



WHAT IS A TRUST?

Hong Kong

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ADVISING FAMILIES ACROSS GENERATIONS

WHAT IS A TRUST?

Trusts have been used by families for centuries.

A trust is a mechanism whereby one person (the 'settlor') may give away the enjoyment of assets to a group of individuals (the 'beneficiaries') while control and decisions on the administration and investment of those assets lies with others (the 'trustees').

- *The settlor* is the person who provides the assets of the trust. Unless he is a beneficiary or reserves powers to himself in the trust deed, he has no rights over the trust assets once they are transferred to the trustees.
- *The beneficiaries* are the persons entitled or potentially entitled to the benefit of the capital and income of the trust fund. The extent of their entitlement depends on the precise terms of the trust.
- *The trustees* hold the legal title to the assets upon trust for the beneficiaries. Their duty is to administer the assets in the trust and, eventually, to distribute them in accordance with the terms of the trust deed. They are in a strict fiduciary position vis-à-vis the beneficiaries, i.e. they must always exercise their powers in the best interests of the beneficiaries and, in particular, must not allow their own interests to conflict with those of the beneficiaries. If they commit a breach of trust (i.e. break the trust imposed on them by acting in a way that is not for the benefit of the beneficiaries) they may be liable to make good any loss out of their own pockets. It is possible for the settlor to be one of the trustees (but this may be undesirable in certain circumstances) and it is also possible for a beneficiary to be a trustee (whether this is desirable will depend upon the nature and purpose of the trust).

Problem:

Parents, grandparents and others have always been concerned that children and grandchildren are at risk if they receive or inherit too much too soon. In addition, increasingly families are concerned to protect assets in the event of a child's divorce.

Solution:

Create a trust to hold the assets until the children are older and wiser and seek to 'ring fence' family wealth.



In law, the trustees are the legal owners of the trust assets and have effective control of them. The beneficiaries, as beneficial owners, merely have rights against the trustees. While these rights give the beneficiaries full power to enforce the trust in their favour, the fact that a particular beneficiary cannot be said to own or have control over the assets can be very useful in tax and estate planning.

If the trust is to be made in your lifetime, to take immediate effect, then it is usually evidenced by a trust deed. 'Trust' and 'settlement' have broadly the same meaning. If it is to be created on or shortly after your death then the trust provisions must be set out in your will – a 'Will Trust'. Whether by lifetime settlement or by will, the trust document states who are responsible for looking after the gifted assets (the trustees), who are to benefit (the beneficiaries) and any rules or conditions that the trustees and beneficiaries must adhere to. Additionally it must specify clearly the initial trust property, sometimes called the 'trust fund'.

How long a trust shall last is entirely as you think is appropriate but you must stipulate the trust period in the trust document. It might be for just a few years, perhaps during a person's widowhood or until a child attains a certain age or marries. However, trusts can last for much longer. Since 1 December 2013, Hong Kong trusts are capable of existing in perpetuity. It is usually advisable to give the trustees the power to terminate the trust at their discretion.

WHY MAKE A TRUST?

Throughout their history, trusts have been used for a wide range of purposes:

Avoidance of probate

Where assets are transferred to a trust, they are outside the estate of the settlor. This avoids the need to deal with those assets in the event of the settlor's death.

Trusts for children/grandchildren

Parents or grandparents often create flexible trusts for the benefit of children or grandchildren who may be too young or financially unsophisticated to benefit from an outright gift. Trusts provide a mechanism for the long-term retention and control of assets.

Trusts for those under a disability

A trust can be used to hold and administer assets for those who are unable to hold assets themselves, e.g. minors or the mentally disabled.

Family company shares

A settlor may wish to encourage his or her children to become involved in the family company but is perhaps unsure of the relative extent to which one child or another should benefit. If he or she transfers the shares to a trust, the settlor can remain in control of the company (subject to tax considerations) by acting as one of the trustees and can thereby continue to exercise voting control over the shares gifted into trust. The settlor may also continue to exercise management control as a director (but their salary as such must be restricted to commercial levels).

Trusts to protect assets

Trusts can be used in certain limited circumstances to protect the settlor's assets from creditors, disinherited heirs, claims by the ex-spouses or former civil partners of children or grandchildren and the risks associated with political instability. Often it is sensible to use trusts based in a different country from the settlor for this purpose. How far they are effective to protect assets will depend on the law in the settlor's country of domicile or residence and the law under which the trust is established. It is common with these trusts to appoint a protector who will act as a balance to the trustees' powers, and the trust deed can provide that the trustees should obtain the protector's approval before exercising certain powers or taking certain decisions.



TRUST TYPES

Most trusts fall into one or two main categories depending on how the income or benefit (dividends, interest, rents, free use of property, etc) is dealt with:

Interest-in-possession trusts: Those where the income or benefit must be given to the specific beneficiary – it is his or hers by right.

Discretionary trusts: The key feature of a discretionary trust is that the benefits are allocated at the trustees' discretion to any one or more of several beneficiaries. The trustees might even decide, for a time, to benefit no one; the income being accumulated for a future use.

Below we consider these in more detail.

Interest-in-possession trusts

The interest-in-possession trust (sometimes called a 'fixed-interest' or a 'life-interest' trust) is often used in a will when a person dies leaving a surviving spouse, e.g. 'income to my wife for her life and after her death capital to my children'.

The widow can enjoy the income from the assets placed in the trust (shares, cash, etc, or the use of the family home) but it is prevented from dissipating the trust capital. This can ensure that the children receive their inheritance. The same trust can be created in the wills of two people marrying for the second time, each having children by their first marriage. It ensures that the children of the first marriage do not see their parents' wealth passing to the children of the surviving step-parent.

You might leave your estate to your spouse, in part as an absolute legacy and the remainder in trust for life. You can give the trustees wide powers to use their discretion over the capital to help in case of need, including the power to make capital advances or interest-free loans to, say, your widow.

You may want to give shares of the family company to your children or grandchildren but fear that they might sell or gift them outside the family. To avoid this, the shares can be held in trust for, say, 'my children equally for their respective lives and thereafter for my grandchildren who survive'. By this means the children and grandchildren benefit from the shareholding but cannot control the voting power of the shares nor dispose of them – only the trustees can do that.

Discretionary trusts

Discretionary trusts are the most flexible type of trust. The trustees can choose who among the class of beneficiaries benefits from the trust assets. None of the beneficiaries has any fixed rights under a discretionary trust during the trust

period, either to income or to capital, so the trustees are able to adapt to changing family circumstances and tax legislation by exercising their discretion to the best effect. Even the beneficial class can be enlarged by giving the trustees the power to introduce new beneficiaries as the need arises.

A general discretionary trust may suit you if you have identified a particular group of people you want to benefit but you are unsure which of them, in the future, will need help or in what proportions. For example, as a grandparent you might like to set aside capital for your grandchildren – including those who may be born later, even after your death. Some of them might be more in need than others and family and financial circumstances could change from year to year.

Alternatively, you might wish to benefit your children but are aware that some of them are already wealthy and may not wish to be made wealthier by your intended gift. A discretionary trust in favour of all your children and grandchildren would allow your children the choice of taking the benefit themselves or passing it on to their own children according to their particular circumstances.

You might wish to make a lifetime settlement for the benefit of just your children and grandchildren but be worried that, if you died, your widow(er) might be in further need of capital or income; the trust funds would not then be available to help. To quell your fear you could include as beneficiary 'my widow(er)' so that when (and only when) you die, your spouse joins the beneficial class and the capital and income becomes available for his/her use if required.

Your elderly parent or other dependent could be helped with this type of trust as the subsequent death of that person would not bring the trust to an end and so the trust would continue for the benefit of other class members.

Charitable trusts

You may be inclined, or be expected, to make regular donations to charity or you may have a particular interest in some worthy cause. Rather than make regular payments out of taxed income or a legacy to a charity over which you have no control, you could create your own family charity either in your lifetime or on your death by creating a charitable trust in your will.

Of course the trust can only be used for charitable objects, i.e. the relief of poverty, the advancement of religion, education or the public good. Charitable trusts can last forever – a truly lasting memorial.

MATCHING A TRUST TO YOUR NEEDS

It has been said that for every family problem or situation, there is a trust that can be constructed to suit the need. Creating the right type of trust to match your particular situation requires specialist help.

Whether creating the trust by will or in your lifetime, selecting the trust type and its terms are very important. In this brief summary we have mentioned only the main types of trust; there are many variations – the protective trust, which automatically terminates the interest of a profligate beneficiary who attempts to dispose of his interest, the (once popular) marriage settlement and the 'bare' trust, which makes the beneficiary the actual owner, to name a few. For maximum flexibility it is usual to give the trustees wide management powers so that they are better able to respond to any changes in family matters. With such wide trustee powers, be sure to choose your trustees carefully.

A trust that might last forever needs careful planning, but the benefits can last just as long if you take specialist advice beforehand.



Can a settlor be a trustee?

Yes.

Can a trustee be a beneficiary?

Yes.

Can I be a sole trustee?

Technically yes (unless the trust holds land) but it is not preferred.

How many trustees should there be?

Two or three are preferred. Four is usually the maximum.

Must I appoint a professional trustee?

No, but be extra careful to whom you give the power and responsibility of trusteeship.

Can a trust protect assets from divorce or bankruptcy proceedings?

The courts have wide powers so protection is only available up to a point. Much depends on the terms of the trust, the timing, and the purpose for which it was created and the way it has been administered.

My chosen executor/trustees for my modest estate are relatives – but laymen. Is this wise?

If they are an adult and sensible this should not cause a problem. They will have the power to hire (and fire) professionals who should be able to advise them what to do.

WHAT IS STEP?

STEP is the worldwide professional association for those advising families across generations. We help people understand the issues families face in this area and promote best practice, professional integrity and education to our members.

Today we have over 20,000 members across 95 countries from a range of professions, including lawyers, accountants and other specialists. What connects our members is that they all help families plan for their futures: from drafting a will or advising family businesses, to helping international families and protecting vulnerable family members.

This leaflet and the companion leaflets 'Why make a will?', 'What to do when someone dies' and 'Why make an Enduring Power of Attorney?', have been prepared by the STEP Hong Kong Branch. These and other informational leaflets produced by STEP, are available to view and order at www.step.org/leaflets

This booklet was revised and updated in May 2014 by Katie Graves TEP, and is applicable to trusts governed by Hong Kong law.

For further details of our members practising in your area, contact the STEP Hong Kong office or visit: www.step.org/online-directory

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