CAMBRIDGE
TRUST
LETTER
VOLUME 25, NUMBER 1 | WINTER 2016

The Importance of Corporate Governance

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Corporate governance is a system of rules by which a company is controlled. Oversight of a company's corporate governance practices is generally provided by the Board of Directors and senior management. Historically, corporate governance was often viewed as a parameter considered more by socially responsible investors, but as company scandals and lax oversight have cost investors millions of dollars in lost investment performance, the way in which a company is supervised has come under increased scrutiny by both mainstream and more activist investors.

The Board of Directors

Directors play an important role overseeing the operations of a company, including driving long-term strategic vision, overseeing company operations, and hiring and firing CEOs. Boards should have a majority of independent directors that are able to supervise management for the benefit of shareholders as well as independent committees. Board members should attend a majority of the meetings held and consideration should be given to how long a director has served on a board. Often, there are concerns that long-tenured directors become too entrenched in a company to be considered truly independent.

The separation of the Chair and CEO roles should be considered. In many cases, it may be appropriate to have the roles combined if there is some counterbalancing independent leadership position on the board such as a lead director. Otherwise, the combined CEO/Chair may be able to lead the Board to make rules that create a conflict of interest. For example, there has been recent publicity over a loan extended by Goldman Sachs to the CEO of Valeant Pharmaceuticals, Michael Pearson, who is also the Chairman of the Board. Under the terms of the loan, shares of Valeant were pledged and eventually sold to satisfy the loan. In 2014, Valeant's board changed its policies to prohibit the use of Valeant shares as collateral, with the exception of the CEO's loans. Most companies prohibit the use of shares as collateral, feeling that it takes away alignment with shareholders' interests, so it appears to be a conflict of interest to allow Valeant's CEO to consider pledging when others in the company cannot.

Overboarding has also been questioned in recent years. This refers to the problem of directors holding too many board seats, either for publicly traded companies or nonprofit organizations. As a result, they may be unable to attend meetings, not be able to prepare questions or discuss key issues, and generally be unable to adequately serve the shareholders who elected them. A recent Boston Globe article, *Debate Swirls on How Many Board Directorships are Enough, December 10, 2015*, highlights the directorships held by Jonathan F. Miller, the former head of AOL, Inc. As of November 2015, he was on the board of eight publicly traded companies. That equates to over 100 meetings a year, held in multiple cities (generating income in directorship fees of over $1 million a year). Additionally, he sat on 11 nonprofit or private boards and had a full-time job as a partner in a venture capital company. Following the article published by The Boston Globe, it was revealed that Miller was violating a number of company stipulations limiting the number of board seats a director could hold; he has since resigned from several of them.

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Shareholders should review the performance of directors who held seats on boards of companies that underwent significant accounting or ethical scandals, questioning whether the directors should have known beforehand or taken a different course of action. Valeant Pharmaceuticals has received significant coverage over issues regarding its relationship with a mail order pharmacy and whether the company misled investors. In December 2015, it was reported that Norma Provencio, the independent director who chairs the audit committee, would join two other directors in an internal inquiry into drug pricing allegations. At the time, it was revealed she previously led the audit committee at Signalife, a company that failed following fraud allegations. It was found that Signalife lacked adequate internal controls, allowing for inflation of its earnings. While Ms. Provencio was not accused of wrong doing at Signalife, it raises questions over whether she should have been aware of the internal controls issues and it is certainly a blemish on her record as a director and questions her qualification to lead Valeant's audit committee. At the end of February, it was announced that Valeant's earnings release will be delayed and that the company is under investigation by the Securities and Exchange Commission (SEC).

Diversity

It can be argued that gender, age, and minority diversity should be a part of every company's board and senior management. A recent survey between June and November 2015 by The Boston Globe found that 80% of directors at publicly traded companies in Massachusetts were white men. Twenty percent of companies were found to have no women on the board. Studies have found that diverse boards and management groups tend to engage in less groupthink; promoting diversity also promotes talent. A March 21, 2014 study by Wake Forest University entitled *Board Diversity and Corporate Risk Taking* looked at the performance of more than 2,000 companies from 1998 to 2011 and found that companies with better diversified boards were more risk averse, had less volatile stock returns, and were more likely to pay dividends.

Compensation

Compensation should be reviewed at both the board and executive management levels.

Director compensation has been increasing in recent years. According to a December 2, 2015 Boston Globe article, *Few Hours, Soaring Pay for Corporate Board Members*, the compensation received by directors has nearly doubled since 2000 at the largest 200 publicly traded companies in the U.S. to a median of $258,000. While the role board members play should not be diminished and the hours devoted to board positions have been growing, the position remains part time and many directors are also employed full time elsewhere. Concerns have been voiced that directors may not adequately question the actions of senior management for fear of losing their board fees.

A 2006 study in the Journal of Corporate Finance (*CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism?* by Ivan E. Brick, Oded Palmon, and John K. Wald) found that highly compensated boards often underperformed their peers. A notable example is Enron, which had one of the highest paid boards in the U.S. in 2001, the same year the company collapsed.

The highly paid directors of Chesapeake Energy were questioned in 2012 about their failure to monitor the spending and conflicts of interest of the company's CEO. For several years prior, the CEO was borrowing against his Chesapeake shares in order to purchase positions in wells that the company drilled. This strategy worked against him as the market turned down in 2008 when he was forced to sell shares to service his debts. The stock price fell 40% in the week his shares were sold. A year later, the Board removed requirements on the level of shares a CEO must own while at the same time granting a $75 million dollar bonus to be used for further purchases in company wells. The Board later claimed to have not fully understood the CEO's borrowing, but it is easy to see how many investors perceived a conflict of interest in both the Board and the CEO's actions. It was also later learned that the CEO had run a hedge fund that focused on Chesapeake's products, another conflict of interest. In addition he was also forced to buy back a map collection that he had sold to Chesapeake for $12 million in order to settle a shareholder lawsuit. The CEO was eventually forced out in 2013, costing Chesapeake a further $6 million in severance expenses. Chesapeake continues to struggle with both Standard & Poors (S&P) and Moody's downgrading their ratings this past December (See Appendix 1 for Chesapeake Timeline).

The scope and method of management compensation should be considered as well, with proxy statements a good source of information about executive compensation plans. Institutional Shareholder Services (ISS), a proxy voting recommendation service, spells out five compensation

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guidelines that it feels should be adhered to in its proxy voting principles:

1. Pay should be aligned with performance, with an emphasis on the long term.
2. Avoid "paying for failure," by avoiding guaranteed compensation and excessive severance packages.
3. Have an independent compensation committee for effective oversight.
4. Have transparent and comprehensive compensation disclosures.
5. Manage payments made to nonexecutive directors. Overpaid nonexecutive directors may not make independent judgments on managers' compensation and performance.

Auditors

Audit practices and company accounting can also be a sign of problems to come. Auditors should be independent (with no financial interest in a company) and the majority of their revenues earned should be derived from audit activities, not consultation services. Accounting issues should be handled in a transparent manner, with measures put in place to prevent recurrence of an event.

Shareholder Rights and Takeover Provisions

Investors should consider shareholder rights. Do all shareholders hold equal voting rights or is one share class advantaged over the other? Multiple shares/classes do not necessarily indicate poor governance. This can be common in the information technology sector, with company founders and insiders holding shares that have greater voting rights than outside investors. Shareholders should have access to place proposals on proxy ballots or nominate directors. A company's record of dealing with shareholder proposals that receive a majority of votes may also be an indicator of how a company deals with its shareholders. Investors should also consider what actions a board can take without shareholder approval, such as amending company bylaws.

Finally, takeover provisions should be reviewed. Are there plans in place, such as poison pills, that can make it difficult for a company to be acquired? How is management rewarded in the event of a takeover? Shareholders should have adequate rights to vote on these provisions.

Proxy Voting and Corporate Governance

Increasingly, investors use proxy voting as a means to judge a board's corporate governance or even to improve it. According to ISS' *2015: Proxy Season Review – Governance Proposals*, there were 238 governance-related shareholder proposals on ballots in 2015, with proxy access and calls for independent board chairs being the top two most received proposals.

The number of shareholder proposals seeking proxy access provisions has been growing although social and environmental proposals continue to be the majority. Hedge fund activists have also continued with attempts to place their nominees on boards. As a result, many boards also submitted corporate governance proposals for shareholder approval in 2015, including proxy access, board declassification, calling special meetings, and supermajority voting.

Perhaps the most well-known proxy contest of the year happened at DuPont. Trian Fund Management, one of the company's largest shareholders, had been attempting for some time to engage with DuPont on value enhancing strategies. When this engagement failed, Trian proposed four of its own candidates to replace incumbent directors on the Board. In the end, all of the DuPont nominees won their board seats. Success in fending off Trian is attributed in part to a shareholder outreach campaign targeting both institutional and retail investors. Subsequently plans were announced for Dow Chemical and DuPont to merge.

In 2014, as it was preparing to spin off PayPal, eBay found itself the target of activist investor, Carl Icahn, who focused on the company's corporate governance, alleging that certain directors were acting in their own interests rather than the interests of shareholders. He felt that the financial performance of the company could be affected if directors were making decisions that had the potential to hurt eBay's profits. Ultimately, an Icahn representative joined eBay's board, and will transition to PayPal's board. As part of its spinoff, it was also agreed that PayPal's chartering documents would contain more shareholder-friendly corporate governance provisions regarding poison pills, a nonstaggered board (all directors will be elected annually), shareholder ability to call special meetings, and supermajority voting provisions. Carl Icahn ultimately sold his position in eBay in the third quarter of 2015, swapping into an equal number of shares of PayPal.

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Planning for Noncitizens: An Overview

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"Are you a U.S. citizen?" In the context of tax and estate planning, the answer to this question is very important. And considering that there are more than 22 million noncitizens in the U.S.*, it is a question that professional advisors should ask all of their clients.

Background

If you are a U.S. citizen, the U.S. has the power to tax your income, wherever in the world the income is generated, regardless of your domicile, residency, or location of your property. In addition, your assets will be subject to U.S. estate taxes, notwithstanding where in the world those assets are located.

In contrast, a noncitizen's residency is determinative with respect to U.S. taxation. This article will review the requirements for residency and only address the more common issues and options for noncitizens who are residents of the U.S. Accordingly, please be mindful that different issues and rules apply with respect to U.S. taxation of noncitizens who do not reside in the U.S. and to citizens who have renounced their U.S. citizenship.

Residency Test for Income Tax Purposes

A noncitizen is presumed to be a nonresident unless he or she proves residency.

There are several different ways to determine residency. One method is being lawfully admitted as a permanent resident, which is typically evidenced via a green card giving the noncitizen the right to work in the U.S.

Alternatively, a noncitizen is considered a resident if he or she satisfies a substantial presence test, by being physically present in the U.S. for a prescribed number of days during the year, without having a closer connection to another country. The rules surrounding this test are beyond the scope of this article. The takeaway is this: an individual can still be a resident noncitizen even if he or she does not have a green card.

There is one additional way a noncitizen can be considered a resident and that is by making an affirmative election to be considered a resident during the first year of living in the U.S. This election is made on the noncitizen's U.S. income tax return by filing as a resident.

Residency Test for Transfer Tax Purposes

Just because a noncitizen is a resident for U.S. income tax purposes does not automatically mean he or she is a resident for transfer tax purposes, i.e. gift taxes, estate taxes, and generation skipping taxes (GST). For these purposes, residency requires both a physical presence in the U.S. *and* the intent to remain in the U.S. indefinitely. This is essentially the common law concept of domicile. The intention to remain in the U.S. indefinitely can be evidenced by the amount of time spent in the U.S. versus other countries, location of family and friends, location of personal property, location of business interests, declarations of residence, or intent in legal documents, such as wills and trusts and visa status.

Residency Test for Other Countries

It is important to keep in mind that it is possible that both the U.S. and another country consider the noncitizen to be a resident. Absent a treaty with that other country, the individual could be subject to tax by both countries, with only the U.S. foreign tax credit rules to lessen the U.S. estate tax liability. Accordingly, the residency requirements of other potentially applicable countries should also be considered.

U.S. Taxation of Noncitizens

Income Taxes

With respect to U.S. income taxes, a noncitizen is treated the same as a citizen: all income, wherever generated, is taxable. In addition, a noncitizen is entitled to a U.S. income tax deduction for contributions to qualified charities (but keep in mind that the deduction is generally limited to donations that will be used in the U.S. or are made to a U.S. organization). Donations to charities located in other countries may be deductible if allowed by treaty.

Gift Taxes

Gifts made by noncitizens are generally subject to the U.S. gift tax wherever in the world the property is located.

If the donor is a noncitizen and makes a gift to a spouse who is a citizen, then the unlimited gift tax marital deduction is allowed, subject to the otherwise applicable gift tax rules. However, if the spouse *receiving* the gift is a *noncitizen*, then the unlimited marital deduction is not available;

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instead, the donor is allowed an enhanced annual exclusion ($148,000 in 2016, adjusted annually for inflation) each year without using any of the donor's lifetime estate and gift tax exemption ($5,450,000 in 2016, adjusted annually for inflation). Considering that gift transfers between spouses are commonly implemented during estate planning, it is critical not to overlook this limitation. Accordingly, if you or your spouse is a noncitizen, your estate planning advisors should be made aware of this fact.

With respect to gifts to a spouse who is a citizen, a noncitizen has the same lifetime gift tax exemption as a citizen, and the tuition, medical, and annual exclusions are also available. Also, gift-splitting between spouses is available as long as each spouse is a citizen or a resident noncitizen.

Generation Skipping Taxes

Noncitizens are subject to U.S. generation skipping taxes (GST) in the same manner as citizens; which includes the GST exemption available to citizens. All of the resident's property, wherever situated in the world, is subject to the GST tax system.

Estate Taxes

In general, noncitizens are subject to U.S. estate tax in the same manner as citizens. The gross estate includes all property located anywhere in the world and the same tax tables, deductions, and credits apply as they do to a citizen's estate. The one important difference is that, similar to the unlimited gift tax marital deduction, an individual can pass an unlimited amount to their surviving spouse without incurring an estate tax *only* if the surviving spouse is a citizen.

Considering that many estate plans for married couples rely upon the unlimited marital deduction available to citizens, this limitation should not be overlooked and it stresses the importance of making sure the estate planning attorney and other professional advisors know the citizenship of the couple. Some planning options to address this limitation are discussed below.

Equally important to note is that, with respect to estate taxes and the other various taxes discussed above, it is critical to determine whether the U.S. is party to a tax treaty with the country in which the noncitizen holds citizenship or where property is located because such treaty may reduce or eliminate U.S. tax liability. In addition, if another country also considers the noncitizen a resident, absent a tax treaty with that country, the individual may be subject to income taxes in both countries.

Estate Planning Solutions

Qualified Domestic Trust ("QDOT")

One estate planning option for married couples when one or both are noncitizens is to include a QDOT as part of the plan. Because the unlimited marital deduction is not available when the surviving spouse is a noncitizen, the deceased spouse's assets can be held in a QDOT for the benefit of the surviving spouse and there will be no estate tax liability at that time with respect to such assets. Instead, estate taxes will be deferred until a triggering event occurs, namely: (1) a nonhardship distribution of principal to the surviving spouse, (2) the trust ceases to meet QDOT requirements, or (3) the death of the surviving noncitizen spouse. The deferred estate tax due is the amount that would have been owed if the QDOT property was included in the deceased spouse's estate and estate taxes were paid at that time using the tax tables, deductions, and credits then in effect.

This differs in two significant ways from the situation where the surviving spouse is a citizen: first, the estate tax due upon the surviving spouse's death would be based on the tax tables, deductions, and credits in effect at the time of the second death, not the first spouse's death; and second, distributions of income and principal to the surviving spouse for any reason are not subject to the estate tax.

In a QDOT, a hardship distribution to a surviving spouse must be for an *immediate and substantial financial need* relating to the health, education, maintenance, or support of the spouse or someone legally dependent upon the spouse. If the spouse has access to other sources of money that are reasonably available, such as personally owned, publicly traded stocks or cash, then the distribution will be considered a nonhardship distribution and be subject to the estate tax.

In addition, there are a myriad of requirements that must be satisfied for a trust to be a QDOT that are beyond the scope of this article.

QDOT Advantages

For some, deferral of estate taxes is enough of a reason to have a QDOT. Other reasons why a QDOT may be preferred to other alternatives is that it can allow the donor spouse to control who will receive the assets after the death of the surviving noncitizen spouse. The deferred estate tax can

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PetSmart was also a target of activist hedge fund, Jana Partners, in 2014, which at the time held a 10% position in the company. Following disappointing performance, Jana demanded that the company put itself up for sale, believing it would be attractive to private equity ventures. Ultimately, the company chose to bow to those demands, with an agreement announced to sell the company in December of that year. According to a New York Times article published on January 4, 2015, (*How Jana Partners Got a Quick PetSmart Payday*), Jana earned $450 million from its position in PetSmart, doubling its investment in five months.

Letter writing campaigns can also be successful in lobbying for change in a company's corporate governance and have, in some cases, taken the place of putting proposals on shareholder ballots. Pension funds and asset managers have successfully used letter writing, often joining forces to bring in voting measures, including majority voting, repealing classified boards, and removing supermajority voting provisions.

Shareholders can use their votes to send a message to directors, withholding votes from directors in cases where companies have failed to act on past winning shareholder proposals, failed to take action against directors with poor performance or if the board lacks accountability and sufficient oversight.

Volkswagen: A Failure in Corporate Governance?

The Volkswagen Group, headquartered in Germany, is one of the leading automobile manufacturers in the world. Founded by Adolf Hitler in 1936, it was controlled by the British army after World War II and then privatized in 1960. With 12 car brands, the company today is the largest carmaker in Europe. Volkswagen also looks to the U.S. for a large percentage of its sales.

In September 2015, Volkswagen admitted to installing software on cars in model years 2009 to 2015 that circumvented nitrogen oxide emissions standards. There is the potential for 11 million vehicles to be affected worldwide, with over 400,000 vehicles in the U.S. The CEO resigned and the company has set aside a large reserve to cover the potential costs of the scandal as investors have seen the stock price plunge. Lawsuits are expected and the company has seen its access to credit suspended and its debt rating cut. According to a New York Times article published on December 17, 2015 (*Europe Investigates Green-Tinted Loans Made to VW*), Volkswagen now faces inquiries by European anti-fraud investigators looking at whether low-interest loans intended to finance environmental impact reductions were misused. Concerns have also been raised about the business ethics of Volkswagen as well as the control mechanisms in place by management and the board in light of the fact that the company deliberately deceived regulators and consumers. The stock has dropped 25% since the first of September.

A September 23, 2015 Special Company Alert report published by Sustainalytics entitled *Volkswagen – Violation of the U.S. Clean Air Act* highlights the risks that the company may face going forward:

Reputation risks: The news has generated significant widespread negative attention, particularly on Volkswagen's commitment to sustainability and the environment.

Legal risks: There will likely be criminal charges brought against Volkswagen executives as well as class action lawsuits by consumers and shareholders.

Operational risks: The Environmental Protection Agency will compel Volkswagen to recall affected cars as well as develop a plan to change its technologies to actually meet environmental standards.

Market and business risks: Sales have declined since the violations were announced and are expected to fall further. The U.S. has been of strategic importance to Volkswagen's sales and consumer trust will likely affect future sales.

Regulatory risks: There will be increased regulatory scrutiny of all Volkswagen products going forward, both in the U.S. and abroad.

What were some of the potential corporate governance warnings that might have helped investors avoid the emissions scandal?

Over the long term, Volkswagen has rated poorly on a number of factors in corporate governance. The company does not have an independent board. Instead, there is a large nonindependent supervisory board that includes representatives of the Federal State of Lower Saxony, the local union, family members, and company insiders. A nonindependent board can lead to problems of integrity and clarity of responsibilities with sensitive issues discussed outside of the boardroom. Large family holdings, such as the approximately 50% held by the Porsche-Piech family, can also be a red flag; investors should consider the motivation

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and drive of the family to have a long-term view to grow the company. Volkswagen has a dual class voting structure, with one class carrying no voting rights. This can allow shareholders with voting rights to resist takeover or other outside proposals.

MSCI, which issues company ratings and research, saw potential controversies with Volkswagen going back to 2013 in the areas of product and service quality, bribery and fraud, and collective bargaining. By April 2015, the company scored lower in governance than 72% of the company's covered by MSCI ESG Research and was eventually dropped from MSCI's ACWI ESG Index.

ISS Proxy Advisory Services noted a number of deviations from the local corporate governance code, the German Corporate Governance Code (Kodex), in its May 2015 proxy recommendation report for Volkswagen shareholders. Notably, Volkswagen has no specified age limit for management board members, feeling that age does not limit ability to manage the company. The company also stated that it was unsure its audit committee chair could be considered independent because of the relationship with the Porsche-Piech family as well as holding a minority interest in Porsche Automobil Holding SE. Finally, Volkswagen does not agree with the recommended practice of disclosing the personal and professional backgrounds of its supervisory board nominees. This information is often used by investors to determine whether a nominee is truly independent.

In its report, ISS recommended that shareholders vote against a number of proposals on the ballot. This included voting against two nonindependent board nominees because of low board independence, which would have been lowered to only 5% independent directors if both nominees won their seats. There was also a proposal to create a 179.2 million euro capital pool to be used for the issuance of new nonvoting preferred shares. ISS recommended a vote against the creation of this capital pool because it perpetuated the company's dual class voting structure and there were no specifics given on the purpose of the capital creation (See Appendix 2 for Volkswagen Timeline).

Corporate governance can be an important risk management tool for investors to use when evaluating an investment as it may highlight potential risks or problems before they come to light. A company that has entrenched directors, management with compensation tied to short-term performance, or auditors paid more for consulting than auditing can be a sign of issues to come that may affect the long-term performance of a stock. While strong governance may not prevent all problems, nor guarantee a superior investment return, a strongly governed company may suffer less damage and recover more quickly from unanticipated events, leading to more sustainable results and less volatility.

Chesapeake Timeline (Appendix 1)

1989 – Chesapeake Energy is founded.

1992 – A company well participation program allows the CEO to invest in wells drilled by Chesapeake. He begins to take loans pledging his portion of Chesapeake wells as collateral.

2004-2008 – The CEO runs hedge fund that focuses on the products that Chesapeake produces.

October 2008 – The CEO sells 31 million Chesapeake shares for debt service; stocks falls 40% in the week sales are made.

2008 – Chesapeake Board buys CEO's map collection for $12 million.

2008 – SEC requests more information about CEO benefits as part of a review of the company's annual report.

June 2009 – CEO borrows $225 million, pledging well shares as collateral.

December 2010 – CEO borrows $375 million, pledging well shares as collateral.

November 2011 – CEO buys back map collection in order to settle shareholder lawsuit.

November 2011 – Chesapeake hires corporate governance and executive compensation consultant.

January 2012 – CEO borrows $500 million, pledging well shares as collateral.

June 2012 – Shareholders reject two board members and approve increased proxy access.

June 2012 – CEO steps down as Chairman of the Board but remains as CEO.

February 2013 – An internal board review finds no evidence of improper conduct or excessive costs to the company.

April 2013 – CEO steps down.

February 2015 – Chesapeake sues former CEO for the misappropriation of company data.

December 2015 – Debt ratings cut by S&P and Moody's.

February 2016 – Former CEO indicted on charges of conspiring to rig the price of oil and gas leases from 2007 - 2012.

March 2, 2016 – Aubrey McClendon dies in car crash.

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Volkswagen Timeline (Appendix 2)

2008 – Software that will evade emissions tests is put in place in vehicles. Recently departed CEO Martin Winterkorn was, at that time, the head of Research & Development.

May 2014 – Volkswagen claims that emission discrepancies are due to technical issues and other unexpected conditions.

April 2015 – Succession and leadership dispute between CEO Martin Winterkorn and board chairman Ferdinand Piech. Piech resigns after the supervisory board supports Winterkorn.

September 2015 – Volkswagen announces plans to have 20 new models of hybrid and electric cars by 2020 in line with commitments to improving sustainability.

September 18, 2015 – The EPA issues a notice of violation against Volkswagen.

September 22, 2015 – Volkswagen reserves $7.3 billion to cover costs and fines.

September 23, 2015 – CEO Martin Winterkorn resigns.

October 2015 – Sales fall 5.3% globally.

November 4, 2015 – Moody's downgrades rating from A2 to A3.

December 2015 – European anti-fraud investigations begin to evaluate Volkswagen's use of low-interest loans that were intended to finance environmental impact reductions.

December 1, 2015 – Credit rating cut from A- to BBB+ by S&P.

February 2016 – Diesel vehicle recall begins in Europe.

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Cambridge TrustLetter is a publication of Cambridge Trust Company, an FDIC member bank with 12 Massachusetts branch offices in Cambridge, Boston, Belmont, Concord, Lexington, Lincoln, and Weston. The Wealth Management group maintains offices in Boston, Massachusetts, and Concord, Manchester, and Portsmouth, New Hampshire. Telephone connecting all Massachusetts offices is 617-876-5500. For New Hampshire offices, call 603-226-1212. Visit our website at cambridgetrust.com.

also have the effect of forcing the surviving spouse to use his or her own assets before invading QDOT principal for nonhardship purposes. This can be particularly useful in a second marriage situation.

QDOT Disadvantages

One of the advantages discussed above is also a disadvantage: payment of estate taxes for distributions of principal for nonhardship purposes. Keep in mind that a distribution of principal from a QDOT to pay the tax on the nonhardship distribution is itself considered a nonhardship distribution, meaning the money distributed to the spouse to pay the tax is also subject to the tax. Further, the complexity and compliance requirements of a QDOT are time consuming and can be costly. There are strict limitations as to who can be a trustee and the trustee may be at odds with the surviving spouse concerning investment strategy because distributions may effectively be limited to income only.

Accordingly, while a QDOT is often considered the default estate planning solution for noncitizen spouses, careful consideration should be made of the couple's circumstances and the various advantages and disadvantages of a QDOT before making a decision.

Irrevocable Life Insurance Trust ("ILIT")

If life insurance is an option, then an ILIT should be considered as part of the estate plan for married couples where one or both are noncitizens. Properly drafted and funded, the proceeds of life insurance policies owned by the ILIT will not be subject to estate taxes of the insured or the surviving noncitizen spouse, which means there can be greater flexibility for distributions to the spouse than are available from a QDOT, where distributions may be subject to the estate tax.

If a QDOT is not employed, the ILIT can replace the amount of estate taxes paid as a result of an outright bequest from the estate to the noncitizen spouse. Alternatively, if a QDOT is employed, then the ILIT can be used to support the surviving noncitizen spouse while deferring estate taxes on the QDOT principal until the death of the spouse – arguably, a best of both worlds scenario. Note: an ILIT does not need to satisfy the QDOT requirements even though the beneficiary spouse is a noncitizen.

Conclusion

In summary, if you are not a U.S. citizen, your professional advisors need to know. Likewise, professional advisors need to confirm a client's citizenship when providing tax and estate planning services. Overall, the issues, rules, and options for noncitizens are not particularly more complex or difficult than they are for citizens, just different. There is another option available to noncitizens not previously mentioned: the noncitizen can become a citizen. This is not to suggest that taxes should be *the* reason to become a citizen, but it may be *a* reason. Finally, even though previously stated, it is important to remember to check whether the U.S. is party to a tax treaty that alters the default U.S. laws on these issues.

* U.S. Census Bureau, 2010-2012 American Community Survey

Cambridge TrustLetter

Winter 2016

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