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Passing the torch

How to effectively manage the succession of a family business

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Guy Abrahams explains how to maximise inheritance tax relief on a family business and simultaneously address the problem of succession

The 40 per cent inheritance tax charge for an estate above the nil rate band inevitably focusses clients' minds on the issue of succession; when considering long-term planning for a family, it remains as crucial a factor as anything else.

Here I will set out (in simple terms) two ways families can use companies to reduce their inheritance tax liability, as well as how they can address succession issues along the way.

Unlocking inheritance tax relief in the family business

Many clients already own their family business through a private company so they will, at some point, need to think about the inheritance tax treatment of its shares. The shares will escape inheritance tax only if the company's business is predominantly based on trading, as opposed to investment.

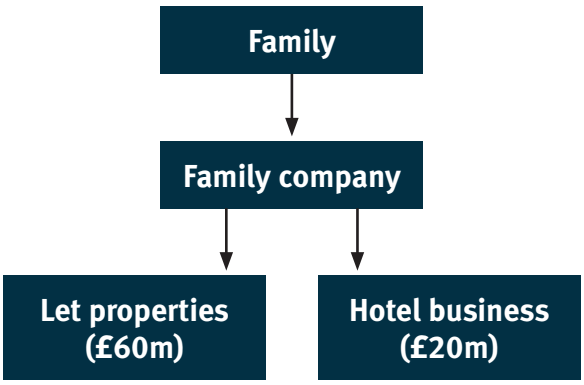
Given the value of this relief, there is an unsurprisingly huge amount of commentary about what is required for a business to qualify as 'predominantly trading', so I will not go into the subject in any great detail. In essence, the difference is that trade is active and an investment is passive.

For example, the business of letting property involves marketing, dealing with leases and so on, which is predominantly passive because the landlord does not trade his properties; he holds onto them and receives the rent. By contrast, the widget business (say) is an active one because the widgets are manufactured and then sold to the end user. Shares in that business will therefore be eligible for 100 per cent relief.

Speed read

- Tax planning can be the catalyst for making decisions about succession
- Families who own a business should periodically review the holding structure, as they may be missing out on IHT relief
- For those starting with a 'clean sheet', companies can be good vehicles for tax and succession planning

Figure 1: Typical family business structure



It is worth mentioning that the business of dealing in stocks and shares, while being an active one, can never qualify for relief; the legislation expressly excludes it.

Many clients have never properly examined their business to see whether any of it might be eligible for relief from inheritance tax. Some clients may have a trading business locked inside a larger investment business, which is an inefficient model (see figure 1 above).

There is a wasted opportunity here because a potentially inheritance tax-free asset (the £20m hotel business) will end up being taxed.

The family company is predominantly investment (due to the value of the let properties) and hence not eligible for relief. The family should therefore conduct a liquidation demerger and move to the structure detailed below (see figure 2).

The shares in the hotel company will (after two years) be eligible for 100 per cent relief from inheritance tax, thus reducing the family's tax exposure by £8m.

If the original corporate structure is more complicated, there will be many traps on the way through the liquidation, principally in the form of stamp duty land tax. However there are also further opportunities. If the liquidation follows certain steps, the base cost of the assets in both businesses can be 'uplifted' for tax purposes to their market value.

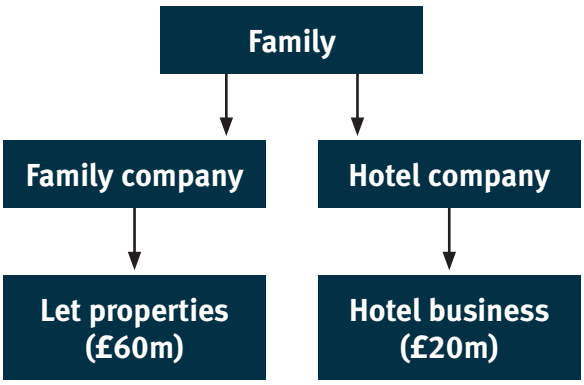
This means that the property company could sell a property after the liquidation and pay no corporation tax. Because of anti-avoidance rules, the liquidation cannot be done with the principal aim of securing this tax advantage, but it can legitimately be made an extremely valuable incidental benefit.

Rather than simply replicating the share structure of the original company in the two new companies, a way to maximise tax relief is to emerge from the liquidation having issued more shares in the trading company to the parents, and more shares in the investment company to the children. This is detailed in figure 3.

This maximises the relief available on the deaths of the parents, as they hold more shares in the relievable hotel company. It's the perfect opportunity to grasp the nettle and pragmatically address the issue of succession

The family has an almost clean sheet when it comes to deciding how to hold the two new companies. For instance, if the parents are not happy to relinquish control of the property company to the children, they could retain a single share which carries no economic rights, but which entitles them to hire and fire a majority of the board.

Figure 2: IHT efficient structure



> **"The property company could sell a property after the liquidation and pay no corporation tax"**

Families who have sold their business

Imagine that a husband and wife have just sold their business and are now sitting on £8m of cash. This is good news of course, but they have acquired a £3.2m inheritance tax problem. They are however, in the enviable position of being able to solve that problem by moving value down the generations, without triggering capital gains tax.

They could simply make outright gifts to their children, but they may not be willing to hand over large sums for fear of the children's lack of responsibility, whether financially or in their choice of a spouse.

Traditionally, trusts were the vehicle they would have used, but now they will only be able to settle £650,000 into trust without an immediate 20 per cent inheritance tax charge. The £650,000 will also not go very far towards alleviating their inheritance tax problem.

The parents could consider creating a family investment company. Because they are starting with a blank canvas, there are many ways they could structure the company, but the following example will illustrate some of the main options.

Potential route

The parents would be the directors. There would be one class of voting share and a number of classes of non-voting share. The parents would settle £650,000 of cash into a trust, of which they would be the trustees, and the trust would subscribe for all of the voting shares.

The parents would then subscribe for non-voting shares by investing £4m and then giving those non-voting shares to their son and daughter. Finally, they would lend, say, £3m to the company. The result would be the investment model detailed in figure 4.

> **"The creation of the family company is the perfect time to consider succession"**

Provided they survive seven years, the parents will have removed £4.65m from their estates, thus reducing their inheritance tax liability by £1.86m. Any growth on that £4.65m also accrues outside their estates. If the parents need funds, they can call in part of their loan.

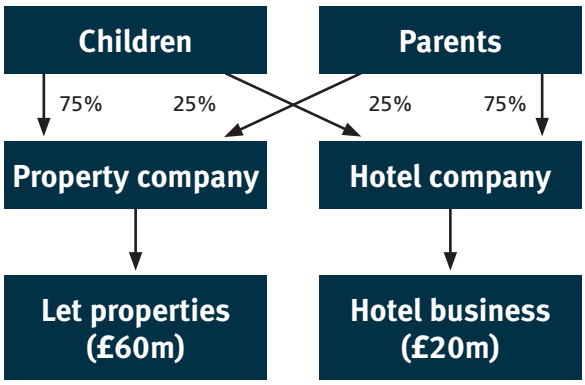
The advantage of the parents investing by way of loan is that the growth generated by their investment will be outside their estates, because it will accrue to the shareholders (i.e. the trust and their children). If the parents eventually call in and spend their loan, they will have reduced their original £3.2m inheritance liability to zero.

The company is an efficient vehicle for investment because it pays corporation tax rates. The parents are the directors and hence make the investment decisions. The family trust owns all the voting shares in the company, and so has ultimate control over the composition of the board. The parents can decide who will also take on the trusteeship after their deaths.

Because the shares are of different classes, dividends can be declared in respect of one class of share without having to declare dividends on the others. Therefore if the daughter needs funds but the son is going through a divorce, the company can declare dividends only to the daughter.

The creation of the family company is the perfect time to consider succession. At the outset the children might have no control over the company at all (as in our example). However they could be granted limited voting rights or even full control over a segregated 'pot' within the company, in order to allow them to develop the skills of a responsible investor.

Figure 3: Succession efficient structure



Conclusion

While the tax tail should not wag the dog, it can be the prompt which forces a family to address issues of succession.

The flexibility afforded by companies (thanks to the two layers of control at board and shareholder level) and the endless possibilities for share rights, means they can be an excellent means of capturing tax advantages and dealing with succession simultaneously. ■

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Figure 4: Investing business sale proceeds