

DEACONS
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Introduction to Trusts



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Introduction

This introduction provides a general overview of some of the factors to be considered by clients and their advisers in the establishment of a trust in Hong Kong, or in other common law jurisdictions. It should not be regarded as specific legal advice applicable to any particular circumstances. Equally, it is not intended to be comprehensive and it is recommended that a client seek legal advice on any proposed structure or transaction prior to taking steps to implement it. If you would like specific trusts and/or tax advice, we should be delighted to receive your instruction, for which please see the “How we can help” section below.

What is a trust?

A trust is a legally binding arrangement whereby a person (known as a **settlor**) transfers assets to another person (known as a **trustee**) who is entrusted with legal title and management to the trust assets, not for his own benefit, but for the benefit of other persons chosen by the settlor (known as **beneficiaries**, who may include the settlor) or for a specified purpose. A trust is therefore a legal relationship. It is not a separate legal person, like a company.

The terms and rules upon which the trustee is to hold the trust assets are normally contained in a document called the **trust instrument**. This ensures that the settlor, the trustee, and the beneficiaries know precisely what their respective rights and obligations are. The trust instrument will usually provide that the trustee has the power and the duty to manage the trust assets in accordance with the terms of the trust instrument and the **governing law** of the trust. In addition to the trust instrument, it is also usual for a settlor to indicate to the trustee his wishes as to the future management and disposition of the trust fund in a less formal manner. Such an expression of wishes is often contained in a letter of wishes which, although not legally binding, will generally be considered by the trustee to be persuasive when performing its duties.

The settlor

The settlor constitutes the trust fund by handing over legal title to property to be held by the trustees on trust, for the benefit of beneficiaries. This means that the trustee cannot hold or dispose of the trust property as it wishes, but must do so in the interests of the beneficiaries and in accordance with the terms of the trust instrument. Although, in many jurisdictions, the settlor may reserve certain powers over the trust – such as a power of veto over the distribution of any assets out of trust – it is crucial that the settlor forego both legal and beneficial title to the trust property; otherwise, no valid trust will be constituted. There must, accordingly, be some measure of surrender of control.

The trustee

A trustee may be a natural person or a legal person, like a company. There may be one or more trustees. Legal title to the trust assets is vested in the trustee subject to the obligations imposed by the trust as shown in the trust instrument. The trustee is responsible for the administration of the trust. A trustee must act with due diligence, as would a prudent person, to the best of its ability and skill and must observe the utmost good faith. A trustee must exercise its powers solely for the benefit of the beneficiaries in accordance with the terms of the trust instrument. The trust assets, however, constitute a separate fund and do not form any part of the trustee’s own estate. Accordingly, if the trustee becomes insolvent, its creditors would not be able to recover out of the trust fund.

It is imperative that diligent, cooperative, and able trustees be chosen. Trust service providers are in the business of supplying corporate trustees. Instructing such service providers may in certain circumstances be convenient; however, there is no obligation to do so. Any fit and proper person, including a family member or a trusted friend, or a company controlled by such people, may in principle act as trustees.

The beneficiary

The beneficiaries are the persons entitled to benefit from the assets held on trust. The settlor may himself be one of the beneficiaries. In order for a trust to be valid, there must be sufficient certainty as to the identity of the beneficiaries. An express power for the addition of further persons to the class of beneficiaries may, however, be included in the trust instrument. The beneficiaries may enjoy equal or unequal benefits, as the trust instrument prescribes or, in the case of a discretionary trust, as the trustee may in its discretion determine. It is also possible to include in the trust instrument a power to exclude beneficiaries from future benefit. This may be done for family, commercial, or even tax reasons.

Generally, there is no restriction on the identity of a beneficiary – any person, or sufficiently clear class of persons – may in principle be designated.

Reservation of powers

Although once a settlor creates a trust he must divest himself of legal ownership of the trust assets, he may reserve certain powers for himself. Most commonly, settlors wish to reserve powers in the area of investment. Other powers that may be reserved include the powers to revoke or amend the terms of a trust, to advance or pay income or capital of the trust property, to appoint or remove the trustee, and to change the proper law of the trust.

Forms of trust

Various types of trust have been developed over time and the most appropriate structure will depend on the settlor's particular circumstances and objectives. Some of the more common types of trust are described below.

Fixed interest trusts

Under a fixed interest trust, the beneficiary will normally be granted a vested interest in the income of the trust fund throughout his lifetime and the discretion of the trustee regarding the disposition of the trust fund will be limited. For example, the trust instrument may specify that the trustee is required to distribute the income of the trust fund to a particular individual during that person's lifetime and subsequently to distribute the capital of the trust fund in fixed proportions to named beneficiaries (such as the settlor's children).

Discretionary trusts

A discretionary trust provides maximum flexibility and is often the most efficient structure for both settlor and beneficiaries. In a discretionary trust, the trustee is given wide discretionary powers as to when, how much, and to which beneficiaries it should distribute the income and capital of the trust. A discretionary trust is thus useful where at the time of creation of the trust the future needs of beneficiaries cannot accurately be determined. The beneficiaries do not have any direct legal rights or interests over any particular portion of the trust fund, but only a right to be considered for benefit when the trustee exercises its discretion.

Whereas a trustee of a discretionary trust is apparently vested with great power to administer trust assets, and to distribute trust income or assets to beneficiaries, such trustees are in reality limited by the general law of trusts, which requires them to act in the best interests of the beneficiaries and in any event not for their own benefit or gain. Further, trustees usually defer, though they are not obliged to do so, to the letter of wishes communicated to them by the settlor.

Charitable trusts

A charitable trust does not require named beneficiaries; instead, the trust must be established for a charitable purpose. What constitutes a charitable purpose for a trust will vary from jurisdiction to jurisdiction; typically, trusts for the advancement of education, relief of poverty, advancement of religion (religion being construed very broadly), and the general public benefit are considered charitable in most common law jurisdictions. Generally, charitable trusts are either tax exempt in the jurisdiction in which they are established and operate, or enjoy considerable fiscal privileges. Donations of cash to a charity may be tax deductible in some jurisdictions.

Why use a trust?

The range of uses to which a trust may be put is open-ended, but flexibility and confidentiality are the principal advantages that a trust has over other legal forms designed to hold, preserve, and transfer wealth. Private trusts do not generally need to be registered and such trusts are not subject to the same regulatory strictures as bodies corporate. For example, a trust does not need to draw up audited financial statements or file annual returns with the Companies Registry. It is in the ordinary course not possible to find out who the beneficiaries of a trust are from a public search.

The trust concept has proved to be enormously adaptable and is widely used in financial planning. Such is the flexibility of a trust that it would be difficult to define its potential uses comprehensively, but some typical applications are explained below.

Asset protection

Trusts may be used to preserve the continuity of ownership of particular assets, such as a business, within a family. By vesting legal ownership of the assets in the trustee, the relevant individuals may be able to continue to benefit from the assets, whilst avoiding fragmentation of ownership amongst a large number of second- and third-generation beneficiaries. The use of a trust avoids, on the death of a beneficiary, the risk of a share of assets becoming owned outside the family, and thus enables settled assets to be preserved intact for the benefit of future generations. A carefully structured trust may also assist in preserving the settlor's business or assets in the event of the settlor's divorce or insolvency.

Succession planning

Upon the death of a settlor there will be no need to obtain a grant of probate or similar formalities in order to deal with the trust fund. A trust therefore provides an efficient vehicle for the transfer of beneficial interests following the death of a settlor. Further, because the interests of a beneficiary under a discretionary trust will not constitute a separate asset, a trust structure may assist in the avoidance of stamp duty or inheritance taxes that might otherwise be payable on the death of a beneficiary. In addition, a trust can be used to hold shares in a company owning immovable property, rather than directly in the real property itself, which can present attractive opportunities for tax and financial planning.

Tax planning

A trust may be constituted to arrive at tax-efficient outcomes both in Hong Kong and abroad. In particular, the transfer of trust assets from the settlor to the trustee may be fiscally advantageous for the settlor (who may no longer be regarded as owning the assets in question) and/or for the beneficiaries, who would benefit from the assets only at certain times, and in certain proportions. Depending on the taxing jurisdictions involved, a trust may be used to mitigate or eliminate income tax, capital gains tax, and inheritance tax/estate duties.

Popular jurisdictions

A trust must have a governing law. This is the law that will govern the rights of the beneficiaries, the duties of the trustee as well as any disputes arising from the trust instrument. Trusts are usually established in common law jurisdictions, but are also recognised in many civil law jurisdictions. Ultimately, the jurisdiction of choice will depend on the specific requirements and objectives of the settlor. British Virgin Islands and Cayman Islands trusts are popular because of their flexibility and “light-touch” regulation. Jersey and Guernsey provide greater regulation of trustees, and, together with Hong Kong, bring the added benefit of a highly sophisticated judiciary and excellent trust service providers. Hong Kong has recently updated and reformed aspects of its trusts law, but has left the provision of private trust services largely unregulated. Finally, jurisdictions like Belize and the Cook Islands have aggressive asset protection legislation favouring the settlor and beneficiaries against third party claimants.

How we can help

Deacons is the oldest and largest full service commercial law firm in Hong Kong. Since 1851, Deacons’ quality and consistency have enabled the firm to become a trusted legal advisor to local and international clients.

We have extensive experience in both domestic and international trusts planning. We advise on every stage of a trust’s life-cycle, from settlement, to restructuring, to termination, and have consolidated experience in designing and implementing trust structures.

As one of the leading tax and trusts practices in the Asia-Pacific region, we are also happy to take instruction on trusts for fiscal efficiency and succession planning. We benefit from an outstanding network of contacts in all major common law jurisdictions, and can therefore advise on international trusts and tax planning.

Our market-leading litigation team is also in a position to assist trustees, settlors, and/or beneficiaries with any trusts disputes as and when they arise. We are in a unique position to provide full-service, “one-stop shop” litigation as we have partners who are solicitor-advocates with higher rights of audience. That means we do not need to instruct outside counsel, enabling us to address all your dispute resolution needs in a time-and cost-efficient manner.

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