

Review and outlook of China's private wealth planning market

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China has just released its GDP growth number for 2014 – 7.4%, which is the lowest growth rate for the past 24 years. This number may be low for China but it is two to three times the GDP growth rate of any other large economy. As the second largest economy in the world and with the high economic growth over the past two decades, the amount of private wealth accumulated in China has been unmatched. The recent Alibaba IPO is a perfect example, which produced a record number of billionaires and millionaires overnight. As a result, Jack Ma, Alibaba's president and a former English teacher, is now the richest person in Asia.

Not surprisingly and thanks to the hard work of the world's leading private banks as well as trust companies, China's high-net-worth individuals (HNWIs) have also quickly learned about the importance of wealth protection and succession planning. Many of them have adopted commonly used structures and planning tools, such as the offshore trust structure, to put what they have learned into action.

As a leading PRC law firm, our firm has been working seamlessly with international and Chinese private banks as well as Chinese HNWIs over the past ten years in this respect. In this article, we will briefly summarise our review of the current state of China's private wealth planning market and provide an outlook of its future.

Current state

Private wealth planning for HNWIs is an extremely hot topic in China. Pretty much all of the

leading international private banks and trust companies regularly send their representatives from Hong Kong or Singapore to China for business development, although none of them have established a formal presence in China due to the regulatory restrictions. All of the large Chinese banks have also formed their private bank divisions and included wealth planning (in addition to asset management) in their service scope. Conferences, seminars, training, reports, and articles focusing on private wealth planning are also becoming the norm.

In terms of HNWIs' interest and needs in wealth planning, the triggering event has expanded from traditional pre-IPO planning to immigration from China to other countries, privacy preservation, concerns about China's political uncertainty and tough anti-corruption environment, increasing divorce rates, relaxation of the one-child policy, and finally the need for business succession. For example, as a result of community property rules in China, many high-net-worth (HNW) parents worry about the potential loss of assets when their children get divorced. Also, although China still doesn't have estate tax or gift tax, HNW families need a good structure to minimise the estate tax or gift tax implications when they immigrate to countries like the US, the UK and Canada.

Moreover, Chinese HNWIs are more interested in offshore structures and planning tools than onshore ones. That is mainly because Chinese trust law is very different from the trust laws in other countries and not designed



for wealth protection and succession. As a civil law country, China also hasn't aligned its tax system and property record system with the fundamental concept of the separation of legal ownership and beneficial ownership existing in common law countries.

Lastly, on offshore structures and planning tools, Chinese HNWI's have started to choose more sophisticated ones. For example, due to the size of his wealth and his wish of maintaining enough control over the wealth, one of our clients asked us to design a structure which includes a double-tier trust managed by a private trust company recently.

Current barriers to the offshore trust structure

The offshore trust structure such as the British Virgin Islands/ Cayman/Guernsey/Jersey trust structure has been the most popular structure for Chinese HNWI's. However, not every Chinese HNWI can take advantage of this structure and there are certain barriers that may not go away quickly.

The biggest barrier is that the offshore trust structure only works for assets which are offshore already and wouldn't work for the assets that are in China, because it is either legally not allowed or tax/cost prohibitive to have a foreign trustee take the legal ownership of such assets. For example, a foreign company cannot own real estate in China directly unless it uses it as its own office. Even if the regulatory restriction were lifted, the transfer of legal ownership of real estate would be subject to transfer taxes at as high as about 10%. The same would apply to privately-held Chinese companies. The transfer of the legal ownership of such companies from a Chinese HNWI to a foreign trustee would likely be a taxable event and subject to individual income tax at 20%. This barrier has basically made those Chinese HNWI's with assets onshore inaccessible to the offshore trust structure. There are ways to get around this barrier, such as going through the complex restructuring to convert the onshore ownership structure to the offshore ownership structure, but that process could be quite time consuming and could still result in a high tax cost.

Another barrier is the Chinese tax risks resulting from the uncertain Chinese tax implications

of the offshore trust. There are several aspects here. The first aspect is whether the contribution of appreciated assets into the trust would be taxable in the hands of the Chinese HNWI as settlor. A position that has been taken by many professionals is that this should not be taxable because there is no gift tax in China. But this hasn't been confirmed by the Chinese tax authorities. The second aspect is whether the beneficiary would be taxable on the distribution. A lot of professionals have taken the position that this would not be taxable as China doesn't treat gifts from family members as taxable income. However, a recent tax circular may complicate this position. Under this circular, in the case of a gift of equity interest in a domestic company from one person to his or her immediate family member(s), while there is no tax due at the time of gift, when the gifted assets are transferred by the family member receiving the gift, he or she would need to pay individual income tax on the difference between the proceeds from the transfer and the original tax basis of the person making the gift. It is not clear whether the Chinese tax authorities would expand the application of such rules to the offshore trust. If so, the beneficiary could be taxed on the full appreciation of the trust assets. The last aspect is whether the foreign trustee would have the legal obligation to withhold Chinese individual income tax when making a distribution to a Chinese beneficiary. There is no clear rule on that. All such uncertainty has made foreign trustees uncomfortable because they don't want to bear any PRC tax risk. In practice, they would typically ask for a legal opinion from a PRC law firm to protect themselves.

The third barrier lies with the Chinese community property rule. Under such a rule, assets obtained during the period of marriage presumably become community property and each spouse has an equal 50% interest in such assets. In the case of offshore trust planning, a common solution is to have the other spouse sign a consent letter. However, whether such a letter is sufficient to make the community property issue completely go away is arguable. For example, it is an open question whether or not the spouse who acts as the sole settlor could later on change the beneficiary or beneficiaries without the other

spouse's consent at all. This has not been tested under Chinese law. How to deal with this type of request from the settlor by the foreign trustee could be a challenge.

Outlook of the future state of the market

Looking forward, there are several developments on the way. The first one is the domestic trust structure. Many Chinese banks' private banking divisions are eager to act as trustees of domestic trust structures. However, as mentioned earlier, Chinese trust law is not suitable for wealth protection and succession planning. Also, the Chinese tax system and the property record system would need to be updated to accommodate the separation of legal ownership and beneficial ownership of assets. Before that takes place, it would be very difficult for Chinese banks to be creative and it would be interesting to see how they could get around those issues.

The second development is the potential tightening of the Chinese individual income tax law enforcement. Chinese individual income tax has largely been neglected by tax authorities because of the high collect cost and the sufficient indirect tax revenue such as VAT, Business Tax and Consumption Tax. China has decided to reduce the indirect tax revenue and increase the direct tax revenue to be more aligned with international standard. As a result, it is anticipated that the Chinese tax authorities will come up with a lot of new individual income tax rules including those relating to trusts and tighten up the tax law enforcement. With that, it would be reasonable to foresee that the offshore trust may soon be subject to strict scrutiny of the Chinese tax authorities.

The last possible development is that, with the increasing number of offshore trust structures adopted by Chinese HNWI's, the offshore trust structure may undergo the judicial scrutiny of the Chinese courts very soon. That could stem from the claim from a creditor of the settlor or from an unhappy spouse. How the Chinese courts will decide on such claims would be interesting to observe.