Family investment companies (FICs)

Synopsis: Corporate investment by SMEs and FICs as a trust alternative in IHT planning and as a potentially tax effective home for investment.

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Especially since the effective widening of the relevant property regime to apply (broadly speaking) to most non bare trusts, increasing interest has been shown in the potential use of a family investment company (FIC) to enable funds to be gifted, beyond the nil rate band but with a high degree of control retained by the donor whilst not triggering any relevant property inheritance tax (IHT) charges.

There is also the appeal of the relatively low rate of corporation tax (25%) on corporate profits.

Aside from the attractive environment for generated income, the establishment of a FIC can be estate-planning motivated representing - a bespoke vehicle which can be used as an alternative to a family trust.

Essentially, it’s a private company whose shareholders are family members. A FIC enables parents to retain control over assets whilst accumulating wealth in a tax-efficient manner and facilitating future succession planning.

But surely a trust can do that? Well, yes, but any transfer that exceeds the settlor’s available nil rate band will trigger an immediate IHT charge.

So how is a FIC structured? There are a few variations on the theme.

One example

- The parents provide the funds to the FIC either in the form of interest-free loans or by subscribing for preference shares. This will not be regarded as a transfer of value for IHT purposes and these funds can be extracted from the company later tax-free.

- The parents also subscribe for voting shares in the FIC, which give control of the company at shareholder and board level.

- The parents could also subscribe for a class (or classes) of non-voting shares. The parents can then choose to give non-voting shares to their children (preferably before significant value accrues to those shares). The gift will not be subject to IHT, provided the parents survive for seven years from the date of the gift. The non-voting shares may pay dividends in the future.

- The parents could also put funds into a discretionary trust for the benefit of their minor children without triggering an IHT charge, to the extent that their IHT nil rate bands and annual exemptions are available. The parents should be irrevocably excluded from benefiting under this trust. The

trustees then subscribe for a class of non-voting shares in the FIC at market value, i.e. at nominal value if the company is being newly created.

The company could be set up as a UK unlimited company rather than a UK limited company, to reduce the filing requirements. However, a 'small' limited company (annual turnover of not more than £10.2 million, with an average number of employees of not more than 50 even if the balance sheet total exceeds £5.1 million) will currently only need to file abridged accounts with no profit and loss account or directors' report and there will be no audit requirement.

An unlimited company will not have the same protection from creditors as a limited company although, assuming that the only assets held by the company are, say, investments (and not property for example), it is unlikely that claims will be brought against the company.

Note that the passing of the Economic Crime and Corporate Transparency Act means that small companies (and micro-entity companies) will have to file a profit and loss account, with small companies having to also file a director's report. The Act also removes the option for companies to prepare abridged accounts. Whilst the key dates and timeline for implementation haven't been confirmed, Companies House has indicated certain measures will become live in early 2024.

As already noted, the company will pay corporation tax at 25% from 1 April 2023.

Capital gains realised by the company are chargeable to corporation tax at 25%. This is higher than the current main rate of capital gains tax (CGT) of 20% (although lower than the 28% rate applying to residential property) that would be payable by an individual. Indexation allowance was available for companies up to the end of 2017.

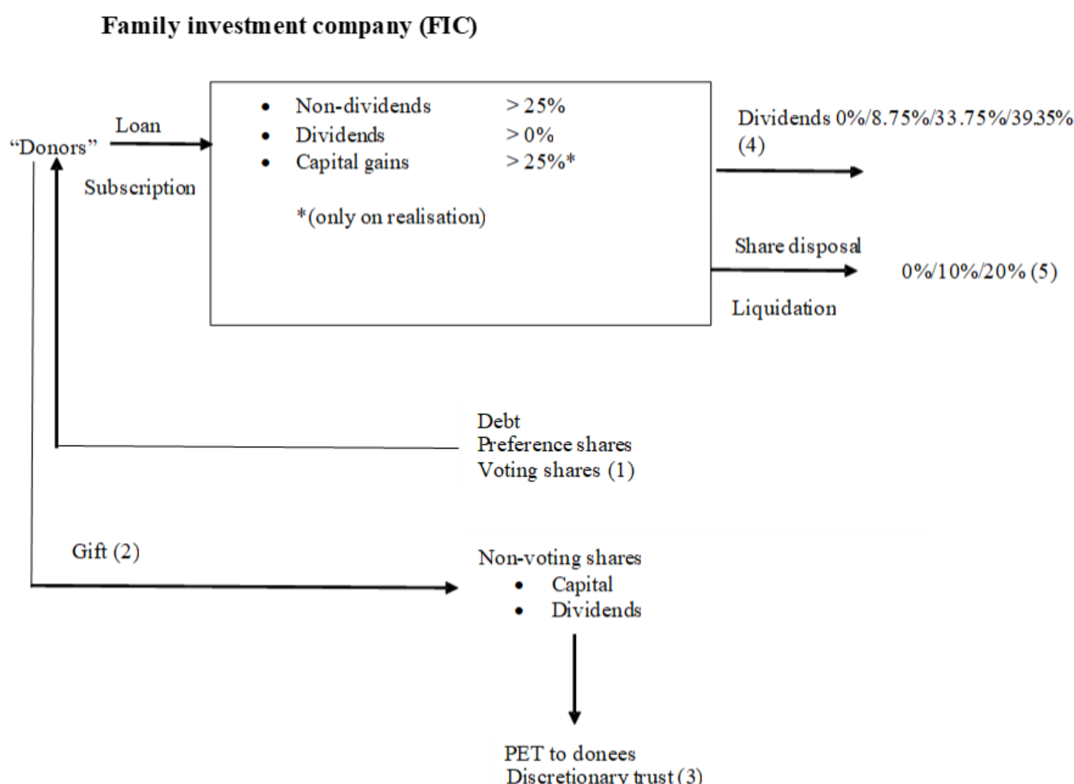
Proceeds from the sale of investments can therefore be reinvested in the company, having possibly suffered less tax than would be the case for an individual reinvesting the proceeds of the sale of investments held personally.

Fundamentals

1. These shares (retained) confer retained control over the FIC for the donor(s) – typically, parents.
2. Donors would also subscribe for, and then gift, non-voting shares carrying rights to capital and/or dividends.
3. The non-voting shares would (typically) be given as a potentially exempt transfer (PET) to donees, or, up to the available nil rate band(s), transferred into a discretionary trust.
4. Dividends declared are assessed on the shareholder(s) at the appropriate tax rate.

Shareholder CGT is only payable on actual/deemed realisation (e.g. on liquidation) by the shareholder(s).

Here is a graphic representation of the main tax implications of a FIC...



In addition to the fundamentals outlined (and illustrated) above most dividends received by a UK company (including foreign dividends) are exempt from corporation tax.

Distributions (i.e. dividends) received by a small company are exempt, provided...

- The paying company is resident in a territory with which the UK has a double tax treaty with a non-discrimination provision;
- The distribution is not interest treated as a distribution;
- No tax deduction is given for the dividend outside the UK; and
- The distribution is not made as part of a tax advantage scheme.

(Interest may be treated as a distribution where it is paid in respect of non-commercial securities.)

A small company, for these purposes, is a company with fewer than 50 employees and with either a turnover or gross assets of not more than €10 million.

Distributions received by companies that are not small are exempt provided...

- They are not interest treated as a distribution;
- No tax deduction is given for them outside the UK; and
- They fall into one or more of the exempt classes.

Most dividends will fall into one or more of the exempt classes. There are general and specific anti-avoidance measures, but, in general, unless a distribution is paid as a contrived means of avoiding tax on what would otherwise be taxable income for the company, the anti-avoidance provisions should not apply.

Dividends and interest received from overseas may be subject to withholding tax, but this may be reduced under the terms of any relevant double tax treaty and it is, it seems, often easier for a company to obtain the benefit of the treaty rate of withholding tax than for an individual.

In any event, withholding tax can be offset against the UK corporation tax on the corresponding income.

When a dividend distribution is made from an Authorised Investment Fund (AIF), then in the hands of a unit holder (participant) within the charge to corporation tax part of the distribution (any interest element) is treated as unfranked. The unfranked part of the distribution is then effectively treated, in the hands of the unit holder, as interest received after deduction of income tax at the lower rate (20%).

Any repayment of the income tax treated as deducted is restricted so that it must not exceed the unit holder’s share of the AIF’s liability to corporation tax on the income. As the corporation tax rate is 25% – please see below - corporation tax of 5% may apply to this income (25% corporation tax - 20% income tax) instead of a potential repayment.

The remaining part of the dividend distribution is treated by the unit holder in the same way as for other UK company dividends.

The company should be able to claim a corporation tax deduction for interest on loans taken out against the value of its investments, where the loans are used for the purposes of the company’s business (e.g. acquiring new shares or generally managing its business). Loan interest deductions may be restricted where the total interest payable exceeds £2 million per annum (on a group basis).

By contrast, individuals are not eligible to claim tax relief on interest on loans to acquire a portfolio of shares.

Expenses incurred by the company in managing its investments and running its business will be eligible for corporation tax relief. This will include investment managers’ fees and remuneration paid to employees/directors. Certain items are not eligible for tax relief, such as the costs of entertaining.

By contrast, an individual investor cannot obtain tax relief on the expenses of managing their share portfolio.

The company will be able to offset items against its taxable income – e.g. interest receivable and taxable dividends (i.e. dividends not exempt) – and capital gains.

Any excess amount can be carried forward and offset against the company's future taxable profits from its investment business.

So much for the relatively tax attractive position at the corporate level. How about the shareholders in the company? Well, it's the same as for any holding of shares in a private limited company...

- There will be income tax on dividends – the effective rate will be up to 39.35%. Nil taxpayers will have no liability, basic rate taxpayers will be taxed at 8.75%, higher rate taxpayers at 33.75% and additional rate taxpayers at 39.35%. Of course, the dividend allowance (note not an exemption) will deliver a rate of 0% up to a cumulative £1,000 of dividends in the 2023/24 tax year; reducing to £500 in a tax year from 2024/25 onwards.

- There would, of course, be income tax and National Insurance (NICs) on any salaries received by the shareholders – as directors or employees.

- There would be CGT to consider on capital distributions on the liquidation of the company – usually at 20% for higher rate taxpayers to the extent that the annual CGT exemption has been used. Naturally, it would be important to avoid the distribution being taxed as income.

HMRC's specialist FIC unit closes

In August 2021, HMRC announced that it had closed its specialist FIC unit after finding no evidence of a correlation between the use of FICs and non-compliant behaviour.

In a sample of FICs reviewed by HMRC, the average assets amounted to around £5m, leading HMRC to conclude that FICS are mainly used by wealthy people. [For this purpose, HMRC defines wealthy people as having an annual income exceeding £200,000, or those with wealth of more than £2 million.] Further analysis showed that FICs are not a vehicle often used by the extremely wealthy, who tend to use family offices to manage their wealth.

HMRC's dedicated unit, which was introduced in 2019, was tasked with conducting risk reviews of private companies used by family offices and high net worth individuals to manage their wealth and making sure that they are operating in line with UK tax laws. The existence of the unit was not publicised at the time, but came to light in early 2020 after a Freedom of Information (FOI) request from Pinsent Masons.

FICs will now be treated as 'business as usual' by HMRC, rather than be subject to the scrutiny of a dedicated unit. Whilst this will be good news for users of FICs, they will nevertheless still be subject to normal scrutiny by HMRC even though no longer by a dedicated unit. Also, the Government does not rule out bringing into play anti-avoidance rules for FICs in the future.

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Corporation tax rate increase from 1 April 2023

The previous 19% rate will continue to apply to companies with profits of up to £50,000, subject to associated companies' rules. However, the 19% rate will not apply to close investment-holding companies. For close investment-holding companies and companies with over £250,000 of profits, the rate of corporation tax will be 25%.

Marginal relief provisions will apply for companies (that are not close investment-holding companies) with profits between £50,000 and £250,000, meaning that 19% will apply to the first £50,000 of profits and 26.5% will apply to the excess up to £250,000 (£50,000 @ 19% + £200,000 @ 26.5% = £62,500 = £250,000 @ 25%).

A close investment-holding company is defined in a negative way. Effectively, it is a close company that does **not** exist wholly or mainly for trading on a commercial basis or investing in land which is (or is intended to be) let commercially (CTA 2010 s 34). And, subject to certain exceptions, a close company is, broadly, a company which is under the control of...

- five or fewer participators (a participator is any person having a share or interest in the capital or income of the company), or
- any number of participators if those participators are directors, or

more than half the assets of which would be distributed to five or fewer participators, or to participators who are directors, in the event of the winding up of the company.

FICs are usually split into two types, in that they hold one or the other of the following types of investment...

1. Property – in which case the FIC should **not** be treated as a close investment-holding company and the 19% rate will apply for profits under £50,000 and thereafter the additional 25% and 26.5% rates will apply; and
2. Stocks and shares – such FICs will likely be treated as close investment-holding companies and therefore will be taxed at the 25% corporation tax regardless. However, if such profits are paid to the FIC by way of dividends, then (subject to what is said above about the taxation of unfranked income) such payments are exempt from corporation tax in any event.

Accordingly, even with the increased corporation tax rates from 1 April 2023, FICs are still attractive for wealth accumulation, especially when compared to paying income tax.

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