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PARTNERS ' VIEW
September 2018

WEALTH MANAGEMENT
Equity Markets hit by summer storms and Turkey

As Europe basked in glorious summer weather, concerns over on-going trade disputes between US & China has decreased investor appetite in recent weeks. However, as the mid- term elections in America are scheduled to take place in a few months' time and Trump is trailing in the polls, we feel that the rhetoric on trade disputes may well decrease in the coming months.

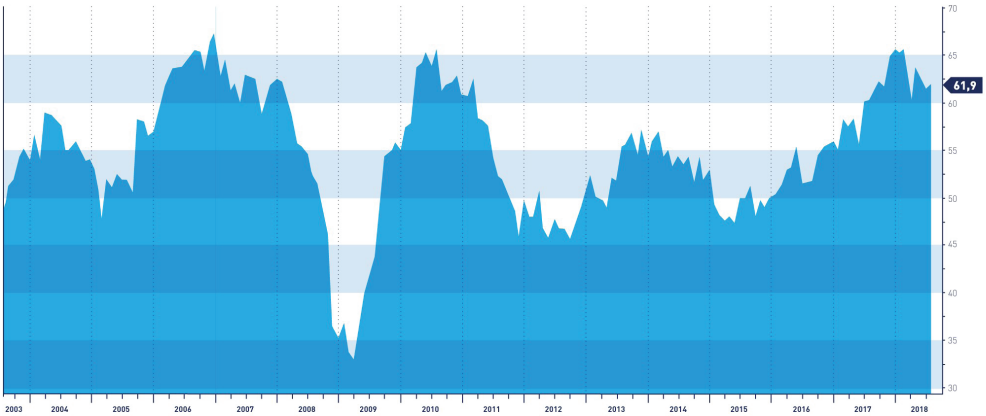
Technology – rational investors still around

It is still hard to argue against holding good quality technology shares for the longer term. Results from the sector have been spectacular over many years, especially since 2007/8 and show few signs of abating. Moreover, technology is creeping into every facet of modern life and this positive tail wind seems unlikely to abate.
Whilst we acknowledge that there is always some froth in the tech space, especially around new issues, we are heartened by the fact that the market is willing to steadily reduce ratings on former darlings – such as Tencent, the well-known Chinese Group.

Switzerland – the orders keep coming

Closer to home, Switzerland PMI's (Purchasing Managers Index) has been in fine form recently. A combination of a stable currency, a pro-business legislature, innovative management teams and a commitment towards investment in plant and equipment through capex, has in our view kept the orders coming in at a good rate.

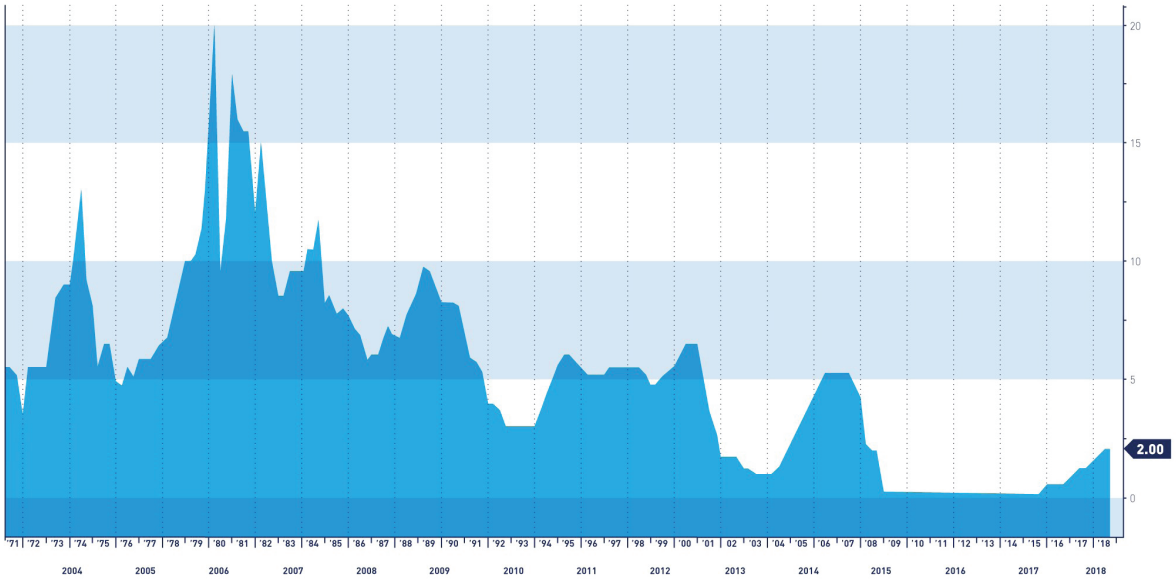
Switzerland PMI · July 2003 – July 2018



Switzerland PMI; Source: Bloomberg 15/8/18

Bonds- High yield – time for a diagnostic check?

US Federal Funds Rate · March 1971 – August 2018



US Federal Funds Rate; Source: Bloomberg 15/8/18

All good parties come to an end

Like attendance at a great party which went on way too long, bond investors in Europe and America are starting to take note of the rising risks.

As any self-respecting financial commentator will tell you, US rates have been rising for some time now as their economy booms and this higher cost of borrowing is being felt by borrowers and consumers. These groups include among their ranks, little known bond issuers from Latin America, Asia and of course Eastern Europe.

But I am only looking for 5% - seems fair?

The first lesson is that in every decade since 1979, many investors have been attracted to high bond yields regardless of the risks and in the good times this works like a charm.

'After all, (says the bond salesman), it's yielding 5% and that is what you used to get for simple cash deposits, so it seems like a fair yield'. Like, but not quite. The lesson is of course just because you cannot see the risks does not mean they do not exist.

Bond Price & liquidity shock

Most of the time bonds perform without too much volatility and seem safe. Safe that is until the investor notices that the bond price is falling sharply and what used to trade at $100 is now bid for at $78. Then, as in previous bond cycles, their investigation begins and the bond investor notices that there is speculation that their company is in serious trouble. Then comes the next big shock, there is very little liquidity in the bond (no one really wants to buy it) and with the benefit of hindsight the obscure Asian issuer no longer feels like a great place to invest.

Reaction from 2 mindsets – (it's good to talk)

At this stage investors tend to fall into 2 mindsets. The first group decide to hold on in the hope that the bond price will recover and sadly for many within this group the price keeps falling.

However, the second group decide to request a detailed review of all their bonds with an Investment Specialist and are able to decide based on careful financial analysis which bonds to keep and which to sell in order to protect their overall wealth.

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Getting in touch

As US rates are likely to rise over the next 12-24 months, we feel that this will put pressure on some Bond issuers. Moreover, if you are concerned over any direct bond which you have purchased in recent years, perhaps through another investment house, please do not hesitate to contact swisspartners.

Turkey and Emerging Markets

In recent weeks, Emerging Equity markets have fallen sharply following renewed US trade sanctions against Turkey and concerns over the leadership of PM Erdogan.

As equity markets entered their Summer doldrums, America again voiced its displeasure that there has been no progress in recent talks to release an American Religious Pastor on what many believe are spurious charges of being involved in a coup attempt in 2016.

The talks appear to have ground to a halt for now but despite all the posturing some commentators are hopeful that a resolution can be found through the normal Diplomatic ' back channels'.

Amid concerns over Erdogan and the trade sanctions from America, the Turkish Lira has plunged over 40% this year and the 'fear factor' spread as Emerging Market investors displayed their usual 'herd like' mentality by reducing their equity exposures in certain countries. The exchange rate matters a lot in Turkey as it relies a lot on imports of products such as oil. This rise in the cost of imports has a serious knock on effect through higher inflation for local people.

Thankfully within our model portfolios we don't have direct exposure to Turkish Bonds or Equities.

Furthermore, in our "swisspartners Emerging Market Opportunities FoF" we don't have exposure to Turkey, Mexico, Russia or Brazil, whereas South Africa is quite underweight.

We do of course keep these relative positions under constant review and so if market conditions improve we may look to reduce these gaps, except Turkey. However, it is quite likely that we would take such actions in stages.

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FINANCIAL PLANNING
US inheritance tax can also affect Swiss citizens

At the beginning of August, it was reported that Apple became the first company to have a market capitalization of over one trillion, i.e. more than 1000 billion. This has been the result of a rising price of Apple shares, which has gained about 80% within the last three years. Also, a look at the American stock market indices, makes immediately apparent that they achieved a much better performance than their European counterparts.

Therefore, it has been for many investors only natural to profit from the rally and also invest in Apple, Coca Cola, Amex and other US equities. However, what many investors do not realise is the issue with the US inheritance tax. Non-US citizens who are resident in Switzerland may, under certain circumstances, be subject to an inheritance tax.

The following investment categories could be affected: equities of the US companies, US real estate and, in some cases, US bonds and investment funds of the US issuers with a total volume of more than USD 60,000. This is a consequence of an agreement with the USA from signed in the year 1951.

The following calculation formula can be applied:
US assets x tax exempt amount for US citizens * / total value of estate

If an investor holds USD 2 million in US equities with a total estate of USD 25 million, the tax-exempt amount is USD 896,000. If this allowance is deducted from the US assets of USD 2 million, USD 1,104,000 will be taxed. With a tax rate of presumably 40%, the tax amount to be paid is, thus, just under USD 450,000.

In order to be eligible for this allowance, the entire estate must also be disclosed to the US tax authorities.

In principle, the US estate tax does not apply to non-US collective investment schemes or to other indirectly held US investment vehicles designed as, for example, structured products. This gives investors the opportunity to still participate in the US equity market without risking their own estate being heavily taxed. It is important that every case is examined individually in order to implement a tailor-made solution.

* The allowance for US persons is adjusted for inflation annually. For the year 2018, this amounted to USD 11,200,000

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FIDUCIARY SERVICE SWISS
What does art have to do with taxes?

It has been already for some time and before the articles appeared in the media in recent months about the Zurich art collector, that many private art collectors found themselves in the spotlight of the tax authorities hovering with a hawk's eye over anything that could be subject to taxation.

Honestly! Have you ever considered whether this painting of a country landscape, which has been hanging in your study for many years, and which you originally received as a gift, makes you a potential tax evader? Maybe the value of this painting is subject to wealth tax and you should have, therefore, declared it on your tax return. How is that possible?

The cantonal tax laws stipulate that paintings and other collections as well as works of art, jewellery and ornamental objects form part of the taxable assets, while only household effects are tax-free. It is particularly important to note that not only art collections but also a single art object may have to be declared on the tax return. But where does the borderline between tax-free household effects and taxable assets run?

For a long time, the practice has been that the context in which the art object is used constitutes the deciding factor. As long as the object of art serves residential purpose or personal use and can be counted as the "usual furnishings of the home", it is considered as a household goods. If, on the other hand, the acquisition of the art object has the character of an investment, then it constitutes a taxable asset. The conclusion of a separate insurance contract can be a strong, although not irrefutable indication in this regard. In any case, the income and wealth circumstances of the taxpayer must be taken under consideration.

In 2012, a controversy arose from a decision of the Administrative Court of the Canton of Zurich, which stipulated that regardless of their purpose, such objects should always be classified as taxable assets, as soon as their market value exceeds a certain amount. However, the level of this "certain amount" has been left open by the court. In that specific case it concerned a painting insured for CHF 150,000.

Should you have now accepted that the landscape painting is after all a part of the taxable assets, further tax issues immediately arise.

Should, for instance, your painting appreciates in value and you decide to sell it, the tax authorities will most likely want to know more about the circumstances of the sale. If you have acted "commercially" in the sense of official practice - which might be the case, for example, when selling through an auction house - the profit actually generated will be subject to both income tax and AHV contributions. In addition, a high revenue from the sale could become taxable for VAT. The Federal Supreme Court has already upheld respective assessments of the tax authorities and the Social Insurance Funds (AHV Ausgleichkassen) taking into account the approach to and the specific circumstances of the sale.

Even if this makes you shake your head and you rather opt for giving away the painting, remember that all cantons with the exception of Schwyz, Lucerne and Obwalden levy a gift tax. If the recipient is not himself exempt from paying gift tax (as is the case with spouses and descendants as well as with many museums), this donation can be an expensive affair. And please do not forget: as a general rule, the donor is jointly and severally liable with the recipient for paying the gift tax!

Our tax consultants at swisspartners have extensive experience in tax matters relating to works of art and art collections. If you have a specific question, do not hesitate to contact us.

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TRUST & CORPORATE SERVICES

Protectors of Anglo-Saxon trusts: an old concept with a few pitfalls (part 1)

Summary: Protectors of trusts (and foundations) are often friends or long-time business partners of the trust settlor. We strongly advocate appointing of independent and professional protectors.

Initial situation

A wealthy entrepreneur, with his family scattered across several countries, wishes his wealth to be managed legally and tax-wise in a most optimal manner. His advisers recommend that he set up a trust under the Anglo-Saxon law* and transfer substantial part of his assets to this trust. The entrepreneur agrees. However, as he does not know and will rarely meet the trust company, which his advisers recommend to him (they are based in Cayman Islands), the advisers urge him to appoint a protector to represent his and his family's interests. In this situation the following questions need to be addressed:

Who are the protectors of trusts?

The function of a protector does not constitute a regulated activity. Therefore, the spectrum of possible protectors can range from a school friend of the trust settlor, long-time business associates such as asset managers, or specialized companies that act exclusively and professionally as protectors.

The developments within the trust sector clearly go in the direction of professionalisation of the protector function.

- Family friends and godparents may find themselves easily overwhelmed in times of crisis while, at best, they are not impartial, being often too close to the events.
- Long-time business associates, such as asset managers or bankers, should, on the one hand, have in mind the interests of the beneficiary but, on the other hand, have financial interest in the trust's assets. For this reason, some banks prohibit their employees from accepting such mandates.
- Trust companies or specialized consulting firms avoid the weaknesses of the aforementioned individuals and offer instead an independent, professional service. However, in such a relationship, proximity and connectedness to the settler and his family may be missing. Also, such an arrangement results in additional costs since professional protectors are generally remunerated with a fixed fee as well as an hourly fee.
- In the case of very large fortunes, a Protector Council, consisting of family members and professional trustees, is occasionally set up.

How is the role of a protector defined and what powers does he possess?

There is no legally binding definition of the protector. The function is best summarized as follows: a protector is not a trustee but a "watchdog" who controls the trustee and his activities.

The protector as a watchdog

His duties must be fully defined in the Trust Deed. In the today common Trust Deeds, the duties of the protector include at the minimum the dispositive decision-making authority to remove the trustee and to select a new one. In addition, protectors often have veto rights over decisions of the trustee.

These veto rights usually include:

- exclusion and addition of beneficiaries·
- distributions to the beneficiaries·
- investment strategies·
- granting of loans·
- changes to the Trust Deed
- changes to the relevant legal regulations, etc.

The list can be shortened or extended as desired and extends or curtails the autonomous decision-making authority of the trustee.

For whom does the protector work? For the settlor?

When establishing a trust, the settlor determines who should be the primary protector. Should it be a school friend, the lawyer, or a professional? With the appointment of the protector, the active relationship between the settler and the protector ends in principle. It is important to understand this statement. The Protector is never a representative of the settlor, but rather he is solely committed to act in the interests of the beneficiaries. This may sound a bit strange, however, especially for discretionary irrevocable trusts (where the settlor irrevocably assigns his rights to the trust assets to the trustee), the protector must not become a puppet of the settlor, as this could invalidate the trust!

In the second part, which will be published in the forthcoming issue of partners' view in November, we will be looking at cases in which a protector becomes active, talk about basic pitfalls, and examine how protectors are treated in the Automatic Information Exchange ("AIA").

* For the sake of simplicity, we refer in the following to discretionary irrevocable trusts (where the settlor irrevocably transfers his rights to the trust assets to the trustee). Other types of trusts, however, are subject to similar problems.

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INSURANCE
Life insurance solutions for residents from France – Recent changes

Life insurance has been a favorite inheritance planning tool for French residents for a number of years. The recently introduced Real Estate Wealth Tax ("IFI") will affect life insurance policies without reducing its most important advantages.

The French parliament finally adopted (on 31.12.2017) a new Finance Bill for 2018 which contain two main changes impacting life insurance solutions for French residents.

First of all, the replacement of the French Wealth Tax by the Real Estate Wealth Tax (so-called "IFI") for real estate assets held directly or indirectly by a taxpayer. As a general rule, life insurance contracts will not be affected by the new real estate wealth tax regulations. However, real estate investment funds and other real estate linked investments held within a life insurance portfolio will fall within the scope of the new tax regime. A close look at the investments held within such portfolio is recommended to identify the assets which might be affected by the new tax. It will not be difficult for an experienced investment advisor to identify such investments and avoid holding them in the future.

Second of all, the introduction of a global 30% "flat tax" on income and capital gain as from the 1st of January 2018. Previously, the tax regime applied a digressive income tax rate from 35% within the first four years of the contract, 15% from four to eight years and down to 7.5% after eight years, plus 15.5% social contributions. The new flat tax has two components, 12.8% income tax (reducing to 7.5% after eight years) and 17.2% social taxes (increase of 1.7% from previous General Social Contributions). The flat tax will apply on income derived from life insurance policies, but only upon partial or full surrender of the contract. However, the new Finance Bill distinguishes between insurance premiums invested before September 26, 2017 which remain subject to the previous tax regime; and premiums invested after September 27, 2018 which will be subject to the new 30% flat tax. For older life insurance contracts, a policyholder may face two different taxation regimes to cope with!

Comment

Even though it seems to be a major change in taxation of life insurance contracts, the effect is minimal for French resident policyholders and in some cases, beneficial from the previous tax regime. In a nutshell, it makes life easier for both, policyholders and French tax authorities.

Outlook

Life insurance strategies remain a powerful tool for wealth planning, especially for succession planning. Inheritance taxation remains untouched. If the insured person is under 70 years old at the moment when the insurance premium is paid to the insurance company, beneficiaries of life insurance policies will receive benefit payments taxed as follows: first EUR 152'500 free of inheritance tax per beneficiary and, thereafter, a reduced inheritance tax rate of 20% for the portion up to EUR 700'000 and at a rate of 31.25% for amounts exceeding EUR 700'000. For all premiums paid after the insured life reached the age of 70, the benefits received from a life insurance contract will be taxed as follows: first EUR 30'500 free of inheritance tax for all beneficiaries and application of the general inheritance tax regime but only on the amount of premium paid, which means that gains are not taxed.

Compared to the progressive inheritance tax rate which can go up to 60%, depending on the value of assets and the family link with the deceased, there is no better alternative than life insurance strategies for succession purposes. It's cheaper, easier and faster!

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