Hong Kong’s Private Unit Trust Structures

The purpose of this article is to discuss certain trust law aspects of the private unit trust structure considered in the June 2000 decision of the Hong Kong Court of Final Appeal in Shiu Wing Limited and others v The Commissioner of Estate Duty. This decision, known as the “Pong Case” after the settlor of the trust structure involved, the late Mr Pong Ten Un, is primarily a decision about the so called Ramsay doctrine, i.e., the application of general anti avoidance principles in Hong Kong. In this regard the decision in the Pong case is an important one for Hong Kong as it is the first time that a court has held that the Ramsay doctrine applies in Hong Kong. (It is also the first reported case examining a Hong Kong estate duty mitigation arrangement since 1988.) This article, however, will not touch on the Ramsay doctrine.

Estate Duty Basics

The Pong case is concerned with planning to avoid Hong Kong estate duty. This is imposed on the Hong Kong situs property which passes on a person’s death. There is a specific exemption from estate duty for non Hong Kong situs property that passes on death.

The property which passes on a person’s death is deemed to include, amongst other things, the subject matter of gifts made within three years of death (this assumes there has been a gift without reservation of interest or benefit). The property deemed to pass on death can also include Hong Kong property held under a “controlled company” to which the deceased had made a transfer of property and from which benefits had accrued to the deceased within the three years prior to the date of death. The provisions which operate to impose a charge to estate duty on the Hong Kong assets of a controlled company are known as the “controlled company provisions.” These are designed to prevent the avoidance of estate duty on Hong Kong situs property through the mechanism of holding Hong Kong situs property through a company while still reserving the ability to enjoy the fruits of that property during the lifetime of the transferor.

Estate Duty Structures

The basic building block of many Hong Kong estate duty planning structures is a discretionary trust. A gift of Hong Kong property to the trustee of a discretionary trust under which the settlor is excluded from benefiting should not be subject to estate duty if the settlor can survive for three years. In general terms, the death of one of the beneficiaries under a discretionary trust will also not attract a charge to estate duty on any underlying Hong Kong trust assets, provided such death does not trigger a change in the terms of the trust. While three years is not necessarily a long time, the practice became common of arranging for a round robin funded sale in order to try to avoid the application of the gifting rules on the transfer of the Hong Kong assets into trust.

The next variation on the structure might involve the establishment of a discretionary trust, but instead of the trustee holding the Hong Kong assets directly (or through a nominee) the trustee would take up the shares in a tax haven company. The Hong Kong property is then sold to the tax haven company. The problem with this approach, however, is that the tax haven company is a controlled company within the meaning of the Estate Duty Ordinance, and estate duty can still be charged on the Hong Kong property if the settlor has (or could have) benefited from the tax haven company within three years of the date of his death. This leads on to the private unit trust structure.

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This article looks at some of the trust law issues emerging from Hong Kong’s “Pong case.” This includes trust law aspects of a private unit trust structure, the nature of the interest of a unit holder and the effect on this of the Saunders v Vautier principle and the circumstances under which a private unit trust scheme may be construed as a sham.
PRIVATE UNIT TRUST STRUCTURES

With a private unit trust structure, the starting point would still be the establishment of a discretionary trust. Instead of the trustee of the discretionary trust holding shares in a tax haven company, it holds the majority of the units in a private unit trust. The trustee of the private unit trust is typically a tax haven company. The trustee of the unit trust then acquires Hong Kong property from the settlor. The controlled company provisions should not have application to a company that only holds assets in its capacity as a trustee rather than beneficially. This is the rationale behind the adoption of the private unit trust structure.

Under the terms of the unit trust deed, the trustee holds the trust income upon trust for the unit holders in proportion to the number of units held by each unit holder out of the total number of units on issue. The capital of the trust fund is divided in the same fashion. The unit trust deed would also include provisions dealing with matters such as the transfer of units and meetings of unit holders, very much like the provisions one would find in the articles of association of a private company. In essence, this was the kind of structure used in the Pong case.

While private unit trust structures have been very popular for Hong Kong settlers as a more sophisticated form of estate duty planning vehicle, the question has been raised whether these private unit trusts can be challenged on one or more grounds as not constituting a valid trust. These concerns will be discussed further below. It can be noted however that the Estate Duty Office (“EDO”) did not raise any kind of challenge to the structure itself in the Pong case. Of course, it would have been in their interest to do so if this were possible on the facts. If the unit trust structure had been a sham or was otherwise ineffective such that Mr Pong retained the beneficial interest in the Hong Kong property he transferred to the trustee, then the Hong Kong property would have passed on his death and attracted estate duty. Hence, the validity of the trust structure in the Pong case was an essential first condition in order to avoid estate duty.

THE FACTS AND THE ARGUMENTS IN THE PONG CASE

A summary version of the facts is as follows:

- the wife lent the money to the trustee of a private unit trust (“UT Trustee”);
- UT Trustee used the money to buy certain private Hong Kong company shares and immovable property situated in Hong Kong from Mr Pong for fair market value;
- Mr Pong made a loan of the sale proceeds outside Hong Kong to the trustee of a discretionary trust (“DT Trustee”). The loan was documented so as to constitute a non Hong Kong situs specialty debt;
- DT Trustee used the money to subscribe for an issue of units in the private unit trust; and
- UT Trustee repaid the wife, who then repaid the bank.

This round robin occurred within the space of a single day and was effected by pre-prepared bank instruction letters. In fact there were actually multiple unit trusts and discretionary trusts involved and different assets being transferred on different days. The trusts were established in 1989 and the round robin sales effected in 1990. Mr Pong died just short of the three year gifting period.

The EDO looked at the above transactions and concluded that neither the trust structure nor any of the steps in the round robin sale could, on the particular facts of the case, be described as a sham as per the definition of Diplock LJ in Snook v London and West Riding Investments Limited. The EDO went further than this and agreed that the trust structure was established for various legitimate, non fiscal purposes (meaning in this context, purposes other than the avoidance of estate duty). These non fiscal purposes included the need to establish a non Hong Kong holding structure for the family for the purposes of investing overseas, and the minimisation of political risk in face of Hong Kong’s return to China in 1997. Nevertheless, the EDO argued that all of these legitimate non fiscal purposes could have been achieved by Mr Pong simply making a gift of his Hong Kong assets to the trustee of the unit trust. The EDO, while accepting the validity of the trust structure, argued that under the Ramsay doctrine, they could disregard the steps of the round robin sale to say there had been a gift for estate duty purposes. The matter was first heard before a single judge of the High Court, went on Appeal to the Hong Kong Court of Appeal and was finally brought before Hong Kong’s Court of
Final Appeal. The Court of Final Appeal held that the round robin sale did comprise of a pre-ordained series of steps, that these steps were implemented solely to avoid the gifting rules, but that the Ramsay doctrine would not allow a sale step to be recharacterised as a gift step. In this regard reference was made to *Countess Fitzwilliam v IRC* as authority against recharacterisation. The EDO therefore lost their main argument and the Court of Final Appeal held that no gift of Hong Kong situs assets could be identified.

**THE TRUST STRUCTURE IN MORE DETAIL**

An Isle of Man company, Shiu Wing Limited (“SWL”) was established in December 1989. SWL established five Isle of Man Unit Trusts. SWL was the sole trustee of each unit trust. The directors of SWL were the wife of Mr Pong and his seven children. The sole shareholders in SWL were two more Isle of Man companies, one called Futurian Limited (“Futurian”) and one called Shiu Kwong Limited (“SKL”). The directors of Futurian and SKL were made up of different combinations of the same family members. Mr Pong was not a director. Different assets were purchased by SWL in its capacity as sole trustee of the various unit trusts. Futurian and SKL were the sole unit holders in the five different unit trusts (apart from one initial unit held by the wife in one of the unit trusts). Futurian held its units as sole trustee of four discretionary trusts constituted for the benefit of the families of four of the children. SKL held its units as sole trustee of three discretionary trusts established for the benefit of the families of the remaining three children. There was an eighth discretionary trust, again an Isle of Man Trust, known as the Pong Ding Yuen Trust of which Futurian and SKL were joint trustees. Presumably the Pong Ding Yuen Trust was established for the benefit of the wife of the settlor, and the trustees also held units in one or more of the unit trusts.

Clause 16 and the provisions of schedules A3, L1 and L2 in the trust deed for each unit trust provided that the unit holders did not have any interest in the assets under the unit trust. These provisions also required the trustee of the unit trust to convert the trust property into money. In this regard, the provisions of the unit trust deeds appear to have been designed to mimic the terms of the equitable doctrine of conversion, or to place the unit holders on the same footing as a beneficiary under an un-administered estate. Under the equitable doctrine of conversion, where there is a binding trust for sale imposed upon a trustee holding land, the beneficiaries of the trust would, by virtue of the doctrine be considered to have an interest in the proceeds of the sale of the trust fund (an interest in money) rather than an interest in the land held by the trustee.

**WHAT IS THE NATURE OF THE INTEREST OF A UNIT HOLDER?**

There is authority in the Australian High Court decision of *Charles v Federal Commissioner of Taxation* that a unit in a unit trust confers a proprietary interest in the assets of the trust fund on the unit holders. In *Charles*, a unit in a unit trust was contrasted with a share in a company. The High Court stated at 609:

"... a unit held under this trust deed is fundamentally different from a share in a company. A share confers upon the holder no legal or equitable interest in the assets of the company; it is a separate piece of property. ... But a unit under the trust deed before us confers a proprietary interest in all the property which for the time being is subject to the trust deed ..."

The unit trust considered in *Charles* was a collective investment vehicle established to invest in certain specific securities. It was constituted by a manager and the trustee. The manager created a market in the units. The reported decision contains a description of the terms of the unit trust deed. A holder of a certain number of units was given the right to redeem those units for cash and securities, or securities only, forming a proportionate part of the trust fund. On winding up the trust fund was to be distributed in specie or cash amongst the unit holders in proportion to their respective unit holdings. There do not appear to have been provisions similar to those inserted into the unit trust deeds considered in the *Pong* case. It should also be noted that the passage from *Charles* quoted above was expressly limited to describing the nature of a unit under the trust deed in question in that case.

**WHAT INTEREST DID THE UNIT HOLDERS IN THE PONG CASE HAVE?**

In the Pong case, the question was raised as to whether the unit holders (ie, Futurian and SKL as trustees) or whether the family members (as beneficiaries under the discretionary trusts of which Futurian and SKL acted as trustees) had any interest in the underlying Hong Kong assets held by
SWL. If one referred to the decision in Charles (which was not mentioned in the Pong case), the initial reaction might be to conclude that the unit holders did have an interest in the underlying Hong Kong assets. It is understood however that the unit trust deeds in the Pong case contained a clause to the effect that:

“No Unit Holder shall have any interest in the assets comprised in the Trust Fund but instead shall have a right to have this Trust duly administered in accordance with its terms.”

Findlay J at first instance in the Pong case rejected the argument that Futurian and SKL as trustees obtained any beneficial interest in the Hong Kong situs assets held by SWL. Findlay J stated:

“The fact of the matter is that the second and third plaintiffs did not acquire “a beneficial interest” in the Hong Kong property by acquiring the units. The [unit] trust provides explicitly that they do not acquire such an interest. What they acquired were only contractual rights against the first plaintiff. Of course, it must be so that the value of the units in the hands of the second and the third plaintiffs was ultimately reflected, to some extent, in the value of the property owned by the first plaintiff, including the Hong Kong property, but they had no right to any legal or equitable interest in that property. It might be said that the second and third plaintiff were in a position similar to the holders of shares in a limited company.”

The statement that the unit holders had contractual rights against the trustee (which must be in addition to their equitable rights) could be based on the contribution of money by the unit holders to the trustee in accordance with the terms of an application to be issued units on and subject to the terms of the unit deed.

The conclusion of Findlay J that ownership of units in the unit trusts could not be equated with having ownership of the underlying Hong Kong assets was upheld first in the Court of Appeal and then finally in the Court of Final Appeal. In this regard, the Pong case could be used as authority for the proposition that a trust may be drafted so as to exclude an in specie interest in the beneficiaries in the underlying trust assets. This authority may be useful for estate duty and other tax planning arrangements.

**Saunders v Vautier**

The question was also raised whether the rule in Saunders v Vautier could be relied on as a basis for looking through the trust/discretionary trust structure to treat the beneficiaries under the discretionary trusts as owning the underlying Hong Kong assets. Rogers JA (dissenting) in the Hong Kong Court of Appeal rejected this argument in the following terms:

“As I have indicated, there were strong commercial reasons for the Pong family to have the ... property held under an overseas trust. There was thus no likelihood or realistic possibility that the members of the Pong family would seek to put an end to the trust and treat the ... property as their own personal property. Even if under the rule in Saunders v Vautier ... the holders of the units in the unit trust and the beneficiaries under the trusts on which those units are held could have put an end to the trust and claimed the assets for themselves, that in the circumstances of this case was not even a remote possibility. The purpose of the establishment of the ... Unit Trust and the Pong Ding Yuen Trust was precisely because the members of the Pong family did not wish to own the assets in their personal names.”

Rogers JA did however raise the question of whether the provisions in the unit trust deed disclaiming the existence of any in specie interest in the trust assets could operate to prevent the unit holders from terminating the unit trusts under the rule in Saunders v Vautier. However, surely the
whole point of this rule is that it allows all of the absolutely entitled sui juris beneficiaries to call for the trust assets notwithstanding the express terms of the trust deed? It is suggested, therefore, that if both Futurian and SKL (assuming they are the only unit holders) wanted they could have demanded a transfer to them of the Hong Kong assets held by SWL.

In the Court of Final Appeal Litton J agreed with Rogers JA that it was not appropriate to treat the beneficiaries as having an interest in the underlying Hong Kong property just because, collectively they may have been able to make a claim under Saunders v Vautier, given the purposes of establishing the trust structure was:

"... presumably because the members of the Pong family did not wish to own assets in their personal names and wanted a trust structure."

It appears from his judgement that Litton J considered that the unit holders could, if acting together, have called for the transfer of the trust assets notwithstanding the express provisions of the trust deeds. Again the Pong case points towards the conclusion that it is possible to establish a trust under which the beneficiaries are denied any in specie interest in the trust assets (being left only with a claim for due administration of the trust by the trustees) and the fact that a claim might be made under Saunders v Vautier by all of the sui juris beneficiaries (or unit holders) would not alter this conclusion unless such a claim were actually made.

**WHAT IS THE SITUS OF A UNIT IN A UNIT TRUST?**

Throughout the High Court, the Court of Appeal and the Court of Final Appeal in the Pong case it was assumed that the units issued by SWL were non Hong Kong situs assets. Unfortunately, however, there was no elaboration at all on this point in any of the three courts. The Pong case in this regard represents an opportunity lost to obtain some judicial authority on the situs of units in a unit trust, which is quite surprising given that the conclusion that the units had a non Hong Kong situs was actually quite important in reaching the decision that there had been no gift made of any Hong Kong situs assets.4

We know that the unit trusts appear to have been established under laws of the Isle of Man and that the trustee was incorporated in the Isle of Man. The reports do not, however, specify where the registers of unit holders were maintained (assuming the units were transferable by registration), where the directors of the trustee held their meetings or whether there were any relevant provisions in the trust deeds, (other than those already mentioned above), which impacted on the situs question.

**THE SHAM ARGUMENT**

A subsidiary argument put forward by the EDO in the Pong case (ie, as an alternative to their Ramsay argument) was that the loans owing to Mr Pong by Futurian and SKL were a form of sham.

The EDO agreed that the debts were not shams within the Snook formulation of a sham. It was accepted by the EDO that the directors of Futurian and SKL on the one hand, and Mr Pong on the other hand, intended that the loans would be repaid, although it was expected that Mr Pong might later decide to waive the loans (which in fact he did). Nevertheless, the EDO argued that it would be a misnomer to say that Mr Pong had made a loan to Futurian and SKL on the basis that the terms of the loan documentation did not reflect the ordinary legal definition of a loan. This argument is quite similar to cases which have involved a court looking at a document which has been labelled eg, as a “license” but the terms of which have in fact revealed a lease rather than a license.

The loans in question in the Pong case were for very substantial amounts but were interest free, unsecured and repayable upon demand. It was also provided that the loans were not assignable by the creditor without the consent of the debtor, which feature, the EDO argued, indicated the debtors Futurian and SKL would never be put in a situation where the loans would be assigned to a person who would call for their repayment. The EDO also relied on certain observations of Lord Goff of Chieveley in *Ensign Tankers Ltd v Stokes*5 as support for disregarding the loans as having no legal effect. The EDO's sham argument, or at least the reliance on Ensign Tankers, was rejected by Mason NPJ who delivered the main judgment in the Court of Final Appeal. Mason NPJ was unwilling to accept that these could be any kind of sham which was not covered under the Snook formulation of a sham.

Notwithstanding that the EDO's sham argument was not accepted in the Pong case, there at least appears to be academic support for the identification of different...
kinds of sham, with the Snook formulation being regarded as just one kind of sham. For example, Professor David Hayton, writing in Modern International Developments in Trust Law\textsuperscript{16}, suggests that a sham trust could arise either as a matter of form or as a matter of substance. The EDO in the Pong case had argued (unsuccessfully) that the loans in question, were as a matter of form not loans.

**WERE THE UNIT TRUSTS SHAMS AS A MATTER OF FORM?**

An interesting question is whether the validity of the private unit trust structure used in the Pong case could have been challenged on the basis that it would be a misnomer to call the structure a unit trust. The conclusion that the unit trusts considered in the Pong case lacked certain features more normally associated with a public unit trust, or a unit trust established as a form of collective investment vehicle, should not be fatal to the arrangement.

**A SHAM IN SUBSTANCE?**

The concern has been raised that a structure comprising of a discretionary trust with an independent professional trustee which only holds units in a private trust must, in substance, be a sham trust if the trustee of the private unit trust is a company controlled by the settlor, or by the family of the settlor. The argument is that the unit trust in such circumstances is merely a device used to ensure that the independent professional trustee does not, at least in practice, have control over the underlying trust assets. Even if keeping control over the underlying assets away from the professional independent trustee was not the reason behind the decision to use a private unit trust, if this was an effect of its use, then the argument against the structure must still remain.

It is suggested that it would indeed be a misnomer to call the unit trusts in the Pong case a public unit trust or a unit trust established as a form of collective investment vehicle. However the conclusion that they were not “unit trusts” of the kind that one might normally think does not automatically lead to the conclusion that they did not constitute a valid express private trust. The objective behind this particular kind of sham argument must be to identify what really is in law the arrangement in question i.e., to apply the correct legal label to the arrangement. That is to say, having determined that the unit trusts in the Pong case were not some kind of “public” unit trusts, what were they? It is submitted that the answer to this is that they may simply have been private trusts, the trust fund of which had been divided into certain shares or portions (which no doubt had been called “units” in the trust deed for the sake of convenience). In conclusion, the fact that the unit trusts considered in the Pong case lacked certain features more normally associated with a public unit trust, or a unit trust established as a form of collective investment vehicle, should not be fatal to the arrangement.
supervise the underlying assets, notwithstanding the interposed family or settlor controlled entity. However the real risk must be that if in hindsight, the independent trustee never did exercise any supervision or control over the underlying assets. In conclusion, a private unit trust structure should be no more prone to this kind of sham “in substance” argument than structures involving eg, the use of a holding company.

FAMILY RUN PRIVATE TRUSTEE COMPANIES

There must, however, be a concern that a family run trustee company, whether acting as trustee of a discretionary trust or as trustee of a private unit trust, will in practice give rise to another sham argument in the absence of the family obtaining regular professional support. The concern is that such non professional directors will have no knowledge of the duties and obligations of trustees, the rights of beneficiaries, and trust law in general. In the absence of external professional advice, would a family member who is on the board of a company appointed as the sole trustee of a discretionary trust be aware of the duty of the trustee to periodically consider the exercise of its discretionary powers? Would such an individual be likely to refuse to follow the instructions given by the settlor and would they ensure that proper accounts and records are kept in respect of the trust fund? The fear must be that a family run trustee company, whatever the nature of the trust may be, will not be properly administered in the absence of some kind of external professional support, whether from an independent professional trustee, or from the family’s own advisors.

CONCLUSION

Private unit trust structures are a feature of Hong Kong estate duty planning and are likely to remain so. The Pong case, has shown that such structures in practice can be effective for estate duty purposes. The decision in the Pong case has also helped to shed a little bit of light (although not as much as might have been hoped for) on some of the trust law issues concerning private unit trusts. It is also encouraging that the EDO, who were advised by London counsel, did not identify any obvious grounds for attacking the validity of the private unit trusts in question.

The fact that a private unit trust does not have features typically associated with a unit trust structure used as a collective investment vehicle strictly should be irrelevant. Care must be taken, though, to ensure that the trustee of the discretionary trust maintains effective supervision and control over the assets held by the trustee of the unit trust and that if the trustee of the unit trust (or the discretionary trust) is a company administered by family members, that there is sufficient external professional support to ensure the unit trust trustee is properly administered as a real trustee company.

Endnotes:
3. The classic case would be holding Hong Kong property through a non Hong Kong tax haven company.
5. If the corporate trustee of a private unit trust could be charged under the controlled company provisions then so too could the corporate trustee of a discretionary trust.
6. [1967] 2 QB 786 (at 802).
10. (1954) 90 CLR 598.
11. Hong Kong High Court, [1998] HKC 44.
13. (1841) 4 Beav 115, 10 LJ Ch 354.
14. On one characterisation of the transaction, there had been a gift of units made by Mr Pong.

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