

Hong Kong (SAR) Tax Alert

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The Board of Review finds that a property developer is not entitled to profits tax exemption on stakeholder account interest income

Summary



The Board of Review held in [Case No. D12/22](#) determined that the sums received by a property developer, which represent interest income derived from amounts placed in stakeholder accounts in respect of pre-sale of uncompleted residential units, do not qualify for the profits tax exemption for bank interest income in the hands of the property developer.

In this tax alert, we discuss the Board's findings and analysis and share our observations on the Board's decision.

Background of the case

The taxpayer is a Hong Kong SAR ("Hong Kong") incorporated company engaged in property development and property investment businesses. It pre-sold uncompleted units in a residential development project and received deposits and part payments of the purchase prices (the Deposits) from the purchasers.

Such pre-sale was governed by a standard form of agreement for sale and purchase (the ASP) approved by the HKSAR Government. Under the ASP, (i) a purchaser had to pay the Deposits to the solicitors' firm engaged by the taxpayer as stakeholder, (ii) the solicitors' firm undertook to hold the monies received as stakeholder and was required to place the monies into interest-bearing bank accounts in Hong Kong and (iii) the taxpayer was entitled to all interest earned (i.e. the Sums) on such accounts.

The monies kept in the stakeholder accounts would only be applied and released according to the terms and conditions stipulated in the ASP – e.g. first released towards payment of the construction costs / professional fees of the property developer and second towards repayment of funds drawn down under the building mortgage (if any).

There was no separate agreement between the taxpayer and the solicitors' firm on the stakeholding arrangement.

The taxpayer treated the Sums as tax-exempt bank interest income pursuant to the [Exemption from Profits Tax \(Interest Income\) Order](#) (the Exemption Order) in its 2015/16, 2016/17 and 2017/18 profits tax filings.

The Inland Revenue Department (IRD) disagreed on such treatment and issued tax assessments that included the Sums as the taxpayer's assessable profits. The taxpayer lodged an objection against the tax assessments (which was unsuccessful) and then an appeal to the Board.

The key issues involved

The key question in this case is whether the Exemption Order applied to the taxpayer in respect of the Sums. In this regard, the key issues for the Board to consider are:

1. Regarding the construction of section 2(1)¹ of the Exemption Order (**the Construction Point**):
 - whether the Deposits must be (i) the taxpayer's monies / funds in respect of its trade or business carried on in Hong Kong and (ii) directly placed by the taxpayer with the banks; and
 - whether the Sums are "interest" within the meaning of the Exemption Order.
2. Whether there was any trust or agency relationship between the taxpayer and the solicitors' firm in respect of the "interest" portion on the Deposits – i.e. the "interest" on the Deposits always belonged to the taxpayer and the solicitors' firm only held the interest on trust for the taxpayer (**the Agency/Trust for Interest Portion Point**); and
3. Whether the Deposits were held on trust for the taxpayer and hence the beneficial interest of the Deposits, while they were held by the solicitors' firm, was intended to belong to the taxpayer only (**the Trust for Deposits Point**).

The Board's decision and analysis

1. On the application of the Exemption Order under **the Construction Point**, the Board held that:
 - The Exemption Order should be interpreted based on the context and purpose against the background of which it was enacted – i.e. the Exemption Order was introduced to encourage taxpayers to repatriate offshore deposits to Hong Kong and increase the overall liquidity of Hong Kong's financial system.
 - The taxpayer's case is not a situation which requires the application of the Exemption Order to encourage the placing of the Deposits in Hong Kong as the Deposits must be placed in a Hong Kong bank account according to the ASP.
 - The Hong Kong bank accounts were opened in the name of the solicitors' firm. The Deposits were not placed with the banks by the taxpayer and the Sums were derived from the Deposits which did not belong to the taxpayer.
 - The wording of section 2(1) of the Exemption Order mirrors that of the Inland Revenue Ordinance (IRO) charging provisions that deem interest income as taxable for certain corporations and persons other than a corporation – i.e. sections 15(1)(f)² and 15(1)(g)³ respectively. Although the phrase "*in respect of the funds of the trade, profession or business*" is not included in the charging provision for corporations, it may be readily assumed that the funds of a corporation are funds in respect of its trade, profession or business. The explicit inclusion of such phrase in the charging provision for persons other than a corporation is necessary because one may hold personal savings and derive interest unrelated to his/her trade, profession or business. The additional wording in section 15(1)(g) of the IRO is to ensure that persons and corporations are placed on equal footing as far as chargeability to interest income is concerned.

Based on the above, the Board held that the Exemption Order does not apply to the taxpayer in respect of the Sums.

2. On what is regarded as "interest" under **the Construction Point**, the Board held that:
 - Based on case law, two requirements must be satisfied for a payment to amount to "interest", namely (1) there must be a requisite sum of money by reference to which the payment which is said to be interest is to be ascertained and (2) those sums of money must be sums that are due to the person entitled to the alleged interest.
 - The Sums were passed to the taxpayer by the solicitors' firm pursuant to the ASP and based on a contractual arrangement. In the Board's view, the Sums no longer bore the character of "interest" when being passed to the taxpayer.

Based on the above, the Board held that the Sums were not "interest derived from any deposit" from the taxpayer's perspective within the meaning of the Exemption Order.

3. On the **Agency/Trust for Interest Portion Point**:
 - The ASP expressly provided that the Deposits were paid to the solicitors' firm as stakeholder, and stakeholder is not an agent or trustee based on established legal principles.

¹ Section 2(1) provides, among other things, that any sum received by or accrued to a corporation carrying on a trade, profession or business in Hong Kong by way of interest derived from any deposit placed in Hong Kong with an authorised institution shall be exempt from profits tax.

² Section 15(1)(f) of the IRO: "... sums received by or accrued to a corporation carrying on a trade, profession or business in Hong Kong by way of interest derived from Hong Kong; ..."

³ Section 15(1)(g) of the IRO: "... sums received by or accrued to a person, other than a corporation, carrying on a trade, profession or business in Hong Kong by way of interest derived from Hong Kong which interest is in respect of the funds of the trade, profession or business; ..."

- There was no reference to a trust or agency relationship in the ASP other than a **deemed** agency, which only operates in the event the solicitors' firm acted in default of the article in the ASP that governed the application and release of the Deposits.
- The taxpayer failed to discharge its burden of proving the creation of a trust or agency relationship.

4. On the **Trust for Deposits Point**:

- The government's regulatory requirement for the taxpayer to engage a solicitors' firm to hold the Deposits was designed to protect the purchasers, especially when the property units remained uncompleted. Although the Deposits can be applied for the taxpayer's benefits under the ASP, the Board did not agree that the intention of the parties was for the beneficial interest of the Deposits, while being held by the solicitors' firm, to belong to the taxpayer only.

Based on the above, the Board dismissed the taxpayer's appeal and held that the Sums should not be exempted from profits tax pursuant to the Exemption Order.

KPMG observations

As the Board mentioned in its decision, its determination of this appeal will have industry-wide implications as it may be applicable to other similar transactions in the real estate sector.

It has yet to be confirmed whether the taxpayer in this case has lodged an appeal against the Board's decision to a higher court, and whether other taxpayers in the real estate industry that have a similar dispute with the IRD will bring the issue to court.

The Board did not explicitly mention in its decision which party/parties is/are the legal owner(s) of the Deposits and the interest income during the period in which the amounts were held in the stakeholder accounts, and whether the solicitors' firm was entitled to a profits tax exemption on the bank interest income derived from the stakeholder accounts.

It is worth noting that in [CIR v Messrs. Lau, Wong & Chan Solicitors](#), the court held that the clients' monies held in a trust / escrow account by the solicitors' firm belonged to the clients and not the solicitors' firm, and the interest earned from the account would also belong to the clients if there was not a specific agreement between the solicitors' firm and the clients for the former to keep the interest. The IRD refers to this case in [Departmental Interpretation and Practice Note No. 34](#) on the Exemption Order and takes the position that interest income derived from solicitors' clients' money does not fall within the scope of the Exemption Order because clients' money is not funds of the solicitors' profession.

Taxpayers facing a similar situation should closely monitor the development of this case and consider whether it is appropriate and feasible to enter into a separate agreement with their solicitors to deal with the tax savings arising from the profits tax exemption of bank interest income (if any) derived from sums deposited into a stakeholder account under a stakeholding arrangement.

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