Family Fortunes

Inheritance tax and trusts | OMB | Personal tax

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Trusts are no longer the most tax-efficient way to transfer assets to future generations. Steven Holden and Roland Roberts look at how a family investment company could be more attractive

Key Points

What is the issue?

Trusts have become less efficient vehicles for transferring family wealth after FA 2006. After recent changes to the corporation tax rates, family companies have again become an attractive proposition

What does it mean for me?

An understanding of the application of family investment companies in the estate planning process and identifying the opportunities available through their use particularly around the areas of tax mitigation and asset protection

What can I take away?

Even though the use of trusts has been restricted as a tax planning vehicle, there remain options under FICs that will still allow families to distribute benefits and wealth without the loss of control and potential for dilution of family wealth normally associated with outright gifts

In recent years we have begun to see the rise of alternatives to trusts in estate planning. These have been driven largely by the changes introduced in FA 2006, which significantly curtailed the tax opportunities that trusts enjoyed previously. Couple this with the reduction in corporation tax to a flat 20% and one can understand why holding private wealth through a corporate structure has started to look attractive again.

FA 2006 – where did it all go wrong?

Before the changes introduced in FA 2006, it was possible to transfer assets in excess of the nil-rate band into certain types of trust without incurring an immediate tax charge of 20% of the excess over and above the settlor's inheritance tax (IHT) threshold. This reduced the estate of the donor without necessarily passing legal control of the assets transferred into trust to the intended beneficiary; rather, it allowed them the income from or use of the assets held on trust. Usually, this was through fear of the loss of control of assets to the next generation resulting from concerns around immaturity, poor financial management skills and even the effect of poor marriage choices. The position is that if you transfer assets over the nil-rate band – currently £325,000 – you will incur an IHT charge straight away at the lifetime rate on that excess, regardless of the type of trust used (with some minor exceptions).

It also extended the reach of principal and periodic charges for trusts, once the domain of discretionary trusts and we saw the extension of the relevant property regime to all forms of trust structure. This means that regardless of the nature of the trust in a legal sense, it will still be subject to a maximum 6% charge every 10 years should its value exceed the then nil-rate band. The result is that longer running settlements would potentially suffer an increase in IHT. This is likely to be further compounded because, although HMRC seem to have abandoned their consultation on further changes to the way in which the relevant property regime applies, we are told that they intend to introduce new anti-avoidance legislation in this area.

We have also seen various changes to the way in which the income and capital gains are taxed on trusts in the UK over the same period, adding to the woes of the efficacy of trusts as a tax planning vehicle. We now find ourselves with the trustees' rate of tax being aligned with the additional rate for individuals at 45%, while capital gains are taxed again at the higher rate of 28%.

So, we can see that these changes, along with FA 2006, have greatly curtailed a client's ability to plan for IHT while safeguarding the assets so gifted – at least in a more conventional way. Couple this with the fact that the nil-rate band hasn't increased for a number of years and it becomes understandable why people are looking at alternatives.

What is a family investment company?

A family investment company (FIC) is simply a private company whose shareholders are members of the same family and whose memorandum and articles of association can be drafted to suit their needs. The way that the shares are structured can allow the passing of ownership of underlying assets to the next generation without the older family members necessarily losing control of them too soon.

Unlike a trust, no tax charge is payable on setting up an FIC when the initial subscription for shares is made in cash only. However, a transfer of property may give rise to a stamp duty land tax (SDLT) charge, and capital gains tax (CGT) may also be payable if moving other assets into the company. Even if such a one-off charge arises, FIC may still be the best long-term option when factoring in the individual's overall objectives, and at costs versus the long-term benefits. A possible example is detailed in ***Example 1***.

Example 1

The Spencer family have considerable cash savings; they create a family investment company with Mr and Mrs Spencer as directors and with them and their three adult children as shareholders. They transfer £5 million of cash into the company with no tax implications.

Since Mr and Mrs Spencer wish to retain control over the company, the articles of association are drafted but give their children no voting rights. This means they are entitled to receive dividends and ultimately capital should the FIC be wound up; but they will not have the power to make financial decisions in the same way as other shareholders, although these rights could be altered in the future.

If the company makes profits, corporation tax will be payable at the 20% rate (from 1 April 2015). That is significantly lower than the higher, or additional rate of income tax, or that applicable to a trust fund. It is worth pointing out that any UK dividend income received by the FIC will not be subject to tax; however, interest, rents and other income will be.

With regard to extracting those profits, tax-efficient withdrawals can be made to the shareholders in the form of dividends according to their personal circumstances. Making the assumption that the five family members have no other sources of income, they could extract profits of up to £212,375 in 2015/16 without suffering additional tax. If the FIC made profits of 5% a year, the family could extract all of the post-tax profits tax efficiently, while Mr and Mrs Spencer retain nominal control.

This is of course a straightforward example, and one could consider it attractive to pay the directors a modest salary, or make contributions to a company pension scheme, or even look at the use of directors' loans as part of the set-up for Mr and Mrs Spencer. However, as illustrated, it remains that if shareholders do not have personal income in excess of the basic rate band, their dividends will not attract an income tax liability because they are treated as being net of tax. But more importantly, any undistributed net profits accumulated within the FIC are retained within the company with no further tax payable. This results in an attractive 25% increased net income (as opposed to a trust) for individuals intent on wealth accumulation.

It is worth pointing out, however, that there is a potential double tax charge when profits are extracted by shareholders, who may pay further tax on dividends paid from the FIC if their overall incomes exceed the basic rate band. So, if the overriding consideration is to maximise income, the use of an FIC may not be beneficial.

Trusts can still have a use within family asset planning running alongside FICs, typically if the corporate structure is created by a grandparent and a trust is created to hold shares for minor grandchildren, or even when one has concerns over giving outright ownership to one's children. This has the benefit of allowing the family to use the minor's personal allowances in paying school fees, for example, without relinquishing control of the underlying shares. It should be noted that, when such a gift is made by the minor child's own parents, any income is still taxed on the parent under settlement rules; this is not the case for grandparents.

Greater consideration would need to be given if an individual transfers an existing portfolio of assets into an FIC, both from a tax perspective and also from a legal point of view. This is why it is often just as important to consider the commercial and emotional aspects of the proposition beyond merely the tax issues. We have already mentioned the usual suspects in terms of why a client may create a trust, such as protecting assets against the bad financial judgments or poor marriage choices of younger generations. In the past, family courts have often run roughshod over the protections that trusts offer, treating them in judgments as legitimate pools of funds to be accessed. Conversely, FICs offer the advantage of the greater protection of the ‘corporate veil’. Indeed, the case of *Prest v Petrodel Resources Ltd and others* [2013] UKSC 34 demonstrated that nothing short of proof of impropriety by a party would encourage the family court to even consider looking at ‘piercing the veil’.