New Year resolutions for families in business (and their advisors)

2017: The year of governance, transparency and tax

The year 2017 is going to be a busy one for many business families in the Middle East as they prepare, not only for the effects of the Common Reporting Standard (CRS) but also that of Value Added Tax (VAT). This dual impact means that families in business have even more reason (if any were ever needed) to prioritize the formalizing and restructuring of their business affairs.

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Tax and banking matters will drive the urgency for family structuring and family governance systems and processes. Already, by not distinguishing between business and personal expenditure and not holding separate business and personal bank accounts, a family business is operating at a disadvantage. Starting 2017, the failure to segregate business and personal finances will likely prove costly for the family business in what will be an expensive year, particularly once VAT is instated.

How to cushion the impact in 2017 and beyond?

An effective family office, with strong protocols governing the interaction with the key stakeholders, is the best way of managing these financial challenges. To be effective, it is imperative that the family office manage the family's interaction with the business and their investments, and capitalizes on its unique position: Having an overview of the entire family's personal financial and tax matters. Understanding the likely cash-flow from the business enables the finance department to put in place a realistic budget for the family to meet their needs without placing undue stress on the business.

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As such, family governance is an essential discipline for the long-term well-being of the family business and the family's wealth. It enables a family to define and control the nature of the relationships between shareholders, family members, and other stakeholders, enabling the operating business to prosper, while promoting harmony within the family as well as protecting its unity and its human, social and financial capital.

How will the Common Reporting Standard (CRS) affect local families in business?

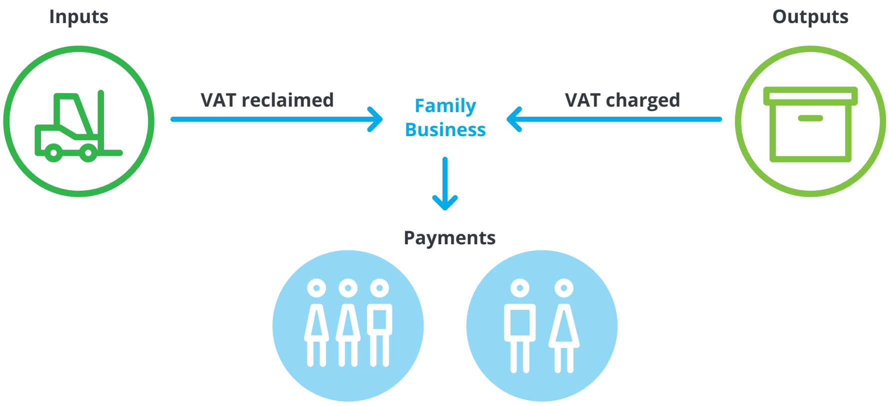
CRS, in simple terms, means that individuals who are resident in a CRS jurisdiction (country A), will have details of their financial accounts (including bank balances, interest received, etc.) in another CRS jurisdiction (country B) shared with the tax authorities in country A.

Lebanon, Saudi Arabia, the UAE, Qatar and Kuwait have all indicated their intention to sign up to the CRS, meaning they will collect information in 2017 ready for exchange in 2018. Most G20 and European countries have already collected financial information and will begin exchanging it with other CRS jurisdictions later in 2017.

CRS becomes particularly complicated for family businesses when family members are tax resident in different jurisdictions. Information about the family's wealth and interaction of the various businesses and with the businesses and family members in the differing jurisdiction may be exchanged with more jurisdictions than is strictly necessary.

Not only is the potential for the wrong information to be sent to the wrong country self-evident, the right information will also be shared with the right country. All information exchanged will often be compared with tax returns that are filed and any discrepancy (including failure to file a return) may lead to an investigation by the relevant authority.

Family offices should oversee an urgent and thorough review of the family's tax affairs to bring to light any errors or omissions in relation to tax liabilities or tax reporting. Regularizing these at the earliest opportunity is recommended; generally speaking, penalties are lower for voluntary rather than prompted disclosures.



The multi-faceted effect of Value Added Tax (VAT) on local family businesses

Without forward planning, strategic decision-making and a clear demarcation between family and business (i.e. between ownership and management) the advent of VAT could have a snowball effect on the family's finances.

Operating mixed family and business bank accounts means that business expenditure is difficult to track, creating additional work for what may be an already over-stretched finance department grappling with the new VAT rules. If the family business is unable to properly identify all business expenditure subject to VAT, failing to reclaim the VAT in full will result in increased costs. The ability to obtain credits for VAT incurred will be largely dependent on having the required documentation. This means that the listed recipient of the supplies acquired must be able to show that the goods or services were acquired for business use. Supplies acquired by the business for the use of family members are unlikely to qualify in such instances.

A commercial decision that all businesses need to make is how to deal with VAT on their own prices, i.e. do they wish to pass on all of the VAT included in the charge to their customers, or to what extent will they suffer the increase themselves in an effort to retain market share? If they choose to pass the VAT charge on in full or in part to the customer this may impact revenues. This is likely to depend very much on the nature of the goods or services supplied, and how competitive the marketplace might be.

The net effect of increased costs and reduced revenues is likely to mean less cash available for distribution as dividends to family members, who themselves will suffer higher prices for goods and services on which VAT is charged and, as such, incur higher living expenses.

Existing family businesses could find that their running costs are unavoidably increased too. To the extent that the family office is treated as a financial intermediary it is unlikely to be subject to VAT on its charges, but will also not be able to claim VAT back on costs incurred. It is imperative that the family office is designed to operate in a way that limits the effect of VAT on running costs and optimizes cost efficiency in other areas. It will also be essential to create proper books of account for the business, as distinct from the family members.

The good news

Many of the financial impacts highlighted above can, and will, be avoided by taking action sooner rather than later.

The family office is ideally placed to spread awareness of the impact of these new rules on family members. By preparing a proper set of books of account for the business and cash flow projections, both the family and the business will be aware of the demands and constraints on income, enabling both to function without undue interference impacting on the commercial objectives.

The financial impact of VAT and CRS are an imminent and immediate threat to the lifestyle of all family members reliant on the family business, including those who may be resistant to any proposed restructuring. The inevitable resultant reduction in dividends is likely to prompt questions and requests for justification from shareholders. The time may be ripe to proceed with a family governance mandate, building a family office and improving the chances of the business surviving into the next generation, as well as mitigating the potential effects of CRS and VAT on family members.

Now is the time to take action, turning a potential negative business impact into a positive action to future-proof the business for the coming generations.

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