



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. 34 (REVISED)

**EXEMPTION FROM PROFITS TAX
(INTEREST INCOME) ORDER 1998**

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 March 1999.

LAU MAK Yee-ming, Alice
Commissioner of Inland Revenue

December 2004

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

No. 34 (REVISED)

CONTENT

	Paragraph
Introduction	1
Exempt persons	3
Basis of exemption	5
Relevant interest income	6
Associated expenses	7
Effective date of Order	9
Deposits as security for banking facilities	12
Advance rulings	13
Practical application of the Order	14

INTRODUCTION

On 30 June 1998, the Chief Executive in Council made the Exemption from Profits Tax (Interest Income) Order 1998 under Section 87 of the Inland Revenue Ordinance (the Ordinance). The purpose of the Order is to exempt persons other than financial institutions from the payment of profits tax on interest income chargeable under Part IV of the Ordinance. The Order has been amended by the Inland Revenue (Amendment) Ordinance 2004 (the 2004 Amendment Ordinance), in consequence of the amendments made to section 16 of the Ordinance.

2. This Interpretation and Practice Note sets out the Department's views on the application of the Order, as revised to reflect the amendments made by the 2004 Amendment Ordinance. In addition, the opportunity is taken to explain the approach the Department will adopt in respect of practical issues arising out of the application of the Order.

EXEMPT PERSONS

3. Taxpayers exempted from payment of profits tax on interest income to which the Order applies are -

- (a) corporations, other than financial institutions, carrying on a trade, profession or business in Hong Kong, and
- (b) persons, other than corporations, carrying on a trade, profession or business in Hong Kong where the interest income is in respect of funds of the trade, profession or business.

The exemption from the payment of profits tax does not apply to interest income received by financial institutions.

4. A financial institution is defined in section 2 of the Ordinance as being -

- (a) an authorized institution within the meaning of section 2 of the Banking Ordinance (Cap. 155);

- (b) any associated corporation of such an authorized institution which, being exempt by virtue of section 3(2)(a) or (b) or (c) of the Banking Ordinance (Cap. 155), would have been liable to be authorized as a deposit-taking company or restricted licence bank under that Ordinance had it not been so exempt.

Section 2 of the Banking Ordinance defines the term “authorized institution” as meaning a bank, restricted licence bank or deposit taking company.

BASIS OF EXEMPTION

5. The Order specifies that a taxpayer is exempt from the payment of tax on interest income to which the Order applies. Accordingly, whilst no tax is payable on the relevant interest income, the income itself does not come within the categorisation of “exempt” income. Such income therefore continues to retain its underlying characteristic as chargeable profits. Examples of the application of the Order to a number of practical situations are set out in paragraph 14.

RELEVANT INTEREST INCOME

6. For the purpose of the Order, the relevant interest income is interest income derived from any deposit placed with an authorized institution in Hong Kong by a person to whom the Order applies. Such person may either be a corporation, or a person other than a corporation, carrying on a trade, profession or business in Hong Kong. Where the person is not a corporation, the interest income has to be in respect of funds of the trade, profession or business carrying on by that person. It is worth noting that interest income derived from solicitors’ clients’ money does not fall within the scope of the Order. This is because clients’ money is not funds of the solicitors’ profession [*see CIR v. Messrs. Lau, Wong & Chan Solicitors, 2 HKTC 470*]. The currency in which the deposit is denominated is not relevant and there is no requirement for the deposit to be evidenced by a certificate of deposit.

ASSOCIATED EXPENSES

7. The interest income that is exempt from the payment of tax is the net amount derived by the person as reduced by all attributable losses, outgoing and expenses incurred in the production of that interest income. The general principles embodied in the Ordinance requiring an appropriate adjustment to be made for expenses not incurred in the production of assessable profits are applicable to determining the amount of the interest income that is subject to exemption from the payment of tax. Only the net interest income earned (the interest income received after deduction of attributable costs) is so exempted.

8. Expenses attributable to Hong Kong-sourced interest income will be computed on the same basis as that applied to the calculation of offshore interest income. The Department's policy as regards adjustments for expenses attributable to the earning of interest income is only to require an adjustment for expenses to be made where there is a direct link between the expenses in question and the interest income in question. Where the link is merely indirect or incidental, adjustments to expense deductions are not usually required to be made. Assessors do, however, reserve the right to make adjustments in specific situations where the particular facts of individual cases indicate that such adjustments are appropriate in the circumstances.

EFFECTIVE DATE OF ORDER

9. The exemption from payment of tax applies, in respect of a **deposit placed or renewed prior to 22 June 1998**, to the whole of **the interest accrued on or after that date**. For any **new deposits placed on or after 22 June 1998** or any existing **deposit renewed** on or after that date, the **whole of the interest paid** on such deposit, when received by a qualifying person, is exempt from the payment of tax.

10. It is well established judicially that interest accrues on a day-to-day basis. Accordingly, as regards deposits placed prior to 22 June 1998, only the interest that accrued on or after 22 June 1998 will qualify for the exemption. In particular, any interest that accrued prior to 22 June 1998, whether paid to the taxpayer before or after the date, will continue to be subject to profits tax. Where the term of a deposit straddles 22 June 1998, it will be necessary to

apportion any interest received on a “days before” and “days after” basis to ascertain the amount qualifying for exemption under the Order.

11. For deposits placed with financial institutions on or after 22 June 1998, the whole of the interest income received will be exempt from the payment of profits tax.

DEPOSITS AS SECURITY FOR BANKING FACILITIES

12. Any interest income arising on deposits that have been pledged as collateral for financing facilities is not exempt from the payment of tax, if the interest expenses incurred on the financing facilities are allowable for tax deduction. While the interest expenses deduction scheme has been amended by the 2004 Amendment Ordinance, the basic principles for granting exemption from payment of tax under this Order remain unchanged. The positions on the application of the exemption before and after the 2004 Amendment Ordinance are as follows -

(a) Before the 2004 Amendment Ordinance

The exemption does not apply to any deposit which is used to secure or guarantee a loan of money where the condition specified in the then section 16(2)(d) of the Ordinance is satisfied. In such case, the interest income earned from the deposit is chargeable to tax, while the interest expense incurred on the loan is allowable for deduction. The position remains the same even if there are other securities for the loan or the interest expense incurred on the loan is less than the interest income earned from the deposit. The whole of the interest income is chargeable to tax because the Order does not allow partial exemption for the interest income. The taxpayer cannot give up the interest expense deduction and claim the interest income exemption.

(b) After the 2004 Amendment Ordinance

The exemption does not apply to any deposit which is used to secure or guarantee a loan of money where the condition under section 16(2)(c), (d) or (e) of the Ordinance is satisfied and the restriction on interest expense deduction under section 16(2A) does not apply. In such case, the interest expense is allowable and the interest income is not exempt from payment of tax by the Order, notwithstanding that there are other securities for the loan or the interest expense incurred on the loan is less than the interest income earned from the deposit. As before, partial exemption for the interest income is not allowed. The taxpayer cannot give up the interest expense deduction and claim the interest income exemption.

ADVANCE RULINGS

13. Section 88A of the Ordinance permits the Commissioner, upon application from a person, to make a ruling on matters specified in Part I to Schedule 10 of the Ordinance. In particular, section 1 of Part I of Schedule 10 provides that the Commissioner may make a ruling on how any provision of the Ordinance applies to the applicant or to the arrangement described in the application. Advance rulings may be given in respect of the application of Orders made under section 87.

PRACTICAL APPLICATION OF THE ORDER

14. As noted above, the Order exempts taxpayers from the payment of profits tax on interest income to which it relates. Notwithstanding the legislative approach adopted, the practical effect of the Order is to exempt the relevant interest income from tax. To ensure consistency in the basis of assessment with the situation that would have prevailed had the relevant interest income been excluded from chargeability, the following practices will be adopted by the Department in finalising assessments -

- (a) The Order will be applied to the relevant interest income as regards both the final profits tax liability and the provisional profits tax liability.
- (b) In computing the assessable profits of a taxpayer, the relevant interest income will be treated as “exempt income”.

Example 1

Taxpayer commenced business on 1 April 1998. For the year ended 31 March 1999, the taxpayer has the following assessable profits -

	(\$M)
--	-------

Assessable trading profits	10
----------------------------	----

Local deposit interest:-

Period earned

01.4.1998 - 21.6.1998 ⁽¹⁾	1
22.6.1998 - 31.3.1999 ⁽²⁾	<u>3</u>

Total assessable profits \$ (10M + 1M)	<u>11</u>
--	-----------

Calculation of Tax Payable

1998/99 Final profits tax

\$11M x 16%	\$1,760,000
-------------	-------------

1999/2000 Provisional profits tax⁽³⁾

\$11M ⁽⁴⁾ x 16%	<u>\$1,760,000</u>
----------------------------	--------------------

Total tax payable	<u>\$3,520,000</u>
-------------------	--------------------

- (1) Exemption under section 87 applies to interest accrued on or after 22.6.1998. Such interest income is treated as exempt income.
- (2) Local deposit interest income treated as exempt income.
- (3) The exemption is extended to the payment of provisional profits tax.
- (4) 1999/2000 Provisional profits tax is based on the assessable profits for 1998/99, which includes \$1M interest accrued prior to 22.6.1998.

Example 2

For the year ended 31 March 2000, the taxpayer in Example 1 has the following assessable profits -

	(\$M)
Assessable trading profits	11
<i>Local deposit interest⁽¹⁾</i>	<u>5</u>
Total assessable profits	<u>11</u>

(1) Local deposit interest income treated as exempt income.

Calculation of Tax Payable

Final profits tax for 1999/2000

\$11M x 16% \$1,760,000

Less: Provisional profits tax paid
\$1,760,000
\$0

Provisional profits tax 2000/2001

\$11M x 16% \$1,760,000

Total tax payable \$1,760,000

(c) For loss set-off purposes, relevant interest income will be treated as “exempt income”.

Example 3

[Loss brought forward exceeds current year's assessable profits plus the relevant interest income]

For the year ended 31 March 1998, the taxpayer's agreed loss was \$15M. For the year ended 31 March 1999, the taxpayer's assessable profits are as follows -

	(\$M)
Assessable trading profits	10
Local deposit interest -	
<i>Period earned</i>	
1.4.1998 - 21.6.1998	1
22.6.1998 - 31.3.1999 ⁽¹⁾	<u>3</u>
Total assessable profits \$ (10M + 1M)	11
Less: Loss set-off ⁽²⁾	<u>(11)</u>
Net assessable profits	<u>0</u>

Statement of Loss

Loss brought forward	15
Less: Loss set-off	<u>(11)</u>
Loss carried forward	<u>4</u>

Provisional Profits Tax

Provisional assessable profits	11
Less: Loss set-off	<u>(4)</u>
Net provisional assessable profits	<u>7</u>

Calculation of Tax Payable

1999/2000 Provisional profits tax payable (\$7M x 16%) \$1,120,000

(1) Local deposit interest income treated as exempt income.

(2) Loss brought forward set-off against normal trading profits & interest income accrued prior to 22.6.1998.

Example 4

[Loss brought forward equal to current year's assessable profits plus the relevant interest income]

For the year ended 31 March 1998, the taxpayer's agreed loss was \$14M. For the year ended 31 March 1999, the taxpayer's assessable profits are -

	(\$M)
Assessable trading profits	10
Local deposit interest:-	
<i>Period earned</i>	
1.4.1998 - 21.6.1998	1
22.6.1998 - 31.3.1999 ⁽¹⁾	<u>3</u>
Total assessable profits \$(10M + 1M)	11
Less: Loss set-off	<u>(11)</u>
Net assessable profits	0

Statement of Loss

Loss brought forward	14
Less: Loss set-off	<u>(11)</u>
Loss carried forward	<u>3</u>

Provisional Profits Tax

Provisional assessable profits	11
Less: Loss set-off	<u>(3)</u>
Net provisional assessable profits	<u>8</u>

Calculation of Tax Payable

1999/2000 Provisional profits tax payable (\$8M x 16%) \$1,280,000

(1) Local deposit interest income treated as exempt income.

Example 5

[Loss brought forward less than current year's assessable profits plus the relevant interest income.]

For the year ended 31 March 1999, the taxpayer's assessable profits were -

	(\$M)
Normal assessable trading profits	10
Local deposit interest:-	
<i>Period earned</i>	
1.4.1998 - 21.6.1998	1
22.6.1998- 31.3.1999 ⁽¹⁾	<u>3</u>
Total assessable profits \$ (10M + 1M)	<u>11</u>

(1) Local deposit interest income treated as exempt income.

The loss brought forward from 1997/98 is (a) \$13M; (b) \$11M; and (c) \$10M.

	(a) (\$M)	(b) (\$M)	(c) (\$M)
Assessable profits for 1998/99	11	11	11
Less: Loss brought forward	<u>(13)</u>	<u>(11)</u>	<u>(10)</u>
Net assessable profits	<u>0</u>	<u>0</u>	<u>1</u>
Loss carried forward	<u>(2)</u>	<u>0</u>	<u>0</u>

Calculation of Tax Payable

1998/99 Final profits tax

(a)	\$0
(b)	\$0
(c) \$ 1M x 16%	\$160,000

1999/2000 Provisional profits tax

(a) \$ (11M - 2M) x 16%	<u>\$1,440,000</u>
(b) \$ 11M x 16%	<u>\$1,760,000</u>
(c) \$ 11M x 16%	<u>\$1,760,000</u>
Total tax payable	<u>\$1,440,000</u> <u>\$1,760,000</u> <u>\$1,920,000</u>

Example 6

For the year ended 31 March 1999, the taxpayer's agreed trading loss (excluding local deposit interest income) is \$5M. The taxpayer has local deposit interest income of, respectively, (a) \$5M; (b) \$4M; and (c) \$6M -

	<u>(a)</u> (\$M)	<u>(b)</u> (\$M)	<u>(c)</u> (\$M)
Agreed trading loss	(5)	(5)	(5)
Local deposit interest <i>Period earned</i>			
22.6.1998 to 31.3.1999 ⁽¹⁾	5	4	6
Assessable profits	<u>0</u>	<u>0</u>	<u>0</u>
<u>Statement of Loss</u>			
Loss brought forward	0	0	0
Loss for year	<u>5</u>	<u>5</u>	<u>5</u>
Loss carried forward	<u>5</u>	<u>5</u>	<u>5</u>
<u>Calculation of Tax Payable</u>			
1998/99 Final profits tax	\$0	\$0	\$0
Provisional profits tax for 1999/2000	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>
Total tax payable	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>

(1) Local deposit interest income treated as exempt income.

- (d)** As relevant interest income is treated as “exempt income”, applications for the holding over of 1998/99 provisional tax (or any subsequent year of provisional tax for that matter) in respect of that income may be made if the assessable profits for the 1998/99 year of assessment (excluding the relevant interest income) are, estimated or are likely to be, less than 90% of the assessable profits on which the provisional profits tax has been charged.

Example 7

For the year ended 31.3.1998, the taxpayer has the following assessable profits -

	(\$M)
Assessable trading profits	10
Local deposit interest	<u>4</u>
Assessable profits for 1997/98	<u>14</u>

1997/98 Final profits tax
\$14M x 16.5% \$2,310,000

1998/99 Provisional profits tax for 1998/99
\$14M x 16% \$2,240,000

In January 1999, the taxpayer estimates that its assessable profits for the year ended 31 March 1999 will be -

(\$M)
Normal assessable trading profits 10

Local deposit interest :-

Period earned

1.4.1998 - 21.6.1998	1
22.6.1998 - 31.3.1999 ⁽¹⁾	<u>3</u>
	<u>14</u>

1998/99 Provisional profits tax held over
\$3M x 16% \$480,000

- (1) The interest of \$3M earned on or after 22 June 1998 is treated as exempt income. The estimated 1998/99 assessable profits are therefore less than 90% of the 1997/98 assessable profits and provisional tax charged on the relevant income can be held over.