Hong Kong Tax Alert

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New legislation passed to allow taxpayers to align the tax treatment of financial instruments with their fair value accounting treatment under HKFRS 9

Commencing from the year of assessment 2018/19, subject to certain exceptions, taxpayers who prepare their accounts in accordance with HKFRS 9, or its equivalent, can elect to be assessed for tax purposes based on the profits and losses as reflected in such accounts. In other words, upon election, the accounting profits or losses so recognized, regardless of whether they are realized or unrealized, would generally be taxable or deductible as the case may be, provided the amounts are revenue and onshore in nature.

This alert discusses some of the clarifications the Government provided in respect of certain provisions of the new law during the legislative process.

Notwithstanding the clarifications, many of the provisions of the new law are complicated. Where necessary, clients should seek professional advice on the tax implications of electing to be taxed on the basis of fair value accounting under the new law.

The new law

After one minor amendment, the bill for the new legislation passed its third reading in the Legislative Council and is expected to formally become law (the new law) on Friday 1 March 2019 when it is gazetted.

Many financial instruments are required to be accounted for on a fair value basis under Hong Kong Financial Reporting Standard No. 9 (HKFRS 9). Such a basis of accounting involves recognizing profits or losses in respect of financial instruments which is then regarded as unrealized or anticipated for tax purposes.

In November 2013, the Court of Final Appeal held in the case of *Nice Cheer*[1] that such unrealized profits or losses should not be taxable or deductible. As such, taxpayers who prepare their accounts under HKFRS 9 will need to make tax adjustments to their accounts when they file their tax returns.

Despite the decision in *Nice Cheer*, many taxpayers have expressed a desire to file their tax returns on a fair value basis. In so doing, these taxpayers hope to avoid the trouble of tracking transactions on a realization basis for tax reporting purposes.

In response to requests made by such taxpayers, as an interim administrative measure, the Inland Revenue Department has since 2013/14 accepted tax returns in which taxpayers have chosen to file on a fair value basis.

To provide more clarity and certainty, the new law has now been passed to codify the interim administrative measure into the Inland Revenue Ordinance (IRO).

Only one minor amendment was made to the original bill

Apart from a minor Committee Stage Amendment (CSA) to the legislative bill, the bill in its original form was passed into the new law without any further amendments.

Under the original bill, only accounts prepared under HKFRS 9, or its equivalent under the International Financial Reporting Standards, i.e., IFRS 9, fell within the scope of the new law. The effect of the CSA is that it extends the scope of the new law to cover accounts which, in the opinion of the Commissioner of Inland Revenue, are prepared under the local equivalent to IFRS 9 in a foreign jurisdiction.

As such, clients may also refer to our previous Hong Kong Tax alert – 15 November 2018 (2018 Issue No. 15) in which we discussed the provisions of the original bill in detail.

This alert will focus on the some of the clarifications the Government provided in respect of certain provisions of the new law during the legislative process.

[1] *Nice Cheer Investment Limited v CIR* FACV 23/2012

Clarification of certain provisions of the new law

During the legislative process of the new law, several professional bodies and business organizations made submissions to the Bills Committee that was formed by the Legislative Council to scrutinize the bill.

Some of the concerns raised in these submissions, and the Government's response to the same are discussed below.

Interaction between sections 18K(3)-(5) and section 16(1)(d)

Sections 18K(3)-(5) of the IRO introduced by the new law specify that an impairment loss in the form of expected credit loss (ECL) recognized under HKFRS 9, both in respect of loans made in the ordinary course of a money-lending business in Hong Kong and trade receivables (previously included as a trading receipt), would be deductible provided that the financial assets concerned are credit-impaired.

Impairment loss of such a financial asset in the form of ECL is essentially a bad debt provision, the deductibility of which is also governed by the existing provisions contained in section 16(1)(d) of the IRO.

As such, some of the submissions requested the Government to clarify how the new provisions as contained in sections 18K(3)-(5) would interact with the existing provisions contained in section 16(1)(d) of the IRO.

In response, the Government indicated that sections 18K(3)-(5) are standalone provisions not subject to the conditions stated in section 16(1)(d) of the IRO. Nonetheless, the Government also indicated that when such a financial asset is considered as credit-impaired under HKFRS 9, the ECL so recognized and deductible under sections 18K(3)-(5) would in any case most likely also qualify for a tax deduction under section 16(1)(d).

Deduction of credit-impaired ECL in respect of financial instruments acquired for trading purposes

Financial instruments e.g., bonds acquired in the secondary market for trading purposes are not necessarily regarded as being loans made in the ordinary course of a money-lending business in Hong Kong. Nor can such financial instruments be regarded as trade receivables previously included as a trading receipt.

As such, several submissions expressed the concern that under the terms of sections 18K(3)-(5) as noted above, credit-impaired ECLs in respect of such financial instruments which are valued at amortized cost, or at fair value through other comprehensive income (FVOCI) under HKFRS 9, would not be tax deductible before the instruments are sold or realized at a loss.

The Government responded that credit-impaired ECLs in respect of financial instruments valued at amortized cost or FVOCI would be tax deductible provided that the assessor is satisfied that the relevant financial instruments were acquired for trading purposes.

In giving such a response, the Government apparently considers that taxpayers who acquire financial instruments in the aforesaid circumstances in the secondary market for trading purposes, can also in a sense be regarded as making loans in the ordinary course of a money-lending business in Hong Kong. As such, the relevant conditions as specified in sections 18K(3)-(5) would be considered as having satisfied.

Transfer of a credit-impaired loan not made by way of a sale in the ordinary course of business

Sections 18K(6)-(8) specify the tax treatment for situations where a credit-impaired loan of a financial institution, together with a related loss allowance for ECL, is transferred not by way of a sale in the ordinary course of the business of the transferor, and a tax deduction was previously allowed to the transferor in respect of the ECL.

These provisions specify that (i) where on the date of such a transfer, both the transferor and the transferee are in the business of lending money in Hong Kong, the deduction previously allowed to the transferor is treated as having been allowed to the transferee (thereby any subsequent recovery of the ECL by the transferee would explicitly be taxable); and (ii) in any other cases, the amount previously allowed as a deduction is deemed to be a trading receipt of the transferor (thereby the deduction previously allowed to the transferor is clawed back).

A number of submissions sought clarification from the Government of the rationale behind the clawing back of the tax deductions for ECLs previously granted to the transferor in the situation envisaged in point (ii) above.

In response, the Government clarified that sections 18K(6)-(8) would not apply where a credit-impaired loan is sold. This is because in such a situation the loan is normally not transferred together with a loss allowance for the ECL in respect of the loan.

Instead, sections 18K(6)-(8) would primarily only apply to a merger situation where under merger accounting a credit-impaired loan would be transferred to the merged entity together with a loss allowance for the ECL in respect of the loan.

In such a situation, the Government considers that it would be justified to claw back the tax deductions previously granted to the transferor because any subsequent recovery of the ECL in the accounts of the merged entity would generally not be taxable in Hong Kong.

Notwithstanding the above clarifications, many of the provisions of the new law are complicated. Where necessary, clients should seek professional advice on the tax implications of making an election to be taxed on the basis of fair value accounting under the new law.

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