Family Investment Companies

11 October 2024

We'll cover...

MHA

- Background to FICs
- Passing value to the next generation
- Tax considerations
- Summary

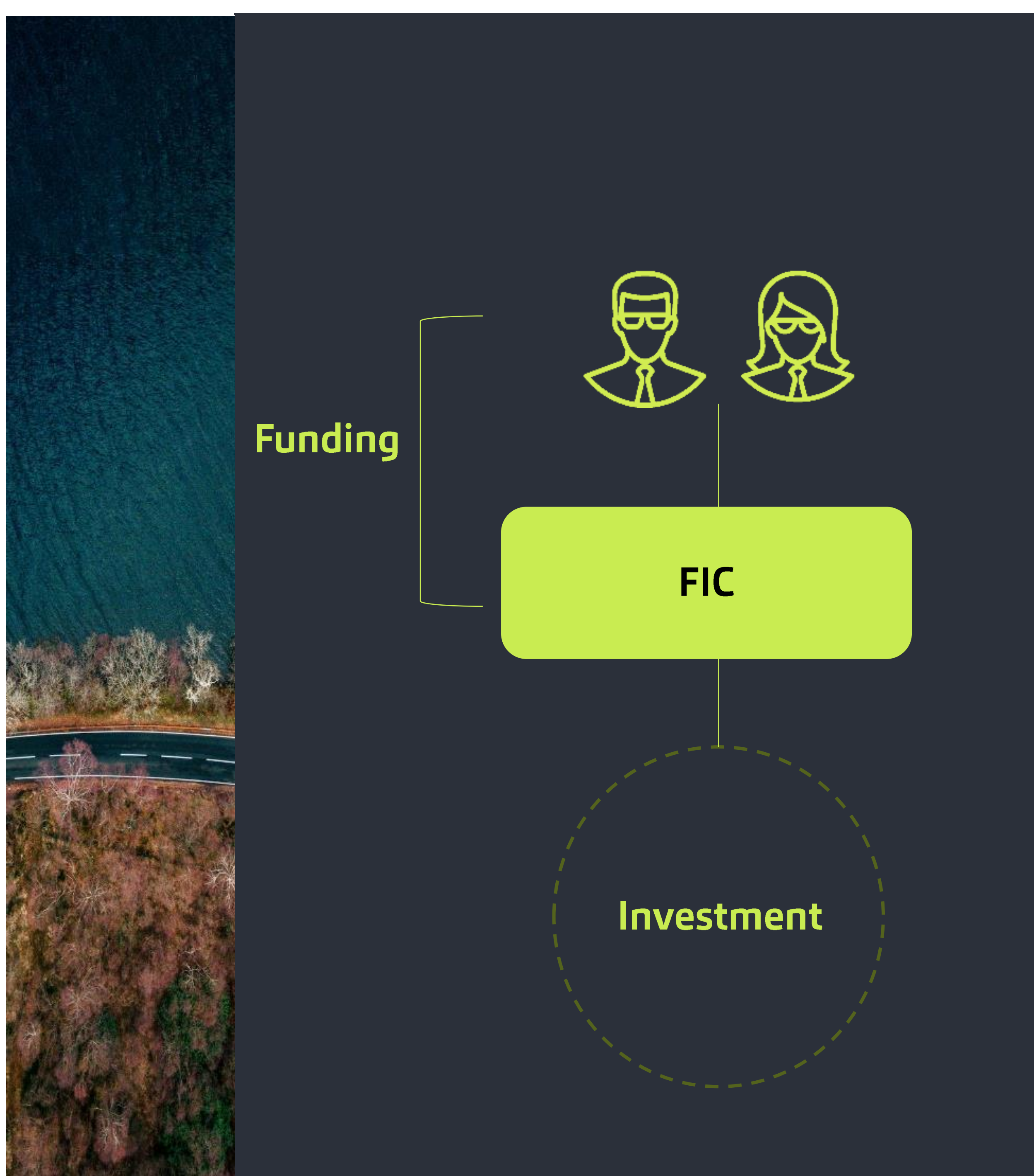
MHA
Caves Wealth

- Investment management
- Planning outside of a FIC
- Economies of scale & viability
- Investments in trusts
- When is a FIC not suitable?

Background to Family Investment Companies

Outline

- Designed to replicate a UK trust without the IHT disadvantages that followed the 2006 changes to the IHT treatment of Trusts.
- FIC is usually UK resident even if (for non-doms) a foreign incorporated company so managed and controlled in the UK.
- Limited or unlimited company.
- Generally used to hold investment assets especially to invest in equities where in contrast to trusts the dividends received by FICs from quoted equities are exempt.
- Minimum investment level?



How to set up a FIC

- To allow flexible and efficient extraction of capital, many FICs are funded by a combination of share capital and debt, often interest-free and repayable on demand.
- Share capital maximises the benefit of the discounts for minority interests. Share capital also gives the FIC substance and a subscription has no tax consequences.
- Loans are flexible, can be interest free and repayable on demand. If the loan is made interest free and repayable on demand, there is no transfer of value for IHT purposes where the loan is equal to the amount owed. (See IHTM14317).
- Care must be taken to consider whether the settlements legislation and the transactions in securities code may apply. Also to avoid a gift with reservation of benefit.
- It may be preferable to avoid any requirement to pay a commercial rate of interest by structuring this funding element as redeemable zero-coupon preference shares.
- We generally advise to keep the share structure and funding as simple as possible.

FIC vs holding investments personally

	FIC	Direct personal ownership
Taxation on gains	Chargeable gains are subject to corporation tax at 25%.	Capital gains tax is charged at up to 20% (up to 24% on residential property).
Taxation on dividends	Most dividends received by a UK company (including foreign dividends) are exempt from corporation tax.	Income tax on dividends is charged at up to 39.35%. Individuals each have an annual tax-free dividend allowance of £500.
Taxation on other income	Non-dividend income is assessed at 25% in the company.	Non-dividend income is assessed at up to 45%. Individuals each have an annual tax-free personal allowance of £12,570.
Control	A FIC enables parent(s) to retain control over assets and facilitates future succession planning.	No control or protection of assets given outright.
Expenses	Expenses incurred by the company for investment management and other qualifying running costs will be eligible for corporation tax relief.	An individual investor cannot obtain tax relief for the expenses associated with managing their investment portfolio.

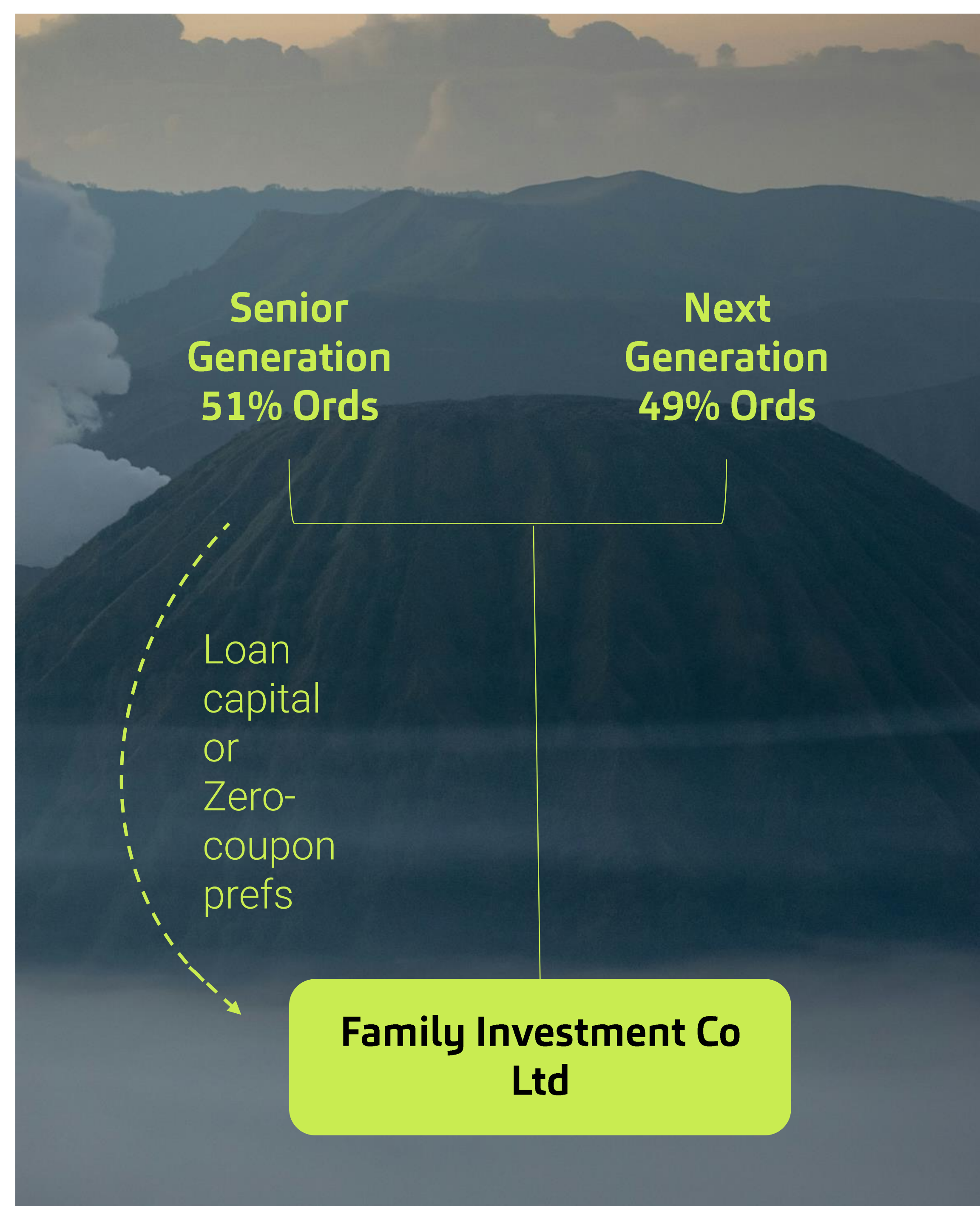
Choice of investments

	Personally	FIC	It depends
Quoted entities		x	
Unquoted trading company equities	x		
Fixed interest			x
Reporting funds			x
Offshore non-reporting funds		x	
Buy to let property		x	
Commodities (such as cryptocurrency)	x		

Passing value to the
next generation

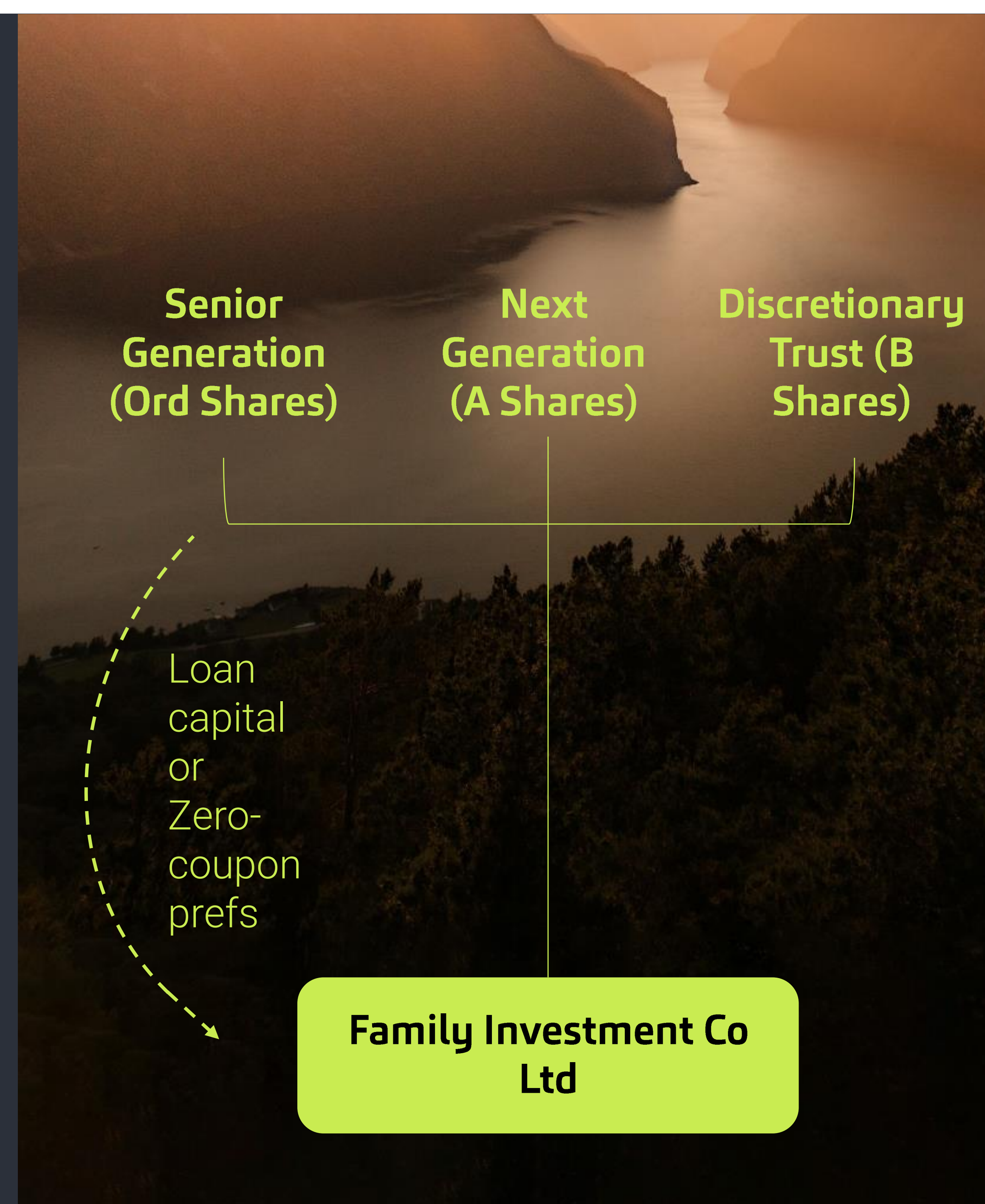
A simple FIC structure

- Shares in the FIC may be gifted to the next generation on incorporation (when they are not standing at a gain).
- Alternatively, cash may be given to the children to enable them to subscribe for shares.
- Gift of shares or cash is a potentially exempt transfer for IHT, and no CGT will arise.
- Any shares retained by the senior generation will form part of the relevant individual's taxable estate for IHT.



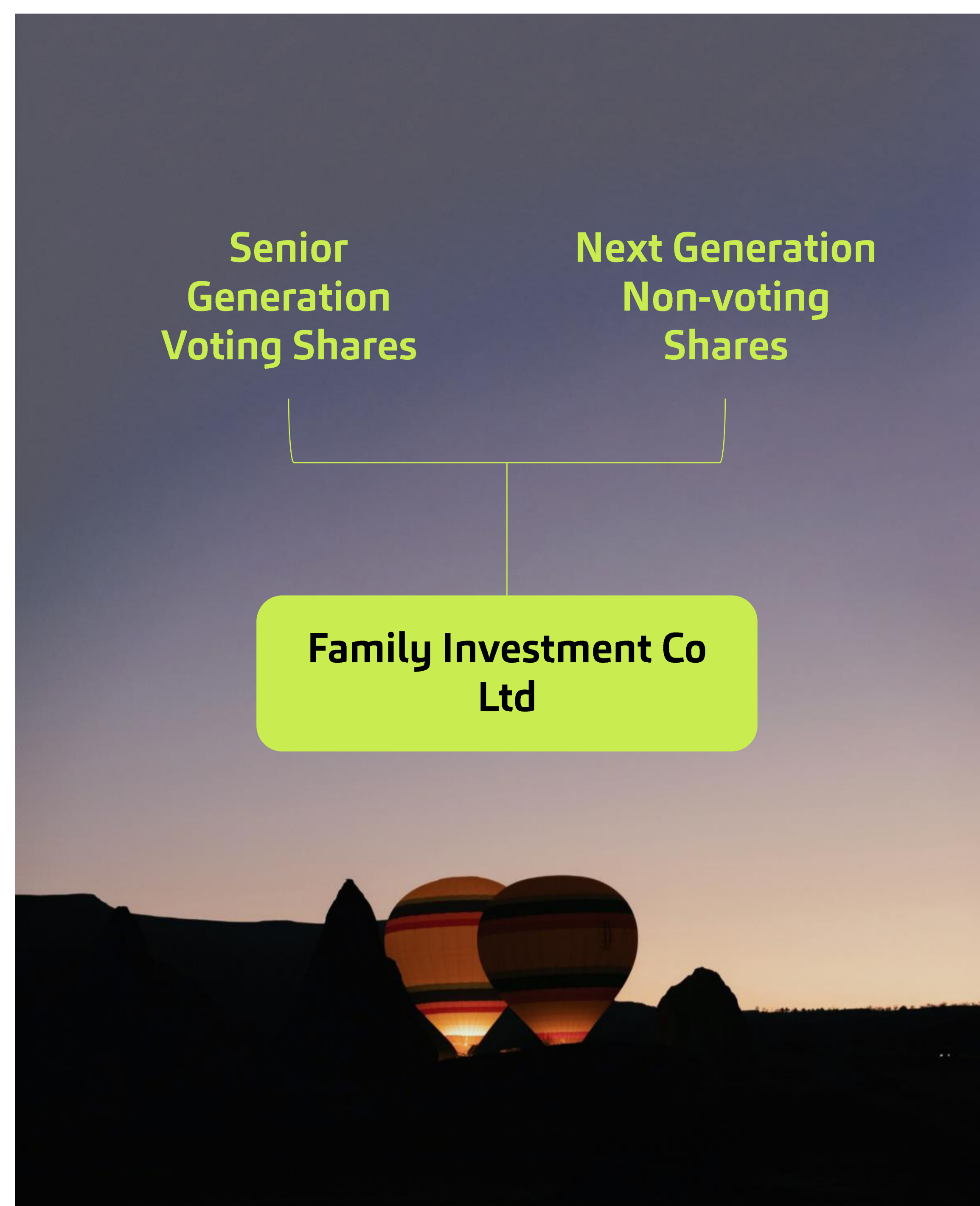
FIC in conjunction with trusts

- Shares of different classes but with similar rights can be used to facilitate different levels of income payments to different family members.
- Trust ownership provides flexibility, perhaps to benefit grandchildren or unborn grandchildren.
- Trust ownership alongside different classes of shares can facilitate efficient income tax planning.
- The effect of relevant property IHT charges minimised by low initial value of share capital.



FIC with different share rights

- Day to day control of the investment and distribution policy of the company rests with the directors.
- However, a cautious founder might retain voting rights or create and gift non-voting shares. Particularly if significant share capital is to be gifted to the next generation.
- This will dilute the IHT benefit of the FIC as additional value attaches to the voting shares. Holt v Holt.
- Children’s shares could require that on any disposal the children must offer their shares at a discount to others first. This devalues the shareholding in the event of divorce not for IHT.



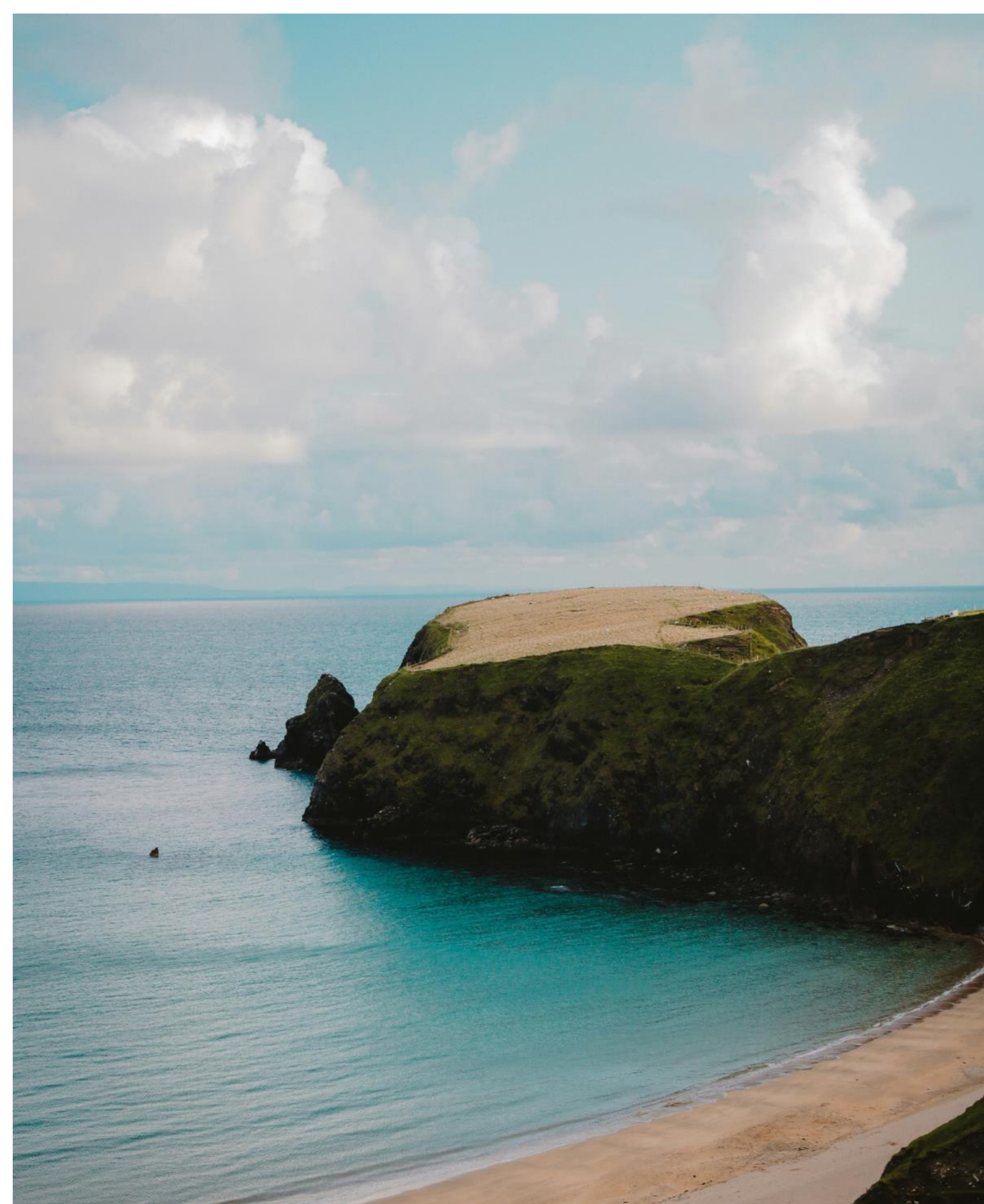
Tax
considerations

Gift with reservation

- Low risk of gift with reservation of benefit arising under FA1986/S102 in relation to a gift of shares, changes in share rights or assignment of loan where:
  - Remuneration paid after the gift is unreasonable, uncommercial or a condition of the gift
  - Different levels of dividend are paid on shares with similar rights

- If everyone subscribes to, say, £1 shares and then one person puts in the loan there should not be a GWR issue.

- However, if the founder gives away the loan and retains shares, they could reserve a benefit in the loan, if it is interest free, because their share value increases because the loan is interest free.



Settlements legislation

- Applies to prevent an individual from gaining a tax advantage by diverting income to another person who is liable to a lower rate of tax or is not liable to tax.

- The settlor is treated as having retained an interest if there are any circumstances in which the property or any related property is payable to or for the benefit of the settlor or his spouse/civil partner.

- Where these provisions apply the income of the settlement will generally be taxed on the settlor.

- The code might apply to an FIC where different levels of dividends are paid on shares with similar rights. This risk can be avoided by a policy of paying dividends proportionate to the entitlement of each class of shares to the distributable profits of the company.

- HMRC have expressed a view – although not yet taken in practice – that when an interest free loan is made to a company and dividends are paid to family members, all or part of those dividends should be taxable on the lender as the loan is a form of settlement. This is unlikely to be successful given it is normal and accepted practice for private companies to be funded by loans.

Settlements legislation

- If there is a settlement the loan repayments could be taxed as income under ITTOIA2005/S633 which applies to a capital sum paid directly or indirectly by “the trustees of a settlement” although it is unlikely that directors could be regarded as trustees.
- Nevertheless, it might be prudent to ensure there is no element of bounty where the FIC is funded by way of a loan. Therefore, charge a commercial rate of interest or fund the company with zero coupon preference shares or ensure no dividends are declared until the loans are repaid.

Transactions in securities

- Making a loan is not a transaction in securities, but subscribing for shares is. Therefore, a loan connected to a subscription may fall within the TiS code.

- The argument HMRC have raised is that receiving loan repayments rather than dividends is the arranging of one's tax affairs to obtain an income tax advantage.

- The consequence being that loan repayments may be liable to income tax.

- HMRC have denied clearance on this point although the risk of a counteraction notice seems to be low especially as such funding arrangements are commonplace in all private trading and investment companies.

- Risk can be avoided by charging a commercial rate of interest.

Summary

Summary

- FICs are well established as an estate planning tool and in the right circumstances work well.

- They work best when kept simple and combined with a trust and maximum use of the dividend exemption is obtained.

- FICs allow growth outside of the founder's estate. The cumulative effect of the double layer of tax when profits are distributed means an FIC is most suited to use as a long-term vehicle to hold and accumulate wealth.

- An FIC is not an effective vehicle to hold personal assets.

- Nevertheless, they are not always appropriate. It is often the case that alternative investment structures are more suitable so a full appraisal of options should be considered and presented before implementation.

Investment management

Managing investments within a FIC

- Personally.
- Discretionary Investment Manager.
- Delegation of the responsibility of making investment decisions to professionals.

Why use a Discretionary Investment Manager?

- Investment professionals not only have the expertise and experience, but the tools to understand and manage risk & maximise performance.
- Time saving.
- Customisation (alongside accountant and / or financial adviser).
- Active portfolio management.

Discretionary investment management

Service levels…

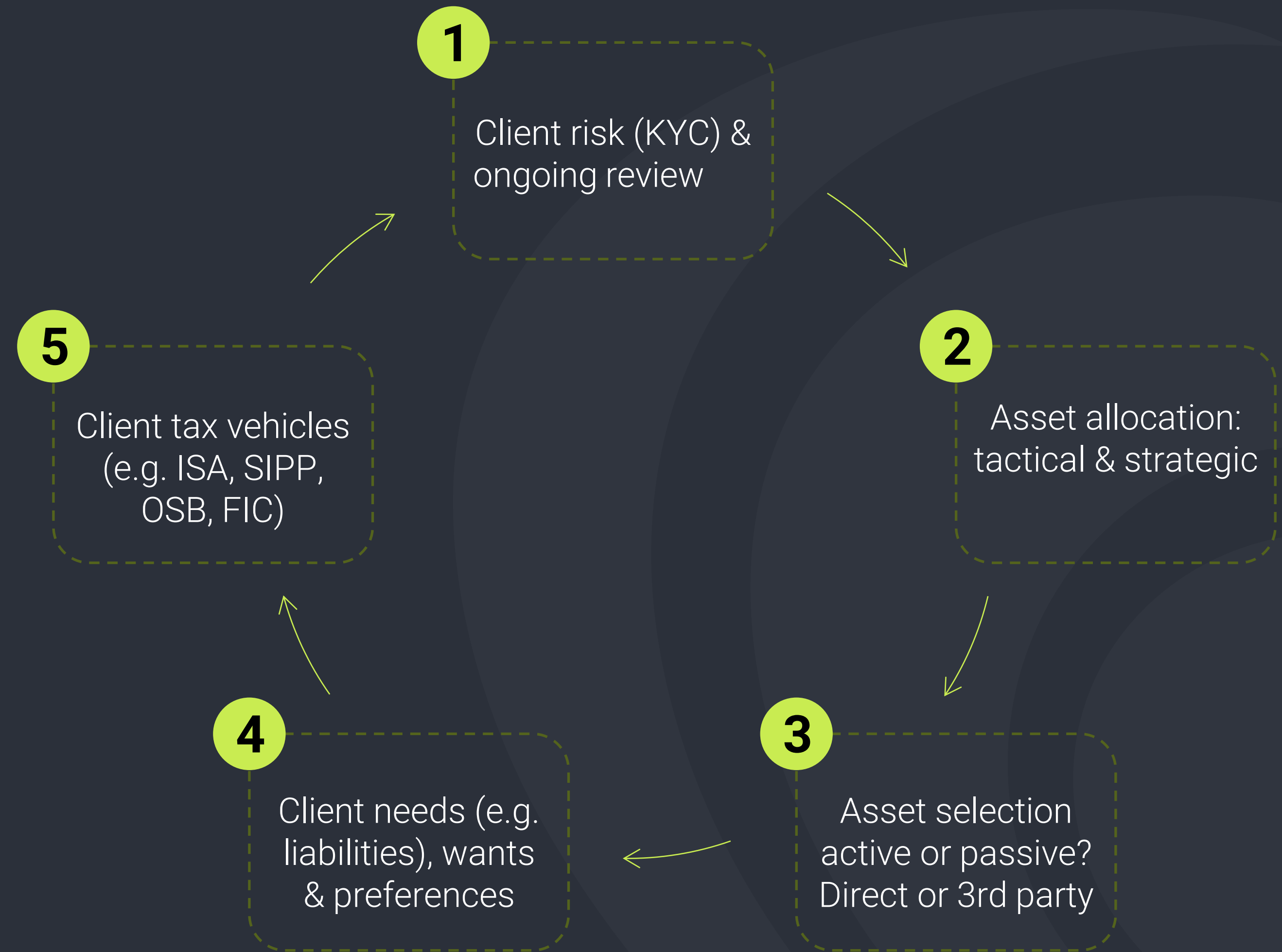
Managed discretionary service

- Predefined investment strategies based on risk categories.
- Efficient portfolio management with a one-size-fits-many approach.
- Limited personalisation in terms of individual client preferences.
- e.g. Multi-Asset (unitised).

Bespoke / tailored service

- Highly personalised investment strategies tailored to you.
- Considers unique circumstances, such as tax implications, ethical preferences and specific income requirements.
- Access to areas of the market, not obtainable with off-the-shelf products.
- More direct and detailed communication between the client and investment professional.

Understand the client's situation and aspirations, while managing risk and maximising returns with consideration to the tax and accounting intricacies for each asset type selected.



Asset allocation

- To manage risk, but also a major driver of returns
- Strategic (3-5 years)
- Tactical (every 3 months)

Sub asset class & factor exposure very important for diversification

Geography
North America
UK
Europe ex-UK
Japan
Asia ex-Japan
Emerging markets

Factor	Tilt (z-score) significance threshold 0.7
Value	-2.20
Growth	-0.17
Quality	0.96
Volatility	-0.86
Yield	-1.75
Size	0.31

Sector
Information Technology
Consumer discretionary
Communication Services
Financials
Health Care
Energy
Consumer Services
Utilities
Materials
Industrials
Real Estate

Asset selection

- Active, Passive or a Blended approach?
- If Active – 3rd Party Fund Manager or 'Direct'

3rd party fund manager – selection process	Direct investment selection process
Investment philosophy and objectives	Identify the universe (e.g.: listings, factor exposure)
Investment styles	Stock screen (value, growth, quality, yield, volatility)
Decision making process	Deep dive into individual stock
Manager tenure	Deep dive into industry dynamics
Factor exposure/bias	Meet the management teams
Risk management process	Diversifications (correlations)
Past performance (relative to competitors & alternatives)	
Cost & fees	
Fund size and liquidity	
Correlations to existing holdings (blend)	

Focusing only on tax avoidance, at the exclusion of sound investment management, can work against the objective of maximising after-tax returns.

However, tax can take a bite out of returns.

Don’t let the tax tail wag the investment dog.

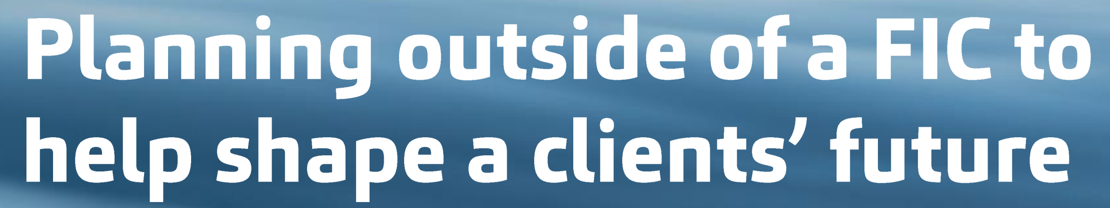
Choice of investments

	Personally	FIC	It depends
Quoted equities		x	
Unquoted equities	x		
Fixed interest			x
Reporting funds			x
Offshore non-reporting funds		x	
Buy to let property		x	
Commodities	x		

Stocks to own in a FIC – an idealised example

Capital return	Dividend return	Total return	FIC desirability
5%	0%	5%	*
2%	3%	5%	**
0%	5%	5%	***
-2%	7%	5%	****

- Maybe my portfolio outside the FIC is the global market portfolio minus these stocks in these weights.
- Dividends tax-free to the FIC; capital gains are not = stocks where most of the returns are generated via the dividend.
- ‘Sterilising’ gains – realise gains when have sufficient offsetting losses in another stock.


Planning outside of a FIC to
help shape a clients' future

Drivers for planning

In an ideal world, clients will generally want or need a degree of access to capital or income, but with a structure in place that allows them to start passing assets on to future generations in a tax efficient manner.

There are two main drivers for planning undertaken outside of FICs.

Economies of scale do not always make FICs financially viable - generally sub £3m-£5m, unless the client is used to company structures and prefers this.

A FIC structure does not meet the clients' objectives.

Economies of scale do not
make FICs financially viable

Loan trusts

Funds could be loaned to a Trust, with the Settlor having access to the loaned amount and growth belonging to the Trust.

- Settlor maintains access to capital.
- Growth of the Trust immediately falls outside of the Settlors estate and can be appointed to beneficiaries at discretion.
- Trust assets can (and often should) be invested for growth.
- Parts of the loan can be waived over time, as a gift to the Trust.
- Considerations must be made to the types of investment the Trust holds, with there being preferential tax wrappers such as life insurance bonds (either onshore or offshore).
- Growth subject to periodic charges.
- Doesn’t remove capital from the Estate unless loan is gifted or spent.

Outright gifts to trusts

Funds could be gifted to a Trust, with the Settlor making a lifetime gift.

- Growth of the Trust immediately falls outside of the Settlors estate, and gifts after 7 years.
- Trust assets can (and often should) be invested for growth.
- Control from Trustees as to how assets are distributed and invested where discretionary trusts are used.
- Gifts in excess of the available Nil Rate Band would be subject to 20% tax as a chargeable lifetime transfer, unless a bare trust is used. Limits typical use to £650,000 gifts every 7 years without tax charge.
- Trust subject to periodic charges.
- Considerations must be made to the types of investment the Trust holds, with there being preferential tax wrappers such as life insurance bonds (either onshore or offshore).

Discounted gift trust

A gift to a Trust providing fixed regular payments of capital during the Settlors lifetime while invested capital can provide this. Being a gift, the amount settled (less a discount associated given the right to income as a benefit to the Settlor) can be used to start a Potentially Exempt Transfer if the beneficiary is absolute, or a chargeable lifetime transfer taxed at 20% if the Nil Rate Band is exceeded.

- Access to income for Settlor (treated as payments of capital).
- Can be used to create a Chargeable Lifetime Transfer.
- When income starts it cannot be changed.
- Settlor loses access to Capital.
- If Settlor is young and in good health, the discount to the transfer could be large, starting a negligible gift for IHT purposes.

A quick word on investments in trusts

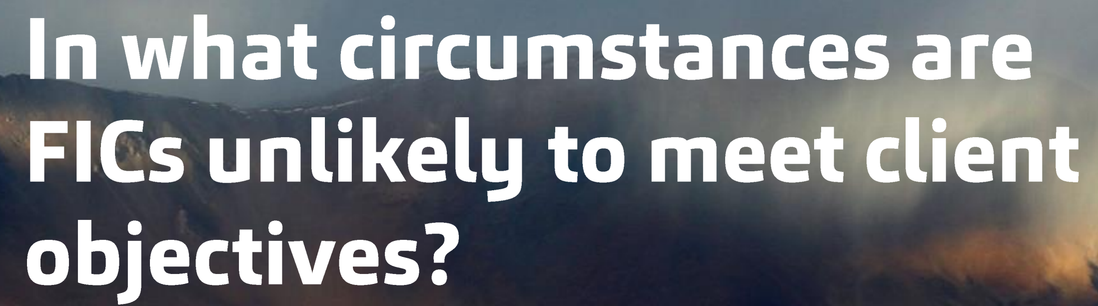
Unwrapped investments vs onshore bond vs offshore bond

- It's rarely appropriate to consider using unwrapped investments for Discretionary Trusts, given Trusts incur the highest rates of tax.

- Financial Advisers tend to recommend Bond structures as the segments that underly these Life Insurance based policies can be assigned to beneficiaries and taxed at their marginal rates of income.

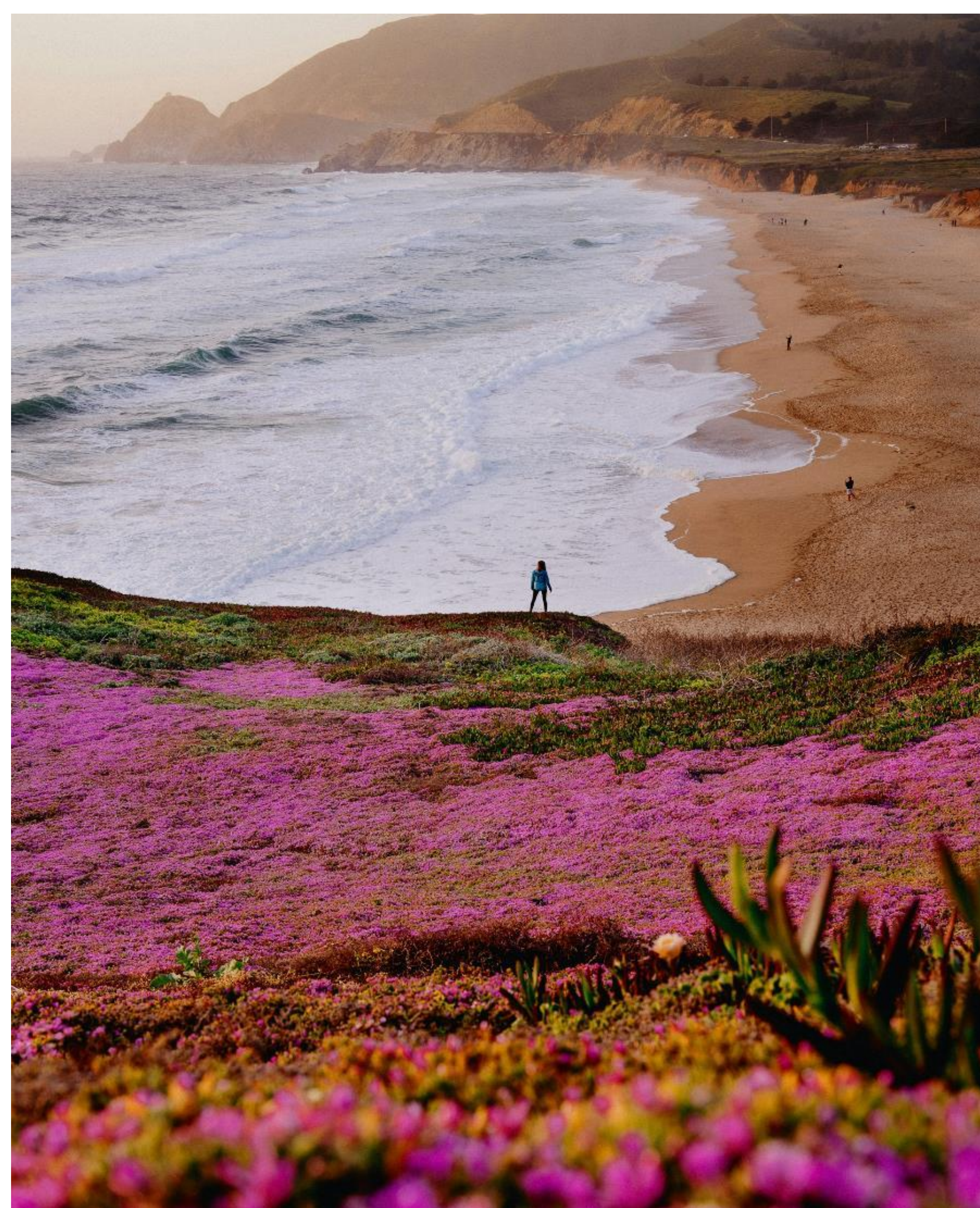
- Don't let a Financial Adviser default to using and Offshore Bond over an Onshore Bond just because the fund being invested is large though. Historically Offshore Bonds gave access to a larger fund range, but some Onshore Bond providers offer a range of 3,000+funds. Gross roll up will grow funds faster Offshore than taxed at a Basic Rate equivalent Onshore, but net returns after withdrawals are normally reduced more when Offshore is used. Only non-taxpayers or non-residents at point of surrender are likely to benefit from Offshore Bond taxation, unless the funds are invested for a very long time.

- It's also important to consider that Onshore Bond surrenders come with a 20% tax credit on surrender, but the Corporation Tax rate the investment provider pays on underlying profits may be lower as dividends are not assessed for tax and can see actual taxation as low as 10% helping returns.


In what circumstances are FICs unlikely to meet client objectives?

When

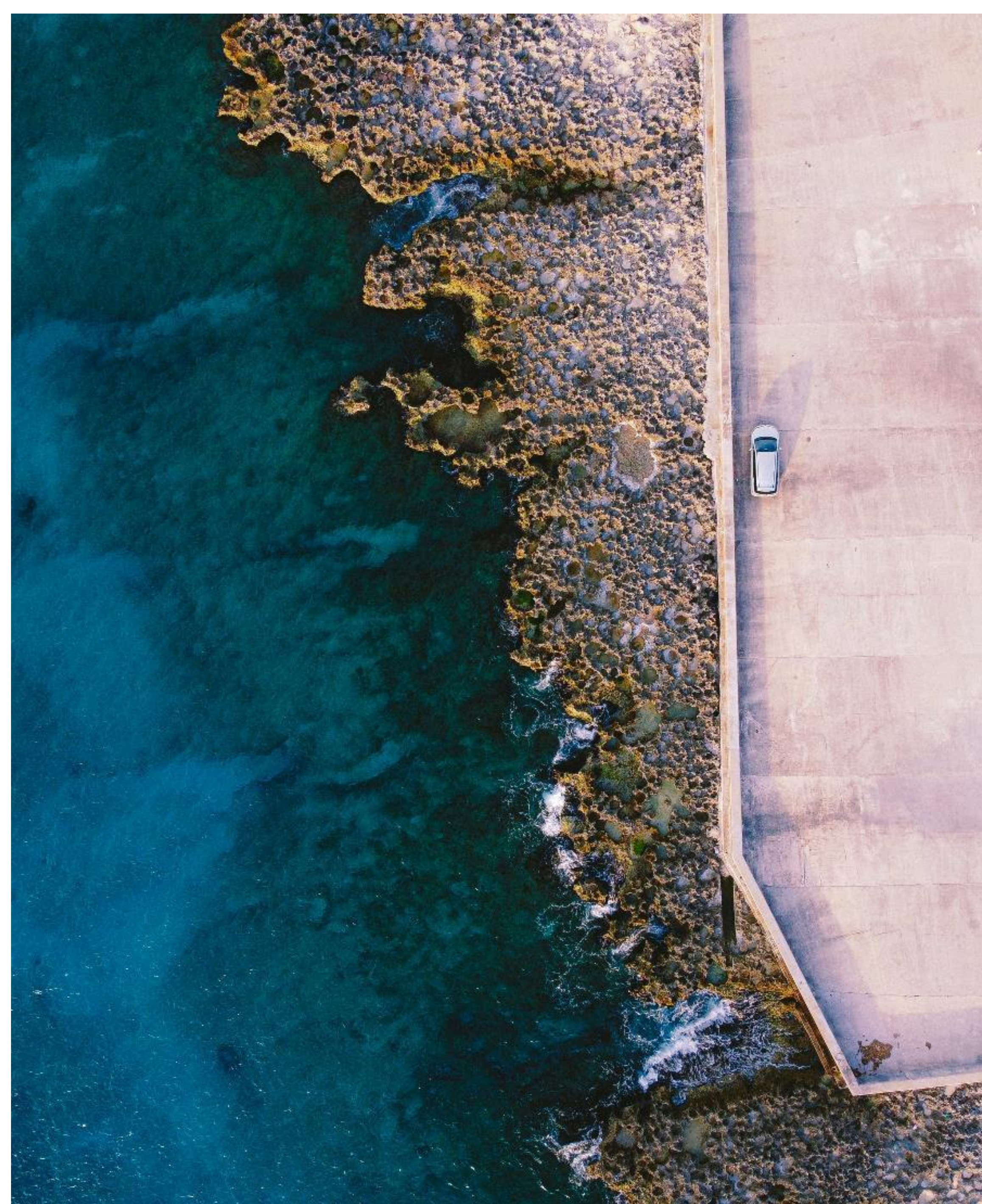
- The client is looking purely for Inheritance Tax mitigation with investments.
- Aside from making lifetime gifts of FIC shares or being able to pass FIC growth to other shareholders, planning where Inheritance Tax is the sole driver can be constrained by FICs.



Outright gifts

Outright gifts to individuals are one option, for recipients to then spend/invest how they see fit:

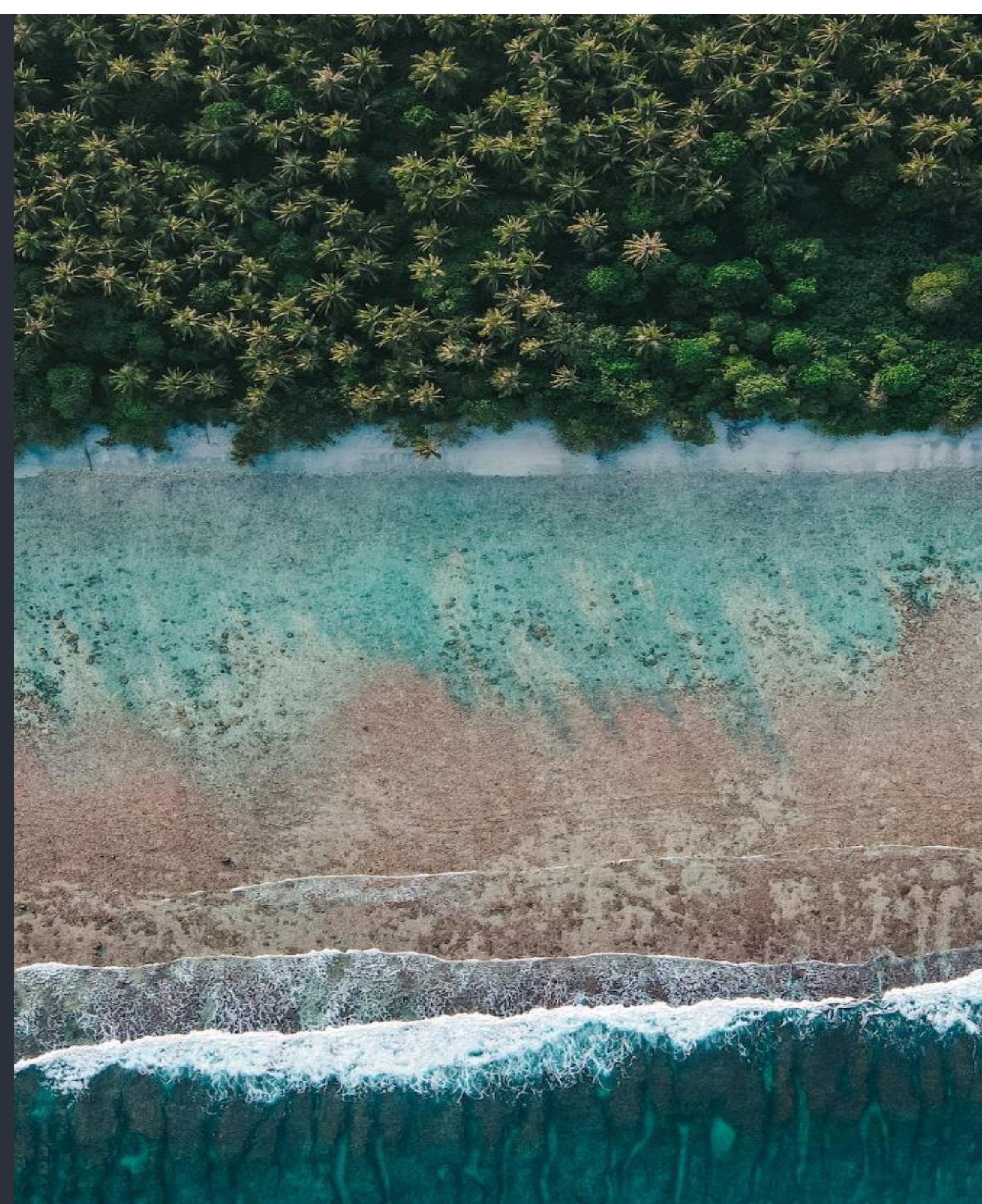
- Funds can be spent on receipt.
- Funds can be invested with individual tax efficient wrappers available, such as ISAs, pensions and VCT/EISs.
- No cost for making gifts.
- If the donor dies within 7 years, 40% IHT could be due or at the very least the available Nil Rate Band Reduced.
- Recipient could misuse the funds, and outright gifts won't protect legacies in the event of divorce.



Life insurance policies

A policy could be put in place to cover IHT potentially due on an estate, gifts or simply to leave funds to protect dependents.

- Can be for a fixed term to reduce premiums or written on a Whole of Life basis.
- Premiums can be guaranteed, meaning a legacy or IHT liability can be met without relying on investment performance.
- Should be written in Trust, so proceeds fall outside of the estate.
- Can be viewed as prefunding liabilities.
- Life insurance is subject to medical underwriting, so costs can vary or may in some cases not be available.



Business relief investments

Qualifying shares in unquoted SPV's or qualifying AIM shares are available for IHT mitigation.

- Two year holding period to potentially qualify for 100% IHT relief when also held on death, or instantly if replacement relief is available.
- Little administration required - it is simply a share purchase.
- Shares still belong to the individual and can be sold to meet expenditure needs.
- Shares held after 2 year holding period can be gifted to Discretionary Trusts and won't be a chargeable lifetime transfer. After 7 years investments in the Trust can then be re-aligned to more 'vanilla' investments. 9-year route, but after 2 years potentially no IHT applicable.
- Viewed as higher risk because assets are either less liquid than large-cap investments, and/or more volatile.
- Can't be used for planning around re-instating Residence Nil Rate Bands unless shares are gifted.

Business Relief schemes are high risk investments and there may be no market for the shares should you wish to dispose of them. You may lose your capital. Certain investments carry a higher degree of risk than others and are, therefore, unsuitable for some investors.

Don't invest unless you're prepared to lose all the money you invest.

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