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Client Briefing Note

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Passing on the family business

Every owner-managed businesses will face the subject of succession and is a matter which, whilst easy to overlook in the time consuming day to day running of the business, every owner should give adequate and early consideration.

Some businesses may be simply sold on to unconnected parties but many family businesses are passed from generation to generation and care must be taken to ensure the business hand over is structured in the most appropriate manner.

Whilst tax will be a major factor in deciding upon the appropriate method of succession it should be borne in mind that there will be other important factors and the situation of both the retiring owner and new owner should be appropriately considered. Successful tax planning will enable the transition to take place with the least possible disruption and should ensure the structure of the business is appropriate for the continuing activity of the new owners and personal circumstances of the retiring owners.

The method of succession will vary greatly depending on how the existing business is structured i.e. whether it trades as company or a partnership. Where a company is concerned the retiring owner will often be making a disposal of shares where in a partnership the assets and goodwill of the business would be transferred.

Capital Gains Tax

It is important that any potential charge to Capital Gains Tax (CGT) is taken into consideration. This occurs when assets are disposed and any gifts of assets or sales at an undervalue, to a connected party, will be subject to capital gains tax as if the asset was sold at market value, even if no cash actually changes hands. This is particularly important as many businesses will hold assets with inherent capital gains.

A possible solution is to apply for hold over relief on gifts. This is a method of delaying any capital gain, effectively passing it on to the new business owner. Relief is available if the asset falls within certain categories, namely an asset used for the purposes of a trade, certain agricultural property relief or transfers of certain company shares and securities.

CGT may also be partially mitigated for the retiring owner by Entrepreneurs Relief which can reduce

tax on gains on disposal of qualifying businesses from 18% to 10%.

Inheritance tax

Unless payment of full value is received for the business, the retiring owner will be deemed to be making a gift and this may have Inheritance Tax (IHT) consequences as if the donor dies within seven years of making the gift, a liability may arise.

Business Property Relief (BPR) from IHT may be available which can reduce charges on interests in qualifying businesses and business assets by up to 100%. This is a complex area and not all businesses or assets of the business will qualify.

For unquoted companies to qualify for BPR, the business of the company must consist wholly or mainly of carrying on a trade i.e. not property letting or other investment business. It is interesting to note that a business may carry a small proportion of investment assets and activities, e.g. letting property surplus to requirements, without loss of relief. This involves a delicate balancing act of including only such an amount of non trading assets as does not jeopardise loss of relief on the entire business.

When assets qualifying for BPR are gifted during an individual's lifetime two conditions must be satisfied to ensure the BPR is still available in the event of the donor's death within the following seven years. Firstly the asset should continue to be owned by the recipient on the donor's death. Secondly the requirements for BPR should be satisfied at the time of death of the donor as well as at the time of the gift. Various scenarios could cause a problem in this regard, for example if the family business was sold, or ceased to trade after the gift was made and began to let the premises it would then fail to met the second condition as it would not be classed as a trading company. There are provisions which can be used to avoid this problem if qualifying replacement property, in one of its various guises, is purchased.

In an unincorporated business, such as a partnership, full BPR is applied to the individual partner's share of the business. It may be hard to define what assets are actually part of the business and it may be prudent to ensure assets are included on the business Balance Sheet. Cash may either be deemed to be a business asset or an investment. If it can be demonstrated as being needed for future replacement of business assets, it is more likely to attract relief.

Practical ideas and solutions

There are various planning points which can be put in place to assist in making the transfer effective and we consider a few of these below.

A gradual retirement may be attractive and it is possible for the retirement to be staged so that profits are spread. This can save income tax in the short term.

The requirement to retain an income for the retiring partner is also an important consideration. An opportunity may exist for them to retain any business premises and then rent it to the business. Alternatively the business could be transferred to a limited company ('incorporated') prior to the retirement of the owner with their interest in the current value of the business being repaid to them over a period of time. A similar exercise could be carried out using the existing partnership structure. These methods may have further tax consequences for the retiring owner and should be considered in light of their personal circumstances.

In a company there is a distinction between management and control. An individual could retire as company director but retain a shareholding. If the company was a trading company this could result in no IHT on death with any dividends paid providing an income in retirement.

In the longer term, retained business premises could be passed to a trust, perhaps for the benefit of grandchildren, which can be an extremely tax efficient method for providing assistance with education costs. Similarly any retained company shares could also be passed on to the successor to the business or a trust for grandchildren, perhaps as a means of facilitating further future succession to an even younger generation !

Certain tax privileged share options could be issued to the business successors to allow them to buy into the business over time at a discounted price and in a tax efficient manner. In some circumstances, the business can obtain a tax deduction in connection with the options. Care should be taken to ensure the value of any shares passed to family members is not caught by the rules which can create a charge to Income Tax and National Insurance.

If a company has surplus cash funds, perhaps these could be used to buy back shares from the retiring business owner. In the appropriate circumstances and correctly structured, this method can allow a retiring business owner to extract cash from the business at a very low effective tax rate.

In a partnership situation, a partner could cease to have day to day involvement in the business but remain a partner taking a nominal profit share. In this case a substantial accumulated share of the business could attract full BPR for IHT and an income could be provided in retirement. Care must be taken to avoid classification as a sleeping partner.

In conclusion the succession of a family business is a complex but very important area. Every family and business will be different and will require a tailored succession plan and specific advice. To ensure opportunities are maximised it is imperative that professional advice is taken at an early stage to allow appropriate planning to be undertaken.

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