



Inland Revenue Department
The Government of the Hong Kong Special Administrative Region
of the People's Republic of China

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 42 (REVISED)

PROFITS TAX

PART A: TAXATION OF FINANCIAL INSTRUMENTS

PART B: TAXATION OF FOREIGN EXCHANGE DIFFERENCES

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

These notes replace those issued in November 2005.

WONG Kuen-fai
Commissioner of Inland Revenue

June 2020

Our web site : <http://www.ird.gov.hk>

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

No. 42 (REVISED)

CONTENT

	Paragraph
Introduction	
Gains or losses on financial instruments	1
Foreign exchange differences	3
Part A : Taxation of Financial Instruments	
Taxable profits	
Principles of commercial accounting	4
The two cardinal principles	5
Interim measure	6
Legislative amendments	8
Accounting treatment of financial instruments	
Hong Kong Financial Reporting Standards	9
Definitions of terms	12
Basis for profits tax assessment	
Realization basis	13
Fair value basis	14
Election for assessment on fair value basis	
Conditions for adopting fair value basis for assessment	15
Irrevocable election	19
Revocation of election	20
Assessment on fair value basis	
Alignment of tax treatment and accounting treatment	
- Tax relevant amount equals accounting relevant amount	24
- Financial assets measured at amortized cost	26

- Financial assets measured at fair value through other comprehensive income	27
- Financial assets measured at fair value through profit or loss	28
- Financial liabilities measured at amortized cost	29
- Financial liabilities measured at fair value through profit or loss	30
Special treatment of impairment loss	
- Expected credit losses	31
- Non-credit-impaired financial assets	32
- Credit-impaired financial assets	33
- Purchased or originated credit-impaired financial assets	39
- Transfer of credit-impaired loans	40
Other special treatments	
- Equity instruments	44
- Financial liabilities – changes in credit risk	47
- Embedded derivatives – convertible debt security	49
- Preference shares	51
- Non-arm’s length loans	53
- Hedging instruments	57
Reclassification	60
Tax adjustment for change of assessment basis	
- From realization basis to fair value basis	62
- From fair value basis to realization basis	63
Transitional accounting adjustments	66
Impact on other Part 4 provisions	
- Regulatory capital securities	68
- Interaction with other Part 4 provisions	69
Tax avoidance arrangements	
Section 61A	73
Relevant tax cases	74
Effective date	76

Part B : Taxation of Foreign Exchange Differences

Foreign currency transactions

Foreign currencies	77
Accounting treatment	78
Relevant tax cases	84
Unrealized exchange differences	89

Appendices

1. Overview of HKFRS 9
2. Assessing Practice

INTRODUCTION

Gains or losses on financial instruments

Hong Kong is a major financial centre in the Asia Pacific region and financial instruments are widely used in Hong Kong to achieve investment, trading or hedging objectives. Since financial instruments have become increasingly complex, detailed financial reporting standards have been developed to deal with the related accounting issues. Against this background, Hong Kong Financial Reporting Standard 9 *Financial Instruments* (HKFRS 9) has been issued, setting out the requirements for recognizing and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items.

2. The Inland Revenue (Amendment) (No. 2) Ordinance 2019 was enacted to provide for the alignment of tax treatment of financial instruments with their accounting treatment. Part A of this Departmental Interpretation and Practice Note (DIPN) sets out the Department's views and practices regarding the tax treatment of gains or losses in respect of financial instruments to which HKFRS 9 applies.

Foreign exchange differences

3. In Hong Kong, business is often transacted in foreign currencies. Gains or losses will result from such transactions due to the fluctuation in the rates of exchange of the foreign currencies. Hong Kong Accounting Standard 21 *The Effects of Changes in Foreign Exchange Rates* provides guidance on the translation method and on determining the functional and presentation currencies. Part B of this DIPN explains the Department's views and practices regarding the tax treatment of foreign exchange differences.

PART A: TAXATION OF FINANCIAL INSTRUMENTS

TAXABLE PROFITS

Principles of commercial accounting

4. Profits tax is charged on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong. The Inland Revenue Ordinance (the Ordinance) itself does not contain a comprehensive definition of the term “assessable profits”. In *CIR v Secan Ltd & Another* (2000) 3 HKCFAR 411, the Court of Final Appeal established the principle that the assessable profits or losses of a taxpayer must be ascertained in accordance with the ordinary principles of commercial accounting, as modified to conform with the Ordinance. Delivering the unanimous decision of the Court, Lord Millett NPJ said at page 419:

“Both profits and losses therefore must be ascertained in accordance with the ordinary principles of commercial accounting as modified to conform with the Ordinance. Where the taxpayer’s financial statements are correctly drawn in accordance with the ordinary principles of commercial accounting and in conformity with the Ordinance, no further modifications are required or permitted. Where the taxpayer may properly draw its financial statements on either of two alternative bases, the Commissioner is both entitled and bound to ascertain the assessable profits on whichever basis the taxpayer has chosen to adopt.”

The two cardinal principles

5. In *Nice Cheer Investment Ltd v CIR* (2013) 16 HKCFAR 813, the Court of Final Appeal, further elaborated what constitutes taxable profits within the meaning of the Ordinance. Lord Millett NPJ said at page 825:

“There are two cardinal principles of tax law: (i) the word ‘profits’ connotes actual or realized and not potential or anticipated profits; and (ii) neither profits nor losses may be anticipated.”

He further explained at page 829:

“In the present case the subject matter of the tax is ‘profit’, and the question what constitutes a taxable profit is a question of law. While the amount of that profit must be computed and ascertained in accordance with the ordinary principles of commercial accounting, these are always subject to the overriding requirement of conformity, not merely with the express words of the statute, but with the way in which they have been judicially interpreted.”

Interim measure

6. Following the judgment of the Court of Final Appeal in *Nice Cheer*, taxable profits, though computed and ascertained in accordance with the ordinary principles of commercial accounting, will be subject to the two cardinal principles of tax law.

7. Financial institutions and securities dealers, which marked their financial instruments to market (i.e. fair value accounting), had since requested the Commissioner to accept financial statements prepared on a fair value basis for tax reporting as substantial costs would have been incurred to re-compute their profits on a realization basis. Pending the required legislative amendments that permit the use of fair value accounting as a basis for tax purposes, profits tax returns with assessable profits computed on a fair value basis had been accepted by the Commissioner as an interim administrative measure.

Legislative amendments

8. The Inland Revenue (Amendment) (No. 2) Ordinance 2019, which became effective on 1 March 2019, aligns the tax treatment of financial instruments with their accounting treatment. The main provisions are as follows:

- (a) Section 18G provides for the interpretation of terms used.
- (b) Section 18H provides for the alignment of the treatment of financial instruments for profits tax purpose with their

accounting treatment if the financial statements are prepared in accordance with a specified financial reporting standard and an election is made.

- (c) Section 18I explains the effect of the alignment of tax treatment and accounting treatment of financial instruments on the other provisions of Part 4 of the Ordinance (*other Part 4 provisions*) in determining whether any profit, gain, loss, income or expense is chargeable to tax or allowable for deduction. In summary —
 - (i) profits are not limited to realized profits and a change in fair value of a financial instrument is to be brought into account in assessing profits tax in certain circumstances;
 - (ii) the way in which a profit, gain, loss, income or expense is computed is changed in certain circumstances (e.g. interest is computed in some cases at the effective rate instead of the contractual rate); and
 - (iii) apart from the changes described in paragraphs (i) and (ii), sections 18J and 18L apply subject to the other Part 4 provisions.
- (d) Section 18J provides that the amount of profit, gain, loss, income or expense computed for a financial instrument for profits tax purpose for a period is the amount of profit, gain, loss, income or expense recognized for the instrument for accounting purpose for the period.
- (e) Section 18K provides for special treatment of an impairment loss.
- (f) Section 18L provides for special treatment of an equity instrument or financial liability on revenue account, an embedded derivative, a preference share, a loan made or debt security issued otherwise than on an arm's length basis and a hedging instrument.

ACCOUNTING TREATMENT OF FINANCIAL INSTRUMENTS

Hong Kong Financial Reporting Standards

9. HKFRS 9 has replaced Hong Kong Accounting Standard 39 *Financial Instruments: Recognition and Measurement* (HKAS 39) and applies to entities for annual periods beginning on or after 1 January 2018. Under HKFRS 9, the classification and measurement of financial assets is dependent on the business model within which the asset is held and the contractual cash flows of the asset. HKFRS 9 also introduces an impairment model which is based on expected credit losses. Appendix 1 gives an overview of HKFRS 9.

10. Apart from HKFRS 9, the following standards are also relevant to financial instruments:

- (a) Hong Kong Accounting Standard 32 *Financial Instruments: Presentation* (HKAS 32) which sets out the principles for presentation of financial instruments;
- (b) Hong Kong Financial Reporting Standard 7 *Financial Instruments: Disclosures* (HKFRS 7) which sets out the requirements for disclosures of financial instruments;
- (c) Hong Kong Financial Reporting Standard 13 *Fair Value Measurement* (HKFRS 13) which provides guidance on the determination of fair value and the term “fair value” is defined therein; and
- (d) Hong Kong Accounting Standard 21 *The Effect of Changes in Foreign Exchange Rates* (HKAS 21) which deals with the effects of changes in foreign exchange rates.

11. The way the profits tax treatment for financial instruments interacts with the accounting rules stipulated in HKAS 32, HKFRS 7, HKFRS 9 and HKFRS 13 is also explained in Part A of this DIPN.

Definitions of terms

12. The term “financial instrument” is defined in HKAS 32 as “any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity”. HKAS 32 also contains definitions of the terms “financial asset”, “financial liability” and “equity instrument”. HKFRS 13 defines “fair value” to be “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”. It is not proposed to list out all the relevant definitions here. HKAS 32 should be consulted for the detailed definitions that are also applicable to HKFRS 9.

BASIS FOR PROFITS TAX ASSESSMENT

Realization basis

13. Taxable profits from financial instruments are ascertained in accordance with ordinary principles of commercial accounting as modified to conform with the other Part 4 provisions and subject to the two cardinal principles established in the *Nice Cheer* case. In effect, only realized profits or losses will be brought into account in ascertaining the taxable profits from financial instruments.

Fair value basis

14. Sections 18G to 18L provide for computing the taxable profits from financial instruments by aligning with their accounting treatment. In general, where an election is made, both realized and unrealized profits or losses will be brought into account if they are recognized in profit or loss. In the context of this DIPN, the expression “fair value basis” refers to the accounting treatments permitted in HKFRS 9, namely at fair value through other comprehensive income (FVTOCI), at fair value through profit or loss (FVTPL) and at amortized cost.

ELECTION FOR ASSESSMENT ON FAIR VALUE BASIS

Conditions for adopting fair value basis for assessment

15. Section 18H(1) provides that the provisions for assessment on the fair value basis apply to a person for a year of assessment only if:

- (a) the person prepares financial statements for the basis period for the year in accordance with a specified financial reporting standard; and
- (b) the person has elected in writing that the provisions for assessment on the fair value basis apply to the person (*election*) and the election has effect for the year.

16. The option to elect for assessment on the fair value basis is available to a person only if the person prepares financial statements in accordance with a specified financial reporting standard. In other words, if a person does not adopt a specified financial reporting standard in preparing financial statements or does not make an election, the provisions for assessment on the fair value basis will not apply and assessable profits on financial instruments will be ascertained on the realization basis.

17. Specified financial reporting standard is defined in section 18G(1) to mean:

- (a) HKFRS 9;
- (b) the International Financial Reporting Standard 9 *Financial Instruments* (IFRS 9); or
- (c) a financial reporting standard adopted by a relevant authority of a jurisdiction other than Hong Kong, which is, in the Commissioner's opinion, equivalent to IFRS 9.

18. Entities incorporated or established outside Hong Kong and operating in Hong Kong, whether or not through a permanent establishment, can also elect for assessment on the fair value basis if their financial statements are prepared in

accordance with IFRS 9 or a standard equivalent to IFRS 9. Whether a standard is equivalent to IFRS 9 is a matter of fact and degree. If the standard is not fully identical to IFRS 9, adjustments have to be made.

Irrevocable election

19. To maintain tax consistency and to avoid taxpayer taking tax advantage by opting in and out the fair value basis for assessment, the election is made irrevocable. Section 18H(2) provides that a person may make an election for a year of assessment (*election year*). The election, once made, is irrevocable and has effect for the election year and all subsequent years of assessment.

Revocation of election

20. Taking into account that there may be circumstances where a person who has made an election in a previous year of assessment may not be in a position to apply the fair value basis in future years, an “escape clause” is provided to authorize the Commissioner to allow revocation of the election if the Commissioner is satisfied that the revocation is not driven by a tax avoidance motive and that there are good commercial reasons for doing so. In particular:

- (a) Section 18H(4) provides that an election may be revoked with the Commissioner’s approval and, on the revocation, the election ceases to have effect from the year of assessment specified by the Commissioner.
- (b) Section 18H(5) provides that the Commissioner may, on a person’s application in writing, approve the revocation of the person’s election if the person proves to the Commissioner’s satisfaction that:
 - (i) there are good commercial reasons for the revocation; and
 - (ii) avoidance of tax is not the main purpose, or one of the main purposes, of the revocation.

21. In general, revocation of an election should have no retrospective effect. If the revocation is approved by the Commissioner, the election will

only cease to have effect from the year of assessment specified by the Commissioner.

22. Whether there are good commercial reasons for revocation of an election is a question of fact and each case should be considered on its own facts and merits. In a business merger/ acquisition/ disposal/ restructuring, a company may be taken over by a group of companies that adopts a different tax treatment for financial instruments. Revocation of election in such a case will be considered as having good commercial reasons.

Example 1

Company-HK was a member of Group-HK headquartered in Hong Kong. Profits derived from financial instruments by companies within Group-HK were reported and offered for taxation on a fair value basis. Company-HK closed its accounts on 31 December each year and elected to apply the provisions for assessing profits from financial instruments on the fair value basis for the year of assessment 2018/19.

On 1 January 2020, Company-HK was taken over by Company-F and became a member of Group-F headquartered in Jurisdiction-F. As financial instruments of members of Group-F were reported and taxed on a realization basis, Company-HK applied to the Commissioner for revocation of the election with effect from the year of assessment 2020/21.

Company-HK's reason for revocation of its election was to conform with Group-F's tax reporting policy. In the absence of any tax avoidance motive, the Commissioner would be ready to accept that there was good commercial reason for the revocation.

23. The mere reduction in the amount of tax payable is a factor for deciding whether there is a tax avoidance motive but it alone is not equivalent to tax avoidance. The Commissioner will consider the taxpayer's purpose of revocation when processing the application of revocation.

ASSESSMENT ON FAIR VALUE BASIS

Alignment of tax treatment and accounting treatment

Tax relevant amount equals accounting relevant amount

24. Upon the election for assessment on the fair value basis, the tax treatment of financial instruments will generally align with the accounting treatment. Section 18J(1) provides that the tax-relevant amount in respect of a financial instrument is the accounting-relevant amount in respect of the instrument where:

- (a) the tax-relevant amount, in respect of a financial instrument, is the amount of profit, gain, loss, income or expense to be brought into account for computing the person's assessable profits in respect of the instrument for the basis period for the year of assessment; and
- (b) the accounting-relevant amount, in respect of a financial instrument, is the amount which is recognized in determining any profit, gain, loss, income or expense of the person in respect of the instrument for the basis period for the year of assessment.

25. In brief, the timing in the recognition of profit, gain, loss, income or expense per HKFRS 9 on financial assets and financial liabilities will normally be followed for profits tax purpose. The relevant accounting treatments are explained in paragraphs 17 to 21 of Appendix 1.

Financial assets measured at amortized cost

26. Gains or losses on disposal will be assessed or deducted for the year in which the financial assets are derecognized. Foreign exchange gains or losses will be assessed or deducted for the year in which they are recognized in profit or loss. Interest, discount or premium income from debt instruments will be assessed for the year in which it is recognized in profit or loss through the amortization process by using the effective interest method. In other words, discount or premium income will not be deferred for assessment until the financial instrument is redeemed.

Financial assets measured at fair value through other comprehensive income

27. Gains or losses recognized in other comprehensive income will not be assessed or deducted until the assets are derecognized. The cumulative gain or loss previously recognized in other comprehensive income will be assessed or deducted for the year in which it is reclassified from equity to profit or loss upon derecognition. Foreign exchange gains or losses will be assessed or deducted for the year in which they are recognized in profit or loss. Interest, discount or premium income from debt instruments will be assessed for the year in which it is recognized in profit or loss through the amortization process by using the effective interest method. Similarly, discount or premium income will not be deferred for assessment until the financial instrument is redeemed.

Financial assets measured at fair value through profit or loss

28. All gains or losses, including fair value changes and related exchange differences, will be assessed or deducted for the year in which they are recognized in profit or loss, even though they are not realized. Interest, discount or premium income from debt instruments will be assessed for the year in which it is recognized in profit or loss.

Financial liabilities measured at amortized cost

29. Gains or losses on disposal will be assessed or deducted for the year in which the financial liabilities are derecognized. Foreign exchange gains or losses will be assessed or deducted for the year in which they are recognized in profit or loss. Interest, discount or premium expenses of debt instruments will be allowed for deduction for the year in which they are recognized in profit or loss through the amortization process by using the effective interest method. In other words, discount expenses will not be fully deductible for the year in which the financial instrument is issued.

Financial liabilities measured at fair value through profit or loss

30. All gains or losses, including fair value changes and related exchange differences, will be assessed or deducted for the year in which they are recognized in profit or loss, even though they are not realized. Interest,

discount or premium expenses in respect of debt instruments will be allowed for deduction for the year in which they are recognized in profit or loss.

Special treatment of impairment loss

Expected credit losses

31. HKFRS 9 applies an “expected credit loss” model to impairment. Credit losses are recognized when expected rather than when incurred. The model is forward-looking and it is no longer necessary for a trigger event to have occurred before credit losses are recognized. In general, there are three stages of credit risk of deterioration (three-stages approach). The relevant accounting rules in relation to impairment are explained in paragraphs 12 to 16 of Appendix 1. Despite the accounting treatments, impairment losses or impairment gains so recognized in profit or loss are not all allowable for deduction or chargeable to tax.

Non-credit-impaired financial assets

32. Section 18K(2) provides that any impairment loss recognized by a person in respect of a financial instrument that is not credit-impaired is not deductible and any subsequent reversal of any amount of the impairment loss is not chargeable to tax. Therefore, for Stage 1 and Stage 2 credit risks (i.e. not credit-impaired), any impairment loss recognized in respect of the instrument will not be allowable for deduction. Equally, any subsequent reversal of the impairment loss (i.e. impairment gain) will not be chargeable to tax.

Credit-impaired financial assets

33. For financial assets that are at Stage 3 credit risks (i.e. credit-impaired), as explained in paragraph 13(c) of Appendix 1, section 18K(3) provides that:

- (a) if the instrument represents a debt that was included as a trading receipt in ascertaining the person’s assessable profits for the basis period in which the debt arose – the impairment loss is allowable as a deduction up to the amount of the debt so included;

- (b) if the instrument represents a debt in respect of money lent, in the ordinary course of the business of lending money in Hong Kong, by the person who carries on that business – the impairment loss is allowable as a deduction up to the amount of the debt; and
- (c) in any other case – the impairment loss is not deductible.

34. Similar to the deduction rule for bad debts and doubtful debts as provided in section 16(1)(d) of the Ordinance, deduction of impairment loss in respect of credit-impaired instruments is restricted to trade debt and money lent in the ordinary course of money lending business in Hong Kong.

35. The application of section 18K(3) is not subject to section 16(1)(d). An impairment loss is allowable for deduction if the instrument in respect of which the impairment loss is recognized satisfies the conditions specified in section 18K(3)(a) or (b) and is credit-impaired at the end of the year.

36. A trade receivable is credit-impaired, as explained in paragraph 13(c) of Appendix 1, when one or more events that have a detriment impact on the estimated future cash flows of the trade receivable have occurred. HKFRS 9 allows a person to adopt a simplified approach for making loss allowance for expected credit loss on trade receivables (i.e. expected credit loss is calculated based on the historical default rate and adjusted for future forward-looking estimates). In such a case, no assessment has been made on the credit risks of individual trade receivables and those trade receivables are not classified in accordance with the three-stages approach. If a trade receivable is considered credit-impaired and deduction of impairment loss is claimed under section 18K(3), evidence has to be produced to prove that the trade receivable is credit-impaired at the end of the year (e.g. reasonable steps have been taken to assess and estimate the impairment of the trade receivable).

37. The impairment requirements under HKFRS 9 do not apply to financial assets measured at FVTPL. In general, financial instruments (e.g. trading securities) acquired for trading purpose would be measured at FVTPL. Any expected credit loss would be reflected in the fair value changes and recognized in profit or loss and allowed for deduction accordingly and no separate loss allowance or impairment loss would be made. If a person

classifies a financial instrument as measured at amortized cost or at FVTOCI but claims that it is acquired for trading purpose and the Assessor is satisfied that it is for trading purpose, adjustment can be made in tax computation as if the financial instrument were measured at FVTPL and any fair value changes will be taxed or allowed accordingly.

38. If a deduction in respect of a financial instrument was previously allowed to a person in respect of a bad debt or doubtful debt under section 16(1)(d) or an impairment loss under section 18K(3), any recovery of an amount of the bad debt or doubtful debt or any reversal of the impairment loss (i.e. impairment gain) recognized by the person for a subsequent year of assessment is chargeable to tax for the subsequent year of assessment in which the bad debt or doubtful debt is recovered or the impairment loss is reversed.

Purchased or originated credit-impaired financial assets

39. “Purchased or originated credit-impaired financial assets” are those financial assets that are credit-impaired on initial recognition (e.g. junk bonds). For such instruments, the purchase price/ fair value at initial recognition includes an expectation for credit losses which was priced into the instrument. No loss allowance is recognized at initial recognition. As a result, the loss allowance only consists of subsequent changes in lifetime expected credit losses (ECL) since initial recognition. Any favourable changes in lifetime ECL will be recognized as an impairment gain, even if the lifetime ECL is less than the amount of ECL that was included in the estimated cash flows on initial recognition. In other words, if an impairment gain subsequently recognized in respect of the financial asset is not a reversal of any impairment loss which has been previously allowed, section 18K(4) would not be applicable. Section 18K(5), however, stipulates that if the financial asset is held on revenue account, any impairment gain so recognized should be treated as the person’s trading receipt for the year of assessment in which it is recognized.

Example 2

On 1 January 2018, Company-HK purchased a bond with a remaining term of 4 years for \$8,000,000. The nominal amount of the bond was \$10,000,000 with coupon payable at 10% per year. The bond was credit-impaired at the time of purchase and Company-HK did not

expect to recover all the contractual cash flows. Company-HK expected to receive coupon payments of \$550,000 (instead of \$1,000,000) annually and repayment of principal of \$8,700,000 (instead of \$10,000,000) at the end of the term. Company-HK closed its accounts on 31 December each year.

No loss allowance was recognized at initial recognition. Instead, the ECL was reflected in the fair value of the bond recognized and taken into account when calculating the credit-adjusted effective interest rate. The credit-adjusted effective interest rate calculated on initial recognition of the bond was 8.794% (i.e. the rate that discounted the expected cash flows to the amortized cost at initial recognition of \$8,000,000).

The cash flows received for the years ended 31 December 2018 and 2019 matched Company-HK's expectation and on 31 December 2019, Company-HK expected that it would recover principal of \$9,500,000 at the end of the term.

The amortized cost of the bond as at 31 December 2019, as indicated in the amortization table below, was \$8,320,541.

Year ended 31 December	Opening balance	Interest revenue @8.794%	Interest received	Closing balance
	\$	\$	\$	\$
2018	8,000,000	703,520	550,000	8,153,520
2019	8,153,520	717,021	550,000	8,320,541
2020	8,320,541	731,708	550,000	8,502,249
2021	8,502,249	747,688	550,000	8,699,937

On 31 December 2019, the present value of the revised expected cash flows (i.e. \$550,000 annual interest and \$9,500,000 principal at the end of the term) over the remaining term of 2 years, discounted using the original credit-adjusted effective interest rate of 8.794% was \$8,996,491. Accordingly, on 31 December 2019, Company-HK recognized the favourable change in the ECL of \$675,950 (\$8,996,491 – \$8,320,541) as impairment gain. If the bond was held on

Company-HK's revenue account, the impairment gain of \$675,950 would be treated as Company-HK's trading receipt and chargeable to tax for the year of assessment 2019/20. The revised amortization table would be as follows:

Year ended 31 December	Opening balance	Interest revenue @8.794%	Interest received	Closing balance
	\$	\$	\$	\$
2020	8,996,491	791,151	550,000	9,237,642
2021	9,237,642	812,358	550,000	9,500,000

Transfer of credit-impaired loans

40. Section 18K(7) or (8) will apply to a financial institution (*transferor*), which transfers a credit-impaired loan to another person (*transferee*), if all of the following conditions specified in section 18K(6) are satisfied:

- (a) a financial institution (transferor) transfers to another person (transferee) a credit-impaired loan;
- (b) a loss allowance in respect of the credit-impaired loan is also transferred to the transferee;
- (c) the transfer is not by way of a sale in the ordinary course of the transferor's business; and
- (d) in respect of the loss allowance, a deduction of an amount was previously allowed to the transferor under section 16(1)(d) in respect of a bad debt or doubtful debt or under section 18K(3) in respect of an impairment loss.

41. Where a credit-impaired loan is transferred to the transferee by way of sale, HKFRS 9 requires the transferee to record the purchased credit-impaired loan at the purchase price in its account. In this situation, there is no transfer of loss allowance and section 18K(7) or (8) will not apply.

Example 3

Bank-HK had a credit-impaired loan portfolio of face value of \$10 million in respect of which a loss allowance of \$3 million was provided. Bank-HK transferred the credit-impaired loan portfolio in the ordinary course of its business to Company-HK by way of sale at a price of \$7 million.

In accordance with HKFRS 9, Company-HK recognized the purchase price of \$7 million as the value of the purchased credit-impaired loan portfolio but not any loss allowance. Since the loss allowance of \$3 million was not transferred to Company-HK, section 18K(7) or (8) will not apply.

42. The question whether section 18K(7) or (8) should apply depends on whether the transferor and transferee are in the business of lending money in Hong Kong on the date of the transfer.

- (a) If both of the transferor and the transferee are in the business of lending money in Hong Kong, by virtue of section 18K(7), the amount of deduction previously allowed to the transferor (i.e. deduction under section 16(1)(d) in respect of a bad debt or doubtful debt or under section 18K(3) in respect of an impairment loss) will be treated as having been allowed to the transferee. Pursuant to section 18K(4), any recovery of the bad debt or doubtful debt or reversal of the impairment loss subsequently recognized by the transferee will be treated as a trading receipt of the transferee for the year in which it is recognized.
- (b) If the transferor or the transferee is, or both, are not in the business of money lending, section 18K(8) provides that the amount of deduction previously allowed to the transferor (i.e. deduction under section 16(1)(d) in respect of a bad debt or doubtful debt or under section 18K(3) in respect of an impairment loss) will be treated as the transferor's trading receipt accruing on the date of the transfer and chargeable to tax.

43. Section 18K(8) would be invoked only if the loss allowance in respect of the credit-impaired loan is transferred to the transferee together with the loan. In such a case, the loss allowance is not effectively written off by the transferor in the course of recognizing any gain or loss upon the transfer, but is transferred to the transferee only. Since the loan is no longer held by the transferor (i.e. a financial institution) and the transferee is not in the business of lending money in Hong Kong, deduction under section 18K(3)(b) would no longer apply to any impairment loss in respect of the loan. Any impairment loss which has been previously allowed to the transferor should therefore be clawed back.

Other special treatments

Equity instruments

44. Equity instruments are generally measured at FVTPL because contractual cash flows on specified dates are not a characteristic of equity instruments. Any gain or loss from the changes in fair value of the equity at the end of each accounting period would be recognized in profit or loss and would be chargeable or allowable for the year in which the gain or loss is recognized. However, if an equity instrument is not held for trading, an entity may make an irrevocable election at initial recognition to present subsequent changes in fair value of the equity instrument in other comprehensive income, fair value changes including the related foreign exchange differences would then be recognized in other comprehensive income. The cumulative gain or loss recognized in other comprehensive income would not be “recycled” to profit or loss, even upon disposal of the equity instrument.

45. Section 18L(2) stipulates that if an equity instrument is measured at FVTOCI but is held on revenue account, all gain or loss derived from the disposal, including the cumulative gain or loss recognized in other comprehensive income, is chargeable to tax or allowable as a deduction for the year of disposal.

46. Whether an equity instrument is held on capital or revenue account is a question of law and accounting classification is not decisive. All the surrounding circumstances have to be considered. If the equity instrument is held for trading or on revenue account, the cumulative gain or loss previously recognized in other comprehensive income will be chargeable or allowable for

the year of disposal though it is not “recycled” to profit or loss. If the equity instrument is not held for trading or on revenue account, the cumulative gain or loss recognized in other comprehensive income will not be chargeable to tax or allowable for deduction.

Financial liabilities – changes in credit risk

47. For financial liability that is measured at FVTPL, the amount of fair value changes attributable to changes in the credit risk of that liability would be presented in other comprehensive income and would not be “recycled” to profit or loss upon maturity, sale, buyback or redemption (each an *event*) of the financial instrument.

48. Section 18L(3) to (5) stipulates that if such financial liability is held on revenue account of the person, all gain or loss derived from the event, including the cumulative gain or loss presented in other comprehensive income, is chargeable to tax or allowable as a deduction for the event year. Therefore, for financial liability measured at FVTPL, if it is on revenue account, the cumulative amount of fair value changes attributable to changes in the issuer’s own credit risk (i.e. the amount recognized in other comprehensive income) will be chargeable to tax or allowable as a deduction for the event year. Other profit, gain, loss, income or expense will be chargeable to tax or allowable as a deduction for the year in which it is recognized in profit or loss in accordance with section 18J(4).

Embedded derivatives – convertible debt security

49. According to HKAS 32, the issuer of a convertible debt security (which provides an option to the holder of the financial instrument to convert it into a fixed number of ordinary shares of the issuer) is required to split the convertible debt security into a “liability component” and an “equity component” (i.e. the option rights) and present them separately in the statement of financial position. At initial recognition, the issuer is required to measure the “liability component” at fair value as if there were no “equity component”, and the “equity component” will be the difference between the fair value of the convertible debt security as a whole and the fair value of the “liability component”.

50. The issuer stands in a position no different from that of a debtor of a money debt before the right to convert is exercised. A convertible debt security would be treated as debt and the interest/ discount/ premium, after deducting the value of the equity component, will be allowed for deduction if the conditions in section 16 are satisfied. Therefore, section 18L(6) provides that any part of the “interest, discount, premium and expense” recognized by the person in respect of the convertible debt security that is attributable to the “equity component” is not deductible.

Example 4

Company-HK issued convertible bond at \$10,000, redeemable at a premium of \$1,000. Assuming the fair value of the “liability component” was \$9,500 (i.e. the fair value of a similar bond without the option to convert into shares), the “equity component” would be \$500 (\$10,000 – \$9,500). During the tenure of the convertible bond, the difference between the redemption price of \$11,000 and the fair value of the “liability component” at initial recognition of \$9,500 (i.e. \$1,500), would be amortized to profit or loss in accordance with HKFRS 9.

For accounting purpose, the imputed premium should be \$1,500. However, for tax purpose, only the actual premium of \$1,000 (being the premium on redemption per contractual terms) would be allowable as a deduction. The remaining \$500 are attributable to the “equity component” and would not be allowed as a deduction.

Preference shares

51. Section 18L(7) provides that any interest, discount, premium or expense recognized by a person in respect of a preference share issued by the person is not deductible.

52. HKAS 32 sets out the principles for presenting financial instruments as liabilities or equity. Depending on the terms of the instrument, a preference share may be classified as an equity instrument or a financial liability. Where a preference share is classified as a financial liability, any dividend declared in respect of the preference share would be charged as an interest expense to the

profit or loss. Despite the accounting treatment, preference shares should be treated for tax purposes as share capital because the relationship between the holders and the company is not that of a debtor and creditor. Dividends declared will not be allowed for deduction as interest expenses and will not be assessed as interest income.

Non-arm's length loans

53. Section 18L(9) provides that if a loan is made, or a debt security is issued, otherwise than at arm's length, the amount of profit, gain, loss, income or expense in respect of the loan or debt security that is chargeable to tax, or allowable as a deduction, is the amount computed in accordance with the contractual terms of the loan or debt security. Section 18L(8) provides that section 18L(9) would not affect the operation of sections 50AAF and 50AAK.

54. Under HKFRS 9, an entity shall, at initial recognition, measure a financial asset or financial liability at its fair value plus or minus transaction costs. Normally, the fair value of a financial instrument at initial recognition is the transaction price (i.e. the fair value of the consideration given or received). However, if part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument.

55. If a long-term loan or receivable does not carry interest, the fair value of the long-term loan or receivable will be measured as the present value of all future cash receipts discounted using the prevailing market rate of interest for a similar instrument with a similar credit rating. The difference between the transaction price and the fair value at initial recognition is recognized as a gain or loss unless it qualifies for recognition as some other type of asset. As a result, there would be an imputed gain, loss, income or expense at initial recognition of the financial instrument and a corresponding imputed interest income or expense for amortization. By virtue of section 18L(9), any such imputed profit, gain, loss, income or expenses computed in accordance with HKFRS 9 will not be chargeable to tax or allowable as a deduction. Instead, any actual profit, gain, loss, income or expenses computed in accordance with the contractual terms will be taxable or deductible.

56. Section 18L(9) normally relates to a non-arm's length loan made or debt security issued to associated persons. The provisions would not be invoked simply because the loan or the debt security carries no interest or the interest is below market rate. If a loan is made or a debt security is issued at an off-market interest rate but with good commercial reasons, section 18L(9) should not be of relevance. In the absence of a tax avoidance purpose, the provisions in section 50AAF would not be invoked to apply to an intra-group interest-free loan of a domestic nature if the no actual tax difference condition or the non-business loan condition in section 50AAJ is satisfied.

Hedging instruments

57. Section 18L(10) provides that if a hedging instrument is designated, under a hedging arrangement made in good faith, for the purpose of hedging against any risk associated with a hedged item and the hedged item is on capital account, any amount of profit, gain, loss, income or expense recognized in respect of the hedging instrument must be disregarded.

58. In determining whether there is a hedging arrangement and whether the hedging instrument is really a hedge against the hedged item, the facts and circumstances of each individual case have to be examined. In general, if the hedging relationship qualifies for hedge accounting under HKFRS 9 and is accounted for as such, the Commissioner will accept that there is prima facie evidence that the arrangement is for the purpose of hedging against any risk associated with the asset or liability.

59. By virtue of section 18L(10), if the hedged item is of capital in nature, any amount of profit, gain, loss, income or expense recognized by the person would not be taxable or deductible. If the hedged item is of revenue in nature, no tax adjustment is required and the tax treatment will generally follow the accounting treatment as provided in section 18J.

Reclassification

60. HKFRS 9 requires that when an entity changes its business mode for managing financial assets, it shall reclassify all affected financial assets prospectively from the reclassification date. There is no need to restate any previously recognized gains, losses (including impairment gains or losses) or

interest. The reclassification applies only to financial assets that are debt instruments since equity instruments must be measured at FVTPL and the election, if any, to present subsequent changes in fair value in other comprehensive income, is irrevocable. HKFRS 9 prohibits the reclassification of financial liabilities.

61. For financial assets that are of a revenue nature, the accounting treatment of gains or losses arising from reclassification will be followed for profits tax purpose. Gains or losses arising from reclassification will be taxed or allowed accordingly if they are charged to profit or loss. Where any gain or loss arising from reclassification is charged to other comprehensive income, the amount will not be taxed or allowed. Instead, the cumulative amount in other comprehensive income will be taxed or allowed for the year in which it is recognized in profit or loss upon derecognition. Unless the entity could establish a change of intention towards the financial asset upon reclassification, the reclassification alone cannot operate to change the nature of the financial asset.

Tax adjustment for change of assessment basis

From realization basis to fair value basis

62. If a person has made an election, transitional tax adjustments are required to be made for the election year. Pursuant to section 18H(3), the amount of any profit, gain, loss, income or expense which would have been brought into account for computing the person's assessable profits for the basis period for any year of assessment preceding the election year, had the assessable profits been computed on the fair value basis, must be brought into account for computing the person's assessable profits for the election year. This includes the transitional accounting adjustments made in accordance with the transition provisions of HKFRS 9 when the person first applies the requirements of the standard. See paragraphs 66 and 67 below.

Example 5

On 1 January 2018, Company-HK acquired equity shares issued by another company at \$10,000. The shares were measured at FVTPL. The fair value of the shares was as follows:

<i>At 1 January 2018</i>	<i>\$10,000</i>
<i>At 31 December 2018</i>	<i>\$13,000</i>
<i>At 31 December 2019</i>	<i>\$11,000</i>

Company-HK closed its accounts on 31 December each year. It recognized and measured the shares in accordance with HKFRS 9 and accounted for the shares as follows:

<i>Account</i>	<i>Debit</i>	<i>Credit</i>
	<i>\$</i>	<i>\$</i>
<u><i>Year ended 31 December 2018</i></u>		
<i>To recognize the acquisition of the shares on 1 January 2018:</i>		
<i>Financial asset – equity shares</i>	<i>10,000</i>	
<i>Cash</i>		<i>10,000</i>
 <i>To measure the shares to fair value on 31 December 2018:</i>		
<i>Financial asset – equity shares</i>	<i>3,000</i>	
<i>Profit or loss</i>		<i>3,000</i>
 <u><i>Year ended 31 December 2019</i></u>		
<i>To measure the shares to fair value on 31 December 2019:</i>		
<i>Profit or loss</i>	<i>2,000</i>	
<i>Financial asset – equity shares</i>		<i>2,000</i>

Company-HK made an election for assessment on the fair value basis for the year of assessment 2019/20. Profit/ loss in respect of the shares would be assessed as follows:

Year of assessment 2018/19

Since Company-HK did not make any election for assessment on the fair value basis, its assessable profits in respect of the shares would be computed on the realization basis. Therefore, the gain in fair value changes of \$3,000 recognized in profit or loss for the year ended 31 December 2018 would not be chargeable to tax for the year of assessment 2018/19.

Year of assessment 2019/20

Company-HK made the election and its assessable profits in respect of the shares would be ascertained on the fair value basis. When computing the assessable profits in respect of the shares, apart from bringing into account the loss in fair value changes of \$2,000 recognized in profit or loss for the year ended 31 December 2019, the gain in fair value changes of \$3,000 recognized in profit or loss for the year ended 31 December 2018 would also be brought into account as a transitional adjustment in accordance with section 18H(3). Therefore, the profits in respect of the shares assessed to profits tax for the year of assessment 2019/20 would be \$1,000 (\$3,000 – \$2,000).

From fair value basis to realization basis

63. An election will cease to have effect under the following circumstances:

- (a) Section 18H(4) provides that if, on a person's application, the Commissioner approves the revocation of the person's election, the election ceases to have effect from the year of assessment specified by the Commissioner;
- (b) Section 18H(6) provides that if, after a person has made an election, the person ceases to prepare, in accordance with a specified financial reporting standard, financial statements for the basis period for a year of assessment, the election ceases to have effect from the year.

64. Section 18H(7) provides that if an election ceases to have effect from a year of assessment under section 18H(4) or (6) (***cessation year***), the provisions for assessment on the fair value basis will not apply to the person for the cessation year and all subsequent years of assessment. Further, every financial instrument held by the person at the end of the basis period for the year of assessment immediately preceding the cessation year is taken to have been disposed of and reacquired, or released and reassumed, at its fair value on the first day of the basis period for the cessation year.

65. The effect of section 18H(7) is that any gain or loss from the deemed disposal will be chargeable to tax or allowable as a deduction for the cessation year if the financial instrument is held for trading purpose or on revenue account. However, if the financial instrument is held on capital account, any gain or loss from the deemed disposal will not be taxable or deductible.

Example 6

On 1 January 2018, Company-HK purchased \$10 million 4% debenture at par. Company-HK paid in cash and incurred no transaction cost. Interest would be paid annually on 31 December. The debenture would be redeemable at par on 31 December 2021. Company-HK adopted HKFRS 9 and classified the debenture as measured at FVTOCI. The fair value of the debenture was as follows:

<i>At 1 January 2018</i>	<i>\$10 million</i>
<i>At 31 December 2018</i>	<i>\$12 million</i>
<i>At 1 January 2019</i>	<i>\$12 million</i>

Company-HK closed its accounts on 31 December each year. The journal entries in respect of the debenture for the year ended 31 December 2018 are as follows:

<i>Account</i>	<i>Debit</i>	<i>Credit</i>
	<i>\$'000</i>	<i>\$'000</i>
<i><u>Year ended 31 December 2018</u></i>		
<i>To recognize the acquisition of the debenture on 1 January 2018:</i>		
<i>Financial asset – debenture</i>	<i>10,000</i>	
<i>Cash</i>		<i>10,000</i>
<i>To recognize the interest income:</i>		
<i>Cash</i>	<i>400</i>	
<i>Profit or loss – interest income</i>		<i>400</i>
<i>To measure the debenture to fair value on 31 December 2018:</i>		
<i>Financial asset – debenture</i>	<i>2,000</i>	
<i>Other comprehensive income</i>		<i>2,000</i>

Company-HK elected for assessment on the fair value basis for the year of assessment 2018/19. As the increase in fair value of \$2 million was not charged to profit or loss, pursuant to section 18J(1), the sum would not be chargeable to profits tax for the year of assessment 2018/19. Only interest income of \$400,000 would be chargeable to tax for the year of assessment 2018/19.

If Company-HK applied subsequently to revoke the election with effect from the year of assessment 2019/20 and the application was approved by the Commissioner, the debenture would be taken to have been disposed of at its fair value of \$12 million on 1 January 2019 pursuant to section 18H(7)(b). If the debenture was acquired for trading purpose, the gain on disposal of the debenture of \$2 million (\$12 million – \$10 million), which was previously recognized in other comprehensive income for the year ended 31 December 2018, would be chargeable to tax for the year of assessment 2019/20. The debenture would be taken to have been reacquired by Company-HK on 1 January 2019 at \$12 million.

Transitional accounting adjustments

66. HKFRS 9 prescribes the transitional accounting adjustments for financial assets or financial liabilities when an entity first adopts the standard. In short, the financial assets and financial liabilities have to be reclassified and their carrying amounts have to be re-measured. Any difference between the previous carrying amounts and the re-measured amounts should be accounted for by adjusting the opening balance of retained earnings or other component of equity, as appropriate.

67. The Commissioner takes the view that an adjustment for the financial asset or financial liability of a revenue nature should be treated as a taxable receipt for an increase in retained profits or a deductible expense for a decrease in retained profits for the year of assessment in which the adjustment is made if an election for assessment on the fair value basis is made for that year. This view is supported by the case of *Pearse v Woodall-Duckhall Ltd* [1978] 51 TC 271. In that case, a taxpayer changed the basis of valuing its work-in-progress in 1969 and included the surplus on revaluation in the profit and loss appropriation account. Templeman J held that the “anticipated profit for work

carried out prior to 1969 falls to be taxed in the year 1969 when it is first revealed and first brought into account”. In any event, section 18H(3) should now have provided another legal basis for taxing the adjustment.

Example 7

Company-HK is a money lender. Prior to 1 January 2018, it recorded its currency swap agreements and interest rate swap agreements in its statement of financial position at a certain value. On 1 January 2018, Company-HK after ascertaining the fair value of the unexpired agreements in accordance with HKFRS 9 recognized a profit of \$500,000 which it credited to its retained profits. Company-HK closed its accounts on 31 December each year. It elected for assessment on the fair value basis for the year of assessment 2018/19.

The adjustment of \$500,000 related to financial assets on revenue account should be treated as a taxable receipt for the year of assessment in which the adjustment was recognized (i.e. year of assessment 2018/19).

If no election for assessment on the fair value basis is made for the year of assessment in which any adjustment is recognized and later, an election is made for a subsequent year of assessment, such an adjustment will be chargeable to tax or allowable for deduction for the election year.

Impact on other Part 4 provisions

Regulatory capital securities

68. Section 18I(2) provides that sections 18J, 18K and 18L do not affect the operation of sections 17C and 17D. For regulatory capital security (RCS), despite the election for assessment on the fair value basis, profits of the issuer and the specified connected person of the issuer of a RCS are to be determined as if fair value accounting were not applicable in relation to the RCS.

Example 8

On 1 January 2018, Bank-HK issued at \$10 million a RCS to Company-HK, both were resident and carrying on business in Hong Kong. Company-HK was a specified connected person of Bank-HK. Company-HK classified the RCS as measured at FVTPL. Both Bank-HK and Company-HK closed their accounts on 31 December each year. The fair value of the RCS at 31 December 2018 was \$12 million. According to HKFRS 9, Company-HK measured the RCS at \$12 million and a gain of \$2 million was recognized in profit or loss on 31 December 2018.

Company-HK made an election for assessment on the fair value basis for the year of assessment 2018/19. According to section 18J(1), the accounting gain of \$2 million recognized by Company-HK should be brought into account for computing Company-HK's assessable profits for the year of assessment 2018/19. However, by virtue of sections 18I(2) and 17D(2), the gain of \$2 million due to changes in fair value of the RCS should be excluded from Company-HK's assessable profits for the year of assessment 2018/19.

Interaction with other Part 4 provisions

69. Section 18I(3) provides that sections 18J, 18K and 18L apply despite any other Part 4 provisions to the extent that:

- (a) those other provisions (regardless of how they are expressed) would otherwise limit the profit, gain, loss, income or expense chargeable to tax or allowable for deduction to that which is realized, received, receivable, accrued, paid, payable or incurred; or
- (b) under those other provisions (regardless of how they are expressed), any profit, gain, loss, income or expense would otherwise be computed in a way different from that provided for in any of sections 18J, 18K and 18L (whether or not by having the profit, gain, loss, income or expense wholly or partly brought into account for a different year of assessment).

70. Further, section 18I(4) provides that sections 18J and 18L apply subject to the other Part 4 provisions, except as provided for in section 18I(3).

71. Section 18I(3) and (4) sets out the interaction of the provisions for assessment on the fair value basis with the other Part 4 provisions. The other Part 4 provisions include, for example:

- (a) the rules that profits/ losses which are offshore or capital in nature are not chargeable to tax or allowable for deduction;
- (b) the deeming provisions and deduction rules.

In general, the application of the provisions in sections 18I to 18L relating to profits tax assessment on the fair value basis are subject to the other Part 4 provisions (i.e. the source principle and the distinction between capital and revenue remain intact). Further, all the deeming provisions and deduction rules provided in the other Part 4 provisions will continue to be applicable. Appendix 2 relates to assessing practice concerning: locality of profits; capital/ revenue nature of income; capital/ revenue nature of expenditure; legal form and economic substance; hedge accounting and embedded derivatives.

72. Subject to the other Part 4 provisions, the fair value basis for profits tax assessment relates to: the timing of assessment; and the method of allocating income and expenses (i.e. assessable profits are not limited to realized profits and the way in which a profit, gain, loss, income or expense is computed may deviate from the contractual terms). In other words, profit, gain or loss may be taxable or deductible even though the financial instrument has not been disposed of; and income or expense may be taxable or deductible even though it has not been accrued or incurred.

TAX AVOIDANCE ARRANGEMENTS

Section 61A

73. When tackling transactions to avoid tax, the Assistant Commissioner is prepared to invoke the powers in section 61A to recharacterize a financial transaction, including reclassification of the nature of the financial instrument

and the nature of the income or expense, so as to counteract tax benefits obtained by the relevant person or persons who entered into or carried out the financial transaction for the sole or dominant purpose of obtaining such tax benefits. Though there are differences in tax legislations, useful reference can be found in judgments of other common law jurisdictions.

Relevant tax cases

74. In *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] 2 NZLR 175, non-interest bearing optional convertible notes were issued to Alesco Corporation, the parent company in Australia, and the difference between the present value of the debt component and the redemption amount was claimed for deduction as interest. The questions were: whether Alesco New Zealand suffered an economic cost commensurate with its claimed deductions; and whether the deductions for expenditure incurred fell outside the legislature's contemplation if Alesco New Zealand did not incur an economic cost. It was held that Alesco New Zealand did not actually pay interest but obtained a reduction in tax liability as if it had. Alesco New Zealand failed to prove that its use of the financial arrangement to claim deductions were within the legislature's contemplation.

75. In *Fidex Ltd v Revenue and Customs Commissioners* [2016] STC 1920, it was held that a loan relationship debit arising in respect of a tax avoidance scheme was wholly attributable to an unallowable purpose. Fidex, a BNP Paribas group company, issued to Swiss Re four classes of preference share. The terms of each preference share matched those of four bonds held by Fidex and entitled Swiss Re to receive 95% of the cash flows from each bond. Fidex then changed its accounting policy from UK GAAP to IFRS. The effect was that the 2004 UK GAAP accounts recognized both the preference shares and the bonds but the 2005 IFRS accounts recognized neither the preference shares nor 95% of the bonds. The IFRS treatment reflected the economic effect of the arrangement that Fidex had disposed of 95% of the bonds. The loan relationship rules at the time provided that if a change in accounting policy from one period to the next created a difference in the accounting value of a loan relationship asset then a corresponding debit or credit had to be brought into account in the later period. Fidex claimed such a debit in the sum of €84 million which, if allowable for tax purposes, would have been available for group relief throughout the BNP Paribas group of companies.

EFFECTIVE DATE

76. The aforementioned assessing practices will apply in relation to a year of assessment for which the basis period begins on or after 1 January 2018.

PART B: TAXATION OF FOREIGN EXCHANGE DIFFERENCES

FOREIGN CURRENCY TRANSACTIONS

Foreign currencies

77. Payments in foreign currencies may be made or received as a result of transactions carried out. Though circumstances may vary considerably, foreign currencies received may be converted into Hong Kong dollars immediately or after a lapse of time, or the foreign currency may be kept in an account maintained in a financial institution. At the same time, transactions carried out or assets or liabilities held may be denominated in foreign currencies. In preparing the annual financial statements, translation of the foreign currency transactions becomes necessary.

Accounting treatment

78. HKAS 21 deals with the effects of changes in foreign exchange rates with effect from 1 January 2005. The standard, however, does not apply for those derivative transactions and balances which are within the scope of HKFRS 9 and does not apply to hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation.

79. In accordance with HKAS 21, a foreign currency transaction is to be recorded on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction. At the end of each reporting period, foreign currency monetary items shall be translated using the closing rate; non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of the transaction; and non-monetary items that are measured at fair value in a foreign currency shall be translated using the exchange rates at the date when the fair value was measured.

80. Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements will normally be recognized in profit or loss in the period in which they arise.

81. When a gain or loss on a non-monetary item is recognized in other comprehensive income, any exchange component of that gain or loss shall be recognized in other comprehensive income. Conversely, when a gain or loss on a non-monetary item is recognized in profit or loss, any exchange component of that gain or loss shall be recognized in profit or loss.

82. Monetary item is defined in HKAS 21 as “units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency”. The essential feature of a monetary item is a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency (e.g. pensions and other employee benefits to be paid in cash, provisions that are to be settled in cash and cash dividends that are recognized as a liability). Similarly, a contract to receive (or deliver) a variable number of the entity’s own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency is a monetary item. Conversely, the essential feature of a non-monetary item is the absence of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency (e.g. prepaid rent, goodwill, intangible assets, inventories, property, plant and equipment and provisions that are to be settled by the delivery of a non-monetary asset).

83. According to HKFRS 9, the requirements under HKAS 21 will generally apply to financial assets and financial liabilities that are monetary items in accordance with HKAS 21. In particular, a financial asset measured at FVTOCI is treated as a monetary item. An exception is an investment in equity instrument for which an irrevocable election at initial recognition is made to present subsequent changes in fair value in other comprehensive income. Such an investment is not a monetary item and any foreign exchange gains or losses shall be recognized in other comprehensive income.

Relevant tax cases

84. While HKAS 21 has laid down the factors for determining the functional currency of an entity, the Commissioner accepts that a non-Hong Kong company may maintain its Hong Kong Branch accounts in its home country currency. However, per the judgment in *CIR v Malaysian Airline System Berhad* 3 HKTC 775, assessable profits or losses for each year must be expressed in Hong Kong dollar terms.

85. Exchange gains or losses are neither taxable nor allowable if they are of a capital nature. In *CIR v General Garment Manufactory (Hong Kong) Ltd* 4 HKTC 532, the exchange loss was found deductible because, notwithstanding the Board's limited analysis, the intention at the time of acquisition of the foreign currency was to dispose of it quickly for profit, not to acquire a permanent investment. In *CIR v Li & Fung* 1 HKTC 1193, Garcia J held in the High Court that although the sums in question originated as trading income the exchange loss was not deductible because their nature was altered to that of capital investment when accumulated and placed on deposits over time.

86. Whether a borrowing is on capital account or revenue account is a question of law to be determined on the facts of each particular case. A gain or loss of fixed capital is an item on capital account, while a gain or loss of circulating capital is an item on revenue account. In *Avco Financial Services Ltd v FCT* [1982] 13 ATR 63, it was held that exchange losses incurred in respect of funds borrowed by a person who carried on business of borrowing and lending money or dealing in foreign exchange were inherently on revenue account unless the funds were used to strengthen that person's profit-making capital base. In the case of an ordinary trading company, loans are on revenue account if they are temporarily fluctuating and incurred in meeting the ordinary running expenses of the business. In *CIR v Chinachem Finance Co Ltd* 3 HKTC 529, it was held at the High Court that in deciding whether a loss arising from borrowing was made on capital or revenue account, regard must be made to the length and other terms of borrowing and to the nature of the person's trade. In *Beauchamp v F W Woolworth plc* [1989] STC 510, Lord Templeman decided that the borrowing of a definite sum for a period of five years was on capital account. The case is important as it explored the borderline between capital and revenue borrowing which is relevant to determining the treatment of exchange gains and losses arising on such loans. For such traders, where borrowing is on capital account, exchange gains are not taxable and exchange losses are not relievable. The case established broad principles to be used in deciding whether borrowing is on capital or revenue account.

87. In *Overseas Containers (Finance) Ltd v Stoker* [1989] STC 364, it was held that the exchange losses were not deductible because the transactions undertaken solely for fiscal purposes (i.e. to get a tax advantage) were not trading transactions, even if the outward characteristics of trading were present.

88. Exchange gains or losses arising in or derived outside Hong Kong are neither taxable nor allowable. Normally, exchange differences arising from capital investment in a “foreign operation” as defined in HKAS 21 should not have any effect on the assessable profits.

Unrealized exchange differences

89. In the case where the exchange differences are in relation to financial instruments which are within the scope of HKFRS 9 and an election is made for assessment on the fair value basis in accordance with sections 18G to 18L, any foreign exchange gains or losses recognized in profit or loss, whether realized or unrealized, would be assessed or allowed accordingly.

90. For other cases, taxpayers may exclude any unrealized foreign exchange gains or losses in the tax computation and bring them back for assessment or deduction when they become realized in subsequent years. However, consistency should be observed.

Example 9

Company-HK was carrying on an import and export business in Hong Kong. It made up its accounts to 31 December each year and elected for assessment on the fair value basis. On 31 October 2018, it sold goods at a price of €10,000 to a customer in Germany. The exchange rate at the time of sale was €1 = \$9. A receivable of \$90,000 showed up in the accounts. Assuming that as at 31 December 2018, the exchange rate was €1 = \$10, the journal entries at year end would be:

<i>Account</i>	<i>Debit</i>	<i>Credit</i>
	\$	\$
<i>Receivable</i>	<i>10,000</i>	
<i>Profit & loss - exchange gain</i>		<i>10,000</i>

The exchange gain of \$10,000 would be assessable profit of the year of assessment 2018/19.

Overview of HKFRS 9

Classification of financial assets

1. Unlike Hong Kong Accounting Standard 39 *Financial Instruments: Recognition and Measurement* (HKAS 39) which prescribed four different rule-based classification and measurement criteria and approaches for financial assets (i.e. financial assets at fair value through profit or loss, held-to-maturity investments, loans and receivable, and available-for-sale financial assets), Hong Kong Financial Reporting Standard 9 *Financial Instruments* (HKFRS 9) adopts a single principle-based approach for all types of financial assets based on the business model within which they are held and their contractual cash flow characteristics. Under HKFRS 9, an entity shall classify financial assets as subsequently measured at amortized cost, fair value through other comprehensive income (FVTOCI) or fair value through profit or loss (FVTPL) on the basis of both:

- (a) the entity's business model for managing the financial assets;
and
- (b) the contractual cash flow characteristics of the financial assets.

2. The classification of financial assets in HKFRS 9 can be summarized as follows:

- (a) a financial asset shall be measured at amortized cost if:
 - (i) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flow; and
 - (ii) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding;
- (b) a financial asset shall be measured at FVTOCI if:

- (i) the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and
 - (ii) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding;
- (c) a financial asset shall be measured at FVTPL unless it is measured at amortized cost or at FVTOCI.

3. Equity instruments are generally measured at FVTPL because contractual cash flows on specified dates are not a characteristic of equity instruments. However, if an investment in equity instrument is neither held for trading nor contingent consideration recognized by an acquirer in a business combination, an entity may make an irrevocable election at initial recognition to present subsequent changes in fair value in other comprehensive income (i.e. at FVTOCI).

4. Despite paragraphs 2(a) and (b), an entity may, at initial recognition, irrevocably designate a financial asset as measured at FVTPL if doing so eliminates or significantly reduces an accounting mismatch.

Classification of financial liabilities

5. HKFRS 9 essentially does not change the approach to classification and measurement for financial liabilities. All financial liabilities shall be subsequently measured at amortized cost except for certain financial liabilities which are measured at FVTPL. A financial liability is classified as measured at FVTPL if it is held for trading or it is designated as measured at FVTPL. Derivatives that are liabilities shall be subsequently measured at FVTPL.

6. At initial recognition, a financial liability may be designated irrevocably as measured at FVTPL: when the entire hybrid contract is permitted to be designated as measured at FVTPL; or when doing so results in more relevant information because either it eliminates or significantly reduces an accounting mismatch or a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis.

Recognition and Measurement of financial instruments

7. Under HKFRS 9, an entity shall recognize a financial asset or a financial liability in its statement of financial position only when the entity becomes party to the contractual provisions of the instrument. At initial recognition, the entity shall measure the financial asset or financial liability at its fair value. In the case of a financial asset or financial liability not at FVTPL, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability should be added to or deducted from the fair value. In the case of trade receivables that do not have a significant financing component, the entity shall at initial recognition measure them at their transaction price.

8. As the classifications suggest, financial assets are subsequently measured, after initial recognition, at

- (a) amortized cost using the effective interest method;
- (b) fair value through other comprehensive income; or
- (c) fair value through profit or loss.

Further, an entity shall apply the impairment requirements to financial assets that are measured at amortized cost and at FVTOCI. Financial assets designated as hedged items are subject to the hedge accounting requirements.

9. After initial recognition, all financial liabilities shall be measured at amortized cost (using the effective interest method) except for financial liabilities at FVTPL (e.g. derivatives), which shall be subsequently measured at fair value. Financial liabilities designated as hedged items are subject to the hedge accounting requirements.

Effective interest method

10. “Effective interest method” is used in the calculation of amortized cost of a financial asset or a financial liability and in the allocation and recognition of interest revenue or interest expense in profit or loss over the relevant period by applying the “effective interest rate”.

11. The “effective interest rate” is the rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial instrument. The practical effect is that interest expenses, costs of issue and income (including interest, premium and discount) are spread over the term of the financial instrument, which may cover more than one accounting period.

Impairment

12. HKFRS 9 applies an “expected credit loss” model to impairment. Credit losses are recognized when expected rather than when incurred. The new model is forward-looking and it is no longer necessary for a trigger event to have occurred before credit losses are recognized. A loss allowance for expected credit losses (ECL) shall be recognized on a financial asset that is measured at amortized cost or at FVTOCI (except equity instrument), a lease receivable, a contract asset or a loan commitment and a financial guarantee contract to which the impairment requirements apply.

13. At each reporting date, an entity shall assess the credit risk (i.e. the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation) on the financial instrument and recognize a loss allowance for ECL. Under the general approach to impairment, there are three stages of credit risk deterioration. At each reporting date, an entity shall assess which stage a financial instrument falls into. The stage of credit risk deterioration determines the relevant impairment requirements and the basis of interest recognition.

(a) Stage 1 – 12-month ECL

The credit risk on the financial instrument has not increased significantly since initial recognition – the loss allowance for the financial instrument shall be measured at an amount equal to 12-month ECL. Interest revenue shall be calculated on the gross carrying amount of the financial asset (before credit losses are taken into account).

An entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have low risk at the reporting date.

(b) Stage 2 – Lifetime ECL

The credit risk on the financial instrument has increased significantly since initial recognition – the loss allowance for the financial instrument shall be measured at an amount equal to the lifetime ECL. Interest revenue shall remain to be calculated on the gross carrying amount of the financial asset.

Objective evidence for impairment may not be available at this stage. There is a rebuttable presumption that the credit risk on a financial instrument has increased significantly since initial recognition when contractual payments are more than 30 days past due.

(c) Stage 3 – Lifetime ECL (Credit-impaired financial asset)

The financial instrument is credit-impaired – the loss allowance for the financial instrument shall be measured at an amount equal to the lifetime ECL. Interest revenue shall be calculated by applying the effective interest rate to the amortized cost (after credit losses are taken into account) instead of the gross carrying amount of the financial asset.

A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of the financial asset have occurred. Evidence that a financial asset is credit-impaired includes observable data about the following events:

- (i) significant financial difficulty of the issuer or the borrower;
- (ii) a breach of contract, such as a default or past due event;
- (iii) the lender of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession that the lender would not otherwise consider;

- (iv) it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- (v) the disappearance of an active market for that financial asset because of financial difficulties; or
- (vi) the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

It may not be possible to identify a single discrete event— instead, the combined effect of several events may have caused financial assets to become credit-impaired.

14. An impairment loss (or gain), which represents the amount of ECL (or reversal) that is required to adjust the loss allowance at the reporting date to the amount that is required to be recognized in accordance with HKFRS 9, shall be recognized in profit or loss.

15. HKFRS 9 provides a simplified approach for certain trade receivables, contract assets and lease receivable where an entity shall always measure the loss allowance at an amount equal to lifetime ECL. An entity may select its accounting policy for trade receivables, lease receivables and contract assets independently of each other.

16. For purchased or originated credit-impaired financial assets (i.e. the financial assets are already credit-impaired when they are purchased or originated), the following approach is taken:

- (a) the financial assets are initially measured at the transaction price without an allowance for expected contractual cash shortfalls that are implicit in the purchase price;
- (b) lifetime credit losses are included in the estimated cash flows for the purposes of calculating the credit-adjusted effective interest rate;
- (c) interest revenue is calculated on the net carrying amount at the credit-adjusted effective interest rate;

- (d) ECL is discounted using the credit-adjusted effective interest rate determined at initial recognition.
- (e) subsequent changes from the initial ECL are recognized immediately in profit or loss.

Accordingly, an entity shall only recognize the cumulative changes in lifetime ECL since initial recognition as a loss allowance. Any favourable changes in lifetime ECL shall be recognized as an impairment gain, even if the lifetime ECL is less than the amount of ECL that was included in the estimated cash flows on initial recognition.

Recognition of profit, gain, loss, income or expense

17. For a financial asset or financial liability that is measured at amortized cost (not being part of a hedging relationship), any gain or loss on disposal is recognized in profit or loss when the financial asset or financial liability is derecognized. Foreign exchange differences and impairment gains or losses are recognized in profit or loss. Interest, discounts and premiums calculated using the effective interest method are recognized in profit or loss.

18. For an investment in debt instrument that is measured at FVTOCI, fair value changes are recognized in other comprehensive income. However, the related foreign exchange differences and impairment gains or losses are recognized in profit or loss. When the debt instrument is derecognized, the cumulative gain or loss previously recognized in other comprehensive income is reclassified from equity to profit or loss. Interest, discounts and premiums calculated using the effective interest method are recognized in profit or loss.

19. For an investment in equity instrument that is designated at FVTOCI, fair value changes including the related foreign exchange differences are recognized in other comprehensive income. Amounts presented in other comprehensive income are never transferred to profit or loss, not even when the equity instrument is derecognized. However, the cumulative gain or loss may be transferred within equity.

20. For a financial asset or financial liability that is measured at FVTPL, fair value changes including the related foreign exchange differences are recognized in profit or loss (except for the treatment of the effects of changes in the liability's credit risk described in paragraph 21).

21. For a financial liability designated at FVTPL, the amount of fair value changes attributable to changes in the credit risk of that liability is presented in other comprehensive income (unless such treatment would create or enlarge an accounting mismatch in profit or loss). Amounts presented in other comprehensive income shall not be subsequently transferred to profit or loss. However, the cumulative gain or loss may be transferred within equity. The treatment of the effects of changes in the liability's credit risk is not applicable to loan commitments and financial guarantee contracts that are designated as at FVTPL, all gains and losses on such loan commitments and financial guarantee contracts are recognized in profit or loss.

Hedge accounting

22. Hedge accounting is an exception to the usual rules used for accounting of financial instruments. An entity may choose to continue to apply the hedge accounting requirements of HKAS 39 or apply the hedge accounting requirements of HKFRS 9. Compared with HKAS 39, the hedge accounting model in HKFRS 9 allows greater flexibility which aligns the treatment of financial and non-financial items to also allow the hedging of risk components in non-financial items, provided the component is separately identifiable and reliably measurable.

23. Hedge accounting means designating a hedging instrument, normally a derivative, as an offset to changes in the fair value or cash flows of the hedged item which can be an asset, liability, firm commitment, forecasted future transaction or net investment in a foreign operation exposed to a risk of change in value or changes in future cash flows. Only contracts with a party external to the group or individual entity that is being reported on can be designated as hedging instrument. Hedge accounting matches the offsetting effects of the fair value changes in the hedged item and the hedging instrument. If the hedging relationship comes to an end, hedge accounting must be discontinued prospectively.

24. There are three types of hedging relationships:
- (a) “fair value hedge” is a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss;
 - (b) “cash flow hedge” is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognized asset or liability or a highly probable forecast transaction, and could affect profit or loss;
 - (c) “hedge of a net investment in a foreign operation” is a hedge of the interest in the net assets of that operation.

25. Under HKFRS 9, a hedging relationship qualifies for hedge accounting only if all of the following criteria are met:

- (a) the hedging relationship consists only of eligible hedging instruments and eligible hedged items;
- (b) at the inception there is formal designation and documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge;
- (c) the hedging relationship meets all of the following hedge effectiveness requirements:
 - (i) there is an economic relationship between the hedged item and the hedging instrument;
 - (ii) the effect of credit risk does not dominate the value changes that result from that economic relationship; and
 - (iii) the hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item.

26. In a fair value hedge, the gain or loss on the hedging instrument shall be recognized in profit or loss, or in other comprehensive income if the hedging instrument hedges an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income. At the same time, the carrying amount of the hedged item shall be adjusted by the hedging gain or loss which shall be recognized in profit or loss. However, if the hedged item is an equity instrument for which the entity has elected to present changes in fair value in other comprehensive income, those amounts shall remain in other comprehensive income. When a hedged item is an unrecognized firm commitment, the cumulative change in the fair value of the hedged item subsequent to its designation is recognized as an asset or a liability with a corresponding gain or loss recognized in profit or loss.

27. In a cash flow hedge, the component of equity associated with the hedged item (i.e. cash flow hedge reserve) is adjusted to the lower of the cumulative gain or loss on the hedging instrument from the inception of the hedge and the cumulative change in fair value of the hedged item from the inception of the hedge. The portion of the gain or loss on the hedging instrument that is an effective hedge shall be recognized in other comprehensive income. Any remaining gain or loss on the hedging instrument is hedge ineffectiveness and shall be recognized in profit or loss. The amount that has been accumulated in the cash flow hedge reserve shall be eventually reclassified to profit or loss; or shall be removed and included directly in the initial cost or other carrying amount of a non-financial asset or a non-financial liability resulted from a hedged forecast transaction.

28. Hedges of a net investment in a foreign operation shall be accounted for in a manner similar to cash flow hedges where the portion of the gain or loss on the hedging instrument relating to the effective hedge shall be recognized in other comprehensive income and the ineffective portion shall be recognized in profit or loss. The amount that has been accumulated in the foreign currency translation reserve shall be reclassified from equity to profit or loss on the disposal of the foreign operation.

29. An entity may enter into an option contract and designate only the change in intrinsic value of the option as the hedging instrument. HKFRS 9 prescribes the accounting treatment for the time value of the option. Change in fair value of the time value of the option shall be recognized in other

comprehensive income to the extent that it relates to the hedged item. The amount recognized shall be subsequently reclassified to profit or loss or adjusted against the initial cost or other carrying amount of a non-financial asset or a non-financial liability. Similar treatment applies to the forward element of a forward contract or the foreign currency basis spread of a financial instrument that is separated and excluded from the other element which has been designated as the hedging instrument. If an entity uses a credit derivative that is measured at FVTPL to manage the credit risk of all, or a part of, a financial instrument, it may under certain circumstances designate that financial instrument to the extent that it is so managed as measured at FVTPL.

Embedded derivatives

30. An embedded derivative is a component of a hybrid contract that contains a non-derivative host. Embedded derivatives can be found in a number of financial instruments, including put options in bonds, callable bonds, put options on preference shares etc.

31. From the holder's perspective, the general rule under HKFRS 9 is that if the hybrid contract contains a host that is an asset within the scope of the standard, the entire hybrid contract should be classified and measured as a whole. In the exceptional case that the hybrid contract contains a host that is not an asset within the scope of the standard, an embedded derivative should be separated from the host and accounted for as a derivative if, and only if, the following conditions are satisfied:

- (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host;
- (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- (c) the hybrid contract is not measured at fair value with changes in fair value recognized in profit or loss.

Reclassification

32. In the rare circumstances when an entity changes its business mode for managing financial assets, it shall reclassify all affected financial assets prospectively from the reclassification date. There is no need to restate any previously recognized gains, losses (including impairment gains or losses) or interest. As a matter of fact, only financial assets that are debt instruments can be reclassified since equity instruments are by default measured at FVTPL and the designation, if any, at FVTOCI is irrevocable. The entity shall not reclassify any financial liabilities.

33. The accounting treatment on the reclassification of financial assets is as follows:

- (a) if a financial asset is reclassified out of the amortized cost category into the FVTPL category, any gain or loss arising from a difference between the previous amortized cost and the fair value at the reclassification date is recognized in profit or loss;
- (b) if a financial asset is reclassified out of the FVTPL category into the amortized cost category, its fair value at the reclassification date becomes its new gross carrying amount;
- (c) if a financial asset is reclassified out of the amortized cost category into the FVTOCI category, any gain or loss arising from a difference between the previous amortized cost and the fair value is recognized in other comprehensive income;
- (d) if a financial asset is reclassified out of the FVTOCI category into the amortized cost category, the cumulative gain or loss previously recognized in other comprehensive income is removed from equity and adjusted against the fair value of the financial asset at the reclassification date;
- (e) if a financial asset is reclassified out of the FVTPL category into the FVTOCI category, the financial asset continues to be measured at fair value;

- (f) if a financial asset is reclassified out of the FVTOCI category into the FVTPL category, the financial asset continues to be measured at fair value and the cumulative gain or loss previously recognized in other comprehensive income is reclassified from equity to profit or loss at the reclassification date.

Assessing Practice

Locality of profits

1. Pursuant to section 14 of the Inland Revenue Ordinance (the Ordinance), only those profits which arise in or are derived from Hong Kong (i.e. sourced in Hong Kong) are chargeable to profits tax. Offshore profits are excluded from the charge of profits tax. The ascertainment of the source of an income is a practical, hard matter of fact. No simple, single, legal test can be employed. However, there is a substantial body of case law on the determination of the locality of profits. The broad guiding principle is to look at what the taxpayer has done to earn the profit in question and where he has done it. The Department has set out its views on the locality of profits in Departmental Interpretation and Practice Notes No. 21 (Revised). The general principle of law in this area is not affected by the accounting practice under Hong Kong Financial Reporting Standard 9 *Financial Instruments* (HKFRS 9).

2. It should be noted that provisions in section 15(1) deem the following sums as receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong:

- (a) section 15(1)(i) and (ia) — sums received by or accrued to a financial institution or a corporation, by way of interest which arises through or from the carrying on of its business (in the case of a financial institution) or its intra-group financing business (in the case of a corporation) in Hong Kong, notwithstanding that the moneys in respect of which the interest is received or accrues are made available outside Hong Kong;
- (b) section 15(1)(ib) — sums received by or accrued to a LAC banking entity (the meaning of which is defined in section 2 of the Ordinance), by way of interest in respect of a regulatory capital security, that arises through or from the carrying on by the entity of its business in Hong Kong, even if the moneys laid out for the acquisition of the security are made outside Hong Kong;

- (c) section 15(1)(l) and (la) – sums received by or accrued to a financial institution or a corporation, by way of gains or profits from the sale, disposal or redemption of certificates of deposit, bills of exchange, or regulatory capital securities, which arise through or from the carrying on in Hong Kong by the financial institution of its business or by the corporation of its intra-group financing business, even if the moneys laid out for the acquisition were made outside Hong Kong; or the sale, disposal or redemption is effected outside Hong Kong; and
- (d) section 15(1)(lb) – sums received by or accrued to a LAC banking entity, by way of gains or profits arising through or from the carrying on by the entity of its business in Hong Kong, from the sale, disposal or redemption of a regulatory capital security, even if the moneys laid out for the acquisition of the security were made outside Hong Kong; or the sale, disposal or redemption is effected outside Hong Kong.

Capital/ Revenue nature of income

3. Profits arising from the sale of capital assets are excluded from the charge of profits tax. Capital profits or losses, if any, recognized in profit or loss will be excluded from the computation of assessable profits. The accounting treatment, by itself, cannot operate to change the character of an asset from capital to revenue and vice versa. Whether the asset is of a capital or revenue nature is a question of law and all the surrounding circumstances, including the accounting treatment, have to be considered. Well-established tax-principles like the “badges of trade” will continue to be applicable. In deciding whether a financial instrument is a capital or revenue asset, the intention at the time of acquisition of the financial instrument is always relevant.

4. By definition, a financial asset or financial liability measured at FVTPL includes a financial asset or financial liability that is held for trading. It is regarded as held for trading if it is acquired or incurred principally for the purpose of selling or repurchasing; or there is a pattern of short-term profit-taking. Typically, unless it is a designated and effective hedging instrument, a derivative will be regarded as held for trading. Thus, the change in fair value

and the gain or loss on disposal, recognized in profit or loss, are prima facie taxable or deductible as the case may be.

5. Normally, financial assets are trading assets where the entity is a financial institution or it carries on an insurance, money lending, securities dealing or finance business because financial assets are often acquired in the course of the business with a view to resale at a profit. In *Punjab Co-operative Bank, Ltd, Amritsar v Income Tax Commissioner, Lahore* (1940) AC 1055, the Privy Council held that a bank had always to keep enough cash or easily realizable securities to meet any probable demand by the depositors and the realization of such securities by the bank was a normal step in carrying on the banking business. In *CIR v Sincere Insurance & Investment Co Ltd* 1 HKTC 602, the disposal of leasehold properties was held to be part of the normal business of an insurance company.

6. It should be noted there are specific provisions that apply to particular types of financial instruments. Section 14A provides that interest from and gains or profits from the sale, disposal or redemption on maturity or presentment of “qualifying debt instruments” are chargeable to tax at half rate (for debt instruments issued before 1 April 2018) or are not chargeable to tax (for debt instruments issued on or after 1 April 2018). Section 15(1)(j), (k), (l), (la) and (lb) deems as chargeable receipts gains or profits from the sale, disposal or redemption on maturity or presentment of “certificates of deposit”, “bills of exchange” and “regulatory capital security”. Section 26A excludes interest and profits derived from certain financial instruments from profits tax. The taxability of the sums stipulated in aforesaid legislative provisions should not be affected by the accounting practice under HKFRS 9.

Capital/ Revenue nature of expenditure

7. For the purpose of ascertaining profits in respect of which a person is chargeable to profits tax, section 17(1)(c) provides that no deduction shall be allowed in respect of any expenditure of a capital nature or any loss or withdrawal of capital. Neither HKFRS 9 nor Hong Kong Accounting Standard 21 *The Effects of Changes in Foreign Exchange Rates* (HKAS 21) in this respect prescribes any rules for distinguishing capital and revenue expenditures. Whether the expenditure is capital or revenue in nature is a question of law. The accounting treatment will not determine the nature of the expenditure.

8. In deciding the nature of an expenditure, capital or revenue, it is necessary to examine the facts and the circumstances. Where the expenditure is a one-off payment that brings into existence an asset or advantage for the enduring benefit of the trade, it is likely to be a capital expenditure. In *Sun Newspaper Ltd v FCT* [1938] 1 AITR 403, Dixon J observed at page 410 that expenditure was of a capital nature if its purpose was to establish, replace, or enlarge the capital structure of the taxpayer's business. In contrast, recurrent expenses connected with the process of operating it are generally considered to be revenue in nature.

9. In *CIR v Tai On Machinery Works Ltd* 1 HKTC 411, McMullin J, after referring to the textbook *Spicer and Pegler*, held that interest payments on a loan to finance the construction of a building which was a capital asset were non-deductible payments of a capital nature to the extent that the payments were made before the building could be used to produce profits. In *Wharf Properties Ltd v CIR* 4 HKTC 310, Lord Hoffmann at the Privy Council said whether interest payment was of a capital or revenue nature depended on the purpose for which the money was required during the relevant period. In *FCT v Energy Resources of Australia* 29 ATR 553, the Australian Federal Court observed that in some circumstances a discount expense incurred by the issuer of a discount note may be loss of a capital nature.

Example 2.1

Company-HK was an importer and exporter of household wares. It had made a forward purchase £1,000,000 that related to the future payment of the purchase price of machinery acquired for use in its business. The currency forward contract was clearly for the purpose of hedging against the foreign currency risk arising from the purchase of the machinery and Company-HK consistently adopted a basis adjustment.

The nature of the gain or loss arising from the currency forward contract depended on the nature of the underlying asset (i.e. hedged item). Thus the gain or loss from the currency forward contract was capital in nature. It should be taken into account in determining the capital expenditure incurred on the provision of the machinery for depreciation allowances purposes. Such gain or loss would similarly

be taken into account for depreciation allowances purposes if the company does not “basis adjust” (i.e. it was simply debited or credited to profit or loss).

Example 2.2

Company-HK was a retailer. It entered into forward contracts to hedge against foreign exchange risks in relation to goods purchased from various overseas suppliers, thus reducing fluctuations in the costs of its inventory.

Profits and losses from the forward contracts would be taken into account as part of the profits and losses of the trade because they related closely to the purchase of the inventory.

Example 2.3

Company-HK borrowed money at a floating rate of interest for purchase of trading stock and entered into an interest rate futures contract with a view to protecting itself against rises in interest rates.

Profits and losses relating to the interest rate futures contract would be taken into account as trading income or expenditure because the interest rate futures contract closely related to money borrowed on revenue account for the purchase of trading stock.

10. It should be noted that under a pass-through arrangement whereby an obligation to transfer the cash flows from the financial asset is assumed and the financial asset has been derecognized, it does not necessarily follow that the interest payments included in the cash outflows have fulfilled the conditions in section 16(2).

Example 2.4

Company-HK1 and Company-HK2 were carrying on business in Hong Kong. They were not connected. Company-HK1 advanced an interest bearing loan of \$100 million to Company-HK2. Company-HK1 funded its advances to Company-HK2 with a non-

recourse loan from Company-F, which was a company operating in Jurisdiction-F. Company-HK1 did not earn an interest spread and was only required to make payments of interest and repayments of principal out of the cash flows it received from Company-HK2. There was no assignment of the loan or of the cash flows by Company-HK1. Under the above arrangement, Company-HK1 did not have any risk or reward. Thus under HKFRS 9 Company-HK1 derecognized from its accounts the advance to Company-HK2 and the non-recourse loan from Company-F.

Though Company-HK1 had derecognized the loan in its accounts, the interest payments made by Company-HK1 to Company-F would be denied deduction under section 16(2)(c) because Company-F was not chargeable to profits tax in respect of the interest income it received. The interest received by Company-HK1 from Company-HK2 remained chargeable to tax under section 14 alone or in conjunction with section 15(1)(f) depending on the facts of the case. In law, Company-HK1 would remain entitled to collect interest from Company-HK2.

Example 2.5

Same facts as in Example 2.4 except that Company-HK2 and Company-F were connected.

The interest payments made by Company-HK1 and Company-HK2 would be denied deduction under section 16(2B).

Legal form and economic substance

11. Pursuant to Hong Kong Accounting Standard 32 *Financial Instruments: Presentation* (HKAS 32), the issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the economic substance of the arrangement.

12. In analysing a financial instrument, the Commissioner takes the view that the starting point is to decide its nature according to its legal form rather than

the accounting treatment or the underlying economic characteristics. Determining the legal form of a financial instrument will involve an examination of the legal rights and obligations created by the instrument. If the purported legal form of a financial instrument is not consistent with such rights and obligations, then it is necessary to look beyond the label given to the financial instrument.

13. The labels of “liability” and “equity” may not reflect the legal nature of the financial instrument. In these circumstances, it is necessary to take into account other factors which include the character of the return (e.g. whether fixed rate return or profit participation), the nature of the holder’s interest in the issuer company (e.g. voting rights and rights on winding-up), the existence of a debtor and creditor relationship and the characterization of the instrument by general law.

Example 2.6

Company-HK, registered under the Companies Ordinance (Cap. 622), issued preference shares with a par value of \$100 million and a dividend of 10% per annum. Puttable options attached to the preference shares allowed the redemption of the instruments for cash. The holders would have rights to attend members’ meetings, to receive notices of general meetings and to approve resolutions. The directors would be allowed to omit the dividend without throwing the company into bankruptcy.

Though the preference shares are accounted for as financial liabilities and the dividends declared are charged as interest expenses to the profit and loss account under HKAS 32, the preference shares would be treated for tax purposes as share capital because the relationship between the holders and the company was not a debtor and creditor relationship. Dividends declared would not be allowed for deduction as interest expenses and would not be assessed as interest income.

14. HKAS 32 requires the issuer of a compound financial instrument (e.g. a convertible debt instrument) to split the instrument into a “liability component” and an “equity component” and present them separately in the statement of financial position. Since the accounting treatment would reflect the economic

substance, the interest, discount, premium and expense attributable to equity component of the compound financial instrument should be denied deduction. Otherwise, part of the consideration payable for the compound financial instrument but attributable to the equity component, which is capital in nature, will be allowed for deduction.

Example 2.7

Company-HK issued 2,000 convertible bonds each having a face value of \$1,000,000 with a five-year term and an annual interest rate of 10%. At any time up to maturity, each bond would be allowed to convert into 250,000 ordinary shares. The terms of issue provided for a monetary settlement of bonds not having converted into ordinary shares.

Though in the accounts of Company-HK, the convertible bonds were split in accordance with HKAS 32 into “equity components” and “liability components”, they would be treated in whole as debts because Company-HK was a debtor of the money debt and the subordinate right to convert need not be exercised. Since the convertible bonds were issued with an embedded derivative recognized as an equity component, the part of the interest/ discount/ premium, if any, attributable to the equity component would not be allowed for deduction. The remaining part of the interest/ discount/ premium would be allowed for deduction if the conditions in section 16 were satisfied.

Hedge accounting

15. It is normal business practice for a company to engage in hedging activities in order to reduce its exposure to risk and uncertainty, such as changes in prices, interest rates or foreign exchange rates. Hedge accounting means designating one or more hedging instruments so that their change in fair value is offset, in whole or in part, to the change in fair value or cash flows of a hedged item.

16. HKFRS 9 provides guidance relating to hedging and allows hedge accounting where there is a designated hedging relationship between the hedging

instrument and a hedged item. It is prohibited otherwise. Hedge accounting is therefore not mandatory. An entity may choose to continue to apply the hedge accounting requirements of Hong Kong Accounting Standard 39 *Financial Instruments: Presentation and Measurement* (HKAS 39) or apply the hedge accounting requirements of HKFRS 9. As a practice, the Commissioner considers that the tax treatment should follow the accounting treatment of the hedging relationship.

17. If the hedging relationship qualifies for hedge accounting under HKAS 39 or HKFRS 9 and is accounted for as such, the Commissioner considers that the hedged item and the hedging instrument should not be considered separately because hedging is an attempt to mitigate the impact of economic risks of the hedged items. A distinct locality should not be imputed on to the hedging instrument and the locality of the hedging instrument should follow that of the hedged item. Regarding the nature of the profit or loss, capital or revenue, arising from the hedging instrument, the Commissioner accepts that it depends on the nature of the hedged item.

18. Hedge accounting will not occur in any one of the following situations even though a hedge exists:

- (a) the hedge relationship fails to qualify for hedge accounting;
- (b) the hedge relationship qualifies for hedge accounting but it is not adopted; or
- (c) hedge accounting is discontinued because the hedge becomes ineffective.

19. In the absence of hedge accounting, the hedging instrument and the hedged item are accounted for separately in the accounts. It follows that the changes in their values are not set off against each other. The tax treatments for the hedging instrument and the hedged item are therefore considered separately unless the hedging instrument is as a matter of fact a hedge against the hedged item even though hedge accounting is not or cannot be adopted. That may occur for example in the case of a small business where documentation is not properly done. In such situations, the tax treatment of the hedging instrument and the hedged item may not necessarily be considered separately even though

they are accounted for separately in the accounts. The facts and circumstances of each individual case have to be examined to determine whether the hedging instrument is really a hedge against the hedged item and should be treated together with the hedged item as a whole.

20. Enterprises sometimes control their group financial activities through a central treasury unit that trades with external third parties. This avoids a subsidiary having to go directly to the market to find a hedge. The usual practice is for the central treasury unit to execute a hedge with an external third party and that the terms and conditions of that hedge are passed on to the subsidiary through an internal hedge. An internal hedge will normally not be accepted unless there is a corresponding external hedge because an internal hedge will be eliminated on consolidation and will not achieve any commercial results for the group as a whole. It is recognized and accepted that the netting of exposures within a group on an arm's length basis by the treasury unit is possible. However, the taking of any net exposure would require a factual basis and would suggest that the central treasury unit is trading in derivatives. Often a group treasury company would not be taking any position of significance. In short, the Commissioner holds the view that hedge accounting should normally be available to those internal or centralized hedging activities with "matched external transactions" that are entered into on a one for one basis.

Example 2.8

Company-HK was buying and selling commodities (e.g. metals). The commodities were purchased from suppliers located in Australia and sold to enterprises located overseas. The profits from the commodity trade were fully assessable to profits tax. To guarantee the sales prices of the commodities, Company-HK was to short futures contracts on the commodities with appropriate settlement dates on an overseas exchange. The futures contracts qualified for hedge accounting and were accounted for as such.

The locality and nature of the commodity futures followed those of the underlying onshore trading transactions. The commodity futures were ancillary to the trading transactions and the intention was not to speculate in commodity futures.

Example 2.9

Company-HK whose functional currency was the Hong Kong dollar, carrying on a garment trading business in Hong Kong, held as investment yen-denominated shares listed on the Tokyo Stock Exchange and in order to eliminate the perceived risk of a fall in their value, entered into a forward contract with a local financial institution to sell for Hong Kong dollars an amount of yen equivalent to the yen value of the shares. The forward contract qualified for hedge accounting and was accounted for as such.

The forward contract and the shares would be given similar tax treatment because the forward contract was regarded as ancillary to the offshore capital transaction in shares. The forward contract in essence was part and parcel of an offshore investment.

Embedded derivatives

21. An embedded derivative is a component of a hybrid contract that contains a non-derivative host. Embedded derivatives can be found in a number of financial instruments, including put options in bonds, callable bonds, put options on preference shares etc. In form, a hybrid instrument remains one single instrument.

22. From the holder's perspective, the general rule under HKFRS 9 is that if the hybrid contract contains a host that is an asset within the scope of the standard, the entire hybrid contract should be classified and measured as a whole. In the exceptional case that the hybrid contract contains a host that is not an asset within the scope of the standard, an embedded derivative should be separated from the host and accounted for as a derivative under certain specified circumstances.

23. For tax purposes, the nature (i.e. capital or revenue) and locality of profit and loss of the hybrid instrument are determined on the basis that it is one single instrument. In other words, the nature and locality of profit and loss arising from the embedded derivative and the host contract should always be the same. Under HKFRS 9, the embedded derivative and the host contract are required to be separated under certain circumstances. Notwithstanding such accounting requirement, the same tax treatment will be applied because in form

the hybrid instrument is still one single instrument.

24. Where the embedded derivative has been separated from the host contract and the accounting treatments of changes in the carrying amounts of the embedded derivative and the host contract differ, the Commissioner so far as timing of assessment is concerned is prepared to accept the accounting treatment under HKFRS 9 as the tax treatment under assessment on the fair value basis. The Commissioner does not accept that the entire gain will only be taxed in the year the hybrid instrument is sold.