

FAMILY INVESTMENT COMPANIES - A VIABLE ALTERNATIVE VEHICLE TO TRUSTS?

PATRICK HARNEY and ANGUS HUNTER SMART ask - are FICs the 'next big thing'?

Trusts have been with us since the time of the Crusades; yet following the Finance Act 2006 (FA), professional advisers have been forced to cast around for a viable alternative vehicle to allow wealthy families to pass money down the generations in an orderly and tax-efficient manner. Family limited partnerships (FLPs) and family general partnerships (FGPs) have each been mooted¹, but less has been written about a third option, family investment companies (FICs), to date. Of course, since the original excitement surrounding family partnerships, a new 50 per cent top rate of income tax will be introduced from 6 April 2010, adding another dimension to the puzzle. So, are FICs the 'next big thing'?

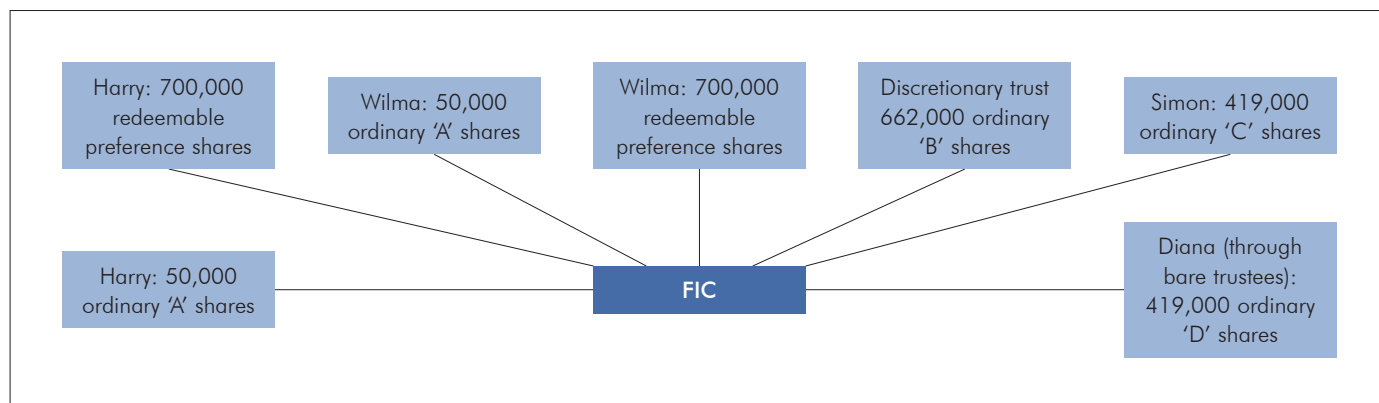


Figure one

The need for an alternative to the trust

Before looking at the detail of FICs, and how they can be used in tax planning, it is important to understand the context in which this search for an alternative to the trust is set. The FA was nothing less than an attack on trusts. In short, the funding by gift of virtually all new trusts by UK domiciliaries or deemed domiciliaries will trigger a 20 per cent up-front inheritance tax (IHT) charge, after the settlor's nil-rate band has been exceeded. On top of that, the trust will thereafter fall within the 'relevant property' regime, with consequent ten-yearly charges (at up to six per cent) and exit charges (at a proportion of the six per cent rate). In addition, holdover relief is no longer available on assets being transferred into settlor-interested trusts.

Despite the government's best endeavours, clients remain keen to pass assets down one or more generations tax efficiently, but without allowing their children or grandchildren access to capital and income at too young an age. The crucial requirement, in their eyes, is the separation of control from ownership of the assets being handed down, thus meeting their tax planning objectives while allaying fears that their children or grandchildren will spend the money inappropriately. Both FLPs and FGPs are capable of achieving this, but the set-up and running costs of FLPs can be prohibitively high below investment levels of, say, £10m. Can FICs, therefore, be the answer to everyone's prayers?

What are FICs?

Put simply, an FIC is a private company, the shareholders of which are all members of the same family. It can have limited or unlimited liability, and its constitution (memorandum and articles of association, perhaps supplemented by a shareholders' agreement) can be drafted to suit the family's needs, either being very straightforward or giving as much flexibility as is required. The FIC will typically be used to hold investments in the form of shares or land (or indeed anything else), though importantly it will not constitute a 'collective investment scheme' under the Financial Services and Markets Act 2000, and will not, therefore, be subject to the increased regulatory requirements that being classed as such would bring.

Structure of a typical FIC

Let us look at an example. Harry and Wilma have £3m in cash following the sale of their business. They want to be able to

benefit from half of this, but, being mindful of estate planning considerations, would like to pass the remainder down to their children Simon (who is 23) and Diana (who is 16). However, they are concerned that Diana is too young to have access to such a significant amount of money, and have serious misgivings about some of Simon's university friends, all of whom seem to have been given too much money too young and spend it like it was going out of fashion.

Having taken appropriate advice, Harry and Wilma decide to set up an FIC. They each subscribe for 50,000 ordinary 'A' £1 shares in the company, and 700,000 redeemable preference £1 shares. They also set up a discretionary trust for Simon and Diana, of which they are the initial trustees, along with their former business partner, Philip. They settle £662,000 of the cash on this trust, making use of their combined nil-rate bands and annual exemptions. The trustees in turn then subscribe for 662,000 ordinary 'B' shares of £1 in the FIC. Finally, Harry and Wilma subscribe for 419,000 ordinary 'C' £1 shares and gift them to Simon, and 419,000 ordinary 'D' £1 shares and gift them to Diana by declaring that they hold them on bare trust for her. The constitution of the FIC provides that two nominees of the discretionary trust are the sole directors of the company, and Harry and Wilma initially take on this task.

The ownership of the FIC will therefore be as per Figure one, above.

There would be no initial tax to pay on setting up this structure, provided that Harry and Wilma survive for seven years from making the potentially exempt transfers to Simon and to Diana's bare trustees. The advantages of having an FIC, and in particular of structuring its ownership in this way, are outlined below, but first it is important to look at how the FIC would be taxed.

How are FICs taxed?

One of the main fears that clients have when FICs are suggested is the potential for a double tax charge. This can come about because the FIC will pay corporation tax (CT) on its profits (be they income or gains) at 28 per cent, and the shareholders will have to pay further tax (in the form of capital gains tax (CGT) at 18 per cent or income tax on dividends at their own marginal rate), to extract those profits. This can give an effective rate of tax of 46 per cent (assuming a 32.5 per cent income tax rate on

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dividends) on gains or non-dividend income made by the FIC if all these profits are distributed (from 6 April 2010, the rate on dividend income over £150,000 will be 42.5 per cent. This will cause the 46 per cent effective rate to increase to 54 per cent for non-dividend income over £150,000). However, there are a number of reasons why this might not be as bad as first seems:

- ◆ Shareholders who are lower rate taxpayers will not have to pay additional tax on their dividends from the FIC (though the usual child-of-settlor anti-avoidance provisions found in s.629 Income Tax (Trading and Other Income) Act 2006 will apply);
- ◆ An FIC is a structure that is used with the long-term in mind, rather than a short-term vehicle from which all profits are to be extracted. Therefore, provided income and gains are to be accumulated, these will be taxed at the CT rate of 28 per cent rather than the maximum rate of income tax of 40 per cent (50 per cent from April 2010). This will allow £72 out of every £100 of profit to be reinvested, rather than £50;
- ◆ Paying CT on gains at 28 per cent might seem high when set against the CGT rate for individuals of 18 per cent, but it should be remembered that indexation allowance is still available to companies, which could bring the effective tax rate on capital gains below 28 per cent;
- ◆ If the only asset that the FIC invests in is property that is let to unconnected persons, the FIC will fall outside the 'close investment companies' rules in s.13A Income and Corporation Taxes Act 1988, and the smaller companies rate of CT at 21 per cent will be applicable on profits of up to £300,000 in each tax year, rather than the standard 28 per cent rate; and,
- ◆ The 'transactions in securities' legislation in s.682 Income Tax Act 2007 will need to be considered on an eventual liquidation of the FIC so as to ensure that the return is subject to CGT treatment rather than income tax treatment.

The so-called 'double tax charge' is therefore not a fatal flaw to FICs, provided suitable investments are chosen and a long-term view is taken (for instance, that the FIC's main aim is to accumulate wealth).

Advantages

Aside from the long-term tax advantages outlined above, FICs have several other appealing features:

- ◆ The directors (in this case whoever is appointed by the trustees of the discretionary trust) can retain a significant amount of control over the FIC, much in the same way as trustees do with a trust structure. The exact level of this will be determined by the constitutional documents, but the directors can, for example, decide how the FIC's assets should be invested, and (subject to some necessary limitations in order to avoid falling foul of the 'gift with reservation of benefit' (GROB) rules) retain discretion over when dividends should be paid, how much these should be and which class

of shares they should be paid to. Subject to what is said below, this allows dividend income to be paid to any one or more classes of shares.

As an example, the directors could declare a dividend of all profits for the year to the 'B' shares (those held by the discretionary trust), and the trustees could then accumulate this income (if within the accumulation period of the trust) or distribute it to Simon or Diana as they felt appropriate. However, it should be noted that the GROB rules prevent excessive income being able to be paid to Harry and Wilma in relation to their 'A' shares or their preference shares, and it will be necessary to use the constitution to irrevocably limit the amount of dividend income that can be paid to these two share classes to the percentage of overall share capital retained by Harry and Wilma at any one time to ensure that a GROB can never be found to occur;

- ◆ One benefit of having different classes of shares has been outlined above. Another is that, in relation to Harry and Wilma's preference shares, these can be redeemed at the discretion of the directors for their par value at no tax cost to Harry and Wilma – meaning that they can extract their cash from the structure should they need it, but the other shareholders can benefit from income and gains of the FIC. Again, care would have to be taken to ensure that the GROB rules are not breached if this is intended, but that can be managed through careful drafting of the constitutional documents;
- ◆ In a similar way, it would also be possible for Harry or Wilma to make interest-free loans (repayable on demand) to the FIC as a way of retaining access to capital but allowing future growth on those funds to accrue to the FIC, and ultimately to their children;
- ◆ The FIC's constitution can be used to exert further control over the FIC, for example by restricting shareholders to family members (which will make any sale of shares by Simon or Diana (once she has reached 18) more difficult). Equally, the identity of Harry and Wilma's successor directors can be predetermined, by controlling the appointment of successor trustees; and,
- ◆ The matrimonial courts have traditionally been reluctant to pierce the corporate veil where family companies are concerned, and an FIC can therefore be viewed in almost the same way as a pre-nuptial settlement. It will be considered a resource of either Simon or Diana in divorce proceedings, but the court is unlikely to make an order allocating shares in the FIC to a spouse unless Simon or Diana (as the case may be) does not have any other significant assets.

Are there any downsides to an FIC?

Clients may be worried about the following issues, although none of these are insurmountable:

Set-up costs

Although the set-up costs of an FIC will be considerably less than an FLP, there will still be professional fees to be paid for, in particular, drafting the memorandum and articles of

associations and shareholders' agreement, and setting up any trusts that are needed.

Running costs

There will be a certain amount of annual running costs of an FIC, although these are limited to modest filing fees with Companies House and accountancy fees (the latter of which would, of course, also be required were a trust to have been used instead). There will also be legal fees, but there should be little input from the lawyers on a day-to-day basis unless changes need to be made (for example, the creation of a new share class).

Publicity

An annual return, stating the directors of the FIC and the shareholders, will have to be filed with Companies House each year, as will annual accounts (although the latter can be in the abbreviated form if the FIC qualifies as a small or medium sized company (in practice, it will do if its balance sheet total is less than £12.9m)). Once filed, the annual return and accounts become public documents and anyone can inspect them for a small fee. This may give rise to concerns for clients who would prefer the anonymity of a trust, but steps could be taken to keep the identity of the family secret by employing non-family directors, and perhaps even having the shares held by non-family nominees. Equally, it would be possible to set up the FIC with unlimited liability, in order to avoid many of the reporting requirements, though there are of course other disadvantages of doing this.

Are FICs the answer?

Assuming that the potential double tax charge can be accepted and managed, FICs are an attractive alternative to trusts in the post-Finance Act 2006 regime, particularly in cases where a long-term view can be taken. They are, of course, not an exact replacement for trusts, but FICs can provide a cost-efficient and easily understandable vehicle to help clients pass wealth down to younger generations in a tax efficient manner, while preventing immediate access to large amounts of capital or income, and retaining a degree of control over the assets being passed on. They are a very useful tool for the private-client adviser and may have been made more attractive by the introduction of the 50 per cent income tax rate. FICs, therefore, have a significant role to play in providing tax-planning solutions for wealthy families in the UK. TAX ADVISER

Footnote

1. See the author's articles 'In FLPs we trust' (*Tax Adviser*, May 2008) and 'In FLPs we trust, in FGP's even more' (*Tax Adviser*, May 2009)



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