Briefing Note

Family investment companies

Family investment companies are a means of gifting assets for inheritance tax (IHT) purposes while retaining control over the investment and use of the funds gifted.

Until 2006, trusts were more commonly used for this purpose. However, since 2006, gifts to a trust in excess of £650,000 are subject to an immediate IHT charge at 20%. Family investment companies (and family partnerships) seek to mimic some of the controls available from a trust without an upfront IHT charge.

Outline structure

A family investment company would typically be established by the founders incorporating a company and funding it with cash. The cash funding could be provided as a mix of equity and loan notes. The founders would be appointed as directors of the company with a mechanism to appoint an appropriate replacement in the event of the founder's death.

The equity would be divided into at least two classes of shares. A shares would have little or no economic rights but would carry all voting rights for the company. B shares (or B, C and D shares for children, for example) would have no voting rights but would have economic rights to dividends and capital in the event of a sale/winding up. The directors and A shareholder would control the payment of dividends and the sale of shares and winding up of the company together with all other matters affecting the company.

The loans can be interest free or have an entitlement to interest. Interest free would be more tax efficient. The repayment of the loan notes in whole or in part would be at the sole discretion of the company. The shareholders and loan note holders would be prohibited under the company documentation from granting securities over their interest.

Following establishment of the company, the founders would gift their loan notes and B shares (or B, C and D shares) to the children. The founders, or a trust established by the founders, would retain the A share which carries voting control.

Tax treatment

Inheritance tax

The gift of shares and loan notes by the founders would be a potentially exempt transfer for inheritance tax. Accordingly, provided the founders survive seven years from the date of the gift, no inheritance tax would arise. The risk of inheritance tax arising in that period could be protected by a seven-year decreasing term policy.

The value of the shares and loans notes in the children's hands would be discounted from the net asset value of the company for inheritance tax purposes due to:

- the restrictions in the articles/shareholders' agreement and loan note terms; and
- because the shareholdings would represent a minority interest in the company.

A greater minority discount could be achieved if the shareholding is spread among more than the children, eg if some family trusts also invested in the company.

Minority discounts of up to 75–80% could be available on the shares. Less substantial discounts would be available in respect of the loan notes.

Corporation tax

The corporation tax treatment of income received by the company would depend on the nature of income received. Dividends on investments held by the company, would be free of corporation tax. Other income, such as property income, would be subject to corporation tax (presently 19%).

Capital gains realised by the company would be subject to corporation tax at 19%. Unlike for individuals and trusts, indexation relief would be available on gains realised by the company.

If there is a wish to extract cash from the company, repayments of the loan notes would be free of tax (and this is the primary reason for using loan notes rather than solely equity). Once all the value of the loan notes has been repaid, distributions from the company could be made either by:

- dividend; or
- capital return on liquidation.

Dividends would be subject to income tax at the recipients' marginal rates of tax, which are presently 7.5% (basic rate); 32.5% (higher rate) and 38.1% (highest rate) on dividends above £5,000.

It is likely that the future tax treatment of liquidations will be such that distributable profits that could have been paid as a dividend (rather than a capital return on liquidation) would be subject to the income tax (at the rates outlined above) rather than capital gains tax (presently 20%).

Asset protection issues

Family investment companies do not provide the same degree of protection as a family trust against certain asset risks including divorce, bankruptcy and claims on death.

Divorce

In Scotland, assets owned prior to a marriage and assets received by gift or inheritance are excluded from financial provision on divorce. The exclusions do not apply to the same extent if the assets received by gift or inheritance change in nature during the course of the marriage (eg if cash is gifted and then assets are bought with the cash). Holding shares in a family investment company is an effective way of 'ring-fencing' the gift for inheritance so that it does not change in nature. There is not an issue with the company's underlying investments changing from time to time as long as the company itself is not restructured.

However, other jurisdictions, including England, do not have the same exclusions. Assets owned before marriage or received by gift or inheritance can all be taken into account. It may be that it would be only be the discounted value of shares and loan notes that would be taken into account in a divorce, but the family law courts, particularly in England, have a reputation for ignoring the formal legal treatment of assets and structures.

Pre-nuptial agreements can provide protection against such claims in both Scotland and England.

Creditor claims

Similarly, shares and loans would be available to creditors in the event of a shareholder/loan note holder's bankruptcy. Provisions can be included in the company's documentation to allow the other shareholders to acquire a bankrupt shareholder's shares and loan notes so that a trustee in bankruptcy is not involved in the company.

Claims on death

In Scotland, spouses and children have a right to claim 'legal rights' in the estate of a deceased spouse/parent who was domiciled in Scotland. A trust provides complete protection against such a claim. However, if a shareholder/loan note holder dies, his spouse and children would be entitled to claim a specified share of discounted value of the shares/loan notes. In practice, legal rights claims are very rare but if there is a concern that a legal rights claim will be made this can often be dealt with via a pre-nuptial agreement/legal rights discharge.

This note is intended as a brief summary of the taxation and legal position surrounding family investment companies. Taxation is subject to change and depends on the individual circumstances of each client. Legislation is also subject to change. No responsibility can be taken for any action taken in reliance on this note and specialist advice should be taken in every case. Turcan Connell would be happy to provide such advice.
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