

Pre-IPO family trust: key points to note

Yumei Zhang TEP

Business owners considering raising funds from the public by having their private shares listed for sale on a regulated stock exchange (IPO) often need to think beyond the corporate aspect of the listing process. This means that while they work with the corporate lawyers to ensure the planned listing proceeds to success within an often-complex cross-border regulatory environment, they should also consider their personal circumstances in terms of their potential impact on the listing process. In addition, they should consider the various consequences of a successful listing, such as the personal wealth that may be generated for themselves as well as their families and future generations. They therefore need to bring in private client advisors, such as tax and trust lawyers, to work closely with their corporate lawyers to put in place a wealth holding structure (pre-IPO trust) as part of the IPO process.

Getting the business listed with a pre-IPO trust built in is a complex project; the business owner has a great deal to think about and do. This article looks at the why and how, in order to give the client and their advisors some useful guidance. Although the pre-IPO trust structure is not unique to Chinese clients/companies, special reference is made to Chinese features wherever relevant.

1. What is a Pre-IPO family trust?

This is normally an offshore reserved powers trust set up by the founder/major shareholder of a company that is planning to be listed. With the help of qualified tax and trust professionals, the founder normally transfers his/her shares (the founder's shares) in the company to be listed (the ListCo) to a regulated trust company (the trustee), which holds these shares for the benefit of his/her family members in accordance with the terms of the trust. In the context of a Chinese business, we normally refer to Chinese companies considering listing in an overseas stock exchange such as Hong Kong, usually effected via the listing of a Cayman/BVI company holding the PRC entity.

2. Why set up such a trust?

There are many advantages, including:

- a) Smooth and successful listing: once the founder's shares are transferred into a trust, he/she no longer owns the shares. In the event of any adverse personal circumstances, such as adverse publicity, ill health or divorce etc, the risk of their delaying or even derailing the listing is minimised.
- b) Stable growth of the company: for the same reason, post-listing, the operation of the company will not be adversely affected by the eventual death of the founder as the family trust can avoid and protect against potential family disputes regarding the founder's shares.

- c) Wealth protection: both pre- and post-IPO, the shares of the company will grow without being affected/ diluted by anything adverse that involves the founder and their family, thus protecting the value of the family's investments.
- d) Orderly succession of family wealth: family members can enjoy the economic benefit of a concentrated shareholding while at the same time avoiding the risks of holding the investments personally which could disrupt the succession as well as the company's operation.
- e) Confidentiality: as the family hold the shares through the trust, their confidentiality is protected in that their personal information is not readily available in the public domain.
- f) Tax planning: as the trust is established in a tax neutral offshore jurisdiction, the trust assets may enjoy a tax-free growth (after the deduction of any relevant tax paid at the investment level) and beneficiaries can also benefit in a tax efficient manner if the trust is of a discretionary nature.
- g) Secured lending: in Asia, it is common that the founder wishes to raise funds by pledging their shares in the ListCo as security. Having the shares held by a professional trustee can make it easier to obtain the loan.

3. How to control the management of the trust asset

It is often important for the founder to retain control and/or an ongoing role in the ListCo through their significant shareholding via the family trust. This is also important for the trustee who wishes to avoid the potential liability of managing a business it does not have expertise in.

The founder's continuing control of the business following the IPO is often achieved by reserving the powers of investment to a Management Committee with the founder being a member, so that the founder effectively retains the power of the management of the trust asset.

4. Some possible features of the Management Committee

- a) This is the sole body that gives the trustee directions relating to the ListCo shares, in particular, how and when to exercise any voting rights attached to them; and
- b) Members of the committee often include more than the founder to ensure continuity in the event of the death, incapacity or retirement of the founder. Potential committee members may include other professionals familiar with the business, such as senior management of the ListCo, the founder's family members and adult children and trusted advisors. At the same time, care needs to be taken to ensure the membership does not create any potential tax liabilities in any onshore jurisdiction.

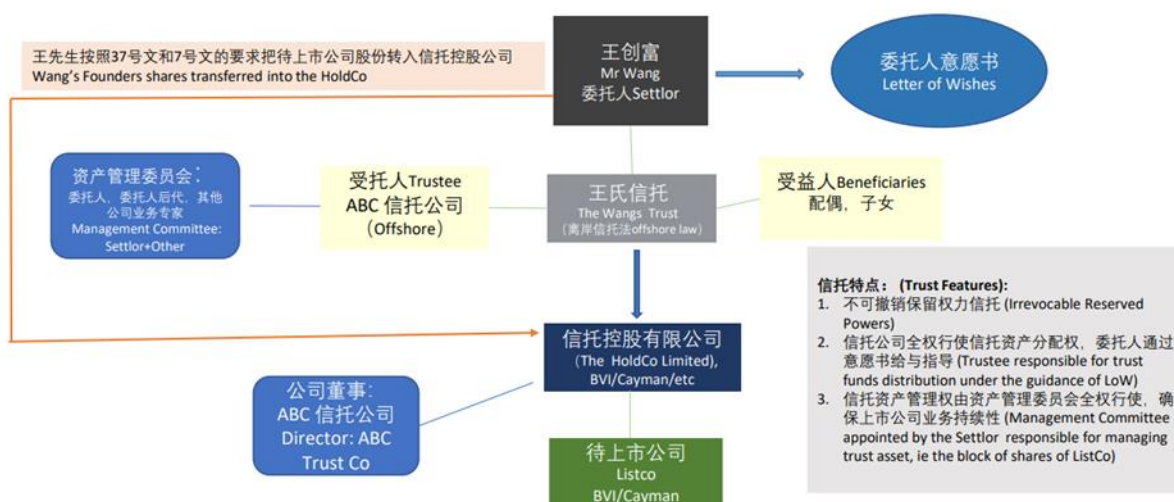
5. The process of setting up the trust

The IPO is often a long and complex process, involving multiple parties. It is important that the founder's private client advisors, including their tax and trust lawyers and proposed trustees, start to work with the IPO lawyers as soon as the planning for the IPO begins. This is to ensure that the appropriate structure of the trust is in place as part of the listing process. In particular, the significant shareholder information needs to be disclosed in the offering document to be submitted for listing purposes.

For Chinese companies considering overseas IPOs, there are specific tax compliance requirements regarding any share restructuring involving the ListCo in addition to the foreign exchange compliance requirements. Specifically, the transfer of the founder's shares in the ListCo into the family trust should only take place following careful advice from Chinese tax advisors to ensure the transfer complies with Circular 37 issued by SAFE and Bulletin 7 issued by STA.

In short, the trust set-up process should go hand in hand with the IPO process.

6. Indicative structure chart of a pre-IPO family trust



7. Summary/ key takeaways

- A Pre-IPO family trust is often an irrevocable reserved powers trust established by the founder/major shareholder of a Chinese company to be listed in an overseas market.
- In addition to the usual benefits of a trust arising from the separation of legal ownership from beneficial ownership, such as asset protection, succession and tax planning, a Pre-IPO family trust offers the additional potential benefits of assisting with the smooth listing and, after listing, the smooth operation of the business. In addition, having the founder's

shares in the Listco held by a professional trustee may also make it easier for the founder to obtain loans secured against the shares, a practice common in Asia.

- c) The appointment of the Management Committee, which has the sole authority to direct the trustee in managing the founder's shares in the Listco, ensures the company continues to be run by the most suitable professionals after the listing.
- d) The founder should engage professional private client advisors, from both the Chinese tax and law side and the offshore structuring side, as soon as the decision to list is made.