

Hong Kong Tax Alert

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Bank interest on deposits for purchase of property held by solicitors as stakeholders before completion held not tax-exempt when received by the developer

- whether the deposits were held as trust monies for the developer and, even if not so, whether the interest was nonetheless exempt from tax under the Interest Exemption Order given that the developer was absolutely entitled to the interest under the agreement for sale and purchase (ASP) with the purchasers

Brief facts

The Taxpayer, a company incorporated in Hong Kong, pre-sold uncompleted property units in a development (the Development) under the Lands Department Consent Scheme. The ASP was a standard form of agreement for sale and purchase approved by the government.

The terms of the ASP provided that the deposit or part payment of the purchase price to the solicitors' firm engaged by the Taxpayer (the Solicitors) shall be held by the Solicitors as stakeholders pending the completion of the ASP and before that can be applied and released in the following manner only:

- (a) first, towards the payment of the construction costs and professional fees for the Development as certified;
- (b) second, towards the repayment of funds drawn under the building mortgage (if any) for payment of (a) above; and
- (c) third, if the monies held by all the relevant stakeholders were more than enough to cover the entire outstanding balance of (a) and (b) above, the excess may be released to the Taxpayer.

The ASP also provided that, before the above application, the monies were to be placed by the Solicitors in their interest-bearing clients' accounts with banks and that the Taxpayer would be absolutely entitled to the interest so earned.

Issue

The Deputy Commissioner of Inland Revenue (DCIR) determined that the interest when received by the Taxpayer from the Solicitors under the ASP was not exempt from profits tax in Hong Kong under the Interest Exemption Order for the years of assessment 2015/16 to 2017/18.

The Taxpayer then appealed to the Board of Review (BOR) against the DCIR's determination.

BOR decision

The law - Interest Exemption Order¹

Section 2(1) of the Interest Exemption Order provides that "...where any sum is received by or accrue to (a) a corporation carrying on a trade, profession or business in Hong Kong; or (b) a person, other than a corporation, carrying on a trade, profession or business in Hong Kong, in respect of funds of the trade, profession or business, which sum is by way of interest derived from any deposit placed in Hong Kong with an authorized institution, the corporation or person other than a corporation shall be exempt from the payment of profits tax ...in respect of a new deposit placed or an existing deposit renewed on or after 22 June 1998..." [Emphasis added]

All the banks with which the Solicitors maintained the interest-bearing clients' accounts were authorized institutions as defined under the Interest Exemption Order.

The Taxpayer's arguments

The Construction Point

(i) whether the exemption covered the Sums

The Taxpayer argued that amounts of interest ("the Sums") paid to it by the Solicitors were sums received or accrued to it by way of interest from deposits placed in Hong Kong with authorized institutions and therefore exempt from profits tax under Interest Exemption Order.

Further or alternatively, on a true construction of the ASP, the amounts paid as deposit or part payment of the purchase price under the ASP were received by the Solicitors as agent or trustee for the Taxpayer. The Sums, being interest on such amounts paid, belonged to, or accrued to the Taxpayer as a matter of law, irrespective of how the monies held by the Solicitors were to be applied under the ASP.

Based on the literal reading of section 2 of the Interest Exemption Order, the Taxpayer argued that (i) the Sums were received by or accrued to it as a corporation carrying on a trade, profession or business in Hong Kong; and (ii) the Sums were by way of interest derived from **any deposit** placed in Hong Kong with authorized institutions, i.e., notwithstanding that the deposits were placed with banks in the name of the Solicitors.

The Taxpayer argued that (i) there was no requirement in section 2(1) of the Interest Exemption Order that the deposits must be the Taxpayer's money or (ii) the deposits must have been placed by the Taxpayer in its own name. The Taxpayer referred to the use of the words "**any deposit**" in the Interest Exemption Order to support its contention that a wide application of the exemption was intended.

Furthermore, the Taxpayer also argued that limb (a) of the section 2(1) of the Interest Exemption Order that applies to a corporation does not require that the funds for the deposits must be "in respect of funds of the trade, profession or business" of a corporate taxpayer, unlike that of limb (b) that applies to a non-corporate taxpayer.

Rejecting the Taxpayer's above argument, the BOR considered that in the case of a non-corporate taxpayer, e.g., an individual that carries on business as a proprietor, the funds of the proprietorship could be the personal savings of the proprietor unrelated to the business. As such, interest on such savings

would not fall within the scope of charge to profits tax under section 14 of the Inland Revenue Ordinance (IRO) in the first place. That was why the deeming section for bringing interest to tax under section 15(1)(g) of the IRO specifies that to be so deemed the interest must be "in respect of funds of the trade, profession or business" of a non-corporate taxpayer. Therefore, correspondingly limb (b) of the Interest Exemption Order also needs to explicitly include the term "in respect of funds of the trade, profession or business" when it applies to a non-corporate taxpayer. In other words, the scope of the exemption under the Interest Exemption Order mirrors the scope of charge under section 15(1)(g) of the IRO.

However, the BOR considered that in the case of a corporate taxpayer, it could be readily presumed that the funds of a corporation are funds in respect of its trade, profession or business. As such, the corresponding deeming section for charging interest received by a corporation under section 15(1)(f) of the IRO does not need to explicitly contain the term "in respect of funds of the trade, profession or business".

The BOR therefore considered that, both for corporate and non-corporate taxpayers, only interest derived from funds in respect of their trade, profession, or business would be exempt from tax under the Interest Exemption Order.

In support of its above construction of section 2(1) of the Interest Exemption Order, the BOR noted that the purpose of the Interest Exemption Order was to encourage taxpayers to keep their deposits in Hong Kong, thereby injecting liquidity into the Hong Kong financial system.

In this case, the BOR noted that under the Solicitors' Accounts Rules, (i) "client money" of a solicitor must be maintained in their accounts with a bank located and licensed in Hong Kong in the name of the solicitor and (ii) "client money" includes money held by a solicitor as stakeholder.

Thus, the BOR considered that the situation of the case was not one which required the application of the Interest Exemption Order to encourage the placing of deposits in Hong Kong. The BOR therefore concluded that section 2(1) of the Interest Exemption Order, properly construed in its context and purpose, did not cover the Sums received by the Taxpayer, notwithstanding the employment of the wide term "**any deposit**" in the section.

Note:

(1) [Exemption From Profits Tax \(Interest Income\) Order \(Cap. 112T\)](#)

(ii) whether the Sums when received by the developer were interest in nature

The BOR noted that when the Sums were passed to the Taxpayer by the Solicitors, they were passed pursuant to a contractual arrangement under the ASP (see also discussion on the legal principles on stakeholding arrangements below). The ASP was not a mere form. It provided the legal basis on which the Taxpayer was entitled to the Sums notwithstanding that the Taxpayer did not yet have the ownership of the deposits when they were placed with the banks by the Solicitors (not by the Taxpayer).

The BOR then held that when the Sums were passed to the Taxpayer, they no longer bore the character of “interest”, which is defined in many case-law authorities, as meaning compensation to the recipient for deprivation from having the use of its money (the principal for a period of time).

Agency/Trust for Interest Portion Point

The Taxpayer argued that under the ASP, the “interest” portion on the deposits always belonged to it, thereby contending that the Solicitors held the interest portion on trust for it. The Taxpayer also referred to the Solicitors’ Account Rules, which stipulate that solicitors must account for clients for any interest earned on clients’ accounts as indicative of a fiduciary or agency relationship.

Citing relevant case-law authorities on the legal principles on stakeholding arrangements, which were not disputed by the two parties in this case, the BOR noted that the general position was that the stakeholder is not an agent or trustee, as neither of the other two parties has any proprietary interest in the stake. The stakeholder, subject to any agreement to the contrary, is not liable to account for any profit which they may make upon the stake (in the way of interest or otherwise).

Turning to the facts of the case, the BOR noted that the ASP expressly provided that the purchase price was paid to the Solicitors as stakeholders. There was no reference to trust or agency in the ASP.

The BOR was of the view that the mere fact that one of the terms of the ASP provided that the Taxpayer was entitled to the interest, without more, was not sufficient to evidence the creation of trust or agency. This was because the entitlement may arise by reasons other than trust or agency, such as contractual agreement.

Neither did the existence of a “deemed agency” clause in the ASP that if any money paid under the ASP to the stakeholders was not applied in the manner as prescribed, such money would be deemed to have been paid by the purchaser to the Solicitors as agents for the Taxpayer, alter the BOR’s above view.

The BOR reasoned that the need to have an express provision of “deemed agency”, which only operated under a specific condition, suggested that but for this provision, no agency was created between the Solicitors and the Taxpayer insofar as the money at the stakeholders’ accounts was concerned.

Furthermore, the BOR noted that the Sums as interest were mixed with the deposits (i.e., the principal) in the stakeholders’ accounts. Although the terms of the ASP provided that the Taxpayer was entitled to the interest, unless and until the Sums were paid to the Taxpayer, the Sums remained mixed in the solicitors’ accounts by the Solicitors without segregation.

There was also no evidence to show that when considering whether a sufficient sum was maintained for the application of the deposits under condition (c) as noted in the brief facts above, the Sums were not counted for that purpose.

The BOR then concluded that while the Sums in the stakeholders’ accounts remained so mixed with the deposits, it cannot be concluded that the Sums would only go to the Taxpayer but no one else. For example, the purchasers may look to the Solicitors for refund of the purchase prices in the event that the Development cannot be completed within the stipulated time.

On the above basis, the BOR held that the Taxpayer received the Sums under its contractual terms of the ASP or Section 6A(1) of the Solicitors’ Accounts Rules. As such, the Sums were not received as interest and therefore the Interest Exemption Order did not apply to the Sums.

Trust for Deposit Point

The Taxpayer further contended that the whole of the deposits was held on trust for the Taxpayer and a Quistclose trust was created because the money was paid to and received by the Solicitors for a specific purpose, i.e., the money should be applied for the specific uses provided for under the ASP. The BOR noted that the ASP under the Consent Scheme was designed to protect the purchasers, especially when the property units remained uncompleted and not assigned to the purchasers. The deposits were held by the Solicitors for the protection of the purchasers, while the application of the funds pursuant to the terms of the ASP also benefited the Taxpayer as the developer.

As such, the BOR did not agree that the parties intended that the beneficial interest of the deposits, while being held by the Solicitors, belonged to the Taxpayer only. Therefore, the BOR found that there was no trust or Quistclose trust created in respect of the deposits.

The BOR thereby dismissed the Taxpayer’s appeal.



Commentary

The BOR decision of this case will have wide implications for property developers given that the ASP is a standard agreement for sale and purchase of uncompleted property units in Hong Kong and that the amount of interest involved could be substantial. Therefore, other taxpayers in similar situations may be keen to see whether the Taxpayer would appeal against this decision.

The Commissioner of Inland Revenue's (CIR) contention that the deposit or part payment of the purchase price paid to the Solicitors' clients' accounts constituted a conventional stakeholding arrangement under which the monies belonged to the Solicitors as a stakeholder pending the application of the monies under the terms of the ASP seems to be unconventional.

In contrast, in an earlier case *CIR v. Messrs. Lau, Wong & Chan Solicitors*², the CIR accepted that monies held in the clients' accounts of a solicitors' firm were fiduciary funds, albeit the facts of the case might not be the same as in this case.

If on appeal, the dispute may focus on whether the quoted case-law authorities on the legal principles on a conventional stakeholding arrangement adopted by BOR apply to the monies held by the Solicitors as stakeholders in this case.

One point of dispute may be that unlike the facts in some of the cases quoted, where the stakeholding monies can go to either one of two parties concerned depending on the events, the occurrence of any one of which may be anticipated as a normal course of the business dealing of the two parties. In contrast, the deposits in this case would go to the developer or be applied for the benefit of the developer, except perhaps in certain remote possibilities such as the Development cannot be completed within the stipulated time.

The issue would then be whether such features in this case could make the monies held by the Solicitors as stakeholders not a conventional stakeholding arrangement but held in a fiduciary or trust capacity for the developer.

Another point of note may be that where monies are not held by a stakeholder, e.g., interest income earned on monies held by a stockbroker in their clients' accounts with banks that was kept by the stockbroker pursuant to their services contracts with clients, the reasoning of this BOR decision does not seem to be applicable to them.

In such cases, interest earned by stockbrokers on monies kept in their clients' accounts with banks would, based on this BOR decision, be interest in nature and, as such, be tax-exempt under the Interest Exemption Order. This would appear to be the case regardless of whether the interest could also be said to be in consideration for their services rendered to clients, given that all funds of a corporate taxpayer could probably be regarded as their business funds.

Whether interest on clients' accounts maintained by a service provider or vendor of goods kept by the latter under their service contracts or sale and purchase agreements with clients would be exempt from profits tax under the Interest Exemption Order could be complicated. Clients who need to address such an issue should contact their tax executive.



Note:

(2) *CIR v. Messrs. Lau, Wong & Chan Solicitors* 2 HKTC 470

https://legalref.judiciary.hk/lrs/common/search/search_result_detail_frame.jsp?DIS=28919&QS=%28%7BMessrs%5C.+Lau%2C+Wong+%5C%7C%5C+Chan%2C+Solicitors%7D+%25parties%29&TP=JU

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