PREST v *PETRODEL RESOURCES LTD*

ARE FAMILY INVESTMENT COMPANIES STILL A VIABLE ALTERNATIVE TO TRUSTS?

BY PATRICK HARNEY TEP, LAURA BROWN AND HOLLY JONES

Ever since the *Finance Act 2006* clampdown on the use of trusts by UK domiciliaries and, as a separate development, the 2009 amendments to the corporation tax legislation, family investment companies (FICs) have become an extremely useful and sometimes essential tool in the family wealth-planner's armoury. The England and Wales Court of Appeal judgment in *Petrodel* [2012] EWCA Civ 1395 affirmed this and indeed served as a reminder to those who practise in family law that if there is no evidence of impropriety, it will not be open to a judge to make orders transferring assets owned by a company.[1] In *Petrodel* [2013] UKSC 34, the companies lost on appeal to the Supreme Court and their seven properties were ordered to be transferred to the wife, but, paradoxically, the judgment confirms the efficacy of FICs as wealth-protection vehicles where sensibly and appropriately used. This article first examines the implications of *Petrodel* from a family law perspective and goes on to consider the use of FICs as vehicles for separating control and ownership in a tax-efficient manner.

Petrodel

The judgment of the Supreme Court in *Petrodel* was handed down on 12 June 2013. It was following an appeal by the wife of the decision made in the Court of Appeal, following an appeal by the companies (the husband taking no further part in the proceedings following the decision of Moylan J in the High Court, as he failed to meet the separate conditions for leave to appeal).

At first instance Moylan J made an order that the husband pay the wife a lump sum of GBP17.5 million. When the husband failed to make the payment, Moylan J ordered the companies (in which the husband had a controlling interest) to transfer seven London properties to the wife in part satisfaction of the order, having found the husband to be the effective owner of those properties. This was in reliance on the *obiter dicta* in *Nicholas* v *Nicholas* [1984] FLR 285.

The companies appealed this order on the basis that the Family Court had no jurisdiction to make it because although it was correct that the husband controlled the companies, they were separate legal entities and it was the companies that owned the properties not the husband. The Court of Appeal allowed the companies' appeal by a majority.

The wife appealed this decision to the Supreme Court. In an interesting twist, although the wife lost on all but one of the points argued on her behalf, she won her appeal and the order of Moylan J was reinstated. The basis upon which the Supreme Court reached this decision (Lord Sumption giving the lead judgment) was by a different route from Moylan J, and it considered

1. Patrick Harney, Holly Jones and Spencer Clarke, 'The new holy grail?', *STEP Journal*, Volume 21, Issue 2, p60 (March 2013)

> It is not possible to pierce the corporate veil just because it is in the 'interests of justice'

a number of different angles used by family lawyers to access assets held in corporate and trust structures on divorce.

The Supreme Court considered three options:

i) **whether the wording at s24(1)(a) of the *Matrimonial Causes Act 1973* allowed them to redistribute the property on the basis that the husband was 'entitled' and thereby to pierce the corporate veil in order to do so;**

(ii) **whether the *Petrodel* companies were nuptial settlements; and**

(iii) **whether the properties were held on trust by the companies for the husband.**

In respect of (i), the Supreme Court took the view that piercing the corporate veil is possible 'in a small residual category of cases where the abuse of the corporate veil to evade or frustrate the law can be addressed only by disregarding the legal personality of the company' (para 35). Lord Sumption endorsed Munby J's judgment in *Ben Hashem* v *Al Shayif* [2009] 1 FLR 115, which sets out a useful summary of when the corporate veil can be pierced. It is not possible to do so just because it is in the 'interests of justice': there needs to be impropriety 'linked to the use of the company structure to avoid or conceal liability'. In addition, even if the Court was able to pierce the corporate veil, it could only be done 'as far as it was necessary in order to provide a remedy for the particular wrong which those controlling the company had done' (thus reaffirming the principle of the corporate veil). This did not therefore assist the wife, given the finding by Moylan J at first instance that there had been no impropriety that would allow the piercing of the corporate veil.

The Supreme Court also gave little time to (ii), with Lord Sumption saying at para 53: 'The Court ruled in the course of argument that leave would be refused. The point was not argued below and does not appear seriously arguable here'. This does lead to questions in respect of the recent Mostyn J decision in *DR* v *GR and others* [2013] EWHC 1196 (Fam).

It was (iii) that led the Supreme Court to decide in the wife's favour. This was due to the fact that Moylan J had left this option open, having not made any finding on the point (save that the matrimonial home was held on trust for the husband as it has a special significance for the Family Court). The properties had been bought with the husband's money, not the companies'. It was also based on the husband's conduct during the proceedings and the fact that this allowed the Supreme Court to make adverse inferences and come to this conclusion 'given that the defective character of the material is almost entirely due to his persistent obstruction and mendacity' (para 43).

It is important to note the different treatment of the matrimonial home by the Family Courts, which was recognised by Lord Sumption (para 52), who suggested that in many cases 'the facts are quite likely to justify the inference that the property was held on trust for a spouse who owned and controlled the company'. In this case the wife was fortunate that there were a number of UK properties (not just the matrimonial home, which would have gone only a small way to satisfying her claim) about which the Court could make orders that could be enforced and could at least go towards satisfying her financial claims against the husband (subject to the mortgages on the properties). This will not always be the case.

As a result, while it is clear that the Supreme Court strongly endorsed the legal delineation between companies and individuals, and the limited circumstances in which the corporate veil could be pierced, it did seek to find a 'fair' outcome for the wife. It is, however, important for family lawyers to note that this decision and a number of other recent decisions, including *Imerman* [2010] EWCA Civ 908 and *Radmacher* [2010] UKSC 42, seem (after many years of the law moving in the opposite direction) to be moving back to being more in favour of the stronger financial party. This is to say nothing of the growing problem of enforcement given the higher number of cross-jurisdictional cases – but that is beyond the scope of this article.

It would seem that in the future, the stronger financial party can avail themselves of an increasing number of options in terms of their assets and how they are held, not only as tax-efficient structures but also as protective structures on any divorce, while the weaker financial party will need to ensure that they take advice as early as possible and possibly during the marriage to protect their position on any divorce. With the increasing use of prenuptial agreements, following this decision it seems that the business of marriage becomes ever less romantic and ever more commercial. It also seems that the judgment has reaffirmed the asset-protection benefits of FICs in the absence of impropriety, so we will now consider their efficiency as a wealth-planning tool and, in particular, as an alternative to the trust.

Use of FICs as an alternative to a trust

The family trust has been an important and useful wealth-planning vehicle since the time of the Crusades. The trust offered the wealthy individual an effective means of separating control and ownership of assets and a tax-efficient vehicle for holding family wealth, both during lifetime and after death. Sadly, the trust's force now seems to be waning. In recent years the English family courts have seen fit to look through trustee ownership of assets on a divorce. [2] In addition, the *Finance Act 2006* completely changed the wealth-planning landscape for UK-domiciled families by making accumulation and maintenance trusts creatures of history and by extending the relevant property regime – including the 20 per cent lifetime entry charge on gifts over the nil-rate band (which was also frozen at GBP325,000 until 2017/18 in the most recent Budget) – to almost all lifetime trusts. As a result of these changes, although the trust can still achieve separation of control and ownership, the separation now comes at a significant cost and a family can no longer be certain that the separation will be respected by the courts on a divorce. This had led families to consider other wealth-planning vehicles.

Before considering FICs in detail, it is also helpful to consider other vehicles that have been put forward as an alternative to trusts since 2006. Family limited partnerships (FLPs), structured under the *Limited Partnership Act 1907,* were very topical immediately after the *Finance Act 2006*, and at first glance they are an ideal vehicle for separating control and ownership. The parents would retain control through their ownership of the general partner and they would make potentially exempt transfers of limited partnership shares (holding cash or unappreciated assets) to their children. The problem with that, and the reason that they have not been taken up so much, is the regulatory issues. They are

2. For example, *Charman* v *Charman (No. 2)* [2007] 1 FLR 1246 and *Whaley* v *Whaley* [2011] EWCA Civ 619

Often clients are drawn to FICs because of their familiarity with the legal and taxation regime

considered to be collective investment schemes in the UK, and for that reason there are significant regulatory requirements: the need to appoint an FSA-authorised operator. So it is hard to justify the costs of an FLP with investable assets of less than GBP10 million, and they have not been used widely.

Family general partnerships (FGPs) are something our firm has used as an alternative way to separate control and ownership. They can achieve a lot of the same objectives as FLPs: passing assets down a generation, but keeping control in the senior generation. Under the *Financial Services and Markets Act 2000* in the UK, a collective investment scheme arises where you have an arrangement for the pooling of property or the holding of property, and the participants do not have day-to-day control. Clearly, that is what you have with a limited partnership under the 1907 Act. With an FGP the same issues can arise. If control is in the hands of the senior generation, you would end up with a collective investment scheme, but it is possible – with careful drafting – to arrange for the senior generation, effectively, to have weighted votes without the arrangement constituting a collective investment scheme. All the participants can participate in the management of the partnership, but the real control remains with the senior generation.

Interestingly, limited companies are exempted from being treated as collective investment schemes.[3] Companies were traditionally avoided as family investment holding vehicles by UK-domiciled families because of the double layer of corporate and personal taxation necessary to extract investment profits. Until 2009, the tax treatment of dividends received by UK-resident companies from companies resident outside the UK compared to those from other UK-resident companies was unattractive. However, changes were introduced in 2009 which significantly enhanced the tax treatment of dividend income received by UK companies and the rate of corporation tax is now on a downhill trajectory to 20 per cent from 1 April 2015. In addition, in contrast to other vehicles, the legal regime surrounding FICs has remained stable while the regimes surrounding trusts and partnerships have had some turbulent years. Often clients are drawn to FICs because of their familiarity with the legal and taxation regime.

The separation of control and ownership: the structure of an FIC

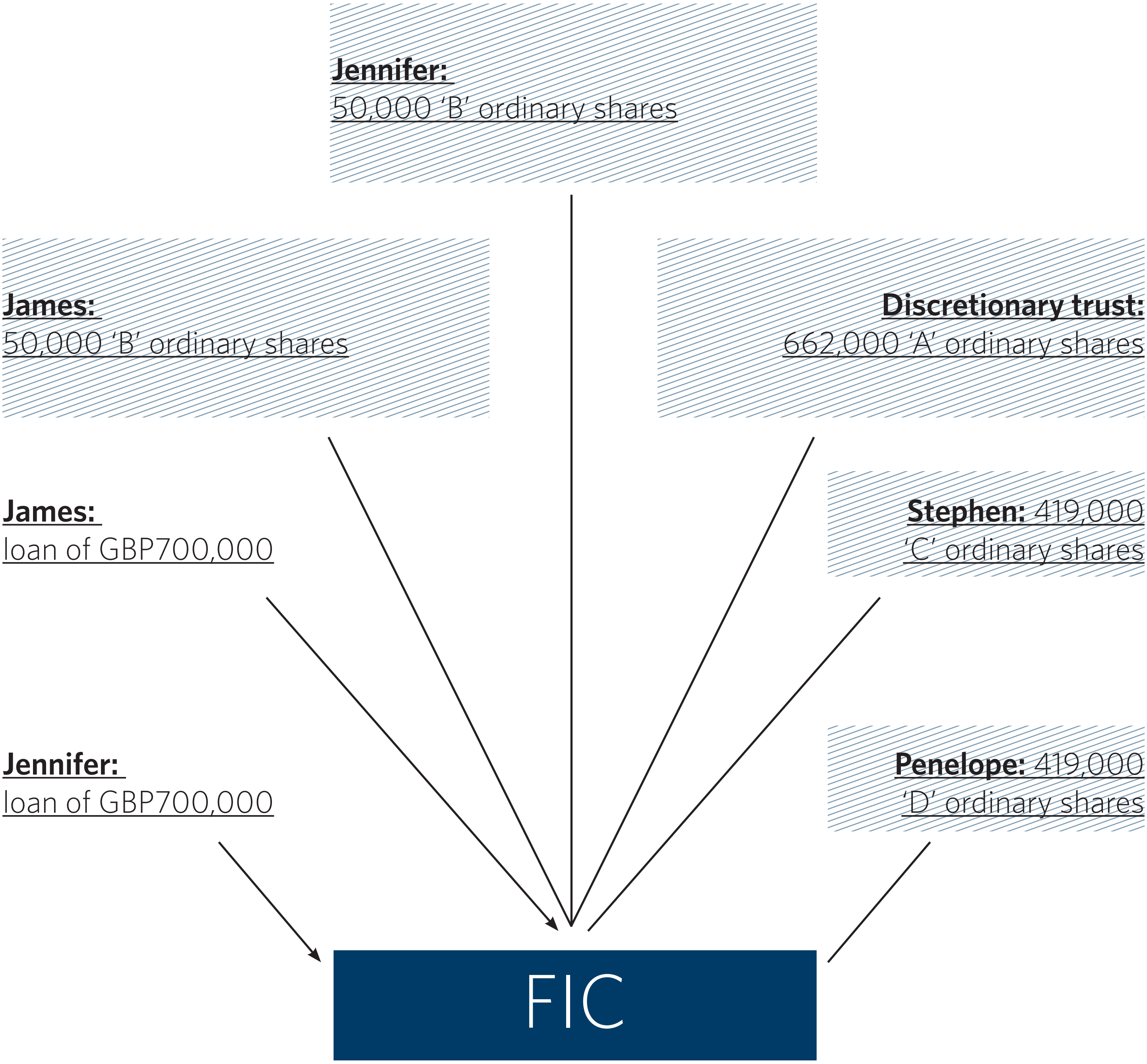
The first question to ask is how an FIC should be structured. The answer is that this will always depend on the facts. There is no specific way an FIC needs to be structured, and this is why an FIC is potentially such a useful investment vehicle. At the very least, an FIC will be one

3. Section 236, *Financial Services and Markets Act 2000*

private company, the shareholders of which are family members and/or family trusts. It will have a memorandum and articles of association, and it will have a shareholders' agreement. The memorandum and articles will be public documents, but the shareholders' agreement will be private, so this often contains any family governance procedures. The shareholders' agreement may or may not be supported by a family constitution.

A sample structure might look like the diagram below.

Sample FIC structure



James and Jennifer have two children: Stephen and Penelope. James and Jennifer have just sold their business for GBP3 million. They have plenty of other assets so have decided to engage in some estate planning with the GBP3 million. They want to invest half of the amount for their children, and they want to continue to be able to benefit from the remaining half. Stephen is at university but James and Jennifer are concerned that the new friends he has made are a bad influence on him. Penelope is only 16 years old and so is not legally capable of owning assets herself. Her parents could make a gift to her that would be held on a bare trust until she is 18 years old, but they are worried about her receiving a significant amount of money at that age. So what should James and Jennifer do?

One suggestion is that they use the funds to set up an FIC. A primary objective of the parents is to retain control of the assets in the FIC but also to get GBP1.5 million out of their estates and held for the benefit of their children. To achieve this using an FIC, the key consideration at the outset is what share classes the FIC will have and what rights will be attached to each of those share classes.

“For the parents to retain control of the FIC, they need to retain control of the shareholder voting rights. This can be done by limiting the voting rights of the FIC to those classes of shares which the parents hold”

The diagram on the previous page assumes there will be a combination of ‘A’, ‘B’, ‘C’ and ‘D’ ordinary shares. Each share class can have its own bespoke rights, and it is through these rights that the estate-planning objectives of the parents can be met.

In this example, for the parents to retain control of the FIC, they need to retain control of the shareholder voting rights. This can be done by limiting the voting rights of the FIC to those classes of shares which the parents hold. The parents can hold the voting rights personally or through a trust. One way of achieving this is for the parents to fund a discretionary trust for the benefit of their children and remoter issue with up to GBP662,000 (the combination of their nil-rate bands and annual allowances for this year and last). They could be appointed trustees of the trust and, as trustees, they subscribe for up to GBP662,000 of ‘A’ ordinary shares. To achieve their aim of getting the monies out of their estates, the settlors/parents will need to be irrevocably excluded from benefit from the trusts. As trustees, James and Jennifer will control the voting rights of the FIC as the trustees hold the majority of the voting shares in the FIC. In the future, either Stephen or Penelope (or both) could also be added as trustees; this can be a useful way of initiating their involvement in the management of the FIC and the family wealth.

As James and Jennifer can only contribute up to GBP662,000 without triggering an inheritance tax liability, they will need to consider other ways of funding the FIC. How they achieve this will depend on how much of the GBP3 million they wish to give away. In the example above, they want to retain the benefit of GBP1.5 million. This amount can still be used to fund the FIC, but to keep the benefit of it James and Jennifer could either subscribe for additional ‘B’ ordinary shares which have voting rights and dividend rights or make loans to the

FIC. Alternatively, James and Jennifer could subscribe for preference shares in the FIC instead of loans. However, unless there is a reason for them to participate by way of preference shares it is preferable for them to provide additional funding by way of loan as there are fewer company law considerations on making loan repayments.

One point to note on this structure is that if James and Jennifer subscribe for additional 'B' shares in the FIC then it is important to irrevocably limit the amount of dividend income which can be paid to this share class to the percentage of the overall share capital retained by James and Jennifer at any one time, to ensure that a gift with reservation of benefit (GROB) cannot occur. Care would also need to be taken, if James and Jennifer had subscribed for preference shares, that the GROB rules are not in point on a redemption. In fact, where possible, there is a strong preference that parents do not retain any equity interest in the FIC as this will trigger the need to manage the GROB issue both immediately and in the long term. It also makes the drafting of the documents more complex.

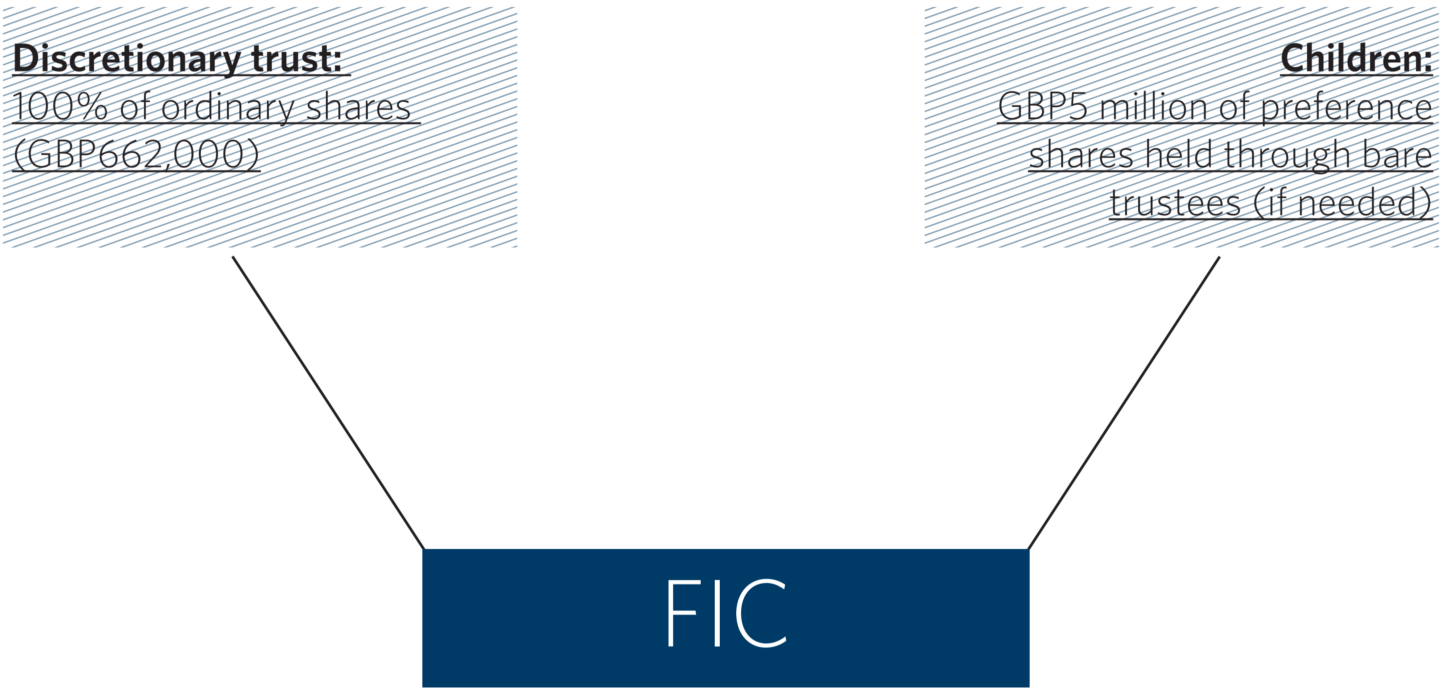
To achieve their objective of gifting up to GBP1.5 million to their children, James and Jennifer could create an additional share class for each of them. Subscribing for different share classes can enable a dividend to be declared on one share class but not on the other (i.e. money can be passed to Stephen and Penelope independently of the other).

This alternative structure is shown below.

In this approach, the parents do not retain any funds for themselves. Instead, they each contribute their nil-rate band to a discretionary trust, which holds the ordinary shares in the FIC and thereby controls the voting rights. Because the parents do not retain any shares in their own names the GROB concerns are significantly reduced.

The remaining funding is provided by way of preference shares, which are held in the names of the children (via bare trustees if needed). The terms of those shares could be drafted with or without income rights (although see below) and,

Alternative FIC structure:



more importantly, can be drafted to delay any redemption rights until the children are older.

There are some technical points to consider here. The first is that if the preference shares do not carry income rights and are not repayable for a specified period, in economic terms they would be similar to an interest-free loan for a fixed term and HMRC might argue that the holder of the preference shares is making a lifetime chargeable transfer to the company (and to the ordinary shareholders of the company, i.e. the trust). To avoid this, the preference shares could carry appropriate income rights. The issue this creates is that the holder of the shares would have an ongoing income tax liability or, if the coupon is rolled up for a fixed period subject to the directors' discretion to pay earlier, the holder may receive more money on the eventual redemption of the preference shares than was originally intended and so this issue will need to be balanced against the risk of a lifetime transfer.

The second point to consider is whether any tax issues arise from how the preference shares are subscribed for. The subscription options are that either the parents subscribe cash for the shares and then gift the shares to the children, or the parents gift cash to the children and the children (in Penelope's case through her bare trustee) could subscribe for the shares in their own names.

The first option presents an inherent capital gains tax (CGT) risk. The transfer of the shares from the parent to the child is a disposal for market value for CGT purposes because the parties are connected. When determining that market value, the risk is that because the share rights are restricted, HMRC could argue that the market value is less than the initial subscription monies. If such an argument were successful, the children's base cost in the shares will be lower than what was actually subscribed for them by their parents, so the children would make a much larger capital gain when the shares are eventually disposed of.

The alternative is for the parents to gift monies to the children and the children to subscribe for the shares themselves. This, however, may not be suitable if the children are over 18 years old as they could then choose to invest the monies in something else! However, if the child is under 18 the funds can be held on bare trust for them and invested on their behalf. Although unlikely, it is worth noting the possibility that when the child reaches 18, they could, in theory, choose to repudiate the contract entered into by the bare trustees on their behalf or they could bring a claim for breach of fiduciary duties by the bare trustees if the child feels the money has been poorly invested. In practice, the risk of these claims being brought, and then being successful, is low for a number of reasons. But the risk is worth considering.

Once the subscription process is finished, and the FIC fully funded, the first objective of retaining control while changing ownership will have been achieved. The next question is how monies can be extracted from the FIC in a tax-efficient way, and this is where the recent changes to the taxation of companies in the UK come to the fore.

Taxation of FICs: mitigating the effect of the traditional double-tax charge

The double-tax charge on (i) profits in the company and (ii) subsequent profit extraction by the shareholder was traditionally why a company was unattractive as a wealth-holding vehicle.

Profits in the company

Due to recent decreases in the corporation tax rate, there is now a significant difference between corporation tax rates (currently 23 per cent and due to decrease to 20 per cent by 1 April 2015) and the top income tax rate of 45 per cent. As a result, because the FIC can, after 1 April 2015, reinvest GBP80 out of every GBP100 of profit, it is in a significantly better position to accumulate post-tax wealth than an individual holder of the same investments, who could reinvest only GBP55 out of every GBP100 of profit. An FIC will also be in a better position to accumulate post-tax wealth derived from capital gains, not only because it enjoys the lower corporation tax rate

> The income tax position on receipt of income from the discretionary trust can be improved by granting life interests to beneficiaries

when compared to the 28 per cent CGT rate for an individual, but also because as a company it can still benefit from indexation allowance.

Profit extraction

Profit extraction can, at first, appear inefficient because of the double-tax charge. However, is this charge as bad as first thought?

First, the lower corporation tax rate makes the cost of double taxation lower than it once was. Also, changes to the taxation of dividend income mean dividend income will not be subject to double tax.

Second, the 2009 changes to the taxation of dividends received by non-UK companies have extended an exemption from corporation tax from dividends paid by UK-resident companies to dividends paid by a company resident in most countries with which the UK has a tax treaty.[4] This has increased the tax efficiency of FICs that directly invest in equities by allowing them to receive dividend income free from corporation tax.

Also note that double taxation is an issue only if the trust beneficiary is a higher or additional rate taxpayer. If the recipient is a basic rate taxpayer, because of the 10 per cent tax credit, up to about GBP32,010 can be distributed to them free of tax in this current tax year. This can prove to be a very efficient way of funding university education.

Finally, the income tax position on receipt of income from the discretionary trust can be improved by granting life interests over some or all of the trust fund (which can be revocable for flexibility reasons) to beneficiaries.[5] The company directors (the parents) can still control the dividend flow from the FIC, and so limit the income received by the trust, and thus the beneficiaries.

Conclusion

Salomon v *A Salomon and Co Ltd* [1897] AC 22 is alive and well after *Petrodel*. This means sensibly used corporate structures, particularly where there is third-party ownership, can be effective to protect assets in the event of divorce. This, combined with the potential tax benefits, means FICs, particularly when combined with trusts and other ownership structures, have a significant role to play in wealth planning for UK-domiciled families. FICs are creatures of contract not of equity and they should not be seen so much as replacements for trusts (which after all remain one of English law's greatest innovations) but as powerful tools to be combined with trusts and other vehicles to hold family wealth.

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4. Part 9A of the *Corporation Tax Act 2009*

5. Subject to not falling foul of the child of settlor anti-avoidance provisions found in s629 of the *Income Tax (Trading and Other Income) Act 2006*, which in practice means that the interest in possession beneficiary needs to be 18 or over if they are a child of the settlor