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Hong Kong Tax Newsflash: Taxation of Financial Instruments under IFRS / HKFRS 9

Introduction

On 2 November 2018, Inland Revenue Amendment (No. 7) Bill 2018 ("the Bill") was gazetted. The Bill contains draft rules covering a number of areas, including: the taxation of financial instruments under new International and Hong Kong Financial Reporting Standard 9 ("IFRS 9" or "HKFRS 9"), a change in interest expense deductibility rules relating to export financing and changes regarding the automatic exchange of financial account information. This newsflash summarizes the key components of the draft rules relating to the taxation of financial instruments under IFRS 9 / HKFRS 9.

IFRS 9 / HKFRS 9 is effective for accounting periods starting 1 January 2018 and replace IAS 39 / HKAS 39[1] as the relevant accounting standard for financial instruments. However, there are significant differences between the two standards, and to understand the draft rules in the Bill, it is important to understand that:

- A larger proportion of financial instruments will be measured on a fair value through profit and loss (FVTPL) basis. As a result, changes in the fair value of financial instruments, which may have been measured on an amortized cost basis in the past, will now be included in the profit and loss (P&L) account, leading to an increased visibility of unrealized value changes to the Inland Revenue Department (IRD).

- Certain loans and equity instruments, in limited circumstances, may be accounted for on a fair value through other comprehensive income (FVTOCI) basis, meaning changes in fair value for those instruments will not be recognized in the P&L account.

- Expected credit losses will be recognized on a weighted probability basis from the time financial instruments are first recorded. There are three methods for recognizing such credit losses. The method corresponding to the most significant credit losses uses a newly defined "credit-impaired" term, which is specifically referenced by the draft rules as being necessary to claim an impairment deduction.

The draft tax rules

The draft tax rules would operate on an election basis, with a taxpayer making an election to apply the rules, which may then be revoked only with the approval of the IRD. Based on the draft transition rules, an election may be made for basis periods beginning on or after 1 January 2018, so that the rules should be introduced in time to cover the first IFRS 9 / HKFRS 9 applicable accounting period in Hong Kong.

The draft rules generally aim to achieve several objectives:

Alignment of tax and accounting rules – In 2013, the Court of Final Appeal issued its decision in *Nice Cheer Investment Limited v CIR*, concluding that unrealized fair value gains on shares held on trading account were not taxable. Many taxpayers that preferred the administrative convenience of subjecting all unrealized and realized gains to tax based on the accounts have been able to do so only based on an administrative concession provided by the IRD.[2] The administrative concession was an interim measure and while it functioned well for Hong Kong profits tax purposes, it required an annual refresh to provide certainty to taxpayers and separately may have given rise to foreign tax credit issues regarding the voluntary payment of tax.[3] The draft tax rules specifically state that, for computational purposes, amounts recognized in the P&L account under IFRS 9 / HKFRS 9 are the amounts that would be chargeable to tax. There are exceptions to this in a number of scenarios, including certain equity derivatives, preference shares, hedges in respect of capital items and off-market loans.

The draft rules also contain a “catch up” provision that would bring any profit, gain, loss, income or expense that has not previously been taxed within the charge to tax. This provision could apply, for example, where a taxpayer previously chose not to tax unrealized fair value gains, but then elected to adopt the draft rules. The provision should apply to bring unrealized gains into the charge to tax. Further consideration should be given to this catch up provision and how it would apply to past periods where IFRS 9 / HKFRS 9 was not adopted.

Ensuring that FVTOCI movements do not escape tax – Under IFRS 9 / HKFRS 9, certain loans, receivables and equity instruments can be accounted for on a FVTOCI basis, such that associated gains and losses are not recognized in the P&L account. Where such financial instruments are held on capital account, the draft tax rules would not apply. However, where the financial instruments are held on revenue account, all P&L recognized under the FVTOCI method would be chargeable to tax. This should reduce uncertainty that may have arisen where gains / losses were only recognized on a FVTOCI basis, but were not recognized in the P&L account. Whereby, some taxpayers may have argued that gains and losses only recorded on a FVTOCI basis should not be taxable or deductible.

Controlling expected credit losses – Following the global financial crisis in 2007, the impairment methodology in IAS 39 was criticized as being too slow to recognize impairments, meaning that losses were not recognized in the accounts of financial institutions and companies until it was too late for investors to understand what was happening. This concern has been addressed in IFRS 9 / HKFRS 9 through the use of an expected credit loss methodology which seeks to immediately recognize impairments for the risk of non-payment through a weighted probability methodology. The use of this methodology essentially means that all financial instruments will suffer some form of impairment to reflect the risk of non-payment. However, importantly, under IFRS 9 / HKFRS 9, the term "credit-impaired financial asset" is defined and creates a relatively high threshold for impairment[4]. Under the draft tax rules, only impairments arising in respect of financial assets which meet the definition of "credit-impaired" will be deductible, meaning that the majority of initial expected credit loss impairments under IFRS 9 / HKFRS 9, are unlikely to be deductible.

The draft tax rules, once introduced, will provide a degree of additional certainty to taxpayers with regard to how they tax financial instruments and in many cases will align the Inland Revenue Ordinance (CAP. 112) (IRO) with taxpayer practice. Accordingly, the rules may be considered to be of more technical interest than practical effect. As the draft rules explicitly import amounts for computational purposes directly from the accounts and in doing so, it has been necessary for the draft rules to limit the effect of certain other existing provisions, which would otherwise require amounts to be realized or incurred. These provisions will need to be interpreted appropriately to ensure for example, that entire provisions (such as section 14 of the IRO) are not disregarded, which could impact Hong Kong's source concept. Although, we anticipate these issues will be further discussed as the Draft Bill works its way through the Legislative Council.

Reference:

[1] International Accounting Standard / Hong Kong Accounting Standard 39

[2] https://www.ird.gov.hk/eng/tax/bus_fva.htm

[3] Tax Analysis *(Issue H72/2017)*

[4] A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred.
Hong Kong Financial Reporting Standard 9 (2014)

consult their tax advisors before acting on any information contained in this newsletter.

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