Newsletter

BURGES SALMON

# Family Business

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## Welcome

Welcome to the September edition of Family Business. This edition looks at reducing risk in the family business by ensuring that the family's assets are diversified and that the business is protected.

## Risky business (or, tips to help you sleep at night...)

### Why you should reduce risk

Where a family's fortunes are tied to the success of a business, difficulties at work can affect family life, straining relationships and undermine the business' success by making it risk averse. On the other hand, if owners are confident that their family is protected they will feel freer to run the business in a more entrepreneurial way. This edition looks at ways in which risk levels can be reduced, both by extracting wealth from the business and protecting the business itself.

There is no universal solution and business owners need to find their own balance in both of these areas. The key thing, however, is to have a plan and to review it regularly to ensure that it meets your needs.

## What's yours is yours...

### Making a plan

The starting point for owners is to assess their personal objectives and financial requirements. For example:

- owners approaching retirement should think about when they want to retire and what assets they need. A retiring family member may continue to work in the business in some capacity after retirement, but this may not entitle them to draw a full salary and no one (least of all the retiring member) wants to find that they have to return to work to make ends meet.
- decisions on succession can be made easier if the current owners hold assets outside the business with which to "compensate" children who will not inherit a share of the business.
- spouses of family members will want to ensure their family's financial security if their spouse (ie the family shareholder) dies – ie will they continue to receive income?
- parents of young (and old!) children need to plan for future cash requirements, including school and university fees.
- some shareholders may rely on regular dividends.

Whatever the plan, it is important to get started. A gradual, planned, transfer of assets is likely to achieve a much better result than a sudden rush to allocate assets at the last minute. Moreover, discussing and agreeing a plan between family members is more likely to ensure that everyone's needs are met and there is less room for dispute.

### Extracting value

There are a number of ways to get value from a business into the hands of family members:

- Remuneration (salary/consultancy fees/bonus)
- Pensions
- Dividends
- Sale of shares

Tax will be a significant factor in any decision, but tax planning should not be allowed to obscure the wider

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objectives. The most important thing is to have a clear picture of what amounts will be needed, when and by whom.

### Remuneration

Remuneration in the form of salary, consultancy fees and bonus is probably the most common way to extract funds from the business. However the high rates of income tax, coupled with employee's and employer's national insurance contributions mean that this is not the most tax efficient approach. It is therefore worth considering if remuneration can be combined with other methods.

### Pensions

Pensions can be an extremely tax efficient way of getting value into the hands of the family members employed in the business, up to the individual lifetime allowance (currently £1.25 million). The main tax advantages of using a pension are that:

- the individual pays no tax when contributions are made into the scheme by the employer and only pays income tax when the money is withdrawn (subject to taking up to 25% tax free) by which time he or she may be in a lower tax band
- the company should be able to claim a deduction against corporation tax on its contributions
- there is normally no liability to income tax or capital gains tax on investments held in a pension so investments can grow in a tax-free environment
- if correctly set up, there should be no inheritance tax when the employee dies and the benefit of the pension transfers to a financial dependant.

Aside from the need for care in relation to the lifetime and annual allowances and other benefit taxes, pensions can allow a significant amount of value to be transferred to family members working in the business (even on a part time basis).

Although the pension holder cannot normally receive benefits until the age of 55, money paid into a pension need not be entirely locked away out of the company's reach. Some specialist types of pension scheme (known as SSASs) are able to lend up to half of the value of their funds back to the business. The tax rules are complex but provided that professional advice is taken it is possible for funds which are contained in an individual's pension to be available to the business, or to be used to acquire non-trading assets (such as commercial properties) from the company (see "Leased Assets" below).

### Dividends

Dividends are likely to be the most tax efficient way of regularly distributing funds from the company. They are also likely to be the only way of getting money to shareholders who do not work in the business, who may come to rely on the regular receipt of dividends. The company therefore needs to plan carefully to ensure that it has sufficient distributable reserves to be able to pay dividends reliably and that it communicates clearly with shareholders, particularly those who have little day to day involvement with the business. A series of missed dividends is likely to cause significant tension between shareholders, whereas reliable dividend payments will help to make governance of the business easier.

The simplest position with dividends is where all shareholders hold the same class of shares and receive dividends in proportion to the number of shares held. However, this isn't the only approach. For example, some shareholders could be given preference shares that pay dividends at an agreed rate annually. The company still needs to have distributable reserves in order to be able to pay a dividend but, in a bad year where payment is not possible, the interest can accrue to be paid at a later stage, which may be reassuring to shareholders.

Another approach, used by some family companies, is to create different classes of shares on which dividends can be declared independently, at the discretion of the directors. This requires a high level of trust in the directors (because the shares do not have an equal right to dividends), but in a first or second generation family business it allows flexibility to direct dividends to shareholders according to their individual circumstances.

### Continued Income Stream

Where the company has a policy that shares will only be held by members of the direct family (or "bloodline") there may be legitimate concerns that in the event of the death of the shareholder, the spouse could be left without an income. There are a number of ways to address this including:

- allowing shares to pass to the spouse only (but no further) so that he or she may continue to receive dividends. This could be coupled with a shareholders agreement setting out an agreed dividend policy. In addition the shares may lose the right to vote when the shares transfer to the spouse, in order to prevent any loss of control
- providing a lump sum or ensuring a continued income stream through life insurance, the premium for which may be paid for by the company with the benefit held on trust for the spouse. If correctly arranged as registered schemes (and subject to certain conditions) there should be no income tax charge in respect of any lump sum benefit received.
- ensuring a continued income through a pension arrangement (see "Pensions" above).

### Sale of shares

The most tax efficient way of realising value is through selling shares in circumstances where this qualifies for capital treatment and where entrepreneurs' relief is available to reduce the tax rate to 10%. A sale to a third party is unlikely to be acceptable to many family businesses, but this need not prevent a sale to other shareholders or a transfer of shares to a trust.

In addition a company can, provided certain conditions are met, buy back shares from its shareholders. Whether capital treatment and entrepreneurs' relief will be available for a buy back will depend on the circumstances, but with or without capital treatment, a staged buy back can provide a way of extracting value, possibly linked to the handover of control to the next generation.

In extreme circumstances, where the family is considering reducing its interest very considerably, under new provisions announced at the last budget, a sale of shares can be entirely free of capital gains tax if the sale is of a controlling shareholding to an employee trust.

# Getting the structure right

Long term planning also requires family members to think about the best structure within which to hold their investments.

## Limited Liability

A crucial first step is to ensure that the business is conducted through one or more limited liability vehicles, in order to insulate the family from business risk. This may be obvious but it is important to ensure that, for example, personal guarantees are not given which blur the line between personal and business risk.

## Leased assets

One approach to de-centralising assets is for non-core assets (including properties) to be held in a company owned personally by one or more shareholders with the aim of receiving a reliable income stream from this by leasing the assets/properties to the trading company. Thought needs to be given to the tax consequences of this structure because on the face of it shares in a property holding company will not qualify for business property relief and therefore will fall within the charge to inheritance tax (although there are ways to address this). Equally if there is a likelihood that the business may be sold in the future thought needs to be given to what assets a buyer would expect to acquire as part of the business (ie property which is important to the company may be best held by the company if there is any plan to sell in the near future).

## Reconstruction

Separating parts of the business into different corporate entities can have advantages - for example:

- it allows risks in one part of the business to be separated from other parts. This can be part of a general risk management strategy or can be used specifically for a new venture
- it can be used as part of a tax planning strategy to group together qualifying assets. For example, in some cases separating trading assets from non-trading assets may give certainty about eligibility for business property relief or entrepreneurs' relief (rather than risking a mixed portfolio failing to qualify in its entirety)
- in larger family businesses it can aid succession planning by enabling siblings to receive separate parts of the business and go their separate ways
- where a dispute has already arisen between family members it can provide a way of reaching a final settlement.

If done in the right way, this sort of reconstruction can be achieved without incurring any tax charges.

> *"Trusts can be particularly useful for succession planning in family businesses because not only can the trustees ensure that assets are preserved for future generations but they can also use their judgement in difficult issues such as day to day control of the business."*

## Trusts and Family Investment Companies

Trusts are commonly used for asset protection because they enable the control of assets to be separated from their economic ownership. For example, the assets in the trust may be held for the benefit of children and grandchildren but controlled by the trustees so that they cannot be reduced recklessly or given to one or more of the children leaving nothing for the next generation. Trusts can be particularly useful for succession planning in family businesses because not only can the trustees ensure that assets are preserved for future generations but they can also use their judgement in difficult issues such as day to day control of the business. Putting assets into a trust also helps to ensure that they will not form part of the individual's estate, thus managing inheritance tax risk.

Over the last few years, however, the tax treatment of trusts has become less favourable, and other structures have started to become more widely used. In particular low rates of corporation tax have made family investment companies ("FICs") potentially a very tax efficient way of holding investments for the family. FICs enable parents to retain control by holding, directly or indirectly) all of the voting shares while giving shares with rights to the economic value to children or other family members. FICs therefore can reduce exposure to inheritance tax and can be extremely flexible. If assets are transferred into the FIC and the price is left as a loan due to the transferor, the repayments of interest and capital can also serve as a useful income stream over a number of years.

# Minimising “family risk”

One of the key reasons for the failure of family businesses is disagreement within the family itself. There isn’t room in this newsletter to consider all of the steps which might be taken to reduce the risk of dispute within the family but a few areas to consider include:

- maintaining clear and regular communications within the family so that differences around succession, pay, promotion and business strategy are all carefully managed. One way of doing this would be to document the aims and intentions of the business in a family charter, to establish regular communications with shareholders and clear processes for decision making
- retaining ownership of the business within a small number of individuals through share buy backs and compensating family members who do not work in the business
- enabling family members who want to do so to realise value by selling their shares

- having safeguards in place to ensure that an event such as death, divorce or individual bankruptcy cannot cause a situation where shares pass outside the control of the family (this was discussed in the June edition of Family Business).

# Reducing business risk

Well-run businesses will have procedures for managing commercial risk on a day to day basis, including insurance and disaster recovery procedures. However, family businesses are more prone to certain risks than their non-family counterparts. In particular this includes the risk of the business being heavily dependent on the experience of one or two family members without adequate back-up from others. This can cause risk not only if that person dies or becomes ill unexpectedly, but also if they cannot, alone, visualise a clear strategy for the business in the future.

It is worth, therefore, considering measures to offset this risk, including ensuring that, where necessary the management team is expanded using external managers with the relevant experience and establishing good governance procedures with, possibly one or more non-executive directors to give guidance. This process of “professionalising” the business can be a difficult step, but is necessary to ensure business continuity and that the business adapts as it grows.

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# Our Family Business team

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