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The Use of Domestic and Offshore Trusts in Hong Kong

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INTRODUCTION

Hong Kong has long been described as an "offshore" financial centre. More recently it has come to be known as a "mid-shore" centre in keeping with the recent phenomenon of categorizing as "offshore", only those financial centres that have small domestic economies. The sobriquet "mid-shore" is now employed to characterize those centres, like Hong Kong and Singapore, which have sizeable domestic economies, and which attract business from offshore because of their low taxes, sophisticated financial offerings and administrative expertise.

One significant legacy of Hong Kong's time as a British colony, is a legal system -including its trust and corporate laws - that more closely resembles both the onshore and offshore common law systems familiar to members than the legal systems of China and Taiwan.

For that reason, and because Hong Kong's current trust law, and the manner of its proposed amendments are dealt with in detail in the materials elsewhere, I propose to examine the topic from an historical perspective.

IN THE BEGINNING

The increases in personal and corporate taxation levels experienced in developed countries in the early 70's, the surge in global trade and investment and the relaxation of exchange controls worldwide starting in the late 70's early 80's were powerful drivers of the growth of tax friendly jurisdictions. During this period, the tax regimes of most developed economies' rewarded the investment of funds in tax havens in two ways. Income was exempted from domestic tax if taxed abroad at any rate, or the payment of domestic tax could be deferred until foreign earnings were remitted to the home country. It is fair to say that the singular lack of transparency which characterised tax havens and the rudimentary exchange of information provisions in DTA's made tax evasion through the use of tax havens a simple business at that time.

Hong Kong, like other "offshore centres", greatly benefitted from the combination of factors outlined above. It was an attractive place to administer trusts and companies for offshore clients based in high tax countries. The local inhabitants (many of them refugees from China) were still very much in the wealth accumulation phase so trusts for domestic settlors and their families were not very common. The idea of handing the ownership of assets to a trust company, not owned by the settlor, on the basis of a letter of wishes was

not an easy sell. Even though estate duty had been levied in Hong Kong since 1915 (based on the UK Finance Act 1894) locals (with the notable exception of those listing companies on the local stock exchange) did not actively use trusts to mitigate its effects. This reluctance remained notwithstanding maximum rates of duty which, for a period, reached 52%. The rates actually fluctuated from 8% (prior to 1931) up to 52% (on the value of assets over HK$30m between 1941 and 1959) then down to 15% after 1972 through to the abolition of estate duty in 2006.

Concerns about the proximity of China still made some uneasy about the use of Hong Kong law and at that time the idea of adopting a foreign law to govern a locally administered trust was far less common than it is today. Certainly, the competition between offshore centres to modernize (some might say the bastardize) trust law through ever more inventive statutory intervention was only just beginning. "Jurisdiction shopping", or more correctly, "proper law shopping", was not then in vogue. As a result, the majority of trusts for both onshore and offshore settlors administered here were governed by Hong Kong law with a fairly even mix of the laws of other offshore centres (and England and Wales) making up the balance.

1984 to 1997

On 19 December 1984, the Chinese and British Governments signed the Joint Declaration on the Question of Hong Kong ("the Joint Declaration"). The Joint Declaration changed dramatically the manner in which trusts were employed by both the onshore and offshore market.

The unbridled, at times irrational, fear of the consequences of the proposed resumption of Chinese sovereignty over Hong Kong had immediate and far reaching consequences for Hong Kong law trusts (and even foreign law trusts administered in Hong Kong).

It is no overstatement that the use of Hong Kong law trusts here (and indeed elsewhere) stopped virtually overnight. The vast majority of Hong Kong law trusts in use in Hong Kong by the offshore market were either closed down or had their proper law changed and/or had their place of administration moved to other offshore centres (sometimes through the activation of "flee clauses"). The only Hong Kong law trusts that survived were local charitable trusts, principally because tax exemption was available only to Hong Kong law trusts. Also, it was considered unlikely that even the Chinese Communist Party (either before or after 1997) would expropriate the property of charitable trusts.

As far as trusts for the domestic market were concerned, the fears of expropriation fuelled a steady and increasing exodus of Hong Kong residents. Many of those who remained moved their trust structures to other jurisdictions.

The impact of Hong Kong estate duty on their growing wealth popularized the use of foreign trusts with local residents. The duty was territorial and could be avoided reasonably easily by placing local assets in trusts established and administered under foreign law in exchange for foreign located debts.

What incentive could exist for a local resident to use a Hong Kong law trust, or even have a foreign law trust administered here to hold assets other than local real estate, with the joint threats of estate duty and expropriation? There also appeared no prudent reason for a foreigner to risk expropriation of his offshore assets by operating a trust with any connection to Hong Kong.

Effectively, between 1984 and 1997, Hong Kong trust law fell into disuse, only utilized by those sanguine, steadfast or stupid enough to maintain such trusts in the face of the potential threats, or those looking to house locally situated assets. This remains the position, to a large extent, even today.

During this period, nightmarish scenarios predicting the fate of trusts following the regime change were rampant. Rumour had it that even foreign located assets of foreign law and administered trusts with the slightest connection to Hong Kong were potential targets for the new administration. I remember one client challenging a local branch manager of an international trust company. My client was interested to know how far the trust company's assurances could be relied upon that the identities of its clients who were Hong Kong based settlors of foreign trusts would remain confidential — particularly if, for example, the companies employees were facing a Communist Party firing squad.

The client in question had fled mainland China after enduring the Sino-Japanese War, the Chinese Civil War and the Cultural Revolution and was a firm believer in the motto "Loose lips sink ships". He was utterly despairing of the future under Chinese rule.

The political tension between the Colonial Government and the eager-to-be landlord subsisted right up until the handover on July 1st, 1997 (already almost 16 years ago), achieving little to calm the general jitters about the post 1997 administration's intentions regarding expropriation and Hong Kong's tax and freedom friendly laws generally.

Between 1984 and 1997 many in the trust industry did their utmost to panic locals and foreigners out of Hong Kong trusts into foreign trusts, particularly if the trusts owned foreign assets. Imaginative trust structures, governed by foreign law, were devised so that, although nominally administered outside Hong Kong, they allowed local settlors to interface with local administrators.

Post 1997

After 1997, the fears that I have referred to did not vanish overnight. People adopted a cautious, and quite understandable, "wait and see" attitude. Estate duty stayed on the books even though most people regarded this tax as voluntary for the well-advised.

Although the handover has gone much better than even the most optimistic soothsayers predicted, it has taken time to re-build confidence. Trust has returned largely as a result of people's worst imaginings being unrealized.

It was at least a decade after the hand-over before people began "coming home" in significant numbers, even though the exodus had long lost momentum. It took the same period for people here to feel that the Chinese Government's remarkable restraint in meddling in local affairs was genuine and likely to be lasting. It took much less time to realize that the legal system would carry on as before; and, importantly that the independence, impartiality and competence of the Judiciary would be maintained. The key factor underpinning this sense of stability was the fact that all the players, the people, the lawyers, the Government and the Judiciary performed their roles in the same way after the handover as they did before. The shareholder of the holding company had changed, but the management of the subsidiary hardly seemed to notice.

The abolition of Estate Duty in 2006 was transformative of the reasons local settlors established trusts and they way they used them. Undoubtedly, the avoidance of Estate Duty had been the primary motivator for local settlors. The degree of settlor control was relevant to the success of trusts in Estate Duty planning, so elaborate rituals were often employed in treading that fine line.

The abolition of Estate Duty saw many settlors come out of the shadows and either close down their trusts or convert them to settlor -directed trusts. Only in the last 5 years or so has the idea of the classic discretionary trust made a comeback as a long term estate planning tool and an important piece of a thoughtful family governance structure.

Still, settlors and their advisors remain reluctant to use Hong Kong law trusts for non-charitable trusts. But this reluctance is not based so much on the 1984-1997 reasons but rather that Hong Kong's 1934 trust law has failed to keep us up with the competition. It does not presently have the "bells and whistles" of the competing jurisdictions such as the Channel Islands, the Caribbean or even Singapore. This, however, is being addressed by an Amendment Bill before the Legislative Council which is dealt with in my paper on Hong Kong Trust Law in the materials. ***See Post Script***