2023/24

TAX PLANNING FOR FAMILY COMPANIES

Sarah Bradford

taxinsider
BUSINESS

Contents

'Tax Planning for Family Companies' – First published September 2021, second edition September 2022, third edition September 2023.

About Sarah Bradford

Sarah Bradford (BA) Hons, FCA, CTA (Fellow) is a Chartered Accountant and Chartered Tax Adviser. She is the director of Writetax Ltd, a company providing technical writing services on tax and National Insurance.

Sarah writes widely on tax and National Insurance. She regularly contributes to:

- Business Tax Insider;
- Property Tax Insider; *and*
- Tax Insider Professional.

She is also the author of:

- Tax-Efficient Ways to Extract Cash from Your Company;
- IR35 – Tax Tips for Contractors;
- Tax-Efficient Business Exit Strategies;
- Cash Basis for Landlords;
- Directors' Loan Accounts Explained;
- 101 Business Tax Tips; *and*
- 101 Practical Tax Tips.

All these guides are available for purchase from Taxinsider.co.uk.

1 About this guide

This guide looks at some of the tax issues of particular relevance to personal and family companies, both from the perspective of the company itself and the directors and shareholders behind the company. In particular, it explains the Corporation Tax charge on the company and outlines some tax planning strategies to minimise that charge in a legitimate fashion. It also explains how the company can obtain relief for any losses that it makes.

The guide also considers the role of the family company as an employer and sets out the company's obligations in this role.

Where profits are made by a family company, those profits must be extracted if they are to be used personally by the family members. The guide looks at various ways in which profits can be extracted from a family company and the associated tax implications and suggests a strategy for the tax-efficient extraction of profits. The guide also explains the concept of a director's loan account and the tax consequences that arise if the account is overdrawn.

Finally, the guide takes a look at what happens when the current family members wish to retire, highlighting some valuable reliefs that are available if the business is passed on to the next generation, or sold.

1.1 Introduction

Many businesses are operated as family companies, and while some sizeable businesses are family-owned, the vast majority of family companies are small companies. Many family businesses have been in existence for several generations.

When setting up a new business that is to be family-owned, it is important to consider the set-up in advance. Issues to be addressed include:

- Who will be the directors?
- How are the shares to be allocated?
- Will there be more than one class of shareholding?
- What rights will attach to each class of shareholding?
- What skills does the family possess?
- What skills does the family lack, and how is any skills gap to be plugged?
- How are family members to be paid?
- How is conflict to be resolved?
- How is the business to be passed on?

It is important to appreciate that the family company is a separate legal entity from the family that runs it, and business and personal matters must be kept separate.

The family company will pay Corporation Tax on its profits. The taxation of the company's profits is considered in Section 2. The company will also need to file accounts and an annual confirmation statement at Companies House and comply with company law requirements. Accounts must be filed within nine months of the end of the accounting period. The directors will also have legal responsibilities.

The company may have employees as well as shareholders. These may be family members but may also include other employees who are not part of the family. The family company will generally be an employer, even if this role is limited to paying small salaries to family members. Where this is the case, the family company will need to meet the tax and National Insurance obligations that go hand in hand with being an employer. These are discussed in Section 4.

If the family members wish to use the profits personally, they will need to extract these from the company and, depending on how the profits are extracted, this may trigger tax and National Insurance liabilities. Popular profit extraction methods include paying a salary or bonus and declaring dividends. However, there are also other ways in which profits can be used outside the company. The extraction of profits is considered in Section 5.

Most family companies are close companies (see Section 6.1). This will impose additional obligations on the company, particularly where there are outstanding directors' loans. These are discussed in Section 6.

No one lives forever or works forever, and if the family company is to continue in existence beyond the working lives of the existing directors and shareholders, consideration should be given in advance as to how the business is to be passed on to the next generation. Planning ahead is essential to ensure that valuable reliefs, such as business asset disposal relief (for capital gains tax) and business property relief (for inheritance tax), remain available. See Section 7.

1.2 Setting up a new company

If the family is thinking of starting a new business and plans to operate that business as a family company, it will need to set up the company – a process known as incorporation. The company must be created in accordance with company law requirements and registered at Companies House.

There are various routes that can be taken when setting up a company. The family can use the services of a third party, such as a formation agent, an accountant or a lawyer, to set the company up for them. If the family has not set up a company before and does not have experience in this area, this may be the preferred option; while this will be more expensive than setting up the company themselves, any associated advice that they receive may be invaluable.

Alternatively, the family can set up the company themselves. This can be done on the gov.uk website at www.gov.uk/limited-company-formation/register-your-company. A company can be registered online if it is limited by shares and it uses the standard articles of association (also known as the 'model articles'). This service costs £12 and the company is normally registered within 24 hours. The same service can be used to register the company for Corporation Tax and to register for PAYE. It is also possible to register a company by post using form IN01. The stated timescale for postal applications is eight to ten days and the service costs £40. You must use the postal route if you do not want 'limited' in the company name.

Practical tip

If the proposed structure is simple, the company can be set up online easily and cheaply.

1.3 Deciding on the share structure

When setting up a new company, one of the key decisions that must be made is the share structure of the company. The family will need to decide on the number and class of shares. In doing so, the family must comply with company law requirements and any restrictions in the articles of association. Detailed consideration of these matters is outside the scope of this guide, and it is advisable to seek professional advice.

The share capital is the total nominal value of the shares in the company, such that a company with 100 ordinary £1 shares will have nominal share capital of £100. This is not the same as what the shares are worth, which will depend on the value of the company.

The company can issue different types of shares. Normally, a small company will issue ordinary shares and may choose to have different classes of ordinary shares (such as A ordinary shares, B ordinary shares, etc.). This structure, known as an alphabet share structure, is popular as it allows for different dividends to be declared in respect of different classes of shares, which can be very useful from a tax planning perspective. The company can also choose to give different rights to different classes of shares, too. For example, the parents may have full voting rights, whereas children may be given shares with entitlement to dividends only. However, where shares have restricted rights, this may compromise the availability of business asset disposal relief if the company is sold (see Section 7.1).

Practical tip

Consider what share structure will work best for your family company with regard to what rights you want individual family members to have and what flexibility you wish to retain. Setting up an alphabet share structure at the outset preserves flexibility and allows for tax-efficient extraction of profits. However, when assigning rights and shareholdings, be mindful of the qualifying conditions for business asset disposal relief (see Section 7).

The company could also issue preference shares, which have a fixed right to dividends and no voting rights, although these are less common in a simple family company.

As well as deciding on the type of shares, the family needs to decide how many shares to issue and to whom. The authorised share capital places a limit on the number of shares that can be issued. The company does not need to issue all the shares that can potentially be issued – the shares that are issued form the issued share capital.

The company can decide how many shares to issue, as long as this is within