The Bloomsbury Wealth

GUIDE TO FAMILY INVESTMENT COMPANIES

How a corporate structure can be used to manage family wealth efficiently.

THE FAMILY INVESTMENT COMPANY

When establishing a long term investment portfolio your first consideration should be to determine the appropriate asset allocation strategy. This will be based on achieving an appropriate balance between risk and reward which reflects your personal preferences, needs and resources.

Once you have determined the most appropriate investment strategy, you then need to consider how best to avoid, minimise or defer taxation on the resultant investment returns. While investment returns are never certain and not something that you can control, taxation, costs and your emotions are factors over which you can exercise a degree of control. For the purposes of this guide, we are going to focus on controlling taxation - income, capital gains and inheritance tax - arising on an investment portfolio funded by cash.

For those families with significant wealth, who have a long term objective of preserving that wealth within the family, a family investment company (FIC) might offer a very useful and flexible structure to hold and manage an investment portfolio and possibly other assets. If the company is a UK unlimited liability company this would preserve privacy as the accounts are not in the public domain. Even for a limited liability company, the requirement to file accounts may be limited to a balance sheet, depending on turnover.

Unlike a partnership structure, an investment company is not classed as a collective investment scheme, and so avoids the Financial Services Act regulatory obligations that would otherwise apply. In addition, a FIC is classed as 'plain vanilla' tax planning and as such does not require a Disclosure of Tax Avoidance Schemes (DoTAS) number.

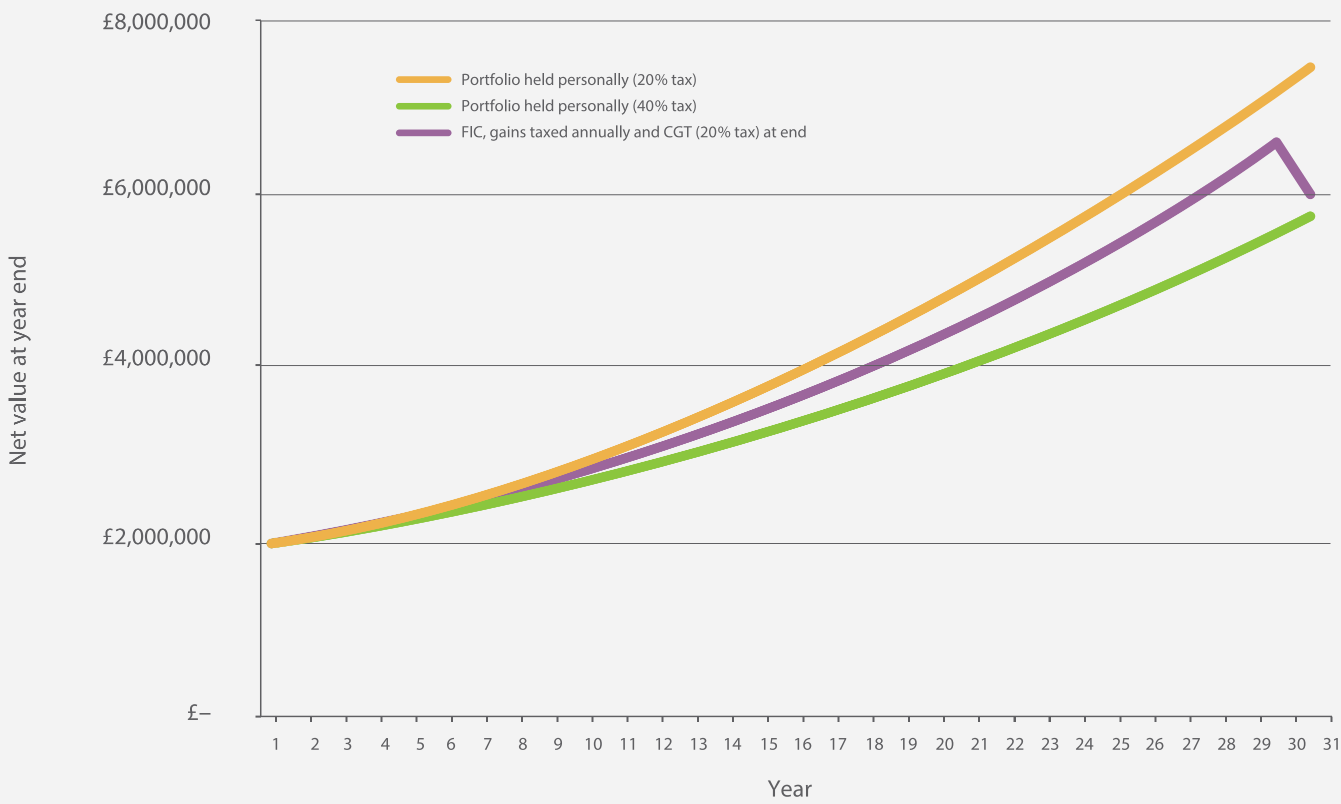
Taxation of returns

Dividend income arising from the company's investment portfolio would be exempt from tax. Interest income would be subject to the corporation tax rate of 19% (due to reduce to 18% in 2020).

For capital gains tax purposes, the acquisition cost of the company's holdings would benefit from indexation allowance up to December 2017, which removes any inflationary gains arising up to that date. Gains arising subsequently do not qualify for this allowance. Any gains realised within the portfolio would be subject to corporation tax of 19%, although the costs of running the company and managing the portfolio are deductible. Care is required where the company holds large amounts of cash and fixed interest investments (whether direct or via funds), as special 'loan relationship' rules might cause unnecessary additional tax charges when these are revalued annually and tax charged on the change in value regardless of whether the gain was realised.

Although capital gains tax, currently at up to 20%, would be charged on the ultimate disposal of the FIC shares, this may not be for many years. In the meantime, the FIC would enable the family to accumulate wealth net of relatively low tax rates, compared to up to 47% on income and 20% on realised gains arising if held personally (indexation allowance was abolished in 2008 for personally owned investments). Exhibit 1 shows the projected value of a £2m investment portfolio after 30 years if held personally and via a FIC. The drop in the FIC value at the end of the period reflects personal capital gains tax for the owner if the company is liquidated at that point.

Exhibit 1 - Projected value of investment portfolio with 60% equities



Return assumptions are based on Bloomsbury's default long term asset class assumptions, adjusted by the current costs for underlying assets, advice & management, custody and portfolio turnover. Forecasts are not a reliable indicator of future performance.

Data source: Bloomsbury

Capital structure

There is total flexibility in how the FIC can be structured in terms of the split of equity and loan capital. For example, you could subscribe a nominal £100 equity for 100 shares and have the main capital as an on-demand loan. If any of the FIC shares are to be gifted or not held jointly by a married couple then it will be necessary to receive a commercial rate of interest to avoid income and inheritance tax (IHT) issues.

As the shares would, in this scenario, only be worth £100 on day one, some or all of these can be gifted outright to other family members and/or transferred into a discretionary trust. This would enable the growth in the value of the shares to be captured by the other family members and/or the family trust(s) and therefore be outside your estate for (IHT) purposes. You could defer the decision on gifting any of the shares to a later date but the longer you leave it, the more valuable the shares may become as the investment portfolio increases in value and any loan is repaid.

The benefit of funding the company with a significant loan is that you can receive loan repayments as you need them, without incurring tax which would otherwise arise on the payment of dividends or the disposal of shares to other shareholders or at wind-up of the company. It makes sense, therefore, to fund the company with a loan to the extent required by your own likely lifestyle needs. Lifetime cashflow forecasting software, using reasonable planning assumptions, can be very helpful in this regard.

The company could potentially also be used as a vehicle to draw a modest salary and other benefits as well as funding pension contributions, as long as these are at a commercial rate for services rendered. This is important to circumvent rules relating to inheritance tax. It is likely that such benefits would not be deductible for corporation tax purposes unless they are very modest and professional advice is essential if considering this option.

Share structure

An FIC can have several classes of share, with different rights, which provides a number of interesting planning opportunities. For example, there could be A, B, C and D shares. While all shares would rank equally for the same treatment (pari passu) on the winding up of the company, only the A shares would have voting rights on all matters. In addition, the A shareholders would usually be directors of the company and so be able to control the investment and dividend distribution strategy.

If all the voting shares are owned by the same person (for these purposes a married couple or civil partnership are considered one person) then for tax purposes their value is aggregated because the owner controls the voting rights. If, however, any of the non-voting rights are gifted to another family member and/or a trust, then the A shares would be treated as being worth a premium to their actual cash value and the gifted shares would be valued at less than their cash value due to the lack of voting rights.

If, at a later date, the owners of the B, C or D shares receive the A shares, perhaps via the A shareholder's will after their death, then the B, C and D shareholders' shares would be subject to an immediate uplift in value due to acquiring the voting rights attaching to them.

Share valuation is a specialist area but where the capital structure is relatively simple, the underlying asset of the company is a quoted, liquid investment portfolio and voting rights are concentrated in one class of shares owned by one shareholder, ascertaining a value should be less problematic. If some of the non-voting shares are gifted to a discretionary trust, this will trigger a chargeable lifetime transfer which means that HM Revenue and Customs (HMRC) would have to consider the values of all the share classes for inheritance tax. They would not have to do this if the gifts were made only to individuals and were potentially exempt transfers.

Costs

The benefits of any planning can be eroded and possibly overridden by the costs, so it is important to be aware of what these are and to factor that into any cost-benefit analysis. In the case of an FIC, the specific costs arise at establishment and on an annual basis, unless a suitable vehicle is already in existence. The initial costs include producing the Memorandum and Articles of Association which govern the company's operation and shareholders' agreement, as well as completing the necessary filings and typically amount to £3-5,000 plus VAT. Annual costs would cover producing accounts, completing and submitting the corporation tax return and ongoing company secretarial work and

Exhibit 1 - Projected value of investment portfolio with 60% equities

	Mike	Jackie	Totals
A shares	£100,000	£100,000	£200,000
B shares	£300,000	£300,000	£600,000
C shares	£300,000	£300,000	£600,000
D shares	£300,000	£300,000	£600,000
Total share capital	£1,000,000	£1,000,000	£2,000,000
Total loan capital	£1,000,000	£1,000,000	£2,000,000
Grand totals	**£2,000,000**	**£2,000,000**	**£4,000,000**

Data source: Bloomsbury

would commonly be £2,500-3,000 plus VAT. This tends to make an FIC cost-effective only for investments of at least £1m.

The FIC in action

It is perhaps easier to understand the key benefits of a FIC by looking at an example. What follows is just one example of how a FIC could be structured; there are numerous permutations possible.

Mike and Jackie are in their late 50s and they have £4m of cash arising from the sale of a property, which they wish to invest in a diversified investment portfolio for their and their wider family's benefit. Mike and Jackie both receive pension, rental and savings income which utilises their personal allowances and basic rate income tax bands. They have two children, Ben aged 32 and Matilda aged 29, who are both married with children but they might have more in the future.

Mike and Jackie decide to create a FIC by subscribing £2m of cash into four classes of share - A, B, C and D - of which only the A shares have voting rights, and appoint themselves as controlling directors. Mike and Jackie also make an on demand loan to the FIC of £2m and charge 3% pa interest (this being the market rate for a competitive mortgage with a low loan to value ratio). The exact allocation of capital is shown in Exhibit 2.

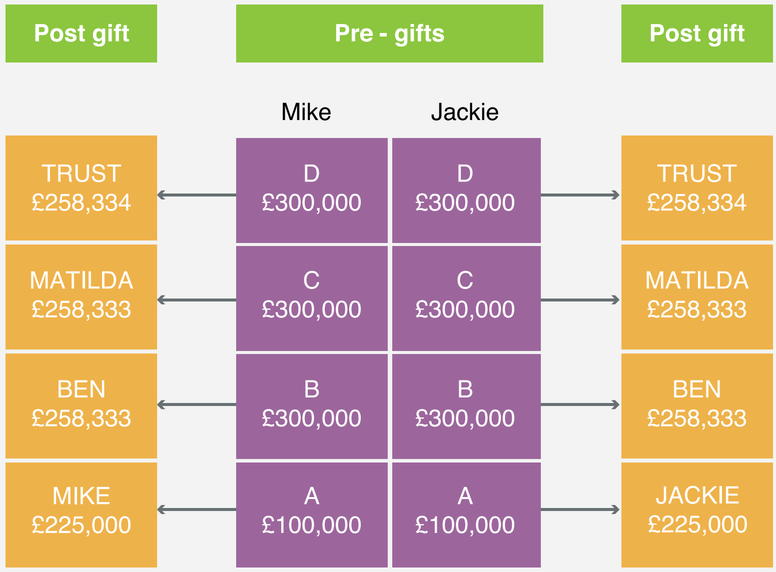
The FIC therefore holds £4m of cash which Mike and Jackie decide, as the controlling directors and sole shareholders, to invest in a diversified and fully liquid investment portfolio of which 70% is allocated to equities and 30% to bonds via investment funds. Mike and Jackie decide to retain the A shares but to gift the B shares to Ben, the C shares to Matilda and the D shares to a discretionary trust which includes Ben, Matilda and their current (and any future) grandchildren as potential beneficiaries. Mike and Jackie are also trustees of the trust.

The gifts of shares to Ben and Matilda will be treated as potentially exempt transfers and the gift to the discretionary trust treated as a chargeable lifetime transfer. On a practical note, the gift to the trust is made a day before the other gifts as this will minimise any inheritance tax that might become due if Mike and Jackie die before seven years have elapsed.

Value of gifts

Because the retention of the A shares means that Mike and Jackie can control the company, and therefore the value attributed to the other shares, the A shares will be deemed to have a value for IHT purposes which is more than the appropriate percentage of the company's net assets, i.e. the underlying portfolio. On the assumption (purely for illustrative purposes) that each of Mike's and

Exhibit 3 – Inheritance tax values



Data source: Bloomsbury

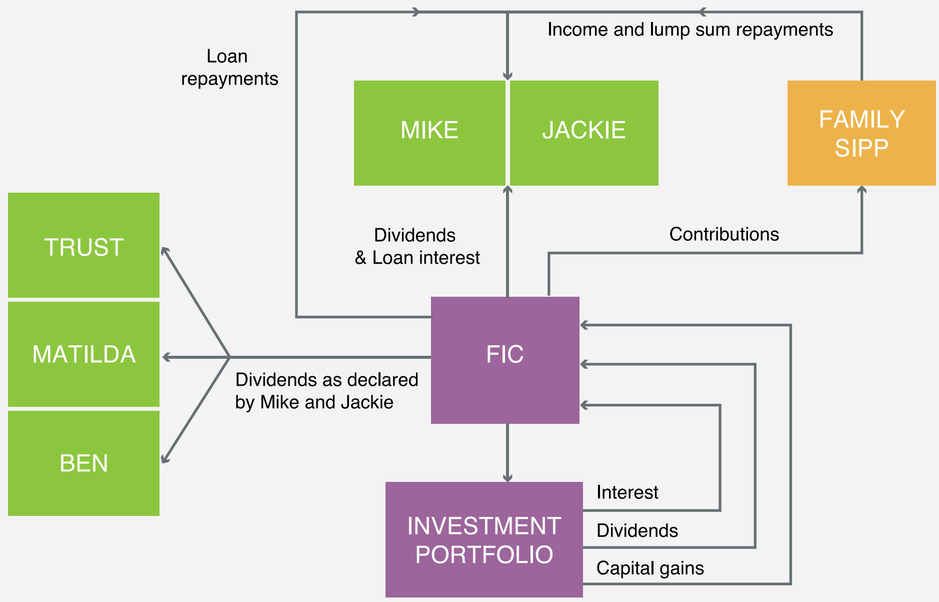
Jackie's retained A shares would be worth, say £225,000 rather than their respective £100,000 basic value, the total value of the other shares gifted for inheritance tax purposes would be £775,000, rather than their nominal value of £900,000 as set out in Exhibit 3.

Extracting value

Mike and Jackie do not need to access their loan immediately, but the intention is to take ad hoc repayments to help meet their living costs in a few years' time when Mike and Jackie stop their part-time consultancy business. In the meantime, Mike and Jackie receive annual interest on the loan of 3% (£30,000pa each) on the basis that it is fully secured against the company's assets and repayable on demand. It would take 20 years for the loan to be repaid if annual capital repayments were taken at the rate of £100,000 per annum. As the loan reduces so will the taxable interest that Mike and Jackie receive each year.

As controlling directors Mike and Jackie oversee the management of the company, including the investment strategy, in return for an annual contribution to their family self-invested pension scheme of £25,000. This avoids income tax and national insurance and some or all of the contribution may be deductible for corporation tax purposes, while also avoiding IHT rules relating to reservation of benefit on gifts. In reality, a decent wealth manager will handle most of the investment governance work including the creation and updating of a formal investment policy statement (IPS). Exhibit 4 illustrates how Mike and Jackie and their family can take benefits from the FIC structure.

Exhibit 4 – Extracting value from the FIC



Data source: Bloomsbury

The end result

By holding their investment portfolio via the FIC, Mike and Jackie have achieved the following:

- The effective tax rate on investment income and gains will be c.19% rather than the c.45%+ had they owned the portfolio personally or via a trust;
- They preserve their personal income tax allowances because their personal income remains below £100,000 each, thus avoiding the effective 60% tax rate on non-dividend income between £100,000 and £123,000 (in 2018/19);
- They retain access to the £2m of capital loaned to the company and may take repayments as they need and investment conditions allow, without incurring personal taxation;
- They will receive reasonable taxable interest on the outstanding loan balance each year, which reduces as the loan is repaid;
- They retain total control over the company including the payment of any dividends;
- They receive tax-free payments into their family SIPP;
- They have started the clock ticking on gifts worth circa £1.5m and as long as they survive for seven years, these will fall out of account for IHT purposes;
- The value held by the discretionary trust and any future growth is sheltered from hostile creditors (such as divorcing spouses or creditors in the event of bankruptcy) and available for any of the wider family, including by granting loans;
- Although the value of the shares gifted to Ben and Matilda is lower than the face value, these would increase if Ben and Matilda received their parents' A shares upon Mike and Jackie's eventual demise. Although capital gains tax will be higher as a result, inheritance tax (which is charged at a higher rate than capital gains) should be lower as a result;
- They retain flexibility to invest in other asset classes in the future.

A properly structured FIC can offer wealthy families a useful, flexible and tax-efficient structure for holding investment capital. As always however, this needs to be considered in the context of a comprehensive wealth plan which reflects your current situation and most likely future scenarios. A progressive and well resourced wealth manager will help to co-ordinate the expert advice needed to make the FIC a reality.

For further information please get in touch with your usual Bloomsbury contact, telephone 020 4502 4560 and ask for a member of the wealth team or alternatively e-mail: truewealth@bloomsburywealth.co.uk

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