



Inland Revenue Department
The Government of the Hong Kong Special Administrative Region
of the People's Republic of China

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 13 (REVISED)

PROFITS TAX

TAXATION OF INTEREST RECEIVED

These notes are issued for the information and guidance of taxpayers and their authorised representatives. They have no binding force and do not affect a person's right of objection and appeal to the Commissioner, the Board of Review or the Courts.

These notes replace those issued in October 1996.

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Commissioner of Inland Revenue

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INTRODUCTION

Interest tax was repealed with effect from the year of assessment commencing on 1 April 1989. Since then, only interest received by or accrued to a person carrying a trade, profession or business in Hong Kong is chargeable to tax under profits tax. This Practice Note sets out the Department's view on the taxation of interest received.

INTEREST EARNED BY PERSONS OTHER THAN FINANCIAL INSTITUTIONS

2. Only interest arising in or derived from Hong Kong is liable to profits tax. For many years, the Department has taken the view that for the purpose of determining the place where interest arises or is derived from, it is the location of the originating cause that almost invariably determines the source. In essence, the place of derivation of interest is the place where the credit was provided to the borrower, i.e. the place where the funds from which the interest is derived were provided to the borrower, commonly known as the "provision of credit" test. This view is based on the decisions in *Commissioner of Inland Revenue (NZ) v. N V Philips Gloeilampenfabrieken*, 10 ATD 435 and *CIR v. Lever Brothers & Unilever Ltd (1946)*, 14 SATC 1.

3. If the originating cause is situated in Hong Kong, the source of the interest is in Hong Kong, irrespective of the currency in which the loan is denominated, the place of residence of the debtor or the place where the debtor employs the capital. Whilst the emphasis is generally placed on the provision of the credit, in some situations, such as mortgages, the originating cause may well be the mortgage itself. In addition, interest has a Hong Kong source where it forms an integral part of a trading transaction carried out in Hong Kong, e.g. where a Hong Kong manufacturer sells his goods to an overseas buyer on extended credit terms. In such situations, the interest is just as much a part of the profit as the trading profit itself and also arises in Hong Kong, e.g. *BR 20/75*, *IRBRD*, vol. 1, 184 and *Studebaker Corporation of Australasia Limited v. C of T*, 29 CLR 225.

4. It should also be noted that the "provision of credit test" is not applicable where the loans are not simple loans of money. The Privy Council

held in the case of *Orion Caribbean Limited v. CIR* 4 HKTC 432 that where the taxpayer earned its profits by borrowing and lending of money, the proper test to determine the source of the profits was the operation test, i.e. “one looks to see what the taxpayer has done to earn the profit in question and where he has done it”. In the case of a money lending business, the taxpayer’s business would normally encompass a broader range of activity, including the borrowing and/or lending of money. For this type of business, the Department will apply the operation test instead of the provision of credit test in determining the source of the interest income.

5. The question of whether the passive receipt of interest income by a company constitutes the carrying on of a business arises occasionally. The Department’s long-standing view on the law in this area is governed by the decisions in *IRC v. Korean Syndicate Ltd*, 12 TC 181; *CIR v. The South Behar Railway Co Ltd.*, 12 TC 657 and *American Leaf Blending Co Sdn Bhd v. Director-General of Inland revenue* [1978] STC 561. The current position is –

- the mere receipt of interest by a company does not constitute the carrying on of a business;
- actions that go beyond “mere passive acquiescence” may constitute the carrying on of a business;
- a period of inactivity does not rebut the fact that a company is still carrying on business.

6. In the case of *CIR v. Bartica Investment Ltd*, 4 HKTC 129, a company placed deposits with financial institutions as security for back-to-back loans, held investments and purchased shares in a listed Hong Kong company. It was held that the company carried on a business in Hong Kong. Cheung J. decided that, without having to rely on its investment holding and share purchasing activities, the company’s principal on-going activity of placing deposits and furnishing securities was, of itself, sufficient to constitute carrying on a business. In other words, the company’s activities had gone beyond “mere passive acquiescence”. The case turned on its own facts and can be distinguished from situations involving the mere passive receipt of interest. The decision does not change the Department’s interpretation and application of the law.

7. Section 15(1)(g) deems interest received in respect of the funds of a business carried on in Hong Kong by a person, other than a corporation, to be receipts arising in Hong Kong from a business carried on in Hong Kong and chargeable to profits tax. Interest is therefore subject to profits tax on the same basis as all other income received by a business. In addition, interest received in respect of monies held on trust e.g. interest-bearing clients' trust accounts that, by agreement with the clients, is retained by a trade, profession or business is also subject to profits tax. Such income is received as consideration for services rendered and consequently arises in or is derived from that business in Hong Kong and is chargeable to profits tax under section 14, e.g. *CIR v. Messrs. Lau, Wong & Chan, Solicitors*, 2 HKTC 470.

PROFITS TAX ON INTEREST EARNED BY FINANCIAL INSTITUTIONS

8. The Inland Revenue Ordinance (IRO) was amended in 1978 by the addition of section 15(1)(i). This subsection deems interest income received by or accrued to financial institutions through or from their businesses in Hong Kong to be profits arising in or be derived from a trade, profession or business carried on in Hong Kong notwithstanding that the provision of credit may have been outside of Hong Kong. The deeming provision applies only to interest income not otherwise chargeable to profits tax. The Board of Review in *D7/84, IRBRD, vol. 2, 58*, held that notwithstanding that the provision of credit was outside Hong Kong, interest derived by a financial institution was chargeable under section 14, the basic charging provision, because the interest arose from the financial institution's operations in Hong Kong. The decision of the Board of Review is in line with the decision by the Privy Council in *Orion Caribbean Limited v. CIR* 4 HKTC 432 mentioned in paragraph 4.

9. The main features of section 15(1)(i) are –

- A financial institution is defined as –
 - an authorised institution within the meaning of section 2 of the Banking Ordinance; and
 - an associated corporation of an authorised institution which would have been liable to be authorised as such an

institution under the Banking Ordinance had it not been exempt under the relevant provisions.

- Only interest arising through, or from the carrying on of, the business in Hong Kong is subject to profits tax.
- The provision of the credit outside Hong Kong will not, of itself, take the interest received outside of the charge to profits tax.

10. Whether interest arises from the carrying on of a business in Hong Kong by a financial institution will be a question of fact to be determined by the totality of the circumstances in each case. Modern international banking is a highly complex business and circumstances will vary between financial institutions. At one end of the spectrum will be financial institutions carrying on business solely in Hong Kong and which, having accepted deposits here, use part of the proceeds to purchase foreign interest-bearing securities or advance loans to overseas borrowers. Unquestionably, the whole of its profits will arise from its Hong Kong business. At the other end of the spectrum are situations where the operations carried out in Hong Kong are confined merely to entering a transaction in the books of account. Clearly, it could not be claimed that the profits on such transactions arise from the carrying on of business in Hong Kong. Conversely, though, if operations of substance relating to a transaction are carried out in Hong Kong the profits tax liability cannot be escaped merely by entering the transactions in the books of an overseas branch of the Hong Kong financial institution or a special purpose vehicle incorporated in an offshore regime.

11. The complexity of finance operations means that it is not possible to lay down one comprehensive formula to cover all situations. Cases falling between these two extremes will arise, where it can be said that the profits arise partly from business carried on in Hong Kong and partly from business carried on elsewhere. In these situations, the operations that are more immediately responsible for the receipt of the profits will determine their chargeability. If those operations are carried on in Hong Kong, then, the whole of the profits will be assessable here. On the other hand, where the operations more immediately responsible for the profits are undertaken outside of Hong Kong, then no part of those profits will be chargeable. In the cases where the extent

and effect of operations undertaken within Hong Kong and outside of Hong Kong are so finely balanced as to render it impracticable to determine which are the more immediately responsible, an apportionment of the profits will be appropriate. The current basis of assessing the interest income of financial institutions is set out in Revised Departmental Interpretation and Practice Note No. 21, issued in March 1998.

DOUBLE TAXATION RELIEF

12. Section 16(1)(c) provides a limited form of double taxation relief to corporations and to all other persons carrying on a trade, profession or business in Hong Kong in respect of interest or gains from certificates of deposits or bills of exchange specified in section 15(1)(f), (g), (i), (j), (k) or (l). When taxes of substantially the same nature as tax imposed under the IRO are charged elsewhere on such interest or gains then, provided the Commissioner is satisfied that the overseas taxes have been paid, a deduction is granted for those taxes in ascertaining the profits chargeable to profits tax. Where the overseas tax is charged on the gross amount of earnings and is payable regardless of whether or not a profit is derived such that it falls outside the ambit of this relief, then a deduction will be considered under the principal provision of section 16(1).