Office of Tax Simplification Capital Gains Tax Review
Institute for Family Business Response

1. Summary

- A long-term outlook is at the heart of family business. Shareholders in family businesses view their role as that of a steward, with an obligation to pass the business on to the next generation in a stronger state than they found it.
- Ownership in modern family businesses can be organised in many ways.
- In the context of successful succession planning, for most families Inheritance Tax and Capital Gains Tax are inextricably linked.
- For transfers made before death, business owners may be eligible for Gift Holdover Relief from CGT. This relief is essential.
- The current Gift Holdover Relief trading test acts as a significant disincentive to entrepreneurs and family business owners planning and executing a phased and efficient succession plan.
- Regarding the treatment of losses, the broad principle should allow for the offsetting of capital losses against capital gains.
- In principle we can see advantages in encouraging patient capital by having different regimes for short term and longer-term gains.

2. About the Institute for Family Business

The Institute for Family Business (IFB) is the UK's family business organization. Our members include some of the most successful, world leading, businesses in the country. Together they employ over half a million people and have a combined turnover of £100 billion[1] annually, and work across the whole UK in every region, and every sector. We work with family businesses to help them build better and stronger business for future generations of their families, employees and communities.

We work closely with family firms to support them in growing their 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.

3. About Family Business

UK Family Business Sector

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.

[1] All figures taken from prior to the COVID-19 pandemic unless otherwise stated.

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.

Family Business Characteristics

A long-term outlook is at the heart of family business. Shareholders in family businesses view their role as that of a steward, with an obligation to pass the business on to the next generation in a stronger state than they found it. They feel a sense of responsibility not only to future generations of their own family, but also to the legacy of their forebears, their employees, and the community in which they are based.

Whilst family businesses generate a significant proportion 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. And the best-run family businesses outlast others by a factor of two.

Family business leaders are frequently found as prominent members of local business groups, industry bodies, school boards and charities. They understand they are part of a wider community and see value in working to raise standards across the whole community.

The family firm often represents not only a key part of a family's monetary wealth, but their heritage. This is a source of great pride, but also a source of responsibility. Family business owners understand better than any the importance of reputation, how long it takes to build, and how quickly it can be lost. When your name is above the door, responsible behaviour becomes part of the commitment to future generations of your own family.

To protect and build on this family owners are generally much more involved in the business than the typical investor. They understand the important role, and responsibilities, of being a governing owner. Successful families work to ensure that their shareholders' motivations and values are aligned, and that they act as responsible owners. But they also understand the importance of embedding these values, and this long-term outlook, in the whole business.

Families care about having a business which is well governed, to ensure that it is viable and sustainable in the long term. Because they intend to own the business for the long term, rather than expecting to sell their stake within a few years, they also understand that good corporate governance is in the best interests of all, as their own family's future would be significantly affected were they to allow a short term focus.

Modern Family Business Ownership

Ownership in modern family businesses can be organised in many ways. Depending on the age, size, industry, structure and values of the family and the business, they will approach ownership structures in a bespoke way that reflects their own needs, the needs of the business and the needs of their employees and community.

While there are many owner-managed businesses in the family business community, ownership and management are not always linked. Because families care about their businesses, they know how important it is to have the best people running those businesses. That means appointments are made based on talent and skill, not family connection. Even in those businesses where family aren't actively involved in management, they still have a very important role to play as active and engaged governors and owners.

Most family businesses are privately owned and do not have large numbers of disparate and institutional shareholders. On the contrary, shareholders tend to have a close relationship with the family business and play an important role in shaping the culture and values in the business. Family businesses have an in-built natural tendency to approaching corporate stewardship in ways that ensure that the pursuit of good financial performance supports their long term objectives and values, rather than harming them.

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Good governance within successful family businesses has two components – family and corporate governance. Corporate governance covers the direction of the business operations, while family governance covers the frameworks and rules that define family members' roles and responsibilities, and how they interact with the business. Introducing the next generation to the principles around good family and corporate governance often starts at a very early age, learning values from grandparents and parents.

Family governance processes and procedures will vary depending on the specific characteristics of each individual family business, but there are some common structures. These have developed naturally as families look at how to ensure their business continues to take a long term approach to investment, and plays a wider role in society. It is essential that families have the flexibility to introduce these structures as best suits the unique requirements of their family and business, to best meet the needs of their employees and community.

Some families establish written policies, or constitutions, to define their roles and responsibilities as family members and shareholders and to establish rules around family members working in the business, succession and share ownership. Larger families, particularly those with a greater number of shareholders, may establish a family council or assembly to help a family find consensus, act as guardians of the family's values, to maintain a strong shared long term vision and to communicate effectively with the Board.

Successful family businesses will view their family governance as something which must continue to be reviewed and updated as the business, and family, grows. We see many examples of family businesses who view discussions of shared sense of purpose as a central component of their family governance, to ensure the family agree about why they are in business together. This has a direct and unique impact on their attitude to share ownership, reinforcing their sense of stewardship and connection to the business

In some families, shares will be owned directly by family members. The next most common ownership type is trusts. Many families will have a mixed ownership structure which supports their long-term custodian approach to ownership.

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.

The separation of the control of, and benefits arising from, the business are also cited by owners 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.

In relation to trusts, beneficiaries are often family members. But in many instances the trust which owns part of the business may be a charitable trust. We also see families where part of the business is owned by the employees through Employee Ownership Trusts, or where shares are held directly by employees. There are also a few cases of family businesses being listed, either on main markets or AIM.

In a single family business it is not unusual to see a mix of family direct ownership, trust ownership where there family are beneficiaries, and a trust as a shareholder which has a charitable purpose. A speciality manufacturer in Yorkshire demonstrates this mixed ownership in a family business context. In this multigenerational business almost a quarter of shares are owned by a discretionary charitable trust which support good causes in the local area. The same number of shares are held in an employee share trusts. With the remainder of shares owned directly by family members, or held in trusts of which family members are beneficiaries. The charitable dimension of ownership reflects the strong values and commitment to the local community which continues in this business owning family.

4. Family Businesses and Capital Gains Tax

In the context of successful succession planning, for most families Inheritance Tax and Capital Gains Tax are inextricably linked. Although often viewed as personal tax issues, both these taxes have a significant impact on how family businesses transfer between generations.

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.

This long-term outlook 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.

> "In our experience families invested in business over multiple generations do not remain invested with a view to capital profit, but view themselves as long term custodians. Unexpected deaths or changes of circumstance leave them vulnerable to tax charges which will fundamentally undermine the business and thus the employment of others, provision of customer services and the wider economy, often with little or no opportunity to plan ahead. The current reliefs from CGT alleviate this risk efficiently and clearly and their removal would create less certainty and potentially dampen long term reinvestment and growth." – *Solicitor working with family businesses*

In relation to Inheritance Tax, our full response to the Office of Tax Simplification Review of Inheritance tax can be found at https://www.ifb.org.uk/media/3758/ots-iht-consultation-ifb-response.pdf.

Whilst CGT and IHT fall under the personal taxation regime, the reality is that the cost of paying any liability would fall on the business, as the individual shareholders will frequently not have enough assets outside of the business to meet the tax charge. For business owning family members, the illiquid business assets form the bulk of their estate. This would require the family business to be sold, liquidated or indebted in order to raise the necessary cash to pay the charge. Businesses with significant profits would stop reinvesting those and would instead build up cash reserves outside the business in order to ensure they had cash available to pay any future tax liability. This would have a knock-on effect on employment and investment. The current regime of Gift Holdover Relief and Business Property Relief 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 CGT and IHT are not a concern.

Some 85,000 family SMEs are expected to transfer ownership of their business to a new generation each year. The existing reliefs afford 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. Without reliefs 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, Gift Holdover Relief and Business Property Relief are significant pro-growth policies for business.

Overall the current regime, and it's interaction with Inheritance Tax, broadly support smooth and successful transfer of ownership and consequently long term ownership and growth. There are however changes to the trading test for Gift Holdover Relief in particular which act as a barrier to some businesses, where changes would be beneficial.

5. Allowances, Exemptions and Reliefs

Annual Investment Allowance

In our experience the Annual Allowance does not influence behaviour in family business context.

Investors Relief

In our experience the Investors Relief does not influence behaviour in family business context, nor do we believe it is particularly widely used.

Rollover Relief

In our experience the Rollover Relief does influence positive behaviour by encouraging people to reinvest in businesses, if for example one is sold and another is acquired as part of a long term strategy for business investment by a family.

Business Asset Disposal Relief

In the March 2020 Budget the Chancellor announced changes to Entrepreneurs Relief (now Business Asset Disposal Relief). From discussions with advisers and business owners we have heard that these changes have had an impact on those planning smaller sales, where the owner or founder would previously have been eligible and is now not.

The recent policy discussion about ER/BADR has focused on the role the relief plays in encouraging early stage entrepreneurial activity. While this is one area of interest, it is also important to consider the impact that availability of ER/BADR has on decision making around scaling up the business. For some founders, the availability of ER/BADR is an important factor in their decision to continue to invest in their business and take it from a 'lifestyle business' to a growing business with more employees.

Gift Holdover Relief

Not all transfers of family business occur at death, and some business owners will phase their departure from the company, often passing part of the of the business ownership to the next generation upon retirement or as part of a phased transfer to the next generation. 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 Gift Holdover Relief from CGT.

Both Gift Holdover Relief and Business Property Relief (in relation to Inheritance Tax) 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. It also ensures family businesses don't have to hold cash aside for future tax bills and can instead continue to reinvest profit into the business. This supports long term investment, growth in businesses and job creation.

However, to qualify for these reliefs firms must pass different trading tests, creating confusion and difficulties for family businesses. The different tests for Gift Holdover Relief and Business Property Relief can act as a barrier for some businesses in executing an efficient ownership transfer during an owner's lifetime.

Gift Holdover Relief is only available if a business contains more than 80 per cent trading activities. In contrast the BPR position refers to a business being 'wholly or mainly' trading, the company must undertake at least 50 per cent trading activities.

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. 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 family businesses also often choose to retain profits (to use for future investment in the growth of the business) and diversify risk into other assets such as ownership of premises or land. Such assets including property can provide counterweight to funding inherently riskier entrepreneurial activity while enhancing the organisation and the strength of its balance sheet.

"Due to the nature of business, we can often face significant increases in our material costs at short notice and it isn't possible to pass this cost on to our customers immediately. So we always keep a healthy cash barrier in the business to deal with these surges. We have invested significantly in recent years, but have always maintained a cash surplus for these surges. This is often viewed with suspicion by tax authorities, but it is absolutely essential in our business to ensure we can continue to operate and don't have to take on expensive debt at short notice." – *family business owner*

Because of the greater burden of the trading criteria for Gift Holdover Relief this can mean that gifts of shares are not made according to a desirable family business succession plan but are instead delayed for tax reasons sometimes hindering owners transferring shares during their lifetime. This creates a disconnect between the interests of the owners and the interests of the business, slowing economic growth and innovation by the next generation.

More businesses are also likely to fall into the category of not qualifying for Gift Holdover Relief because of the way in which Joint Ventures are treated when calculating trading tests. This is an area of particular concern.

In relation to both Gift Holdover Relief and Business Property Relief the legislation has not moved to reflect now common business practices. Businesses will enter Joint Venture arrangements for a variety of reasons. If family members directly held the investment in the joint venture, and it was relevant business property, it would be eligible for relief. However, 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 reliefs). Generally family businesses also prefer to be involved in joint ventures at a practical level, no just as a silent investor.

We believe this is an area which needs to be addressed. Feedback from the IFB's membership strongly suggests that business is being held back by uncertainty on this issue in relation to IHT, and we believe the same is true in relation to CGT.

In light of the UK's withdrawal from the European Union and the Coronavirus pandemic, joint ventures are likely to be increasingly attractive to businesses, as businesses look into developing new opportunities and relationships for growth. Joint ventures provide an attractive route to new markets for businesses who are looking for local partners who can provide resources and expertise – particularly when undertaking foreign expansion, as a means to reduce the initial risk. 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 the future succession of the business.

The current Gift Holdover Relief trading test acts as a significant disincentive to entrepreneurs and family business owners planning and executing a phased and efficient succession plan. Bringing the Gift Holdover Relief 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.

Trusts

The Office for Tax Simplification asked us specifically about our experience of people placing assets in Trusts for short periods before taking them back out, in order to gain an advantage in relation to Gift Holdover Relief.

In our experience this does not happen in a family business context. Where a family puts business assets into Trust it requires significant changes to how the business is run, such as changes to the governance structure, appointment of Trustees, etc. It would be neither financially or administratively efficient or desirable to do this in a situation where the Trust would be unwound shortly afterwards. We have explained more about why family business owners may use Trusts in the section on ownership structures further up this paper.

"Clients rarely use such arrangements to move assets on to the next generation, preferring to set up trusts for the longer term or not use them at all. Family business owners don't like unnecessary complexity and tend to be conservative in their approach to tax planning. They welcome certainty and the ability to pass their assets on at the right time for their business and their family as owners. They don't separate the two in their minds!" – *Solicitor working with family businesses*

6. Treatment of Losses

Regarding the treatment of losses, the broad principle should allow for the off setting of capital losses against capital gains.

In the family business context the offsetting of income losses against CGT, or share losses against Income Tax, is not commonly seen.

In relation to loans being offset, this usually only occurs in the private business environment because a business is facing difficulties. There are many checks and balances in place around this, and therefore we do not see abuse in this area.

7. Treatment of Long- and Short-Term Gains

In principle we can see advantages in encouraging patient capital by having different regimes for short term and longer-term gains. A preferential regime could encourage longer term holding of businesses by founders, encouraging a culture of long-term business investment and growth. We discussed measures which could be used to support patient capital in our response to HM Treasury's consultation 'Financing Growth in Innovative Firms' which can be viewed at https://www.ifb.org.uk/media/3502/ifb-patient-capital-response.pdf.

A regime which differentiated between short- and long-term gains could be achieved by reintroducing measures such as the previous Taper Relief. While this could be desirable to support other policy objectives – such as encouraging long term holdings – it would not be a simplification of the current system.

8. Further Information

The Institute for Family Business will be responding to the second part of the review, and will provide more information in that response.

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