Protecting the family future

Inheritance tax and trusts   Personal tax

30 September 2021

Sofia Thomas and Sharon Dosanjh consider the role that family investment companies can play in passing down generational wealth in a tax efficient manner

Key Points

What is the issue?

A family investment company is essentially a private company to which the shareholders are various generations of a family with the primary aim to preserve family wealth. It allows the parent to retain control over the assets while growing their wealth in a tax efficient manner.

What does it mean to me?

Family investment companies are becoming increasingly popular. It is important that the advisers are equipped with the knowledge to be able to guide on their implementation when considering future success planning vehicles.

What can I take away?

The structure of a family investment company can be relatively simple or complex, depending on the needs of the shareholders. Tailored advice and guidance is needed when making decisions about their implementation.

Family investment companies (FICs) are becoming increasingly popular in today's age. It was announced in August that the specialist unit formed by HMRC to investigate family investment companies has been disbanded, having found no evidence to support the claim that the vehicle was being abused as a means of avoiding tax. HMRC found no correlation between the individuals who had set up family investment companies and tax avoidance.

Of course, this doesn't mean that HMRC cannot open an investigation into this vehicle again in the future. However, the findings of the investigation are reassuring, showing that the family investment company is a useful and legitimate tool for passing down generational wealth in a tax efficient manner.

What is a family investment company?

A family investment company is essentially a private company to which the shareholders are various generations of a family, established with the primary aim of preserving family wealth. It allows the parents (or founding members) to retain control over the assets while growing their wealth in a tax efficient manner. It is also seen as an alternative to a trust, allowing family members to hold various different economic interests of the family wealth by way of shares, rather than distributing fractional interests within assets to the next generation.

A family investment company will follow the same regulations as are required for the management of a private company. It must be registered at Companies House and will appoint directors, provide articles of association, a memorandum of association and a shareholders' agreement, file annual accounts and disclose details of persons with significant control.

It must send a company tax return to HMRC and pay corporation tax.

It is imperative that many different factors are taken into account when setting up a family investment company. The primary question, of course, is to identify the future recipients but there are a number of other issues to be considered, such as those relating to grandchildren, divorce and death.

These factors can be taken into consideration when preparing the bespoke articles of association and the shareholders' agreement. These documents form a fundamental part of setting up the family investment company, as they reflect the rights and controls of the shareholders and can be drafted to suit the family's needs. They will include the share structure to allow the economic interest to be passed to the children individually in line with their individual needs, while the parents or founding members retain control (in the form of directorships) of the assets, investments and dividends.

Provisions can be placed to restrict the transfer of shares, or prevent the amendment of the rights to income and/or capital of the various share classes. They can also include restrictions for events which would trigger a compulsory share transfer, such as in the event of a divorce or death. The articles of association can include drag on provisions (enabling a majority shareholder to force a minority shareholder to join in the sale of the company) and deadlock provisions to safeguard the family wealth further.

When would you use a family investment company?

A family investment company should certainly be considered as an option when seeking advice regarding future success planning. Many would be aware of the use of trusts to pass down generational wealth; however, a family investment company can also be an excellent vehicle to do so.

This model is also likely to appeal to individuals who come from a corporate or entrepreneurial background. For instance, many business owners may feel more comfortable with a family investment company as they already hold much of the knowledge of dealing with a company from the legal and administrative side.

Parents would inject cash or assets into the family investment company and then gift the non-voting shares to their children, thus making them the shareholders of the family investment company. The shares will usually be alphabet shares (see the box above), which allow the company to effectively issue different classes of shares to the stakeholders. This allows family investment companies to pay dividends to shareholders with one class of shares without being required to pay the same dividend to each shareholder.

It is very important to get the alphabet shares right in the first instance, taking all considerations of possible scenarios into account. By gifting the non-voting shares, the economic interest would be passed down to the children, while the parents retain control (in the form of voting shares and directorships) of the assets, investment policy and dividends. This would provide complete flexibility with regards to distributing surplus profits within the family investment company among the family.

Non-voting shares may be set up to carry the rights to the capital and income in a family investment company. The alphabet shares can also be engineered in a way that they pass responsibility to children in stages as the children grow older.

How is it taxed?

Normally, most gifts carry an inheritance tax charge; if assets are placed in a discretionary trust, they would carry an immediate inheritance tax charge of 20% (over the £325,000 nil rate band). However, with a family investment company, this is not the case. Cash placed in a family investment company does not carry any upfront inheritance tax charge or any immediate tax consequences. Transferring the shares would be treated as a potentially exempt transfer for inheritance tax purposes, taxable only if the donor did not survive for seven years. It would also be a capital gains disposal for the parents but if the shares are given away before there is any growth in investment value, there should be no gain in practice.

Disposals within the family investment company, such as property or shares, could carry corporation tax on chargeable gains and acquisitions could have stamp taxes implications.

Due to the family investment company being a limited company, it would take advantage of a lower tax charge – the corporation tax at 19%. This rate increases to 25% from 1 April 2023. This would be chargeable to all the income and capital gains, although dividends are normally exempt from corporation tax.

On the other hand, there can be a ‘double tax charge’ when using a family investment company. This essentially means that the family investment company would pay corporation tax on its income, profits and gains; however, at the point of distribution to shareholders, the shareholder would also have to pay income tax at the relevant dividend rate. As the children or grandchildren would usually be the only ones who hold the economic interest, they would pay tax via Self Assessment on any income received from the family investment company.

The founder may at some point wish to extract funds from the family investment company. As long as the funds had been injected into the family investment company by way of a loan, the extraction will be tax free (as it would be treated as a repayment of loan).

It is also worth noting that while a family investment company is considered to be a success planning tool, it does not attract any specific inheritance tax reliefs and it is not eligible for business property relief (as an investment company, rather than a trading company). The inheritance planning would take place in the form of giving away all appreciation to the capital within the family wealth at the point of creating the family investment company. However, the voting shares held by the parents in our example carry value and would form part of the donor’s taxable estate.

A family investment company can be very similar to a trust. If you wish to read further about the similarities and differences, see ‘Old school or new school’, Tom Klouda and Daniela Andreca (Tax Adviser, April 2020).

Anti-avoidance

A family investment company is by no means a tax avoidance vehicle. There are anti-avoidance rules in place which must be considered when setting up a family investment company to avoid falling into any tax traps. These include (but are not limited to) the ‘settlements’ anti-avoidance rules (Income Tax (Trading and Other Income) Act s 624(1)); ‘gift with reservation’ (Finance Act 1986 s 102(2); inheritance tax anti-avoidance provision; and the general anti-abuse rule (GAAR); and disclosure of tax avoidance schemes (DOTAS) provisions.