

Hong Kong Tax Alert

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Court rules on nature, source and accrual of profit-linked shareholder loan interest¹

- The shareholder loan was provided under a broad Investment Agreement under which the taxpayer was admitted as a joint venture partner in a property project in Shanghai, with the taxpayer also having certain other roles and obligations in the project. These included the taxpayer agreeing that its joint venture partner remained the “public face” of the project and accepting restrictions on holding direct interests in the project.
- In the factual matrix of the case, the taxpayer argued that the shareholder loan, structured only to comply with the above constraints, was in substance its equity contribution to the project and therefore the sums accrued in its accounts were not interest, but non-taxable offshore investment returns akin to dividends.
- The taxpayer argued that even if the sums were interest, they were offshore on the grounds that the Investment Agreement was negotiated and executed, and the project was located, outside Hong Kong.
- The taxpayer also argued that the sums had not accrued to it for the purposes of sections 14 and 15(1)(f) of the Inland Revenue Ordinance (IRO) and therefore non-taxable.
- The Court of First Instance held it could not ignore the clear contractual terms of the Investment Agreement stating that the sums received were in the nature of interest. It upheld the Board of Review’s finding that the profit-producing activity that earned the taxpayer the sums was the advancement of the shareholder loan in Hong Kong and the sums were thus sourced in Hong Kong.
- The Court also held that the fact that the taxpayer did not have an immediate enforceable right to the sums did not prevent them from having accrued.

Thus, the Court upheld the decision of the Board and dismissed the taxpayer’s case.

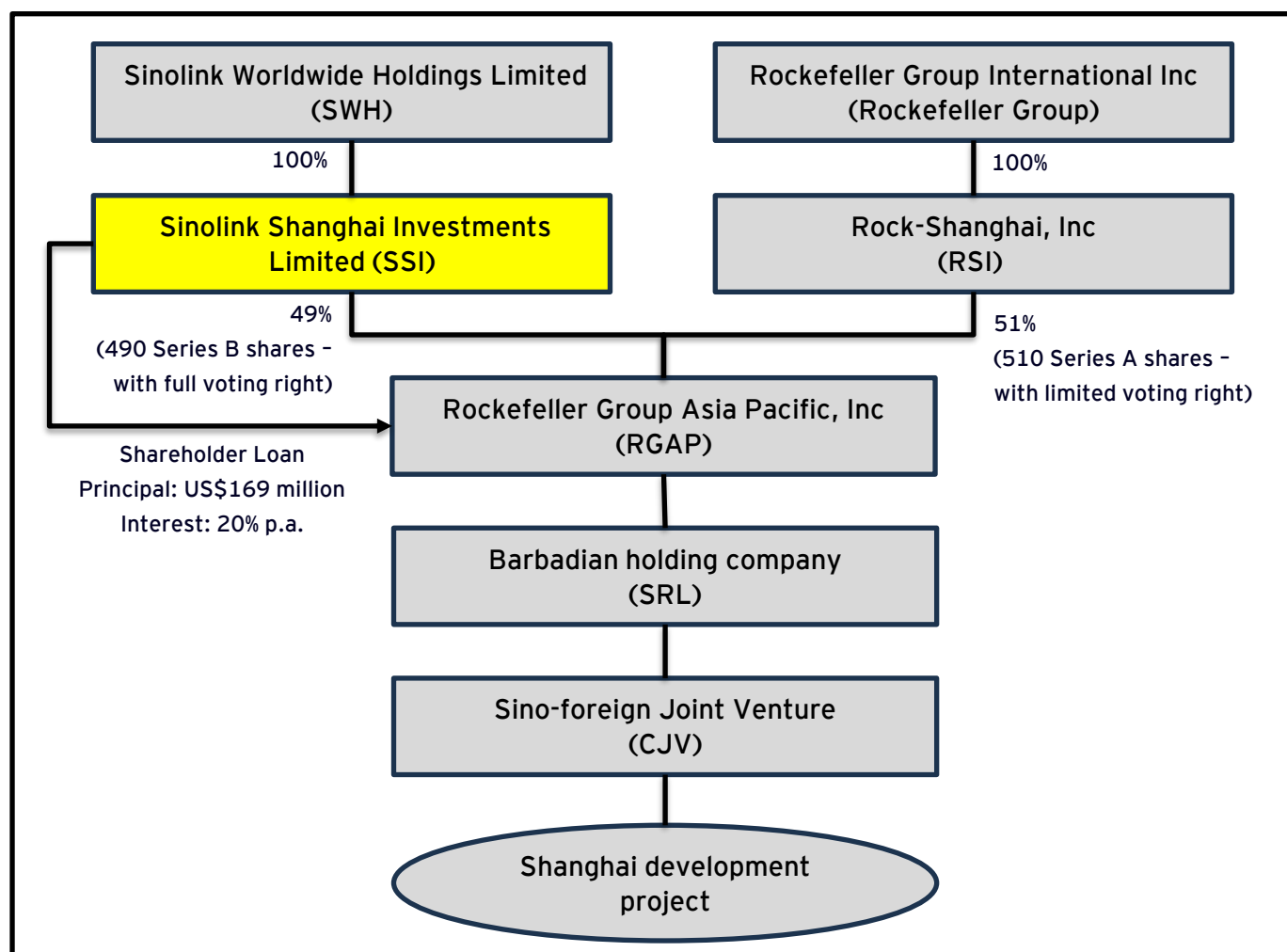
If this case is allowed to be further appealed, one of the issues to be contended could be whether the taxpayer had a vested right to the sums during the relevant period, such that they had accrued and become taxable under sections 14 and 15(1)(f) of the IRO.

The issues considered in this case, including substance versus form in the factual matrix of a case and the meaning of income that “accrues”, are complex. Clients dealing with any of these issues should consult their tax executive where appropriate.

¹ The judgment can be accessed via the link below:
https://legalref.judiciary.hk/lrs/common/ju/ju_frame.jsp?DIS=183312&currpage=T

Background

Sinolink Shanghai Investments Limited (SSI) was a wholly owned subsidiary of Sinolink Worldwide Holdings Limited (SWH), a company listed in Hong Kong. SSI invested in a Shanghai redevelopment project (the Project) through a contractual structure involving several parties, including Rockefeller Group International Inc (Rockefeller Group), Rock-Shanghai, Inc (RSI), Rockefeller Group Asia Pacific, Inc (RGAP) and a Sino-foreign joint venture (CJV) directly held by a Barbadian company, SRL. The Project involved the redevelopment of land in Shanghai's Huangpu District into a mixed-use precinct. The investment structure of the Project is shown in the diagram below.



Under the Investment Agreement dated 30 November 2005, SSI subscribed for Series B shares in RGAP and agreed to provide shareholder loans (the Shareholder Loan) of up to US\$169 million. The Shareholder Loan was stated to bear simple interest at 20% per annum payable on the Series B Funding Amount and in arrears. Payment of the accrued interest and repayment of the principal of the Shareholder Loan were contractually tied to project realization milestones, sales proceeds from completed property units, and net cash flow availability at the CJV level in Shanghai.

SSI's profits and loss accounts described the relevant income (the Sums) as "Shareholder Loan Interest Income" or "Interest Income". In its profits tax returns for the years 2006/07 to 2009/10 and 2012/13, however, SSI contended that the Sums should be treated in substance as a return on investment from a Chinese mainland project, rather than interest income. The Inland Revenue Department disagreed and assessed the Sums as Hong Kong-sourced interest income under sections 15(1)(f) and 14 of the IRO.

Issues before the Court

The appeal concerned four agreed issues originally determined by the Board:

1. Whether SSI carried on a trade, profession or business in Hong Kong during the relevant years.
2. Whether the Sums accrued to SSI by way of interest under section 15(1)(f) of the IRO.
3. Whether the geographical source of the Sums was Hong Kong for the purposes of section 15(1)(f).
4. Whether the geographical source of the Sums was Hong Kong for the purposes of section 14.

The Board had answered all four issues in the affirmative. The Court upheld the Board's conclusions and dismissed SSI's appeal.

Court's decision

SSI carried on business in Hong Kong

SSI argued that, under the Investment Agreement, it had a single composite business carried on in the Chinese mainland – namely, participating in the multi-faceted Project and its underlying transactions. The core transactions included the acquisition of land titles, securing necessary town planning and development permits, demolition of existing structures, engaging contractors, supervising construction, and marketing completed units. Thus, SSI contended that the Board's error stemmed from incorrectly isolating one aspect of this single composite business – specifically, the financing of the Project which was only an incident or antecedent transaction. SSI therefore argued that the effective cause of its contingent entitlement to be paid the Sums was the development of the Project into saleable or lettable units. Once sold or let, these units would generate gains or profits enabling RGAP to make distributions through which the Sums would be paid. The Shareholder Loan was thus not a true loan but in substance SSI's equity contribution; consequently, the Sums were not interest because SSI's entitlement to receive them was contingent upon the Project's post-completion profitability.

The Court rejected this argument, noting that the Project was undertaken by the CJV, and that SSI had received separate project management fees for its role in managing the Project. It held that the Board had correctly distinguished between the different roles of the relevant entities and the distinct roles performed by SSI under the Investment Agreement.

The Court found that SSI carried on a business in Hong Kong by participating in the transactions contemplated under the Investment Agreement – namely, subscribing for Series B shares and providing the Shareholder Loan. The Court emphasized that the focus should be on SSI's own activities, rather than the activities of other entities involved in the Project under the broader Investment Agreement.

The shareholder loan was not recharacterized as equity

The Project was initially secured by the Rockefeller Group from the Shanghai authorities in 2004, before SSI was admitted as a joint venture partner. Against this background, the Investment Agreement imposed a Branding Requirement and a Shareholding Restriction. Under the Branding Requirement, the Rockefeller Group was to remain the “public face” of the Project, and under the Shareholding Restriction, the Rockefeller Group could not transfer its direct interests in the Project to third parties.

SSI argued that the investment amount contributed to the Project in the form of the Shareholder Loan was merely a label used to comply with the Branding Requirement and the Shareholding Restriction. It was, in substance, an equity contribution to the Project when viewed within the factual matrix of the case, including:

- (i) the absence of loan security and periodic annual interest payments;
- (ii) the fact that interest was contingent upon the Project's post-completion profitability;
- (iii) the alignment of SSI's entitlement proportionately with its relative contribution to the Series B Funding Amount (a defining characteristic of dividend entitlements); and
- (iv) the fact that interest entitlement began to accrue irrespective of how much funding was advanced to RGAP.

The Court rejected this submission. It held that these contextual factors did not displace the clear contractual terms under which SSI agreed to provide funding by way of the Shareholder Loan.

The Court emphasized that tax analysis must respect bona fide legal relationships unless a contractual label fails to reflect the true legal effect of the transaction, or unless there is a sham or an applicable statutory basis for recharacterization. In this case, SSI did not allege that the Investment Agreement was a sham, and the Court considered the loan terms to be clear and unambiguous.

The Sums were interest, not a return on capital

The Court agreed with the Board that the Sums possessed the essential characteristics of interest. The Investment Agreement explicitly provided for simple interest at 20% per annum and gave SSI priority for payment of accrued and unpaid interest prior to the proportional distributions.

The Court rejected SSI's argument that the absence of periodic annual payments, collateral security, or a fixed repayment date prevented the Shareholder Loan from being treated as debt or the Sums from being treated as interest. It also rejected the contention that payment contingencies altered the underlying legal character of the Sums.

Citing the definition of interest established in *Euro Hotel Belgravia Ltd* – as “the return or consideration or compensation for the use of retention by one person of a sum of money, belong to, in a colloquial sense, or owed to another” – the Court held that the Sums bore all the indicia of interest. It concurred with the Board that SSI could not stretch the phrase “irrespective of what amount has actually been advanced” in the Investment Agreement too far, given that SSI began advancing funds to RGAP on 2 December 2005, just two days after the signing of the Investment Agreement.

Accrued interest need not be presently enforceable

In Court, SSI sought to rely on the *Nice Cheer* case to argue that the Sums represented anticipated profits and were therefore not taxable until realized. The Court rejected this reliance, noting that SSI had already conceded during the Board’s hearing that the Sums were not anticipated profits.

In the alternative, SSI argued that the Sums had not “accrued” within the meaning of sections 14 and 15(1)(f) unless and until it possessed a presently enforceable right to payment.

Referring to *Forlee v CIR (No 2) [2022] 6 HKC 47*, the Court clarified that accrual generally concerns the coming into existence of a right or obligation, and an entitlement may accrue even if actual payment is deferred to a future date. In particular, the Court cited the following passage from *Forlee*:

“The natural meaning of a fee which has accrued by a certain date is that it comprises a vested right to a sum which is ascertained, or ascertainable by reference to past events. It includes a right to an ascertained, or ascertainable sum where the payment obligation itself is deferred to a particular date in the future (as was the case with the interest provision in the Facility Agreement). It also extends, in my view, to a sum which will undoubtedly be payable at a future date, but the time for payment of which is uncertain...But a fee cannot be said to have accrued if the existence of the right to payment is contingent upon the occurrence of an uncertain future event, as distinct from the time at which it may be enforced... Accrual is concerned with the vesting of rights, albeit it can include those which are not immediately enforceable.” (Our emphasis)

The Court thus considered that the fact that SSI lacked an immediately enforceable right to payment did not prevent the Sums from having “accrued”.

The source of the interest was Hong Kong

The Court upheld the Board’s finding that the profit-producing activity that earned SSI the Sums was the advancement of the Shareholder Loan in Hong Kong and the Sums were thus sourced in Hong Kong. The Court rejected SSI’s argument that the location of the Project or the execution of the Investment Agreement in Shanghai dictated the geographic source of the income.

The Court also distinguished between the source of the funds used to pay the interest and the source of the interest income itself. Although future profits of the Project may have been the source from which RGAP intended to make payments, that did not mean that the interest income itself was sourced in the place where the Project was located.

Commentary

If this case is permitted to be further appealed, it appears that SSI could potentially argue, based on the passage in *Forlee* quoted above, that it possessed no vested right to the Sums during the relevant period, and therefore, as a matter of law, the Sums had not accrued and were not taxable under sections 14 and 15(1)(f) of the IRO.

This argument could be grounded on the premise that SSI’s entitlement to the Sums was dependent upon an uncertain future event – namely, the eventual profitability of the Project. SSI may contend that the Court only addressed the principle that the absence of an immediately enforceable right to payment does not prevent accrual, without explicitly deciding whether SSI possessed a vested right to the Sums in the first place.

From an accounting perspective, taxpayers should also consider when such profit-linked returns are recognized as income in the accounts, such as whether the financial instrument in the form of the Shareholder Loan in this case is measured at amortized cost or fair value.

The issues considered in this case, including substance versus form in the factual matrix of a case and the meaning of income that “accrues”, are complex. Clients dealing with any of these issues should contact their tax executive, where necessary.

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