Inland Revenue Department
Hong Kong

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 42

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.

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Commissioner of Inland Revenue

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CONTENT

INTRODUCTION

Hong Kong is a major financial centre in the Asia Pacific region. Financial instruments are widely used by companies in Hong Kong to achieve investment, trading or hedging objectives. In May 2004, the Hong Kong Institute of Certified Public Accountants issued two new accounting standards dealing with financial instruments. The first one, HKAS 32, contains requirements for the presentation of financial instruments and identifies the information that should be disclosed. The second one, HKAS 39, establishes principles for the recognition and measurement of financial instruments.

2. The scope of, and accounting treatments prescribed by, HKAS 32 and HKAS 39 differ significantly from the existing accounting standard (i.e. SSAP 24) that governs the accounting and disclosure requirements of debt and equity securities. HKAS 32 and HKAS 39 superseded SSAP 24 when they came into effect on 1 January 2005. Part A of this Practice Note sets out the views of the Department regarding the tax treatment of gains or losses in respect of various financial instruments to which HKAS 32 and HKAS 39 apply.

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. In March 2004, the Hong Kong Institute of Certified Public Accountants issued HKAS 21 which deals with the effects of changes in foreign exchange rates. In the light of the development in case law and accounting, the Department has reviewed the tax treatment of foreign exchange differences. Part B of this Practice Note explains the current practice and the reasons for changing it.

PART A: TAXATION OF FINANCIAL INSTRUMENTS

BACKGROUND

Relevance of accounting standards for taxation purposes

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". However, the Court of Final Appeal, in *CIR v. Secan Ltd & Ranon Ltd, 5 HKTC 266*, 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 330:-

> "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."

5. The English authorities are also relevant. In *Gallagher v Jones, [1993] STC 537*, one of the authorities cited in *Secan*, Sir Thomas Bingham MR, having considered various authorities, concluded at pages 555-556:-

> "The object is to determine, as accurately as possible, the profits or losses of the taxpayers' businesses for the accounting periods in question. Subject to any express or implied statutory rule, of which there is none here, the ordinary way to ascertain the profits or losses of a business is to apply accepted principles of commercial accountancy. That is the very purpose for which such principles are

> formulated. As has often been pointed out, such principles are not static: they may be modified, refined and elaborated over time as circumstances change and accounting insights sharpen. But so long as such principles remain current and generally accepted they provide the surest answer to the question which the legislation requires to be answered …
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> The authorities do not persuade me that there is any rule of law such as that for which the taxpayers contend and the judge found. Indeed, given the plain language of the legislation, I find it hard to understand how any judge-made rule could override the application of a generally accepted rule of commercial accountancy which (a) applied to the situation in question, (b) was not one of two or more rules applicable to the situation in question and (c) was not shown to be inconsistent with the true facts or otherwise inapt to determine the true profits or losses of the business."

6. The decision by the Court of Final Appeal in *Secan* has reaffirmed the general principle that, subject to statutory modifications, in the measurement of profits or the timing of income the ordinary principles of commercial accounting should be followed. Thus, in deciding when and how the profit or loss derived from a financial instrument is to be recognised or measured, the accounting treatments under HKAS 39 are relevant, except where there is a specific express statutory provision or where the accounting classification and the legal classification of a financial instrument differ.

Overview of HKAS 32 and HKAS 39

7. 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". 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 HKAS 39.

8. Broadly speaking, HKAS 39 divides financial assets and financial liabilities into four categories, each with a different accounting treatment. A very brief summary is as follows:-

(a) "Financial assets or financial liabilities at fair value through profit or loss" are :-

  (i) financial assets acquired and financial liabilities incurred for the purpose of trading and all derivatives that are not hedges; or

  (ii) those financial assets or financial liabilities designated by the entity as at fair value through profit or loss upon initial recognition.

  They are measured at fair value with all resulting gains and losses recognised in the profit and loss account as and when they arise.

(b) "Held-to-maturity investments" are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity. They are accounted for at amortised cost. Profits or losses are recognised upon impairment, derecognition or through amortisation.

(c) "Loans and receivables" are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They are accounted for at amortised cost. Profits or losses are recognised upon impairment, derecognition or through amortisation.

(d) "Available-for-sale financial assets" are those non-derivative financial assets that are designated as available for sale or are not classified as above. They are measured at fair value with all resulting gains and losses taken to the equity account instead of the profit and loss account. On disposal, gains or losses previously taken to the equity account are recycled or transferred to the profit and loss account.

9. It should be pointed out that the above accounting classifications do not necessarily determine whether the financial assets or financial liabilities are capital or revenue in nature.

ASSESSING PRACTICE

The issues

10. Pursuant to section 14(1), only profits arising in or derived from Hong Kong are chargeable to profits tax and profits arising from the sale of capital assets are not taxable. In the context of financial instruments, the following issues need to be examined:-

(a) Timing of assessment

(b) Legal form and economic substance

(c) Capital v revenue nature of the income

(d) Deduction of expenses

(e) Locality of profits

(f) Hedge accounting

(g) Embedded derivatives

(h) Transitional adjustments

Timing of assessment

11. Under HKAS 39, when a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value. In the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability should be added to the fair value. The "fair value" is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

12. After initial recognition, HKAS 39 requires an entity to measure:-

(a) "Financial assets at fair value through profit or loss", including derivatives that are assets, and "available-for-sale financial assets" at their fair values without any deduction for transaction costs it may incur on sale or other disposal;

(b) “Loans and receivables” at amortised cost using the effective interest method;

(c) “Held-to-maturity investments” at amortised cost using the effective interest method; and

(d) “Financial liabilities” at amortised cost, except for financial liabilities at fair value through profit or loss which are measured at fair value.

Financial assets designated as hedged items are subject to measurement under the hedge accounting requirements (see paragraphs 34 to 40 below).

13. On the whole, the Department will follow the accounting treatment stipulated in HKAS 39 in the recognition of profits or losses in respect of financial assets of revenue nature (see paragraphs 23 to 26). Accordingly, for financial assets or financial liabilities at fair value through profit or loss, the change in fair value is assessed or allowed when the change is taken to the profit and loss account. For available-for-sale financial assets, the change in fair value that is taken to the equity account is not taxable or deductible until the assets are disposed of. The cumulative change in fair value is assessed or deducted when it is recognised in the profit and loss account in the year of disposal. For loans and receivables and held-to-maturity investments, the gain or loss is taxable or deductible when the financial asset is derecognised or impaired and through the amortisation process. Valuation methods previously permitted for financial instruments, such as the lower of cost or net realisable value basis, will not be accepted.

<u>Example 1</u>

Company A is a securities trading company incorporated in Hong Kong. It closes its books on 31 December each year. At the beginning of 2005, it purchased by way of subscription a medium term note due 2008 issued by the treasury arm of a listed company. The note has a face value of $100,000 and an interest of 8 per cent per annum payable at year end. Assuming at the end of 2005, the fair value of the note is $110,000 indicating that the market interest rate has fallen. On 31 December 2005, in accordance with HKAS 39, the following journal entries should be made:-

Account	*Debit*	*Credit*
	$	*$*
Investment - medium term note	*10,000*	
Profit & loss - increase in fair value		*10,000*
Interest receivable	*8,000*	
Profit & loss - interest income		*8,000*

The interest of $8,000 and the increase of $10,000 in fair value recognised in the profit and loss account are accrued profits under HKAS 1. Furthermore, they would be realised profits under section 79A(3) of the Companies Ordinance available for distribution as dividends. For profits tax purposes, the increase in fair value would be an assessable profit of the year of assessment 2005/06 even though Company A has not sold or disposed of the note in that year of assessment.

If Company A sells the note in the following year at $130,000, the gain of $20,000 will be assessed in the year of assessment 2006/07.

14. Under HKAS 39, the amortised cost of a financial asset or financial liability should be measured using the "effective interest method". Under HKAS 18, interest income is also required to be recognised using the effective interest method. 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. Thus a discount expense and other costs of issue should not be fully deductible in the year in which a financial instrument is issued. Equally, a discount income cannot be deferred for assessment until the financial instrument is redeemed.

15. The Department does not accept the argument that when the financial instruments are marked to market, the profits recognised in the profit and loss account are unrealised profits and therefore not taxable until realised in later periods. Such argument is essentially based on the decision in *Willingale v. International Commercial Bank Ltd, [1978] STC 75*.

16. The rationale of the decision in *Willingale* had been considered in the *Gallagher* case. When commenting on the decision in *Willingale,* Sir Thomas Bingham MR said at page 555:-

> "This was therefore a case in which there was evidence of two accounting treatments, both of them accepted by the responsible professional opinion. The bank succeeded because a majority held that the discounts were not, like interest, earned from day to day, but were earned when realised. To account for them earlier was, in the view of the majority, to violate the 'overriding principle of tax law' (as Sir John Pennycuick called it in the Court of Appeal (see *[1977] STC 183 at 196*) that profits must not be anticipated. The speech of Lord Keith (*[1978] STC 75 at 86-87*) does, however, show that in appropriate circumstances the accounting practice of accrual may be acceptable."

17. In respect of the timing of assessment, the Department would agree with the approach taken by the United Kingdom's Inland Revenue. The following extract from its Business Income Manual 31095 is relevant:-

> "Over the years the Courts have been concerned with the time at which profits are to be brought into charge to tax under Case I and II of Schedule D, and a number of judge made principles have emerged. But in recent years the Courts have become increasingly reluctant to discern judge made tax principles which override generally accepted commercial accounting practice.
>
> What is, or is not, commercially acceptable accounting treatment is a question of fact not law. Furthermore the Courts have recognised that accounting practice evolves over time. In principle, therefore, it is possible for a modern Court to come to a different decision from one taken in the past on the sole ground that the accounting treatment has changed. This is because two cases can be distinguished on the basis of their accountancy facts, even though the other facts may be identical. The Courts therefore have proceeded to ensure that the law does not become tied to outdated accountancy practice and to decisions taken where judges were forced to take a view of commercial practice in the absence of any accountancy evidence at all."

18. Notwithstanding that a taxpayer may hitherto claim on the basis of *Willingale* that the taxation of profits recognised in the profit and loss account in relation to financial instruments being marked to market should be deferred to a later period when they are "realised", there is now no longer any legal basis to make a similar claim. In essence, what HKAS 39 advocates is, in relation to profits on financial instruments, to recognise those profits by including them in the profit and loss account as profits, so as to reflect the changes of circumstances over time and the sharpening of accounting insights on the way the profits on financial instruments are presented and recognised. With the introduction of HKAS 39, the taxpayer can no longer rely on *Willingale* in support of its claim. This is not because *Willingale* which holds that profits should not be anticipated is no longer good law. The crucial reason is that unlike *Willingale* where the taxpayer could, at the material time, adduce professional opinion that the alternative accounting treatment was also made in accordance with accepted accounting principle, the taxpayer in the present case would not now be in a position to adduce such evidence in the light of HKAS 39.

Legal form and economic substance

19. Pursuant to 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.

20. In analysing a financial instrument, the Department 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.

21. 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 characterisation of the instrument by general law.

Example 2

Company B, a company registered under the Companies Ordinance, issued preference shares with a par value of $100 million and a dividend of 10 per cent per annum. Puttable options attached to the preference shares permit the redemption of the instruments for cash. The holders have rights to attend members meetings, to receive notices of general meetings and to approve resolutions. The directors can 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 will be treated for tax purposes as share capital because the relationship between the holders and the company is not a debtor and creditor relationship. Dividends declared will not be allowed for deduction as interest expenses and will not be assessed as interest income.

22. HKAS 32 requires the issuer of a compound financial instrument to split the instrument into a liability component and an equity component and present them separately in the balance sheet. The Department, while recognising that the accounting treatment might reflect the economic substance, will adhere to the legal form of the compound financial instrument and treat the compound financial instrument for tax purposes as a whole.

Example 3

Company C 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 per cent. At any time up to maturity, each bond can be converted into 250,000 ordinary shares. The terms of issue provide for a monetary settlement of bonds that have not been converted into ordinary shares.

Though in the accounts of Company C, the convertible bonds are split in accordance with HKAS 32 into equity components and debt components, they will be treated as debts because the company stands in the position of debtor of a money debt and the subordinate right to convert need not be exercised. Interest payments will be allowed for deduction if the conditions in section 16 are satisfied.

Capital / Revenue nature of the income

23. Profits arising from the sale of capital assets are excluded from the charge of profits tax. Capital profits or losses, if any, recognised in the profit and loss account will be excluded from the computation of assessable profits. The accounting treatment, by itself, cannot operate to change the character of an asset from investment to trading and vice versa. Whether the asset is of capital or revenue nature is a question of fact and degree 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 trading asset, the intention at the time of acquisition of the financial instrument is always relevant.

24. By definition, a financial asset or financial liability at fair value through profit or loss includes a financial asset or financial liability that is held for trading. It is classified as 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 classified as held for trading. Thus, the change in fair value and the gain or loss on disposal, recognised in the profit and loss account, are prima facie taxable or deductible as the case may be.

25. Normally, loans and receivables, held-to-maturity investments and available-for-sale financial assets are trading assets where the taxpayer 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 *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.

26. 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” will be assessed at half rate. Section 15(1)(j), (k) and (l) deem as chargeable receipts gains or profits from the sale, disposal or redemption on maturity or presentment of “certificates of deposit” and “bills of exchange”. 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 HKAS 39.

Deduction of expenses

27. 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. HKAS 39 in this respect does not prescribe 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.

28. 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.

29. 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.

<u>Example 4</u>

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

The nature of the gain or loss arising from the currency forward contract depends on the nature of the underlying asset. Thus the gain or loss from the currency forward contract will be capital in nature. It will be taken into account in determining the capital expenditure incurred on the provision of the machinery for depreciation allowances purposes. Such gain or loss will similarly be taken into account for depreciation allowances purposes if the company does not "basis adjust" (i.e. it is simply debited or credited to the profit and loss account).

<u>Example 5</u>

Company E is a retailer. It has 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 will be taken into account as part of the profits and losses of the trade because they relate closely to the purchase of the inventory.

Example 6

Company F has borrowed money at a floating rate of interest for purchase of trading stock and enters 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 will be taken into account as trading income or expenditure because the interest rate futures contract closely relates to money borrowed on revenue account for the purchase of trading stock.

30. HKAS 39 contains rules governing the determination of impairment losses. In short, all financial assets must be evaluated for impairment except for those measured at fair value through profit or loss. As a result, the carrying amount of loans and receivables should have reflected the bad debts and estimated doubtful debts. However, since section 16(1)(d) lays down specific provisions for the deduction of bad debts and estimated doubtful debts, the statutory tests for deduction of bad debts and estimated doubtful debts will apply. Impairment losses on other financial assets (e.g. bonds acquired by a trader) will be considered for deduction in the normal way.

31. 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 derecognised, it does not necessarily follow that the interest payments included in the cash outflows have fulfilled the conditions in section 16(2).

Example 7

Company G and Company H are carrying on business in Hong Kong. They are not connected. Company H advanced an interest bearing loan of $100 million to Company G. Company H funded its advances to Company G with a non-recourse loan from Company I, which is a company operating outside Hong Kong. Company H does not earn an interest spread and is only required to make payments of interest and repayments of principal out of the cash flows it receives from Company G. There is no assignment of the *loan or of the cash flows by Company H. Under the above arrangement, Company H has neither any risk nor reward. Thus under HKAS 39 Company H has derecognised from its accounts the advance to Company G and the non-recourse loan from Company I.*

Though Company H has derecognised the loan in its accounts, the interest payments made by Company H to Company I will be denied deduction under section 16(2)(c) because Company I is not chargeable to profits tax in respect of the interest income it receives. The interest received by Company H from Company G remains 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 H remains entitled to collect interest from Company G. Company G can claim deduction for the interest paid to Company H.

Example 8

Same facts as in Example 7. Assume Company G and Company I are connected.

The interest payments made by Company G to Company H will be denied deduction under section 16(2B).

Locality of profits

32. 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 & Practice Notes No. 21. The general principle of law in this area is not affected by the accounting practice under HKAS 39.

33. It should be noted that section 15(1)(l) deems as chargeable profits gains or profits from the sale, disposal or redemption of certificates of deposit or bills of exchange through or from the business of a financial institution notwithstanding the moneys for the acquisition were made outside Hong Kong or the sale, disposal or redemption is effected outside Hong Kong.

Hedge accounting

34. Hedge accounting is an exception to the usual rules used for accounting of financial instruments. Application of hedge accounting is permitted under HKAS 39 if strict criteria (see paragraph 36) are met. 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 or forecasted future transaction exposed to a risk of change in value or changes in future cash flows. 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.

35. Hedging relationships are of three types:-

(a) "Fair value hedge" is a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, 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 a recognised 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.

36. As a result of HKAS 39, a hedging relationship qualifies for hedge accounting if, and only if, all of the following conditions are met:-

(a) At the inception there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy.

(b) The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk.

(c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

(d) The effectiveness of the hedge can be reliably measured.

(e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective.

37. In a fair value hedge, the profit or loss from remeasuring the hedging instrument is recognised immediately in the profit and loss account. At the same time, the carrying amount of the hedged item is adjusted and the change is also recognised immediately in the profit and loss account. In a cash flow hedge, the portion of the profit or loss on the hedging instrument that is an effective hedge is recognised directly in equity and is recycled to the profit and loss account when the hedged cash flows affect the profit. In other words, in these types of hedges, only the net result is shown in the profit and loss account. Any hedge ineffectiveness, even if the hedge continues to be effective overall, is recognised in the profit and loss account of the current period. As a practice, the Department considers that the tax treatment should follow the above accounting treatment of the hedging relationship.

38. If the hedging relationship qualifies for hedge accounting under HKAS 39 and is accounted for as such, the Department 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 Department accepts that it depends on the nature of the hedged item.

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

(a) the hedge relationship fails to satisfy the conditions in paragraph 36 above;

(b) the hedge relationship satisfies the conditions in paragraph 36 above but hedge accounting is not adopted; or

(c) hedge accounting is discontinued because the hedge becomes ineffective.

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.

40. 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 recognised 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 Department holds the view that hedge accounting should normally be available to those internal or centralised hedging activities with “matched external transactions” that are entered into on a one for one basis.

Example 9

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

The locality and nature of the commodity futures follow those of the underlying onshore trading transactions. The commodity futures are ancillary to the trading transactions and the intention is not to speculate in commodity futures.

Example 10

Company K whose base currency is 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 qualifies for hedge accounting and is accounted for as such.

The forward contract and the shares will be given similar tax treatment because the forward contract is 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

41. An embedded derivative is a component of a hybrid instrument that contains a non-derivative host contract. 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 legal form, a hybrid instrument is one single instrument. Accordingly, for accounting purposes,

the embedded derivative and the host contract are not separated. This was the situation before HKAS 39. However, under HKAS 39, an embedded derivative is now required to be separated from the host contract if:-

(a) the hybrid instrument is not recorded at fair value with profits or losses taken to profit and loss account;

(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(c) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract.

42. 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 HKAS 39, the embedded derivative and the host contract are required to be separated under certain circumstances. However, notwithstanding such change in accounting requirement, the same tax treatment will be applied because in its legal form the hybrid instrument is still one single instrument.

43. 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 Department so far as timing of assessment is concerned is prepared to accept the accounting treatment under HKAS 39 as the tax treatment. The Department does not accept that the entire gain will only be taxed in the year the hybrid instrument is sold.

Transitional adjustments

44. HKAS 39 itself prescribes the transitional adjustments for trading financial assets or liabilities when a taxpayer first adopts HKAS 39. According to HKAS 39, the cumulative change in fair value of the trading financial assets or liabilities in the periods prior to the adoption of HKAS 39

should be accounted for by adjusting the opening balance of retained earnings, i.e. a prior period adjustment.

45. The Department considers that a prior period adjustment for the trading financial asset or liability should be treated as a taxable receipt for an increase in retained profits or a deductible expense for a decrease in retained profits in the year of assessment in which the prior period adjustment is recognised in the retained earning. 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".

<u>Example 11</u>

Company L is a money lender. Prior to 1 January 2005, it did not record its currency swap agreements and interest rate swap agreements in its balance sheet. On 1 January 2005, Company L after ascertaining the fair value of the unexpired agreements recognised a profit of $500,000 which it credited to its retained profits as a prior period adjustment.

The prior period adjustment of $500,000 relates to trading financial assets and should be treated as a taxable receipt in the year of assessment in which the prior period adjustment is recognised, i.e. year of assessment 2005/06.

46. In the case of available-for-sale financial assets, according to HKAS 39, on its first adoption, all cumulative changes in fair value of such assets in the prior periods should be recognised in the equity account. On subsequent disposal, the cumulative gain or loss previously taken to the equity account is transferred to the profit or loss account. The Department would accept that the cumulative change in fair value is taxable or deductible, as the case may be, in the year in which it is eventually transferred to the profit and loss account, i.e. not in the year of first adoption of HKAS 39. This practice would apply only if the assets are of a revenue nature.

ANTI-AVOIDANCE

47. It has to be emphasised that when tackling transactions to avoid tax, the Assistant Commissioner is prepared to invoke the powers in section 61A to recharacterise 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.

EFFECTIVE DATE

48. HKAS 32 and HKAS 39 are applicable for annual periods beginning on or after 1 January 2005. The aforementioned assessing practices will apply starting from the year of assessment 2005/06.

PART B: TAXATION OF FOREIGN EXCHANGE DIFFERENCES

BACKGROUND

Accounting practice

49. Business concerns may carry out transactions as a result of which they receive or make payments in foreign currency. The circumstances may vary considerably; foreign currencies received may be converted into Hong Kong dollars immediately or after a lapse of time; or the concern's accounts may be kept in foreign currency. At the same time, they may carry out transactions or hold assets or liabilities denominated in foreign currencies. In preparing the annual accounts, translation of the foreign currency transactions are necessary. HKAS 21 deals with the effects of changes in foreign exchange rates and has replaced SSAP 11 with effect from 1 January 2005.

50. Under 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 each balance sheet date, 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 determined.

51. 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 recognised in profit or loss in the period in which they arise.

Overview of the case law

52. While HKAS 21 has laid down the factors for determining the functional currency of an entity, the Department accepts that a foreign company may maintain its Hong Kong Branch accounts in its home country

currency. For tax purposes, however, its assessable profits or losses for each year must be expressed in Hong Kong dollar terms (*CIR v. Malaysian Airline System Berhad, 3 HKTC 775*).

53. 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.

54. 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.

55. 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.

ASSESSING PRACTICE

Practice before Secan

56. In the case of financial institutions, the assessing practice before *Secan* was that the exchange gains or losses recognised in the profit and loss accounts in accordance with accounting practice were assessed or allowed for deduction. There had been no argument on the question of taxing unrealised exchange gain or allowing unrealised losses.

57. However, other taxpayers recognised the gains or losses in the profit and loss account but excluded them in the tax computation due to unrealisation. It had long been the Department's practice to accept the taxpayer's tax computation provided that the treatment was followed consistently and that subsequent adjustment was made upon realisation.

Reasons for change

58. Following the general principle laid down by the Court of Final Appeal in the *Secan* case that assessable profits must be ascertained in accordance with the ordinary principles of commercial accounting, the Department has reviewed the practice in paragraph 57 above and decided to cease this practice. In other words, all taxpayers including financial institutions should treat exchange gains or losses recognised in the profit and loss account, whether realised or not, as taxable receipts or deductible expenses. An adjustment in the tax computation on the ground that an exchange difference has not yet realised will not be accepted.

59. As noted above, the *Secan* case requires the tax treatment to follow the accounting treatment. This principle applies to financial instruments. There is no reason why it should not be applied to exchange gains or losses as well. The Department considers that the change of practice brings about a tax treatment of exchange gains and losses that is consistent with the treatment of other types of income and expenses.

<u>Example 12</u>

Company M is carrying on an import and export business in Hong

Kong. It makes up its accounts to 31 December each year. On 31 October 2005, 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 shows up in the accounts. Assuming that as at 31 December 2005, the exchange rate is €1 = $10, the journal entries at year end will be:-

Account	*Debit*	*Credit*
	$	*$*
Receivable	*10,000*	
Profit & loss - exchange gain		*10,000*

The exchange gain of $10,000 will be assessable profit of the year of assessment 2005/06.

60. The new practice is similar to the approach of the UK Revenue of taxing or allowing unrealised exchange differences. The following is an extract from its Business Income Manual BIM 39510 on this topic:

> "(Finance Act 1998) requires Case I profits to be computed in accordance with generally accepted accounting practice, subject to any over-riding rule of law. So in general a business must bring into its Case I computation all exchange gains and losses shown in its accounts, <u>whether realised or unrealised</u>, provided that they conform to the general principles (of taxability and deductibility)." (Emphasis added.)

EFFECTIVE DATE

61. The revised practice will be applied by the Department to any foreign exchange differences for the year of assessment 2005/06 and subsequent years. Accordingly, taxpayers and their representatives should adopt the revised practice in the preparation of profits tax returns for these years of assessment. Where an unrealised exchange difference has been excluded from the tax computation in an earlier year of assessment, it should be adjusted in the tax computation for the year 2005/06.