The Pong Case explored

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Introduction

The purpose of this article is to try to provide some straightforward answers to some of the questions that will arise in light of the June 2000 decision of the Hong Kong Court of Final Appeal in Shiu Wing Ltd & Others v The Commissioner of Estate Duties (the "Pong Case"). The litigation surrounding the Pong Case has been closely followed over the last two years by the trust and private banking professionals based in Hong Kong. The decision is big news in Hong Kong simply because it is the first court decision to examine a Hong Kong estate duty planning arrangement since the so called "Karl Kwok Case[1]" which was decided back in 1988. More accurately it is an important decision because it is the first time the Hong Kong courts have addressed the so-called Ramsey doctrine[2].

Hong Kong estate duty structures

Hong Kong estate duty is imposed on Hong Kong situs property that passes on the death of an individual. The Hong Kong Estate Duty Ordinance has its origins in the old English estate duty legislation. The property which passes on death is deemed to include the subject matter of gifts made within three years prior to the date of death (assuming there is no reservation of interest or benefit), and the Hong Kong situs assets of certain "controlled companies"[3]. As will be discussed further below, there are also circumstances when the Hong Kong situs assets held in trust may be deemed to pass on death.

In the main, Hong Kong estate duty planning structures frequently involve offshore discretionary trusts, the trustees of which directly or indirectly hold onshore Hong Kong assets. It has also been common in the past (and indeed it will probably remain so going forward) to interpose what is called a "private unit trust" between the trustee of the discretionary trust and the underlying Hong Kong situs assets. One objective of inserting the private unit trust is to have a holding entity for the underlying Hong Kong assets, which does not involve a company beneficially owning the Hong Kong assets[4]. Explaining the concept of a private unit trust would probably take an article of its own, but the key feature is that it is a form of fixed trust, the beneficiaries under which are known as unit holders, and which has been drafted so as to allocate the trust fund into a fixed number of units. Each unit provides a proportional interest in the trust fund and the income therefrom. The unit trust deed would provide a mechanism for units to be transferred and to confer rights on unit holders, such as the right to vote at meetings of unit holders. Unlike a unit trust used as a collective investment vehicle, a private unit trust would not usually involve a separate custodian or manager and the assets are simply vested in the trustee who is responsible for managing them.

While adopting a trust based structure may help to mitigate the application of the controlled company rules[5] the next hurdle to overcome is then the three-year gifting rule. In the past it was common to structure a sale of Hong Kong situs assets into a trust structure relying on a round robin fund flow. The Pong Case concerned an attack made by the Hong Kong Estate Duty Office (EDO) against such an arrangement.

The Pong Case in a nutshell

Mr Pong (the settlor) established an offshore trust structure comprising of family discretionary trusts and private unit trusts. Mr Pong sold certain Hong Kong assets to the trust structure. The sale was financed by a round robin fund flow. Mr Pong died within 3 years of these transactions.

The EDO, while respecting the decision to establish a family trust structure, argued that the only purpose of the round robin fund flow was to avoid a gift for estate duty purposes. They argued that under general anti avoidance principles based on UK cases such as Ramsay (WT) Ltd v IRC[6], it was permissible to ignore the sale for estate duty purposes (leaving a gift of Hong Kong assets).

The family conceded that the round robin fund flow comprised of a pre-ordained series of steps. It was also agreed between the parties that the Ramsay doctrine applies in Hong Kong to estate duty matters. The Court of Final Appeal concluded that the EDO was correct in its allegation that the round robin fund flow was only intended to avoid the estate duty gifting rules.

However the Court of Final Appeal

concluded that while the Ramsay doctrine applied on the facts of the case, it would not allow the court to recharacterise a sale for valuable consideration as being a gift. At the end of the day, all that could be identified were gifts made by Mr Pong outside Hong Kong, which were not subject to estate duty. The EDO lost the Pong Case.

What were the steps in the "round robin" sale?

Each round robin sale of Hong Kong assets occurred in the space of a single day and was implemented in Macau. There were multiple trusts involved but for simplicity we will only refer to one private unit trust and one family discretionary trust. The trustee of the discretionary trust held most of the units in the private unit trust. Mr Pong was not a beneficiary. The steps were as follows:

- Mr Pong's wife borrowed money from a Macau bank.
- The wife lent the money to the trustee of the private unit trust.
- The trustee of the unit trust paid the money to Mr Pong as the fair market value purchase price for his Hong Kong assets.
- In one case, Mr Pong made a gift in Macau of the sale proceeds to the trustee of the discretionary trust. In another variation, Mr Pong made a loan in Macau of the sale proceeds to the trustee of the discretionary trust.
- Where Mr Pong had made a loan, the trustee of the discretionary trust provided Mr Pong with a specialty debt instrument which was deposited in the Isle of Man. Mr Pong made a will waiving any such debts still owed to him on death.
- The trustee of the discretionary trust used the money to subscribe for units in the private unit trust.
- The trustee of the unit trust repaid the wife who repaid the bank.

Over the course of the next few years, Mr Pong waived any offshore specialty debts that were owed to him. Mr Pong died just short of the three-year gifting period.

How do the Hong Kong estate duty gifting rules operate?

The primary issue in the Pong Case was whether Mr Pong had made a gift of non-Hong Kong assets, or whether he had in substance made a gift of his Hong Kong situs assets.

Under the gifting rules, Hong Kong estate duty can be imposed on the subject matter of a gift made within three years prior to the date of death provided that the gifted asset remains in existence in Hong Kong at the date of death. It is important to note however that this three-year period is only applicable in the case of a gift without reservation of any interest or benefit. Where there is a gift of a Hong Kong asset and the donor reserves the ability to benefit from that asset, the asset is subject to estate duty irrespective of how many years after making the gift the donor dies.

If Mr Pong was properly excluded from benefiting under the trust structure and had he survived the three-year period, it seems most likely the EDO would not have tried to attack his case. It follows that with any properly structured trust, the critical period should be limited to the first three years.

What is the "Ramsay doctrine" about?

The Ramsay doctrine is based on UK case law. This doctrine is now applicable to Hong Kong estate duty planning. It should also be considered in relation to Hong Kong stamp duty planning. Under the Ramsay doctrine:

- Where there is a pre-ordained series of steps or a single composite transaction.
- If it is possible to identify certain steps interposed into the series purely for the purpose of avoiding estate duty ("artificial steps").
- The artificial steps can be disregarded in order to ascertain what the substance of the transaction is for estate duty purposes.

Due to a technical weakness in this doctrine, the family defeated the EDO in the Pong Case. The technical weakness is that the Ramsay doctrine allows a court (or the EDO) to strip away artificial steps, but it does not allow the court to add back steps that never happened.

It is important to note that the Ramsay doctrine is a developing doctrine. It is possible therefore that the UK House of Lords may yet decide that under the doctrine a court should also have the power to recharacterise steps (for example, by treating a sale step as a gift step). Subsequent UK cases on general anti-avoidance principles may therefore give the Hong Kong EDO new grounds to argue that they can disregard round robin sales of Hong Kong situs assets.

To avoid any potential application of the Ramsay doctrine it remains very important not to enter into any transaction that might involve a pre-ordained series of steps. Second, it is also very important to be able to point to non-estate duty reasons for establishing a trust and for the sale of Hong Kong assets into the trust.

Is the decision in the Pong Case good news for families concerned about estate duty in Hong Kong?

The result in the Pong Case does appear to be good news for trusts for Hong Kong assets. The EDO have suffered a major set back with this decision. It is however very important to look at the Pong Case in its proper context. The EDO were focused on really only one thing in the Pong Case. This was to identify a gift of Hong Kong assets by relying on the Ramsay doctrine. In fact, there can be other grounds upon which estate duty may be imposed apart from the gifting rules (see below). The Pong Case did not really consider any of these other alternatives. This means that care must still be taken when engaging in estate duty planning to avoid falling within an alternative ground for imposing estate duty.

What else is subject to estate duty?

Estate duty in Hong Kong is imposed on Hong Kong situs assets that pass or are deemed to pass on death. Non-

Hong Kong situs assets that pass on death are exempted. Property that passes on death is deemed to include:

- Property caught under the gifting rules.
- Property the deceased put into joint names or procured the joint purchase of.
- Property held under a "controlled company" from which the deceased was able to benefit within three years of death.
- Property held by a trust settled by the deceased if the trust is either revocable or the deceased is a beneficiary under the trust (a "settlement with reservation").
- Property held by a trust where the deceased was "competent to dispose" of the trust assets.
- The property held under a trust which is determined to be a "sham" will also pass on death.

I have already established a trust structure for my family. Is there anything that I need to do in light of the Pong Case?

Having suffered such a major blow it can be expected that the EDO will be looking around to see if there are other grounds upon which they may be able to try to challenge an estate duty planning arrangement.

This means it will be very important where families have already established trust structures to have the structure reviewed periodically to ensure the structure is not at risk in some other way other than under the gifting rules, for example, under the controlled company rules or on the basis that there is a "settlement with reservation" or that the settlor is "competent to dispose".

Proper ongoing maintenance and review of trust structures is also essential in order to avoid the validity of the structure being challenged in the future on the basis that there has been a failure to honour the form of the trust since its establishment.

It will also be important to keep an eye out for any new developments. This includes keeping abreast of the practices and views of the EDO as they evolve.

As a private banking client, what will the Pong Case mean for me?

For individuals with cash and other financial assets, the Pong Case will not be that relevant provided that they are willing to invest those assets out of Hong Kong. The Pong Case is mainly going to have more of an impact on individuals who hold assets that are not easily "moved offshore" such as immovable property investments in Hong Kong and Hong Kong private company shares and operating businesses.

However to the extent that private banking clients have been using non-Hong Kong offshore companies to hold Hong Kong investments it can be expected that this type of arrangement will come under increasing scrutiny by the EDO.

The EDO will now be looking around for a new weapon in the fight against estate duty minimisation. One of the easiest ways for the EDO to fight back is for them to start invoking the controlled company rules in the Estate Duty Ordinance.

The controlled company rules are anti-avoidance rules aimed at preventing the avoidance of estate duty through holding Hong Kong assets through an offshore company. In the past the EDO have hardly ever applied the controlled company rules in practice. We anticipate that the EDO will now start to be more aggressive in applying these rules.

This means a private banking client who holds Hong Kong investments through an offshore company will expose those assets to estate duty on his or her death, with additional penalties, interest and double duty being imposed in cases of non-disclosure.

Can I use a bearer share company instead of a trust?

Apart from the fact that an offshore company holding Hong Kong investments falls squarely within the scope of the “controlled company rules” thereby making all of the Hong Kong investments subject to estate duty, the reality is that using a bearer share company exposes the underlying assets to risks that would not exist had a trust structure been used.

Where a high net worth individual holds assets (Hong Kong or otherwise) through a bearer share company, ownership of those assets will be placed at risk:

- If the share certificate gets lost or destroyed. How do you then prove ownership?
- If the share certificate gets stolen e.g. by an estranged spouse, child, relative or business partner.
- On death, if the share certificate does not go through the formal grant of probate. A bearer share company is not an effective way to avoid probate or laws which allow for a claim for family provision to be made against an estate.

The days of bearer share companies are coming to an end in any event. Bearer share companies have become associated with money launderers and other criminals. There are various international initiatives aimed at putting pressure on offshore finance centres that offer bearer share companies to either cease to offer such vehicles, or alternatively to require measures to be taken to ensure that beneficial ownership can be traced. Examples include the OECD initiatives against harmful tax competition and the FATF initiatives against money laundering. One proposal includes requiring all bearer share certificates to be deposited with a reputable bank or trust company, which will then maintain a register of beneficial ownership.

How about using a tax haven company to make an indirect gift of Hong Kong assets?

The Pong Case suggests that there is little the EDO can do to prevent people from exchanging Hong Kong situs assets for an offshore asset, and then making a gift of the offshore asset. An example of this might be to transfer Hong Kong assets to a British Virgin Islands or “BVI” company for an issue of offshore shares (this step is unlikely to be a gift). Based on the Pong Case it looks like an immediate gift of the shares in the BVI company e.g. to a family trust, can avoid the gifting rules. The problem with this arrangement is that under the controlled company rules, the donor is deemed to continue as the owner of the shares for at least the following three years, and as a result, all of the profits of the company over that period will be attributable to the donor. If the donor dies within that three-year period, the EDO can charge 100% of the Hong Kong assets of the BVI company to estate duty under the controlled company rules.

I have already established a family discretionary trust structure, but unlike the Pong Case, the trustee of the trust holds shares in an offshore company.

The structure in the Pong Case involved offshore discretionary trusts holding units in offshore private unit trusts. This is actually a relatively common approach to Hong Kong estate duty planning. One of the advantages of this approach is that it helps to avoid the application of the controlled company rules.

In contrast, where families have established a discretionary trust that holds shares in an offshore company (which in turn holds Hong Kong situs assets) the offshore company will be a controlled company and this can expose the Hong Kong assets to estate duty. There may also be a personal exposure on the trustee under this structure. There is also a reporting obligation imposed on the directors of the controlled company.

It would be prudent where there is a structure comprised of a discretionary trust the trustee of which holds shares in an offshore company to consider changing to the same structure adopted by Mr Pong, i.e. by replacing the offshore company with a private unit trust.

Is it true that the EDO tried to attack the use of the family trust structure in the Pong Case?

It would be incorrect to say that the EDO tried to challenge the family trust structure in the Pong Case. There was no criticism of either the family discretionary trusts or the private unit trusts. As mentioned, what the EDO sought to attack was the round robin sale by which assets were transferred into that structure.

On the other hand, it seems likely that the non fiscal reasons for the establishment of the trust structure by Mr Pong must have been a factor in helping the family win the Pong Case at the Court of Final Appeal.

A trust structure should not be viewed as simply a tax planning vehicle. It would also be prudent to ensure there is sufficient evidence of the non-fiscal reasons behind the establishment of a trust structure.

If I set up a trust, can I be a beneficiary under the trust?

The ultimate conclusion of the Court in the Pong Case was that the Hong Kong estate duty gifting rules did not apply. Therefore would it have made any difference if Mr Pong had been a beneficiary or not?

It seems likely that if Mr Pong had

been a beneficiary under the trust structure that he created and had he died after the initial three-year period, the EDO would still have tried to challenge his round robin sale as disguising a gift of Hong Kong assets. It also seems likely however that this would not have altered the view of the Court of Final Appeal that at most, they could only identify an offshore gift. Therefore when considering the gifting rules in isolation it may appear that Mr Pong could have remained as a beneficiary under the trusts.

However in our view it remains critical that the settlor or other person who contributes assets to a trust structure below which Hong Kong situs assets are held must not be a beneficiary (in fact they must be excluded from ever being a beneficiary). Aside from the gifting rules, if Mr Pong had been a beneficiary then there would have been technical grounds for attacking the trust structure under the settlement with reservation provisions or on the basis that Mr Pong was competent to dispose of the trust assets. The settlement with reservation rules and the competent to dispose rules are not subject to any three-year time limit. It also remains prudent to avoid the settlor being able to benefit from a trust for Hong Kong assets in order to ensure that any gifting exposure that remains is limited to a three-year time period at the most.

In cases where there is a mix of both Hong Kong and non Hong Kong investments, it is often sensible to establish two separate trust structures. One trust would be established that is compliant with the Hong Kong estate duty rules and under which the settlor is not a beneficiary. A second trust would be established for only offshore assets and under which the settlor may remain as a beneficiary.

Is it a requirement that I have to appoint a professional trustee?

The trusts set up in the Pong Case appear to have had family administered trustee companies. That is to say, the trustees of the family discretionary trusts, as well as the trustees of the private unit trusts, were private entities with family directors. Is this a safe approach to adopt? It is suggested that family run trustee companies are often not a viable option in practice.

In order for a discretionary trust to be effective for estate duty purposes, and for the other non estate duty purposes which it will have been established for, the trust must be properly set up and properly administered on an ongoing basis. Family members who have no knowledge of the strict duties of a trustee, the rights of a beneficiary and trust law in general will have no ability whatsoever to administer a trust. Without the support of professional trustees, the family run trust company will invariably lead to a sham structure.

Where the trustee of a discretionary trust is a company with the settlor as sole director or sole controlling director, the settlor will also not have given up sufficient control over the assets to constitute a valid trust.

Even if it is possible to overcome the hurdle of establishing that a genuine trust exists, the EDO will as a matter of practice challenge a family administered discretionary trust on the basis that the settlor remains competent to dispose of the trust assets, even if the settlor is not named as a beneficiary.

Private unit trusts for Hong Kong estate duty planning are often established with family controlled private trust companies. While this is not best practice, where this is the arrangement it remains essential for the independent professional trustee of the discretionary trust to liaise closely with the family to ensure that the trustee of the unit trust is properly administered in accordance with the form of the structure. Periodic professional review of private unit trusts is also highly recommended.

If I set up a trust, should I use the same round robin sale approach as was adopted in the Pong Case?

More often than not, trusts for Hong Kong assets which have been set up within the last 10 years are likely to have avoided a “round robin” sale. While the Pong family ultimately won their fight with the EDO, it is possible that if their trust had not involved the use of a round robin sale, the EDO might never have tried to attack them under the Ramsay doctrine.

It must remain best practice to try to avoid round robin funded sales. A round robin sale necessarily involves a preordained series of steps and therefore invites the potential application of general anti avoidance principles. As mentioned, the Ramsay doctrine may still evolve further, and so a future attack on round robins cannot be ruled out. It may also be that if the EDO can find a ground upon which to distinguish the Pong Case, they may try again relying on the Ramsay doctrine. For example, there was a suggestion in the 1998 judgement of Findlay J. at first instance in the High Court in the Pong Case that there may be a gift by associated operations of Hong Kong assets where a person sells Hong Kong assets and then there is an arrangement for the sale proceeds to be returned back to the vendor. A simple round robin sale of assets directly to the trustee of a discretionary trust would seem to fall into this description. While the matter is uncertain, prudence is the best approach.

What other reasons are there for setting up a trust apart from estate duty mitigation?

It seems likely that the non-fiscal reasons for Mr Pong establishing the trust structure were helpful in the family winning the Pong Case. Who knows what the result would have been if even the establishment of the trust structure itself had only been for the purpose of avoiding estate duty?

For an individual with liquid financial assets, a trust is especially useful as a structure to consolidate ownership of the assets and to facilitate confidential investment management.

For an individual whose wealth is

represented by private operating companies, property investments, or a major shareholding in a listed company, a trust represents a sophisticated vehicle through which to ensure stability of control. A trust in that case should provide the basis for a business succession plan as well as dealing with the issue of succession on death or disability.

Other advantages which private trusts will provide can include:

- Probate avoidance.
- Confidentiality.
- Mitigation of claims made on an estate for family provision.
- Asset preservation.
- Care for the young, the disabled and the financially insecure.
- The appointment of an objective arbiter (in the form of the independent trustee) to help avoid family disputes.

FOOTNOTES

1. *Kwok Chi-Leung, Karl Commissioner of Estate Duty [1988] 1 WLR 1095.*

2. *Named after the House of Lords decision in Ramsay (WT) Ltd v IRC [1982] AC 300.*

3. *The controlled company provisions were examined in an article by the author published in the September 2000 issue of* ***Offshore Investment.***

4. *If a company beneficially owns the Hong Kong assets, invariably the controlled company rules would then be applicable.*

5. *The controlled company rules are still relevant even with a structure comprising of a discretionary trust and a private unit trust, if the underlying assets include shares in controlled companies.*

6. *[1982] AC 300.*