(h) Taxation of interest from cash pooling arrangements

The Institute would like to seek the IRD's clarification on the determination of the source of interest income arising from cash pooling arrangements. Under a cash pooling arrangement, generally, group entities remit their excess cash into a centralised pool which is managed by a designated group entity (usually the group treasurer entity). The cash pool arrangement is made in order to (i) better manage excess cash; and (ii) derive interest income at a preferential rate. Since the cash pool arrangement is no different from a "simple loan arrangement", the "provision of credit" test has been adopted in determining the source of interest income arising from the cash pooling arrangement. However, practitioners have recently come across cases where assessors sought to assess interest income arising from cash pooling arrangements on the basis that:

- the excess funds have arisen from the taxpayer's Hong Kong-sourced trading transactions; and/or
- the taxpayers are not required to do anything outside Hong Kong and, therefore, adopting the "operation test" the interest income should be Hong Kong sourced.

In this respect, the Institute would like to seek the IRD's clarification on its assessing practice for interest income arising from cash pooling arrangements; specifically, whether the "provision of credit test" or "operation test" should be used in determining the source of the interest income.

Mrs Chu advised that in general, the "provision of credit test" was applicable to a company other than a financial institution where mere lending of the company's own surplus funds was involved. For cases other than simple loan arrangement, like the one in *Orion Caribbean Limited v CIR* (4 HKTC 432), the proper test to determine the source of interest income was the "operation test", i.e. "one looks to see what the taxpayer has done to earn the profit in question and where he has done it". This assessing practice would not be altered on the determination of the source of interest income arising from cash pooling arrangements.

Mrs Chu further explained that whether the provision of a loan constituted a simple loan arrangement was a question of fact. In the case of individual companies within the group, it was likely that the "provision of credit test" would apply to the interest income derived by them from the passive lending of their surplus funds. But for the treasurer company of the group, it was not uncommon that more active management of the excess funds of the group was involved and if so, regard would be had to the operations of the company to determine the source of the interest income.

The Institute would also like the IRD's views on the cash pooling arrangement of a company with branches in different jurisdictions. For example, a company has a branch in Hong Kong and another one in a foreign jurisdiction ("X"). Each of the branches of the company has an account in USD with the respective local branches (i.e. in Hong Kong and X) of a bank. It is agreed between the bank and the company that in computing the interest payable/ receivable by the bank, the bank would net off the balances of both bank accounts standing at the end of each interest period and

charge interest at market rate if the balance is a debit (i.e. due from the company) or credit interest if the balance is a credit (i.e. due to the company). If it is an income, it would be credited to the account with a debit balance. If it is a charge, it would be debited to the account with a credit balance.

In relation to this, the Institute would like to ask the following questions:

(i) Would the IRD assess and allow the interest income and expense of the Hong Kong branch from the aforesaid arrangement?

Mrs Chu advised that the Hong Kong branch of a company (other than a financial institution) was exempt from payment of profits tax on the interest income derived from the bank, subject to section 2(2) of the Exemption from Profits Tax (Interest Income) Order 1998. On the other hand, interest expenses incurred by the Hong Kong branch from the arrangement would be deductible if sections 16 and 17 of the IRO were satisfied. The IRD's views and practices relating to the deductibility of interest expenses as specified under sections 16(2), 16(2A) to 16(2C) of the IRO were summarized in DIPN No. 13A.

(ii) If yes, how much of the interest income and expense would be assessed and allowed? Would it be the amount credited/ charged by the bank or computed otherwise?

Mrs Chu advised that the amount of interest income to be assessed, subject to the Exemption from Profits Tax (Interest Income) Order 1998, was that accrued to the Hong Kong branch and derived from Hong Kong. The amount of interest expense to be allowed is that incurred by the Hong Kong branch where the requirements of sections 16 and 17 of the IRO were satisfied.

(iii) How does IRD consider the BNP case law, which is not applied in practice, impacts on the aforesaid arrangement?

Mrs Chu explained that it was incorrect to say that the *BNP* case (2 HKTC 139) was not applied in practice. The case concerned the deduction claim of "interest expense" charged by the head office of BNP, a multi-national bank, to its Hong Kong branch on the latter's retention of its own profits. The facts in that case were quite peculiar where there was no actual lending at all. It was held that no interest was incurred by the bank. The judgment in *BNP* would apply to cases which have similar facts.

Mrs Chu said in contrast to the *BNP* case, under the cash pooling arrangement as described, it was the company (not a branch) which would derive interest income from or pay interest expense to the bank, a third party. As the facts were entirely different and not comparable, the IRD considered that the *BNP* case would not have any direct impact on the taxation of the cash pooling arrangement.