Succession Planning and the Use of Trusts and Foundations for Family Businesses in the Arabian Gulf

By Paul Homsy, Advisor, Volaw Group

Paul Homsy is an Advisor to Volaw in the GCC and MENA region, and provides strategic advice and assistance to Volaw in those regions. Paul has been working in the Arabian Gulf since 1978 and is considered one of the leading authorities on Islamic finance and Middle East law. He has developed a network of contacts with ultra-high net worth investors (both royal and non-royal), family offices, asset managers, banks, and sovereign wealth funds. He is also a co-founder of Integration Capital & Trade, a boutique investment bank with offices in Muscat, Oman and Special Counsel to the law firm of Johnson & Pump/Mohamed Al Sharif in Riyadh. Paul practiced law for five years as the managing partner of Sidley & Austin's former office in Riyadh, Saudi Arabia. He assists clients with business development and capital access through his consulting firm Noonmark Capital Partners and he is a partner in the New York law firm of Eaton & Van Winkle.

The majority of the Arabian Gulf family businesses were created in the 1970s and 1980s during the first oil boom in the region. Many of these businesses have grown into large companies involved in multiple lines of businesses, and have operations in various countries around the Middle East and also in other regions as well. The owners of these businesses have become, in many cases quite wealthy, and have invested in a broad range of assets in the Middle East and around the world, which are subject to different laws of inheritance and taxation regimes.

While the need for proper succession planning is not just limited to the Middle East, several factors make the need for succession planning particularly acute in the Arab Gulf. First, the founders of these companies are ageing or have already passed on; second, most of the businesses in the Gulf are family owned; third, Arab families tend to be large so there are a large number of heirs many of whom can be competing to take over the family business; and fourth, many Arab businesses are sole proprietorships or lack formal constitutive documents. According to a recent "*Economist*" article, "*the Family Business Institute calculates that only 30% of such businesses survive into the second generation, only 12% into the third generation, and only 3% into the fourth*". Moreover, "*an estimated 70% of Saudi families have at least one succession problem tied up in court.*" (See "*Economist*" Feb. 6 2016: "*Succession Failure*".)

The Arabian Gulf is also facing challenges due to low oil prices and regional instability which calls for more sophisticated succession planning and asset protection, as one way of helping to meet these challenges. The Arab Gulf is also not immune to the changes caused by globalization and the need to adopt best practices and proper corporate governance. Family businesses from the Gulf are looking to expand globally as a way to diversify and forge alliances with international companies, which can also enhance the transfer of technology back to the Gulf. Lastly, the Gulf is seeking more foreign investment in this era of low oil prices and wants to create an entrepreneurial environment with emerging and startup companies. Local corporate laws are unsophisticated when it comes to the issuance of stock options, different share class voting structures, conventional and Shari'a-compliant debt instruments, as well as sophisticated capital markets transactions which are found in a mature tax neutral jurisdiction such as Jersey. The use of a Jersey offshore holding entity can accommodate these more sophisticated capital structures.

Often, a family's business and family wealth are intertwined. Succession planning should cover both family businesses and personal assets, such as residential real estate, and private aircraft and yachts, which may be located outside the Gulf. Business assets and personal assets that are located outside the Gulf should be held separately in a proper structure from assets located within the Gulf to avoid the foreign assets being subject to lengthy probate proceedings under the laws of the country where they are located, costly inheritance taxes, and conflicts between Islamic inheritance laws and laws of inheritance in the countries where the assets are located.

A well-designed succession plan should lay down: a transparent set of rules and procedures for how a family business is to be governed; the roles and responsibilities of family members in such business and those family members who will not have an active role in the business; a mechanism to resolve disputes and make decisions; the establishment of a family council or board; and a procedure for family members to leave the business and transfer their ownership in it.

The use of a Jersey trust, private trust, or family foundation (collectively and individually "Jersey Structure") can help avoid many if not most of these problems. A Jersey Structure is most often used to hold assets that are based outside the Gulf region in a tax efficient manner while providing a degree of separation from business affairs and asset protection. However, a Jersey Structure may potentially also be used to hold assets within the Gulf. A Jersey Structure can also be established in a way that complies with Shari'a rules of investment and inheritance.

A Jersey trust is a legal (equitable) obligation that comes into existence when an individual or other legal entity (known as the settlor) gives assets of their own free will and transfers ownership of those assets to another person or persons (known as the trustees) to hold, not for the trustees' own benefit, but for the benefit of the family beneficiaries in accordance with the terms of the trust. The trust deed describes the duties of the trustees. In such a case, a trustee acts to ensure that the wishes of the settlor are carried out.

The private trust company (PTC) is an alternative structure that gives more control to family members. Instead of a professional third party trustee, a family may prefer to establish their own PTC in Jersey to act as trustee, with selected family members and the professional trustee being directors of the PTC. This enables family members to have direct involvement.

A Jersey Foundation provides an attractive alternative to the traditional financial planning vehicles of companies and trusts for wealth management, succession planning, and charitable giving. A Jersey Foundation is useful for families who do not wish to transfer control of their assets to a trustee. A foundation is managed by a family council, has a guardian who can be the founder, to oversee the decisions of the council, which must include a Qualified Member, which is a regulated service provider. A foundation is used more as an asset holding vehicle, and can only engage in trading where this is incidental to the attainment of its objects. A Jersey foundation is a distinct legal entity like a corporation, can sue and be sued in its own name, can hold any type of assets (except Jersey real estate), and can be used in capital market transactions, securitizations, collateralizations, and for other financial structuring purposes.

Shari'a law provides for a structure, namely a waqf, that has many similarities to common law trusts. The founder of a waqf donates property to the waqf on a permanent and irrevocable basis (unless under the Maliki School where a temporary waqf can be used) and appoints a trustee who administers the property for the benefit of specific individuals or for a charitable purpose such as schools, hospitals, or mosques. A founder can donate up to one third of his/her assets to a waqf unless the heirs consent to a greater amount.

The concept of trusts has been codified in at least two Gulf countries, namely Bahrain under the Financial Trust Law of August 15, 2006, and the DIFC, Trust Law No. 11 of 2005. However local trusts under these laws have apparently not been widely used.

Along with the use of trusts for inheritance and succession planning in the Arab Gulf, it is important to take into account inheritance laws in the region. Shari'a law, which governs on such matters, provides specific rules on how and in what amounts the estate is to be divided among the relatives of the deceased depending on the category of relationship. The relatives of the deceased must receive at least two thirds of an estate. These "forced" heirship rules only allow for testamentary freedom for the remaining one third of the estate, unlike a common law trust. There generally are no restrictions on lifetime gifts although they may not be made while the person is ill and believes he or she may die and death actually occurs.

There are two basic issues when establishing a trust for a Gulf citizen: First, can an offshore trust cover assets both within and outside the Gulf? Second, can an offshore trust be Shari'a-compliant or can it be structured in a non Shari'a-compliant manner?

An offshore trust can cover assets both outside, and within the Gulf subject to certain restrictions. Many of the Gulf States require that local companies be at least 51% owned by local nationals. Gulf States may therefore not recognize a foreign trust, even where the beneficiaries are Gulf nationals, as a local Gulf investor. Saudi Arabia allows 100% foreign ownership except for certain industries such as oil and gas exploration and production. A foreign foundation may be required to obtain a license from the Saudi General Investment Authority, which may not be issued to a foreign trust.

The UAE requires at least 51% UAE national ownership of a local company. However, many "foreign"/local jointly owned companies employ side agreements where the foreign companies, in essence, own 100% of the local company while the Emirati partner is paid a sponsorship or agency fee. A foreign company can only do business in the UAE if it has an Emirati agent, sponsor or partner. Thus, an offshore trust or foundation could in effect own 100% of the UAE company and the UAE beneficiaries could own the company that is the local agent or sponsor.

One hundred percent foreign owned companies are allowed in designated free trade zones in the UAE. Bahrain allows for 100% foreign owned exempt companies, and Saudi Arabia in the future may also allow 100% foreign owned free trade zone companies as part of its national transformation program. Exempt or free trade zone companies could potentially be owned by the offshore trust or foundation and use the beneficiaries' locally owned company as an agent or sponsor to conduct business outside the free trade zone in the country where the free trade zone is located.

An offshore trust or family foundation can be structured to be Shari'a-compliant. The formation documents can be drafted to incorporate Shari'a restrictions against investments in prohibited businesses, such as alcohol, banking, gambling, tobacco, and the like as well as prohibitions against the use of conventional debt. The formation documents can also include the Shari'a requirements on "forced" distributions to heirs. A Shari'a scholar can be used when preparing the formation documents and can also play an ongoing role to monitor the activities of the trust or foundation for Shari'a compliance purposes. To the extent that the settlor wants to utilize a non Shari'a-compliant inheritance plan, this can be done for assets in countries not subject to Shari'a inheritance rules to avoid challenge in local courts in those countries.

There is a rapidly increasing need in the Gulf for trusts, foundations, or similar structures to ensure an orderly transition of family businesses and wealth to future generations in a tax efficient manner. A properly structured Jersey trust or foundation can ensure such a transition of personal and business assets outside the Gulf and, with some creative structuring, potentially within the Gulf as well.

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This note is intended to provide a brief rather than a comprehensive guide to the subject under consideration. It does not purport to give legal or financial advice that may be acted or relied upon. Specific professional advice should always be taken in respect of any individual matter.

For further information about how Volaw Group can help you, please contact:

Paul Homsy (phomsy@volaw.com), **Robert Christensen** (rchristensen@volaw.com), **Trevor Norman** (tnorman@volaw.com), **Richard Fagan** (rfagan@volaw.com) or **Ashley Le Feuvre** (alefeuvre@volaw.com)

volaw group

Fifth floor, 37 Esplanade, St Helier, Jersey JE1 2TR,
Channel Islands
Tel: +44 (0)1534 500400 Fax: +44 (0)1534 500450
Email: mail@volaw.com