

Baker McKenzie's Chan and Ma on Key Developments in Cases Affecting Legacy Planning in Hong Kong

The act of guiding Asia's high net worth individuals through the complexities and challenges of legacy and estate planning can easily be regarded as a highly exacting exercise. In aid of those industry practitioners continuing to cut their teeth in this area of practise in what is a dynamic and evolving region, Baker McKenzie's Pierre Chan and Lisa Ma share their insights into key cases and guidance in Hong Kong pertaining to trusts, charitable organisations and stamp duty.

BY:

PIERRE CHAN, PARTNER, HONG KONG

Baker McKenzie

LISA MA, ASSOCIATE, HONG KONG

Baker McKenzie

1. Trustee's duty to supervise investment

In November 2019, the Hong Kong Court of Final Appeal (CFA) published the long-awaited judgment in the case of *Zhang Hong Li v DBS Bank (Hong Kong) Limited [2019] HKCFA 45 (DBS Case)*. The CFA considered, amongst other things, the effect of "anti-Bartlett" provisions on the trustee's duty to supervise investment decisions.

The DBS Case involves a trust governed by Jersey law (Trust) whereby DBS Trustee HK (Jersey) Limited (DBS Trustee) acted as the trustee, and its affiliate company (DHJ) acted as the sole corporate director of a trust underlying company (PIC) held by the Trust. The PIC appointed one of the settlors (Ji) to be its investment advisor, and DHJ granted authority to Ji to give investment instructions on the PIC's behalf in relation to the PIC's account with the private banking division of DBS Bank (DBS PB).

The trust deed of the Trust contained typical anti-Bartlett provisions, which expressly forbade the trustee's interference with the management of the PIC.

The PIC applied for a credit facility of USD10 million, which was then increased to USD100 million in order to fund its investments starting from 2007. The investment strategy of the PIC was also switched by Ji from mutual funds into foreign exchange transactions focusing on Australian dollars (AUD). From late July 2008, the AUD began to fall. The private banker at DBS PB introduced decumulators to Ji who purchased them. Yet, the continuing decline in AUD against USD led to margin calls to the PIC because of the heavy leverage of its investments. The PIC eventually suffered huge losses on the decumulators dominated in AUD.

In 2011, the settlors of the Trust commenced proceedings asserting claims against: (a) DBS Trustee for both dishonest and negligent breach of trust; (b) DHJ (and another DBS entity which provided other corporate related services to the PIC and performed work for DHJ) for both dishonest and negligent breach of fiduciary duty; and (c) DBS PB and the individual bankers for dishonest assistance of the asserted breaches of trust and fiduciary duty.



PIERRE CHAN

Baker McKenzie

At trial, the Court of First Instance (CFI) dismissed claims against DBS PB and other parties, but held that:

- a) DBS Trustee failed to discharge a trustee's "high level supervisory duty" over the PIC's investments and such failure constituted a breach of its "duty to act with due diligence, to act as would a prudent person, to act to the best of his ability and skill, and to act only in the interests of the beneficiaries" (because of DBS Trustee's approval of the PIC's purchase of AUD, decumulators as well as the increase of the PIC's credit facility); and
- b) DHJ was in breach of its director's fiduciary duties as it failed "to act in the best interests of the company and to exercise reasonable care, skill and diligence in the performance of their functions and their management of the company's affairs", and "acted in a negligent manner and that their degree of negligence was a serious or flagrant degree of negligence," (also because of DHJ's approval of the same three transactions in its capacity as PIC's director).

The Court of Appeal upheld the CFI's ruling.

However, the CFA reversed the decisions of the lower courts, holding that neither DBS Trustee nor DHJ owed any supervisory duties over the PIC's investments, mainly on the following grounds:

- a) The basic duty of a trustee was to carry out and administer the trust in accordance with the terms of the trust. Any "high level supervisory duty" over the PIC's investments imposed on the trustee would be inconsistent with the express anti-Bartlett provisions in the trust deed.
- b) Although Article 21(1) of the 1984 Trust (Jersey) Law provided that "in the execution of its duties, and in the exercise of its powers, to act with due diligence, as would a prudent person, to the best of the trustee's ability and skill,



LISA MA

Baker McKenzie

and to observe the utmost good faith", such provisions did not create free standing duties on the trustee to act prudently but merely operated to lay down the standards to which the trustee must adhere (if there were such duties in place). Thus, where the anti-Bartlett provisions expressly excluded the trustee's duty to supervise investments, such standards laid down in the statute did not come into play.

c) Where the Jersey law expert evidence provided that the anti-Bartlett provisions did not exclude a "*residual obligation*", such "*residual obligation*" might refer to an obligation to interfere where there was actual knowledge of dishonesty (but not as what the Court of Appeal noted being "*a power which has to be exercised in circumstances where no reasonable trustee could lawfully refrain from exercising those powers*", as any such implied non-derogable external duty would expose the trustees to unanticipated risks of liability by undermining the legitimate arrangements (i.e., the anti-Bartlett provisions, consciously adopted by the parties). Yet, such "*residual obligation*" was not to be equated with the trustee's fundamental "*irreducible core of obligations*" which consist of the "*trustee's duties to perform the trusts honestly and in good faith for the benefit of the beneficiaries*" but do not include "*the duties of skill and care, prudence and diligence*".

d) In the case of DHJ, even if the trustee were under a duty to supervise the PIC's investments instigated by Ji as the PIC's investment advisor, no basis had been shown for concluding that the approval given by DHJ in respect of the transactions in question constituted negligence to a serious and flagrant degree.

The CFA also discussed the measurement of compensation where there was a breach of duty, which depended on the nature of the fiduciary duties involved.

As indicated by the CFA, the DBS Case involves issues of law which are of public importance both in Hong Kong and internationally. Although the CFA decision appears to have now alleviated trustees' concerns about the effectiveness of anti-Bartlett provisions, trustees and wealth management professionals should still pay extra attention in drafting anti-Bartlett provisions, and should continue to act with caution without simply over-relying on their anti-Bartlett provisions.

2. Charitable organisations

The Hong Kong Inland Revenue Department (**IRD**) issued an updated "Tax Guide for Charitable Institutions and Trusts of a Public Character" (**Guide**) in September 2019, which provides more comprehensive guidelines and examples on the taxation of charities in Hong Kong. The Guide has been further revised in April 2020 with some additional supplements, e.g., reiterating the charging provision for profits tax under the Inland Revenue Ordinance (**IRO**), the definition of trade and business, and the key indicia of carrying on business.

The key updates included in the Guide since September 2019 include:

- a) Expressly noting that whilst the IRD does not have statutory power to register or monitor charities, the IRD may withdraw the recognition of a charity's section 88 tax exempt status¹, and raise a tax assessment if the IRD considers that a charity's contravention of its charitable objects would fundamentally change its charitable status;
- b) Highlighting the importance for a charity to be established for "public benefit", and indicating factors which the IRD will consider when deciding whether the two aspects of "public" and "benefit" are satisfied;
- c) Clarifying that, if a charity can show that the payment of allowances or remuneration to the members of its governing body (e.g., directors, members of the executive committee, trustees) is necessary and reasonable in exceptional circumstances, such members may receive remuneration² subject to the conditions set out in the Guide being satisfied;
- d) Setting out specific examples of trades or businesses which may constitute (i) "primary purpose trades/businesses" (where the trades/businesses contribute directly to an expressed object of the charity); (ii) "ancillary trades/businesses" (i.e., trades/businesses ancillary to the primary purpose of the charity that contribute indirectly to the successful furtherance of the charity's expressed objects); and (iii) trades/businesses where the work in

¹ If a charity carries on a trade or business in Hong Kong, profits from such trade or business (excluding profits arising from sale of capital assets) is chargeable to Hong Kong profits tax. However, such profits may be exempt from tax if all the following conditions as set out in the proviso of section 88 of the IRO are satisfied:

a) The profits are applied solely for charitable purposes;

b) The profits are not expended substantially outside Hong Kong; and

c) Either (i) the trade or business is exercised in the course of the actual carrying out of the expressed objects of the charity; or (ii) the work in connection with the trade or business is mainly carried on by persons for whose benefit such charity is established.

connection with the trades/businesses is mainly carried out by the beneficiaries of the charity;

e) Noting that a charity may invest in a trading company, make financial investments/programme related investments, or let out its own real estate properties - however: (i) any return generated on financial investments or rental income will be subject to profits tax unless all the conditions set out in the proviso of section 88 of the IRO have been fulfilled; (ii) profits derived by the trading company held by the charity or profits derived by the charity in the course of a trading venture will not qualify for tax exemption under section 88 of the IRO; and (iii) financial investments/programme related investments which give rise to unacceptable level of personal benefits to members of the charity's governing body, thereby not fulfilling the public benefit requirement, can affect the charity's section 88 tax exempt status;

f) Confirming that a charity may charge for the services or facilities it offers, but it has to consider whether the public benefit requirement would be satisfied;

g) Highlighting that the IRD will take into account the dormancy or cessation of operation of an organisation when assessing whether such organisation can continue to be a tax-exempt charity under section 88 of the IRO;

h) Reiterating the ongoing obligations of a tax-exempt charity, e.g., duty to inform chargeability to tax, and to report remuneration paid to employees.

Given that the IRD has now provided more comprehensive guidance on taxation of charities in Hong Kong through this updated Guide, it is expected that the IRD will conduct more stringent and regular reviews of existing tax-exempt charities in order to assess their status. Trustees and family offices should keep reviewing the operation of any charities under their administration, and consider whether there is any area of concern which might require additional control or oversight in order to maintain the section 88 tax exempt status of such charities.

3. Stamp duty on divorce order

In the case of *Ngai Sau Ying v Collector of Stamp Revenue [2019] HKCA 1104*, the Court of Appeal considered the stamp duty chargeable on two assignments executed in relation to the exchange of two Hong Kong real estate properties between a divorced couple made pursuant to an ancillary relief order granted by the Family Court (**Family Court Order**).

The question was whether the two assignments constituted an "exchange" of properties under section 25(7) of the Stamp Duty Ordinance (**SDO**) such that only the equality consideration paid would be chargeable with stamp duty and, if yes, how the equality consideration should be calculated.

The Collector of Stamp Revenue argued that:

a) The two assignments did not constitute an exchange of properties under section 25(7) of the SDO, and stamp duty should be calculated based on the respective consideration or market value of the property transferred under each instrument.

b) Even if the transactions were an exchange of properties, section 25(7) of the SDO was inapplicable because the assignments did not stipulate any consideration for equality (but merely stated that the properties were assigned at nil monetary consideration). Thus, section 27(4) of the SDO should apply such that the exchange would operate as voluntary dispositions inter vivos by reason of a substantial benefit having been conferred on one of the parties (i.e., stamp duty should be calculated by reference to the difference in the values of the two properties as of the date of the assignments).

The Court of Appeal held that the transactions constituted an exchange of properties under section 25(7) of the SDO, and that stamp duty should only be chargeable on the equality consideration being the difference in the values of the properties at the time when the Family Court Order was made. In particular:

a) While stamp duty was a charge on instruments and not on transactions, it did not mean that one should merely look at the form of the instrument to decide on its chargeability. The true substance of the transaction as effected by the instrument should also be ascertained in order to determine whether (and if any) stamp duty is chargeable on the instrument.

b) In this case, the assignments were made to implement the court order, which was made in the context of a distribution of family assets on the dissolution of a marriage in order to give effect to the fairness approach and the principle of equal sharing. Thus, the true substance of the transactions effected by the assignments in this case was an exchange of properties.

Clients should be reminded to pay attention to the stamp duty implications arising from any exchange of Hong Kong real estate properties. ■

² In considering whether an institution or a trust constitutes a charity, the IRD has generally indicated that the governing instrument of a charity must include a clause prohibiting members of its governing body from receiving remuneration.