The new holy grail?

PATRICK HARNEY, SPENCER CLARKE AND **HOLLY JONES** CONSIDER THE POTENTIAL OF UK FAMILY INVESTMENT COMPANIES IN LIGHT OF THE RECENT *PETRODEL* CASE

Since the time of the crusades we have had trusts; one of English law's most wonderful innovations. In recent times, English family law courts have seen fit to drive an articulated truck through equity's darling and ignore the legal effect of trusts in divorce proceedings, and UK tax law has followed suit by penalising their use. English law invented trusts and is now crucifying them. By contrast, the recent case of *Petrodel Resources Ltd and others* v *Prest and others* [2012] EWCA Civ 1395 shows that even English family law courts will, unless there is impropriety associated with the use of the structure itself, respect the corporate veil and all that it protects. Moreover, tax changes introduced in 2009 have significantly enhanced the tax treatment of dividend income received by UK companies, and the rate of corporation tax is on a downward trajectory. What this all means is that in light of the reduced effectiveness of trusts as family wealth holding vehicles for UK-domiciled families, family investment companies (FICs) are increasingly becoming a tax-efficient alternative structure that can also provide a significant layer of protection from divorce.

As many readers will be aware, the changes to the taxation of trusts introduced in the UK *Finance Act 2006* completely changed the wealth planning landscape. Gone were the days of using trusts as a tax-neutral method of protecting family wealth. Instead, a new dawn of 20 per cent entry charges and 6 per cent ten-year-anniversary charges for almost all lifetime trusts arose as the cost of entering into the vehicles that had traditionally been used as a means of separating ownership and control of family assets. This effectively eliminated the widespread use of trusts for lifetime gifts in excess of the nil rate band. There is, however, a strong appetite among wealthy individuals to find a suitable alternative.

Various entities have been put forward as the alternative: family limited partnerships (FLPs), family general partnerships and FICs. There are, however, regulatory downsides to using partnerships and, until recently, there were taxation downsides to using FICs. As indicated above, further tax changes introduced in 2009 have alleviated some of those taxation downsides, and, first, this article will set out how these changes have affected FICs. The second part of this article examines the recent *Petrodel* case, which reinstated the supremacy of the corporate veil in FICs and discusses what this means for FICs where protection from divorce is a consideration.

What is an FIC?

When considering the use of an FIC, the first question to ask is: 'What is it?' The answer is that no two FICs are the same, and the structure of each company is bespoke to the family, assets and wealth involved. They are private companies, the shareholders of which are members of the same family and/or family trusts. An FIC will have a memorandum and articles of association and a shareholders' agreement. The memorandum and articles will be public documents, but the shareholders' agreement is private and it is this that can provide for family governance procedures, although it may be supplemented by a family constitution. Importantly, there are no substantive regulatory requirements associated with FICs, as there are with FLPs.

A sample structure for an FIC might involve two parents with, for example, GBP3 million of excess assets. The parents wish to be able to benefit from half of this, and for their children to benefit from the rest. They do not wish to gift this directly to the children as one child is at university with slightly questionable friends and the other child is a minor and so is not capable of owning assets outright. The parents use the funds to set up an FIC. They put GBP1.5 million into the FIC by way of an interest-free loan, repayable on demand. Sometimes preference shares are used instead, although a straight loan has the advantage of avoiding company law concerns when it is wished to have the loan repaid. The parents put as much money as they are able without triggering inheritance tax into a trust (i.e. GBP662,000, their combined nil rate bands plus annual exemptions) for the benefit of their children. They are both irrevocably excluded from benefit from the trust. As trustees of that trust, they subscribe for the one 'A' voting share and 662,000 'B' GBP1 ordinary shares. The parents personally subscribe for 419,000 'C' GBP1 ordinary shares and 419,000 'D' GBP1 ordinary shares and they gift the 'C' shares to the adult child and the 'D' shares to a bare trustee for the minor child. Only the B, C and D shares may receive dividends. In estate-planning terms the parents have achieved the following objectives:

- They have made a gift to their children that will avoid inheritance tax if they survive seven years.
- They have pooled family investments in an investment vehicle that is controlled by the senior generation.
- They can control the distribution of income among the family members.

These sound like many of the objectives that were once achieved by a accumulation and maintenance trusts or pre-22 March 2006 gifts into life interest trusts.

Tax efficiency

The estate-planning benefits outlined above seem clear. It is also necessary to consider the taxation of the FIC at entity and shareholder level. The 2009 changes to the taxation of company dividends are what have really improved the FIC's potential as an investment vehicle. Traditionally, dividend income received by a UK-resident company, from another UK-resident company, was not subject to tax in the UK. The 2009 changes extended this to dividends received by a UK-resident company from a company resident in most countries with which the UK has a tax treaty. This is a powerful change as it facilitates 'gross roll up' of dividend income. Effectively, it allows the taxation of dividend income to be indefinitely deferred until a distribution is made from the FIC.

Any other income received by the FIC will be taxed at the corporation tax rate (currently 24 per cent, due to decrease to 23 per cent in April 2013). Immediately one can see that the lower rate of taxation in the FIC, when compared with personal taxation, leverages the reinvestment potential of the profits made by the FIC if they are retained and reinvested. In figures, the comparison is that if the profits of an FIC are to be used to grow wealth then the FIC can reinvest GBP76 out of every GBP100 (or GBP100 of every GBP100 if dividend income is received), compared to an individual being able to reinvest GBP50 out of every GBP100 (or GBP55 from 6 April 2013).

Moving on to shareholder taxation, there is of course the dreaded double-tax charge. On a closer examination, however, the impact of double taxation is perhaps not as bad as first thought. First, there is no double taxation of dividend income. Second, where the recipient of dividend income is a basic-rate taxpayer and has no other income, because of the 10 per cent dividend tax credit, they can receive GBP34,370 free of tax. This can prove to be an efficient way of funding university education.

Asset protection on divorce

In addition to the tax benefits of using FICs, the *Petrodel* case has reiterated that an appropriately structured and appropriately used FIC can be an effective tool in sheltering assets from divorce.

The case is an appeal from the judgment of the Family Division (which has often found itself in conflict with other divisions of the High Court in its approach to certain issues). The appeal was made by companies in which the husband, Mr Prest, has a controlling interest, against orders made that the companies transfer company-owned assets (properties in London) to Mrs Prest.

At first instance the judge followed what he considered to be the standard practice (endorsed by Thorpe LJ's dissenting Court of Appeal judgment) of ordering that the properties be transferred, even though not owned by the husband, on the basis that the companies that owned them were his 'alter ego'.

The lead judgment in the Court of Appeal was given by Rimer LJ, with whom Patten LJ concurred. Rimer LJ asserted the supremacy of the principle affirmed in the well-known 1897 House of Lords Case of *Salomon* v *Salomon and Company Ltd* [1897] AC 22 that incorporated companies are, legally, wholly separate from those who incorporated them, i.e. their shareholders.

The Court of Appeal held that 'the veil of incorporation' can only be pierced (i.e. to look through the company structure to the shareholders, so that, as in the first instance in *Petrodel*, orders can be made against company assets) if there is proof of impropriety by the party in question in the sense of misuse of the company structure for the purpose of concealing wrongdoing, and where that wrongdoer, e.g. on the wife's case, the husband in *Petrodel*, has control of the company.

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Where there was no impropriety, there was no basis for an order that assets belonging to companies of which a party was the controlling shareholder be transferred to the other party on divorce. In *Petrodel* Moylan J had specifically found that there was no such impropriety and therefore his orders regarding the company assets being transferred to the wife were overturned, and the Family Division was given a stern warning to be consistent with the approach taken by other divisions of the High Court.

Family lawyers, if acting for the non-shareholder party, and family judges, may well try to continue to find ways to do justice in cases where most of the assets are held in a company structure (thus preventing offsetting by transfer of assets outside such a structure), for instance by arguments revolving around trust law, greater use of the Family Court's powers to restrain the disposal of assets or to set aside such a disposition, or a finding that the company will continue to be a resource for the shareholding party, justifying the transfer of a greater proportion of the other assets to the other party.

That said, the *Petrodel* case is a strong reminder to those who practice in family law that, if there is no evidence of impropriety, it will not be open to a judge to make orders purporting to transfer assets owned by a company. Given the Family Court's extensive power to deal with (nuptial) settlements, this may make family investment companies a more attractive proposition for reasons of asset protection on divorce, as well as tax efficiency. ■

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