

Manivest Jurisdiction Topics

[Special Report by Guest Experts]

The Private Trust Company

[Using New Zealand Company in Formation of Private Trust]

by

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The Private Trust Company

A presentation given in Hong Kong by
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Over the last 50 years or so manufacturers and property owners in South Easy Asia have accumulated significant fortunes. One of the results of this wealth accumulation has been the steady growth of private discretionary trusts designed to hold a portion of this wealth and to act as a vehicle for transmitting the wealth from one generation to another.

Initially such trusts contained fairly liquid assets such as bank deposits and investment portfolios. Subsequently they contain more complex assets such as real estate, shares in family companies, strategic stakes in public companies etc. An additional rationale for trusts was the wave of emigration from Hong Kong. Because of the highly favourable tax treatment of so-called 5 year trusts, it would have been unthinkable for anyone of any level of wealth to have emigrated to Canada without first establishing a trust to hold part of their wealth.

Before focussing on private trust companies I would like to briefly cover a few basic points:

1. What are the basics of the typical trust encountered in Hong Kong?

A traditional private trust is a relationship between the **Settlor**, who gives property to the **Trustee**, who then holds and administers that property for the benefit of the **beneficiaries**. The beneficiaries are entitled to enforce the trust in the court of equity which make the trustees meet their obligations. The result of this is that in order to constitute a valid trust, the direction to hold property for another must meet the test of the three certainties:

- **intention** – the words used must demonstrate a clear intention to create a trust.
- **property** – the settlor must clearly identify the property which is the subject matter of the trust
- **objects** – the beneficiaries or purposes of the trust must be clearly identified

Although there are some quite significant family trusts based in Hong Kong with Hong Kong trustees, the nature of Hong Kong and in particular the 1997 issue led to the vast majority being established offshore in Locations such as the UK Channel Islands (Jersey and Guernsey) or Bahamas/Caymans in the Caribbean.

Wherever the trust was located it was most commonly a discretionary trust, i.e., one where the trustee has full discretion as to how the trust fund is invested and how much and to which beneficiaries any payments of capital or income are made. The settlor normally gives a "letter of wishes" to the trustee setting out guidelines re investments and in particular what proportion of the trust fund is attributable to any given beneficiary and at what stage will payments commence. It must however be emphasized that such a letter is non-binding and in theory if not practice, can be readily ignored by the trustee..

In an attempt to gain some indirect control over this absolute discretion it has not been uncommon to have a lawyer or confidant to act as Protector. The mechanisms vary but typically the protector has the power to change the trustee if he believes the trustee is about to make an unwise investment or distribute capital/income unfairly.

2. What is a purpose trust?

Put at its simplest a purpose trust is one designed to benefit a purpose rather a person or persons. Historically the only purpose trust that could be enforced was one whose purposes were exclusively charitable and of a public nature. A trust which was for a mixture of purposes, only some of which were charitable, has traditionally been unenforceable at law and therefore void. Furthermore a trust was only considered to be charitable if it were for:

- **the relief of poverty;**
- **the advancement of religion;**
- **the advancement of education; or**
- **some other purpose beneficial to the community.**

The courts have tended to be very strict in their interpretation of charitable purpose trusts and there is little doubt that a large number of so-called charitable trusts have in fact been void.

As I am sure many of you know the special purpose charitable trust has been widely used in commercial transactions. In particular where a neutral owner of an offshore company – perhaps one involved in an intermediary step in a financial transaction – was required, it was commonplace to cause the company's ownership to be in the hands of a charitable trust.

In order to overcome the uncertainty associated with charitable purpose trusts, many offshore jurisdictions have enacted special legislation providing for a trust for non-charitable purposes. Examples include Bermuda, the Cayman Islands and the BVI. Specific legislation has been passed that permits a trust to be for any purpose that is certain, lawful and not contrary to public policy. Some jurisdictions require at least one trustee to be a professional of some nature; all require an enforcer who has right of access to the books and accounts of the trust and who has the power to ensure that the provisions of the trust are followed.

Normally the trust is created by declaration.

3. How are trusts taxed?

Trusts are not separate legal entities and as such are not subject to taxation. The normal taxing regime is applied to the trustees in that capacity. For example a tax assessment might well be levied on ABC Limited as trustee of the XYZ trust. I believe this is the case in Hong Kong.

In many jurisdictions trusts are used to split income and otherwise avoid tax. Consequently anti-avoidance legislation is frequently found designed to attribute income and therefore taxation to beneficiaries and/or the settlor. Often one finds more substantial anti-avoidance legislation in respect to offshore trusts.

Of course most offshore trusts are established in zero tax financial centers such as Jersey or the Cayman Islands and as a result are not taxed. It is however good practice to remember that an offshore trust should be reviewed not only by reference to the tax law where the trust is established and based but also by reference to the tax law of the country or countries where the settlor and beneficiaries are resident.

Specific locations worthy of note are

a) Canada

Despite numerous warnings of potential changes and adverse reporting requirements, a trust established for an immigrant in an offshore location is not taxed for the first 60 months following the person taking up residence in Canada.

b) New Zealand

New Zealand is very different to most highly taxed jurisdictions. It

does not tax offshore income earned by a “foreign” trust either at the level of trustee or as and when the income is distributed to a beneficiary. A foreign trust is one settled by a non-resident of New Zealand for the benefit of non-resident beneficiaries. This is the case even if the trustee is a resident of New Zealand and/or the trust is based and administered in New Zealand. The main qualifications to this are

- i. The foreign trust regime does not apply to unit trusts
- ii. There are significant anti-avoidance provisions concerning who may be regarded as the settlor of a foreign trust. Considerable care is needed if there is any risk at all of a New Zealand resident giving a benefit to the trust (however minor or inadvertent).

As we will see the New Zealand foreign trust regime can be quite an interesting opportunity for private trust companies.

Private Trust Companies

Recently a well known Hong Kong based practitioner, James Wadham, updated the late Professor Peter Willoughby's book “Misplaced Trust”. James quotes the general manager of a leading international trust company:

“Ten years ago Bank of Bermuda did not administer any private trust companies. Today these vehicles comprise a significant amount of the Bank's trust business.”

At its most basic a PTC is nothing more than a limited company permitted by its constitution to act as trustee of one or more family trusts. In many ways it is not much different from a traditional bank owned trust company. The major differences flow from ownership and the specialized nature of its client base.

What then are the real and/or perceived advantages of using a PTC over the more traditional structure of independent bank owned trust company?

1. Reassurance to the settlor/client

For many clients there is a very real disadvantage to holding assets through a discretionary trust, i.e., the fact that legally they have vested full control over the assets to the trustee. The problem is eased if the trust is revocable but often this is not technically possible. For example there may well be powerful tax reasons why the trust

must be irrevocable.

Even though the same legal transfer of control arises where a private trust company is employed, it is more than likely that the use of a private trust company will give him or her considerable comfort. The board of directors of the private trust company may, for example, be composed of trusted advisers known to the settlor for several years and who themselves have extensive knowledge of the underlying businesses held in trust. In addition it may well be possible to have one or more family members on the board.

2. Flexibility re assets held in trust

As I mentioned earlier there has been a steady change in the nature of assets held by a typical offshore trust established for families based in HK and South East Asia. Originally they tended to be for the very wealthy and held surplus wealth in the form of bank accounts and investment portfolios. This gradually changed such that the trustees were required to hold more “difficult” assets. For example it became increasingly common for a settlor to wish to place active business assets into a trust – in particular shares in a private manufacturing or trading company. Many traditional bank owned trustees were (and still are) reluctant to hold such assets since

- a. Being non-financial by their very nature, such assets are not readily understood by professional trustees
- b. In any case the client would not want active management involvement from the trustees
- c. If things went wrong then they were likely to give rise to liability; who better to sue than a professional trust company owned by a bank with deep pockets

This type of constraint falls away when a private trust company is used.

3. Speed of decision making

The more that trust assets trend towards active business assets the more likely is the need for speed in decision making. The ability to make rapid decisions, particularly where the trust holds shares in operating companies of a family group will be a significant factor in selecting a trustee as new “owner” of the shares. However capable and however efficient, it is most unlikely that a professional trust company owned by a major bank will be able to make important decisions without considerable deliberation, legal clearances etc.

On the other hand if the board of a private trust company is already familiar with the family's business interests they will be in a position to act quickly and decisively.

4. Changes of control and management

Most trust deeds permit an outsider (normally called the Protector or Guardian) to change the trustee. Normally this will be as a result of a disagreement re the proposed or actual actions of the trustee. Most professional trust companies could be expected to cooperate but nevertheless this can be a costly and time consuming process. This is assuming that trust assets are held via an underlying tax haven company rather than directly by the professional trust company. If they are in fact held directly by the trustee company then a change of trustee can be particularly difficult.

By way of contrast the change of a board of directors of a private trust company can normally be arranged quickly with minimum cost.

Normally the private trust company will be administered by a professional trust group or some other form of service provider. In the same way as it is relatively painless to switch directors, it is also fairly easy to change the administrator of a private trust company.

5. Choice of investment advisor, banker, custodian etc

If a professional trust company is used then there is a natural tendency to utilise the same group for other financial services. Of course most professional trust companies now recognise their duty to seek out the most suitable investment advisor, bank etc irrespective of whether the provider is in the same group. It will, however, normally be the case that sister companies are used and it can be embarrassing for the settlor to institute changes. Even if the professional trust company is prepared to actively cooperate on the choice of advisers, bank etc there will be a tendency to restrict the choice to institutions of a similar size/reputation.

Although similar problems can arise with a private trust company administered by a professional trust organisation, the freedom of movement is greatly enhanced.

6. Costs

Another factor often quoted is one of cost. For large and/or complex trusts the costs of a private trust company may well be less than those of a bank owned trust company. This may particularly be the case if the trust is active and there is a continuing need for the professional trustee to secure expensive legal advice.

7. Liability issues

In most cases the directors of a limited liability company are protected from creditors etc. As a result the directors of a private trust company could expect to be insulated against any liability affecting the trust. Liability should fall squarely on the trustee company rather than on themselves as directors. This will of course normally be the case. However such protection shouldn't be taken for granted; directors of a private trust company should act properly with the interests of the beneficiaries in mind at all times.

Of course where there are advantages there are normally some disadvantages. These can be summarised as follows:

1. Proximity to settlor

The problem with trusts is that the more control outsiders exercise over the trustee then the greater risk there is of a trust being regarded as a "sham" and being disregarded. This can be particularly troublesome if the existence of the trust is essential to secure tax advantages. Equally if after the settlor's death, a dispute arises between the beneficiaries then an obvious strategy would be to dispute the actual existence of the trust. If anyone would like to explore the problems in more depth I would commend Willoughby's Misplaced Trust to them.

One of the side benefits of having a professional trust company as trustee, especially one which insists on exercising its independence from the settlor and/or client, is that a challenge on these lines is unlikely to be successful. Using a private trust company can of course compound the danger and needs to be very carefully considered at the time the relevant decision is made.

2. Ability of beneficiaries to sue

One significant factor in favour of a professional trustee is their connection with a financial institution with deep pockets. When a client is in the process of establishing a trust it is worth considering what would happen if there were a serious breach of trust. Any action by the beneficiaries against a private trust company or for that matter its directors may be worthless whereas an action against a professional trust company could result in significant damages.

3. Ownership of the private trust company

The obvious owner of a private trust company would be the settlor. Bearer shares could be used but nevertheless there are problems with disclosure of beneficial ownership and in particular deciding who should own the shares after the settlor's death.

An alternative on similar lines would be to vest ownership in some or all of the directors of the company. This could be particularly the case if in effect the private trust company had been established to incorporate a group of individual co-trustees.

In most cases, however, ownership of the private trust company is placed in neutral hands via the use of a purpose trust.

I would just like to re-emphasise an earlier point, i.e., using a private trust company doesn't avoid the need to recognise that the ownership and control of the assets resides in the trustee and not in the settlor/client. Having said that the private trust company has a number of significant advantages including flexibility and speed.

New Zealand as a location

There are of course many jurisdictions suitable for incorporating a private trust company. I imagine that by far the most popular in Hong Kong and South East Asia would be Bermuda or the BVI. I would however like to look specifically at New Zealand as a location and to consider the pros and cons.

1. Tax treatment

A New Zealand based trust is not subject to New Zealand taxation as long as neither the settlor nor the beneficiaries have any connection with New Zealand (in particular are not residents of New Zealand) and as long as the income earned is not sourced from New Zealand. No tax file number need be obtained. No filing with the New Zealand tax authorities is required.

2. Respectable nature of New Zealand as a jurisdiction

As I am sure you are all aware there has been considerable publicity concerning so called tax havens. Despite the fact that New Zealand permits a structure which can earn and distribute offshore income free of tax, there has been little if any publicity.

3. Location of New Zealand

A considerable advantage is the relatively geographic closeness of New Zealand.

4. Legal infrastructure available

A well developed and readily available court/legal system is available.

5. Underlying cost structure

Costs are relatively low; certainly when compared with some traditional tax havens.

6. Ability to use “trust” or “trustee” in the private trust company’s name

In so far as it would be regarded as an advantage, there is no restriction on the use of the words “trust” “trustee” etc. No licence is required.

A standard private limited company incorporated in New Zealand is able to act as trustee.

7. Composition of the board

New Zealand requires a minimum of one director which must be a natural person. Corporate directors are not permitted

8. Ownership of the private trust company

A minimum of one shareholder is required. Corporate shareholders are permitted.

9. Advisory trustee

New Zealand permits any third party to be appointed to give advice to the responsible trustees. Their role is restricted to advice; they have no power of management or administration.

10. Custodian trustee

New Zealand allows for situations where the responsible trustee for any particular reason wishes to arrange for assets to be held by a different legal entity. Such a custodian trustee has the sole function of holding trust property, investing trust funds, and disposing of trust assets as the responsible or managing trustees direct. It cannot be held liable for any act or default of the managing trustees.

11. Ease of administration

New Zealand is a modern jurisdiction. Of course in line with any other company there is a basic level of administration that is required. In the appendix I have set out the basic requirements which I suggest we briefly go through, if only to convince you all that the requirements are familiar and fairly straightforward.

With the above in mind I would like to briefly consider the position of a settlor who wishes to benefit his wife and then his children after his death. Prior to his death the settlor wishes to use the trust as an asset holding vehicle which accumulates income and only distributes to one or more beneficiaries in specific circumstances to be determined by him. A number of different types of assets are to be transferred to the trust. These range from simple investment accounts with banks/portfolio managers through direct equities to operational businesses. The client understands that once assets have been transferred to the trustees to hold on trust, he loses direct control. However he would like to retain as much influence/involvement as possible. To avoid unnecessary complexity, I am assuming that all parties remain resident in Hong Kong, are adults and have no current or intended connection with New Zealand.

In analysing this problem let's look at the various things we need to consider:

1. Classification of the trust assets

Class 1 – simple, traditional assets	- bank accounts and investment portfolios
Class 2 – more complex assets	- direct equities and real estate
Class 3 – difficult assets	- operating businesses

2. Influence in respect to day to day decisions re trust assets

As much as possible to the settlor; if for any reason the settlor is not available then the major influence is to vest in his long time legal advisor.

3. Type of trust company

In view of the desire to vest "difficult" (Class 3) assets into the trust the settlor and his legal adviser determine that a private trust company would be the best solution.

4. Location of private trust company

Principally because of the respectable profile offered as well as cost and location, the settlor decides to use a private trust company incorporated in New Zealand

5. Ownership of the private trust company

The settlor decides that he would prefer own the shares in the private trust company personally. At his legal advisor suggestion, he agrees to own them jointly with his children so that there will be a simple transition of control on his death.

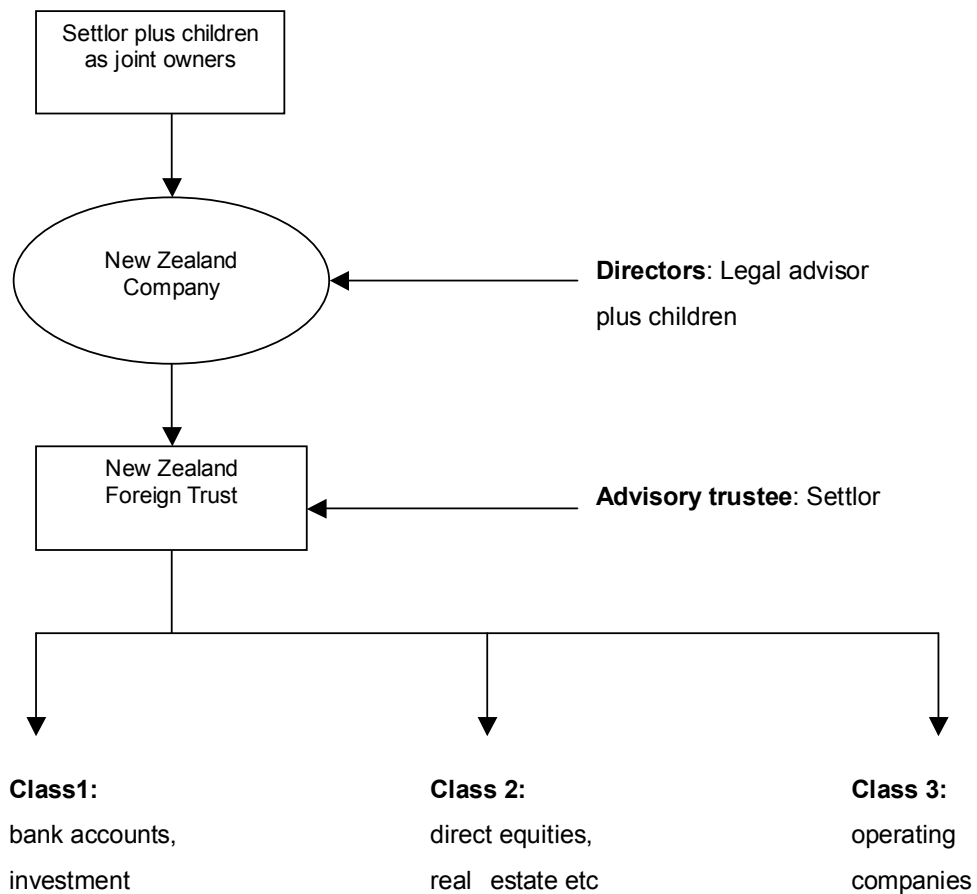
6. Board of the private trust company

The settlor decides that he will be represented on the board by his legal advisor. In addition each of his children should be on the board both to give them involvement in the family assets and also to prepare them for the future.

7. Advisory trustee

In order to formalise his involvement in the ongoing decisions required of the trustees whilst at the same time distancing himself somewhat from the trust, the settlor decides that his role should be restricted to an advisory role only.

As a result the following structure is put into place:



To summarise the various issues:

1. What are the advantages of using a private trust company?
 - Reassurance to the settlor/client
 - Flexibility re assets held in trust
 - Speed of decision making
 - Changes of control and management
 - Choice of investment advisor, banker, custodian etc
 - Costs
 - Liability issues
2. As against problems:
 - Proximity to settlor
 - Ability of beneficiaries to sue
 - Ownership of the Private Trust Company
3. Why choose New Zealand as a location for incorporating a Private Trust Company?
 - Tax treatment
 - Respectable nature of New Zealand as a jurisdiction
 - Location of New Zealand
 - Legal infrastructure available
 - Underlying cost structure
 - Ability to use "trust" or "trustee" in the private trust company's name
 - Composition of the board
 - Ownership of the private trust company
 - Advisory trustee
 - Custodian trustee
 - Ease of Administration

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