Hong Kong (SAR) Tax Alert

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Accounting and tax treatments of provision for long service payments after the abolition of the offsetting mechanism

Summary

The Inland Revenue Department (IRD) recently set out it's views on how various items linked to long service payments provision, recognised in financial accounts, should be treated for Hong Kong's profit taxes. This guidance comes following Hong Kong's abolition of the offsetting mechanism between the Mandatory Provident Fund (MPF) and Long Service Payment (LSP) (the Abolition).

In this news alert, we provide a high-level summary of the accounting treatments of LSP provision taking into account the impact of the Abolition and share the IRD's views on the Hong Kong profits tax treatments of the related items recognised in the financial accounts.

Background

The Employment and Retirement Schemes Legislation (Offsetting Arrangement) (Amendment) Ordinance 2022[1] (the Amendment Ordinance) was enacted in June 2022. The Amendment Ordinance abolishes the use of the accrued benefits derived from employers' mandatory MPF contributions to offset severance payments (SP) and LSP payable to employees[2]. The Abolition will take effect on 1 May 2025 (the Transition Date).

Accordingly, the accrued benefits derived from an employer's mandatory MPF contributions can no longer be used to offset SP or LSP payable to an employee in respect of the employment period falling on or after the Transition Date (the post-transition portion of SP/LSP that is not offsetable).

The HKSAR Government has indicated that it would launch a scheme to subsidise employers for a period of 25 years after the Transition Date on the SP or LSP payable by employers up to a certain amount per employee per year (the Government Subsidy Scheme).

As provision for LSP (rather than SP) is a more common issue for employers in Hong Kong and MPF is the most prevalent retirement scheme in Hong Kong, the below discussion focuses on the interaction between MPF and LSP as well as the accounting and tax treatments of LSP provision in light of the Abolition.

The accounting treatments

As the Amendment Ordinance was enacted in June 2022, entities in Hong Kong are required to take into consideration the effect of the Amendment Ordinance when accounting for the LSP provision from the financial year that includes June 2022 (e.g. the financial year ended 31 December 2022 for a December accounting year-end entity).

[1] The Amendment Ordinance can be accessed via this link: https://www.legco.gov.hk/yr2022/english/ord/2022ord004-e.pdf
[2] The Abolition also applies to certain portions of occupational retirement scheme benefits and schools provident fund benefits.

The guidance[3] issued by the HKICPA on 4 July 2023 discusses the acceptable approaches to accounting for the offsetting mechanism, the accounting issues resulting from the Abolition, and the accounting for the impact of the Abolition, etc. The guidance also contains examples that illustrate the related accounting entries.

According to the HKICPA guidance, employers can choose one of the following two acceptable accounting approaches to account for the provision for LSP (including the offset mechanism) and the impact of the Abolition:

Under Approach 1:

- The accrued benefits arising from an employer's MPF contributions that have been vested with the employee and which would be used to offset the employee's LSP benefits (offsetable accrued benefits) are treated as a deemed contribution by the employee towards the LSP and a reduction in service cost (i.e. a negative service cost).
- The LSP obligation is measured on a "net" basis after deducting the negative service cost arising from the offsetable accrued benefits.
- The Abolition results in a reduction in expected offsetable accrued benefits. As such, there is a one-off catch-up adjustment recognised as an additional past service cost in the profit or loss and a corresponding increase in the LSP obligation in the year of enactment of the Amendment Ordinance.

Please refer to Appendix 1 for the sample accounting entries under Approach 1.

Under Approach 2:

- The LSP obligation is measured on a "gross" basis without being reduced by the offsetable accrued benefits.
- Employer's mandatory MPF contribution is recognised as a separate asset (the Reimbursement Asset) in the balance sheet[4] and measured at fair value until the fair value reaches the amount of LSP in respect of the employment period before the Transition Date (i.e. the pre-transition portion of LSP that is offsetable).
- A one-off adjustment is made to the LSP obligation to reflect the change in reference date used for determining the last month's salary for the purposes of calculating the pre-transition portion of LSP[5].

Please refer to Appendix 1 for the sample accounting entries under Approach 2.

In addition, any changes in actuarial assumptions will affect the LSP liability (under both approaches) and the reimbursement asset (under Approach 2) with a corresponding adjustment to Other Comprehensive Income (OCI) as a remeasurement gain or loss.

The Hong Kong profits tax treatments

As a response to the inquiry made by the Hong Kong Institute of Certified Public Accountants (HKICPA), the IRD recently set out its views on the Hong Kong profits tax treatments of provision for LSP and the items recognised in the financial accounts as a result of the Abolition. Below is a summary of the IRD's responses:

- Hong Kong profits tax deduction of LSP is governed by sections 16(1) and 17 of the Inland Revenue Ordinance (IRO). In general, any LSP or provision for LSP made in accordance with the Employment Ordinance (EO) will be allowed for deduction under section 16(1) of the IRO so long as the provision is fairly accurate and incurred in the production of assessable profits.
- Under Approach 1:
  - any specific provision (i.e. current service cost and the relevant interest expense) made by an entity for meeting its liability to pay LSP will be allowable for deduction provided that it is made in accordance with the provisions of the EO (and in particular, has taken into account the offsetable accrued benefits) and is fairly accurate (i.e. based on valid actuarial assumptions and reasonable estimates by reference to the wages and service years of each employee); and
  - the one-off catch-up adjustment for the expected net cost of the LSP obligation to an entity as determined in accordance with the Amendment Ordinance and recognized as the "past service cost", is in the nature of a provision made for meeting the entity's liability to pay LSP under the EO. It will be deductible (or taxable) in the year in which it is recognised in the accounts, provided that it is made in accordance with the provisions of the EO and is fairly accurate.

[3] The guidance issued by the HKICPA can be accessed via this link: https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/SSD/gMPFLSP.pdf

[4] An employer may either pay the gross LSP to an employee and claim a reimbursement from the MPF trustee, or pay the net LSP to an employee after deducting the offsetable accrued benefits. In other words, the employer has a statutory right to reimbursement or offset. The right to reimbursement or offset is accounted for as a reimbursement asset.

[5] The Amendment Ordinance changes the reference date for calculating the last month's salary from last month's salary immediately before the termination of employment to last month's salary immediately before the Transition Date.

- Under Approach 2:
  - given that it is only a matter of timing difference where the total amount of allowable deduction in respect of an entity's LSP liability throughout an employee's period of service is equal to the total actual amount of employers' mandatory MPF contributions and LSP incurred by the entity, the amounts recognised in the entity's profit or loss (i.e. the gross amount of current service cost and the one-off adjustment to the pre-transition portion of LSP) will be deductible (or taxable) by concession on the condition that no separate claim for deduction of employer's mandatory MPF contributions has been/will be made.
- The remeasurement gains or losses (due to changes in actuarial assumptions) recognised in the OCI can be regarded as part of LSP made or provisions made for meeting the employer's LSP liability. Such remeasurement gains or losses will be taxable or deductible in year they are recognised in the OCI provided that they are recognised in accordance with the provisions of the EO, fairly accurate and incurred in the production of employer's assessable profits.
- Alternatively, tax deduction could be claimed based on the actual amount of LSP paid in accordance with the provisions of the EO so long as the basis is consistently adopted.
- As far as the Government Subsidy Scheme is concerned, the IRD just noted the suggestions from the HKICPA without making any further comments. The HKICPA suggested that the HKSAR Government considers granting profits tax exemption for reimbursement received under the scheme and enacting legislation to confer clarity and legal certainty on the tax consequences of the reimbursement.

KPMG Observations

We welcome the clarifications from the IRD on the Hong Kong profits tax treatments of various items recognised in the financial accounts in relation to provision for LSP and the Abolition.

Business groups in Hong Kong may account for the impact of the Abolition (i.e. the one-off adjustment to the past service cost) in the basis period of either year of assessment 2022/23 or 2023/24, depending on the accounting year end dates of the groups. They should take note of the Hong Kong profits tax treatments mentioned by the IRD as discussed above for future tax filings and consider whether any actions are required if the filing positions taken in their 2022/23 or 2023/24 profits tax return already lodged with the IRD are not in line with the IRD's stated positions.

Appendix

Sample journal entries under Approach 1 (Note 1)	Sample journal entries under Approach 2 (Notes 1 and 2)
1. To recognise a one-off catch-up adjustment for past service cost and a corresponding increase in the long service payment (LSP) obligation *Dr Past service cost* *Cr LSP obligation*	**1. To recognise a one-off adjustment for the amount of pre-transition LSP** *Dr LSP obligation* *Cr Past service cost*
2. To recognise the employer's mandatory contributions under the MPF Scheme *Dr Employee benefits expense* *Cr Bank*	**2. To recognise the employer's mandatory contributions under the MPF Scheme as a reimbursement asset associated with the LSP** *Dr Reimbursement asset* *Cr Bank*
3. To recognise the defined benefit obligation for the LSP before taking into account the deemed employee contribution as a negative service cost *Dr Current service cost* *Dr Interest expense* *Cr LSP obligation*	**3. To recognise the interest income on the reimbursement asset** *Dr Reimbursement asset* *Cr Interest income*
4. To recognise the deemed employee contribution as a negative service cost *Dr LSP obligation* *Cr Interest expense* *Cr Current service cost*	**4. To recognise the defined benefit obligation for the LSP (on "gross" basis)** *Dr Current service cost* *Dr Interest expense* *Cr LSP obligation*

Notes:
1. For simplicity, it is assumed that there are no changes in the actuarial assumptions.
2. For simplicity, it is assumed that the return on the reimbursement asset recognised in OCI is nil.

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