

HONG KONG TAX ALERT

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Tax implications of recent accounting changes – HKFRS 9, 15 and 16

Summary

There have been various accounting changes (in particular, HKFRS 9, 15 and 16) which have significant tax implications for how businesses need to account for certain items, and hence how these items will be taxed.

Companies and especially financial institutions need to review the impact of these accounting changes to ensure that adjustments are carefully accounted for in order to avoid double counting of taxes and/or deductions.

In recent years, there have been various accounting changes which have significant tax implications on how certain items are accounted for and potentially taxed. The main changes are: (i) HKFRS 9 (Financial Instruments); (ii) HKFRS 15 (Revenue from Contracts with Customers); and (iii) IFRS 16 (Leases).

HKFRS 9 – Financial Instruments

HKFRS 9 applies to annual periods beginning on or after 1 January 2018, with earlier adoption permitted. HKFRS 9 makes changes to the:

- classification and measurement of financial assets and financial liabilities
- determination of impairment losses for financial instruments.

From a tax perspective, the tax treatment of financial assets and financial liabilities generally follows their accounting treatment.

However, whether financial instruments are capital or revenue in nature (and thus whether gains or losses arising from the financial instruments are assessable or deductible for tax purposes and whether such gains or losses are onshore or offshore sourced will still depend on the facts and circumstances of each case.

HKFRS 9 could result in timing differences between the accounting and taxation treatment of financial assets / liabilities. More importantly, tax deductibility issues on expected credit losses could lead to increased tax compliance and operational costs. While the adoption of HKFRS 9 is not limited to financial institutions, its impact will be most significant to financial

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institutions given the volume and types of financial instruments that they transact.

For expected credit losses, HKFRS 9 also prescribes new rules for calculating impairment losses. It employs a three-staged approach to determine the quantum of impairment losses. Based on current law and practice, financial instruments should only be regarded as credit-impaired in stage 3, at which stage the impairment would likely qualify for a bad debt deduction under section 16(1)(d) of the Inland Revenue Ordinance ("IRO"). There are a number of considerations that would need to be taken into consideration in determining whether a loss is impaired and thus tax deductible.

Ideally, there should be some legislative revision to ensure Hong Kong remains competitive with the likes of Singapore and the UK in respect of the tax deductibility of such losses.

HKFRS 9 also makes changes to hedge accounting rules and align the accounting treatment more closely with risk management.

HKFRS 15 - Revenue from Contracts with Customers

HKFRS 15 applies to annual periods beginning on or after 1 January 2018 (with earlier adoption permitted). Under HKFRS 15, an entity must recognise revenue from providing goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in return.

Depending on whether certain criteria are met, revenue is recognised either over time, in a manner that best reflects the company's performance obligations, or at the particular point in time when control of the goods or services is transferred to the customer.

A five step model applies to determine when to recognise revenue, and in what amount. The core principles are that entities should recognise revenue to depict the transfer of promised goods or services to customers, and the amount of revenue recognised should reflect the consideration to which they expect to become entitled in exchange for those goods or services:

- Step 1: Identify the contract with the customer
- Step 2: Identify the performance obligations in the contract
- Step 3: Determine the transaction price
- Step 4: Allocate the transaction price to the performance obligations in the contract
- Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation

From a tax perspective, generally, revenue is earned when the profit is realised. Given the judgements and estimations required to be made, particularly for variable considerations, it is likely there could be a mismatch between the timing and classification of revenue and expenses for tax and accounting purposes.

HKFRS 16 – Leases

HKFRS 16 applies to annual periods beginning on or after 1 January 2019, but earlier adoption is permitted for entities under certain conditions. HKFRS 16 eliminates the accounting distinction that has been made in the past by lessees between operating leases and finance leases. HKFRS 16 introduces a single lessee accounting model under which all leases will be treated similar to a finance lease under the existing Hong Kong Accounting Standard (HKAS) 17.

Under HKFRS 16, a lessee is required to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. The balance sheet of the lessee will recognise both (i) a right-of-use asset representing its right to use the leased asset, and (ii) a lease liability representing the present value of the future lease payments that the lessee is obliged to pay. Depreciation of the leased asset (i.e., the right-of-use asset) and interest on the lease liability will be charged to the lessee's profit and loss account.

Under the current position, from a tax perspective, IRD has stated that tax deductions for lease payments incurred by a lessee are governed by the ordinary deduction provisions in Sections 16 and 17 of the IRO. As such, if the lease payments are in the nature of rent for the use of the leased asset only, the lessee should be entitled to a tax deduction for the lease payments.

However, if the lease payments are, in substance, consideration for the sale of goods framed as a finance "lease", the relevant lease payments excluding the interest element would be outgoings of a capital nature which are not tax deductible, although they might qualify for tax depreciation allowances.

The IRD considers that the implementation of HKFRS 16 does not change anything and that it will have no effect on the operation of sections 16 and 17 of the IRO. Lease payments incurred by a lessee should therefore continue to be tax deductible.

Ultimately, the legal form and substance of the relevant contractual arrangements for a lease would still have to be ascertained in order to determine the tax treatment of the lease payments concerned, regardless of the single lessee accounting model adopted under HKFRS 16.

The previous accounting model required lessees and lessors to classify their leases as either finance leases or operating leases and account for those two types of leases differently. In particular, it did not require lessees to recognise assets and liabilities arising from operating leases (i.e., "off balance sheet" items). As a result, amounts reported in a lessee's financial statements were adjusted to reflect the assets and liabilities arising from off balance sheet leases.

KPMG observations

While most of these changes will not impact tax filings for 2017/18, companies will need to consider the tax impact for financial reporting during the current year.

The recent accounting changes will have a significant impact on how companies and financial institutions account for certain assets and liabilities. Given the potential mismatch between tax and accounting, these accounting changes could increase compliance and operational costs and create additional administrative burdens for tax reporting and filing.

The changes in the classification and timing of income and expenses could also result in more challenges from the IRD. To avoid this, further guidance and/or legislative changes to provide clarity on the tax treatment would be welcomed. The IRD is not expected to be making any changes to Sections 16 and 17 of the IRO in respect of HKFRS 16. However, we understand that the IRD is in the process of updating its Departmental Interpretation and Practice Notes No. 42 that deals with the taxation of financial instruments and foreign exchange differences to take into account the accounting changes brought by HKFRS 9.

Taxpayers will need to also ensure that any transitional adjustments are carefully accounted for in order to avoid a double counting of taxes and/or deductions arising from the nature and reclassification of income and expense items.

For more information and assistance, please contact your usual tax advisor or one of our tax advisors below.

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