Family investment companies: the bet you didn't mean to place

Personal tax | Inheritance tax and trusts | OMB



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Family investment companies are a long-term gamble – especially when not carefully planned or reviewed over time.

Key Points

What is the issue?

Family investment companies are often promoted as a tax-efficient estate planning tool, allowing families to pass wealth to future generations while retaining control. However, FICs – whether deliberately structured or formed accidentally over time – can create significant long-term challenges.

What does it mean to me?

While FICs may offer tax advantages during the growth phase, the benefits often diminish upon liquidation due to double taxation. The article highlights multi-generational complications, family governance issues, regulatory burdens and the limited asset protection FICs offer compared to trusts.

What can I take away?

Advisers must carefully assess whether a FIC truly meets a family's needs, considering simplicity, liquidity and long-term planning. Sometimes, traditional methods like outright gifts or trusts may be more effective and less risky.

Family investment companies (FICs) are frequently touted by tax advisers as the silver bullet to a client's estate planning problems. Given the £325,000 limit on how much can be placed into trust without an upfront inheritance tax charge, FICs on the face of it provide a useful way to pass value to younger generations whilst retaining control over the assets. There are countless articles around proclaiming the benefits of FICs, but do advisers need to be cautious before suggesting a FIC to a client?

In this article, we consider both the 'accidental' FIC and the 'advised' FIC. The former is a long-running company where shares have slowly been passed down the generations by way of gift, the creation of new share classes or a mixture of the two. The latter is a new company formed with the intention that it should be a FIC – a bet you meant to place versus one you didn't know you'd made.

Joanna, the accidental gambler

Throughout this article, we will use the example of Joanna, 85 with failing health, who falls into the accidental FIC category.

Joanna formed a company in 1992 to use as a vehicle to purchase 15 flats rented to statutory tenants in North West London. Her initial subscription for 100% of the share capital was £450,000. The indexed base cost of those 15 flats is £1 million, and their market value is £16 million.

In 2010, Joanna gifted 10% of the shares in the company to each of her three adult children, and the relevant capital gains tax was paid at the time. She therefore retains a 70% shareholding, which has a discounted value of £7.5 million and a base

cost of £315,000.

During her recent divorce settlement, Joanna gave up other matrimonial assets to avoid diluting her holding in the company. As such, her estate now consists of her main residence, valued at £2 million, with an outstanding mortgage of £1.5 million, and her shares in the company. She has no liquid assets, living off a small pension.

As a result of these circumstances:

- Joanna's estate will have insufficient cash to pay the inheritance tax on her death;
- Joanna herself has insufficient liquid assets to pay any capital gains tax due on lifetime gifts; and
- realising cash within the company by selling properties will result in tax at almost 25% of the proceeds, given the minimal base cost.

The reader might be thinking that this is a result of poor tax planning on Joanna's part. After all, she does fall into the accidental FIC category. However, it is contended in this article that even the best advised FIC on day one can encounter similar issues later down the line.

Tax in brief

Readers of *Tax Adviser* will be well versed in the taxation of companies compared to the taxation of individuals, and we do not seek to regurgitate what has already been said many times before. Similarly, there are anti-avoidance provisions which must be borne in mind if you are advising a client to set up a FIC. For those that need a reminder of the general tax position of FICs, we would point you in the direction of the article by Sofia Thomas and Sharon Dosanjh in the September 2021 *Tax Adviser* article 'Protecting the family fortune' (see tinyurl.com/36vmv9hx).

Know the odds: tax rates and arbitrage

To analyse whether a 'typical' FIC is worthwhile, we modelled two investment portfolios – one financial and one property (see pages xx and xx). We compared the outcomes under personal ownership and through a FIC using broad assumptions and current tax rates.

These illustrations highlight the underlying wager that long-term tax efficiency will outweigh complexity, governance and future risks.

Our modelling highlights that even modest changes in input assumptions, such as the balance between income and capital returns, can materially affect the long-term outcomes. The scenarios are illustrative and based on simplified, realistic assumptions that aim to isolate the impact of the FIC itself. For example, if a financial portfolio generates little or no dividend income, the FIC cannot benefit from the dividend exemption and so the investment income is taxed before being reinvested (as opposed to the entire dividend being available for reinvestment).

These examples are not intended to predict actual outcomes. They compare the same asset base held personally versus through a FIC, using consistent investment returns and sale patterns over a period of 30 years.

Illustrative portfolio growth graphs

The graphs on pages xx and xx illustrate how the portfolio values evolve over 30 years for both scenarios (corporate and personal ownership).

The corporate portfolios show higher compound growth:

- **Financial portfolio:** largely due to the lower corporation tax rate and dividend exemption.
- **Property portfolio:** largely due to the lower corporation tax rate and the ability to deduct mortgage interest.

However, once the portfolios are liquidated, the personal ownership structure in both portfolios result in slightly more post-tax proceeds.

The differences are modest, and the outcomes are sensitive to the assumptions used for the illustrative calculations.

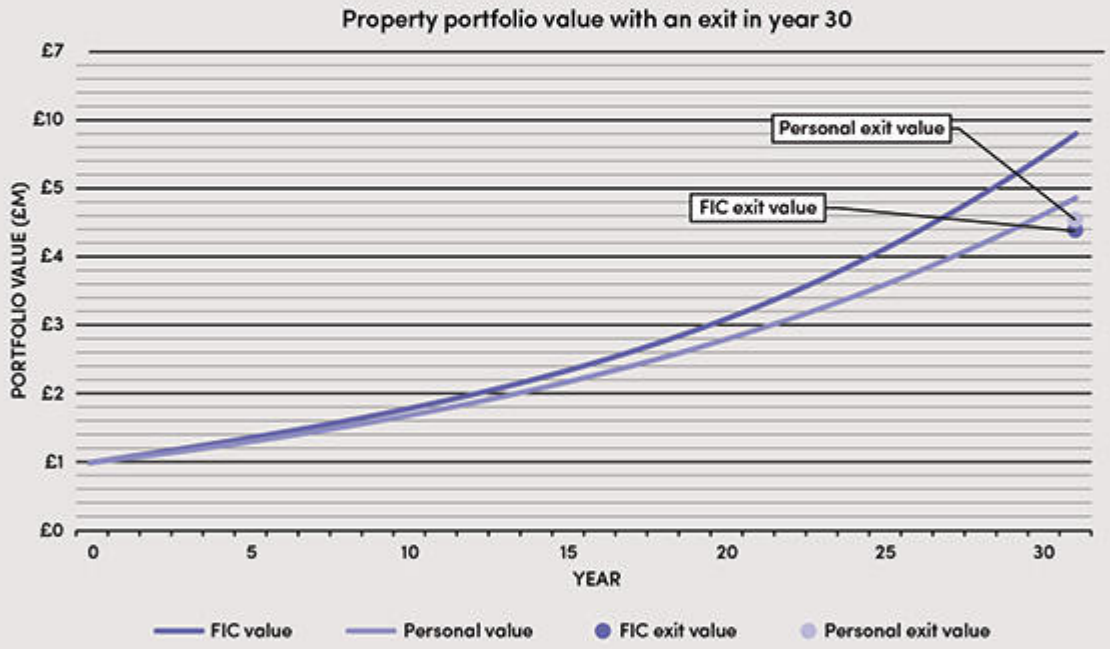
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FINANCIAL PORTFOLIO

Assumptions:

- Additional rate taxpayer
- £1 million invested in Year 1 (today)
- The portfolio is split: 50% into fixed-income investments earning 3% annual interest; and 50% into equities providing a 3% dividend yield plus 4% capital growth.
- At the end of each year the investor sells 10% of the holdings.
- Net sale proceeds are reinvested to keep the portfolio balanced.
- All assets are sold at the end of 30 years. In the corporate scenario, proceeds are distributed via liquidation.

Illustrative portfolio growth graph



Illustrative outcome

Scenario	Final cash (after 30 years)
Personal: after portfolio liquidation	~£4.6m
Corporate: after portfolio and company liquidation	~£4.4m

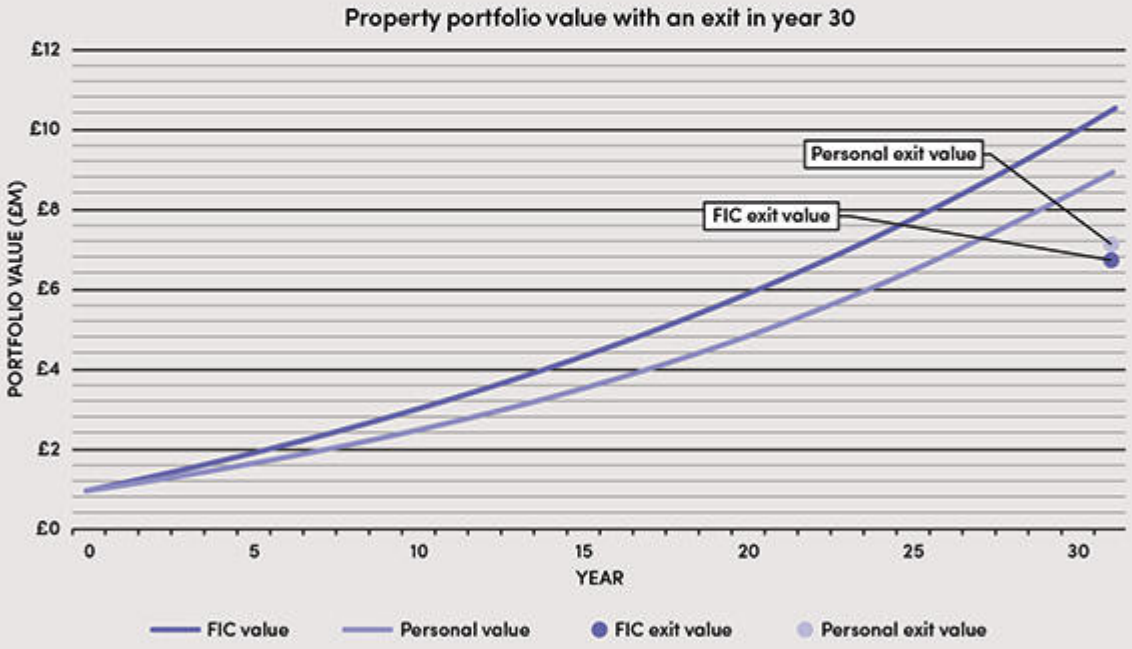
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PROPERTY PORTFOLIO

£1 million equity in a property company
Assumptions:

- Additional rate taxpayer
- £1 million invested in Year 1 (today)
- The capital is used as a 25% deposit to purchase properties worth £4 million, financed by a £3 million interest-only mortgage (75% LTV).
- The properties yield rent equal to 5% of their value each year.
- Property prices grow at 3% per year.
- Mortgage interest rate is 4%.
- Rental profits are retained in the company and accumulate as cash.
- All assets are sold at the end of 30 years. In the corporate scenario, proceeds are distributed via liquidation.

Illustrative portfolio growth graph



Illustrative outcome

Scenario	Final cash (after 30 years)
Personal: after portfolio liquidation	~ £7.1m
Corporate: after portfolio and company liquidation	~ £6.8m

Modelling conclusion

In both cases, the portfolio owned by the FIC may grow larger over the time period under certain assumptions, but once the portfolios are liquidated and distributed to shareholders, the portfolio owned personally is likely to deliver a similar or better outcome. The double layer of tax on liquidation is likely to outweigh any tax arbitrage, even when the benefit of the tax arbitrage has been compounded over a long time.

This assessment applies equally to both advised and accidental FICs; however, for accidental FICS, like Joanna’s, there may be no modelling at all, just a situation that evolves slowly over time and is difficult to unwind.

The following factors influence the illustrative modelled outcomes:

- percentage of assets sold each year and reinvestments;
- investment returns and future tax rates;
- portfolio composition, i.e. equity vs fixed income;
- use of leverage (especially in property companies); and
- exit plans and timeline.

In both examples, we have compared ownership personally with ownership through a corporate vehicle of the same underlying assets, with the same investment growth and over the same time period, to try to isolate the impact of the wrapper itself.

Even with professional modelling tools, these projections remain sensitive to multiple assumptions and should be treated as indicative. The decision to use a FIC is ultimately a long-term bet on tax policy, investment returns and not just a calculation on tax savings using a fixed set of assumptions. The next sections discuss whether it is worth placing that bet.

Stick or twist: is a FIC right now and forever?

There are many articles outlining the benefits of FICs, especially advised FICs with long-term planning in mind. However, our modelling illustrates examples where this is not the case and for many families, especially those with accidental FICs, those benefits may never materialise.

When considering estate planning, tax is rarely the only driver. Another is to leave simplicity for future generations. When a FIC is considered as a long-term planning vehicle, many clients conclude that the FIC is passing complexity down a generation, which in itself is unattractive. Some do implement an advised FIC, and others find themselves in a similar position to Joanna with an accidental FIC.

So, what are those complexities?

1. Multi-generational complexities

A FIC on the surface of it can seem like an attractive way to pass value from, say, parents to adult children. Parents gift shares with income and capital rights to their children, retaining the voting rights in a separate share class. There will be some value in the voting rights (a matter for another article!) but the majority of the value will have passed to the adult children. Provided the parents survive seven years, they will not be subject to inheritance tax on their death.

This is efficient inheritance tax planning for the parents, but what about the children? When they come to do their estate planning, the shares will be sitting at a potentially significant gain, much like Joanna with shares worth £9.5 million with a base cost of £315,000. To pass that value down to their own children, therefore, they would be faced with the following options:

1. Hold the shares until death and suffer inheritance tax at 40%.
2. Liquidate the company, pay corporation tax on gains at company level, and pay capital gains tax on the growth in value of the shareholding at 24%. Gift the net cash proceeds and survive seven years, otherwise face inheritance tax in addition to the corporation tax and capital gains tax.
3. Gift the shares and face a dry tax charge on the growth in value of the shareholding at 24%, assuming they hold other assets to pay the tax. Again, survive seven years, otherwise face inheritance tax in addition to the capital gains tax.

Faced with the above scenario, many second generation FIC shareholders will choose liquidation. The FIC, therefore, does not serve its purpose as a multi-generational planning vehicle. This is the reason for modelling liquidation after 30 years.

2. Family relationships

Families are inherently complicated, particularly as the familial relationships become more distant. Siblings might get along, but will cousins? Share ownership can raise expectations about entitlement and disagreements can arise about access to funds and the dividend policy. The emotional implications of ownership without any control can be significant.

3. Regulatory complexities

A FIC requires management, accounting and regular review. In practice, FICs require a level of professionalism that can be disproportionate to the amount invested or the client's affairs. Even FICs with small portfolios must comply with the Companies Act 2006 by maintaining statutory records, filing accounts, upholding directors' duties and ideally having a shareholders' agreement to govern decision-making and ownership.

4. Asset protection

Finally, FICs are often described as a useful tool for asset protection or for handing wealth down to generations whilst accumulating wealth at the corporation tax rate. The founder can retain control by remaining a director and owning shares that come with the decision-making power.

However, the level of asset protection available is not the same as a trust and so, if asset protection is the main driver, it's likely that a trust will be more suitable.

In most scenarios, it is our view that there are other options which are likely to be more appropriate as they involve less complexity and don't require the individual to place a bet on the future tax landscape. For example, a simple gift or a bare trust.

Death and the FIC

What about clients, like Joanna, who are FIC shareholders with significant latent gains and are, sadly, unlikely to survive the seven years if they make a lifetime gift? There is no desire to sell the company to a third party, and the children cannot afford to purchase the shares.

In these cases, there is no silver bullet. Joanna will likely die holding the shares, and her executors will need to find a way to fund the inheritance tax. Payment of tax by instalments may soften the blow, but it does not reduce the overall tax payable, and with HMRC interest rates currently at 8.25%, many clients would prefer to accelerate the payment.

Inheritance tax will be payable on Joanna's death of £3.07 million, calculated as follows:

Image

	£m
House	2.000
Less mortgage	(1.500)
Shares	7.500
Total	**8.000**
Less: Nil rate band	0.325
Taxable estate	7.675
Tax at 40%	**3.070**

£500,000 could be paid from the equity in Joanna's house, but the estate will need to realise cash of £2.57 million from the company to fund the inheritance tax if the instalment option is not taken.

Option 1: Liquidation

Although the base cost of the shares will have uplifted to probate value on Joanna's death, the underlying company assets will not have. Corporation tax at 25% will therefore be payable on the £15 million capital gain at company level.

Image

	£m
Proceeds from flats	16.000
Less: corporation tax	(3.750)
Net proceeds	**12.250**
70% share on liquidation (ignoring liquidators and other costs)	8.575
Less: inheritance tax paid	(2.570)
Less: capital gains tax on disposal of shares	(0.258)
Residuary estate value	**5.747**

In addition, as this is a liquidation, the three children will pay capital gains tax on their own 10% holdings in the company.

Option 2: Dividend

Instead of liquidating the company, the company could make a dividend distribution. This would be taxed at 8.75% on the estate, although this can be taxed at up to 39.35% in the hands of the eventual beneficiary of the estate. Therefore, the estate would need to receive a dividend of £2.816 million to pay the basic rate tax at 8.75% and have net cash to pay the £2.57 million inheritance tax.

As this would be a dividend, it would need to be paid to all entitled shareholders (depending on how the share capital of the FIC has been structured). In a worst-case scenario, where there is only one share class with dividend rights, a dividend of

£4.023 million would need to be declared across all shareholders, which would require the sale of five flats:

Image

	£m
Proceeds from flats	5.333
Less: corporation tax	(1.250)
Net proceeds	**4.083**
Dividend declared	(4.023)
Cash remaining in company	0.060
Properties remain in company (net of latent corporation tax)	8.167
Value of company	**8.227**

The value of the residuary estate would be calculated as follows:

Image

	£m
70% shareholding (undiscounted)	5.759
Cash received from dividend	2.816
Less: inheritance tax paid	(2.570)
Less: income tax on dividend	(0.246)
Cash remaining in estate	(0.000)
Residuary estate value	**5.759**

Additionally, the beneficiaries of the estate may be subject to further tax on the estate income of up to £861,200 (being 39.35% less the 8.75% paid by the estate), although there may be the opportunity for will planning to mitigate this. If the 10% shareholders are additional rate taxpayers, they would also each be subject to income tax of £158,310 on their dividends.

Option 3: Share buyback

Instead of paying a dividend to all entitled shareholders, the company could enter into an agreement to repurchase its shares up to the value required by the estate to pay the inheritance tax. As the FIC is an investment company, capital treatment would not be available on the buyback, and instead the estate would be subject to income tax at the basic dividend rate. Again, the beneficiaries of the estate may be subject to further income tax at the higher or additional rate.

Buybacks are inherently more complex than simple dividend distributions or liquidations, and the figures below are simplified for many of the nuances which would arise in practice, for illustration only.

This would require the sale of four flats:

Image

	£m
Proceeds from flats	4.267
Less: corporation tax	(1.000)
Net proceeds	**3.267**
25% buy back paid	(3.063)
Cash remaining in company	0.204
Properties remain in company (net of latent corporation tax)	8.983
Value of company	**9.187**

The value of the residuary estate would be calculated as follows:

Image

	£m
45/75 shareholding	5.512
Cash received from buyback	3.063
Less: inheritance tax paid	(2.570)
Less: income tax on buyback	(0.268)
Cash remaining in estate	0.225
Residuary estate value	**5.737**

As can be seen above, the route to paying the inheritance tax is not simple, particularly in cases where the FIC is invested in illiquid assets.

HMRC scrutiny and legislative risk

Even where the structure has been properly implemented, it is important to consider the ongoing risk of tax policy change or a change in the interpretation of current tax rules. These risks may not undermine every structure, but they increase the stakes. The decision to use a FIC or property company is not only a bet on future rates, but on the sustainability of the structure under scrutiny. A FIC set up today on the basis on current tax rates may look much less favourable in five or ten years.

Conclusion: betting wisely

For advisors, a FIC is something to discuss, an alternative to a trust and a way to provide some options to a client. However, FICs are not a one size fits all solution. While there are cases where a FIC can be an appropriate structure, advisers must remain cautious of overselling the long-term benefits without fully considering liquidity constraints, family governance and the potential for tax policy change.

Setting one up is akin to placing a series of bets: on future tax rates; on the performance of investments; on the ability of directors to manage the company; on the stability of legislation; and on the family to continue to have aligned goals.

Joanna’s case illustrates how an accidental FIC can trap wealth and create liquidity problems. Even for advised FICs, where structures are designed carefully, future tax charges, governance breakdowns or poor investment performance can quickly turn a calculated bet into a failure.

Financial planning, regular review and a clear exit strategy are important to establish what bet you are making.

Before setting up a FIC, ask:

- Do you need a company?
- Are you prepared for the long game?
- How will you fund the future inheritance tax bill?
- How will you manage the company?

Like any gamble, of course, a FIC might pay off, but only if you are sure that you understand the odds and are willing to live with the consequences. The best bet for many families is still the simplest: make outright gifts when you can afford to, use trusts where appropriate, and remember that doing nothing may sometimes be the wisest move.

Before recommending a FIC, advisers must be confident that it solves more problems than it creates, not just today but for generations to come.

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