

Winning Chinese clients' trust

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Trust law in China is rather different from that in common-law jurisdictions. A trust is not a turnkey product and is definitely not an off-the-shelf structure, and that is not an easy concept to understand, especially for Chinese clients who are used to civil-law concepts and reticent to cede control over their assets entirely.

Designing a trust structure for Chinese clients requires more than just technical trust knowledge. Practitioners need to understand Chinese traditions and culture, explain the meaning of a common-law trust, and share experiences from other cases where trusts created decades ago have operated successfully. This article offers some instructional examples and tips for dealing with Chinese clients.

Introduction of "Gift tax"

China has recently amended its Individual Income Tax Law (IIT Law) which took effect on 1 January 2019. There is a notable change for private clients; the scope of deemed disposal will be expanded to transactions with non-cash consideration, transfer by way of gift or as repayment of debt or investment.

Currently there is no gift tax or inheritance tax in China and, while there will not be a gift tax per se, the amended IIT Law is in essence a gift tax.

It is common for settlors to inject assets into a trust as a gift. After 1 January 2019, such transfers of assets will be subject to tax. The Chinese tax authority may determine the reasonable value of such assets, and the difference between the determined value and the cost will be subject to income tax of 20%. Chinese tax residents are subject to worldwide income tax, so such a tax regime will be applicable to both China and offshore assets.

When designing how to inject the assets into a trust post the amended IIT Law, one should keep in mind that the amendment to the general anti avoidance rules is a broad one and the Chinese tax authority has tightened its enforcement for tax non-compliance.

There may be suitable and legitimate ways for a Chinese settlor to make contributions to a trust structure, which may mitigate or not give rise to liability under the new IIT Law regime. But the new IIT Law developments will mean that settlors will need to approach the issue with care and get good and experienced advice before acting once the new regime comes into force.

Keeping family disputes private

Keeping family harmony is vital in traditional Chinese culture. Traditionally, disputes are resolved in private by the family elders and the family must respect their decision. This tradition has been changing gradually in families as more of the younger generation are educated overseas. These younger parties tend to be more ready to enforce their rights through legal proceedings, thereby making such disputes public.

To keep family disputes private, Chinese settlors could include conflict resolution provisions in a trust deed, setting up a dispute resolution committee to resolve any initial conflict. However this would not prevent or restrict the disputed party from going public in court.

Arbitration is another option. By its nature arbitration is private and the parties are bound by the decision. A carefully drafted arbitration clause and dispute resolution mechanism could help Chinese families keep their disputes private, but concerns remain on the enforceability of such clauses in trust-related disputes in China.

To try to address this concern, a handful of jurisdictions, such as Guernsey, expressly provide in their trust laws to permit trust deeds to include mandatory arbitration provisions binding on the trust parties.

Under the Trusts (Guernsey) Law, 2007 such arbitrations need not be conducted in Guernsey or in accordance with the procedural law of Guernsey.

Settlor control

One of the biggest challenges facing many Chinese clients is the notion of handing all control over to a third party. Many Chinese settlors are not comfortable with giving up their assets completely, and requests to reserve powers or retain some decision-making to themselves, either as settlors or in their capacity as protectors or enforcers, are common. Some typical reserved powers are investment, appointment and removal of trustees, and appointment of trust assets.

Another way Chinese settlors may retain some control is to be a director (or sole director) of a holding company owned by the trust, allowing them to manage the day-to-day operation of the underlying trust assets.

But while offshore jurisdictions have a list of powers that settlors may reserve, [1] the extent of

these and their treatment by onshore courts are a matter of real importance.

Generally, the more powers a settlor reserves and the higher control a settlor retains, the less likely that they will be seen as having divested their beneficial interest in the trust assets, and clients seeking to reserve powers may be introduced to *JSC Mezhdunarodniy Promyshlenniy Bank v Pugachev*. In this case[2], the settlor as a protector has reserved a range of rights (in particular, veto right to trustee's exercise of appointment and investments) and could appoint and remove trustee as he wished. He was also one of the beneficiaries.

Considering all the powers and duties as a whole, the court held that Mr Pugachev was indeed in control of trust assets and had not divested his beneficial ownership. Following this finding, the whole trust assets became available to Pugachev's creditors. This case provoked some concern about reserved power trusts.

Balancing a settlor's involvement against the robustness of the trust structure is key. Settlers may reserve a wide range of powers under offshore trust legislations and doing so is entirely legitimate. But it is by no means a default position of settlers to reserve all those powers. Depending on a settlor's particular circumstances, reserving only some or even no powers at all, may be advisable.

Reserving some powers

If settlers must reserve some powers, there are still various ways to give different levels of involvement to a settlor; giving them decision power is just one.

A settlor may give non-binding directions, allowing the trustee to exercise its own independent judgment to decide whether to follow such directions. For lesser involvement, a settlor may request that a trustee give prior notice before exercising certain powers. Instead of involvement at trust level, perhaps such involvement can be achieved at the underlying asset-holding company level e.g. by injecting participating shares into a trust, leaving non-participating management shares held by the settlor, or utilising a limited partnership structure.

Private Trust Companies

A private trust company (PTC) is also a very popular choice among Chinese settlers, as it potentially gives absolute control over the trust to the family. A number of offshore jurisdictions permit PTCs. However, the requirements to qualify as a PTC vary, as the following examples show.

British Virgin Islands (BVI)

PTCs in BVI must either be unremunerated or act solely in related trust business. A related trust means each beneficiary of the trust is connected to the settlor through blood, marriage or adoption, or is a charity.[3]

Cayman Islands

Cayman law allows a PTC to manage connected trust business, meaning trusts with all contributors/settlors connected to each other. [4] Unlike in the BVI, there is no restriction on the relationship between contributor/settlor and beneficiaries.

Jersey and Guernsey

A PTC can also be established in both Jersey and Guernsey, with the flexibility to structure the PTC as a company or as a foundation to dispense with the additional purpose trust layer to hold the PTC. Both require PTCs to be administered by a locally regulated trust company. [5] Differing from the BVI, Jersey and Guernsey do not restrict the relationship between settlors and/or beneficiaries. As such, the PTC may administer trusts, connected via various relationships, such as registered partnerships, same sex partnerships and co-habitants, that may not be recognised or included in the relevant legislations.

Conclusion

From control to privacy, there are many factors particular to Chinese clients wishing to establish offshore trusts. Such concerns must be understood, and Chinese clients need competent advisors with sufficiently broad and deep trust knowledge to be able to work through such concerns articulately. Whenever necessary, advisors should seek not only onshore, but also offshore, advice from advisors who have experience in advising Chinese clients on structures across offshore jurisdictions.

[1] Article 9A of The Trusts (Jersey) Law 1984, Section 15 of The Trusts (Guernsey) Law, 2007

[2] [2017] EWHC 2426 (Ch)

[3] Financial Services (Exemptions) Regulations, 2007

[4] Private Trust Companies Regulations 2013 Revision

[5] Financial Services (Trust Company Business (Exemptions) (Jersey) Order 2000 and Regulation of Fiduciaries, Administration Business and Company Directors, etc (Bailiwick of Guernsey) Law, 2000

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