

## Passing on the Family Business : Inheritance Tax and Ensuring Tax-Efficient Succession

If you are planning to pass on your family business you will need to know the answer to these questions:-

- What types of business attract relief?
- What are the six categories of 'Relevant Business Property'?
- How long must they have been owned to qualify?
- How do 'excepted assets' restrict Business Property Relief?
- 'Life time' giving and inheritance on death : what are the tax implications?

Read on to find out the answers and let us help you find the most tax efficient method for you.

The 100% rate of Business Property Relief (BPR) from Inheritance Tax (IHT) has been with us now for 15 years, 5 years under Conservative and 10 years under Labour administrations – though its continuation cannot be guaranteed for the future. Not all businesses will qualify - and certain business assets will attract only 50% relief. The business, whether legally a sole trade, a partnership or shares in a company, may be handed on either in stages or at one fell swoop – and whether by lifetime gift or on death. If on death, Capital Gains Tax (CGT) will not be an issue. If by lifetime gift, there will be a disposal for CGT, but typically one with no immediate CGT consequences through 'hold over' of any gain then arising. Stamp Duty Land Tax (SDLT) should not be forgotten either where land is involved.

This Briefing assumes a family business which, whether or not first generation, the proprietor(s) intend(s) to pass on to a future generation. That of course presupposes that there is a 'ready, willing and able' recipient of the gift or, if not yet, perhaps trustees for him, her or them. While the Finance Act 2006 regime for trusts has generally made it disadvantageous in IHT terms to transfer more than the nil-rate band (£300,000 for 2007/08), the availability of BPR at 50% or 100% at present means that for the time being at least this should not present a problem – certainly for those businesses which attract 100% BPR.

With any business there is a distinction between ownership and management. Generally, this Briefing assumes (perhaps simplistically) that these functions will be exercised by the same person or persons. Further, there is the entirely separate subject of employee share schemes, viz using the award of shares or options over shares to incentivise the workforce – in a tax-efficient manner. This subject is not considered at all.

This Briefing is concerned principally with IHT and where relevant CGT and SDLT. Agriculture is a special type of business which has its own relief from IHT, Agricultural Property Relief (or APR), though certain farming assets will attract BPR rather than APR. APR is a subject in its own right, especially with the vexed question of whether or not APR may be available on the farmhouse. This may be the subject of a future Briefing. For the time being, readers with farming businesses should

note that APR where available takes priority over BPR and this Briefing is therefore not directly concerned with such businesses.

### Business Property Relief – An Overview

To attract BPR, the property must fall within one of six categories of 'relevant business property' and must generally have been owned for at least two years. Where within a qualifying business (whether run by a company or unincorporated), there are assets surplus to business requirements (called 'excepted assets'), BPR may be restricted. BPR is given at either 100% or 50%, as explained below.

### Relevant Business Property

The six categories are as follows<sup>1</sup>:-

- 1) A business or an interest in a business;
- 2) Unquoted securities which whether by themselves or together with other such securities or unquoted shares give voting control;
- 3) Unquoted shares;
- 4) A controlling holding of quoted shares or securities;
- 5) Land or buildings, machinery or plant used in its business by (a) a company which is controlled by the owner of the land etc or (b) a partnership to which he belongs; and
- 6) Land or buildings, machinery or plant owned by a person and used in a business owned by a trust in which that person has an interest in possession (a right to income).

100% relief is given to categories 1, 2 and 3 and 50% to categories 4, 5 and 6.

### What types of business attract relief?

Not every type of business will qualify. First and foremost is the rule that the business must be carried on for gain, that is, a hobby business will not attract BPR<sup>2</sup>. It does not matter whether the business is a sole trade, a partnership or within a company, but in all cases the business must *not* be one which is wholly or mainly an investment or a dealing business<sup>3</sup>. 'Wholly or mainly' means broadly more than 50%, with regard to four particular features (as established by the courts), namely: asset values (at market rather than balance sheet value); turnover; profitability; and time spent by the directors, employees and any outside agents or consultants, in each case applied to the 'trading' and 'investment' sides of the business respectively. It is unlikely, though always possible, that a company has more than one business. This is rather more probable with either a sole trade or a partnership (see below).

---

<sup>1</sup> Found in Inheritance Tax Act 1984 section 105(1)

<sup>2</sup> Inheritance Tax Act 1984 section 103(3)

<sup>3</sup> Inheritance Tax Act 1984 section 105(3)

### An example

Suppose that a company carries on a trade of making widgets and also owns property which is let. The let property is *prima facie* an investment. But there is likely to be a single business with a single set of accounts. Suppose that the market values of the assets employed in the trade account for 60% of the whole and the investment property 40%. The turnover of the trade is 85% of the whole; that of the investment properties 15%. The let properties contribute 75% of the profit, whereas the trade produces only 25%. The directors and employees of the company spend 90% of their time on the trade and 10% on the let property. Standing back and looking at things 'in the round' (the approach and expression used in successive cases in the courts), the business of the company is probably not wholly or mainly investment and so BPR will be available on the whole.

The same principle applies to sole trades and partnerships, except there it is much more likely that there will on the facts be two or more separate businesses, perhaps one (the trade) attracting full relief and the other (the investment) not attracting relief at all. But in an important Special Commissioner's decision in 1999<sup>4</sup> it was established that there would be a single business if in particular only a single set of accounts was produced and there was unified management across the whole of the partnership's activities.

### Excepted assets

The 'wholly or mainly' test is 'all or nothing'. Having passed the test, however, a subsidiary test must be passed. That is, there should be no 'excepted assets'<sup>5</sup>. An excepted asset is one which was neither:-

- a) Used wholly or mainly for business purposes throughout the two years before the transfer nor
- b) On the date of transfer required for future business use.

Excepted assets might broadly be described as 'lazy assets'.

The thinking behind the rule is to prevent a person 'parking' non-business assets within a company or partnership and claiming relief on them. BPR is denied to the extent that there are excepted assets. Excepted assets will very often be cash, where Her Majesty's Revenue and Customs (HMRC) traditionally accept that a figure of 25% of the turnover of the business is reasonably required for business purposes: anything more than that and you will have a fight on your hands, in the absence of appropriate evidence<sup>6</sup>.

### Holding companies

A company which simply owns shares in various subsidiaries is *prima facie* an investment company and should get no relief. But a special rule requires one to 'look through' the investment company if the business of the holding company is wholly or mainly trading<sup>7</sup>: to the extent that the business of the underlying subsidiaries is 'wholly or mainly trading' (in broad terms), relief will be

---

<sup>4</sup> In a case called *Farmer & Giles v Commissioners of Inland Revenue*

<sup>5</sup> Inheritance Tax Act 1984 section 112

<sup>6</sup> See the 1998 Special Commissioner's decision in *Barclays Bank Trust Co Ltd v Commissioners of Inland Revenue*

<sup>7</sup> Inheritance Tax Act 1984 section 105(3)

given on the shares in the holding company<sup>8</sup>. In any case where some subsidiaries attract relief and others do not, it may be possible to arrange a judicious transfer of assets and activities within the subsidiaries, in a neutral way for both CGT and SDLT purposes so as to maximise BPR.

### No relief for a creditor

In a Special Commissioner's case in 2000<sup>9</sup> mother and daughter had been in partnership; mother retired some years before her death, but at her death still had money in the business which her executors tried to claim attracted BPR. However, this was denied because on retirement from the partnership her relationship with the firm changed from that of partner to creditor, so what she owned at death was not risk capital but loan capital. The benefit of BPR at 100% could so easily have been secured by her remaining within the partnership, albeit as a limited partner to protect her from unlimited liability.

### The other categories of relevant business property

Category 2 will not be found very often, as referring to securities in a company eg debentures which, whether by themselves or with other securities or unquoted shares, gave voting control (that is, more than 50%, in which can be included the voting power of spouse or civil partner).

Unquoted shares, whether ordinary shares or preference shares, will attract relief within Category 3, however small the holding. Shares listed on the Alternative Investment Market are treated as unquoted, importantly as confirmed at Budget 2007 – at least for the time being.

Category 4 will be rare in the extreme.

Category 5 is interesting, in particular the distinction between a business run by a company, where the owner of the land or buildings, machinery or plant must have control, and a partnership, where he simply needs to be a partner.

Category 6 will be unusual.

### The profit motive

Running a business with a view to a profit will generally, though not always, mean more often than not having a figure in the black at the bottom line. However, consider for example a woodlands business where it should be possible to show that, despite annual deficits on the profit and loss account (with no loss relief for income tax now), the woods are being managed with a view to long term gain on sale. The importance here of managing the woods in a business-like way keeping accounts, registration for VAT purposes etc cannot be overstated.

### Caravan parks and holiday accommodation

Most of the decided cases on the investment or trade issue have concerned caravan parks, whether won by the taxpayer or by HMRC. Here the four criteria mentioned above under the wholly or mainly issue need to be kept carefully under review. While the BPR question will arise at date of

<sup>8</sup> Under Inheritance Tax Act 1984 section 105(4)(b)

<sup>9</sup> Called *Beckman v Commissioners of Inland Revenue*

## Passing on the Family Business : Inheritance Tax and Ensuring Tax-Efficient Succession

transfer, whether lifetime gift or on death, the practice of the courts is to consider the overall shape of the business over a two to three year period. The general principle is that property run as an investment will not attract relief.

Furnished holiday lettings are not given express relief from IHT (as they are for income tax and CGT purposes) though the HMRC Inheritance Tax Manual<sup>10</sup> advises that relief should normally be allowed where:-

- The lettings are short term (for example weekly or fortnightly); and
- The owner – either himself or through an agent such as a relative or housekeeper – was substantially involved with the holidaymaker(s) in terms of their activities on and from the premises even if the lettings were for part of the year only.

### The Period of Ownership

The statutory rule<sup>11</sup> is that the property must have been owned for at least two years and not that it must have been relevant business property throughout that period. Relief is given<sup>12</sup> where property has been replaced and the replacement property has not itself been owned for two years but together with the original property was owned for at least two out of the last five years.

Where the taxpayer has not owned the property for at least two years but inherited it from his spouse or civil partner, the period of ownership of the deceased can be taken into account in computing the two year period<sup>13</sup>. Generally, this rule will not help where there is a lifetime gift and the donee spouse or civil partner dies within two years. But in that case another provision<sup>14</sup> may come to one's aid (whether or not between spouses or civil partners). This applies where there are two successive transfers of value one of which is a transfer and death. If the earlier transfer attracted BPR, the second transfer may also attract the relief where the two year test is not satisfied. Even if the first transfer was spouse exempt, it will be protected as a 'successive transfer' because it is a transfer of value which would have been eligible for BPR if such relief had been capable of being given in respect of a transfer of value made at that time.

### Application: 'Death Bed' Planning

Given the two year ownership rule, consider:-

- (a) Conversion of an investment company to a trading company in circumstances where one of the shareholders is unlikely to survive two years (but before he dies). There would of course have to be clear evidence of the change in character of the business. In other words HMRC Inheritance Tax must not be given grounds to argue that at the date of death there was simply an intention to trade on the part of directors, as opposed to an actual conversion to trading status.

---

<sup>10</sup> At IHTM 25279

<sup>11</sup> Under Inheritance Tax Act 1984 section 106

<sup>12</sup> Under Inheritance Tax Act 1984 section 107

<sup>13</sup> Inheritance Tax Act 1984 section 108

<sup>14</sup> Inheritance Tax Act 1984 section 109 (relief for successive transfers)

- (b) The transfer of assets to a trading company before the death. The point here would be to increase the rate of relief from 50% (or none at all) to 100%. Remember that the assets must be taken into use by the company for its trade and at the date of death must clearly be shown to be required for future business purposes, to avoid their being excepted assets. This will be subject to any CGT and SDLT implications.

With a transfer to a company, it should be possible to 'hold over' any gain (see below) for CGT purposes, so that the company takes over the transferor's base cost. If the trade is carried on by a partnership, it may be possible to avoid a disposal at all (and therefore unnecessary to consider hold-over relief if the asset is held in a capital account owned solely by the transferor).

For SDLT there will be a charge on land at market value where the transferee company is controlled by the transferor<sup>15</sup>. However, interestingly, this does not apply where the transferor is a partnership rather than a sole trader and under the special partnerships code there will be no charge here because the company is wholly owned by members of the partnership<sup>16</sup>. A transfer of land to a partnership will not attract SDLT if all the other partners are 'connected with'<sup>17</sup> (broadly, related to) the transferor.

### Lifetime Giving or Inheritance on Death?

If one could be assured that, whenever the business proprietor's death were to occur, BPR would remain at 100%, obviously one would wait until then, with assured freedom from IHT and the beneficiary inheriting for CGT purposes at the market value on death. Sadly, that is not necessarily going to be the case and so the proprietor might be tempted to think in terms of a lifetime gift, when four further taxes must be considered: IHT, CGT, SDLT and indeed income tax.

#### IHT: the gifts with reservation regime (GWR) and the clawback rules

The assumption is that the gift, whether made to an individual as a potentially exempt transfer (PET) or to a trust as a chargeable transfer, will benefit from 100% BPR. If the donor dies within seven years, the PET will become chargeable: could there be IHT to pay on the gift into trust if say the rate of BPR had fallen to perhaps 50% at the date of death? It is well established that the rate of tax payable on a failed PET is that in force at the date of death.

However, the legislation suggests that the rate of relief applying is that in force at the date of gift, which should be good news. That said of course, Governments can of course do anything and so it should not necessarily be assumed that 100% relief would be given. Certainly with an investment business which is unlikely to become a trade it would be sensible to think in terms of a lifetime gift to one or more individuals.

Further, the proprietor should not 'reserve a benefit', eg in terms of taking a salary or other benefits from the business more than are justifiable on an arm's length basis by reference to the work performed or to any retained equity ownership. Rules introduced by Finance Act 1986<sup>18</sup> treat

<sup>15</sup> Finance Act 2003 section 53

<sup>16</sup> Finance Act 2003 Schedule 15 paragraph 18

<sup>17</sup> Within Taxes Act 1988 section 839

<sup>18</sup> Finance Act 1986 section 102 and Schedule 20

## Passing on the Family Business : Inheritance Tax and Ensuring Tax-Efficient Succession

a person as beneficially entitled to property which is given away in which he reserves a benefit whether at death or on cessation of the benefit during lifetime. There is a helpful relieving provision for BPR<sup>19</sup> which effectively reads the circumstances of the donee into those of the donor who has reserved a benefit, so preserving 100% BPR if that would be available to the donee on a transfer then by him, but reliance should not be placed on this provision.

To avoid a clawback of the BPR given on a lifetime gift which the donor fails to survive for seven years, it must be shown (in broad terms) that on the first death of either donor or donee within that period, the donee had retained either the original asset given away or qualifying replacement property and that it continued to be relevant business property in his hands<sup>20</sup>.

### CGT

A gain arising on the gift will be a disposal (just as much as a sale), though should be capable of hold over by election<sup>21</sup> so avoiding an immediate CGT charge and transferring the donor's base cost to the donee on any future disposal by him.

### SDLT

A straight gift of shares in any company may be certified as exempt for Stamp Duty purposes<sup>22</sup>. There will be no implications for SDLT purposes of a gift of land within a partnership share unless the business of the partnership is 'property-investment'<sup>23</sup>. In that event there is a market value charge on so much of the land within the partnership as is represented by the transfer.

These provisions should not be of concern on death - depending on exactly how the beneficiary comes into the partnership. Most likely the proprietor's capital account would be paid out and the beneficiary would then apply to join the partnership on transferring capital to the firm, when there should be no SDLT implications given that the new partner is connected with the continuing partners<sup>24</sup>.

### Income tax

In a case where GWR does not apply, care should be taken with the pre-owned assets legislation introduced from 2005/06 where there is a gift of land which the donor continues to occupy (other than for full consideration). These rules should not apply, but should be considered.

### **Conclusions**

With a family business the main issue is to ensure that, certainly prior to any lifetime gift and from time to time (as one never knows when the proprietor's death might occur), the business is in good 'fiscal shape'. This means in particular that 100% BPR would be available with no restrictions under the present regime. Consider also the proprietor's Will, under which there should be a

---

<sup>19</sup> In Finance Act 1986 Schedule 20 paragraph 8

<sup>20</sup> Inheritance Tax Act 1984 sections 113A and 113B

<sup>21</sup> Under Taxation of Chargeable Gains Act 1992 section 165

<sup>22</sup> Under the Stamp Duty (Exempt Instruments) Regulations 1987 Category L

<sup>23</sup> Finance Act 2003 Schedule 15 paragraph 14

<sup>24</sup> Finance Act 2003 Schedule 15 paragraph 10

## Passing on the Family Business : Inheritance Tax and Ensuring Tax-Efficient Succession

specific gift of the shares or other assets to one or more beneficiaries or to trustees, to avoid certain anti-avoidance provisions<sup>25</sup>.

The terms of any partnership agreement should be examined to clarify what happens on death, most likely that the interest of the deceased is paid out to his beneficiaries after a period of time, subject to payment of interest thereafter. Alternatively, under pre-emption provisions in a shareholders' agreement, there could be options for the continuing proprietors to sell and/or for the deceased's family to buy the business interest without prejudicing the availability of BPR<sup>26</sup>.

This Briefing is merely an introduction to a complex subject. What arrangements are appropriate to adopt will vary from case to case – but should always be kept under review.

### September 2007

This briefing note is not intended to be an exhaustive statement of the law and should not be relied on as legal advice to be applied to any particular set of circumstances. Instead, it is intended to act as a brief introductory view of some of the legal considerations relevant to the subject in question.

---

<sup>25</sup> In Inheritance Tax Act 1984 section 39A

<sup>26</sup> Which would be the case if there were a 'binding contract to sell' within Inheritance Tax Act 1984 section 113