people and resources. Their commitment to passing something on to the next generation is locked into their corporate DNA.

The family business sector is extremely diverse. Family businesses come in all sizes and are found in all industries. Whilst the majority of family firms are small or micro businesses, there are over 17,000 medium and large firms. Family businesses are found in all parts of the UK. There are almost half a million family firms in the East of England, over one hundred thousand in Northern Ireland, and over three hundred thousand in Yorkshire.

Whilst family businesses generate a quarter of UK GDP[1], they recognise that success in business is about more than short term financial results. Success is about sustainable value creation. Family

[1] Oxford Economics and IFB Research Foundation (2016) *The State of the Nation: The UK Family Business Sector 2015/16*

businesses perform better than non-family firms in non-financial metrics such as investing in their employees and in supporting communities.[2] And the best-run family businesses outlast others by a factor of two.[3]

Patient Capital and Family Business

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 outlook, whilst adapting to stay relevant to the modern world. Family firms turnover £1.3 trillion in the UK each year. Growth in the sector brings benefits to the whole UK economy, consumer, the exchequer and the millions who work for family firms.

We welcome the Government's focus on long term investment, something which has too often been overlooked by policy makers.

Family firms have a unique ownership model which, at its best, sustains and promotes long-term stewardship balancing the management of resources in the short, medium and long-term. They embody long term investment and patient capital. They tend to be less driven by short-term financial results and are prepared to sacrifice short-term gains for the achievement of longer-term goals, which allows them to align the deployment of resources with their strategic objectives. A parallel exists with the German *Mittelstand* where profit maximisation is not generally the exclusive business goal-investment and long-term growth are generally prioritised.

The scope of this consultation is described as "long-term investment in innovative firms led by ambitious entrepreneurs who want to build large-scale businesses". This is what family businesses are also aspiring to achieve – to building successful and growing businesses. As part of this process, it is important to consider how the tax environment continues to support long term family business investment, and that there are no unintended consequences to changes introduced to stimulate investment in other areas of the economy.

Investment in Family Businesses

Sustainability, custodianship and long termism are core values which unite family businesses. The long term outlook of family firms influences their needs when accessing finance to invest in their businesses.

This includes investment options which do not require them to give up equity in the business, as this is unattractive to some family business owners as it dilutes the family ownership, and can introduce shareholders who may not share the same core values. Keeping the business private also allows for longer term planning, rather than focusing on quarterly reporting, which is essential for sustainable

[2] M Institute and IFB Research Foundation (2012) *Sustainable Value Creation*

[3] Miller, D and Le Breton-Miller, I. (2005) *Managing for the Long Run: Lessons in Competitive Advantage From Great Family Businesses*

economic growth. These are just some of the reasons that families often decide not to list their business, and why it is important that this should not be viewed as the most appropriate or desirable route for all businesses.

The UK private placement market has a potential but is still underdeveloped. More than half of all medium sized businesses in the UK are family owned. We believe development of the UK private placement market provides an opportunity for investment in these mid-sized business. We support the development of initiatives aimed at encouraging the development of a UK private placement market, but more needs to be done to support growth and awareness of the options available through private placement markets.

Family businesses typically have lower rates of borrowing than non-family firms. Their long term focus means family businesses are prepared to sacrifice short-term gains to achieve their longer-term goals. As part of this, family firms reinvest profits back into their businesses rather than loading themselves with debt. One consequence of the average low leverage in the sector is that during the recession there were lower comparable failure rates for family firms, as many sector firms had a financial cushion to help them ride through a harsh trading environment they were facing.[4]

The current tax system favours debt over equity financing, particularly since changes to dividend taxation policy have made the equity model for family firms more expensive. At a time when further growth is needed in the economy it is important to examine how growth finance is treated by the tax system. We recommend resolving this issue, and making progress in rebalancing the economy, by introducing the same tax treatment for equity financing as debt financing. This will allow businesses to make their investment decisions for commercial reasons and not tax advantage. It would also have the benefit of simplifying the tax code and the overall regulatory burden on business.

Equity funding supports and encourages decision making that enhances the long term competitiveness of business. This long term outlook means family firms are able to make large investment in new product lines, factories or in transforming underperforming companies - benefitting the wider economy through investment in productivity and employment.

The European Commission has published proposals to introduce an Allowance for Growth and Investment (AGI) to address the debt bias in taxation. We encourage the Treasury to consider this as a means to support further patient capital investment.

Current Interventions

The consultation looks at certain tax reliefs and interventions that play a role in encouraging patient investment. This section will consider some of the reliefs mentioned, but also highlight other tax considerations which can have an effect on long term investment.

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

[4] Nottingham University Business School- 2010 UK Family Business Benchmarking report

approach which focuses on stability and sustainability. Without Business Property Relief, each time ownership of a business passed from one generation to another an IHT tax liability would be created. In order to satisfy this liability the family business would require to be sold, liquidated or indebted.

Alongside this, BPR is also a positive example of how tax reliefs can support business growth. The consultation paper talks about the role of BPR in driving investment decisions in relation to non-family qualifying investments in unlisted shares. It is important to also recognise how BPR influences and supports investment behaviour in family firms by the family owners themselves.

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. It also ensures businesses can concentrate on reinvesting profits, rather than building up a fund which will then be used to pay an IHT liability.

Some 85,000[5] family SMEs are expected to transfer ownership of their business to a new generation each year. Around 64% of family SMEs are estimated to be first generation businesses[6]. BPR supports these family firms in continuing invest and grow under stable ownership, and successfully transition to the next generation.

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 to investment which focuses on stability and sustainability. It has effectively supported the investment in patient capital. Particularly at this time of significant economic uncertainty, it provides family businesses with some of the stability they need to be able to continue to operate and plan for the future.

It is essential that any moves to utilise BPR to stimulate further patient capital investment, and to target in businesses which are looking to scale-up, do not have unintended consequences for family owned businesses. This would include discussion about the holding periods, trading tests, type of eligible assets, etc. The current qualification criteria reflect many of the unique characteristics of family owned businesses, and the unpredictable nature of when an IHT liability might occur. Any changes to BPR would require further consultation.

The consultation also considers the effectiveness of the Enterprise Investment Scheme (EIS). Between 2010 and 2015 more than 1 million new family businesses were created – start-ups by enterprising families. While the EIS has proved highly successful with business angels, 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 entrepreneurial talent – with an estimated that 13 per cent of family businesses starting as spin-offs from an existing family firm[7].

---

[5] Department for Business, Innovation and Skills, 2014 Small Business Survey
[6] Praxity, 2015
[7] Global Entrepreneurship Monitor, Family Business Specialist Summary, 2006

We believe 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.

Long Term Ownership

The consultation paper considers reasons why owners might exit their business at any early stage, rather than remaining in the business and driving growth, and states that this can limit options on future ownership structures. A dimension of this, not mentioned in the paper, is around the growing divide between the levels of Dividend and Capital Gains taxation.

In the July 2015 Budget, the Government removed the Dividend Tax Credit and introduced new rates of taxation on dividends. Following the announcement of these changes family businesses expressed concerns 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. This is exacerbated by the reduction in Capital Gains rates.

We are also concerned about the effect of Dividend taxation changes on the availability of funding for new investments to support growth in 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 invest, and disincentivise the reinvestment of profits which is common in family firms and could be encouraged in other firms as a source of patient capital.

Supply of Capital – Pension Schemes

The consultation discusses Defined Benefit Pension schemes as a source of long term investment, highlighting the challenges associated with small schemes in this respect. Consolidation may be desirable for some schemes, particularly smaller schemes, as a means of helping schemes access different investment opportunities, and reducing the costs and charges associated with running a defined benefit scheme. However, consolidation should not be mandatory as it may not be suitable for all.

Our conversations with family business owners indicate that there is a lack of awareness and understanding of the consolidation options available. Guidance should provide more information on consolidation, so that those schemes which might benefit from this option are able to find out more about whether it is suitable for the circumstances and how practically to go about consolidating.

Conclusion

Family firms have a unique ownership model which, at its best, sustains and promotes long-term stewardship balancing the management of resources in the short, medium and long-term. They embody long term investment and patient capital, thinking in generations rather than quarters.

Institute for Family Business

Long term investment is important, it allows business to think differently and make decisions about growth that can help deliver real value over the long term. And the UK does have an issue around availability and diversity of supply of patient capital.

We welcome the Government's focus on long term investment, and stimulating the availability of patient capital for ambitious businesses – including family firms. However alongside this it is important to ensure that the tax environment continues to support those who are already making these long term investments, and that any changes in other areas do not lead to unintended consequences.

For more information contact:
Fiona Graham
External Affairs and Policy Director
fiona.graham@ifb.org.uk