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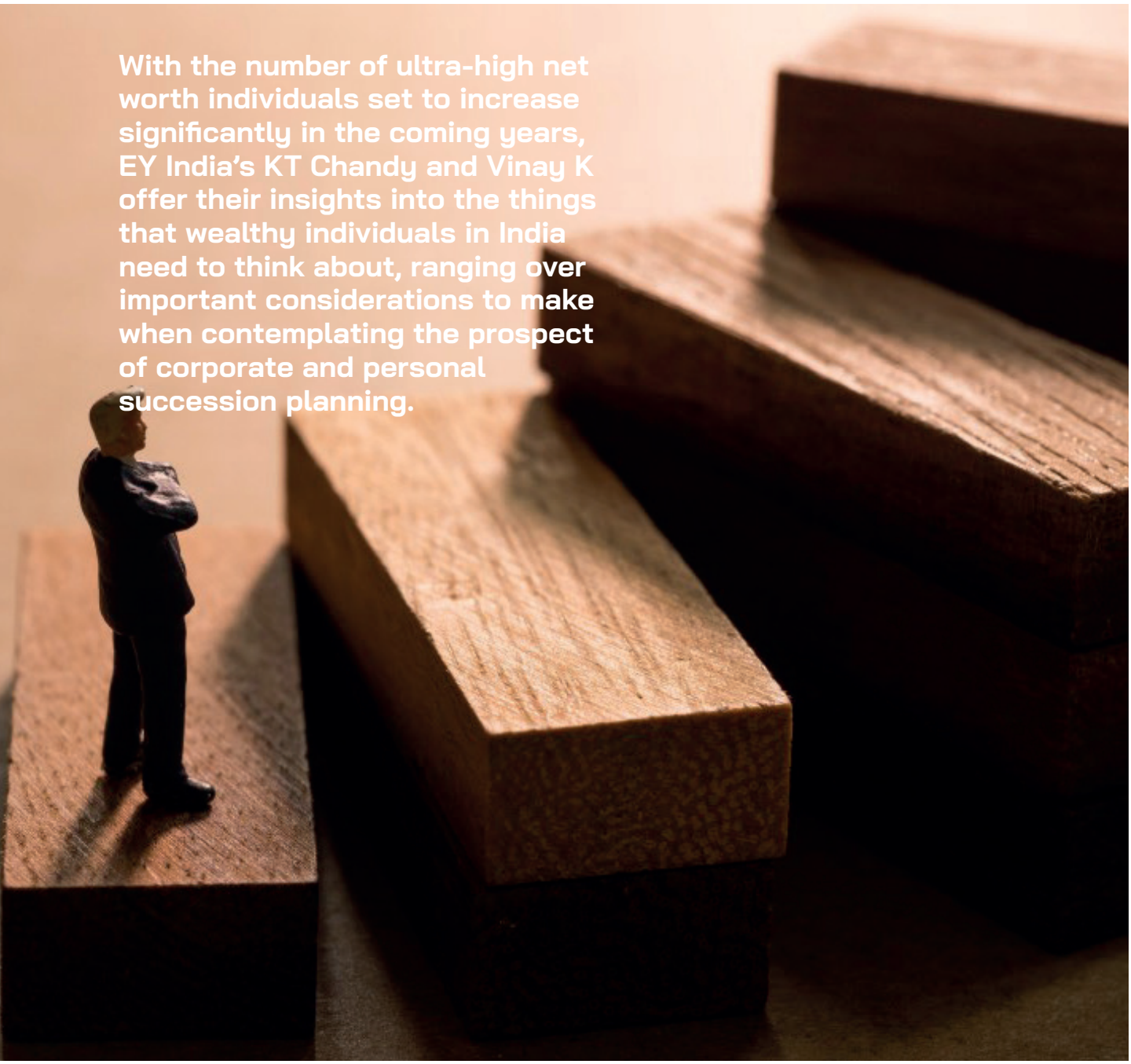
Aspects to be Considered for an Effective Succession Plan



With the number of ultra-high net worth individuals set to increase significantly in the coming years, EY India's KT Chandy and Vinay K offer their insights into the things that wealthy individuals in India need to think about, ranging over important considerations to make when contemplating the prospect of corporate and personal succession planning.

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Ultra-high net worth Individuals [1] ('UHNIs') are expected to grow by 73% over next five years. With the history of large family business houses operating in India, especially post liberalisation, and emergence of a new class of entrepreneurial HNIs, there is an increased need for succession planning more now than ever before.

If Indian corporate history is anything to go by, large business groups have either seen their businesses split through murky battles of succession issues (often in the public eye), or very rarely through a muted and amicable succession planned through a structured approach.

Troubled succession plans, even when resolved can lead to a pyrrhic victory with the bone of contention - i.e. prized family businesses - suffering almost in an irrecoverable manner while the resolution plays out. Therefore, it is extremely important that the aspect of succession planning is not acted on through some rite of passage but an actively thought through endeavour.

Multiple set of dynamic factors are at play in such an endeavour, which include complex inter-generational relationships, entangled ownership structures, diverse businesses, retaining control, managing dispute, overseas residency, citizenship issues and tax matters. Devising an efficient succession structure which addresses all these aspects, without compromising on business continuity therefore plays a vital role.

In this article, we have focused to shed some light on some of the key aspects to be considered and evaluated for a smooth and an effective transition of wealth from one generation to another.

Broadly, the decision making matrix would include the following categories:

1. Strategic consideration
2. Succession law in India
3. Indian exchange control regulation
4. Taxation

The role and importance of each category in an effective succession planning have been briefly discussed in this article.

1. STRATEGIC CONSIDERATION

While considering succession options, the following aspects play an important role in decision making:

Flexibility:

Choice of structure [*Will or Partnership/ LLP or Trust*] plays a vital role in effective succession planning.

- A will involves the declaration of a person's wishes regarding the disposal of his estate post his death. The peculiar feature of a will is that it takes effect only upon the death of the testator.

- While a partnership firm is more of a legal structure to hold assets and run businesses, many families have used partnerships to keep the family members together in joint family business. The deed of partnership which defines the rights, obligations and relations inter se the partners, usually contains provisions relating to death of partners and how their share of partnership is dealt with. However, while the legal heirs of a deceased partner are entitled to his share (including share of goodwill) in the firm, they are not automatically entitled to be inducted into the partnership, without the consent of all the other remaining partners.

- A trust, especially a discretionary one, offers more flexibility as compared to a Will or Partnership structure.

- For example, a Trust allows to provide appropriate benefits to different family members at different points in time, taking into account changing necessities, opportunities, etc., and also taking into account contributions made by such members for the well-being of the family and for the growth of family businesses (if any);

- Further, in the context of business succession, it allows flexibility to take various factors into account in determining how change in management should be effected and how management responsibilities should be divided among family members and independent professionals (if contemplated).

Ring fencing:

- A trust structure offers several advantages, not the least of which is ring fencing of assets against possible losses due to business liabilities, family related liabilities arising out of divorce, maintenance claims, tax claims,

[1] According to Knight frank report 2020

re-introduction of estate duty in India, and / or actual or potential creditors.

Engaging external and independent persons:

- Considering the risk that any family member or friend may tend to become biased in favour of / against some family members, there may be a preference to appoint an unbiased independent person for acting as the executor (in case of a Will), as the trustee (in case of trust), etc.

- Of late, there has been a steady growth in institutions providing such services. Depending on the objective and nature of discretion required to be exercised by the executor, trustee, etc., and on cost-benefit analysis, one may consider appointing such service providers.

Degree of control:

- The decision on whether or not and the extent to which one wishes to exercise control over one's property is often an important factor. For persons who wish to retain ***absolute control over their property*** during their lifetime, a Will may be preferable and if appropriate, a trust structure may be created through a Will.

- For persons who are willing to ***part away with ownership while retaining the ability to exercise some level of control***, they may consider the option of setting up a revocable trust or setting up an irrevocable trust where they or a private trust company (set up by the family) act as the trustee, etc.

- For persons who are ***willing to part with ownership and control subject to checks and balances***, they may set up an irrevocable trust with an institutional trustee and with terms and conditions they consider appropriate. Institutional trustees often maintain close contract with the settlor to understand the intentions underlying the creation of the trust and exercise their discretion in a balanced manner.

Manner of dispute resolution:

- Often there is a preference, both on the part of the family members and on the part of the trustee to resort to arbitration for various reasons, including, confidentiality vis-à-vis family disputes, timely resolution, ability to appoint arbitrators who understand nuances regarding the family and the role played by institutional trustees, etc.

- For trust disputes to be arbitrable in India, a statutory amendment to the Indian Trusts Act appears to be necessary.

- Meanwhile, parties could consider mediation and conciliation of disputes as alternative remedies.

Cost:

- Stamp duty implications, annual costs of having institutional trustees, etc., also play an important role.

2. SUCCESSION LAW IN INDIA:

Succession laws in India are diverse and depend on:

- The personal law of the deceased, which in turn is largely based on their religion; and

- The nature of the assets.

Owing to the multiple laws applicable to persons of specific religions, determining the relevant succession regime can be more complicated in India than in other common law countries.

Within this broad regime, succession laws vary depending on whether succession is intestate or testamentary.

Interstate succession

'Intestate succession' occurs when the deceased does not leave a will in respect of their assets.

The rules of intestate succession vary based on the personal law applicable to the deceased, which is based on the deceased's religion. For Hindus, Jains, Buddhists and Sikhs, the rules set out in the Hindu Succession Act 1956 (HSA) apply.

For Muslims, the law is uncodified and is based on principles of Sharia, which are further divided into rules applicable to various sects and subsects.

The Indian Succession Act 1925 (ISA) applies to both Christians and Parsis.

Testamentary succession

- The rules for testamentary succession are significantly less complicated than those for intestate succession. The ISA applies uniformly to wills of persons of all faiths, other than Muslims.

- Therefore, concepts of capacity, formal validity and essential validity of the wills of Hindus, Sikhs, Jains, Buddhists, Christians and Parsis are contained in the ISA.

Uniform civil code

■ The endeavour to enact a code which will unify and simplify India's succession laws has been long debated in the Constituent Assembly. There is also a notion that the present framework is too complex and results in inequality.

■ The solution proposed is the enactment of a uniform civil code to deal with not only inheritance matters, but also all aspects governed by personal law (eg, marriage, divorce, adoption and guardianship). Therefore, while one is not aware of whether/if the civil code would come into force, this aspect also needs to be borne in mind wherever applicable.

3. INDIAN EXCHANGE CONTROL REGULATION:

In India, exchange control laws are applicable to investment (equity / debt / otherwise) by non-residents in businesses and properties in India and vice versa (i.e., investment by residents in businesses and properties outside India). Exchange control laws also govern remittance of funds by residents and non-residents from India.

From a succession planning perspective, these considerations becomes critical where family members, businesses, properties, etc., are spread in different jurisdictions or such a probability exists in the future.

If a promoter (resident / non-resident) wishes to set up a trust in India, if the trust is proposed to have non-resident beneficiaries, from an exchange control perspective, to determine whether such trusts are permissible, it would be important to evaluate the nature of assets the trust is expected to hold (especially, investment in equity or in properties which are not permitted under the exchange control laws vis-à-vis such non-resident beneficiaries), type of trust (revocable or irrevocable; determinate or discretionary), the nature of benefits envisaged for the beneficiaries (in specie distribution of assets or only monetary distributions), etc., and the manner in which the non-resident beneficiaries may be able to utilise distributions received from the trust or remit the proceeds outside India.

Given the complexity involved, it may also be preferable to create separate succession planning structures - (i) for Indian assets with Indian residents as beneficiaries and (ii) for offshore assets with non-residents as beneficiaries, with both structures operating in parallel and in such a manner that effectively similar benefits are given to beneficiaries under both trusts.

4. TAX CONSIDERATIONS:

In the recent past there has been a debate on the possibility and consequence of re-introduction of estate duty in India.

Tax implication would depend on the nature of Trust [Revocable or irrevocable].

Gift tax implication – India has introduced gift tax in the hands of the recipient of certain assets subject to certain exemptions. While transfer to a blood relative should normally be exempt, interposing a governing mechanism through trust/any other vehicle may lead to some unintended tax impact which should be considered to avoid tax on notional attributed income.

General Anti-Avoidance Rule ("GAAR") - These provisions target arrangements whose "main purpose" is to obtain a tax benefit by way of either misuse or abuse of provisions of the Income-tax Act, 1961 or lacks commercial substance or is not at arm's length or is not bonafide.

While succession planning has a larger commercial rationale, since the tax considerations go into the building of a robust structure, one needs to ensure that a strong commercial defence/rationale of the on the structure and individual aspects are articulated in the documents.

Given that assets, individuals could be spread over two or multiple countries, the impact of double taxation on both the asset and the income should be considered. In certain cases, although tax credits are available there could be situations where the tax trigger could be at different points of time leading to an unintended cash pay-out.

In case person is domiciled of any other country (e.g. UK or USA), the impact of inheritance tax should also be factored. ■

CONCLUSION

Given the specific facts, objectives and complexity involved, it is pertinent to stitch together an ideal structure to align with the end of objective of succession of business and personal wealth of a promoter/HNIs in an efficient manner. ■