# Hong Kong

# The Taxation of Trusts in Hong Kong

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**The question of to what extent, if at all, trusts are taxable in Hong Kong is regularly raised and debated in both academic and professional circles. In light of the increasing interest in Hong Kong as a jurisdiction in which to establish trusts and develop wealth and estate planning solutions, there is a greater need than ever for certainty on how exactly a trust is taxed in Hong Kong and its domestic and international implications both for trustees and beneficiaries. This article aims to provide an overview of the law in Hong Kong and evaluate different analytical approaches to the question, before proposing a clear, elegant solution consistent with the statutory schema of the Inland Revenue Ordinance and common law decided authorities.**

## 1. The Issue

The tax system in Hong Kong is strictly schedular. In the absence of a general charging provision on income, business and trading profits are subject to a discrete charge to tax, known as profits tax. The charging provision for profits tax is found in section 14 of the Inland Revenue Ordinance ("IRO"),[1] which provides that:

> […] profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business […].

The charge to profits tax may be reduced to the following cumulative requirements:

(1) there must be a person, as defined in the IRO;
(2) that person must carry on a trade, profession or business in Hong Kong, whether as a principal or through a dependent or independent agent; and
(3) that person must derive profits arising in or derived from Hong Kong, which are "his assessable profits", from that trade, profession or business.

Section 2 defines a "person" as including a "trustee". The same section in turn provides by way of definition that a "trustee" includes: "any trustee, guardian, curator, manager, or other person having the direction, control, or management of any property on behalf of any person, but does not include an executor".[2]

It is axiomatic that in common law a trust has no separate legal personality. A trust is not, therefore, a legal person, nor is it a body of persons. In essence a trust is, to paraphrase Underhill and Hayton in the *Law of Trust and Trustees*, an equitable obligation, binding a person (i.e. the trustee) to deal with property owned by him as a separate fund (i.e. the trust property) for the benefit of other persons (i.e. the beneficiaries of the trust).[3] A trust is therefore not taxable as such in Hong Kong because it is not by its nature a legal person, and is not otherwise deemed to be a person by the IRO.

The current definition of "person" in the IRO was introduced by the Inland Revenue (Amendment) (No. 2) Ordinance 1981 (the "Amendment Ordinance"), ostensibly to clarify any legal uncertainty that may previously have arisen on how, if at all, a trade, business or profession carried on for the benefit of a trust should be taxed in Hong Kong. That was not, however, the end of the matter. There remains an implicit, prior question: what did the Legislature mean by "his assessable profits"

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1. Unless otherwise specified, all statutory references in this article are references to the Hong Kong Inland Revenue Ordinance (Cap. 112).
2. An executor is subject to a discrete taxation regime under section 54 of the IRO, making him liable to account for any tax due in respect of the decedent's estate.
3. 17th ed., art. 1.1.

when the IRO was first enacted in 1947? Is it necessary that the profits merely arise to the taxpayer, such that he holds legal title to the same, or must the taxpayer beneficially be entitled to those profits as and when they arise before they are taxed in his hands? This is not a question of pedantry; instead, it goes to the crux of the question of *who*, if anyone, is taxable in respect of the profits of a trade or business carried on for the benefit of a trust in Hong Kong, from which Hong Kong source profits arise.

Indeed, it has been suggested by practitioners and academics in arguments considered in further detail below that the IRO lacks an express charging provision for profits arising to a trustee in consequence of him carrying on a business in Hong Kong for the benefit of the trust (as opposed to his own trade as a trustee), such that profits arising to that trust should not be taxable in Hong Kong, irrespective of whether or not they are sourced in Hong Kong. A.J. Halkyard et al.[4] and the authoritative KPMG textbook *Hong Kong Taxation – Law and Practice* [5] discussed this theory and its implications in some detail, though in both cases the authors do not venture beyond summarizing the contours of the controversy, concluding the issue to be ultimately unsettled.[6]

## 2. Why It Matters

This is an unsatisfactory state of affairs – it is crucial for investors, professional trustees and their advisers to have legal certainty of the fiscal implications of utilizing a trust structure with a Hong Kong nexus. Trusts in general remain a vehicle of remarkable flexibility in Hong Kong, and are in practice used to implement an extensive array of wealth management and planning solutions, which, as is the case in most Far Eastern jurisdictions, often arise at the intersection between family and corporate interests. Hong Kong trust law is predominantly governed by common law jurisprudence, with a relatively limited statutory overlay.[7] Further, the recent introduction of a mutual recognition regime for regulated investment funds between China and Hong Kong on 1 July 2015 is a promising development for the trust industry in Hong Kong. Whilst Hong Kong funds eligible for mutual recognition in China are expected in any event to be exempt from Hong Kong profits tax by virtue of section 26A(1A),[8] increased exposure to trusts as asset management and investment solutions in China should, in turn, likely focus the interest of a potentially vast Mainland client base on the benefits of utilizing trusts in other contexts. Certainty on the fiscal treatment of trusts in Hong Kong is also of practical interest both to professional trustees and their advisers because of the implications of tax liabilities as a factor in the negotiation and agreement of indemnities for outgoing trustees.

The purpose of this article is therefore to consider the application of section 14 to trusts and, in so doing, offer a robust and definitive resolution to this ongoing controversy which is consistent with the limited jurisprudence considering this issue, the guiding principles of taxation in common law jurisdictions, and, most importantly, the general schema of the IRO. In so doing, this article will seek to show that the right answer has always been hidden in plain sight. From the coming into force of the Amendment Ordinance there have been clear words in the IRO providing that the trading profits of a trust are taxable to the extent to which they are from a trade, business or profession carried on in Hong Kong, and arise in or are derived from Hong Kong, and, when so taxable, they are invariably taxable in the hands of the trustee of that trust as the person in fact carrying on the business in question. A necessary corollary to this conclusion is that a "trustee" as defined in the IRO is in any event the person effectively managing the profitmaking property on behalf of another, thereby excluding a mere nominee, albeit that such nominee may be a bare trustee at law.

## 3. Applying Section 14 of the IRO to Trusts

### 3.1. A beneficiary is generally not taxable in respect of trust profits

The default approach in most common law jurisdictions is in the first instance to tax the profits from a trade or business carried on for the benefit of a trust in the hands of the trustee.[9] Because the trustee usually takes actual receipt of and thereby acquires legal title to trust income, this approach appears well grounded in the first principles of taxation and has a practical advantage compared to seeking to tax subsequent or, in the case of a discretionary settlement, contingent

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4. *Encyclopaedia of Hong Kong Taxation*, vol. 3, issue 20 (LexisNexis Butterworths), at [1577]-[1583].
5. A. Macpherson Lau & J. Pearce (15th ed., The Chinese University Press 2014), pp. 198-199.
6. Deloitte's *Hong Kong Master Tax Guide* offers only a cursory introduction to the issue, *see* for example the 22nd edition published by CCH, at p. 245, ¶6-0240.
7. In particular, the Trustees Ordinance (Cap. 29) and the Perpetuities and Accumulations Ordinance (Cap. 257), making for a relatively "light touch" regime, compared to, say, England and Wales.
8. Broadly speaking, this provision operates to exempt the profits of regulated collective investment schemes from tax.
9. *See*, for example, section 35(11) of the Income Tax Act of Singapore, section 61 of the Income Tax Act 1967 (as amended) of Malaysia, and section 8 of the Income Tax (Trading and Other Income) Act 2005 of the United Kingdom, National Legislation IBFD.

distributions to beneficiaries. It also places the initial onus of the obligations to file a return on the trustee, rather than on the beneficiary or the settlor, with the attendant benefit of restricting the extent of the tax administration burden on the trust.

Turning to the application of section 14 of the IRO, because the profitmaking trade or business must be the trade or business carried on by the taxable person, a beneficiary will in the ordinary course not be carrying on the profitmaking business with which the trust is concerned.[10] Instead, he will be a passive recipient of income and/or capital when this is duly distributed to him by the trustee, or is otherwise advanced to him. In this passive capacity he cannot be regarded as carrying on any business at all: he does not, as a matter of fact, carry on the profitmaking trade or business carried on by the trustee for the benefit of the trust and there is no statutory provision imputing that trade or business to him. On this footing, such sums as the trustee pays over to the beneficiary should not in any event be chargeable to Hong Kong tax in his hands. The IRO does not contain a "sweep up" charging provision analogous to Case VI of Schedule D of the United Kingdom Income and Corporation Tax Act 1988.[11] Absent an express provision charging a beneficiary to tax for passive income or gains arising from a trust, that beneficiary should not be chargeable to tax in Hong Kong, irrespective of whether or not the income or capital distributed to him had a Hong Kong source. There is in any event no risk of double taxation in respect of trust profits where the trustee is the taxable person in respect thereof. Section 26(b) provides that:

> […] no part of the profits or losses of a trade, profession or business carried on by a person who is chargeable to tax under this Part[12] shall be included in ascertaining the profits in respect of which any other person is chargeable to tax under this Part.

## 3.2. The profits of a professional trustee for acting as trustee are taxable

A professional trustee receiving consideration for the provision of its services as trustee will, to the extent that such consideration has a Hong Kong source and is derived from the carrying on of the business or profession of a professional trustee in Hong Kong, be taxable in Hong Kong. Acting as a professional trustee is plainly sufficient to amount to the carrying on of a business or profession.[13] This is understood to be the default position adopted by Hong Kong trust corporations, which are perhaps the paradigmatic examples of a business conducted on these lines. Profits arising from the provision of services as a professional trustee are nevertheless in substance distinct from profits arising to that trustee from a trade or business, not being the business of a professional trustee, carried on by that trustee for the benefit of the trust.

## 3.3. The definitions of "trustee" and "person" in the IRO

In order to be chargeable to profits tax, a "person" as defined in the IRO must first carry on a trade, profession or business in Hong Kong. The trust itself, not being a person or otherwise deemed to be a person, cannot carry on such a trade, profession or business. Thus it must logically be the trustee that carries on the business conducted on behalf of the trust. A "trustee" as defined in the IRO includes a range of offices and functions that go well beyond those of a trustee as understood in the law of trusts, and this may have important implications in cases where, as is commonplace for investment trusts, the substantive trading activities are not carried on by the trustee at law (i.e. the person occupying the fiduciary position of a trustee), but by an investment manager.[14] Indeed, the definition includes guardians, curators, and managers, etc. controlling and managing property on behalf of another person. This is an open-ended class extending beyond a trustee owing formal fiduciary duties. It includes terms with no specific technical or juridical meaning, such as "curator" and "manager", and any other person "having the direction, control, or management of any property on behalf of any person". So it is also potentially a circular definition: a trustee, being a "person", may be a trustee in the sense of

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10. The principal exception to this rule is a situation where a bare trustee operates as nominee for a beneficiary that in fact carries on the taxable business. This is discussed in greater detail in section 4. below.
11. A provision charging income tax on annual profits or gains not falling under any other case of Schedule D and not charged under any other charging Schedule. The Income and Corporation Tax Act 1988 has largely been repealed, but relevantly reproduced in subsequent legislation.
12. Part 4 of the IRO, governing profits tax.
13. Per the decision in *CIR v. Bartica Investments Ltd.* [1996] 4 HKC 599, where the Court of First Instance found that rolling up interest in bank accounts in the ambit of a broader tax-saving structure was sufficient to amount to the carrying on of a business, the threshold for carrying on a business for the purposes of section 14 of the IRO is low and easily met.
14. In the alternative, taxable profits arising to an investment manager operating on behalf of a non-Hong Kong resident principal may be taxed under section 20A of the IRO in the hands of that manager as an agent of the non-resident principal. Section 2(1) of the IRO makes it clear that a taxable agent is not limited to an agent at law, but includes a "manager".

having control of the property of another person, as defined in the IRO, where the latter, too, is likewise a trustee and so forth.

A taxable trustee (i.e. the trustee to whom the section 14 charge to tax should arise) is thus not necessarily a person who is legally a trustee, but corresponds to a broader class of persons performing the function of holding property on behalf of another person. Deploying the *ejusdmen generis* approach to statutory construction, it appears that the better reading of the term "trustee" in the IRO is that it refers to an open-ended genus of persons having effective control and management of property on behalf of another, whether the character of such management is fiduciary or otherwise.

## 3.4. "His assessable profits"

Hong Kong source profits are taxable in the hands of the person to whom they belong; hence, the express reference in section 14(1) to "*his* assessable profits" [emphasis added] in establishing the incidence of taxation. In this context the possessive "his" imports a degree of ownership of the profits subject to tax. It follows that it would need to be determined whether trust profits may be properly said to be the profits *of* the trustee for the purposes of the charge to tax. Herein lies the complication: is the fact that the trustee only acquires legal title to the trust property (in this case, the profits of the business carried on for the benefit of the trust), and holds them on trust for the beneficiaries, sufficient for those profits to be regarded as the trustee's profits, or do those profits otherwise belong to another person, including, notably, a person beneficially entitled to those profits? The Third Inland Revenue Ordinance Committee was alive to this incipient controversy and set out the following observations in its report on the Amendment Ordinance:

> One correspondent called attention to the possibility of arguing that section 14 would be ineffective to support a profits tax assessment on trustees, who as a body, were carrying on a trade – on the ground that the trading profits did not belong beneficially to the trustees whereas the use of the possessive adjective ("*his* profits") might be thought to confine liability to cases where the recipient of business profits were absolutely entitled to those profits.[15]

Frustratingly, the Committee declined to pronounce itself on this point, though apparently on the very proper grounds that this was best left either to the Legislature or the Courts, limiting itself to remarking that it was "satisfied that there is no equitable distinction between trustees and an absolute owner in this respect".[16] That being said, there is no apparent statutory requirement that entitlement to profits be beneficial as a precondition for liability to tax nor any apparent indication that the Legislature intended this to be the case. Indeed, the insertion of the definition of "trustee" in section 2(1) suggests quite the opposite.

At this stage, some consideration of English case law on the taxation of trusts is instructive. In *Williams v. Singer* 7 TC 387 (HL), Viscount Cave noted:

> [T]here are many cases in which a trustee in receipt of trust income may be chargeable with the tax upon such income. For instance, a trustee carrying on a trade for the benefit of creditors or beneficiaries […] The fact is that, if the Income Tax Acts are examined, it will be found that the person charged with tax is neither the trustee nor the beneficiary as such, but the person in actual receipt and control of the income which it is sought to reach. The object of the Acts is to secure for the State a proportion of the profits chargeable, and this end is attained (speaking generally) by the simple and effective expedient of taxing the profits where they are found. If the beneficiary receives them, he is liable to be assessed upon them. If the trustee receives and controls them, he is primarily so liable.[17]

Although undoubtedly obiter in the context of that case, Viscount Cave's comments were cited with approval by Lord Clyde in *Reid's Trustees v. CIR* 14 TC 512,[18] where the House of Lords held that interest income arising to trustees was taxable in their hands under Schedule D of the Income Tax Act notwithstanding that it was received by the trustees in a representative capacity. There is therefore no requirement either under the statute or derived from jurisprudence for the trustee to have a beneficial interest in profits arising from a trade it carries on as trustee in order for them to be taxable in

15. Page 214, at para. 212.
16. Id., at para. 213.
17. At 411.
18. At 524.

its hands.[19] The reasons for the absence of such a requirement are easy to identify. If it were right that only the beneficial owner of profits were taxable thereon, it would be virtually impossible to tax the profits arising to the trustee of a trust as trustee within the schema of section 14. Even if the profits of the trade or business carried on by the trust were regarded as the profits of the beneficiaries of the trust for the purposes of section 14, the trade or business from which those profits arose would not, in the ordinary course, be carried on by the beneficiaries in question. Indeed, there is no identifiable provision in the IRO deeming the trade or business carried on by a trustee to be carried on by the beneficiaries of the trust and the Legislature enacting the Amendment Ordinance evidently did not consider the inclusion of any such provision necessary to complement the insertion of the term “trustee” as a taxable person. If the Legislature had wished to keep trust profits outside the scope of the general charge to profits tax, it is difficult to see why it amended the IRO to specify that trustees were taxable persons. Consider, in this regard, the explanatory memorandum to the Amendment Ordinance, wherein it is stated that: “Clause 2 of the Bill […] amends the definition of “person” to make it clear that it includes a trustee”.[20] It may be evinced from this drafting that the Legislature intended this amendment to put beyond doubt the position as it had been all along: that is, that a trustee was always a taxable person in respect of a business it carries on for the benefit of a trust.

Of further interest is the origin of the phraseology adopted in the statutory definition of “trustee” in the IRO. Perhaps the earliest precursor is found in section 41 of the United Kingdom Income Tax Act 1842, which provided that a “trustee, guardian, tutor, curator or committee of any person being an infant, or married woman, lunatic, idiot, or insane and having the direction, control or management of the property” should account for income tax on behalf of such person. In *Kelly v. Rogers* 19 TC 692, the Court of Appeal of England and Wales thought it clear[21] that whereas amounts received by a person as trustee would ultimately be paid for the benefit of the beneficiaries of the trust, such amounts, to the extent that they fell within the charge to tax, were taxable in the hands of the trustee.[22] This is consistent with the argument developed thus far that the insertion of “trustee”, as defined in the IRO, as a taxable person was aimed at ensuring that profits arising ultimately for the benefit of persons who, whether by misfortune or design, are not capable of being in receipt or control thereof, are taxable in the hands of the person who by virtue of its actual control of the profitmaking assets is therefore in the best position to account for and pay tax due.

There nonetheless remains in Hong Kong a lively debate on the possibility that the profits of a trade carried on for the benefit of a trust may not be taxable at all. It has been suggested that the decision of the majority of the South African Appellate Division[23] in *CIR v. Friedman & Others (Trustees of the Phillip Frame Will Trust)* [1993] (1) SA 353 (A) is a possible rallying point for minimalist interpretations of section 14 to the effect that, there being no express charging provision for the profits of a trust as such in Hong Kong, those profits are not, in fact, taxable. The decedent, one Phillip Frame, settled property comprised in his estate on a trust pursuant to his will, which rolled up and retained income arising to it. The South African revenue authority assessed accumulated and undistributed income to tax in the hands of the trustees as the “representative taxpayers” of the will trust. In allowing the appeal of the trustees against the assessments, a 3 – 2 majority of the Appellate Division ruled that because a trust was not a legal person, it was not chargeable to tax as such under the Income Tax Act 1962 (“ITA 1962”), and, further, since the trustees were not representative taxpayers in respect of undistributed income (in the sense that the charge to tax on trustees or other persons having management and control of income to which they had no beneficial entitlement operated on the basis that such representatives were chargeable exclusively on behalf of the beneficiary), they were not liable to income tax thereon because, prior to the appointment of a beneficiary under the discretionary trust, they could not be regarded as taxable representatives of any person to whom taxable income could be said to accrue.[24] Under the ITA 1962, a trustee was a purely representative

19. The decision of the Hong Kong High Court in *Hong Wah Investment Co. Ltd. v. CIR* [1986] HCIA000001/1986 has on occasion been cited as authority for the proposition that one does not look beyond legal title in order to ascertain ownership of taxable profits, although the ratio of that decision turned on a finding of agency for tax purposes, and there was no detailed analysis of the question of whether a trust relationship subsisted.
20. Inland Revenue (Amendment) (No. 2) Bill, C33-C34.
21. Considering Miscellaneous Rule 4 of the Income Tax Act 1918, to which section 41 of the Income Tax Act 1842 had been substantially rewritten.
22. Per Hanworth M.R., at 710. Notably, however, the United Kingdom legislation avoided problematic references to “his profits” by imposing the charge to tax to profits arising or accruing to the taxpayer, for which *see* the various permutations of the Schedule D, Case I charge.
23. At that time the Court of final appeal of the Republic of South Africa.
24. The Phillip Frame Will Trust was a discretionary settlement, such that beneficial title to income arising to the trustees of the trust, but left undistributed, was in suspense until so distributed to a beneficiary.

taxpayer in that he was required to account for tax on income accruing to beneficiaries on behalf of the same, but was not a taxable person in his own right in respect of trust income.[25]

This author is not persuaded that the judgment in *Philip Frame Will Trust* merits the prominence ascribed to it in discussions on the taxation of trusts in Hong Kong. The majority decision turned on the construction of the South African taxing statute specifically in the limited context of a discretionary settlement where the trustees had the option of either applying trust income or capitalizing it.[26] It was common ground that trust income accruing to a beneficiary was taxable in the hands of a trustee as the statutorily designated representative person, but counsel for the trustees successfully argued that where there was no underlying taxable person – in this case, an identifiable beneficiary to whom trust income could be said to accrue – capable of being represented by a representative taxpayer, no charge to tax could arise to that representative taxpayer in that capacity because the charge to income tax was thereby incapable of applying.[27] Such, however, is not the nature of the IRO. Whereas South African revenue case law should generally be regarded as a useful comparison for Hong Kong in light of the common historical genesis of the tax codes in both jurisdictions, the two regimes have significantly diverged in recent times. Section 14 is concerned exclusively with the question of whether a person carries on a trade, business or profession in Hong Kong and derives Hong Kong source profits therefrom. A trustee is a taxable person as such in Hong Kong. It is not taxable in any representative capacity, but in its own capacity as a person carrying on a business, *notwithstanding* that it ultimately carries on that business and holds the profits thereof for the benefit of another. It would moreover be remiss in any discussion of *Phillip Frame* to ignore the lead dissenting opinion given by Botha JA, which adopted a purposive reading of ITA 1962:

> Moreover, I am unable to think of any reason why the Legislature would wish to ordain that a trustee should be a representative taxpayer when he receives trust income accruing to a beneficiary [e.g., as would be the case in an interest in possession trust], but not when the income does not so accrue. In truth, such an arrangement relating to the taxation of trust income would be so devoid of reason as to be absurd. I do not believe that the Legislature could have contemplated it.[28]

*Phillip Frame* was decided on a narrow point of South African statutory interpretation and fundamentally turned on whether there was any basis for income arising to a trust with no ascertainable beneficiaries as respected a source of trust income to be treated differently relative to a trust where such income did accrue to its beneficiaries. Under the IRO, there is no requirement for the taxpayer to be beneficially interested in profits, or that profits “accrue” to him, before being taxed in respect of the same. All that is required by the section 14 charging provision is that they be “his” profits, which, in the first instance, suggests that mere receipt denoting ownership of those profits is sufficient. Unlike the ITA 1962 as it was in force when *Phillip Frame* was decided,[29] there is no indication that one has to look beyond mere receipt and ascertain whether profits accrue to some other person.

## 3.5. IRO contemplates a trustee being taxable in more than one capacity

A Hong Kong trustee may carry on more than one trade or business for tax purposes. As noted in section 3.2. above, if it is a professional trustee drawing remuneration for the provision of its services, any profits arising in Hong Kong from the carrying on of that business in Hong Kong would be assessable under section 14. This is in addition to any separate trade or business the professional trustee may carry out for the benefit of the trust. A representative example of an arrangement of this nature would be a Hong Kong trust company acting as trustee for a Hong Kong family trust and carrying on a trade for the benefit of that trust in Hong Kong. In this scenario, the trustee would be in receipt of two sources of profits: first, profits it derives from the provision of its services as trustee, in respect of which it is beneficially entitled; and, second,

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25. Section 1 of the South African Income Tax Act 1962 as then in force defined a trustee in terms familiar to the Hong Kong practitioner: “in addition to every person appointed or constituted as such by act of parties, by will, by order or declaration of court or by operation of law, includes an executor or administrator, tutor or curator, and any person having the administration or control of any property subject to a trust, usufruct, fideicommisum or other limited interest or acting in any fiduciary capacity or having, either in a private or in an official capacity, the possession, direction, control or management of any property of any person under legal disability”.
26. At 368-369.
27. At 374-377.
28. At 380 I-J.
29. Section 1 of the South African Income Tax Act 1962 was amended following the judgment in *Phillip Frame* to make it clear that a trust was a taxable person, and section 25B was inserted clarifying the distinction in the taxation of income vesting in the relevant year of assessment in the beneficiaries and unvested income accruing to but undistributed by a discretionary trust.

profits it receives as trustee of the trust. Indeed, that same professional trustee may manage more than one trade or business for the benefit of one or more discrete trust structures.

The practical reality of the conduct of the business of a professional trustee was apparently evident to the draughtsman of the Amendment Ordinance. Thus, one finds the insertion of section 19C(6)(e), which provides:

> the amount of any loss sustained in any trade, profession or business carried on for the benefit of a trust by a person in his capacity as trustee shall not be available for set off except against the assessable profits of that trust from that trade, profession or business for subsequent years of assessment.

This section thus operates to prevent losses incurred by the trustee of a trust in respect of one trust from being set off against the assessable profits of another trust of which it is also a trustee. It likewise prevents the set-off of losses arising to any given business or trade carried on as trustee for the benefit of a trust against any profits it derives from any business or trade it carries on in its own capacity (e.g. that of a professional trustee). Hence, it is implicit from the effect of section 19C(6)(e) that the Legislature understood and assumed trust profits to be taxable in the hands of the trustee and sought to ensure that losses of a business carried on by a trustee on its own account were not commingled with the profits and losses of any other business it carried on as trustee for the benefit of a trust. It would evidently be inconsistent with the coherence of the IRO if the trustee were allowed to set off losses incurred in the business it carried on as trustee in order to reduce its liability to profits tax on its profits from acting as a professional trustee.

## 4. The Nominee Problem

There is a line of decisions of the Hong Kong Board of Review (the “Board”) for the proposition that a nominee carrying out trading transactions on behalf of a taxpayer is not chargeable to profits tax in respect of such transactions because the profits do not belong to the nominee. The most frequently cited lead case in this taxon of decisions is Case D 37/93 IRBRD 304.[30] A company purchased a piece of land for the purposes of trading, but registered the land in the name of a nominee, which then sold the same to a third party. The gain from the disposal was assessed to the company and the company appealed on the basis that the gain should have been assessed in the hands of the nominee as trustee. In dismissing the appeal, the Board found that the gain arising from the transaction was in no meaningful sense the profit of the nominee – the nominee was merely a convenient intermediary through which the taxpayer company carried on *its* trade and derived *its* profits. In this respect, the Board clearly distinguished this case of a temporarily interposed nominee with a trustee actively carrying on and managing a trust business, in which respect it considered that it was clear that those profits were the trustee’s profits and, presumably and by extension, taxable in its hands.[31] On similar facts, the Board found in Case D 47/02 IRBRD 737[32] that because the property subject to the trading disposal was not bought with the taxpayer’s money and the taxpayer did not receive the price or the profit from its sale, the taxpayer fell to be regarded as a mere nominee and not a taxable trustee, such that profits arising from the transaction were not taxable in its hands. Relevantly, the Board distinguished an active, trading trustee, who was a taxable trustee within the meaning of section 2(1), from a mere nominee, who was not.[33]

This is an important distinction, but invites the further question of where the border lies between the respective realms of taxable trustees and non-taxable nominees. In neither of the aforementioned cases did the Board seek to articulate a general test and, to date, none has been formulated in Hong Kong. Here the Board missed an important opportunity. It could have, in the interests of legal certainty for cases of this nature, broken down the section 14 test into its elemental components. If it had done so, it would have found that the prior question is the finding of a business carried on in Hong Kong, which existence is a prerequisite for the identification of a taxable profit and which must be attributed to some person capable of conducting it. That business must be the taxpayer’s business. If it is the taxpayer’s business, then the profits thereof should be regarded as the taxpayer’s profits. The distinguishing feature of a nominee is that it does not actually carry on the business from which taxable profits arise. Its involvement is merely a contrivance of the taxpayer and it has no actual control or oversight over the assets it holds as nominee. On this analysis, it would seem that the possessive qualification “his” in “his profits” in the context of a trustee as defined in the IRO presupposes a degree of factual control and management, as distinct from a purely formalistic approach based on legal or equitable title. A

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30. Cited with approval in subsequent Board decisions on point – *see*, for example, Case No. D 39/09 IRBRD 740 at [29].
31. At 316-317.
32. Decision handed down in Chinese.
33. At 741-742.

nominee does not carry on the business from which taxable profits arise. It is not, in any respect, the nominee's business and, in light of the clear causal relationship between the business and the profits thereof, it would follow that the profits thereof cannot be regarded as the nominee's profits.

Taking this line of reasoning further, it is tenable to argue that the essential distinction between a statutory "trustee" and a nominee is that, returning to the drafting in section 2(1), the trustee as defined in the statute has the direction, control or management of property on behalf of another person, whilst a nominee does not. Surprisingly, the Board in D 37/93 construed "direction, control or management" as qualifying only an "other person",[34] and not, therefore, the enumerated categories of fiduciary and non-fiduciary representatives in that section. It appears that the Board adopted this position, which in Hong Kong is in any event of a persuasive rather than binding authority,[35] because it assumed that, with reference to the enumerated classes of representatives, the qualifier was redundant. It took for granted that a trustee would necessarily have control or management of trust property. But consider, for example, the case of a trustee carrying on a trade in securities for the benefit of the trust and executing individual securities trades through a nominee.[36] That nominee may at law be a bare trustee, but it should not fall within the statutory class of trustees not because it is not a trustee so-called, but because it does not have direction, control or management of the property the legal title of which is vested in it as nominee. It is a conduit through which a transaction is effected; it does not carry on a trade or business to which the transaction relates, but is an accessory to that trade or business. Regrettably, the Board has to date failed to articulate the solution that the active role distinguishing a taxable trustee from a non-taxable nominee goes to the carrying on of the trade or business which is a necessary prerequisite for taxation under section 14. It follows that if a nominee, though a trustee at law, plays no active role in a given transaction, it cannot be regarded as carrying on the trade or business to which that transaction relates, such that it is incapable of being charged to profits tax. Therein lies the crucial conceptual and mechanical linkage between the definitional provision in section 2(1) and the charging provision in section 14.

When examined through this lens, the Board decisions finding that nominees are not taxable under section 14 may be readily squared with the argument of this article. The defining characteristic of the genus comprised in the definition of "trustee" is the direction, control or management of property on behalf of another. In light of the genealogy of the definition of "trustee", which owes its current form in the IRO to the venerable notion of a representative taxpayer originating in the United Kingdom and now widely disseminated in the common law world, this would make a great deal of sense. It is eminently practical that the person having actual control of the taxable profits stream, thus discounting merely interposed intermediaries like nominees, be the designated taxable person because it is ultimately best placed to discharge any tax liability out of those profits. This analysis accords with Viscount Cave's statement of principle in *Singer* (*supra*) and would further resolve the apparent circularity in the statutory definition of "trustee" by limiting its application to the person having effective management and control of property on behalf of another, discounting mere conduits or intermediaries.

## 5. The Offshore Funds Exemption

The broader profits tax code in the IRO provides further evidence of the clear legislative assumption that trading trusts are, in the ordinary course, taxable. This is perhaps best illustrated with reference to the preferential taxing regime in Hong Kong for certain offshore funds. In order to attract and anchor offshore funds to Hong Kong, the IRO contains a preferential taxing regime exempting from profits tax certain fund transactions effected either directly[37] or indirectly through a special purpose vehicle[38] by investment vehicles not resident in Hong Kong. To qualify for this preferential regime the person effecting the exempted class of transactions must be a non-resident. A resident person is defined in section 20AB(2), which provides that a trustee of a trust estate is resident in Hong Kong where "the central management and control of the trust estate is exercised in Hong Kong in that year of assessment".[39] This evidences the implicit assumption in the IRO that absent the application of the preferential taxing regime for offshore funds, an offshore collective investment vehicle structured as, for instance, a discretionary trust or unit trust, would in principle be chargeable to profits tax on its Hong Kong source profits to the extent that its trustee derived those profits from a business carried on in Hong Kong and the relevant trustee would be the taxable person in respect thereof. If the Legislature had not intended

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34. At 314.
35. And parenthetically probably obiter as well.
36. As expressly authorized by section 41G of the Trustees Ordinance.
37. Sec. 20AC IRO.
38. Sec. 20ACA IRO.
39. Section 20AB(2)(d) of the IRO – and *see also* the Hong Kong Inland Revenue Department *Departmental Interpration and Guidance Notes No. 43 (Revised)*, which make clear that the exemption is capable of applying to the trustee of a trust who would otherwise be the chargeable person in respect of that trust's profits.

for the charge in section 14 to extend to trustees carrying on a business for the benefit of a trust, section 20AB(2)(d) would be otiose. It is further interesting to note that, in the context of establishing residence in Hong Kong, the corporate test of central management and control is applied to the trust estate itself, and not to the trustees of the trust. This is a remarkable approach in that it clearly acknowledges the trust estate itself as an entity (albeit not a person) of fiscal relevance, thereby echoing the dicta of the Board in D 37/93 sympathetic to the analogy, in the ambit of taxation, between a body corporate and a trust.[40]

## 6. Summary and Conclusion

The debate on the extent to which trust profits are taxable in Hong Kong continues to be regarded in some quarters by both practitioners and academic commentators as unresolved. It is this author's modest submission that it is high time to stop the fence sitting on what is essentially a reasonably straightforward question of purposive statutory construction. A trustee is designated as a taxable person in the IRO because the legislation contemplates that all Hong Kong source profits derived from the conduct of a business or trade in Hong Kong should be chargeable to profits tax, which is the essence of the territorial basis of taxation. Because a trust has no legal personality and is therefore incapable of carrying on any function requiring a legal persona, a person must necessarily be identified, which, as a matter of fact and law, carries on the trade or business of the trust and is capable of being in receipt of any profits arising therefrom. That person must, by definition, be the trustee. In this regard, it is likewise important for taxpayers to appreciate that the statutory definition of "trustee" includes non-fiduciary designations, such as managers, who, provided they have control of property on behalf of another, may be taxable in Hong Kong in respect of that property.

This conclusion, which is consistent with both the drafting and schema of the IRO, is the cornerstone for legal certainty on the fiscal status of trusts in Hong Kong. Comparison with common law authorities considering allied questions is always instructive, but reliance on the same to support a point of statutory construction where the statutory bases for taxation are clearly divergent is misguided. The taxable trustee in the IRO is doubtless a creature of the historic concept of a representative taxpayer, but this observation has no bearing on the interaction between sections 2(1) and 14. A trustee in Hong Kong is taxable not on behalf of the beneficiary nor the person on whose behalf he manages property – who would in any event not be chargeable to profits tax by virtue of not carrying on the business in question – but in his own right as a person carrying on a trade or business in Hong Kong. One need look no further.

40. This has been the approach of common law courts in other jurisdictions, such as Canada, where the Federal Court of Appeal in *St Michael Trust Corp. v. The Queen* [2009] TCC 450 approached the question of the residence of an offshore trust by drawing an analogy with a body corporate, finding that a trust is not resident where its trustee was resident, which had until then been supposed to be the correct position under common law, but where it was centrally managed and controlled.