Institute for Family Business

HMRC Taxation of Trusts Review
Institute for Family Business Response

Summary

- Trusts allow generational transitions in family businesses to take place while ensuring stability of ownership and management
- Tax is not a driver for family businesses to use trusts - the 2006 changes mean that using trusts is now tax inefficient
- Trustees bring new skills and oversight to a family business, which support stability and a long term view that promotes the interests of the business, its staff, customers and suppliers
- The use of trusts ensure that the directors of the business receive a unified voice from the trustees as owners, and reduces the likelihood that inter-family disagreements will need to be addressed by those running the business
- Trusts are already sufficiently transparent to allow government authorities to ensure that people are meeting their obligations
- It is not accurate to look at the ten yearly charge in isolation when considering the tax charges made against trusts, particularly in comparing the tax situation to IHT on death
- Family business owners, trustees and advisers raised many issues with us around dealing with HMRC on trust taxation matters, and other areas of administration

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]

Use of Trusts

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. Trusts are an important succession and ownership tool for many family firms.

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.

In preparing this response we spoke to a range of family business managers, owners and advisers. All those that we spoke to cited issues associated with ownership and family dynamics as the primary drivers for the use of trusts. Tax was not a driver for their use, in fact most cited that following the 2006 changes the use of trusts was now tax inefficient. In particular, the complexity was a serious disincentive to the use of smaller trusts.

In family businesses the transfer of ownership management responsibilities between generations tends to be a gradual and ongoing process. However an early or unexpected death can undermine even the best laid plans, and may see extensive business assets inherited by very young adults who do not have the necessary skill or experience required for a responsible owner. Placing those assets in trust can provide the business with a greater degree of stability and structure in the event of such an event, and can help protect vulnerable and young family members. Trusts have proved an important facilitator in this process, offering good governance, often trustees will have the requisite skills to bring a level of professionalism to a family business, stability and a long term view that promotes the interests of the business, its staff, customers and suppliers.

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[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*

Members also spoke about the flexibility which discretionary trusts offered to help provide for families over time as their needs changed. For example, a settlor could establish a trust which would ensure the whole family continued to benefit from the business which they had built, without fixing what that benefit will be - based only on the information available to them when they settled their affairs - instead leaving trustees with the discretion to take appropriate decisions at the relevant time. This was seen as an advantage in ensuring fairness in future generations. At the same time, use of discretionary trusts were identified as advantageous in being able to restrict access to wealth where it would otherwise stifle ambition, or facilitate personally destructive behaviours.

The separation of the control of, and benefits arising from, the business were also cited as important considerations in setting up share owning trusts. Trusts allow the benefits of the business to be transferred in a managed way, while providing a separate responsible 'controlling owner' in the trustees. This can also help to bring an extra level of outside professional perspective, in the form of professional trustees. Trustees can provide independent oversight of a company, and as they are personally liable for their actions they will make considered decisions in the best long term interest of the business and beneficiaries. This also helps the business to take a more long term view, as the business is again separated from any short term matters effecting individual family members, such as divorce.

Trusts were also identified as a way of protecting the business from any potential disagreements within the family. The use of trusts ensure that the directors of the business receive a unified voice from the trustees as owners, and reduces the likelihood that inter-family disagreements will need to be addressed by those running the business. For many family businesses, trust ownership is attractive because Trustees, who are personally liable, can use their professional skills to hold the business to account and to guard against the development of damaging short term thinking in either the management or owners. This long term aspect of trusts is important in securing the success of the family business with the benefit of providing job security for employees.

For those businesses which were not eligible for Business Property Relief (BPR) trusts are invaluable in allowing businesses to plan effectively for the payment of Inheritance Tax (IHT). The ten yearly charge allows businesses to plan for paying IHT over a sustained period. Without this businesses would have to be broken up or sold to pay a single IHT charge on the death of major shareholders.

Transparency

Question 2: There is already significant activity under way in relation to trust transparency. However, government seeks views and evidence on whether there are other measures it could take to enhance transparency still further.

As the consultation recognises, there have over recent years been significant changes to the transparency of trusts. Trusts are already sufficiently transparent to allow government authorities to ensure that people are meeting their obligations.

We do not support any measures which would lead to a public trust register. We believe that the obvious privacy issues created for families establishing a publically accessible register would act as a disincentive to families to utilise trusts and that the amendments would, therefore, be damaging to the long term prospects of the UK's family business sector.

For discretionary trusts there is a 'long tail' of potential beneficiaries. These may never receive any benefit from the trust. A publically available list of all potential beneficiaries could lead to a risk of coercion or action against those beneficiaries who will never receive any benefit, as well as those who do. This is an unreasonable burden, and the unintended consequences would cause serious risks.

Given that tax authorities already have the full details of settlors, trustees and beneficiaries of trusts, we believe that the opening of this sensitive personal information to a wider public register is not justifiable, and will damage the principle of a right to respect for privacy and family life (Article 8 of the Human Rights Act 1998).

Including trusts in a public register would also undermine individuals' rights to privacy. The ruling by France's Supreme Court on 21st October 2016 (Conseil Constitutionnel Décision no.2016-591 QPC du 21 octobre 2016 3/3) supports this position. The decision stated 'A reference in a publicly accessible register of the names of the settlor, beneficiary and administrator of a Trust provides information on how a person intends to dispose of his or her estate. This results in a breach of the right to respect for private life.'

Fairness and Neutrality

Question 6: The government seeks views and evidence on the case for and against targeted reform to the Inheritance Tax regime as it applies to trusts; and broad suggestions as to what any reform should look like and how it would meet the fairness and neutrality principle.

With the Office for Tax Simplification review of Inheritance Tax still underway we believe the Government should wait for the outcome of that report, together with the responses from this consultation before considering any areas for review.

The family business managers, owners and advisers we spoke to while preparing this response all agreed that since 2006 use of trusts had become tax inefficient. The 20% entry charge for trusts was raised repeatedly as an active deterrent to establishing new trusts.

The consultation considers the best comparator to use when looking at trust taxation (Section 5.3). We believe the appropriate comparator is that of an outright gift, as that is the intention of the settlor. Such a gift could, in fact, be a Potentially Exempt Transfer (PET).

In section 5.5.2 the consultation compares the tax treatment of a settlor holding assets until death and their estate being charged IHT at that time. The paper states that in the first 30 years of its existence a trust incurs IHT charges 'of up to broadly 38%' and 'broadly 18%' in subsequent 30 years. This assumes 30 years is a period equivalent to a generation. This is simplistic and not a suitable comparison, between personal ownership and trust ownership as it overlooks many other elements relating to the taxation of trusts and their use.

As evidenced by the Governments own statistics, the number of estates that pay 40% IHT is quite small. Individuals can organise their affairs to utilise potentially exempt transfers (PETs), or Spousal Exemptions, these exemptions are not available to trustees, who are required to pay the 10 yearly charge without these exemptions. Further trusts are also not eligible for the benefit of the uplift in value for the purposes of capital gains tax (CGT) on the assets they own, an uplift which is available to assets transferred on death. The effect of this, is that if after 30 years a trust sells an asset, it pays CGT based on the historical cost, in addition to the cumulative 38% where as an individual who had inherited an asset and immediately sold it would not pay any further CGT and if that individual had been a spouse, there would be no IHT either. If a trust needs to sell assets to raise funds to pay the ten yearly IHT charges, tax must be paid on the sale of those assets. Beneficiaries also pay income tax on the income derived from the trust.

It is, therefore, not accurate to look at the ten yearly charge in isolation when considering the tax charges made against trusts, particularly in comparing the tax situation to IHT on death.

As mentioned earlier, for those businesses which were not eligible for Business Property Relief (BPR) trusts are invaluable in allowing businesses to plan effectively for the payment of Inheritance Tax (IHT). Though often, in the case of companies owned by shareholder trusts, the requisite dividends required from the business are subject to income tax, which at the current rate applicable to trusts (45%) in effect means the total tax payments made are nearly double the cost of the ten yearly charge. So whilst the ten yearly charge regime allows for trusts to plan to fund the cost, it is often accompanied by a significant income or capital gains tax liability as well. The alternative to the ten yearly charge would be that businesses would have to be broken up or sold to pay a single IHT charge on the death of major shareholders.

Question 7: The government seeks views and evidence on:
a) the case for and against target reform in relation to any of the possible exceptions to the principle of fairness and neutrality detailed at paragraph 5.6;
b) any other areas of trust taxation not mentioned there that would benefit from reform in line with the fairness and neutrality principle.

In relation to point 5.6.2 we do not support a move towards taxing trusts on gross income before expenses. Beneficiaries do not have a say on the expenses incurred by trustees. And their income comes to them after the expenses are deducted. It would, therefore, be extremely unfair to beneficiaries to tax them on the gross income.

Simplicity

Question 8: The government seeks views and evidence on options for the simplification of Vulnerable Beneficiary Trusts, including their interaction with ‘age 18 to 25’ trusts.

Those we spoke to raised the taxation of 18-25 trusts as area which would benefit from review, to enable greater uptake and usefulness. In particular it was highlighted that the 4% charge when the trusts are wound up at 25, on top of the 40% charge at death, acted as a disincentive to their establishment.

Question 9: The government seeks views and evidence on any other ways in which HMRC's approach to trust taxation would benefit from simplification and/or alignment, where that would not have disproportionate additional consequences.

Family business owners, trustees and advisers raised many issues with us around dealing with HMRC on trust taxation matters, and other areas of administration.

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 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.

Members reported to us the process for the calculation of the ten yearly charge was extremely time consuming, and that they often received calculations from HMRC which included significant mistakes. In one instance which was relayed to us a delay caused by querying mistakes made by HMRC led to a penalty being incurred.

There were serious concerns about the capacity within HMRC to deal with trusts issues and offer technical support, particularly in relation to complex estates or older trusts.

Members also raised issues around registering information for the Trusts Register for older trusts or those with more beneficiaries, and those were they were administered by a family member rather than a professional service firm.

The need for trusts to pay Capital Gains Tax within 30 days was also highlighted as a significant challenge which should be reviewed, given the time it can take to extract cash to pay the liability.

In relation to attempts to simplify the income tax rules for trusts we have concerns about the unintended consequences of such a move. A move to a flat rate of income tax could lead to basic taxpayers and those on lower incomes paying a disproportionate level of tax purely because that income was derived from a trust.

Conclusion

The 2006 changes to trusts have disincentivised use of trusts, and now means there is in most cases a tax disadvantage to using trusts. The reasons families use trusts to hold shares and business assets are not, therefore, tax driven. They are linked instead to long term decision making, separation of control and benefit, fairness and protection of vulnerable family members.

There have over recent years been significant changes to the transparency of trusts. Trusts are already sufficiently transparent to allow government authorities to ensure that people are meeting their obligations. We do not support any measures which would lead to a public trust register.

With the Office for Tax Simplification review of Inheritance Tax still underway we believe the Government should wait for the outcome of that report, together with the responses from this consultation before considering any areas of trust taxation for review. Trusts incur many tax charges, and using IHT as the only comparator for trust taxation does not paint an accurate picture of the costs incurred.

There are areas around the administration of trusts which do cause issues. The Government should review the allocation of resources to HMRC to deal with trusts queries and administration, to improve the process for agents, trustees and beneficiaries.

For further information please contact Fiona Graham, IFB Director of External Affairs and Policy, at fiona.graham@ifb.org.uk or on 0207 630 6250.