HONG KONG TAX ALERT

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The Inland Revenue Department issues updated guidance on HKFRS 15

Summary

On 18 September 2020, the Inland Revenue Department (IRD) issued an updated guidance Departmental Interpretation & Practice Notes No. 1 ("DIPN 1") on: (a) computing assessable profits; (b) revenue recognition under HKFRS 15 *Revenue from Contracts with Customers*; and (c) measurement of inventories or stock. The updated guidance primarily sets out the IRD's views and assessing practice under HKFRS 15 and contains examples illustrating the accounting and tax treatments of HKFRS 15; and the stock valuation methods for tax purposes. In this alert, we focus on the key changes and updates on HKFRS 15 and summarise the IRD's views on the standard for tax purposes.

Overview

The updated DIPN 1 is a substantial revision to the previous DIPN 1 published in July 2006. The key changes are summarized as follows:

Part A - Computation of assessable profits

The updated DIPN 1 outlines the core principles for computing assessable profits (and adjusted losses, as the case may be) on revenue derived from customer contracts under HKFRS 15. In particular:

- accounting profits that have been determined in accordance with HKFRS 15 would form the starting point for computing assessable profits (or adjusted loss as the case may be). Similarly, a tax deduction is generally allowed for expenses recognised in accordance with generally accepted accounting principles. In most cases, the accounting treatment should align with the tax treatment unless a specific tax treatment has been established through case law or legislation, or where the accounting treatment deviates significantly from the tax principles.
- profits recognized on an accruals basis in accordance with generally accepted accounting principles are normally taken as profits "arisen" or "derived" for the purposes of Section 14 provided that the profit is not anticipated.
- the DIPN refers to the decision established in *Nice Cheer* case where it was ruled that chargeable profits are actual or realized; and neither profits or losses may be anticipated.

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Part B - Revenue Recognition

HKFRS 15 introduces a five-step recognition model for an entity to recognize revenue from contracts with customers. HKFRS 15 replaces a number of standards and interpretations and is effective for periods beginning on or after 1 January 2018, with early adoption permitted. Under HKFRS 15, an entity recognizes revenue when performance obligations of the contract are satisfied either at a point in time or over time. A performance obligation is satisfied when the control of goods or services is transferred to a customer. Revenue recognized under step 5 of the revenue recognition model would be regarded as having been realized and such revenue would be included as assessable profits of the taxpayer.

The potential impact on taxpayers

Businesses with long term contracts will be mostly affected by HKFRS 15. Particularly, revenue from long-term contracts would often be recognized at a later point than under the previous standard. This is because the threshold in recognizing revenue is stricter under HKFRS 15. In the previous DIPN 1, real estate developers would recognize revenue when a contract is regarded as completed when a final certificate is issued by the supervising architect or consulting engineers. However, under HKFRS 15, the revenue recognition for developers from the sale of units in multi-storey residential building could be deferred even later when the developer fully satisfies the performance obligation (i.e., when the customer obtains control of the purchased unit which could be when keys are obtained to purchased units).

In most cases, HKFRS 15 defers the recognition of revenue when performance obligations are fully satisfied and such revenue is realized for accounting and tax purposes. This provides the IRD with a stronger basis to tax realized profits at a time when revenue is recognized when performance obligations are satisfied which we consider to be reasonable.

Variable consideration

Another notable area of concern is when a contract contains variable consideration (such as claims, awards, rebates, etc). Where a consideration is “variable”, HKFRS 15 allows an amount to be recognized when it is *highly probable* that a significant reversal will not occur when the uncertainties relating to that variable are resolved. This means that when estimating variable consideration, HKFRS 15 sets a higher barrier than the previous standard to recognise revenue resulting in the deferral of the recognition of revenue. From a tax perspective, this is particularly welcomed given the absence of loss-carry back provisions under Hong Kong tax law.

However, it is interesting to note in paragraph 9 of the previous DIPN 1, a reference was made to Section 70A:

> “*An assessment for a year raised …. cannot be reopened if a loss on the same contract is subsequently incurred it is considered that section 70A cannot have application in such circumstances as the earlier estimation of profits would have been an exercise of judgement. The loss incurred would have to be set off against other assessable profits of the same year or carried forward to future years. However, where a contract is the only one undertaken by a taxpayer and the taxpayer has ceased business after the completion of the contract, the Department, as a concession, is prepared to re-open earlier years where profits were assessed, if an overall loss situation has eventuated on completion of the contract.*”

The previous DIPN 1 made clear that Section 70A would not apply in a situation where profits were brought to tax in earlier years and a loss was subsequently incurred on the completion of contract. This was on the basis that earlier estimation of profits have been an exercise of judgement and the point of revenue recognition under HKAS 11 *Construction Contracts* was when the outcome of a construction contract could be reliably estimated. However, a concession was available to taxpayers to apply Section 70A where a taxpayer incurred an overall loss on completion of contract provided that the taxpayer ceased business after the completion of contract. In the updated DIPN 1, this concession no longer appears. Although the different recognition criteria reduce the chance of paying tax on a loss-making contract, without the concession there is a risk that tax will fall due before the final profit or loss from a project can be ascertained. Some taxpayers may question how fully this aligns with the principles of Nice Cheer.

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Significant financing component

It is common for long-term construction contracts to include a significant financing component where payments by a customer and performance by a person may occur at different times. Where the timing of payments to a contract provides a significant benefit of financing the transfer of goods or services to the customer, it may indicate that the contract contains a significant financing component and that promised amount of consideration should be adjusted for time value of money.

Under HKFRS 15, notional interest revenue or notional interest expense is recognized as accounting profit or loss to reflect the time value of money associated with the financing. For tax purposes, notional interest expense or revenue will be disallowed or excluded from tax since no actual expense or income has been incurred or derived for Hong Kong tax purposes. These adjustments are ultimately a timing difference. Taxpayers with high volume of transactions containing a significant financing component may find it administratively burdensome as they would be required to maintain separate records and account for the effects of the significant financing component for each contract. This is in contrast to the tax treatment for HKFRS 16 where lessees have been encouraged to follow the accounting treatment (including the discount elements) in bringing lease payments into tax.

Deductible expenses

The updated DIPN 1 provides limited guidance on the tax treatment of expenses under the new standard. The IRD views that deduction of expenses is governed under Sections 16 and 17 of the Inland Revenue Ordinance (IRO). The old standard provided a broader range of pre-contract costs to be capitalized when it was probable that the contract would be obtained. However, HKFRS 15 generally allows incidental costs of obtaining a contract and fulfillment costs to be capitalized over the course of the contract when they are expected to be recovered. For tax purposes, tax deduction of such costs would follow the amortization treatment in HKFRS 15. Given HKFRS 15 is more restrictive in what costs are allowed to be capitalized, it would be reasonable to treat expenses recognized in the profit and loss account to be deductible for tax purposes unless denied under Section 17 of the IRO.

In some cases, it may be difficult to determine whether a taxpayer has provided a price concession (recognized as a variable consideration under HKFRS 15) or whether the taxpayer has chosen to accept the risk of the customer defaulting on the agreed consideration (which may result in a recognition of a bad debt expense). As such, management will need to exercise appropriate judgment in distinguishing between price concessions and customer’s credit risk as it would affect the accounting and tax treatment for the transaction (i.e., reflected as a reduction in revenue under Section 14 of the IRO or expensed as a bad debt under Section 16(1)(d) of the IRO).

Part C - Measurement of stock or inventories

The updated DIPN 1 contains minor changes to this section. The IRD still prescribes that the accepted basis for stock valuation under HKAS 2 *Inventories* is the lower of cost and net realizable value. This should mean that provided the valuation method is acceptable, reductions in stock value should generally be deductible. For tax purposes, there are two specific provisions on the valuation of stock which requires tax adjustments, namely:

a. Section 15C of the IRO which deals with cessation of business; and

b. Section 15BA of the IRO which provides for the valuation of trading stock upon appropriation for non-trade purposes or disposed of other than in the course of trade.

The key update is the inclusion of Section 15BA to codify the market value principle as established in *Sharkey v Wernher* case. Section 15BA was enacted under the Inland Revenue (Amendment) (No.6) Ordinance 2018 and is effective from the year of assessment commencing on or after 1 April 2018. Section 15BA requires that tax adjustments must be brought into account to reflect the market value of a stock when stock is appropriated for non-trade purposes or disposed of other than in the course of trade.

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KPMG Observations

The updated guidance is welcomed as it provides some clarity to taxpayers of when revenue is recognized and brought into account for accounting and tax purposes under HKFRS 15. However, the scenarios provided in the guidance are limited and based on specific facts and circumstances.

The adoption of HKFRS 15 is likely to lead to significant changes in the timing pattern of revenue recognition for some taxpayers. The previous standards, in particular: (i) HKAS 11 *Construction Contracts* made clear that the standard did not adopt the realization method or the completion method when accounting for revenue and recognized profits only when a contract is completed; and (ii) HKAS 18 *Revenue* required property developers to recognize profits at the time when the risks and rewards of ownership of properties have been transferred (i.e., upon completion of a building). HKFRS 15 essentially replaces the concept of transfer of 'risks and rewards' with 'control' and the introduction of performance obligations and the overall the impact of HKFRS 15 on most taxpayers is generally a deferral of revenue recognition until performance obligations are met.

Given HKFRS 15 has tightened up the revenue recognition policy, the IRD considers they can tax profits as realized when performance obligations are satisfied. This represents a change from the position under the old accounting standards and previous DIPN when they considered the profits would be unrealized. Although this in general will push the timing of revenue recognition back, it may result in some cases in the timing of tax payments being brought forward. Taxpayers should therefore consider discussing with their accounting and tax advisors, at an early stage, of any complex arrangements with customers to assess whether changes to the terms of contracts should be made (especially those with long term contracts, variable consideration and significant financing adjustments) as this may impact the timing of revenue recognition and when profits are taxed. Taxpayers should also assess whether their accounting systems and internal control procedures adequately support the tax and accounting requirements under the accounting standards. For further details, please speak to your usual accounting and tax advisors.

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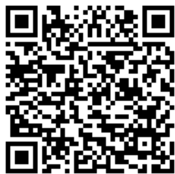

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