Family offices: A growing concept in India

by Shashwat Sharma and T. P. Janani, Nishith Desai Associates

In this article, we discuss the concept of a family office, its role and benefits in the Indian context, important considerations relevant in setting up a family office, disclosure obligations in case of succession planning structures set up outside India and important precautions to be taken in the context of general anti-avoidance rules, which are slated to come into effect from April 2017.

A family office generally refers to an organisation which provides private wealth management advice, fiduciary services (like acting as trustees) and services related to handling club memberships, family holidays, etc., to High Net-worth Individuals (HNIs) and their families. The modern day concept of family offices started in the 19th century with wealthy businessmen such as J.P. Morgan setting up offices to take care of their family assets.

A family office can be characterised either as a Single Family Office (SFO) if it caters only to the needs of a particular family or as a Multi-Family Office (MFO) if it provides such services to multiple families. SFOs are generally set-up by the family members themselves (though they may seek guidance from external advisors as well) while MFOs generally comprise external advisors. A notable example of a family office which started off as a SFO but later became a MFO is Rockefeller Financial Services. It was set-up by John D. Rockefeller to manage his family's business and philanthropic pursuits, but now advises multiple families, including the illustrious Rothschilds.[1]

Typically, family offices are not as pervasive in developing countries as they are in the developed world. This could be attributed to relatively higher proportion of HNIs situated in the developed world as opposed to the developing world. With the economy being opened up more and more and with increasing opportunities brought about by technological developments, India is fast catching up and according to the Asia-Pacific 2016 Wealth Report, by New World Wealth, at the end of 2015, India had around 236,000 HNIs[2]. The report also adds that India is expected to see a 105% growth in its HNI population.[3]

With this rise in the number of HNIs in India, in the past few years, the wealth management industry in India has also been continuously evolving to bring their products and services at par with international trends and we can observe a more organised industry today. Some prominent examples of family offices being used as investment vehicles include Azim Premji's PremjiInvest and Narayan Murthy's Cataraman Investments Pvt. Ltd. However, in general, their use in wealth or succession planning is not common in India. This may be attributed to the fact that much of the wealth generated in India post the 1991 liberalisation is still controlled by the first generation. However, around US$128bn is expected to change hands through inter-generational transfers in India in the coming decade.[4] This makes India an attractive destination for service providers and advisors in the succession planning space.

Functions of a family office

A family office facilitates aggregation of cash flows generated by the family business in an optimised manner and utilisation of such funds in investment opportunities more holistically. In India, the Patni brothers have demonstrated this advantage by channelling investments through the family-owned RAAY Global Investments.[5]

A family office can also serve as an apparatus for family and business governance and providing administrative services such as clearing bills and obtaining legal advice. Establishing rules for succession of management roles of business is very important for sustaining and accelerating business growth upon entry of second, third and subsequent generations and also for protection of intellectual property rights (as there is a risk of such rights ceasing to exist).

Also, both in the case of business assets and other assets, a family office becomes vital where there are multiple decision makers in a family who are placed in different jurisdictions and are separated by long distances and time zones. Setting up a family office also helps in achieving strategic objectives such as providing for contingencies like illness/ accidents, the care of dependents, philanthropic pursuits, etc. Perhaps most significantly, a family office platform allows for the synchronisation of business considerations with personal succession goals and also allows for developing mechanisms related to dispute resolution, which becomes important as it is likely that plans of younger generations may not correspond with those of their previous generation. Particularly in an Indian context, litigation is still an extremely time-consuming and expensive exercise and alternative dispute resolution mechanisms have become highly important. One or more of the following dispute resolution mechanisms may be considered:

i. discussions between the disputing family members, with an intention to resolve their disputes;
ii. mediation, conducted by a family member/ independent mediator held in high esteem by both parties; or
iii. arbitration with an arbitrator appointed by mutual agreement.[6]

As members of a family spread their presence across different jurisdictions, the relevance of succession planning becomes highly pronounced due to the possibility of differences in lifestyle, priorities, opportunities, etc., and due to the possibility of conflict between legal systems of such jurisdictions. In light of exchange control limitations in India, depending on how succession planning is structured, it could provide more flexibility for investing and divesting in offshore assets and for making distributions to family members spread across different jurisdictions.

Arbitrability of trust disputes

While India has steadily been moving towards a regime favourable towards arbitration, there is an ambiguity regarding the arbitrability of disputes arising out of trust structures due to conflicting judicial decisions on this point. The Delhi High Court has held in the case of *Ms. Chhaya Shriram v. Deepak C. Shriram*,[7] that disputes involving beneficiaries are not mandatorily required to be submitted to arbitration. The court reasoned that benefits which a beneficiary becomes entitled to under a trust structure arise not out of any contract between him and the trustee and the settlor but rather because of the desire of the settlor. The trust deed is not a binding contract between the settler and the beneficiary, or between the beneficiaries and hence, disputes involving beneficiaries are not mandatorily required to be submitted to arbitration. Interestingly, the Delhi High Court also applied the same logic to disputes arising between legatees of a Will to hold that the legatees are not mandatorily required to submit their disputes to arbitration.

The Bombay High Court also considered this issue in the case of *Mr. Jayesh Dinesh Shah v. Kaydee Family Trust*,[8] but arrived at a different conclusion. A clause for resolution of disputes "*between the Trustees, or the Trustees and beneficiaries, or the beneficiaries inter-se*" by way of arbitration was incorporated in the trust deed. The Bombay Court held that the beneficiaries who had been identified in the trust deed were also to be treated as parties to the arbitration agreement. The Bombay High Court took this view, even though the beneficiaries were minor at the time of execution of the trust deed and hence, lacked the competence to enter into a valid contract.

As there are conflicting judicial pronouncements from coordinate benches of different High Courts on the issue, ambiguity will persist until a position in this regard is articulated by a judgment of the Supreme Court of India. With respect to multi-jurisdictional succession planning, the issue of whether beneficiaries can be bound by/seek the benefit of arbitration clauses in a trust deed would need to examined as per the laws relevant to arbitration in the jurisdictions involved. In practice, several trust structures in India and abroad are currently being set up with arbitration clauses covering potential disputes between the trustees and some / all beneficiaries, or between the beneficiaries inter-se, as there is generally no down side to inclusion of such clauses.

Further, in light of the possibility that dispute resolution mechanism may be unsuccessful in resolving any dispute, it could be useful to include a framework for exit in the governance documents to mitigate protracted and bitter confrontation among family members. The family members may agree upon a period during which any party which decides to exit, may choose to alter his or her decision. Such a cooling-off period could increase the likelihood that decisions regarding spilt of business, assets or otherwise are adequately deliberated upon and are not made in haste.

Setting-up a family office

A family may set-up a SFO if it has/is expected to generate business or other assets which make the set-up of an SFO both relevant and economically viable (having regard to the costs involved). Alternatively, a family may engage a MFO to advise on setting up a suitable structure to achieve its succession planning goals. Since MFOs pool money from multiple families, it allows them to achieve economies of scale as expenses are shared and they have a larger pool of capital for making investments.

There are various considerations which become relevant while drawing up a succession planning structure. These include the long-term investment objectives and vision of the family concerned, the risk appetite, the anticipated future requirements of different branches of the family, applicable legal, regulatory and tax regimes of various jurisdictions involved, etc.

In India, there are various options for setting up family offices (for example, private company, limited liability partnership and trust). Generally, the trust structure is preferred due to the flexibility it offers. There are also different options available for appointing a trustee. A popular, but slightly expensive option is to use a Private Trust Company (PTC). A PTC is set-up by family members with the sole purpose of acting as the trustee for a family office structured in the form of a trust. Since a company has a separate legal personality, having a PTC as trustee offers several benefits such as ring-fencing potential liabilities that may arise for breach of fiduciary duties as a trustee, flexibility to onboard independent professional managers for management of the trust (as employees of the PTC) with the family members having overall control over the operations of the PTC in their capacity as shareholders.

Disclosure obligations

Individuals who are resident in India are required to disclose all assets held by them (including financial interest held by them) outside India and signing authority held by them for any account located outside India. Such disclosure is required to be made as part of tax returns filed every year. In case of trusts set up outside India, disclosure is required to be made in the following circumstances:

(a) if the resident individual is the settlor of the trust;

(b) if the resident individual is the trustee of the trust; or

(c) if the resident individual is the beneficiary of the trust and if either the trust is a determinate trust (where the shares of the beneficiaries are pre-defined) or if the trust makes distribution during the relevant year for which tax returns is being filed.

Non-disclosure of such information is subject to stringent provisions. Under the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015, 30% tax is levied on undisclosed foreign income (UFI) and undisclosed foreign assets (UFA) held outside India. Further, penalty up to three times the tax liability is also levied. UFI encompasses income from foreign assets which has not been disclosed under applicable tax returns under the Income Tax Act, 1961. UFA refers to an asset (including financial interest in any entity) located outside India, held by a taxpayer in his name or in respect of which he is a beneficial owner and he has no explanation about the source of investment in such asset or his explanation is not to the satisfaction of the revenue authorities.

Rigorous imprisonment for a minimum period of six months and a maximum period of seven years along with fine, has been prescribed for furnishing any false information in any verification with respect to foreign income and assets. Further, similar penalty has also been prescribed for those found to be abetting such furnishing of false information. In the context of the fund managers or wealth advisers engaged by the families, this becomes important as it is presumed that the accused had the intention, motive or knowledge of a fact or belief in, or reason to believe, a fact to commit an act considered an offence under this law. The onus to prove non-culpability beyond reasonable doubt is shifted to the accused.

On a related note, the present Central Government has been continuously taking various steps towards information exchange with other jurisdictions. For this purpose, the Government has been renegotiating India's tax treaties to include express provisions for information sharing. The Government has also signed the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information and the Intergovernmental Agreement with the US to implement the Foreign Account Tax Compliance Act (FATCA). Therefore, the Government is expected to obtain a lot more information relating to assets held by its residents in various jurisdictions than previously seen. There is growing concern on how such information would be used and processed and whether there could be reputation issues or unwarranted harassment faced by taxpayers who may have set up legitimate structures outside India. The recent Panama Papers incident is one such example and it is expected that there would be many such instances going forward.[9]

Applicability of General Anti-Avoidance Rules

In line with emerging international focus on curbing tax avoidance, India has enacted certain General Anti-Avoidance Rules (GAAR) as part of the income tax law conferring powers on tax authorities to investigate and declare an arrangement as an "impermissible avoidance arrangement". Upon such declaration, tax authorities have been empowered to disregard or re-characterise such structures and adopt a "look through" approach to determine the real nature of the arrangement. The tax authorities may also deny benefits conferred under an applicable double taxation avoidance treaty. An "impermissible avoidance arrangement" is an arrangement entered into with the main purpose of obtaining a tax benefit and satisfying one or more of the following: (i) non-arm's length dealings; (ii) misuse or abuse of the provisions of the domestic income tax provisions; (iii) lack of commercial substance; and (iv) arrangement similar to that employed for non-bona fide purposes.

Since its introduction, commencement of applicability of GAAR has been deferred multiple times and is now slated come into effect from April 1, 2017. In view of the announcement of the Finance Minister in the course of his speech for the 2016 Budget, no more deferrals are expected. Also, during his speech for the 2015 Budget, the Finance Minister announced that investments made prior to April 1, 2017 will be grandfathered from the applicability of GAAR and that rules will be issued in this regard. However, such rules have not yet been issued.

In the context of succession planning and family office structures, to mitigate risk of invocation of GAAR, all documentation (especially trust deeds, minutes of meetings, websites, disclosures and filings before Indian regulatory authorities, etc.) should clearly and consistently reflect the commercial objectives of the structure, wherever appropriate.

Notes:

1 "Rockefellers' family office comes of age", June 1, 2012, http://www.ft.com/cms/s/0/3d461a76-ab4e-11e1-a2ed-00144feabdc0.html#axzz44pKCrpzL.

2 For the purposes of this report, HNIs (millionaires) were defined as those individuals with net assets of US$1m or more.

3 "India home to 2.36 lakh millionaires: Report", January 19, 2016, http://www.businesstoday.in/latest/trends/india-home-to-2.36-lakh-high-net-worth-individuals-millionaires-says-asia-pacific-2016-wealth-report-by-new-world-wealth/story/228321.html

4 "Markets and Markets: Indian Family Offices Are Expected To Reach 940 in Number Till 2015", http://www.marketsandmarkets.com/PressReleases/ultra-hnwi-family-offices.asp

5 "How family office kept Patni brothers Arihant & Amit together", June 19, 2014, http://economictimes.indiatimes.com/magazines/panache/how-family-office-kept-patni-brothers-arihant-amit-together/articleshow/36804604.cms

6 It may be desirable to have each party appoint an arbitrator, and have the two arbitrators select a third arbitrator. This would avoid deadlock in appointment of the sole arbitrator.

7 150 (2008) DLT 673

8 Arbitration Application 278 of 2012.

9 "Panama Papers: Arun Jaitley responds to Indian Express story, says 'such adventurism extremely costly'", April 4, 2016, http://indianexpress.com/article/india/india-news-india/panama-papers-arun-jaitley-indian-express-offshore-accounts/

Authors:
Shashwat Sharma, Associate
T. P. Janani, Senior Associate
Nishith Desai Associates
93-B, Mittal Court
Nariman Point
Mumbai 400021
India
Tel: +91 22 6669 5178; +91 22 6669 5160
Fax: +91 22 6669 5001
Email: shashwat.sharma@nishithdesai.com
tp.janani@nishithdesai.com
Website: www.nishithdesai.com