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Private Banking & Trust
Shaping wealth for generations

Trust Review



Welcome



David McLellan
Chief Executive
Officer, Rothschild
Trust Group, Zurich



Andrew Penney
Managing Director,
Rothschild Trust
Corporation Limited,
United Kingdom

One of Rothschild Private Banking and Trust's core principles is to provide its clients with independent, objective advice based on unbiased analysis. Our (late) summer edition of the Rothschild Trust Review contains an assortment of articles, all from external contributors who provide their views on topical legal and financial issues in the world of international wealth planning.

In these uncertain times investment performance is of paramount concern. We therefore have two articles which consider how certain types of investments are faring in the current economic climate: Damian Cocking, Head of Offshore Sales at Stenham since 2008 and former Head of Fiduciary Relationships at Goldman Sachs, ponders whether the concept of absolute return investing is dead in 2009; while Bill O'Neill, portfolio strategist at Global Wealth Management EMEA at Merrill Lynch with 25 years experience in the financial markets as an economist and strategist, reviews investment performance in the second quarter of 2009 and gives us his take on what will happen next.

The global economic downturn has made many high net worth individuals read their tax returns more carefully. In this context, Victoria Mahon of London law firm Wedlake Bell gives a helpful summary of the key provisions of the Finance Act 2008 impacting on non-UK domiciled UK residents. For those "non-dom" residents (and even some UK doms) fed up with paying UK tax, Nicola Saccardo's piece on the personal tax regime for Italian residents is essential reading. Nicola, a tax partner at NCTM based in London and Milan, explains why Italy has more to tempt UK residents to its shores than simply "la dolce vita".

We have three articles focusing on the theme of international wealth management for families, each considering issues in different jurisdictions. Manuel Tron, founding partner of Mexican law firm Tron Abogados, looks at the Mexican tax issues that arise when families become increasingly "international". Olga Boltenko, counsel at Hogan & Hartson's London office and a former Russian tax inspector, examines the Russian family law concept of community property and provides an overview of Russian inheritance law. Finally, James Freeman and Richard Hogwood, partners in the family law team at Speechly Bircham, review recent developments in UK family law in the context of the global recession.

We end with something totally different, a practical guide from Speechly Bircham private client practitioners Lisa-Jane Fawcett and Nick Dunnell on the exercise of trustees' powers of advancement. Many trusts rely on statutory powers of advancement which are limited to half of a beneficiary's presumptive share in the trust fund. Following a troublesome practical issue experienced by Rothschild Trust, Lisa-Jane and Nick set out how a trustee can determine what half a beneficiary's share amounts to.



Cover: The Gates, Project for Central Park, New York City, 1979-2005 by Christo and Jeanne-Claude.

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RIP absolute return investing?

After a tough eighteen months and despite the bad press, well-chosen hedge funds have proven to be one of the most stable investments available. Damian Cocking examines the prospects for absolute return hedge fund managers and outlines the factors investors should consider when evaluating their allocations to the sector.



by **Damian Cocking** Head of Offshore Sales, Stenham

2008 proved to be a major stress test for the so-called 'absolute return' managers and their investors. Since the bursting of the Tech bubble in 1999, there has been a significant rise in the number of absolute return mandates led by the traditional hedge fund managers who had, for many years, advocated the concept of active risk management as a means of reducing volatility within client portfolios.

For Stenham, the attraction of traditional hedge funds was clear: they were able to use a wider set of instruments than those permitted by more traditional investment funds, providing an opportunity to capture risk adjusted returns whether markets were falling or rising. Since 1987 we have constructed all our client portfolios using hedge funds.

Before we look more closely at the past eighteen months, it makes sense to revisit the true meaning of 'absolute return' and to refocus minds on not only what to expect from managers professing to offer this style of investing, but also to help identify claims from managers that should arouse a high degree of scepticism from investors and their advisors.

What does absolute return mean?

Absolute return is the return that an asset achieves over a certain period of time, typically a full investment cycle.

Absolute return investing differs from traditional relative return investing because it is concerned with the return of a particular asset and does not compare it to any other measure or benchmark. This disregard for equity or bond oriented benchmarks is driven by the belief that they are irrelevant to the aspirations of most investors. Plainly, absolute return investing should be about delivering a cash plus or inflation plus return on a portfolio over the medium to long term and it should do this with low volatility.

It is an investment style that is as much about managing risk as delivering returns, but it is both unrealistic and unfair to demand no negative years and should an investor's risk profiling highlight a lack of appetite for any loss in any given year then cash is virtually the only solution. Like any investment that has an element of capital risk, a longer time horizon is necessary. A minimum of 3-5 years is appropriate and absolute return managers should be judged against this.

Stenham's view of what is achievable in this regard, for acceptable levels of risk, is a return in excess of LIBOR or cash plus 4% with lower volatility than government bonds.

Recently there has been a flood of new providers into this sector and until last year they have been operating predominantly in a bull market. It is therefore no great surprise that they were able to deliver on their promise of 'absolute returns' year-on-year. 2008 challenged that assertion and many were found wanting.

This does not mean that the concept of absolute return investing is dead. The model may have been severely tested but it remains unbroken in the hands of those few managers whose conservative judgment of all that constitutes downside risk was appropriate to the requirements of their investors, and who continued to apply a rigorous due diligence process on their underlying investments. As we have discussed, delivering absolute returns is as much about managing risk as it is about chasing returns.

2008

The year presented a set of circumstances which specifically challenged hedge funds and FoHFs. Those whose business models and risk management were not robust were quickly found out.

Over a six week period in September and October there was deleveraging and liquidation of hedge funds in the order of \$8 trillion,

an unprecedented amount. This liquidation was across all asset classes and strategies having a number of dramatic effects on the market. Such was the rush for the exits that investors, as forced sellers, had to off-load only that for which there were buyers and, as in every case of forced selling, the correct price for assets was rarely achieved. The upshot of this was that absolute return managers who had positioned portfolios defensively by holding only the highest quality assets were left managing high levels of redemptions whilst at the same time dealing with plummeting asset values, a sure fire recipe for under performance.

The only way to have delivered positive performance last year was to have held cash, to have been outright short the market or adopting a single strategy such as CTAs, strategies that are completely at odds with managers delivering a cash plus return with low volatility over an investment cycle.

Holding cash would have guaranteed the portfolio not beating its benchmark and being short the market or investing a single strategy would assume a risk level inimical to the idea of absolute return investing.

In addition to this there has been elevated counterparty risk. Certain strategies have also suffered in terms of liquidity and there have been a number of high profile frauds, all of which have scared investors. As a result of all this hedge funds have been getting terrible press.

However, throughout the current period of economic uncertainty and despite this bad press, well-chosen hedge funds have proven to be one of the most stable investments available. This is true not just of the recent times but throughout a number of historical periods where financial markets have come under pressure.

Although 2008 was disappointing for absolute return hedge funds, the losses they suffered were substantially less than in equity markets. The MSCI World Index was down 42.08%, while the HFRI Fund of Fund Index was down 21.43%, with the best managers suffering single digit losses.

The future of absolute return investing

Bear markets tend to crystallise investors' objectives more acutely than bull markets. This being the case, it is little wonder that "absolute return" investing is currently getting so much attention. Most private investors' number one priority is capital preservation and maintaining their spending power. At most they are agnostic about the direction of capital markets, provided it does not impact their own portfolio. This will continue to be the case.

The significant withdrawal of capital from the industry and many hedge funds going out of business has left the sector with fewer participants and a much higher concentration of the brightest investment talent looking to capitalise on market dislocations, which are easier to identify and less crowded to trade. Generating strong returns will be possible, while taking less risk than was necessary before this crisis. For example, due to the magnitude of opportunities across financial markets currently, global macro managers are not relying on leverage to achieve their returns.

This is a fundamental evolution of the hedge fund industry, the result of which will leave it bearing many similarities to the industry we were drawn to over 20 years ago.

This change has become evident in the better FoHFs, which have delivered good returns for the year to date with many of the underlying hedge funds risking only a small percentage of their book, while keeping relatively high cash positions.

Regarding specific investment styles that we think will be successful over the next phase of the market cycle, global macro is something Stenham favours. These managers have a huge opportunity set available to them and have the flexibility to take advantage of mispricing across all markets including interest rates, currencies, commodities, equities, credit and volatility. We view the current environment as ideal for this style of investing.

The focus here must be on discretionary managers who make liquid investments so they can be more dynamic. Only hedge fund managers that have demonstrably exceptional risk management should be considered. Discretionary managers have historically provided more stable performance and we believe are better positioned to perform going forward. CTAs and systematic strategies performed well in 2008 during the extreme deleveraging but this phase is now over. There is also a risk that the level of assets invested in these funds, following their success, may compromise their ability to perform in the less leveraged environment of 2009.

As we are often told, past performance is no guide to the future but there are a small number of managers out there who have been running absolute return portfolios for a long time and have experienced a number of different market cycles. Investors should be demanding an ability to demonstrate actual returns through at least a full investment cycle, preferably longer, and certainly a track record that takes into account many different environments.

Global investment review and outlook

The performance of global investment markets in the second quarter of this year has boosted investor confidence, with some sectors such as equity markets recording stellar performance, but which sectors should investors be tracking going forward?

by **Bill O'Neill** Portfolio Strategist, Global Wealth Management EMEA, Merrill Lynch



No one could deny that the last quarter was transformational when one views the shift in mood and confidence within financial markets over the period. The best quarter for equities in decades doesn't do justice to what a watershed the period proved to be. In summary, a global meltdown in the financial system looks to have been avoided through a combination of aggressive initiatives and a rapid response from manufacturing industry to the collapse in demand.

The result has been a return to something closer to normality in terms of the pricing and flow of credit, albeit through a still-damaged banking system, as well as a recovery in investor appetite. The impact of both should result in the recession drawing to a close about now.

The risk is that early optimism gives way to a painfully slow recovery over the next two years. For now though, we see a surge in available liquidity and upgrades to growth forecasts for the next twelve months providing the basis for the next phase of recovery in real assets. We take a dispassionate view at this point regarding inflation. Excess capacity is enormous, a feature that will limit pricing power for labour in particular:

Equity market performance was stellar, though mixed leading indicators took some of the shine off through June. In dollar terms, equities were up 21% over the quarter with emerging markets and Asia in the vanguard of the advance. Emerging markets advanced 34% in dollar terms over the period, taking their relative performance against global equities back to the highs of mid-2008.

Having rallied almost 40% from the lows in early March, equities are now in a broad trading range as the levers of recovery shift. The reversion to risk-taking led to an explosive rally in Financials as the major source of beta in portfolios. The sector was up 38.2% in three months to end-June, followed by excellent returns from global cyclicals such as Materials and Tech. Defensive sectors have been largely avoided.

Credit, especially high yield corporates, significantly outperformed government bonds (where returns were zero) with index-linked bettering returns from conventional bonds. We are sceptical that high yield can sustain its performance given the expected extent and size of upcoming delinquencies. We continue to stress the need to maintain a short duration position and an overweight of investment grade. Meanwhile, the turnaround in commodities dominated performance within the alternative investment sector especially in response to Chinese stockpiling which has pushed the copper price up by 60% this year.

Our investment strategy has been geared to capitalising on the incipient recovery with profits being taken where thought appropriate. We are concerned that portfolios retain a tilt toward high quality bets around investment themes that are likely to persist.

The equity weighting has been maintained close to benchmark as markets are no longer compelling on valuation grounds. Nonetheless, a cyclical bias is certainly in place focused on BRIC equity markets and the IT sector:

Regional selection does also back the US market over Japan at this point as we still see a further rally supporting growth stocks. The corporate bond overweight within fixed income is being maintained. We have moved to reduce commodity exposure as we see oil prices and base metals, at best, remaining within a trading range. Nervousness over future inflation should still offer support to gold, a key bull call of ours.

Changes to the UK taxation of non-doms

In the light of the changes brought in by the Finance Act 2008 to the taxation of UK resident non-UK domiciled individuals (“non-doms”), is London still an attractive place to live for non-doms and is it still worthwhile them setting up offshore trusts once they are here?



by **Victoria Mahon** Assistant Solicitor, Private Client Team, Wedlake Bell

Non-doms have historically benefited from a favourable tax regime in the UK. Viewing this regime as giving rise to perceived tax loopholes for non-doms, under the Finance Act 2008 (“the Act”) the Government significantly changed the rules relating to the taxation of foreign income and gains of non-doms with effect from 6 April 2008.

The inheritance tax (IHT) regime that applies to non-doms remains unchanged by the Act. Thankfully, the impact of the Act was not as wide ranging as initially proposed by the Government in the Finance Bill 2008.

However, with HMRC’s guidance on UK residence having changed this year so that it is no longer only the number of days that an individual spends in the UK that is looked at but also that individual’s accommodation and business, social and family ties, which may now mean that it is easier for short term visitors to the UK to become UK resident, it is all the more important for individuals visiting the UK to be fully aware of the tax implications of UK residence and the opportunities for tax planning. So what has changed for the non-dom and is there still scope for tax-efficient planning?

Remittance basis of taxation

The non-dom had, until the Act was brought into force, automatically been taxed on the remittance basis so that he was not taxable on foreign income and capital gains unless they were brought to the UK. The Act has since widened the definition of remittance to include bringing foreign income / capital gains or assets purchased abroad with foreign income / capital gains into the UK and using foreign income / capital gains offshore to pay for services provided in the UK or to satisfy a debt in the UK.

This basic principle of non-dom taxation has now been significantly changed by the Act so that, unless the non-dom has less than £2,000 of unremitted foreign income and gains¹, he will now automatically be taxed on worldwide income and gains as they arise unless he makes an annual election to be taxed on the remittance basis. In an attempt to deter non-doms from claiming the remittance basis, the Government has introduced financial penalties for making this election in the following form:

- i) The non-dom’s income tax personal allowance and capital gains tax (CGT) annual exemption will be withdrawn; and
- ii) He will have to pay an annual charge of £30,000 (the remittance basis charge) if he has been resident in the UK for 7 of the preceding 9 tax years.

In addition, an irrevocable election would need to be made by the non-dom as to how future foreign losses will be treated. Although this is an improvement on before, in that foreign losses may be available in just the same way as UK losses, the election to use foreign losses in this way is a one-off opportunity that may or may not work in favour of the non-dom depending on his position. A non-dom should seek advice as to whether foreign losses should be used in this way.

Broadly, the remittance basis charge is a tax charge on nominated income/gains and should be available to be set-off against foreign taxes paid, although this will depend on the terms of any relevant double tax treaty. A non-dom can nominate income and capital gains which will then be “franked” and treated as already taxed when the funds are actually brought into the UK. However, untaxed income and gains will be treated as being remitted first before the nominated income and gains, even if it is the nominated income and gains that are brought into the UK. In addition, if the nominated funds are remitted, complex

ordering rules are triggered that are best avoided by setting up a new bank account with a relatively small balance yielding a small amount of income which is nominated and never remitted. Practically, therefore, it is recommended that the non-dom has a separate special account to hold the nominated income.

Privacy is, of course, very important to many non-doms and although electing into the remittance basis will limit the amount of information that the non-dom will need to declare to HMRC compared to the arising basis, he is less likely to go “under the radar” of HMRC than under the previous tax regime.

Despite these changes, the underlying benefit remains in that the non-dom can still shelter offshore funds from UK tax provided he is willing to incur the above costs. In addition, planning opportunities remain in that the non-dom can manage the annual £30,000 charge by deciding each year whether it is appropriate to pay it dependent on the amount of his foreign income and gains, as he can elect in and out of the remittance basis on an annual basis. Investments could therefore be structured to realise income and gains in a particular year to avoid paying the annual charge each year. Further, assets can be transferred to one member of the family to avoid several members having to pay the charge.

Offshore gifts

There had previously been various methods for non-doms to convert foreign income and capital gains into capital which could then be brought into the UK without a charge to tax arising. For example, non-doms could make offshore gifts to family members so that they could remit the offshore income and gains as clean capital to the UK so as to avoid a taxable remittance. Following the Act, however, the Government will treat this as a taxable remittance if brought in by the non-dom’s spouse or civil partner (or people living together as if they were spouses or civil partners), his minor children and minor grandchildren and also trusts and companies from which the non-dom or any of these people can benefit.

However, adult children and adult grandchildren can still remit assets gifted to them offshore without constituting a taxable remittance and if the non-dom had segregated his pre-6 April 2008 income into a separate bank account, he could still make a gift of this money offshore to his wife or children, etc., and if they later bring that money into the UK this would not constitute an automatic taxable remittance as the new rules on remittances by gift recipients only apply to post-6 April 2008 offshore income and gains.

Offshore trusts

The changes to the remittance basis of taxation have also affected offshore trusts.

Briefly, assets held in offshore trusts are not subject to UK CGT but any gains made by the trust form a “logged” gains pool and are only taxed, in the recipient’s hands, when a capital distribution from the trust can be matched to the gains.

Previously, capital payments from offshore trusts to a non-dom would be free of UK tax even if he was UK resident so that the trust gains could be “washed out”. Following the changes, a non-dom will now be subject to CGT on receipt of a distribution that can be matched against realised trust gains unless he has elected to use the remittance basis of taxation. This means that, unless the payment is received in the UK, CGT can still be avoided. An offshore trust can therefore still remain an effective CGT shelter. Advantageously for the non-dom beneficiary, he can pass the burden of complying with the remittance basis of taxation on to the trustees.

Further, gains are now matched with capital payments on a more advantageous ‘last in first out’ basis and the retrospective effect of gains being assessed on non-doms receiving capital payments from trusts can be avoided by the trustees making a one-off rebasing election of the entire trust fund to market value as at 6 April 2008, so that gains realised by the trustees before this date will not be matched to capital distributions.

The IHT benefits of an offshore trust remain unaffected by the Act. As UK IHT only applies to UK-situated assets for non-doms, by the non-dom settling property held outside the UK into trust before becoming deemed domiciled for IHT purposes (i.e. resident in the UK for 17 out of the preceding 20 tax years), he can shelter offshore assets from UK IHT. As long as no further assets are added to the trust after the non-dom becomes deemed domiciled, the trust assets will continue to be sheltered notwithstanding the settlor’s UK-deemed domicile.

In addition to the tax advantages of setting up an offshore trust, such a structure remains a useful tool for managing assets. Indeed, the trust can protect assets from family and business difficulties including divorce, bankruptcy and from economic and political instability. It can also be used as a method of easing the implications of forced heirship in jurisdictions where children or other family members have an automatic right to inheritance irrespective of the terms of the testator’s Will and whether or not there is a surviving spouse.

Unlike a Will, a trust offers confidentiality as it is not a public document. Offshore trusts can also be used as a means of avoiding the need for probate in a number of jurisdictions as the trust is an ongoing entity and the trust fund will not form part of the individual's estate for probate purposes. The trust structure can be used to merge a family's worldwide assets into one place and one unit to consolidate the administration and the financial reporting of family wealth.

Conclusion

The public outcry caused by the Government's initial proposed changes to the taxation of non-doms and the Government's retraction of many of the proposals as a result, highlighted the importance of London's appeal to non-doms, and has no doubt made future Governments wary of implementing any far reaching changes to the taxation of non-doms.

Although it is now more difficult to put in place measures to minimise exposure to UK tax, there are continuing tax benefits for the non-dom, as highlighted above, going forward so that London can still be viewed as an offshore tax centre with low taxation where offshore trusts can still be used as a useful planning tool for both tax and non-tax planning.

Indeed, London remains an attractive city for non-doms to reside in provided they are willing to bear the financial costs and be more creative with their tax planning.

Footnote:

1. If a non-dom has less than £2,000 of unremitted foreign income and capital gains in the year of assessment then the remittance basis will apply without the need to make a claim or pay the annual charge.

Moving to Italy?

Italy has for decades tempted foreigners with its natural beauty, history, delicious food, good climate and quality of life, but these days, the tax factor may be another reason for foreigners to move to Italy.



by **Nicola Saccardo** Partner, Tax Team, NCTM (Milan and London)

Despite being perceived as a high tax jurisdiction, Italy provides a number of beneficial features which are relevant to wealthy individuals resident in Italy. This article sets out to summarise the relevant features of the Italian tax system.

Taxation of financial income and gains

Income from financial assets, as well as capital gains upon the sale of such assets, is generally taxed at a rate of 12.5%.

This favourable regime, which has been in force for more than 10 years (since 1998), applies to income and capital gains from financial assets other than income and gains from substantial participations (in general terms, more than 20% ownership) and participations in companies or partnerships resident in tax privileged jurisdictions, income from atypical securities (i.e. securities other than shares and bonds and securities similar to shares and bonds) and income from bank accounts. Particularly, this regime also applies to bonds issued by foreign companies, regardless of the fact that such companies may be resident in a tax-privileged jurisdiction.

Furthermore, provided that the structure is properly set up, the income and gains from domestic and foreign financial assets, as well as the ownership of such assets, is not subject to reporting obligations (the 12.5% tax is levied by any Italian-based financial intermediary, including Italian fiduciary companies).

Inheritance and gift tax

The Italian legislation does not provide for a wealth tax (and never has, apart from a few extraordinary taxes that were levied for a very limited period and only on certain assets, such as bank and postal accounts) and sets forth favourable rules in terms of inheritance and gift tax, as described below. These favourable rules were introduced in 2000 and

re-established in 2006 by the left-wing Government (whereas the right-wing Government repealed inheritance and gift tax from 2001 to 2006), so it is reasonable to expect that possible future left-wing Governments will not significantly increase the burden of inheritance and gift tax.

Transfers upon death and gifts are subject to inheritance and gift tax at the following rates and with the following exempt amounts:

- i) 4%, if the transfer is made to spouses and direct descendants or ancestors; in this case, the transfer is subject to tax on the value exceeding 1,000,000 Euros (this exempt amount applies to each beneficiary);
- ii) 6%, if the transfer is made to brothers and sisters; in this case, the transfer is subject to tax on the value exceeding 100,000 Euros (this exempt amount applies to each beneficiary);
- iii) 6%, if the transfer is made to relatives up to the fourth degree, to persons related by direct affinity as well as to persons related by collateral affinity up to the third degree;
- iv) 8%, in all other cases.

Moreover, the rules for the computation of the taxable base may be extremely favourable. For instance, the value of unlisted participations in companies (or partnerships) is equal to the corresponding quota of the net equity of the company (or partnership) resulting from the last balance sheet drawn up pursuant to the applicable law. The value of (the Italian) real estate is equal to its fair market value, but the tax office cannot dispute the value declared if it is at least equal to the value resulting from the cadastral register (which is generally several times lower than the fair market value).

Simple techniques are available to further reduce the inheritance tax due. This can be achieved through the gift of bare ownership. Upon the death of the owner of the usufruct, the usufruct is extinguished and the bare owner becomes full owner of the assets, but the

consolidation of bare ownership with usufruct does not trigger any taxable event for inheritance tax purposes.

Further, Italian resident individuals, subject to Italian inheritance and gift tax on their worldwide assets according to the above rules, can benefit from a unilateral foreign tax credit and from the Italian inheritance/estate and gift tax treaties, which may preclude the levy of more burdensome inheritance/estate or gift taxes in other jurisdictions. In this regard, the Italian treaties for the avoidance of double taxation on inheritance/estate tax are in force with Denmark (1966), France (1990), Greece (1964), Israel (1968), Sweden (1956), UK (1966) and USA (1955); a treaty with France covers also gift tax.

Trusts, life insurance contracts and foreign partnerships

A wide range of tax planning techniques is available to optimise the tax regime for resident individuals. These techniques include trusts, life insurance contracts and the use of foreign partnerships.

Seventeen years after the Italian ratification of the Hague Trusts Convention, the Finance Bill 2007 has now recognised the trust as a taxable person for income tax purposes and, together with the following administrative guidelines, has clarified the Italian tax regime of trusts (for more details, see N. Saccardo, "Taxation of trusts in Italy", in *Trust Quarterly Review*, 2008, Vol. 6, No. 4 (November), 20).

Life insurance contracts may be used as an alternative to trusts. Indeed, the insured and the beneficiary are not taxed as long as they do not receive any income from the insurance company. Moreover, in the case of policy redemption, the insured is subject to a 12.5% tax (see taxation above) on the difference between the amount received and the premiums paid, whereas the beneficiary is exempt from tax on the income received upon the death of the insured pursuant to a specific exemption applicable since 1974 (moreover, this transfer to the beneficiary is not *mortis causa* and, accordingly, is not subject to inheritance tax).

Finally, tax efficient structures may involve the use of foreign partnerships, which are regarded as fiscally opaque from an Italian perspective and, therefore, may allow the deferral of the taxation upon the resident partner.

Other beneficial features

Other beneficial features of the Italian tax system include the following:

- i) Italy does not tax capital gains upon the sale of "assets of cultural value" (other than real estate) – such as paintings, statues, prints, engravings, etc. – by individuals acting outside the context of a

business or of a professional activity. Indeed, since 1988, capital gains realised by private individuals may be taxable only if derived from the sale of financial assets or real estate. Moreover, assets (including real estate) of cultural value may be exempt from inheritance tax and gift tax.

- ii) Other jurisdictions do not view Italy as a tax privileged jurisdiction. Therefore, for instance, the transfer of residence to Italy may be outside the scope of anti-abuse measures of the country of departure or may be considered less suspicious by the latter country as compared to the transfer to a tax privileged jurisdiction. Furthermore, after acquiring Italian residence, the individual may benefit from the wide network of income tax treaties to which Italy is a party (there are almost 80 income tax treaties currently in force).
- iii) Italy is an EU Member State. The transfer of residence from another EU Member State to Italy may thus benefit from the protection of the EC fundamental freedoms (this may preclude the levy of exit taxes by the former State). In addition, nationals of another EU Member State that are resident in Italy in order to be granted equal treatment to Italian nationals may invoke the EC fundamental freedoms.
- iv) For income tax purposes, Italy does not have a part-year residence rule. Indeed, individuals are held to be Italian residents for income tax purposes on an annual basis, so that in a given tax period (i.e. calendar year) either the individual is a resident for the whole year or he/she is not. Consequently, if an individual moves to Italy in the second half of the calendar year, he/she will be regarded as non-resident in Italy in the year of transfer because the conditions for tax residence will not be met for most of the tax period. This feature of the Italian income tax system may permit individuals to maximise the tax efficiency of the transfer of residence.
- v) Italy has never levied an exit tax upon individuals (other than for latent capital gains on assets held by an individual in his/her capacity as an entrepreneur). Accordingly, the possible transfer of residence outside Italy triggers no Italian taxation whatsoever.

Conclusion

So far, the "Beautiful Country" has tempted foreigners with its natural beauty, history, delicious food, good climate and quality of life. These days, the tax factor may be another reason for foreigners to move to Italy as UK and other European Governments have announced an intention to increase taxation on wealthy individuals and tax privileged jurisdictions have become less appealing due to the international fight against tax havens. It may very well be that many foreigners will find their place in the sun in Italy.

Bi-national families and wealth management – a Mexican perspective on tax issues



When dealing with wealth management for a bi-national family, tax issues for specific events have to be identified and carefully evaluated to avoid any unpleasant surprises.

by **Manuel E. Tron** Partner, Tron Abogados (Mexico)

The 21st century has seen not only economic globalisation, but family globalisation as well. Two hundred years ago, some families (usually those living in isolated areas and having the necessary resources) used to send their offspring to schools in other cities, but usually within the same country, and they expected them to then return home. During the last hundred years or so families started sending children to renowned schools (even in other countries) to be educated to the highest standards, but usually with the explicit intention of having them back after they graduated, in order for them to take care of the family business, or to practice their profession at home.

Today, things have changed dramatically. Children from all over the world attend the most prestigious schools and universities in different countries, and a lot of them, once graduated, decide to stay in those other countries to practise what they have learned and, more often than not, they stay to work, get married and live there permanently: bi-national families (and in some cases multi-national families) are thus born. Mexican families are not an exception to the rule. Our families are becoming increasingly bi-national: every year more and more of our children are leaving Mexico to study in the US or in Europe and are staying there for good.

The global family, in addition to the regular intricacies of family life, puts added pressure on family relationships. Family members effectively suffer detachment deriving from not seeing each other more than once or twice a year and, after one or more generations, the language barrier between the members of the family residing in different countries is unfortunately only too real. Global families (either bi-national or multi-national) also face complications when it comes to wealth management, distribution and succession, and the tax aspects of these are particularly relevant.

Tax issues during the life of the current owners of the property

Wealth management during the life of the current owner may be affected in a number of ways because of the involvement of different jurisdictions when events with legal relevance occur within the family. Such events may be as varied as an individual attaining a certain age, marrying or divorcing, having children (either within or outside the institution of marriage) or suffering a disability so he/she is no longer able to support himself/herself.

The taxation of family wealth can be affected by the involvement of different jurisdictions claiming a right to tax it. Depending on the location of the assets, the tax residence of the members of the family owning the assets and the residence of those entitled to the benefits produced by said assets, income tax may have to be paid in one or more jurisdictions. Thus, when dealing with wealth management for a bi-national family, the particular tax issues for the following events have to be identified and carefully and simultaneously evaluated to avoid any unpleasant surprises:

1. *Creation of an investment structure:* fiduciary and corporate formulas designed to defer or even avoid taxes in one country may result in undesirable effects in the other. A foreign trust structure which may be effective to defer Mexican income tax and to permit the Mexican investor not to report or declare the assets to the government, may easily produce a substantial income tax problem for a beneficiary of the foreign trust if that beneficiary resides in the US. Throw back rules in the US, when applicable, are very expensive for the beneficiaries (as US tax experts have been explained to me on several occasions) and would result in payment of taxes worth many times the "saved Mexican tax". You do not want your heirs to suffer such taxes.

2. *Contribution of existing assets to the structure:* On this event, accumulated gains, the recognition of which may have been deferred for tax purposes, could be triggered if the contribution is not properly handled. Rules on the time when the recognition of income or gains occurs for tax purposes may also differ in one country from the other: Gifts made (including deemed gifts of goods occurring at the time of its contribution to a certain type of trust) may be taxable in the hands of either the donor (in the case of the US gift taxes) or the recipient of the gift (in the case of the Mexican income tax on goods received for free).
3. *Management decisions on the assets during the life of the structure:* The issue here is deferral vs. distribution. If the earnings of a given structure are to be regularly distributed to either the creator of the structure, his/her beneficiaries or both, said earnings will usually be taxable at that time in the hands of the recipient and (if necessary) rules to prevent international double taxation may be invoked. If, to the contrary, a deferral of the time of recognition of income for tax purposes is sought through the structure, there is a risk of having both jurisdictions presumptively attributing the income, one jurisdiction to the creator of the structure, and the other jurisdiction to his/her beneficiaries, thus both having to pay taxes without the possibility of double taxation relief.

There is a fourth legal event which occurs within the family which is as relevant (or even more relevant) for tax purposes: the succession of the patrimony.

Tax issues as a consequence of the succession in the patrimony

When a person dies, a number of legal consequences are triggered: some of them concern the rights to the patrimony. Who is and who is not entitled to part or all of it? In what order should the beneficiaries receive it? What is the income deriving from it? In some countries, you have to look into the personal circumstances of the family members, such as the minimum standards of living for the issue of the deceased who are minors. Within some countries, the Will of the deceased will be tested against forced heirship rules to determine its validity or the scope of its application once the part corresponding to the forced heir is separated from the rest of the estate.

Tax consequences vary substantially from country to country. Under Mexican tax law, benefits received from a succession are considered as falling within income tax law. The Mexican tax on death is basically non-existent because the applicable law provides for a full exemption

of the tax on income deriving from inheritance or legacy, regardless of the relationship (or lack of it) between the decedent and the heirs, the types of goods forming the estate, its amount or its location.

US taxes on death are a completely different matter: US tax law does not consider income from an inheritance to be subject to income taxes in the hands of the heirs. It is subject to estate and gift taxes in the hands of the estate itself. Inheritance and legacy benefits are treated as gifts (*mortis causa* gifts, but gifts nevertheless). Thus, if the decedent was a US person, or there are assets in the estate that may be considered as US property (such as US real estate and shares issued by US companies, among others) said inheritance or legacy will be subject to taxes, as high as 45% in some cases.

Based upon this comparison only, the potential tax consequences may differ hugely, as shown in the following examples:

- If the deceased person (i) was a Mexican citizen and resident, (ii) the heirs are US citizens and/or residents, and (iii) the estate does not comprise US property (neither real nor personal property), then there is neither Mexican nor US tax to be paid on the inheritance.
- If the deceased person was (i) a US person, (ii) the heirs are Mexican citizens and residents, and (iii) the estate includes US property (either real or personal property), then there will be US estate tax to be paid on the inheritance which may add up to 45% or so of the value of the estate.

In countries such as Mexico, investment structures, either fiduciary, corporate or a combination of both, may generate additional complications on death. These structures rely, in order to achieve the deferral or even avoidance of the recognition of the income generated through them, on separating the assets from the investor. In other words, if the assets are not mine, the income produced by said assets is not mine either and so I cannot be taxed on it.

Unfortunately, for a Mexican heir, in order to enjoy the full tax exemption provided for by the law, the income has to derive from an inheritance and, as a basic rule, a person can only pass through inheritance for the benefit of others what is rightfully his/hers. In other words, I cannot pass through inheritance those assets that are not my property, such as the irrevocable property of a trustee under a given trust or the property of a foreign corporation.

Therefore, careful steps have to be taken in order to ensure that a structure, effective in avoiding taxes on the income produced by the wealth contributed to it, does not result in the wealth being subject to

taxes in full in the hands of the Mexican heirs when transmitted to the next generation (instead of them receiving it as a tax exempt benefit).

Some final considerations

The creation and use of sophisticated and complex structures for tax and succession planning is clearly overrated. Investors have been led to believe that the more complicated their structure, the better protected their heirs will be. But here's some news for them: this is not necessarily true. More often than not complicated structures often result in problems.

Wealth management and succession structures need to be designed with the investors' family and financial purposes in mind and considering, as a rule, that the tax efficiency of the structure is not the most important factor. If a wealth management and succession structure fails to give peace of mind to its creator and beneficiaries, then it is not well constructed and will not satisfy them, no matter how efficient it is from a tax perspective.

Wealth management for Russians

The Russian HNWI market presents tremendous opportunities for international wealth managers, but setting up conventional Anglo-Saxon trust structures can raise a number of issues related to property rights and forced heirship.



by **Olga Boltenko** Counsel, Hogan & Hartson (London)

It is a well-known fact that until recently Russia has been one of the fastest growing markets for the international wealth management industry. Most of the international private banks have either set up offices in Russia or their representatives travel to Moscow on a regular basis. This growing presence can easily be explained by the fact that most of Russia's wealth is owned by a few individuals. Much of this wealth is "new money" and political instability is driving it from Russia to "safer lands" offshore. Further, the poor legal system and a lack of enforcement mechanisms in Russia allow for non-Russian ownership structures to be legitimate and low risk. In other words, Russia is the land of opportunities for the wealth management industry.

One of the most popular wealth management products on the Russian market is the Anglo-Saxon trust structure. A typical real-life scenario is when a wealthy Russian individual, often tax resident in Russia, sets up an Anglo-Saxon trust in one of the offshore financial centres, such as the Bahamas, the Cayman Islands, the Channel Islands, the Isle of Man, or Bermuda, with Swiss-based trustees. Even when such an individual is tax resident elsewhere, s/he often has Russian-based assets or family members.

The common law concept of the trust is alien to Russian law, so setting up a trust in any of the above jurisdictions poses a number of questions: is the transfer of property to a trust valid in light of Russia's rules on 'community of property' for spouses and forced heirship? Tax issues arising at the various stages of the 'life' of a trust also present a challenge to an advisor.

Community property or post-nuptial agreement?

When a trust is being set up, it is important to consider whether the transferor (the settlor) has a valid title to the assets from a Russian family law perspective. If the settlor in question is married, Russian family law

provides that the ownership of property of a couple can be regulated either by Russian law or by an agreement between the spouses.

The law provides that all property accumulated by a couple during the period of their marriage is owned jointly by both spouses in equal shares. In other words, it is community property. However, spouses can agree a different treatment of communal property by way of agreement. Such an agreement can be entered into either before the marriage or (importantly) during the marriage, and it can be changed or repealed at any time thereafter.

A post-nuptial agreement is null and void if it does not comply with the necessary formalities, is contrary to the law or is not a *bona fide* agreement. A post-nuptial agreement is voidable if it is entered into under duress, a contracting party does not understand its terms, or a contracting party is misled as to its terms.

Further, a court can declare a *bona fide* post-nuptial (or pre-nuptial) agreement to be invalid if its terms place one of the spouses in an unfavourable position. For example, a situation where one of the spouses surrenders all his/her property rights in relation to jointly accumulated property to his/her spouse is viewed as an unfavourable position. In such a situation the court will apply its discretion and divide the property between spouses as it sees fit.

This means that a spouse may have future claims to community property on the basis of a *bona fide* validly executed post-nuptial agreement if all his/her property rights in relation to jointly accumulated property are transferred to his/her spouse, who then disposes of such property.

During the marriage, an individual spouse can solely dispose of community property as there is a presumption of mutual spousal consent for such disposal. No formalities for such transfer are usually required, unless the property to be transferred is either immovable property located in Russia

or the ownership of the property is subject to Russian state registration. In such cases a notarised consent of the other spouse is required.

The above means that if an individual wishes to transfer all of his/her assets to a trust structure, s/he can do so without any technical formalities. However, it is still recommended to obtain a notarised consent of the other spouse for such transfers.

Another approach would be to conclude a post-nuptial agreement which provides that an individual has full ownership of property accumulated by the couple during their marriage. The individual can then transfer property to the trust structure.

Inheritance and forced heirship rules

One of the reasons the wealthy set up trusts is to ensure a smooth transfer of wealth to future generations. To this end, Russian inheritance law is relevant if the deceased's last place of residence was Russia.

Place of residence is defined in the Russian Civil Code as the place where an individual permanently or primarily lives. There are no statutory rules on what constitutes a permanent or primary place of residence. State registration, for example, is often viewed as a clear indication of a permanent place of residence. However, the Russian Constitutional Court, in its ruling of 2nd February 1998, stated that such registration is only of a notifying nature and does not impose any rights or obligations on individuals. Hence, Russian state registration should be taken into consideration when determining the place of residence of the deceased, but it is not the sole decisive factor. Law commentators state that various other factors such as the length of time the deceased resided in a place, their links to the local community (e.g. job commitments, schools for children, where their spouse lives), their legal status (e.g. entry clearance or permanent leave to remain) and their intentions (e.g. an intention to be permanently based somewhere) should be taken into consideration when deciding what constitutes the deceased's permanent or primary place of residence.

Property subject to Russian inheritance law is defined as any property, including property rights and duties, which is owned by the deceased at the date of "the opening of the inheritance". The estate does not include any property or property rights or duties that the deceased, at the time of his death, did not own. The above, in principle, means that if an individual made bona fide transfers of all of his assets to a trust during his lifetime, he ceased to own these assets and, therefore, they ceased to be part of his/her estate, as defined by Russian law.

Russian inheritance law also applies to any real estate property located

in Russia, regardless of the last place of residence of the deceased. Under Russian law the deceased's estate can be passed on either by a will or by law. A will allows a person to dispose of his possessions after death in accordance with his own wishes.

Chapter 62 of the Russian Civil Code sets out the general requirements for a will: it must be made in writing, it must be certified by a notary public and the testator should sign the will himself. Significantly, the capacity of a person to make and revoke a will and the form of a will or of an act of its revocation, is determined in accordance with the law of the country where the testator resides at the time he made the will. If, for example, a will compliant with Swiss law is made in Switzerland, it will only be recognised by a Russian notary or the court if such will was made when the individual had been living with some degree of perpetuity in Switzerland.

If the deceased has left no will, his/her estate will devolve in accordance with the rule of law. The law regulates disposition of property to relatives depending on the proximity of their family and blood ties with the deceased. The legal heirs (being physical persons only) include the children of the deceased and his/her spouse and parents and are divided into eight priorities. The heirs in the higher priorities inherit statutory intestate shares preferentially to the heirs in the lower priorities. For example, heirs of the first priority are children, a spouse and parents of the deceased. The sizes of these shares depend on the number of heirs involved in the succession. In the absence of legal heirs, the estate is declared heirless and passes to the state of Russia.

If the deceased made a valid will but left dependant relatives (minor or disabled children, a disabled spouse, a disabled parent or other disabled dependants), then the terms of the will are overridden by the Russian forced heirship rules. These rules state that dependant relatives of the deceased inherit no less than half of what they would have received by operation of law. From a practical perspective, this means that if the deceased disinherited his wife and children in his will, half of the estate is likely to pass to them by operation of the Russian forced heirship rules.

Under Russian law, *inter vivos* gifts are valid. Testamentary dispositions form part of the deceased's estate and are valid as long as the share received by the heirs in accordance with the forced heirship rules is not affected.

Despite the fact that trusts are very often used by Russians, in practice, analysis of the Russian legal consequences of trusts has received surprisingly little attention from both the Russian legislators and practitioners. However, Russian legislation is developing fast and developments in this field must be closely monitored.

Asset values fall, wealth protection rises: the English family lawyer's perspective



The long-awaited judgment in the case of *Granatino v Radmacher* elevated the status of the pre-nuptial agreement under English law to a new level, and demonstrates the importance of including discussion of pre- and/or post-nuptial agreements in tax planning.

by James Freeman & Richard Hogwood Partners, Family Team, Speechly Bircham

No-one can deny the seriousness of the economic turbulence that has enveloped the world's economies during the last twelve months as the banking crisis has spread to become a global recession.

Although there may be little that can be done to fend off the impact of the downturn itself on private wealth, we have noted the growing emphasis placed by many clients on protecting their assets from such other threats as they are able to identify and address. Often the greatest of those threats is that posed by a divorce, whether in the context of the client's own marriage or indeed the marriages of their children.

London has in recent years attracted wealthy couples from across the world. Most of them, one suspects, were not aware prior to arrival that London has also become the 'divorce capital of the world'. England and Wales is now seen as one of the most, if not the most, punitive jurisdictions in the world for the "paying party" upon a divorce.

The starting point is now often an equal division of all the assets, including assets owned prior to the marriage, those inherited during it, trust interests, pension funds, private businesses and such like. And it matters not whether such assets are in England or anywhere else in the world. From that starting point the onus is then on the wealthier party to justify a departure from equality. It is here that arguments may be adduced about the shortness of the marriage, the quantum of the pre-marital wealth, and the "stellar" contribution of one party.

It should be remembered that it is not just British nationals who may be subject to this potential 50/50 regime. The English courts may well have jurisdiction to deal with a divorce on as little as a year's "habitual

residence" in the country. Those who are non-UK domiciled but UK resident are therefore potentially equally at risk.

The volatile financial climate exacerbates these risks. It is the general rule that the division of capital assets on divorce is not subject to review, save in the light of a very significant and unforeseen change in circumstances shortly after the division is made. This is known as a *Barder* event – something which invalidates the basis, or fundamental assumption, on which the order was made.

The case of *Myerson* recently tested this. At the time of his divorce the South African-born financier Brian Myerson elected to retain his interest in his business, instead giving his wife the more "copper-bottomed" assets – the real estate and cash. At that time Mr Myerson's shareholding was worth more than half of the overall marital estate. However by the time of his variation application, a plummeting share price and mounting legal costs meant that Mr Myerson would get a net debt under the deal. Mr Myerson argued that a *Barder* event had occurred.

The Court of Appeal was unsympathetic to his cause. He had chosen to take the risky assets, despite his ex-wife having offered to split everything equally, and as such was the "captain of his own ship". Poor economic times are not entirely unforeseeable and, at such times, it is not unforeseeable that share prices may rise or fall substantially. Had the assets in this case increased greatly in value the Court was in little doubt that Mr Myerson would not have been offering to increase Mrs Myerson's award. He knew the deal that he had chosen to make and he knew the potential for gain or loss that was implicit in it. The

court would not release him from his bargain simply because time had proved it a bad one.

There is much food for thought arising from this case, for example as to the use of maintenance payments (i.e. alimony) in the place of lump sums as maintenance orders are far more readily variable in the light of changed circumstances. Similarly, parties may elect now to divide their assets in specie rather than retaining all the business assets and foregoing the cash.

From the point of view of an English family lawyer, the dark economic clouds have perhaps most importantly served to reinforce the importance to many individuals and families of wealth protection planning in the matrimonial context. Nor is it any coincidence that the most striking recent examples of how effective these strategies can be have involved international families.

Just as the cost to a wealthy party of an English divorce has increased, so too has the prevalence of protective measures, most notably the pre-nuptial agreement. Many from continental Europe, parts of the Commonwealth and certain US states will be very familiar with the concept of a "pre-nup" and with the fact that, in those locations, they are very often legally binding. This is not - technically - the case in England. Statute obliges the court to consider "all the circumstances of the case" and such matters as the age, health, disability or otherwise and conduct of the parties, before deciding what award to make.

However, the English court has in recent years been increasingly minded to endorse the terms of a properly constructed pre-nup, taking it into account as one of the relevant "circumstances" and, indeed, as an element of the conduct of the parties.

A pattern of case law accordingly demonstrates several instances where the financially weaker spouse has exited the marriage with less than would have been the case without a pre-nup. Moreover, there have been indications from the family courts in recent years that the judges are keen for pre-nups to become more effective in England. This seems to mirror the sentiment of many of those in the legal profession and, indeed, the public at large. It also reflects a growing awareness that England and Wales was out of step with many other jurisdictions.

In July 2009, the long-awaited judgment in the case of *Granatino v Radmacher* took the status of the pre-nuptial agreement under English law to a new level. This case concerned the marriage of Ms Radmacher, a German heiress, to Mr Granatino, an Italian former investment banker turned academic researcher. Although the parties

had executed a German pre-nuptial contract prior to their marriage, the judge at first instance decided that it was sufficiently flawed, from an English perspective, to be of little financial consequence. She noted, for example, that Ms Radmacher had not given any financial disclosure, that the pre-nup was written in German (which Mr Granatino did not speak) and not translated for him, and that Mr Granatino had not received legal advice prior to signing the agreement. It also made no provision for the husband at all, even were he to find himself in a situation of genuine want.

Ms Radmacher appealed the first instance decision. In granting her appeal, the Court of Appeal made several findings. First, it said that, being an intelligent man, Mr Granatino had a decent understanding of Ms Radmacher's wealth and the rights he was potentially giving up by signing the pre-nup. Furthermore he had plenty of opportunity to seek legal advice - and to seek a translation of the agreement - but he simply chose not to do so. The court was satisfied that Mr Granatino understood the meaning of what he was signing, and signed freely.

The court also recognised that Ms Radmacher would not have married, and her family would not have advanced significant assets to her, without the pre-nup. Furthermore, the pre-nup would have been binding and enforceable in both France and Germany. In a world where, as mentioned above, many of England's closest trading partners support pre-nups, the court understood that England does need to move more in line with these other jurisdictions, rather than widening the divide.

Post-nuptial agreements have also recently been catapulted into the English limelight. Whilst such agreements are little acknowledged in many jurisdictions, including ones where pre-nups are favoured, 'post-nups' are now capable of being binding in England. This stems from the 2008 decision of the Privy Council in the Isle of Man case of *Macleod*. Whilst this judgment is not strictly binding authority for the English courts, it will nonetheless be highly persuasive, not least because the Privy Council judges sit in the English House of Lords.

The case involved an American couple who had entered into a Floridian pre-nup, which agreement they then updated during the course of the marriage (and following their move to the Isle of Man, where the matrimonial statute is almost identical to that of England), thereby creating a post-nup.

The Privy Council decided that a post-nuptial agreement could be binding on the parties in a way that pre-nups technically cannot. The reason for the distinction is that agreements between married parties can, under the relevant English statute be classified as binding

'maintenance agreements', whereas pre-nups cannot fit into this category exactly because the parties to them are not yet married. This rather legalistic-sounding distinction may, however, prove less significant in practice than in theory, as there are circumstances in which a post-nuptial agreement will fail to bind, including where there has been a sufficiently noteworthy change in the parties' circumstances.

The likelihood as things presently stand is that any nuptial agreement, whether signed before or after wedding, will suffer before the courts if it does not have sufficient in-built flexibility to withstand changing times. By the same token, it must be clear in each case that to endorse, and therefore effectively to enforce, the agreement must be, in a broad sense of the word, 'fair'. For international couples arriving in England with foreign pre-nuptial documents, the best advice is still to check that they will pass muster in this jurisdiction.

For those who advise members of wealthy families who have, or who may acquire, an English connection, and for those involved in structuring the financial affairs of such families through trust or other mechanisms, the message is clear. The effect of divorce in England can be altogether more destructive than the effect of taxation, especially when the cost and stress of divorce litigation is taken into account. Planning that does not include discussion of pre- and/or post-nuptial agreements – and indeed the equivalent for same-sex couples in Civil Partnerships, known as pre- or post-registration agreements – is not good planning. The success of Mrs Radmacher before the English courts is ample demonstration of that.

Powers of advancement

This case study considers what trustees should take into account in deciding if and how to exercise the power of advancement, and in determining the amount of capital available for distribution – issues that are pertinent at a time when asset values are down.



by **Lisa-Jane Fawcett & Nick Dunnell** Assistant Solicitor and Partner, Private Client Team, Speechly Bircham

The majority of modern trusts are drafted to give the trustees the maximum amount of flexibility and contain an overriding power of appointment giving trustees wide powers to distribute capital, change the terms of the trust or bring the trust to an end. However, not all trusts are this flexible. Some settlors are unwilling to give their trustees this degree of scope to depart from their original wishes, and many older trusts or trusts created pursuant to court settlements are more prescriptive in their terms.

In such cases, if the trustees consider it in the interests of a beneficiary to make a distribution of capital they have to rely on a more limited power of advancement. This may be an express power in the trust deed providing that the trustees have power to advance a certain proportion of capital, or the statutory power of advancement under section 32 of the Trustee Act 1925 in English law or similar statutory provisions in other jurisdictions.

This article considers what the trustees should take into account in deciding if and how to exercise the power, and how much capital is available to be distributed. Such issues are especially pertinent at a time when asset values are down. Trustees need to be particularly careful in determining the extent of their powers.

We consider these issues in the context of the following case study, specifically from the perspective of English law though the same or similar principles are likely to be relevant in other (particularly commonwealth) jurisdictions.

Case study

Jack's Fund is a life interest trust for the settlor's nephew Jack, established in 2000 when Jack was 13. There is no overriding power of appointment but under the terms of Jack's Fund the trustees may

"...at any time or times during the trust period while Jack is under the age of twenty five years pay or apply any part of the capital of Jack's Fund not exceeding one half thereof to or for the benefit of Jack".

The power extends to all of the capital of Jack's Fund between the ages of twenty five and thirty, and Jack becomes absolutely entitled to the capital on his thirtieth birthday.

In 2009 when Jack is 22, Jack's Fund holds cash and investments of £15 million and is owed a debt of £2 million by Jack's mother, and there is also a potential claim against the trustees of £3 million. The claim is by a third party, not a beneficiary, and does not amount to a breach of trust. The trustees have made a number of distributions of capital to Jack in the past, totalling £1 million.

Jack would now like to invest in a business venture and has made a request to the trustees for the maximum distribution of one half of the capital of his fund.

Liabilities

In order to determine the funds available for a potential distribution to Jack, the trustees need to value Jack's Fund.

In the current economic conditions trustees have to give careful consideration to valuing the trust fund. In certain jurisdictions trustees have power to value the trust fund as they think fit for the purposes of making distributions, and such valuations are binding if made in good faith, but in many jurisdictions (including England and Wales) there are no such statutory provisions.

In our case study, the trustees made a loan of £2 million to Jack's mother in connection with her business (which we shall assume

was an authorised loan). The business is struggling and it is uncertain whether it will survive or, if it does, when Jack's mother will be able to repay the loan. In addition, there is the potential claim against the trustees.

There is no case law determining how trustees should value the assets of a trust when these comprise outstanding debts or claims. In such circumstances, the trustees must attempt to value the trust fund on a reasonable basis. They should take a conservative approach because they will be in breach of trust if they advance more than half of its true value. In deciding how to account for the outstanding loan and potential claim the trustees should consider:

- What is the likelihood of Jack's mother being able to repay the loan? Although the loan is an asset of Jack's Fund, it would not be prudent to include its full value when determining the value of Jack's Fund if it is unlikely that the loan will be repaid in full.
- What is the potential liability in the litigation? Have there been any attempts at settlement, and is this liability likely to crystallise?

The trustees of Jack's Fund decide that the value of the loan to Jack's mother should be treated as zero, since the funds may be irrecoverable. The trustees also decide that in taking a conservative approach to valuation it is prudent to treat the litigation claim as a crystallised liability and to deduct the full amount claimed. If in time the loan is repaid and the litigation is resolved, the trustees can reconsider the valuation.

The trustees therefore conclude that the value of Jack's Fund is £10 million.

How much can be distributed?

The trustees' next question is how to interpret their power. Does "half of Jack's Fund" mean half of the initial value, or half of the value at the date of the distribution in question? The power to apply up to one half is interpreted as meaning one half of the trust fund at the time of the distribution (*Re Marquess of Abergavenny's Estate Act Trusts* [1981] 2 All ER 643), not at the date of the settlement. The power of advancement is therefore dependent on the value of Jack's Fund at the time an advance is being made. This means that there can be very different results depending on fluctuating values.

The trustees then consider how to bring into account the capital advances that have already been made. Is it the actual sum advanced that is relevant, or the percentage of the value of Jack's Fund at the time the distributions were made? Where advances have been

made to a beneficiary and at no stage have these amounted to the beneficiary's maximum entitlement, they should be brought into account at the value at the time of the advance, not as a distribution of the fraction of the fund (*Re Gollin's Declaration of Trust* [1969] 3 All ER 1591). They are added onto the present value, which is then divided as appropriate and the previous distributions deducted. However, if a distribution exhausts the whole share of the beneficiary to whom it was made, the trustees may make no further advances to that beneficiary, even if the value of the trust fund later increases (*Re Marquess of Abergavenny's Estate Act Trusts*).

In our example:

	£m
Current value of trust fund:	10
Plus previous advances:	1
Notional value of trust fund:	11
One half of notional value:	5.5
Subtract previous advances:	(1)
Trustees may make an advance of:	£4.5 million

If the full advance of £4.5 million is made, Jack can take no further advance until he reaches 25, even if the value of the fund later increases. By the same token, if the balance of the fund depreciates after Jack has received the full advance (of 50%), there is no obligation on him to repay any part of the sum advanced.

Should the trustees exercise the power?

The trustee's power is a discretionary power. As such, it must only be exercised by the trustees:

- In good faith;
- After the trustees have given proper consideration to relevant matters;
- Only for the purpose for which the power is conferred; and
- Not for any bye or collateral purpose (that is, it must not be a fraud on the power).

If trustees take into account irrelevant considerations, or fail to take into account relevant considerations, the court has the power to set aside the exercise of their discretion. However, in order for a claimant to succeed in setting aside the exercise of a power, it is necessary to show that the trustees would have acted differently had they taken into account the relevant considerations, and not merely that they could have acted differently. Generally the courts are reluctant to exercise trustees' discretionary powers.

In this case, the relevant factors might include:

- The purpose for which the distribution will be made. Although of age to receive such an advance, Jack is relatively young. What is his experience of investing large sums of money? Can he provide more information about the investment? Might he be under the (undue) influence of his mother, whose business is struggling? If the trustees have any concerns on this score, they should ensure that Jack is independently advised in order to avoid liability should Jack later allege under influence as in the Pauling case (*Re Pauling's Settlement, Younghusband and others v Coutts & Co* [1963] 3 All ER 1).
- What funds might be necessary for other purposes? The trustees have made distributions of capital in the past. Is Jack likely to need further distributions for other purposes?
- What are Jack's requirements in terms of income? If a large distribution of capital is made, income will decrease accordingly. If income levels fall further given the current state of the markets, will they be sufficient?
- The advantages of not distributing the full 50%, enabling the trustees to make further distributions if the value of Jack's Fund later increases (for example if Jack's mother repays the loan or the litigation is resolved favourably).

The trustees discuss the business venture with Jack and agree that he could invest £3 million rather than the full £4.5 million. The trustees decide to exercise their power to make a capital distribution of £1.5 million and lend the other £1.5 million, using their separate power under the trust deed to make loans to beneficiaries. This gives them greater flexibility to make further distributions of capital in the future, or alternatively to exercise the power of advancement to write off the loan if appropriate.

Wider uses of the power

When Jack reaches thirty he will become absolutely entitled to Jack's Fund. However, the trustees are wondering whether there are any possibilities for retaining the property in trust, depending on Jack's circumstances at the time.

The trustees' power of advancement contains the words "to or for the benefit" of Jack, which open up vistas of possibility following the case of *Re Pilkington's Will Trusts* [1964] AC 612. Although the case itself was more limited in scope, the accepted interpretation of this case in England is that the words give the trustees an extremely wide power allowing them to deal with a trust fund as they decide provided

that they genuinely consider it to be for the benefit of the beneficiary and it is reasonable for the trustees to consider it to be so. Examples include:

- Making loans to beneficiaries (where there is no other power in the trust deed to do so);
- Bringing forward beneficiaries' interests;
- Altering beneficial interests;
- Resettlement on discretionary trusts;
- Resettlement on trusts excluding the beneficiary but for the benefit of his family such as his spouse, children, grandchildren and parents; or
- Payment to charity (in certain circumstances, in particular where the beneficiary recognises a moral obligation to make donations, taking account of the size of the trust fund and of the payment to charity).

In this case, once Jack has reached the age of twenty five the trustees can exercise the power to advance all of Jack's Fund onto continuing trusts, provided that this is genuinely for Jack's benefit. The trustees should not do this until nearer to Jack's thirtieth birthday and must then consider carefully Jack's circumstances and financial resources. If tax considerations are driving the proposed continuation of the trusts, these must be weighed up against the advantages of Jack receiving the property outright, even if this does result in a tax charge.

Exercising the power

The power of advancement can generally be exercised informally, so need not be exercised by deed or even in writing, although that rather depends on how the power is being exercised. For example, an advancement in the form of a simple payment of a capital sum might be made without a written resolution but altering beneficial interests will, naturally, be recorded in writing. The consent of the beneficiary benefiting from the advancement is not necessary, though the written consent of a beneficiary with a prior written interest is, to the extent that his interest is affected. So the onus is on the trustees (taking such advice as is appropriate) to exercise the power correctly.

contacts
Olga Boltenko

Hogan & Hartson
 Juxon House
 100 St Paul's Churchyard
 London EC4M 8BU
 United Kingdom
 Tel: +44 (0)20 7367 0231
 Email: oboltenko@hhlaw.com

Damian Cocking

Stenham
 180 Great Portland Street
 London W1W 5QZ
 United Kingdom
 Tel: +44 (0)20 7079 6704
 Email: damian.cocking@stenham.com

Nick Dunnell

Speechly Bircham LLP
 6 New Street Square
 London EC4A 3LX
 United Kingdom
 Tel: +44 (0)20 7427 6457
 Email: nick.dunnell@speechlys.com

Lisa-Jane Fawcett

Speechly Bircham LLP
 6 New Street Square
 London EC4A 3LX
 United Kingdom
 Tel: +44 (0)20 7427 6733
 Email: lisa-jane.fawcett@speechlys.com

James Freeman

Speechly Bircham LLP
 6 New Street Square
 London EC4A 3LX
 United Kingdom
 Tel: +44 (0)20 7427 6584
 Email: james.freeman@speechlys.com

Richard Hogwood

Speechly Bircham LLP
 6 New Street Square
 London EC4A 3LX
 United Kingdom
 Tel: +44 (0)20 7427 6721
 Email: richard.hogwood@speechlys.com

Victoria Mahon

Wedlake Bell
 52 Bedford Row
 London WC1R 4LR
 United Kingdom
 Tel: +44 (0)20 7395 3000
 Email: vmahon@wedlakebell.com

Bill O'Neill

Merrill Lynch
 2 King Edward Street
 London EC1A 1HQ
 United Kingdom
 Tel: +44 (0)20 7995 5745
 Email: bill_o'neill@ml.com

Andrew Penney

Rothschild Trust Corporation Limited
 No 1, King William Street
 London EC4N 7AR
 United Kingdom
 Tel: +44 (0)20 7280 5969
 Email: andrew.penney@rothschild.co.uk

Nicola Saccardo

NCTM
 Via Agnello 12
 20121 Milan
 Italy
 Tel: +39 02 725 511
 Email: n.saccardo@nctm.it

Manuel E. Tron

Tron Abogados
 Prado Sur No. 555
 Lomas de Chapultepec
 Mexico D.F. 11000
 Tel: +52 55 5282 4162
 Email: metron@tronabogados.com.mx

