

Hong Kong Tax Controversy Insight

Bank interest income exemption and related controversial issues

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Interest income derived by non-financial institutions from deposits placed with authorized institutions in Hong Kong is exempt from Profits Tax according to the Exemption from Profits Tax (Interest Income) Order 1998 (the Order), subject to a few restrictions. In this insight, we will discuss requirement for exemption under the Order and the related controversial issues, which might be raised by the Inland Revenue Department (IRD) regarding the exemption claim.

In Hong Kong, Profits Tax shall be charged 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 (excluding profits from sales of capital assets), pursuant to Section 14 of the Inland Revenue Ordinance (IRO). However, under the IRO, there are certain types of income that are exempt from the payment of Profits Tax, and one of them is bank interest income.

The Order under Section 87 of the IRO was made in 1998 with an aim to exempt person, other than financial institutions, from the payment of Profits Tax on interest income from financial institutions. This was also an act to encourage taxpayers to repatriate their offshore deposits to Hong Kong at that time. The Order states that interest derived by or accrued to a person carrying on a trade, profession or business in Hong Kong from any deposit placed in Hong Kong with an authorized institution (in respect of the funds of the trade, profession or business, if in the case of a person other than a corporation) is exempt from Profits Tax.

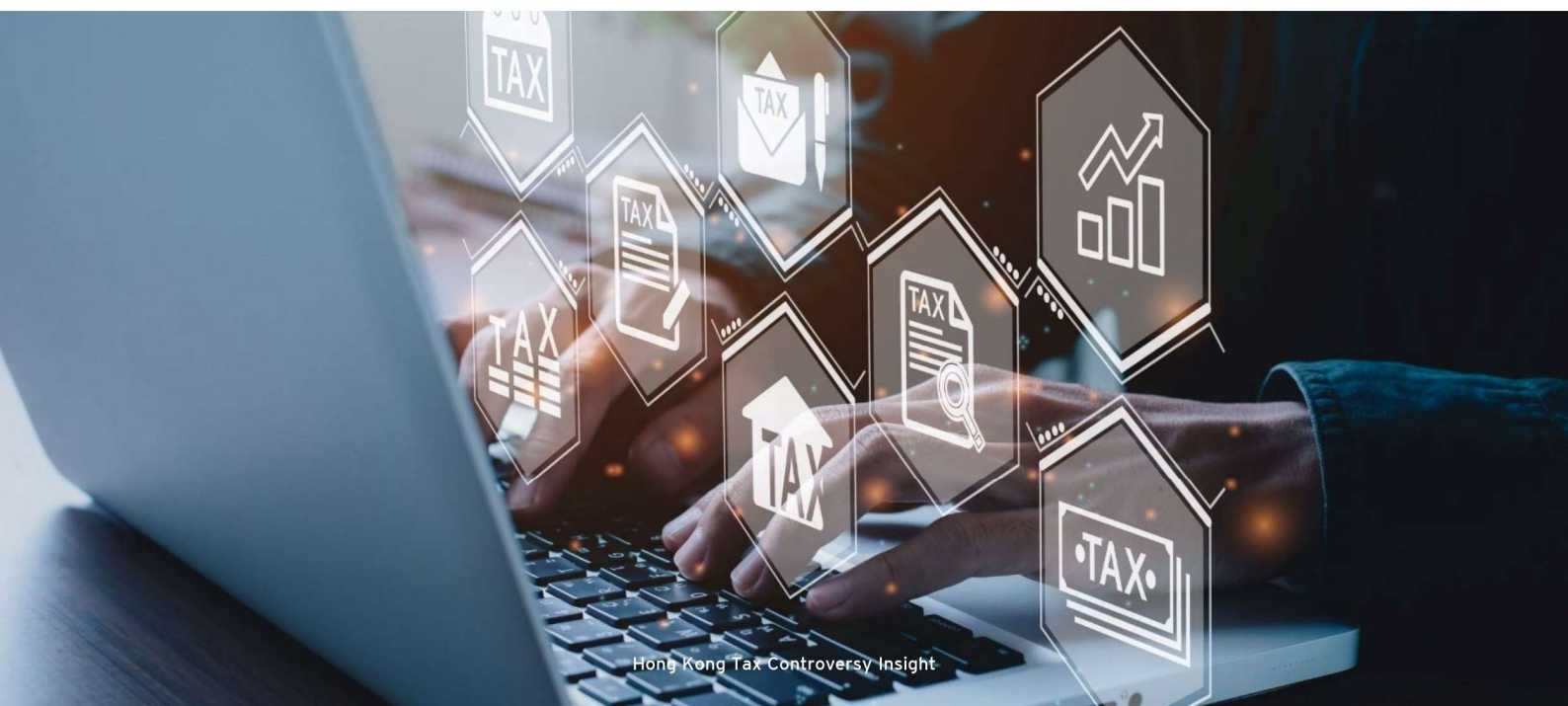
Authorized institution is defined as a bank, a restricted licence bank or a deposit taking company according to Section 2 of the Banking Ordinance. Furthermore, the exempted interest income should be the net amount derived, which has taken into account all attributable losses, outgoing and expenses incurred in the production of that interest income. Apportionment is acceptable to exclude expenses not incurred in the production of assessable profits.

It should be noted that the Order does not apply if the interest income is received by financial institutions, or if the deposit generating the interest income is used to secure or guarantee money borrowed, which the relevant interest expense is treated as deductible for Hong Kong Profits Tax. Nonetheless, whether a deposit is evidenced by a certificate of deposit or not and whether the interest income is denominated in Hong Kong dollar do not have an effect on the Order's applicability.

Controversial situations

With regards to the above, interest income earned directly by a company carrying on a business in Hong Kong from deposits placed in an authorized institutions in Hong Kong, without any security or guarantee arrangement, is generally exempt from Profits Tax pursuant to the Order. Such interest income derived is less controversial and exemption is usually granted by the IRD.

Nonetheless, in the circumstances where the concerned interest income is not earned directly by a company in Hong Kong and involves the use of client's money, the IRD is likely to raise enquiries and challenges the exemption claim of the said interest income.



Companies in securities brokerage business

Examples where clients' money is involved can usually be found in a broker company in Hong Kong. Since a broker company trades securities on behalf of its clients, it typically collects a lump sum of money from its clients as deposits. The deposits will be used to purchase securities for the clients at a later stage.

The clients' money will usually be placed by the broker companies in bank accounts in Hong Kong on behalf of their clients, and bank interest income will be earned from such deposits placed. The broker companies would usually record such bank interest income as their own income and not as interest repayable to their clients.

Sometimes, the broker company's entitlement to the interest income may be provided by specific clauses in the service agreement signed between the broker company and its clients. Since the interest from bank is not paid to the clients, to compensate the clients for the loss on the time value of money, the broker company may also separately pay interest to its clients, but with different and pre-agreed interest rates.

For Profits Tax purposes, the broker companies will normally treat the bank interest income as exempt from Profits Tax pursuant to the Order, on the basis that the interest income is derived from bank deposits placed with authorized financial institutions in Hong Kong where the bank deposits are not used to secure or guarantee any money borrowed.

IRD's common view on the controversial situations

In the past few years, there has been a growing trend of IRD's queries raised on the tax exemption claim of bank interest income earned in similar situations. The common stance of the IRD is that the income earned by the taxpayers is not interest in the scope of the Order.

It should be noted that the IRD may challenge the deposits, from which derived bank interest income, do not belong to the taxpayers, and that they are merely clients' money. Therefore, the interest income is not "bank interest income" from the taxpayers' perspective. Instead, the interest income is solely derived from the service or sales agreements signed with the taxpayers' clients, such that the income shall be "service revenue" or "sales revenue" in nature (rather than "bank interest income" in nature). In this regard, the IRD may consider that the Order to exempt "bank interest income" from Profits Tax does not apply in this situation.

Recommendation

As of today, there is yet a leading court case deciding whether the Order to exempt bank interest income from Profits Tax is applicable to those derived from clients' deposits.

Depending on the facts and circumstances of each transaction, taxpayers could try to defend their original tax filing positions by arguing that the Order does not specify the nature of the deposits and does not exclude interest from clients' money from the scope.

Please note that the above defense strategy differs from case to case. The issue is highly complicated and involves much technical analysis on the Order. If taxpayers face enquiries from the IRD in this regard, it is highly recommended to seek professional advice from tax consultants.

In the meantime, in view that this issue is in the heat of being enquired by the IRD, taxpayers are also recommended to keep proper records of the interest income, including but not limited to the reconciliation of income to the deposits, the relevant agreements, the documentation on the deposition of interest income, the separate payment of interest to clients (if any), etc. A strong documentation system is crucial to defending the original tax filing positions in case of IRD's challenges.

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