Office for Tax Simplification Inheritance Tax Review: Call for Evidence
Institute for Family Business Response

Summary

- Business Property Relief was specifically designed to facilitate the handing of a family business from one generation to the next without introducing unnecessary fiscal pressure on the business.
- Since its introduction it has worked well, and is consistent with supporting the family business sector.
- Given its importance any amendment would result in a negative impact on family businesses, as to fund any IHT liability the business would have to provide funds to the shareholders.
- This would damage investment and future growth in family businesses. It would also place family businesses at a commercial disadvantage to large quoted companies and international competitors.
- The true funding cost of IHT is greater than the IHT liability as there would be a tax charge on the distributions to shareholders to allow them to meet the IHT cost.
- The widening of BPR to cater for the changes to modern business in relation to the restriction on relevant business property - which currently excludes joint ventures – should be considered.
- The administration of, and requirements for, valuations should also be reviewed.

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 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, building on long-term stewardship of people and resources. Their commitment to passing a healthy business 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 and communities across the UK. Whilst the majority of family firms are small or micro businesses, there are around 17,000 medium and large firms. The tax contribution of family businesses now stands at £149 billion – more than the annual NHS budget.

The UK family business sector continues to grow. In the UK there are 1 million more family businesses than in 2010, and family businesses have created an additional 2.3 million jobs. Family firms now turn over £1.4 trillion annually, up 7.2 per cent since 2010 - family business turnover has grown by more than that of non-family businesses since 2010[1].

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

The long term outlook of family firms gives them the opportunity to invest in training their employees, and to 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 the equivalent foreign-owned family business and UK-owned non-family businesses.[4] In 2014, large family businesses are also more profitable than non-family businesses as measured by their return on assets and relative to capital employed.[5] Growth in the sector brings benefits to the whole UK economy, from consumers to the exchequer and the millions who work for family firms.

Business Property Relief and Family Business

Business Property Relief (BPR) is a crucial Inheritance Tax (IHT) relief that facilitates the transfer of family management and ownership of the businesses between generations, that in turn enables 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.

Family businesses are owned by individual family shareholders, or held in trust. IHT is charged to the estate of the shareholder on their death, when shares are passed from one generation to the next. As a family business owner the shareholder's assets/investment are illiquid, forming part of a private, trading company with neither the mechanism nor market to sell their shares – and with an enduring family connection to the business. Shares, particularly minority stakes, in private businesses are illiquid assets.

Whilst IHT falls under the personal taxation regime (and is resourced accordingly by HMRC), the reality is that the cost of paying the liability would fall on the business, as the individual shareholders will not have sufficient assets outside of the business to meet the tax charge. The valuation of a business (as used to calculate IHT liability) is based on a range of factors including business assets, intellectual property and goodwill. It does not reflect the personal liquid wealth of an individual. Family businesses also do not tend to pay large dividends to family shareholders, instead focusing on reinvesting any profits for growth or to support the business during difficult trading periods.

[1] State of the Nation: The UK Family Business Sector 2017/18, Oxford Economics for the IFB Research Foundation
[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*
[4] State of the Nation: The UK Family Business Sector 2016/17, Oxford Economics for the IFB Research Foundation
[5] State of the Nation: The UK Family Business Sector 2016/17, Oxford Economics for the IFB Research Foundation

For business owning family members, the illiquid business assets form the bulk of their estate. As a result, the IHT liability would be borne by the business itself. This would require the family business to be sold, liquidated or indebted in order to raise the necessary cash to pay the charge. This would have a knock-on effect on employment and investment. BPR has allowed family businesses to compete on a level playing field with businesses in the UK under different kinds of ownership, and foreign businesses (family owned or not) for which IHT is not a concern.

Businesses which were required to sell all, or part of, the business in order to meet the IHT charge, or those that paid extraordinary or additional dividends to shareholders to do this, would also face significant double taxation. If a dividend payment was made, this would mean the individual would face a tax charge on the dividend in addition to the 40% IHT charge. This would see even more money – which could be used for investment in growth – taken out of the business to cover the dividend and IHT charges. Where businesses were sold, as a whole or in part, they would also incur a CGT charge.

"My father and his siblings had to sell a business at the end of the 1970's, largely in order to create liquidity as insurance against potential IHT charges. This slowed growth in the business and created a pool of liquid assets that did not serve any positive economic purpose. Since the introduction of BPR, my generation has been able to invest in the business without worrying that we are creating liabilities."

Large, multi-generational manufacturing business

BPR is a positive example of how tax reliefs can support business growth. It is important to recognise how BPR influences and supports investment behaviour in family firms by the family owners themselves.

The introduction, and maintenance, of BPR gives 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. BPR takes away the disincentive for families to grow their businesses, and subsequently continues to benefit the UK economy as a whole.

"There was a time in our business (before BPR was introduced) when my father was very clear that it was essential to restrict the growth of the business so that it was in a condition where it could be passed on to the next generation (my brother and I) without excessive taxes and punitive duties.

"There were several occasions when he actually turned down business that would have led to substantial growth because he said "I would much rather have a business that I can pass on without pain to my sons rather than have a company that looks impressive but is a burden for my family.""

Medium sized, multigenerational manufacturing business

Some 85,000[6] 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[7]. BPR supports these families in continuing to 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. The importance of the relief to family businesses was recently reaffirmed by HM Treasury. In the response to the Patient Capital Review, the Government stated "*BPR plays a valuable role in preventing the breakup of otherwise viable businesses purely in order to meet IHT liabilities […] and is committed to protecting the important role that this tax relief plays in supporting family-owned businesses*".[8] The stability of family ownership brings stability to the UK economy, with family businesses acting as a stabilising force particularly in periods of economic downturn.

BPR Framework

In our experience the existing BPR framework and rules are, on the whole, well understood by family business owners. The stability of the relief has enabled business owners to become familiar with the relief, and the rules associated with it, while also allowing them to plan and invest for the long term. It is also important to recognise that businesses have made long term decisions on the basis that BPR is, and will continue to be, available in its current form.

The existence of BPR, and the stability of the relief since its introduction, gives business owners the confidence to continue to invest in their business, creating more jobs and creating a more sustainable business. Without BPR businesses would always have to plan for the worst case scenario. As the timing of a death cannot be predicted, this would mean taking measures to ensure they were able to meet an IHT liability at any time, and would drive substantially more cautious investment.

Because the cost of an IHT charge on business assets is likely to be borne by the business itself, the outcome of changes to the BPR rules would be to limit the growth and size of the business, reduce investment and to drive money that would otherwise be invested into the equity of the family business into different investments, which would be less productive but more liquid. This would have a long term detrimental effect, stifling business growth. Perception of risk for the future would become a primary driver in the company's business strategy.

Business owners understand the benefits that the continuation of the business brings, not only to the family, but to others connected with the business, including employees, suppliers, customers and the local community. In 2017 HMRC commissioned IFF Research to look at the influence IHT reliefs have on estate planning.[9] The research found "*a desire among testators to keep the business running after their death to ensure security for individuals outside of the family - namely employees - as well as future generations of the family. This was particularly true for larger businesses*".

[6] Department for Business, Innovation and Skills, 2014 Small Business Survey
[7] Praxity, 2015
[8] Financing Growth in Innovative Firms: Consultation Response, HM Treasury, November 2017
[9] The influence of Inheritance Tax reliefs and exemptions on estate planning and inheritances, IFF Research, May 2017

Q12. How, if at all, does the IHT framework, including the related tax considerations set out above, make business decisions challenging? For example, does it affect or distort decisions regarding:

a) whether to sell or transfer a family business to another vehicle or directly to the next generation during lifetime or wait until death,

Succession planning is an important process in family business. Families spend a great deal of time preparing the next generation of owners, identifying the future leaders of the business and looking to the long term future of the business. Whilst business owners take advice on the tax implications around when ownership of the business is transferred to the next generation, it is not now the sole driver for decisions on when transfer occurs.

Families will consider many other factors as part of this planning, including the age of the next generation, their suitability and involvement in the business, the dynamics within the family in relation to other shareholders, and the financial situation of the current owners (e.g. will they rely on a dividend from the business for their retirement income?).

Owners may also decide to phase the transfer of shares over time, rather than passing them all on in their lifetime or on their death. They may decide to pass some shares on when they retire from day-to-day management of the business, but maintain a governance or ownership role in the business.

The current regime was designed in such a way as to allow business owners the freedom needed to be able to plan their succession in such a way that was in the best interests of the long term success of the business, rather than to meet financial pressures arising from a short term tax event. The very diversity of families and the fact that their needs, and the needs of their businesses, change over time means that anything less than 100% relief will inevitably cause harm to many parts of the family business sector.

IHT is almost unique in the tax landscape as you cannot predict when you will incur the tax liability. As stated above, for this reason the absence of BPR would lead to businesses having to plan for the worst. Consequently they would have to limit growth in the business to reduce exposure to a liability, and take money out of the business to prepare a fund to pay a large IHT bill.

b) the structure of the business (for example, how to hold non-trading assets),

One area which should be considered for additional guidance is the issue of joint ventures, and how they might affect the trading test and BPR eligibility. Since the relief was first introduced the use of joint ventures, particularly for export or international ventures, has increased significantly. They offer a practical way for the businesses to work together, and to invest and grow into new markets.

The legislation regarding BPR covers most situations. However it has not moved to reflect common business practice in the area of joint ventures. This is an area of particular concern. For a variety of genuine commercial reasons businesses will form joint ventures. Where a family business does so it may run the risk of jeopardising BPR. The legislation makes reference to the holding company of a group which is relevant business property, though if the holding company owns an interest in a joint venture and the size of the joint venture is greater than the original business (as can be the case if the project is commercially successful) then the holding company might be considered to holding investments (therefore excluded from BPR).

This seems to be unjust, especially as it is the case that if family members directly held the investment in the joint venture, and it was relevant business property, it would be eligible for BPR. Consequently the scope of the current relief needs to be broadened to continue to achieve its stated aims in the modern business environment.

We believe this is an area where HMRC should also seek to provide additional guidance, in order to reduce uncertainty for businesses, and look at the application of the legislation in relation to treatment of joint ventures.

Feedback from the IFB's membership strongly suggests that business is being held back by this uncertainty and that this may be a result of the fact that IHT is dealt with by the personal, not business, taxation teams in HMRC. Consideration should be given to increasing the resource available to HMRC to cover this issue, and to ensuring that any such resource has the skills and experience necessary to understand the time sensitive commercial and business rationale behind requests for pre-clearance.

In light of the UK's withdrawal from the European Union, joint ventures are likely to be increasingly attractive to businesses, as businesses look into developing new opportunities and relationships outside the UK. Joint ventures provide an attractive route to new markets for businesses who are looking for local partners who can provide resources and expertise. It is therefore important that this issue is resolved, so that family businesses can make plans to grow their businesses and seek out new opportunities, feeling confident they are not risking their eligibility for this essential relief.

Q13. Do the different requirements for trading across BPR, CGT gift relief and entrepreneurs' relief cause complexity and, if so, how could this be addressed? Are there any other inconsistent definitions or approaches either within IHT, or across IHT and CGT and if so, does this cause complexity? Do you have any other suggestions as to how to remove complexity around the interaction between CGT and IHT?

Not all business transfers occur at death, and many entrepreneurs 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 prevent businesses being sold 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, differing business models and natural business cycles. Certain types of businesses are also more likely to be taken out of the 80 per cent threshold, whilst still being trading businesses (e.g. pub and brewing companies). Successful entrepreneurs 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 structured succession plan but are made purely for tax reasons, sometimes hindering owners transferring shares during their lifetime. This creates a disconnection between the interests of the owners and the interests of the business, slowing economic growth.

The current test acts as a significant disincentive to entrepreneurs 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 entrepreneurs and ultimately increase the number of businesses continuing to thrive for generations to come. It is essential that any changes must not restrict availability of either relief, as this would have serious implications on family business investment and growth.

Q14. The availability of BPR is not general dependent on the size of a person’s interest in a business or holding it for any period after death. Does this feature of BPR add to or reduce complexity?

Not linking BPR eligibility to size of shareholding or holding after death reduces the complexity of the relief for both businesses and HMRC. Introducing requirements based on these criteria would place significant additional burdens on businesses, individuals and HMRC, and would encourage behaviours around share ownership that could be damaging to family unity and business success.

Linking availability of BPR to the size of an individual’s interest in the business would not only require additional form filling and disclosure from individuals, it would also require businesses to undertake valuations of the business. This is time-consuming and burdensome, as explained in more detail below.

Any changes to introduce a rule about the size of a person’s interest in the business would particularly penalise multigenerational family businesses. In such cases, where the family has grown over the generations and the shareholders may be cousins, there will often be a number of minority shareholders. These shareholders could add significant value to the business but their shares would be devalued by an IHT liability. Questions of inter-family fairness would be created, going against the principle of united shareholders that often helps family firms maintain consistency over the long term, and such a rule would encourage behaviours in planning ownership structures that were driven by tax considerations, not by the commercial interests of the business. Given that multigenerational firms are more likely to employ larger numbers of people (multigenerational businesses are more common amongst mid-sized firms than small businesses, and in small businesses than in micro firms[10], and large family businesses are also more likely to be multigenerational than in their first generation[11]) any behaviours that are encouraged by such a rule have the potential to create larger consequences for employment.

Introducing a requirement to hold shares after death would also add a burden to businesses and individuals, having to prove ownership and complete additional disclosures. In our experience of family business the next generation are not intending to sell the business as soon as they inherit shares. The next generation of family business owners feel a connection to the business, as part of their heritage, and most do not intend to sell the business assets after they are inherited. Research by the IFB Research Foundation showed that about 90% of younger family members want to be involved in the family business because they care about its future success.

In 2017 HMRC commissioned IFF Research to look at the influence IHT reliefs have on estate planning. This research also found that most beneficiaries retained the inherited business assets, because they had a familial attachment to the business. *"Most of the beneficiaries interviewed had retained their inherited business assets. As with agricultural assets, many were motivated to do this because they held a sentimental attachment to the business."* [12]

Introducing such a requirement would also necessarily add complexity to address situations where a sale was already intended, but a death occurred in the run up to the planned sale (for example, if a family was intending to sell part of a group and a shareholder died a few days before the intended sale). Given that these situations cannot be predicted exemptions would necessarily be required for cases such as these, which would add to the complexity rather than reduce it.

Q19. Please tell us about any other areas of complexity in applying any IHT rules, reliefs or thresholds not already mentioned in your response, along with any suggested improvements. You may, for example, wish to comment on the residence nil rate band, the IHT treatment of trusts, the IHT treatment of personal pensions and life insurance products, or the conditional exemption for certain works of art or heritage assets.

Trusts can help in the succession process in family businesses and enable the transfer of management responsibilities to be brought in gradually, smoothly and selectively in the context of family members' skills, competencies and interest. Trusts allow generational transitions to take place while ensuring stability of ownership and management.

When business assets are placed in to a trust the value of the assets, including shares, need to be valued. At present this can be an extremely long, time consuming and costly process. The complexity is sometimes increased when businesses have cash in the business.

There are many commercial reasons why a family firm may retain profits by withholding dividends. Family businesses are highly represented amongst cyclical industries (such as construction) and shareholders agree to profits being retained in order to ensure that the business can continue to operate in poor market

[10] State of the Nation: The UK Family Business Sector 2017/18, Oxford Economics for the IFB Research Foundation
[11] UK Family Business Survey, PwC, 2017
[12] The influence of Inheritance Tax reliefs and exemptions on estate planning and inheritances, IFF Research, May 2017

conditions. Family firms often prefer to fund acquisitions or investments in new product lines and services through reinvesting cash rather than borrowing. It better reflects their long term planning and outlook.

A better understanding within HMRC of how, and why, family businesses retain cash could help to speed up the valuations process. HMRC could also speed up this process, and reduce complexity and cost, by agreeing a policy of accepting valuations made by credible professionals unless there are reasonable grounds not to do so.

Q20. Do you think that the IHT system should be reformed more widely to simplify it? If so, how? Should some IHT exemptions be removed to find a lower graduated rate or a higher NRB? If so, which ones? Are there any useful lessons that could be learned from other countries? If so what, and from which countries?

Removing the reliefs in exchange for lowering the headline rate of IHT does not overcome one of the core principles for the establishment of BPR, namely that as the individual's estate will be unable to meet the liability the cost will have to be borne by the business. It would still result in the sale, closure of fragmentation of businesses that would otherwise have intended to operate, invest and pay tax in the UK for years to come.

Making this kind of charge would mean imposing a tax charge on these businesses that would not have to be borne by any other kind of business, creating a material disadvantage and damaging their ability to be competitive. This would also damage investment and growth, placing a significant financial administrative burden on the business.

It would appear inequitable if successful family businesses were penalised because success created a guaranteed liability when, at the same time, the liability on non-business assets used in lower risk investments were to be significantly reduced. Anecdotal evidence from IFB members suggests that behaviours would be driven by the fact of the introduction of an IHT liability, not the rate at which it were to be levied. In any event, it would not be certain that the rate would remain fixed or remain low.

Bringing business assets into the scope of an IHT charge, at whatever rate, would require a valuation of the business and its assets to calculate the charge. This would place a substantial additional administrative burden on both businesses and HMRC. Businesses already report significant delays in securing valuations when, for example, placing assets in to trusts. This process can already take a couple of years to resolve. A need to process many times more valuations would lead to a large increase in cost of administration for HMRC, driven by the need for significant additional resources to process valuations and establishment payment plans.

Conclusion

Business Property Relief (BPR) is a crucial Inheritance Tax (IHT) relief for family businesses. The design and delivery of the current system has allowed business owners to plan, invest and grow their business with confidence that the business will not have to be sold or broken up in order to pay a large IHT bill on the death of a shareholder. And businesses have made current and future investment and share transfer plans based on the premise the BPR will continue to be available to them.

The original rationale for the relief remains, namely that that as the individual's estate will be unable to meet the liability the cost will have to be borne by the business. Alterations to the qualification criteria, or introducing post-death holding periods, would add unnecessary complexity and bureaucracy for individuals, businesses and HMRC.

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