Family Investment Companies – Succession Planning: An Alternative to Trusts

When carrying out succession planning in the UK, lifetime gifts can be an important part of an individual's tax planning. However, where an outright gift of assets is made, the donor will relinquish all form of control over those assets, as well as the rights to any income arising from those assets. Individuals with substantial wealth may not wish for their beneficiaries to have uncontrolled access to high value assets or sums of money, particularly if they are young or vulnerable.

For these reasons, trusts have often been the preferred structure used by families to pass wealth on to future generations in a controlled and tax-efficient manner. However, a disadvantage of trusts is that they are not recognised in many jurisdictions and the tax treatment can be uncertain. This may be a particular concern for international families with children and grandchildren resident in several different countries. In the UK, over recent years, the tax treatment of offshore trusts (generally suitable for non-domiciled settlors) has become increasingly complex, whilst many domiciled settlors face an immediate inheritance tax charge of 20% on the settlement of assets; hence, many families are seeking alternative solutions.

A Family Investment Company can offer a simpler alternative to a trust structure and it is becoming increasingly common in succession planning. When structured correctly, a family investment company can allow assets to be passed down to future generations tax efficiently whilst at the same time allowing the taxpayer to retain control over those assets.

An additional attraction is that a company structure is familiar to most people and the tax treatment of companies and their shareholders tends to be well-established in most jurisdictions.

Creating a Family Investment Company

Usually, the parents would form a company with different classes of shares, e.g. 'A' and 'B' shares, which would carry different rights. For example, the 'A' shares would carry the economic rights (i.e. rights to dividends and distribution of assets on the winding up of the company) and the 'B' shares would carry the voting rights (and perhaps other controlling rights, such as the ability to appoint directors). The 'A' shares could be designed to provide incremental rights (i.e. rights that increase over time) to the future capital and income of the company if so desired, but would not carry voting rights.

In a typical scenario, the parents would hold the 'B' shares and the children would have the 'A' shares. Depending on the circumstances, grandchildren could also be given 'A' shares.

The 'B' shares allow the parents to retain control over the company (for example, in respect of the investment decisions, dividend policy, sale of assets etc.), but the rights to income and capital would be given to the children. Usually, restrictions would be included in the Articles of Association to prevent the 'A' shares from being sold or transferred to third parties, which is particularly important for asset protection purposes, including in the event of a divorce.

The Articles of Association (and possibly a Shareholder Agreement) would need to be carefully drafted in order to put in place the required rights and restrictions. It may also be helpful for professional valuations to be obtained in relation to the respective values of each share class.

The parents would usually inject cash into the company in exchange for shares and the company would acquire investments. The parents could transfer assets into the company, but this may give rise to a capital gains tax charge for the parents so professional advice would need to be taken. It would not normally be suitable to transfer UK real estate to the company as this would usually give rise to a Stamp Duty Land Tax charge.

Inheritance Tax

Shares in an investment company do not qualify for Business Property Relief (BPR). The gift of the 'A' shares to the children is a potentially exempt transfer (PET) for UK inheritance tax purposes and would only become chargeable to inheritance tax if the donor passes away within seven years of the gift.

Care needs to be taken to ensure that sufficient value is transferred to the children in order for the transaction to be effective for IHT purposes. The value of the economic rights transferred (which will, to some extent, depend on the extent of restrictions placed on the 'A' shares) needs to be balanced against the level of control the 'B' shares provide, as the greater the rights that are allocated to the 'B' shares that are retained by the parents, the higher their value is likely to be, and the lower the value of the 'A' shares that are transferred.

Corporation Tax

Income arising from the assets held by the company will be subject to corporation tax at 19% (assuming a UK company). This compares favourably to the personal income tax rates that would otherwise apply (up to 45%) if the income were received directly by the children (if UK resident).

Any capital gains realised by the company would also be subject to corporation tax at 19% if the company is UK resident, with the benefit of indexation relief.

Different considerations apply where the company is non-UK resident and specific advice should be taken to determine the income tax and capital gains tax treatment for the shareholders.

Dividends

There is no withholding tax on dividends paid by a UK company.

The dividend income will be liable to UK income tax in the hands of a UK resident, although the tax rates for dividend income are lower than the standard rates of income tax (7.5% at the basic rate, 32.5% at the higher rate and 38.1% at the additional rate). Dividend income received by a minor child will generally be taxable on the parent.

As the company profits that are used to pay the dividend income will have been subject to corporation tax in the UK, there is an element of double taxation in respect of those profits.

For non-UK resident shareholders, the tax position on the dividend income will depend on the rules in their country of residence.

Existing Companies

Where there is an existing investment company, the shares can be restructured in a similar way and the ‘A’ shares gifted to the next generation. The capital gains tax position will need to be examined, as the disposal of shares may give rise to a UK CGT charge of up to 20% on the deemed gain. If the company is non-UK resident, the CGT position will depend on the donor’s domicile status. If the donor is not domiciled or deemed domiciled in the UK, the gain arising on the disposal of the shares may be taxable on the remittance basis.

Summary

Family investment companies offer a suitable alternative to trusts when carrying out succession planning. Use of a company structure can allow assets to be transferred to the next generation in a tax efficient manner whilst at the same time providing a mechanism for protection of those assets from vulnerable or profligate family members, or in the event of a family member divorcing.

Verfides can advise on all tax aspects of a family investment company, and can assist with the implementation by incorporating the company and overseeing the creation of the different classes of shares. We can also provide full accounting and tax compliance services on an ongoing basis.