Succession planning for family businesses

December 2024

Introduction

In the circle of life, succession is certain and inevitable. It is a process that ensures continuity of the family legacy, empowers the next generation and strengthens family bonds, thus creating a sense of belonging amongst the next generation. The process aims to achieve peace and harmony amongst the generations to come and parallelly ensures business growth without disruptions. Given the high importance of succession planning, the first step is to start well in advance the expected transition. This allows time to address potential issues and ensures that the transition is smooth. Without a clear succession plan and roadmap, many business families with multiple members (sometimes across generations) face conflicts within the family – primarily on account of factors such as lack of clarity on roles and responsibilities of members, want of decision-making power, and contribution in the business vis-à-vis the entitlement to remuneration. These factors can create feud within the family and potentially threaten the business's survival.

While 9 out of 10 publicly traded companies in India are family owned or controlled, only 63% of Indian family business leaders say they have formal governance structures in place, including shareholder agreements, family constitutions and protocols, and even wills.[1]

Therefore, in order to overcome the above issues, a successful succession plan can be divided into the following two parts:

I. Succession of ownership

II. Succession of management

1. https://www.pwc.in/assets/pdfs/research-insights/creating-holistic-value-for-family-businesses-v1.pdf

I. Succession of ownership

Succession of ownership in family businesses means transferring the legal ownership of the business (or the vehicle which owns the business i.e. company, LLP, etc.) from the current generation to the next generation. For a smooth and successful transition of ownership, the key building blocks are listed below:

01

Designing the framework for succession

Key aspects in the designing phase include selecting successors and determining each member's/family faction's share, listing down businesses/assets and ascertaining valuations, finalising a legal structure to hold the assets, devising a robust migration strategy from a tax and regulatory perspective which achieves the objectives, identifying an independent mediator who is trusted and accepted by all members (if required), etc.

02

Current ownership structure and its alignment with future goals

The ownership structure of a family business defines the manner of distribution of profits, along with associated rights and entitlements. Moreover, it must align with the strategic vision and future goals of the family to ensure business growth and longevity of the family's legacy.

03

Comprehensive succession plan that includes legal, financial and tax considerations

A robust succession plan should be designed keeping in mind the legal, financial, regulatory and tax considerations to ensure a seamless and cost-efficient transfer of assets. The plan should be comprehensive in nature to protect the financial health and legacy of the family while minimising potential conflicts and other liabilities such as tax, stamp duty, etc.

04

Family dynamics

Understand the relationships and dynamics within the family to address any potential conflicts and work towards consensus.

Challenges faced by families in successful ownership transition

Succession of ownership involves multiple intricate challenges and therefore requires sensitive handling to ensure a smooth transition. Some of the challenges faced by families are shown below:

Emotional resistance

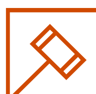
Owners may struggle to let go of control, leading to resistance in the transferring of ownership even when it's necessary for the business's future.

Financial disputes

Disagreements over the valuation of the business, distribution of profits or handling of debts can create rifts among family members.

Family dynamics

Personal relationships can complicate business decisions, and sibling rivalries or favouritism can escalate conflicts.



Legal and tax implications

Navigating the legal and tax ramifications of transferring ownership can be complicated, requiring careful planning and often professional advice.

Communication issues

Poor communication can lead to misunderstandings, misalignment of expectations and a lack of trust among family members.

Time and patience

The transition process can be lengthy and requires patience, which can be challenging for families which are eager for immediate results.

Modes of succession of ownership (trust v/s will)

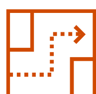
Two common and renowned modes for achieving the ownership succession – i.e. transfer of assets – are: (i) Creation of family trust and (ii) execution of will. Each has its unique characteristics, advantages and limitations, which are summarised below:

Particulars	Trust	Will
Definition	Indian Trust Act, 1882 ('Trust Act') defines 'Trust' as 'an obligation annexed to the ownership of property, and arising out of a confidence reposed in and accepted by the owner, or declared and accepted by him, for the benefit of another, or of another and owner'.	Will, as defined in the Indian Succession Act, 1925, means 'the legal declaration of the intention of a testator with respect to his property which he desires to be carried into effect after his death'.
Effectiveness	Trust comes into effect as soon as it is created, and hence provides the flexibility to distribute the assets before as well as after death.	A will comes into effect only after the death of the testator and the completion of probate.
Requirement of probate	Not required; trust remains a private document.	Required; since a will requires a probate from a High Court, the process and contents of the will become public.
Segregation of ownership and management	Possible	Not possible
Continuity and transition	Provides a seamless transition of management and control of assets	Can delay asset distribution as a will comes into effect post death and completion of the probate process
Flexibility	Revocable trusts can be changed during the trustor's lifetime. Irrevocable trusts cannot be changed.	Can be changed at any time before death, as long as the individual is mentally competent.
Complexity and cost	More complex and expensive to set up initially but can save time and money in the long run	Generally simpler and less expensive to create, but probate can add to the complexity and cost

II. Succession of management

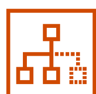
Succession of management in the context of family businesses refers to the process of transferring leadership and managerial responsibilities to the next generation family members or to professionals who are non-family members. Management succession is a process which involves identifying and grooming potential successors who will take over the business operations, and thus needs to be initiated early. The key elements of management succession include identifying potential successors and making sure they are adequately trained and possess the relevant expertise through mentoring, planning the transition in a smooth manner, clearly defining the roles and responsibilities of the incoming management, etc.

Key ingredients for a smooth management succession



Timing of transition

Timing of transition is the most important ingredient for a successful management succession. The correct timing can lead to a seamless management change, business continuity and familial harmony, while poor timing may cause operational disruptions impacting business growth and lead to disputes within the family. Key factors, which one may consider for timing the transition include the readiness of the new leadership, ability and wish of the current owners to transfer management-related powers, current market conditions, overall business position, operational and financial stability and family dynamics.



Current management structure and identifying potential leaders

Before a management transition, it is crucial to understand the existing structure and other aspects such as the working style, hierarchy, etc. Evaluating the structure helps assess efficiency, requirement of professionals, responsibility allocation and the balance between family and non-family staff. Based on these factors, the future leaders from both within the family and non-family, can be identified. The process should be based on factors such as qualification, skills, competency, desire, alignment with the core family/business values, etc.

Unbiased approach in selecting the next leaders

For an organisation to thrive in the long term, it is essential to adopt an impartial approach for choosing new leaders, especially during management transitions. Meritocracy in the selection process is key, and this is particularly challenging for family-run businesses, where emotional ties and the preference for keeping leadership within the family can cloud one's independent judgment.

Training and development for future leaders

Training and development are essential components for the development of a potential next generation leader and, therefore, this forms an integral part of the entire management succession plan and its lifecycle. It is important to prepare the next generation by equipping them with the necessary skills, knowledge and experience so that they can effectively take up leadership roles going forward. In family businesses, this often means that the younger family members and/or identified employees start receiving the right development and mentorship to prepare them for future leadership positions.

Impact on company culture

Company culture refers to the shared values, beliefs, attitudes and practices that characterise an organisation. Management transitions in family businesses can significantly affect company culture since with the arrival of new leaders, there is going to be a possible shift in management style, reflecting their unique values and vision, which impacts the company culture. Therefore, the entire transition should be planned so as to ensure that the core values and the culture of the company do not get compromised.

Communication strategies

Effective communication is essential for a smooth transition in family business succession. It helps navigate emotional complexities and potential conflicts by reducing misunderstandings and aligning expectations. Key strategies include open dialogue, regular meetings, conflict resolution mechanisms, professional facilitation and establishing a feedback mechanism.

Key differences between management and ownership succession

While both management and ownership succession are integral for the longevity and success of a family business, they differ in several ways as highlighted below:

Particulars	Management succession	Ownership succession
Focus	Focuses on the business aspects pertaining to leadership, operational decisions, roles and responsibilities, growth of business through strategic decisions, etc.	Focuses on the legal and financial transfer of ownership of assets/ business
Timing	Can take place independently of ownership succession; non-family members may take over management responsibilities	Often occurs at specific life events (e.g. retirement, death)
Complexity	It is all about assigning roles and responsibilities in order to drive the business towards growth. Management succession may have its own peculiar challenges – e.g. identifying the right persons with the right skill set, co-existence of multiple family members in the business and other aspects like allocation of decision-making power.	Often involves complex legal and financial considerations – e.g. tax and other regulatory implications.
Emotional dynamics	Can be more emotionally charged, as it directly affects the day-to-day involvement of family members in the business.	The emotional dynamics in ownership succession are multifaceted and can significantly impact the success of the transition.

Challenges faced by families in successful management transition

The family management succession process is often fraught with unique challenges that can not only affect the business's continuity but also the familial relationships and overall health of the family and the business. Some key issues that families often face are presented below.

1. Communication gap

Differences in communication styles can create misunderstandings. Older generations may prefer traditional methods, while younger members might lean towards digital communication.

2. Conflicting values and vision

Each generation may have different values, priorities and visions for the business, leading to disagreements on strategic direction.

3. Cultural shift

Each generation may approach business differently, especially in terms of work culture, which can lead to friction.

4. Skill gaps

The younger generation may lack experience or specific skills necessary for managing the business, leading to concerns about their capability to lead.

5. Role clarity

Unclear definitions of roles and responsibilities can cause confusion and tension, particularly if multiple family members are involved.

6. Emotional dynamics

Family relationships can complicate professional interactions, leading to emotional conflicts that might affect decision-making.

7. Resistance to change

Established leaders may be resistant to new ideas or approaches proposed by the younger generation, fearing loss of control or effectiveness.

8. External perceptions

Changes in leadership can affect how customers, suppliers and other stakeholders perceive the business, requiring careful management.

Navigating these challenges often requires open dialogue, strategic planning and sometimes external mediation to ensure a smooth transition.

Key legal, tax and regulatory aspects related to succession planning

a. Legal

Transfer of ownership and management of a family business or assets from one generation to the next should be done through proper documentation, such that it does not lead to disputes in future and the true intent is adequately captured. The is legally achieved through various legal documents/instruments like trust deeds, wills, shareholders' agreements and other agreements.

b. Tax

Family succession involves transfer of assets, business interests or shares from one generation to another within a family. These transfers can have significant tax implications in case not planned in a tax efficient manner. The tax aspects of family succession are complex and can vary widely depending on the method of succession planning – i.e. by way of a will or through setting up a trust, etc.

Broadly, the following tax implications may arise pursuant to the succession of ownership:

Will

Transfer of assets by a person under will is covered under section 47(iii) of the Income-tax Act, 1961 (ITA) and therefore is an exempt transfer without any adverse tax implications for the transferor. Further, section 56(2)(x) of the ITA provides a specific exemption for the recipient, if any sum of money or any property is received under a will or by way of inheritance.

Trust

One of the most used structures for succession planning and managing assets is the creation of private family trusts.

Private trusts are governed by the provisions of the Trust Act. A trust (whether discretionary or determinate) could be created as below:

i. **Revocable:** A trust that can be revoked (cancelled) by its settlor at any time during his life.

ii. **Irrevocable:** A trust will not come to an end until the term/purpose of the trust has been fulfilled.

Taxation on transfer of assets to a trust: A trust establishes split ownership where the trustee is the legal owner, and the beneficiary is the beneficial owner. Ownership of assets is transferred from the settlor or contributor to the trustees of the trust. Tax implications for this transfer hinge on the trust's nature i.e. revocable or irrevocable. Under section 47(iii) of the ITA, transfer of capital assets to an irrevocable trust are exempt from capital gains tax for the contributor, whereas in the case of revocable trusts, the transfer is not specifically covered by the exemption and hence is subject to capital gains tax.

Taxation on receipt of assets by the trust: When a property is settled in a trust without any consideration, the provisions of section 56(2)(x) of the ITA apply. As per this section, any money or property (whether immovable or movable) received by a person from anyone without consideration or for inadequate consideration is treated as the recipient's income. However, the provisions do not apply if the trust, receiving the property, is established solely for the benefit of the settlor's relatives (as defined under the ITA).

c. Regulatory

Securities and Exchange Board of India (SEBI) Takeover Regulations

Will

SEBI Takeover Regulations provide exemption to acquisition by way of transmission, succession or inheritance from applicability of the mandatory public offer provisions. In addition, no disclosure requirement is applicable for claiming the exemption. However, necessary disclosures under Regulation 29-30 are applicable to the legatee. Further, there does not seem to be any restriction under the SEBI Insider Trading Regulations.

Trust

- On literal interpretation of the SEBI Takeover Regulation, change in shareholding takes place on migration to a trust structure – although there may be no change in promoter holding, pre-and-post the trust structure. Even on a perception basis, the transaction appears to be resulting in a substantial movement of shares, which may need the attention of SEBI.
- In case of new trusts, the exemption is not available. However, it is believed that such movement, being a family affair, should not result in a mandatory public offer. Therefore, even those believing that the movement of share breaches certain condition(s) that may lead to the mandatory public offer obligations, they opt to apply to SEBI for specific exemption or informal guidance.
- The above discussion applies to even indirect transfers. The promoters may not be holding shares individually in the listed company but may be holding the same through intermediary unlisted holding companies. Migration of shares of such intermediary company may result in the indirect transfer of shares in the listed company. As a result, the trust shall hold shares in the holding company, which in turn, shall hold shares in the listed company. This discussion also applies to indirect transfers.

Stamp duty

Will

The power to levy stamp duty is divided between the central and state governments. A will is not a specified instrument under the Central Stamp Act and hence may not be subject to stamp duty. However, wills are subject to court fee when presented for the grant of probate or letters of administration, which is different for each court.

Trust

- At the time of creation of a trust through a trust deed, the applicable duty shall be payable. Generally, the relevant state acts provide for the rate of stamp duty.
- At the time of settlement of properties/assets into the trust, duty shall be payable. Generally, the relevant state acts provide for the rate of stamp duty.
- From a practical standpoint, families may decide whether or not to transfer a particular property/asset to a trust. For example, if any immovable property is held as an investment for a short period of time, instead of transferring the said immovable property to the trust (and thereby incurring stamp duty cost), one may retain it in individual hands and contribute the proceeds received upon liquidation of the said immovable property.

Foreign exchange regulations

Will

- A person resident in India may hold, own or transfer foreign currency, foreign security or any immovable property situated outside India, if such currency, security or property was inherited from a person who was a resident outside India. Thus, specified properties situated outside India received on inheritance from a person resident outside India can be held by a person resident in India.
- Further, a person resident outside India may hold, own or transfer Indian currency, security or any immovable property situated in India, if such currency, security or property was inherited from a person who was resident in India. Thus, specified properties situated in India received on inheritance from a person resident in India can be held by a person resident outside India.

Trust

- The Foreign Exchange Management Act, 1999 (FEMA Regulations) relating to permissible capital account transactions do not specifically deal with the transfer of property under a trust. FEMA Regulations relating to securities, etc., provide general permission of gift from person resident outside India to person resident in India
- However, if properties in India are required to be held by/registered in the name of a trustee resident outside India or foreign properties are required to be held by/ registered in the name of a trustee resident in India, RBI approval may be necessary.

d. Other aspects in relation to trust

Parties to a trust

- **Settlor:** The owner of the property who reposes or declares the confidence. Settlor means a person who creates the trust and is called the 'author of the trust'.
- **Trustee:** The person who accepts the confidence is called the 'trustee'. A trustee can be an individual or a corporate – i.e. a professional entity appointed to manage trusts, offering specialised knowledge and experience in regulatory compliances.

  Unlike individual trustees, corporate trustees ensure continuity as they are not impacted by personal circumstances like death. Appointing a corporate trustee as against an individual trustee depends on various factors such as requirement of independence, perpetual existence and costs.
- **Beneficiary:** The person for whose benefit the confidence is accepted is called the 'beneficiary'.
- **Protector and/or an advisory board:** A protector is generally a trusted person who can be a family member or any other individual. A protector monitors the execution of the trust, exercises the discretions and instructs/directs the trustees accordingly. In larger families, an advisory board may be appointed to provide comfort and avoid large number of trustees from an operational perspective. Protectors enhance trust governance and safeguard beneficiaries' interests by ensuring that trustees adhere to the trust deed and the settlor's intentions.

Timing of creation of a trust

The appropriate time for families to consider establishing a trust depends on various factors, such as size of family, number of family members actively involved in the family business, business growth and size of the estate. Early planning and professional advice are key to ensuring that the trust serves its intended purpose effectively.

Single vs multiple trusts

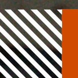
Given the varied asset classes and separate control and management of different assets, families prefer to have multiple trusts for different asset classes – for e.g. business assets are housed in a separate trust as compared to the passive income generating assets. The method of bifurcation depends on the needs of different beneficiaries, diverse family dynamics, ring fencing of assets, costs involved, etc. Independently, whether or not all assets should be transferred to a trust is a question which needs to be answered by every family. This assessment should be done on the basis of the costs, complexities, etc., involved in the transfer, and also the family's requirements, comfort of holding assets through a trust structure vis-à-vis holding it directly, etc.

Significance of proactive and strategic succession planning in family businesses

Proactive and strategic succession planning is vital for family businesses, ensuring continuity and stability during transitions. It promotes talent development by preparing future leaders, aids in risk management by mitigating unexpected disruptions, and aligns successors with business goals and vision. Effective succession planning also strengthens family governance, clarifies roles, and aids in conflict resolution, helping preserve the business's legacy while balancing family dynamics.

Family protocols: A brief perspective

Family protocols, often referred to as family governance, are essential frameworks that guide the operations and decision-making processes within family-owned businesses. These protocols are particularly crucial when addressing the sensitive and complex issue of management transition or succession. Family protocols serve as a roadmap by establishing clear guidelines and expectations. They help in mitigating conflicts that may arise due to personal relationships and emotional ties within the family. Therefore, by having a well-defined set of protocols, family businesses can ensure that the transition of management roles and ownership is conducted in an orderly and transparent manner.



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