

SYNOPSIS SERIES

Decoding the Mysteries of a PTC

A trust may be used for many reasons. While families around the world look for ways to protect their wealth, trust structures can assist in numerous ways including succession, estate planning and asset protection. However, business owners may face various concerns when setting up a typical discretionary trust due to high ongoing operating costs, some professional trustees' unwillingness to take on certain types of assets as well as the business owners' own desire to retain control over their assets.

As such, Private Trust Companies (PTC) have been developed in several jurisdictions as a specific trust structure attempting to resolve these concerns. A PTC is essentially an entity which is set up as a corporate trustee, with the single purpose of providing trust and fiduciary services to a trust or a number of "connected" trusts. In various offshore trust jurisdictions, a PTC is exempt from any licensing requirement, provided that it does not offer trust services to the general public, unconnected trusts or persons not related to the settlor(s).

The need for PTC

PTCs can be useful for families to manage their own wealth without having to place their assets under the control of a third party professional trustee. A PTC structure also enables the family interest to retain continuity for years to come. As the name suggests, a PTC is set up specifically for an individual family for their private needs. The company can be managed by the settlor or anyone the settlor deems to be suitable. Where a professional trustee may avoid interfering with the management of an operating business or the concentration of certain asset classes due to concerns or uncertainty over its fiduciary duty to act in the best interest of the beneficiaries, a settlor may choose to use a PTC for such assets.

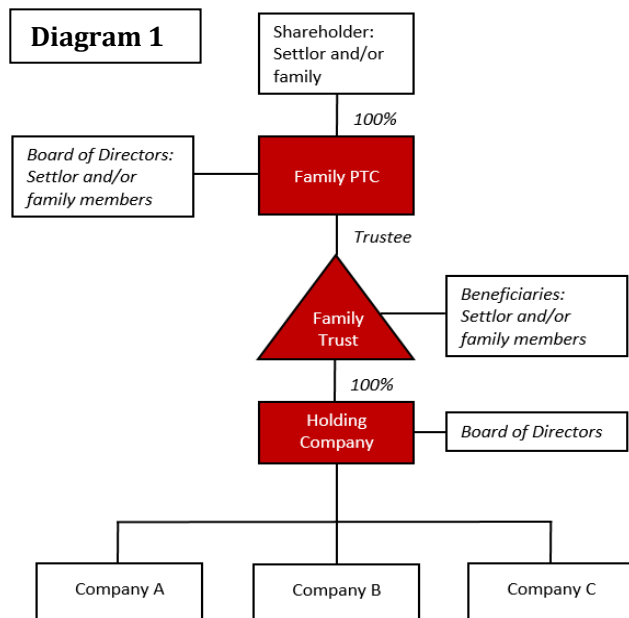
For those who are unfamiliar with the idea of setting up a trust, the idea of surrendering legal ownership and control to a third party and often in another jurisdiction would be a difficult proposition to accept. Here, a key advantage of establishing a PTC is the additional element of control it provides to the settlor and the settlor's family. It is common for the settlor and his or her family members to sit on the board of directors of the PTC to actively take part in the management and business decisions of the family business. Through particular arrangement, a settlor or his or her successor may appoint or dismiss members of the board of directors of the PTC as they see fit. The composition of the board can from time to time include new family members who have genuine interest and business experiences to contribute towards the growth of the family business. Therefore, a PTC could address a settlor's concern on relinquishing control over his/her family business and assets, as well as allow generational transfer of management.

Having said that, it is also important to note that the appointment of directors to the PTC should be taken mindful of the potential conflict of interest due to the different roles that an individual may have under the trust structure. For instance, if a beneficiary is appointed by the settlor of a family trust to be a director of the PTC which manages the said trust, such beneficiary must fully understand the requirements of this position. In particular, he or she cannot be unduly influenced by personal circumstances or interest when making decisions since it is the interest of the beneficiaries as a whole to be considered by the PTC and its board of directors. In some situations, it may be useful to appoint professional director(s) to the board for assistance, to enhance the management and administration of the entire structure.

Ownership

We explore below the ownership alternatives of establishing a PTC. The PTC may be owned directly by the settlor and/or his or her family members; by the trustee of a non-charitable purpose trust; or under a foundation.

Direct Ownership and Management of a PTC



Perhaps the most straight-forward method of structuring a PTC is to place its ownership and management directly under the name of the settlor or the settlor's family. Diagram 1 illustrates a typical arrangement whereby the settlor directly holds the PTC.

Unfortunately, this option lacks a contingency plan or any protection from potential legal actions. Should the structure be solely owned by one individual, upon this individual's demise, the PTC, the trust and any underlying entities may collapse if succession planning is not properly implemented. On the other hand, if the PTC is owned by the settlor and family members to ensure the continuity of the structure, there remains a risk that creditors of the settlor or family members can make claims against the shares of the PTC in order to satisfy the relevant debts.

Ownership and Management of the PTC via a Purpose Trust

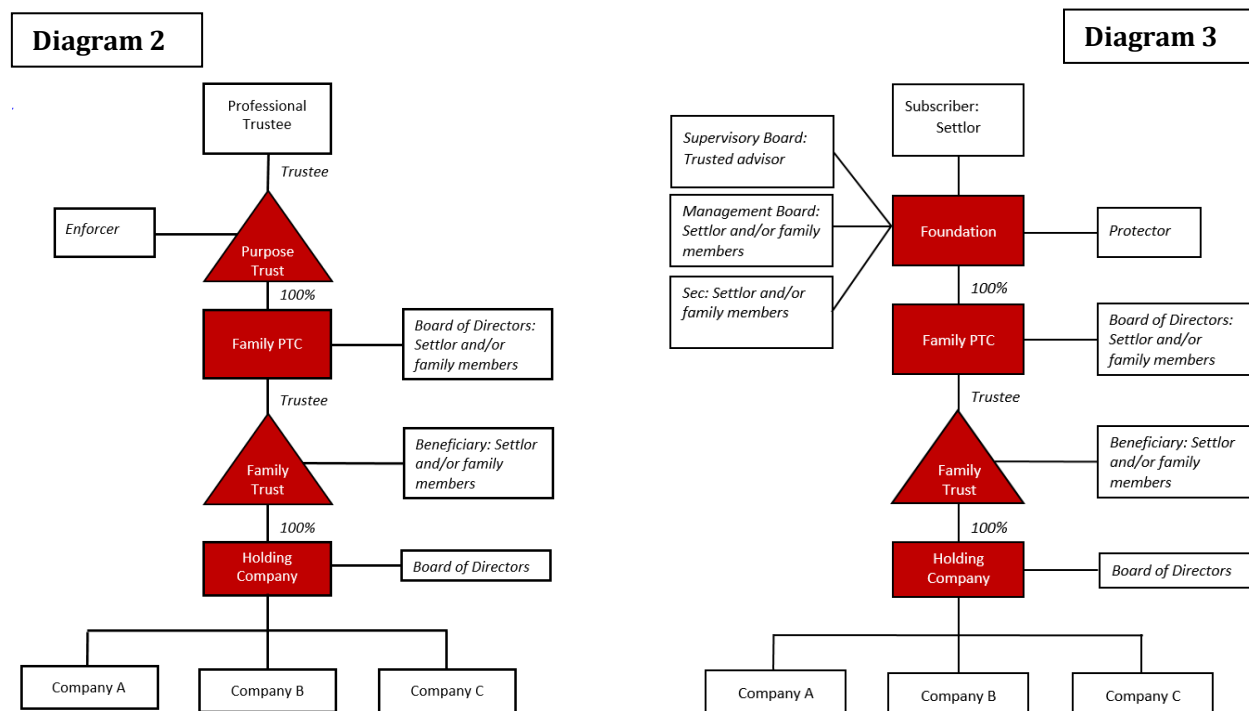
A purpose trust is a particular type of trust which can be established to hold assets for a specified purpose without any named persons or classes of people as beneficiaries. Here, a purpose trust can be used to hold shares of a PTC, whereby the trustee of the purpose trust is usually a professional trustee.

Typically an enforcer or enforcer's committee may be appointed to provide directions to the professional trustee where needed to ensure that the trustee fulfils its duties under the trust. The enforcer may also provide guidance with respect to the composition and appointment or removal of the directors of the underlying PTC. Diagram 2 illustrates the structure of a PTC which is held by a purpose trust.

Ownership and Management of a PTC by a Foundation

Another possible ownership structure for a PTC is having its shares held by a foundation, which is an entity that is separate and distinct from all other interested parties of the PTC. A foundation can simultaneously act as the owner and manager of the PTC, while it is, itself, a self-owned structure that has been endowed by the settlor of the PTC to be utilized for persons or purposes as detailed in its charter. A foundation does not have owners per se, but instead is a legal person and can bring and defend legal actions in its own name.

Under this structure, the settlor and/or beneficiaries can be appointed to the management board of the foundation and also have an active involvement as directors of the PTC. Diagram 3 illustrates how a foundation is used to hold a PTC.



Conflict of Laws for PTCs

Hong Kong is one of the major private wealth management hubs serving many high to ultra-high net worth individuals and families based locally or elsewhere in Asia. Some of these families adopt a PTC structure for the purpose of holding family owned business and assets or even as a platform to carry out investments. Typically, a PTC as such would be incorporated in a traditionally popular offshore jurisdiction (such as Bermuda, Cayman Islands or Jersey), with its sponsor being a trustee company, similarly located in an offshore jurisdiction. The trustee company would play the role of setting up the PTC structure and may also enter into an administrative service agreement with the PTC. Depending on its structure, the Hong Kong office of the trustee company might provide services ranging from liaison and relationship management through to providing secretarial or administrative support for the PTC.

The laws and regulations under the relevant jurisdiction governing an offshore structure may differ significantly from those of Hong Kong or any other onshore jurisdiction(s) where the assets are located. Particularly, the domicile law of a PTC becomes relevant when determining the substantive law applicable in the event of a claim or enforceability of a judgment against the structure. There is no assurance that a court of the (onshore) jurisdiction where the trust assets are located will enforce a judgment obtained from the foreign jurisdiction where the trust was set up. In fact, there appears to be a new willingness to address this issue given the appropriate circumstance, with the issues most recently being brought to the public's attention through the case concerning Yung Kee Holdings Limited.

The Yung Kee Case

While the Yung Kee Holdings Limited case¹ did not involve the use of a trust or PTC, it reflects the Hong Kong court's approach to ruling in a shareholders' dispute over foreign companies holding local assets. To summarize the case, it involved a shareholders' dispute over a family owned company, Yung Kee Holdings Limited (YKL), an offshore company incorporated in the British Virgin Islands. YKL owned the family's assets, most importantly the Yung Kee restaurant in Hong Kong.

The petitioner sought relief under what were previously the provisions of the Hong Kong Companies Ordinance (Cap. 32), section 168A (the unfair prejudice remedy²) and in the alternative section 327(3)(c) (winding up on just and equitable basis). After several rounds of appeal, the Court of Final Appeal (CFA) unanimously agreed that this case had failed concerning the availability of the unfair prejudice remedy (s. 168A), because it could not be shown that the company had established a place of business in Hong Kong. However, the appeal concerning availability of the winding up remedy in Hong Kong on just and equitable basis (s. 327(3)(c)) was allowed. In the context of our present discussion, it is important to note that the CFA was willing to exercise its statutory jurisdiction over YKL, a foreign company for a winding-up order on just and equitable ground as the CFA found that there was sufficient connection between the foreign company and the court's jurisdiction, notwithstanding, the foreign company was incorporated in another jurisdiction.

In light of the case, in the event of a dispute involving an offshore PTC which has its management and control in Hong Kong, this may become relevant to the question whether the Hong Kong courts may assume jurisdiction to hear the dispute and may potentially apply Hong Kong law.

Setting up a Hong Kong PTC

A PTC can be incorporated in Hong Kong although this is not usual for private purposes. The process for setting up a PTC under Hong Kong law can be relatively straight forward whereby the entity may be either incorporated as a private company limited by shares or a company limited by guarantee. As a Hong Kong company, this entity is capable of anything as a natural person is, including acting as a trustee. Unlike trustee companies registered under the Hong Kong Companies Registry that must fulfill certain requirements³, PTCs set up in Hong Kong are not required to obtain any license from any regulating authority.

Licensing Requirements / Exemptions in Other Jurisdictions

BVI – PTCs carrying on only “unremunerated trust business” or “related trust business” are exempted from regulation and licensing under the BVI Financial Services (Exemptions) Regulation

Cayman – PTCs registered under the Banks and Trust Companies Law by the Cayman Islands Monetary Authority (CIMA) and conducting “connected trust business” are exempted from obtaining a license.

For PTCs set up in Hong Kong as an incorporated company limited by guarantee, the Hong Kong Companies Registry would require the annual financial report of the Hong

¹ [2015] HKEC 2370, allowing appeal against [2014] 2 HKLRD 313 (HKCA)

² Section 168A(1) of the Companies Ordinance (Cap. 32) - Any member of a specified corporation who complains that the affairs of the specified corporation are being or have been conducted in a manner unfairly prejudicial to the interests of the members generally or of some part of the members (including himself) may make an application to the court by petition for an order under this section. (*This provision has now been replaced by Section 724 of the Companies Ordinance (Cap. 622)*)

³ Section 77(2) of the Trustee Ordinance (Cap. 29)

Kong PTC to be made public, making the management and finances of the Hong Kong PTC more transparent and hence an unattractive structure for settlors who wish to maintain confidentiality.

Transferring Hong Kong Assets into a PTC

Foreign or local individuals and/or families with assets in Hong Kong that are held in their personal names would have to deal with estate applications in the event of death. Depending on the nature of the assets and the amount of planning carried out by the family member during his/her lifetime, the probate process can be lengthy and take several years, during which time the assets are normally frozen until a grant of probate or letters of administration is issued by the court to enable the executor or administrator to take full control of the administration and distribution of the deceased's estate. One option available to avoid probate is for the deceased's assets to be transferred to a PTC by way of gift during the deceased's lifetime. However, before such transfer of assets is made, it is crucial that relevant tax advice be obtained to understand any tax ramifications arising out of the transfer and whether the holding structure of the assets in question needs to undertake any restructuring.

Settlors would also need to consider the necessary costs incurred for injecting assets into a family trust. If the assets to be injected into the trust are assets located in Hong Kong, the transfer of such assets may involve some Hong Kong stamp duty payable to the Hong Kong Inland Revenue Department ("IRD").

When injecting or transferring an asset into a family trust, a crucial aspect to consider would be the process and costs for such injection or transfer, especially for assets that are located in Hong Kong or other onshore jurisdictions. Unless specifically exempted or otherwise provided, stamp duty on the transfer of immovable property or stock in Hong Kong is chargeable with ad valorem stamp duty.

Section 27(5) of the Stamp Duty Ordinance (Cap. 117) ("**SDO**") provides that stamp duty is not chargeable where no beneficial interest passes in the property conveyed under the relevant instrument of transfer, or where a conveyance of immovable property or transfer of stock is made to a beneficiary by a trustee or other person in a fiduciary capacity under any trust, whether expressed or implied.

Section 45 of the SDO provides that (i) the conveyance of beneficial interest in immovable property or (ii) the transfer of beneficial interest in Hong Kong stock between entities considered as associated body-corporates are exempted from stamp duty if certain conditions are satisfied ("**Intra-group relief**"). The Intra-group relief may apply whether or not the transferor or transferee are incorporated in Hong Kong.

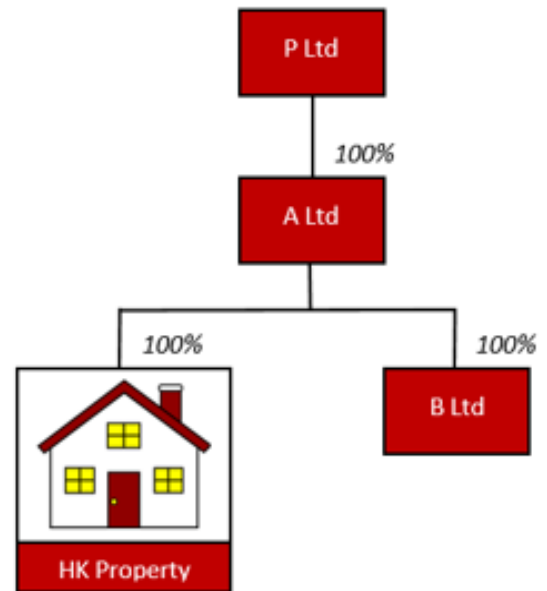
Companies are considered associated body-corporates where (i) either entity is a beneficial owner of not less than 90% of the issued share capital of the other; or (ii) a third of such body is a beneficial owner of not less than 90% of the issued share capital of each. Furthermore, there must also be no cessation of such associated relationship between both body-corporates within 2 years after the relevant transaction has been completed. Should any of the conditions mentioned above change in any way, the parties are required to notify the Inland Revenue Department of such event within 30 days and pay requisite stamp duty as if no such relief has been granted.

From time to time, families may wish to restructure their existing assets by distinctly separating their holding assets from the operating companies which may also be held by the same underlying companies. To illustrate how a structure may utilize the Intra-group relief, the following are case scenario and options available to deploy the Intra-group relief.

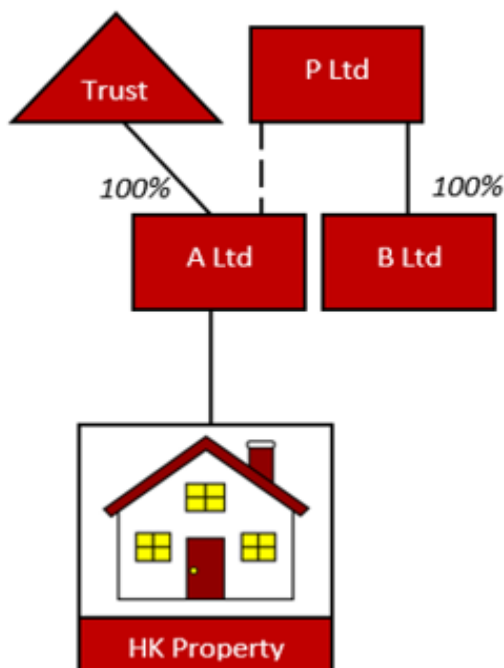
Scenario

Assuming that a family is the ultimate shareholder of a parent company (“**P Ltd**”), which holds 100% of the issued share capital of company A (“**A Ltd**”). A Ltd in turn holds a highly valuable residential property in Hong Kong (“**HK Property**”) and also 100% of the issued share capital of an operating company (“**B Ltd**”) with substantial business. The family wishes to protect their property assets by setting up a family trust and injecting the residential property under A Ltd into the said structure, leaving B Ltd under the group.

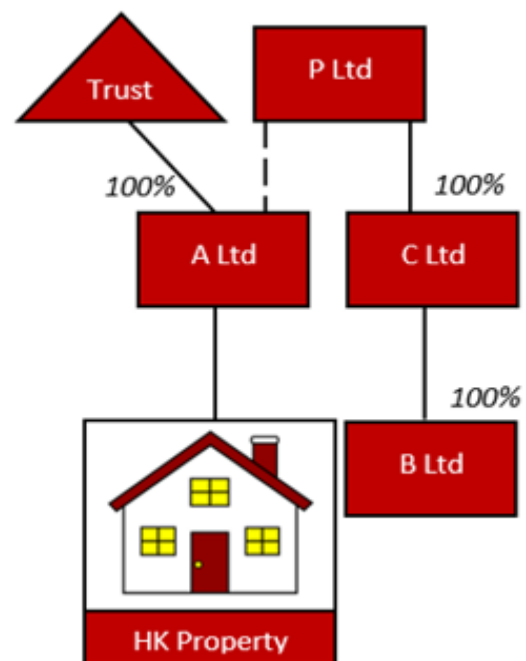
There may be two options available to the family as described and illustrated below: they may either (i) transfer the shares of B Ltd from A Ltd, the subsidiary company, to P Ltd, the parent company; or (ii) set up a new subsidiary company C (“**C Ltd**”) under P Ltd and transfer the shares of B Ltd from A Ltd to C Ltd, now a sister company. Once either of the transfer has been completed, P Ltd will transfer its shares in A Ltd to the trust/its holding company.



Option (i)



Option (ii)



In either case, the transfer of the shares of B Ltd may be undertaken pursuant to the Intra-group relief, subject further to complying with the required procedures of the IRD and related requirements and conditions.

However, the Intra-group relief could not apply on the direct injection of Hong Kong assets into the PTC, as the shareholders or beneficiaries are individuals, or are not associated body-corporates (eg. the professional trustee company).

AEOI/CRS on PTCs

The global standard for the automatic exchange of financial information (AEOI) was introduced by the Organisation for Economic Co-operation and Development (OECD) in July 2014. Hong Kong has brought into effect the tax legislation on implementing CRS through the Inland Revenue (Amendment) (no. 3) Ordinance 2016 (the “**Amended Ordinance**”) on 30 June 2016, thus set into motion the process of having all financial institutions operating in Hong Kong provide the relevant information of all account holders to the Inland Revenue Department. As of 1 January 2017, all Financial Institutions⁴ operating or having presence in Hong Kong (FI), thereby being Reporting Financial Institutions (RFI), are required to implement new customer onboarding process when new “financial accounts” are open, and also conduct reviews and due diligence for all pre-existing accounts opened prior to 1 January 2017. All RFIs are to submit their first-round of reporting to the IRD by 31 March 2018 and complete submission of all accounts (individual and entity accounts) by 31 December 2018.

Any entity account holder in Hong Kong which is not itself considered an FI under the definition specified in the Amended Ordinance, is regarded as a Non-Financial Entity (NFE). There are two types of NFEs namely an “Active” NFE and a “Passive” NFE: the former if less than 50% of its gross income is passive income⁵; the latter if it generates 50% or above of its gross income through passive income. In Hong Kong, third party RFIs are only required to report to the IRD on financial accounts of client entities which are considered “Passive” NFEs.

⁴ According to Section 50A (1) of the Amended Ordinance, ‘Financial Institution’ means (a) custodial institutions; (b) depository institutions; (c) investment entities; or (d) specified insurance companies.

⁵ **Passive Income** means the portion of gross income that consists of:- (a) dividend; (b) interest; (c) income equivalent to interest; (d) rent and royalties (other than rents and royalties derived from the active conducts of a business undertaken, at least in part, by the employees of an NFE); (e) annuities; (f) the excess of gains over losses from the sale or exchange of financial assets that give rise to passive income mentioned in any of (a) to (e); (g) the excess of gains over losses from transactions (including futures, forwards, options and similar transactions) in any financial assets; (h) the excess of foreign currency gains over foreign currency losses; (i) net income from swaps; or (j) amounts received under cash value insurance contracts.

For a PTC which holds a family trust as described earlier in this article, the PTC, the underlying holding company and the family trust (despite the common law concept on trust), are all considered as entities under the CRS. An analysis would need to be carried out in respect of an entity or each entity within a group structure holding or managing financial assets to determine its reporting status under the CRS, whether as an “Active” NFE or a “Passive” NFE. It may also be relevant to consider whether the PTC may be an FI that is itself subject to the requirements to conduct due diligence, reporting or fulfil other obligations for AEOI purposes in respect of the financial accounts it maintains.

There appears to be differences in the approach taken by different jurisdictions when determining whether a PTC is reportable. For example, Cayman authorities may consider PTCs licensed or registered in Cayman as FIs, while BVI authorities focus on whether the PTC is remunerated, whereby an unremunerated PTC may not be considered an FI.

Conclusion

We have witnessed, and will continue to witness a great deal of changes caused by inter-governmental arrangements which focus on the transparency of financial information and asset-holding structures. Nevertheless PTCs still continue to be an option for families to consider for their estate and succession planning. Settlers must carefully consider the advantages and disadvantages of using a PTC and ultimately decide what they seek to achieve.

The establishment of a PTC together with the antecedent trust arrangements and the injection of assets require careful planning with the need to engage experienced advisors and trust professionals. In setting up an effective PTC structure, it is key to balance several aspects of the structure. As for its operation, the improper administration and management of a PTC could put a family trust, and ultimately the assets held thereunder, at risk of becoming the subject matters of potential disputes between family members. Settlers should weigh these risks and consider whether the appointment of suitable and professional directors may be appropriate to instill a level of independence in the structure for proper order, while at the same time having family members present at the board to have some involvement in the oversight and operation within limits.

Contact Details

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