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MAKING IT HUMANLY POSSIBLE

Family Business update: the perils and pitfalls of "Keeping it in the Family"

It is inevitable that when an individual or a family has devoted a lot of time and effort in developing their business or enterprise, they will wish to pass on the fruits of what they have achieved to the next generation. Just ask President (at the time of writing) Mubarak. But any desire to benefit the next generation through a seamless succession is meaningless without careful planning, and without the flexibility to address unexpected events (be they widespread public demonstrations against your rule, or something a little more low-key).

Two recent cases have served to illustrate some of the dangers that can be associated with succession planning for a family business that has been less than comprehensive.

The first case is *Vinton v Fladgate Fielder* [2010] EWHC 904 (Ch) which illustrates the extent to which it is important to keep estate planning constantly in mind, not only when preparing the Wills of the current owning generation, but also in making other commercial arrangements in relation to the business.

Wilton Antiques Limited ("Wilton") was a company that belonged to the Dugan-Chapman family. Matters began to unravel after the death of Mr Dugan-Chapman. At that time his daughters Anna Vinton (Mrs Vinton) and Jennifer Green (Mrs Green) held 506,500 shares in the business. His widow, Mary Dugan-Chapman ("the Widow") held 750,500 shares and Mrs Vinton personally held 1,244,000 shares. At that time the widow was the sole surviving director. She had an outstanding loan due from Wilton to her of £300,000. Although the company did not have cash it did hold significant stock principally valuable paintings.

In the autumn of 2002 the private client department of the defendant solicitors were acting in relation to the estate of the late Mr Dugan-Chapman and were seeking to obtain a grant of representation for the executors, Mrs Vinton and Mrs Green. The corporate team from the same firm was acting for the business in relation to certain restructuring issues.

In late 2002 the executors met with the representatives of both departments and it was agreed that the loan to the Widow would be converted into equity (which would eliminate the risk that in the event of the Widow's death her loan would be called in and Wilton would be obliged to sell stock at a low point in the market in order to effect repayment). The conversion of the loan into equity would also have the advantage that, whereas the loan would be valued in her estate at £300,000, shares in Wilton would be subject to business property relief, so there would be an inheritance tax saving.

A rights issue of 999,733 shares at £1 each took place on 23 December 2002. The Widow was allotted 300,000 shares and she took up her allotment accepting it in satisfaction of her loan account. Mrs Vinton and Mrs Green as executors took up the allotment of 202,465 shares to which the estate of the late Mr Dugan-Chapman was entitled.

497,268 shares were allotted to Mrs Vinton personally under the rights issue, but it was never intended that she should take them up. Instead she signed a letter of renunciation in favour of the Widow, who took up this allotment using funds from her free estate.

At that point it was decided to raise a further £1 million for Wilton. Unfortunately, however, rather than utilising the mechanism of a rights issue the solicitors proceeded by way of an offer of shares for subscription. The Widow subscribed for all the shares on offer, paying for them using £1 million from her free estate. She did so in the belief that they would attract business property relief (so that what would otherwise be £1 million in her free estate would be converted into shares attracting inheritance tax relief). This was on 27 December 2002.

Even more unfortunately, two days later on 29 December 2002 the Widow died.

The usual rule is that business property must be retained for two years before it attracts relief from inheritance tax. The only exception is if the shares owned can be identified with other shares previously owned by the same person, and those other shares had been held for at least two years prior to death. Consequently, the 300,000 originally allotted to the Widow, which were allotted to her by virtue of her existing share-holding, also attracted business property relief. But the shares that the Widow acquired on the renunciation by Mrs Vinton of her rights, together with the shares which the Widow acquired under the offer for subscription were not acquired by her in right of any existing holding of hers, they were simply acquired by her for reasons entirely unconnected with her existing holding.

The result of all of this that the estate was chargeable to an additional £359,344 chargeable as inheritance tax upon the 1,497,268 shares acquired by the widow in respect of which no business property relief was available.

The second case of relevance to family businesses is *Mason v Mills & Reeve* [2011] EWCA Civ 14. Mr Swain had built up a very successful business and was 72% share-holder in a group of companies in which each of his four daughters also held 5.3% of the shares. Two of his daughters were also employed by the business.

During 2006 Mr Swain had negotiated a management buy out of his business. He was at that stage sixty-one years old and had a history of heart problems. His shares and those of his daughters were to be bought out by the current management of the business. This transaction was due to complete in January 2007. Shortly after the due completion date, Mr Swain was scheduled to have a routine surgical procedure in relation to his heart condition. The completion went ahead and two weeks later Mr Swain unexpectedly died during his surgery.

The case came before the Court as a claim of negligence against Mr Swain's solicitors, on the basis of an allegation that they ought to have taken into account his impending surgery in advising on the timing of completion of the MBO. In the circumstances of the case as it developed that point has yet to be determined, but the reasons for seeking to bring the claim are a good illustration of the points that family businesses need to keep in mind.

If, contrary to what actually happened, Mr Swain had died prior to completion, he would still have held the shares in the business at the time of his death and this share-holding would have attracted business property relief. Furthermore, there would have been a deemed disposal of the shares for capital gains tax purposes as at the date of death, with the result that if his executors had then completed the transaction shortly after his death, CGT would only have accrued on the increase in value of the shares between the date of death to the date of disposal.

According to the case report, the total value of these adverse tax consequences was said to be in the region of £1.3 million.

No-one likes to think about their own mortality, and business people are just as susceptible to this as anyone else. Nevertheless, for those businesses wanting to "keep it in the family" these cases demonstrate the vital importance of always anticipating the worst, if the business's best interests are to be protected.

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This Article states the law as at 1 February 2011. It is, however, provided for general guidance only and the author accepts no responsibility for any reliance placed upon that general guidance in specific circumstances. If you want to know more about personal or corporate tax planning issues please contact Patrick on the details above.

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