Family Business *Matters*

Autumn 2016

Discussing the things that matter to family businesses

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Welcome to **Family Business** *Matters*

David Emanuel
Partner

020 7665 0848
demanuel@vwv.co.uk

Welcome to the Autumn 2016 edition of Family Business Matters

Brexit has been the dominating theme in the UK over the Summer, and for many family businesses this has meant factoring in a new element to their strategic thinking. Amid the sometimes frenzied debate, calmer heads remind us that things seldom play out as badly as our worst fears, or perhaps as well as our best hopes.

We look forward to working with you to meet the challenges and explore the opportunities that the post Brexit world will present to family businesses.

Longevity can be one of the unique hallmarks of a family owned business. Over the course of a lifetime - or in the case of a family business that has been passed on through the generations, many lifetimes - there comes the confidence to respond to change and uncertainty in a calm and measured way.

As one distinguished historical example, in the Fleet Street office hallway of C. Hoare & Co (a family owned private bank founded in 1672), is a cabinet containing the flintlock rifles handed out to staff in 1780 to protect the premises during the Gordon Riots. No doubt to the great relief of the clerks, the rioters passed by and they were not pressed into action. Before and since then, the Hoare family business has successfully weathered many financial crises and wars.

Passing on your wealth to the next generation

The pros and cons of family investment companies

Trusts are traditionally the way in which families pass down wealth to future generations.

However since the changes brought in by the 2006 Finance Act, there have been big disincentives for those wishing to put more than £325,000 (value of the nil rate band) into trust. Investments above this level will now attract a 20% inheritance tax charge.

A tax efficient alternative to trusts

Family Investment Companies (FIC) are now emerging as a feasible alternative for those who are wanting to pass their wealth on in a tax efficient way.

An FIC is a private company where all the shareholders are members of the same family. The FIC will have articles of association, and these can be drafted to suit the needs of the family.

When is it fair to dismiss a family member?

Whilst in most cases a fair dismissal will fall squarely within conduct, capability or redundancy, where there has been an intractable relationship breakdown between family members, sometimes 'some other substantial reason' may provide a route to a fair dismissal.

Relationship breakdowns in the workplace are always difficult to deal with. However this can be particularly challenging for families working together within their family owned business, when the stakes and emotions run high.

The recent case of *Express Medicals v O'Donnell* addresses some of the issues arising in this area.

The facts

A minority shareholder was dismissed by the majority shareholder following a breakdown in relations between the two. The former friends had co-founded and worked together in the company over many years. They were the sole directors and shareholders.

In July 2014, the two fell out over a redesign of their website. This led to a subsequent heated exchange, during which the claimant alleged that the majority shareholder was a bully. There followed a period during which the parties discussed terms on which to part ways. When the claimant's employment was eventually terminated he sought to bring a claim for unfair dismissal.

The outcome

At the Employment Tribunal the judge found the dismissal to be unfair, deciding that no particular procedure was followed and therefore the decision did not fall within the range of reasonable responses. The judge did not go on to explain the deficiencies in the procedure, nor how this impacted on the reasonableness of the decision to dismiss.

On appeal to the Employment Appeal Tribunal (EAT), that decision has now been overturned and remitted to a fresh tribunal. The EAT held that there was insufficient explanation from the tribunal as to what deficiencies in the procedure were identified. It also criticised the judge's failure to assess the likelihood that, even if a fair procedure had been followed, the claimant's employment would still have been brought to an end.

Given the fractured nature of the relationship between the shareholders, this was something the judge needed to assess when considering the level of any award of compensation.

Best practice

Owners of family businesses may sometimes be faced with disputes between family members, or between family members and other employees. Alongside the working relationship that family members have, there is also the family tie which brings with it a high level of trust and emotion. As a result some disputes may lead family members to feel that they can no longer work together.

When it is simply not feasible to continue working together, and the breakdown in relations seriously impacts the performance of the organisation, a dismissal for 'some other substantial reason' could be considered. It must be stressed, however, that there is a high threshold to meet and a tribunal will expect employers to take all reasonable steps to resolve the problem in other ways. As ever, early intervention in disputes or disagreements is often the best solution.

Businesses should also be careful to consider why any relationship is alleged to have broken down, particularly where the root of the breakdown is, in actual fact, misconduct on the part of one or both family members or colleagues. In cases of differences of opinion, care should also be taken, especially if the difference relates to some form of protected characteristic which could give rise to claims of discrimination.

For more information, please contact Michael Halsey on 020 7665 0842 or at mhalsey@vwv.co.uk

For example, they can be drafted to allow the donor to retain some control over the company. The articles of association and memorandum are public documents. You could consider a Shareholders' Agreement for more sensitive terms as this can be kept private.

What are the advantages?

Corporation tax savings

The donor usually funds the FIC with a loan which can be repaid from profits free of tax. Other family members are the shareholders and often different classes of shares are created to meet the needs of different family members. Profits (once any loan is repaid) are taxed at corporation tax rates (20%). These are set to be reduced to 17% in 2020.

Inheritance tax savings

When shares are gifted they are treated as a potentially exempt transfer and so there is no immediate charge to inheritance tax. As long as the donor survives seven years, they will fall out of their estate for inheritance tax purposes.

Income tax savings

There are no restrictions on the class of assets in which the FIC can invest. Dividends on equities can be received by the FIC free of tax. Income usually paid in the form of dividends, can roll up tax free inside the company, as no income tax is payable until income is paid out. The new tax rules mean that the first £5,000 is free of tax.

Practical incentives

FICs can be a very good way to pay university fees and living expenses for student offspring. Whilst the income of minor children is taxed at the parents' rate, children over 18 can receive income up to the personal allowance without paying tax.

FICs and divorce

In the event of a divorce the 'corporate veil' will not be pierced, meaning that if a divorcing spouse asks the court to transfer funds to them from the FIC, the court may refuse to do so.

What are the disadvantages?

If non-cash assets are transferred into an FIC then capital gains tax and stamp duty land tax will be payable. And when assets are transferred out of the FIC there will be income tax to pay, effectively meaning that there is double taxation.

It is of course very important to take advice before setting up an FIC. However for the right family they can be a tax efficient choice.

For more information, please contact Angharad Lynn on 020 7665 0904 or at alynn@vwv.co.uk

5 steps to selling your family business

If passing on the family business to the next generation is not an option for you, selling to a third party, including non-family managers, may be the solution.

However experienced you may be, the decision to sell should not be taken lightly. Continuing to run your family business whilst engaging in a sale process will test your reserves of stamina, patience and resilience.

So what is typically involved when selling a business? What are the key issues, procedural steps and documentation you are likely to encounter?

Preparing for sale

Is everyone who needs to be on board with the decision to sell? Confidentiality concerns can make it difficult, but where possible, family stakeholders, even if they are not current shareholders, should know about the plan.

Take financial and legal advice at the outset on issues such as valuation and price expectations, how you approach prospective buyers, pre-sale legal audits, and protecting confidential and commercially sensitive information. Make your advisers part of the team - they can shoulder a lot of the burden if you let them.

Heads of Terms

The parties will usually sign Heads of Terms (sometimes referred to as a Letter of Intent or Memorandum of Understanding) following an initial period of negotiation, which outline the key commercial terms and structure of the deal.

Heads of Terms are not usually legally binding (except for elements like confidentiality and exclusivity) but they should set a clear framework for the commercial deal which neither side should expect to withdraw from without very good reason.

Due diligence

Due diligence is the process by which a buyer investigates financial, legal and commercial aspects of the target business to ensure it has enough information to understand risk and justify price before finally deciding to proceed with the sale.

Many first time sellers find the due diligence exercise far more time consuming than they ever imagined, and it can be a real test of patience, as the buyer presses you to prove what you have told them, and explain what you may regard as obvious.

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Negotiating transaction documents

For reasons of timescale, these are often progressed alongside the due diligence exercise.

The key document will be the acquisition agreement, whether you are selling the shares in a business, or its assets.

A typical acquisition agreement may run to 100 pages or more. The operative provisions (which transfer assets or shares) may only cover two of those pages and most of the rest will be about apportioning risk between buyer and seller on issues such as:

- Price adjustments, if key valuation assumptions on which price has been based prove incorrect.
- Is some of the price dependent on future performance (earn outs)?
- If there is a time lag between exchange and completion, in what (if any) circumstances can the buyer still withdraw after signing?
- Warranties - contractual statements about the business (for instance ‘there are no employee claims’) which can give rise to a contractual damages claim if untrue.

Completion and the future

Completion is the point at which the sale is legally concluded, with shares or assets transferring to the buyer in consideration of cash, shares or other assets paid to the seller.

Even if the seller has been paid out in full, there will usually be a period - typically two years for general warranties and up to six years for tax warranties - when there is a risk of claw back if warranties are breached.

You will need to prepare for a future outside a business that you may have spent a long time working in. It will probably feel very strange - some clients talk of an empty feeling. You should also take steps to protect wealth created on sale, and ensure you have funds available to pay any tax due.

We regard guiding the family through the process as key to our role when acting on any sale or acquisition.

For more details on selling your family business or buying a business, please contact David Emanuel on 020 7665 0848 or at demanuel@vwv.co.uk

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