



Hong Kong - Creation and Breakthroughs of China's Offshore Trust Tax System - Articles 21

Introduction

On July 24, 2026, the Ministry of Finance (MOF) and the State Taxation Administration (STA) jointly issued the Announcement on Individual Income Tax Issues Concerning Offshore Trusts (MOF STA Announcement [2026] No. 21, hereinafter "**Circular 21**"), introducing offshore trust taxation rules for the first time. On the same day, the STA issued the Announcement on Tax Administration Issues Concerning Individual Income Tax on Offshore Trusts (STA Announcement [2026] No. 15, hereinafter "**Circular 15**"), clarifying tax declaration requirements for offshore trusts.

In terms of institutional innovation, Circular 21 and Circular 15 contain ground-breaking tax breakthroughs that will profoundly impact the offshore trust industry and high-net-worth (HNW) families. For HNW individuals who have already been queried by tax authorities or are currently evaluating tax back-payments, these rules provide clearer guidance for historical tax filings, responding to tax audits, setting up new trusts, and restructuring existing trust frameworks.

Regarding rule design, Circular 21 is guided throughout by an **anti-tax avoidance rationale**. Differentiating between resident and non-resident individual trustors, it establishes specific tax rules for asset settlement, ongoing operations, earnings distribution, trust termination, death of the trustor, and changes in tax residency status, while also clarifying statute of limitations for each stage. Circular 15 further specifies competent tax authorities, required supplementary materials, and tax filing forms, making tax administration practically actionable.

However, given the complexity of offshore trust arrangements and the lack of supporting

higher-level tax regulations, these documents leave certain operational gray areas. Below, we analyze key innovations, policy considerations, and potential areas of dispute in a Q&A format.

Why Were Offshore Trust Tax Rules Introduced?

Since early 2026, tax authorities in Beijing, Shanghai, Shenzhen, Jiangsu, and other regions have initiated educational interviews and inquiries with holders of existing offshore trust structures. Some trust holders were required to explain their trust arrangements, and several cases emerged where shareholders of overseas-listed companies were required to perform self-inspections, pay back taxes, or face tax audits due to offshore trusts. Clear legal foundations for taxing offshore trusts became urgently needed.

Previously, domestic Individual Income Tax (IIT) law lacked a dedicated trust tax regime. Tax authorities faced limitations due to a lack of statutory basis and restricted access to offshore trust information. In recent years, channels such as Common Reporting Standard (CRS) financial account information exchange and disclosures by overseas-listed companies have enabled tax authorities to track overseas financial account data and offshore trust earnings of resident individuals, paving the way for the implementation of this tax regime.



What Offshore Trusts Fall Within the Taxable Scope?

Offshore trusts established under foreign laws and other legal arrangements with trust functions fall within the scope of taxation, including common offshore family trusts and employee equity incentive trusts (ESOP trusts). However, financial products issued by overseas financial institutions to non-specific clients are excluded.

This approach "targets major setups while exempting minor ones," granting relief to ordinary individuals' overseas investments by avoiding Circular 21's strict rules. However, it is disadvantageous for individuals participating in nominee/custody arrangements overseas that resemble trusts. For instance, if a resident individual holds shares in an overseas-listed company on behalf of a non-resident individual, foreign laws may classify this as a trust relationship. Once such account data is exchanged back to mainland China, the individual may struggle under Circular 21 to "prove it lacks trust functions". Furthermore, non-profit organizations are not explicitly exempt; overseas non-profit foundations or charitable organizations involving trust-like relationships could also fall under Circular 21.

How is the Settlement of Property by Resident Individuals Taxed?

Circular 21 clarifies that when a resident individual, as settlor, settles property into an offshore trust or its overseas entity, the transaction shall be treated as a property transfer. Taxable income is calculated as the fair market value minus original value and reasonable expenses, subject to **20% IIT**. After tax payment, the cost basis of the property held by the trust or overseas entity is stepped up accordingly, eliminating double taxation upon future transfers of the trust asset.

Settling assets (such as transferring overseas shares free of charge to an offshore trust or a BVI company) is a key step in setting up an offshore trust. Previously, because IIT rules lacked a "deemed sale" clause, whether gratuitous asset transfers should be taxed at market value was heavily debated. Tax authorities could make adjustments under "unreasonably low tax bases without valid cause," but could not apply this universally without uncertainty over cost basis step-ups. Circular 21 directly categorizes asset settlement as a taxable property transfer, resolving this debate. In substance, settling assets exchanges legal ownership for trust beneficial rights, resembling a non-monetary asset swap where market-value income recognition aligns with tax principles.

However, a practical issue remains: when this stage is treated as a sale at fair value, will individuals have sufficient liquidity to satisfy their tax obligations? Circular 21 does not appear to offer instalment payment options for this stage.

Can Asset Settlement by a BVI Company be Exempt?

Circular 21 provides that where a settlor transfers property into a trust via another individual or organization, and the property is actually funded, borne, or controlled by the settlor, the property is deemed acquired and settled directly by that settlor.

Under common Red-Chip structures, if a resident individual wishes to settle Cayman-listed shares into a trust, a two-tier BVI structure is typically used. The individual sets up BVI 1 (completing Circular 37 registration), which then holds BVI 2, which holds the Cayman shares. Due to complex Circular 37 modification filings, individuals usually transfer BVI 2 shares or issue new shares to the trust rather than transferring BVI 1 directly.

Under Circular 21, these BVI share transfers or capital increases may be deemed as direct property transfers by the individual, subject to **20% IIT**. Crucially, Circular 21 does not cover Corporate Income Tax (CIT). If these BVI transfers involve indirect transfers of Chinese taxable assets by non-resident enterprises, Bulletin 7 anti-avoidance rules may be triggered, potentially leading to a **10% withholding CIT**. How to reconcile potential double taxation between IIT and CIT requires further policy guidance and practice.

How are Offshore Trust Earnings Taxed for Resident Individuals?

A long-standing debate in trust taxation was whether undistributed trust earnings during the trust's existence are taxable, who the taxpayer is (settlor vs. beneficiary), and under which income category distributed earnings should be taxed. Circular 21 provides direct rules:

- **Taxpayer:** The settlor who settled the property is the taxpayer for trust earnings, **regardless of whether they are distributed**. Once earnings are taxed during the trust's existence, subsequent actual distributions will not be taxed again. This eliminates double-taxation concerns for HNW individuals distributing income to children, though tax returns, payment certificates, and accounting records must be retained.
- **Income Category:** Earnings are categorized into "**Property Transfer Income**" and "**Interest, Dividend, and Bonus Income**". The latter covers all income other than property transfers, acting as a catch-all category. Failure to declare is treated as tax evasion, incurring back taxes, late fees (~18.25% annualized), and penalties between 0.5x to 5x of the tax amount—a much severe legal consequence than standard Controlled Foreign Corporation (CFC) anti-avoidance adjustments.
- **Calculation Method:** Property transfer income cannot offset interest/dividend/bonus income, and capital losses cannot be carried forward. Expenses such as trustee fees, management fees, legal fees, and advisory fees **cannot be deducted**. In effect, the trust is fully look-through to the resident individual, treating income as directly earned.

Previously, tax authorities attempted to apply Article 8 (CFC rules) of the IIT Law to tax BVI profits retained in low-tax jurisdictions. However, CFC rules lacked clarity on indirect holdings via trusts and required formal written adjustment notices from tax authorities.

Non-declaration did not automatically constitute tax evasion and only incurred LPR interest rather than late fees/penalties, limiting enforcement power.

For distributed earnings, the 2019 IIT Law removed the general "Other Income" category. Categorizing trust distributions under "Interest, Dividend, and Bonus Income" was common practice, but statutory definitions traditionally required holding debt or equity rights, leaving non-equity/non-debt trust beneficial rights in a legal gray area. Circular 21 explicitly classifies offshore trust earnings under "Interest, Dividend, and Bonus Income," settling the classification debate for offshore trusts.

Finally, Circular 21 does not explicitly address how to prevent double taxation when trust assets are eventually sold after accumulated earnings have already been taxed during the trust's existence. In practice, it may be advisable to distribute previously taxed earnings prior to disposing of trust assets.

How to Understand "Liquidation Tax", "Exit Tax", and "Inheritance Tax" for Offshore Trusts?

Circular 21's most significant innovation is using "deemed sales" and dividend income classifications to create economic effects similar to a **Liquidation Tax**, **Exit Tax**, and **Inheritance Tax** within the offshore trust context:

- **Liquidation Tax:** Upon trust termination, taxable gain is calculated based on market value minus original value/expenses, taxed at **20% IIT** under dividend income on the settlor.
- **Exit Tax:** If a settlor changes tax status from resident to non-resident, tax liquidation occurs based on asset market value minus original value on the transition date at **20% IIT**.
- **Inheritance Tax:** If a settlor passes away, the trustee (or designated domestic agency) must declare **20% IIT** on asset appreciation up to the date of death. Subsequently, resident individuals inheriting trust rights (typically beneficiaries) assume ongoing tax obligations upon trust operation, termination, or status changes.

In practice, these rules raise operational questions:

1. **Trustee Obligations:** Will foreign trust companies actually declare tax on behalf of deceased settlors? Under current tax collection law, "filing on behalf" differs from withholding obligations or self-reporting, and legal liability for non-compliance by foreign entities remains unclear.
2. **Determining Tax Residency Change:** China lacks a formal registration process for individuals declaring non-resident status.
 - A "resident individual" under Circular 21 generally refers to a resident with a domicile.
 - If a person surrenders Chinese nationality/household registration, they might still qualify as a resident without a domicile if present for 183 days, leaving the trigger point for the "Exit Tax" ambiguous.
 - Under Article 11 of Circular 21, individuals acquiring foreign citizenship or permanent residence whose **primary economic interests remain in China** can still be deemed resident individuals with a domicile, potentially avoiding the Exit Tax altogether.

How is Property Settled by Non-Resident Individuals Taxed?

Property settled by non-residents is also treated as a transfer, but **only China-sourced income is taxed**. Typically, non-residents trigger Chinese tax only when directly or indirectly transferring PRC equity or real estate.

Under MOF STA Announcement [2020] No. 3, if foreign equity derives over 50% of its value from Chinese real estate during the preceding 3 years, gains are treated as China-sourced income subject to **20% IIT**. Where an offshore trust settled by a non-resident is **actually controlled by a resident individual**, Circular 21 treats the settlement as directly made by the resident individual. This functions similarly to a **Gift Tax** on the resident controller. Non-resident settlors must carefully draft trust deeds to prevent excessive powers given to resident beneficiaries/protectors from triggering unintended tax liabilities.

Are Earnings of Non-Resident Offshore Trusts Taxed?

If a non-resident individual sets up an offshore trust, earnings accumulated during its existence are not taxed under Article 4 of Circular 21 so long as they are not distributed to resident individuals.

However, if earnings are distributed to resident individuals (or formally distributed to non-residents but actually enjoyed/controlled by residents), or if trust assets provide economic benefits (e.g., cross-year loans, guarantees, expense reimbursements, or low-cost asset usage) to resident individuals or their related parties, such benefits are deemed income distributions subject to **20% IIT**.

How Are Existing Offshore Trusts Handled?

Circular 21 takes effect on **July 24, 2026**, but contains retrospective provisions for existing trusts:

1. **Settlement Phase:** Back taxes generally apply for 3 years (assets settled on or after **January 1, 2023**). For large tax amounts, tax authorities may extend the look-back period under the Law on the Administration of Tax Collection.
2. **Existence Phase:** Undistributed earnings generated prior to **January 1, 2026**, must be declared and taxed as a lump sum under "Interest, Dividend, and Bonus Income".

Taxpayers who settle these back taxes within **90 days** of Circular 21's implementation date will be **exempt from late payment surcharges**. Overdue payments after 90 days will face penalties and late fees under standard tax laws.

Conclusion

Circular 21 and Circular 15 mark the official establishment of China's individual income tax framework for offshore trusts. They clarify tax obligations across all trust stages and significantly raise compliance and reporting requirements. HNW individuals with existing offshore trusts should urgently review their structures, historical earnings, beneficiary designations, and underlying assets to evaluate potential back-filing or restructuring requirements. Future trust planning must prioritize long-term tax compliance alongside traditional asset protection and succession goals.



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