Hong Kong Tax Alert

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IRD explains what constitutes a "simple loan of money" and a "money-lending" business

- the "provision of credit test" would determine the source of interest income derived from a "simple loan of money" whereas in other cases the "operation test" would be the default position. Given that generally an "intra-group financing" business would not be willing to lend to "all and sundry", such business would not constitute a "money-lending" business. As such, an unrecoverable loan lent by an "intra-group financing" business would unlikely qualify for tax deduction as a bad debt under section 16(1)(d) of the Inland Revenue Ordinance (IRO).

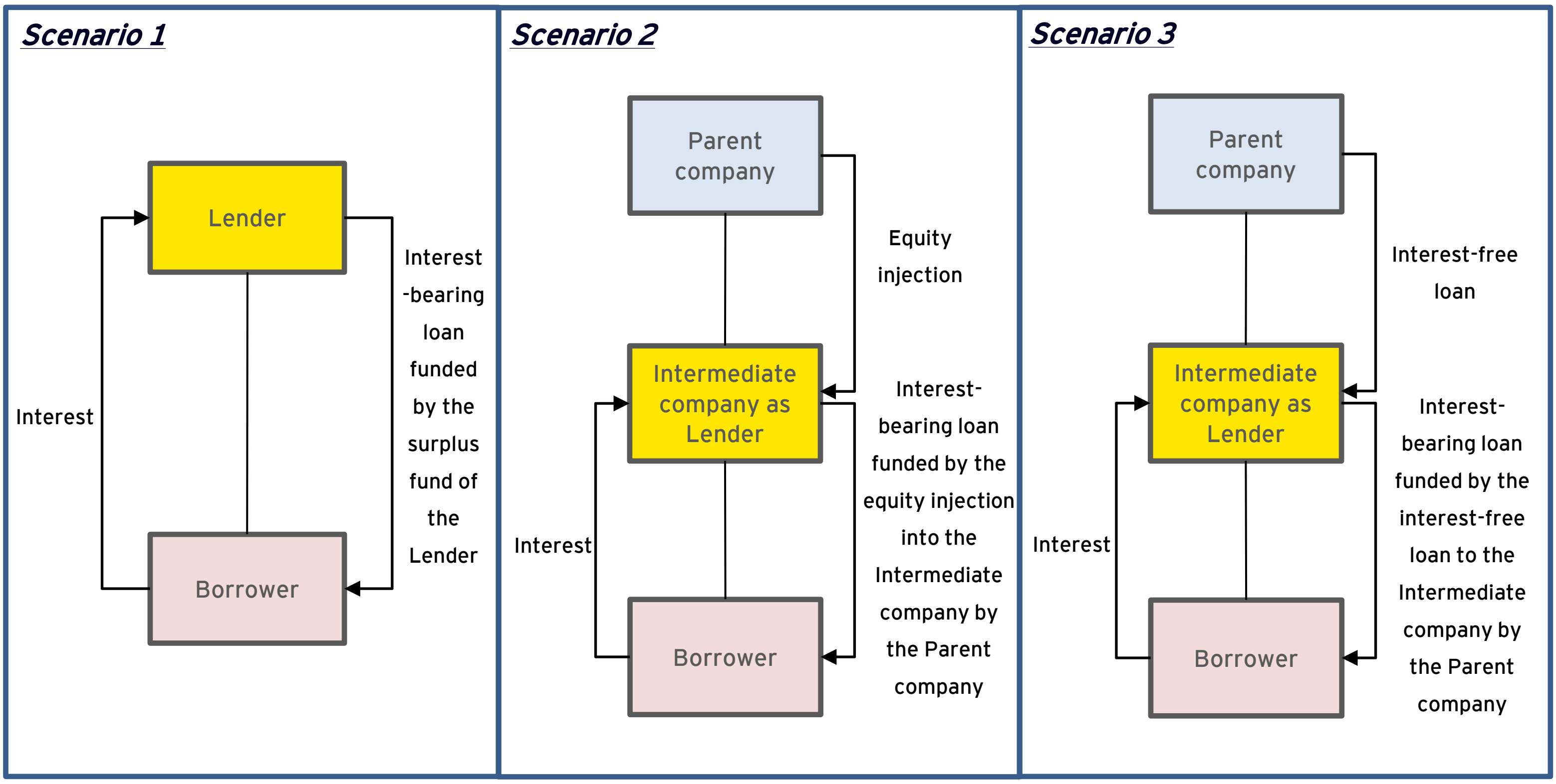
In the recently published minutes of the 2023 annual meeting between the Inland Revenue Department (IRD) and the Hong Kong Institute of Certified Public Accountants, the IRD stated its views on what constituted a "simple loan of money" and a "money-lending" business.

What constituted a "simple loan of money"

Departmental Interpretation and Practice Note No. 13 (DIPN 13) indicates that the source of interest income derived from a "simple loan of money" would be determined by the "provision of credit test". That means where the proceeds of a "simple loan of money" were first made available to the borrower outside Hong Kong, e.g., by crediting the proceeds to an overseas bank account of the borrower, the source of the interest income earned by the lender would be accepted as offshore and, therefore, not taxable in Hong Kong.

In other cases, the source of interest income would generally be determined by the "operation test". Under the "operation test", all relevant factors including how and where (i) the creditworthiness of the borrower was evaluated; (ii) the loan agreements were negotiated, concluded and executed; and (iii) the operations for funding the loan were undertaken would need to be considered in determining the source of the interest income.

In the annual meeting, whether the interest-bearing loans in all the three scenarios diagrammatically depicted below constituted a "simple loan of money" was discussed.



In general, the IRD stated that in a case where a company was not carrying on the business of a financial institution or intra-group financing, the mere lending of its own surplus fund would be accepted as a "simple loan of money". In contrast, where the lending of a company's fund: (a) was made from borrowing; or (b) formed an integral part of its business, the lending would not normally be accepted as a "simple loan of money".

The fact that a loan was one-off did not necessarily mean that it should be a "simple loan of money" or that the "operation test" could not be applied. The IRD took the position that the "operation test" was the default position for determining the source of interest income unless the loan involved was a "simple loan of money. It further emphasized that the "operation test" was not confined to a money lending business where frequent loan transactions were involved. Citing the Privy Council's decision in *Commissioner of Inland Revenue v Orion Caribbean Ltd (in voluntary liquidation) [1997] HKLRD 924*, where money had to be borrowed before it could be lent, the IRD noted that, in such a case, it would be surprising that regard should be had solely to the place of lending, to the exclusion of borrowing.

Applying the above general principles to the three scenarios raised, the IRD indicated that it would accept that the interest-bearing loan in the first scenario would constitute a "simple loan of money" and, therefore, the "provision of credit" test would apply to determine the source of the interest income.

In addition, the IRD would also accept that the interest-bearing loan in the second scenario that was funded by an equity injection into the Intermediate company by the Parent company would also constitute a "simple loan of money". However, this would not be the case if the Parent company needed to raise borrowings for the equity injection.

The IRD however stated that the interest-bearing loan in the third scenario that was funded by an interest-free loan granted by the Parent company to the Intermediate company generally would not be regarded as a "simple loan of money". As such, the "operation test" rather than the "provision of credit test" would apply to determine the source of the interest income.

The IRD indicated that its position on the third scenario would be the same as stated above even if the Parent company funded the interest-free loan to the Intermediate company by way of its own surplus fund. This was because the analysis of what constituted a "simple loan of money" had to be made based on the facts of the taxpayer themselves rather than in a group context.

On the taxpayer's level, the interest-bearing loan in the third scenario was not funded by the surplus fund of the Intermediate company but by an interest-free loan from the Parent company. Thus, the interest-bearing loan granted by the Intermediate company to the Borrower generally would not be regarded as a "simple loan of money". This would be the case regardless of whether the Parent company funded the interest-free loan to the Intermediate company from its own surplus fund or not.

The IRD added that, in the final analysis, whether a loan constituted a "simple loan of money" was a question of fact to be determined by the totality of the circumstances of each case.

In this regard, the IRD seemed to indicate that whether the interest-free loan in the third scenario could be regarded as a quasi-equity injection of the Parent company into the Intermediate company would depend on overall factual circumstances, including whether there were no repayment terms of the interest-free loan. If such a quasi-equity injection case could be established, it appears that, similar to the second scenario, the "provision of credit test" may be applied to determine the source of the interest income of the Intermediate company.

An "intra-group financing" business versus a "money-lending" business

The IRD noted that an "intra-group financing" business and a "money-lending" business may share many common features, e.g., frequency, regularity, and systemic operations in borrowing and lending to earn an interest spread. Nonetheless, generally an "intra-group financing" business would not constitute a "money-lending" business, given that the former would not be willing to lend to "all and sundry".

The IRD added that the "all and sundry" requirement for a "money-lending" business as established in the case *Lichfield v Dreyfus [1906] 1 KB 584* at page 589 meant that a "money-lending" business must be willing to lend to "all and sundry" provided that they were, from its point of view", eligible as a borrower.

EY observation

The IRD's view that where the Parent company (i) needed to raise borrowings for the equity injection into the Intermediate company or (ii) granted an interest-free shareholder's loan to the Intermediate company in the second and third scenarios respectively, would generally render the loan granted by the Intermediate company to the borrower as not a "simple loan of money" may be controversial.

Nonetheless, to ensure that the "provision of credit test" would apply, it would be prudent for a parent company to make an equity injection into an intermediate company, instead of an interest free loan, in situations similar to the third scenario.

The IRD's view that an "intra-group financing" business would not generally constitute a "money-lending" business would mean that it would be unlikely that an unrecoverable loan lent by an "intra-group financing" business could be claimed for tax deduction as a bad debt under section 16(1)(d) of the IRO[1].

Determining the source of interest income and whether a bad debt expense can be claimed could be complicated in certain situations. Clients who have any questions on the issues discussed above should contact their tax executives.

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[1] Section 16(1)(d) of the IRO provides that an unrecoverable loan can be claimed for tax deduction as a bad debt subject to one of the conditions that the loan is "… in respect of money lent, in the ordinary course of the business of the lending of money within Hong Kong, by a person who carries on that business…"

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