Institute for Family Business

Rt Hon Sajid Javid MP
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

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Dear Chancellor

I am writing to outline the Institute for Family Business' priorities for the upcoming Budget. The IFB is the UK's family business organisation, supporting and promoting UK family-owned businesses to help them continue to be successful for generations to come.

As the Government looks to supporting growth and developing opportunities across every part of the UK, family businesses have an essential role in delivering on this ambition. Family firms are the driving force across all regions, communities and sectors of the UK. Well over 80% of businesses in Yorkshire, the North West and the East and West Midlands are family owned. In those four regions alone family firms employ nearly four and a half million people.

Family firms survive and thrive over generations by taking a long term and sustainable approach. But sustainability does not mean inertia. Family firms continue to exist for generation after generation by innovating, adapting and looking for new markets and opportunities. They make investment decisions for the long term, often reinvesting from retained profits.

This submission focuses on measures which could help family firms build on their success and stimulate further investment to deliver future growth across the whole country.

About UK Family Business

The family business sector in the UK now employs 13.4 million people, generating a quarter of GDP and paying £182bn 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, around half of all mid-sized business and one in five 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.

Growth in the sector brings benefits to the whole UK economy, consumers, the exchequer and the millions who work for family firms.

The long-term outlook of family businesses ensures they are often able to perform better than others 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 have adopted a similar strategy.

Whilst IHT falls under the personal taxation regime, the reality is that the cost of paying the liability would fall on the business, as the individual shareholders will not have enough assets outside of the business to meet the tax charge. 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.

Some 85,000[1] 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 on scaling up their businesses. Around 77% 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.

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[1] Department for Business, Innovation and Skills, 2014 Small Business Survey
[2] IFB Research Foundation and Oxford Economics, State of the Nation 2018/2019

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. The impact of a possible future IHT charge on family business confidence and ability to invest would be significant whatever the rate of IHT at the time. And the challenges around the illiquidity of family business owners estates and assets would also remain regardless of the rate.

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. 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 and 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.

We note with interest the Office for Tax Simplifications recent report on Inheritance Tax. Any changes made to the relief must be carefully considered, given the importance of the family business sector and the ability of businesses to continue to succeed over generations. In relation to the OTS recommendation to align the trading tests for BPR and Capital Gains Tax, we are concerned about the impact using the higher trading test would have on certain sectors (such as retail SMEs) and those companies in highly cyclical industries. We believe such a move would leave businesses with more uncertainty, and consequently hit investment. If the two tests are to be aligned for simplification purposes, this should be set in line with the BPR 'wholly or mainly' test.

We also note the OTS comments on joint ventures. We believe additional guidance is needed in this area, and how these arrangements 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

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

Between 2010 and 2015 more than 1 million new family businesses were created – start-ups by enterprising families. More businesses have continued to be founded since then. 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[3].

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.

The APPG for Entrepreneurship report on Tax Reform considered this issue and recommended that the Government should allow family members to invest in EIS/SEIS.[4]

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

There are over 17,000 mid-sized family businesses, over half of all mid-sized businesses in the UK. In the North East there are nearly 500 of these businesses, and in the North West over 1800. Empowering these businesses and supporting investment would see significant economic and employment benefits in their communities.

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.

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

Equity funding supports and encourages decision making that enhances the long-term competitiveness of business. This long-term outlook means family firms can make large investment in new product lines,

[3] Global Entrepreneurship Monitor, Family Business Specialist Summary, 2006
[4] APPG Entrepreneurship, Tax Reform Report, July 2018

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.

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 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 Government's Patient Capital Review in 2017 focused on long term funding options for 'innovative, high growth companies'. We call on the Government to consider opening a second Patient Capital Review with a broader remit, to build on the work of the first report.

Recommendation: The Government should consider opening a second Patient Capital Review to look at the long-term funding options available to businesses.

The transfer of management responsibilities between generations tends to be a gradual and ongoing process - taking place as younger generations mature, and trusts have proved an important facilitator in this process offering stability and structure.

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.

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 so that sensible succession planning can take place over extended periods.

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 low bond yields mean much larger pension deficits being forecast than are necessarily accurate.

As a result, family firms are forced into finding funds to 'plug' the calculated deficit, significantly reducing the funds available to invest in growth. This applies a considerable constraint on the ability of family firms to invest in increasing productivity, creating employment and moving into export. All this is sacrificed, whilst at the same time the system provides no practical benefit to the members of the pension schemes themselves. This particularly impacts on family firms which do not usually have the same access to capital markets as other ownership models. The Government must address this issue and explore ways to introduce a level of flexibility to the existing rules to ensure that the long-term sustainability is not threatened.

Recommendation: Ensure pension deficit calculations are appropriate to family firms, ensuring that the firms that sponsor schemes are able to continue to confidently invest in their businesses for the long term.

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.
- Unlock more investment in start-ups by removing the Connected Persons' Test for the Enterprise Investment Scheme.
- Extend the Enterprise Investment Scheme threshold to support growth in mid-sized businesses.
- Support sustainable business financing by equalising the tax treatment of debt and equity financing.
- The Government should consider opening a second Patient Capital Review to look at the long-term funding options available to businesses.
- Review the tax treatment of Trusts so that sensible succession planning can take place over extended periods.
- Ensure pension deficit calculations are appropriate to family firms, ensuring that the firms that sponsor schemes are able to continue to confidently invest in their businesses for the long term.

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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