Institute for Family Business

Rt Hon Phillip Hammond
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
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Dear Chancellor

I am writing to outline the IFB's priorities for the upcoming Budget. The IFB is the UK's family business organisation, supporting and promoting UK family-owned businesses through representation, thought leadership, events and networking. Our members have a combined turnover of £100bn, and employ around half a million people.

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 businesses are ambitious to grow, and the recommendations in this letter focus on actions the Government should take to support them in fulfilling their potential.

The Government's Industrial Strategy and Patient Capital Review are both looking at how to stimulate long term investment and growth. A thriving family business sector is an essential part of this mix. 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 take decisions over the long term to build businesses which will continue to be successful for generations to come.

About UK Family Business

The family business sector in the UK now employs over 12 million people, generating a quarter of GDP and paying £133bn in tax. From micro start-ups to worldwide brands the innovation, agility and resourcefulness of family owned firms is second to none.

Family businesses are found in all parts of the UK. While the majority of family firms in the UK are small or micro businesses, over half of all mid-sized business and one in ten large businesses are family owned. Alongside the large number of growing entrepreneurial first generation 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.

This long term outlook gives family firms the opportunity to invest in training their employees, and to innovate and develop new products, processes and services. Continuity within the businesses supports innovation, investment and increased productivity. The median large UK-owned family business spends more on R&D than both non-UK-owned family and non-family businesses.[1]

[1] State of the Nation: The UK Family Business Sector 2016/17, Oxford Economics for the IFB Research Foundation

Their long term outlook, 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. Large family businesses are more profitable than non-family businesses as measured by their return on assets[2]. And relative to capital employed, large UK-owned family firms were the most profitable in 2014.[3] Growth in the sector brings benefits to the whole UK economy, consumers, the exchequer and the millions who work for family firms.

The message coming to us from family businesses is that at this time of political and economic uncertainty they need stability and clarity in order to have confidence to make investment decisions which will deliver growth for the long term.

The long term outlook of family businesses 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.

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.

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.

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. 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.

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.

Some 85,000[4] family SMEs are expected to 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. It also plays a key role in ensuring that these small and medium firms can focus

[2] State of the Nation: The UK Family Business Sector 2016/17, Oxford Economics for the IFB Research Foundation
[3] State of the Nation: The UK Family Business Sector 2016/17, Oxford Economics for the IFB Research Foundation
[4] Department for Business, Innovation and Skills, 2014 Small Business Survey

on scaling up their businesses. Around 64% of family SMEs are estimated to be first generation businesses[5]. 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.

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. 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. At a 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. BPR is therefore essential to sustaining the family ownership model in the UK by affirming your commitment to maintaining this important relief in full you will provide family business owners with additional confidence to invest in future growth.

Recommendation: Support further investment, and the smooth transition of ownership, in successful businesses by committing to maintaining Business Property Relief (BPR) in full.

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 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 Capital Gains Tax.

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.

[5] Praxity, 2015

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. 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.

Recommendation: Consult on introducing a single qualifying test to bring Hold-Over Relief in line with BPR, reducing bureaucracy and increasing understanding of the relief.

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 offering stability and structure.

However the current tax treatment of trusts creates an active financial disadvantage to putting assets into 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.

Recommendation: Review the tax treatment of Trusts to encourage succession planning.

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 business 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.

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 increase dividend payments to offset the tax loss. This would thereby reduce the resources available to companies to invest.

Recommendation: Continue to review the wider impact of the recent changes to dividend taxation, and monitor the impact on shareholder behaviours.

Between 2010 and 2015 more than 1 million new family businesses were created – start-ups by enterprising families. Whilst many of the country's most successful family firms are centuries old, family ownership is still a relevant, popular and sustainable business model.

The Government has recognised that a check on the growth of UK businesses is the availability of finance for investment in growth. While the Enterprise Investment Scheme 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 estimate that 13 per cent of family businesses start as spin-offs from an existing family firm[6].

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.

Recommendation: Unlock more investment in start-ups by removing the Connected Persons' Test for the Enterprise Investment Scheme.

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. 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.

The European Commission has now published proposals to introduce an Allowance for Growth and Investment (AGI) to address the debt bias in taxation.

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

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.

Recommendation: Support sustainable business financing by equalising the tax treatment of debt and equity financing.

There are over 17,000 mid-sized family businesses, over half of all mid-sized businesses in the UK. To stimulate additional long-term investment in mid-sized businesses the government should extend the EIS threshold to support investment in the growth of mid-sized businesses, taking the threshold to 499 employees (the same level as for knowledge intensive companies) and increasing the investment limit. This will help firms grow further, and move from being mid-sized business to world-leading large firms.

Recommendation: Extend the Enterprise Investment Scheme threshold to support growth in mid-sized businesses.

Family businesses have a long history of acting as responsible employers, and this includes their provision of pensions to their employees. Many firms now have significant pension scheme obligations, and family business owners are committed to ensuring that their business is able to meet these sustainably whilst also investing in growth for the future. Whilst firms may no longer accept new entrants into final salary schemes, those schemes remain a company liability until all beneficiaries of the scheme have passed away.

The calculation of deficits for defined benefit pension schemes at present relies heavily on the use of interest rates linked to Corporate Bond yields. A function of this formulaic calculation is that even where family businesses are confident that they are able to meet the requirements of their scheme, the exceptionally low bond yields at present mean much larger pension deficits being forecast than are necessarily accurate.

Whilst responsible family firms are committed to ensuring that they are able to meet their pension commitments, many businesses feel that the current regime for calculating liabilities does not provide a reasonable representation of the liabilities on their balance sheets. We are concerned about the sustainability of the current arrangements for Deficit Repair Contributions, and the impact this is having on future growth and investment. This needs to be addressed to ensure successful family firms are able to continue to invest in future employment and growth.

Both the current valuations system and guidance available are too focused on financial metrics, which is not appropriate for multigenerational family businesses. These should be updated and improved to take into account the unique characteristics of multigenerational family firms. In addition, enabling more firms to move their indexation to CPI would help address some of these issues, and support the sustainability of both the defined benefit pension's regime and the future growth of UK firms.

Recommendation: Ensure pension deficit calculations are appropriate to family firms, and introduce more flexibility into the system to allow firms to move their indexation to CPI.

At this time of significant uncertainty family businesses need stability to be able to continue to operate, invest and plan for future. The recommendations in this letter focus on measures which the Government should take to provide family businesses with that stability and certainty. These in turn will provide family businesses with the confidence to invest in boosting productivity and growth.

IFB's Recommendations

- Support further investment, and the smooth transition of ownership, in successful businesses by committing to maintaining Business Property Relief (BPR) in full.
- Consult on introducing a single qualifying test to bring Hold-Over Relief in line with BPR, reducing bureaucracy and increasing understanding of the relief.
- Review the tax treatment of Trusts to encourage succession planning.
- Continue to review the wider impact of the recent changes to dividend taxation, and monitor the impact on shareholder behaviours.
- Unlock more investment in start-ups by removing the Connected Persons' Test for the Enterprise Investment Scheme.
- Support sustainable business financing by equalising the tax treatment of debt and equity financing.
- Extend the Enterprise Investment Scheme threshold to support growth in mid-sized businesses.
- Ensure pension deficit calculations are appropriate to family firms, and introduce more flexibility into the system to allow firms to move their indexation to CPI.

We would welcome the opportunity to meet and discuss the issues raised in this submission in more detail. If we can provide any further information on the recommendations outlined in this paper, or on the family business sector as a whole, please do not hesitate to contact us.

Yours sincerely

Hugh Clark

Hugh Clark
Chairman
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