Institute for Family Business

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

## 1. Summary


- For family businesses, Inheritance Tax and Capital Gains Taxes are inextricably linked
- Succession planning in family businesses is complex and unique to each family
- Family businesses need a tax system which supports successful transition of ownership, in a timely and smooth manner
- That tax system needs to be flexible to allow families to make the right choices without tax being the main driver for succession decisions
- The current system on the whole works, but could be improved by bringing the trading test in line with the BPR level and addressing the issue of joint ventures


## 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, and most longstanding, businesses in the country. Together they employ over half a million people and have a combined turnover of £100 billion 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 14.2 million people, generating a quarter of GDP and paying £196bn 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.

## 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.

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 owning. 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.

## Modern Family Business Ownership

In our submission to part one of the review we shared information on the many ways in which modern family business ownership can be organised.  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.

> "We think long term.  We take our people and our customers on a journey together.  We educate our Pre, Now and Next generation family members on the business and what it means to be a responsible owner.  We consult, review and plan for succession of ownership.  And we plan for careers within the busines based on talent, and support family members in their careers outside the business too.  The timescale and planning in a family business is totally different to anything you see elsewhere in business" - *Family business owner*

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.

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. It is also significant that CGT events do not produce cash for family owners who more often than not are making gifts of shares, so they rely on their own resources to pay any tax bill or the business has to produce that funding. 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.

> "We plan our succession a long time in advance, and that includes educating and informing the next generation. We also make significant long-term investment decisions based on what we expect the future tax and regulatory environment to look like. Our succession plans rely on those things too. We plan well in advance and sudden changes to the tax environment damage our future plans, because we may have to sell parts of the business to pay new large tax bills, or they hit our confidence to invest more in the future and create more jobs" - *Family business owner*

> "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 could 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. This will be exacerbated by the fact that, due to their long term outlook, family businesses tend to reinvest a high proportion of their profits compared to other companies. Reinvestment of own profits is a key source of investment into the business for family businesses where gearing is lower than other business types. 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 Capital Gains Tax 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. Consultation Questions

Many of the questions in this consultation focus on technical and administration aspects of Capital Gains Tax. We have focused our response on answering those questions which are most relevant to family business owners, and as a result have not answered every question.

***Question 3 –*** *To what extent do the current CGT rules influence decisions around whether, how or when taxpayers acquire or dispose of assets? And to what extent and how do taxpayers adjust their activity to reflect this?*

The key aspect of CGT influencing decision making in family businesses is Gift Holdover Relief. For eligible companies, Gift Holdover Relief allows them to plan to transfer ownership to the next generation at the most suitable time for the business and the family members, removing tax as a driver of the timing of ownership succession. Some business owners will phase their departure from the company, often passing part of the business ownership to the next generation upon retirement or as part of a phased transfer to the next generation.

Having a tax system which supports families to pass ownership without a tax charge either during life or on death is essential to support the smooth and successful transition of family firms. Supporting disposals during the owners' lifetime ensures sensible and efficient management and ownership succession in a business. It ensures family owners can continue to take a long term approach to growing the business and planning for the future.

Some 85,000 family SMEs are expected to transfer ownership of their business to a new generation each year. The existing CGT and IHT 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 CGT 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.

***Question 10 –*** *To what extent do the different rates of CGT cause complexity? Is it always clear which tax rate should apply? Which situations present specific problems? Does the dependence on the income tax threshold makes this inevitable? Do you think the rates position could be made simpler, and if so how?*

In our experience the different rates do not cause complexity or confusion for tax payers. The headline rate and rate for Business Asset Disposal Relief (previously Entrepreneurs Relief) are broadly well understood.

***Question 16 –*** *Are there features of CGT that present barriers or distortions at any of these stages? Are the rules simple to understand apply correctly? Please provide example along with any suggestions on how the rules could be made simpler.*

For businesses that are eligible for Gift Holdover Relief the rules are generally simple to understand and apply correctly. We will discuss later in this response where the trading test for Gift Holdover Relief can present issues.

There are however significant numbers of family businesses who are not eligible for Gift Holdover Relief. For those companies that are excluded from Gift Holdover Relief a distortion is created which disincentivises the timely transfer of business ownership and encourages owners to hold shares until death.

This can prevent succession to the next generation, and lead to consequent damage to the family relationships around the business.

Bringing more companies into the scope of Gift Holdover Relief, and bringing the trading test in line with the BPR level, would remove barriers to successful and timely business ownership transfer.

We also believe there is scope to improve the system around pre-clearances. Many businesses report that they feel the information they are given around clearances is not clear enough. We believe improving this system could give businesses more certainty, reassuring them that they have satisfied all the necessary conditions and tax charges, allowing them to invest in their businesses with confidence.

***Question 17 –*** *Do you know of occasions when CGT rules have affected business decision making more generally, including decisions regarding the structure of a business or the choice of business vehicle (for example a corporate entity, partnership, unincorporated business)?*

Incorporation Relief has affected decision making on incorporation, and it is believed has encouraged start up family businesses to incorporate.

***Question 18 –*** *Please tell us about any complications or rules which unduly affect the way businesses operate if payment for the sale of a business is not made in cash but in some other way (such as qualifying and non-qualifying corporate bonds, deferred consideration and earn outs). To what extent is there a business tension between claiming a tax relief at the point of sale as opposed to deferring the tax charge until cash is received?*

If a tax charge is imposed at point of sale rather than when cash is received, it could have a significant impact on cash flow within businesses. For family business owners their family business forms the bulk of their assets. As such when tax charges are imposed where no cash is received owners will need to call on the business to help fund a tax charge. This will remove cash from the business, hitting cash flow and also damaging options for investment within the business.

***Question 19 –*** *Is the scope of each of these reliefs intuitive or are there unexpected differences between them that create practical problems for businesses? Are there aspects of any of these reliefs that you consider are unclear or particularly difficult to utilise in practice?*

***Question 20 –*** *Are there aspects of these reliefs which distort business decision making (for example in respect of such areas as the timing of the disposal of an asset, or how much cash to accumulate on a company balance sheet) or are inconsistent with your understanding of what the relief is aiming to achieve? Are there any ways in which they could be made less distortive?*

***Question 21 –*** *Should gift relief be extended to cover a greater range of business and investment assets as it was until 1989? What would the effect of this be? And would any extension open up unintended avoidance opportunities?*

This section answers questions 19, 20 and 21.

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.

The current crisis, and its impact on trading in many family businesses, demonstrates why a wholly or mainly trading test is needed for Gift Holdover Relief. Many businesses have seen significant drops in their trading, due entirely to external factors, and there is no clarity when trade might return to normal. This will bring many businesses below the 80 per cent threshold now. For those families that were planning ownership transfer in the near future this may now have to be postponed or cancelled entirely.

Those businesses that are still able to trade are also, where possible, seeking to hold onto cash to provide a buffer for future closures or the economic knock on effects. This is an extremely sensible approach to take, and will help businesses to survive and retain jobs. However, this can also have a knock on impact on eligibility for reliefs and may delay succession.

A wholly or mainly test would be more appropriate for Gift Holdover Relief, not only to smooth the succession planning process, but also to reflect the natural economic cycle and ensure that businesses were able to continue to transfer between generations.

"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 a minority 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 there are two potential pitfalls – the interest in the joint venture is treated as an investment for Business Property Relief purposes and it could contaminate the whole group to become an investment holding company (and therefore excluded from reliefs) if the joint venture becomes successful and 'swamps' the overall trading business. This can be seen even more commonly during the current crisis due to the way in which certain industries and sectors have traded. Generally family businesses also prefer to be involved in joint ventures at a practical level, no just as a silent investor and are necessary especially with the anticipated shorter supply chains following Brexit.

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. Our response to the Office of Tax Simplification review of Inheritance Tax included this, and is available at https://www.ifb.org.uk/media/3758/ots-iht-consultation-ifb-response.pdf.

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.

Joint ventures are also now frequently required for public sector contracts, as a means to reduce risk for the public sector. In construction, for example, local authorities as well as central government contracts require joint ventures to pool expertise and reduce risk.

It is also important to consider the difficulty of valuing family business assets where there has been no disposal on the open market. 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. This makes minority stakes in family businesses extremely difficult to accurately value, as there may be no market at all if they were to be offered for sale.

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 established family businesses passing their businesses on to the next generation and ultimately increase the number of businesses continuing to thrive in the UK economy, employing large numbers, innovating and contributing across society 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.

***Question 34 -*** *To what extent does the absence of a CGT charge on death and transferring those assets at market value on death distort and complicate the decision-making process around passing on assets to the next generation?*

Decisions about when and how to transfer the ownership of a family business are complicated, and there are many factors at play which are unique to each family and each business. Indeed within families, different family owners may take different approaches depending on their own circumstances or those of the next generation. For some families the absence of a CGT charge on death may be considered as part of their decision making about ownership succession. What is more likely to distort decision making and prevent the timely succession of the business, is the restrictive trading test for gift holdover relief which prevents many businesses from passing shares during lifetime without incurring a significant tax charge.

Removing the uplift would lead to significant administrative challenges, rather than acting as simplification. Assets have often been held for many generations, may have been split unevenly amongst family members, may have been eligible for a holdover relief already. Resolving these issues would be administratively burdensome for taxpayers and the Government/HMRC.

***Question 35 –*** *Are there any aspects of the taxation of gifts or other disposals that are not made at market value, that you feel would benefit from being simplified? Should the range of assets eligible for a tax deferral when they are gifted be broadened to include a greater range of assets? And would any extension open up unintended avoidance opportunities?*

As stated in answer 16, we believe that there is scope to extend the types of companies eligible for Gift Holdover Relief, to include companies in the property industry.

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