Changes to how financial assets and liabilities are classified and measured will become mandatory from 2015 under the published phases of IFRS 9 Financial Instruments. Further changes to impairment and hedge accounting are impending under exposure drafts ED/2009/12 and ED/2010/13. The main changes to accounting for financial instruments have been outlined in earlier issues of A Plus, particularly in the April 2010 article “Deconstructing IAS 39.” The major changes of potential tax relevance are as follows:

- **Abolition of the existing classification of financial assets.** The four categories under IAS 39 are abolished, with assets simply being classified as measured at amortized cost or fair value.
- **Classification based on business models and contractual cash flow characteristics.** Assets will be measured at amortized cost if they are held within a business model, the objective of which is to hold assets and collect contractual cash flows consisting solely of payments of principal and interest. All other assets are measured at fair value. The tainting rules - whereby a portfolio of assets measured at amortized cost would be reclassified as available for sale if one element of the portfolio were to be sold - no longer apply, providing that the business model does not change.

- **An increase in the number of fair value movements through the income statement.** The abolition of the available-for-sale asset category, under which many fair value movements went through reserves, means that most fair value movements should now go through the income statement. Under the new election option, where fair value movements on a particular non-trading equity instrument are accounted for through reserves, the gain on the asset no longer needs to be recycled to the income statement on realization. In addition, fair value movements on financial liabilities, which arise from changes to own credit risk, will be put through reserves and not be recycled to the income statement on the extinction of the liability. A hybrid financial instrument will no longer be bifurcated into a host contract and embedded derivative and measured separately on different bases. It will be assessed as a whole for classification and therefore be fair valued through the income statement in its entirety.

- **The mandatory use of a credit allowance account for loan impairments.** The impairment event is no longer required for impairment losses to be recognized in the income statement. Projected credit losses over an instrument’s life must be estimated in the first year and updated in each subsequent period to reflect the latest projections. The resulting debits or credits are posted to the credit allowance account. For loans in an identified book of bad debts, expected losses are determined on an individual basis and credited to the credit allowance account up front. For good loans, expected losses are estimated at a portfolio level and credited over the life of those loans. In addition, in each period the losses expected to occur in the next 12 months need to be credited in full. Loans may be transferred between the books. But the exact mechanics of this accounting treatment, set out in the exposure draft on impairment, are yet to be finalized.

The starting point for the calculation of Hong Kong profits tax, as confirmed by the Court of Final Appeal in 2000 in **Commissioner of Inland Revenue v Secan Limited & Ranon Limited** (5 HKTC 266) is the profits per the financial statements, subject to any adjustments required by the provisions of the Inland Revenue Ordinance. Until recently the Inland Revenue Department’s stance, and the commonly accepted position among practitioners, was that fair value gains or losses recorded in the accounts on the basis of the IFRS standards would be given tax effect as long as they were Hong Kong-sourced and not capital in nature. But the recent decision by the Court of First Instance in **Nice Cheer Investment Ltd. v CIR** (2011; HCIA 8/2007), if upheld in the higher courts, makes it possible that gains will not be
recognized for tax purposes until they are actually realized. Until the case goes higher, the IRD is likely to continue with its existing assessment practice. Regardless of the case’s outcome, with the changes in accounting for financial instruments set out in IFRS 9, the amount and timing of profits tax liabilities are expected to change and certain technical tax issues may arise over obtaining tax deductions.

**Accelerated tax deductions for bad debts?**

Under IAS 39, if the relevant impairment event or bad debt recognition occurs after a business has already been in the red for a while, then losses recognized might not be used until profits have recovered sufficiently to absorb the accumulated tax losses carried forward. This may not be for many years. Use of the credit allowance account does not require an impairment event to occur before doubtful debt losses may be recognized. If it is followed for tax purposes, this may mean that bad debt deductions can be taken earlier and used against other profits. But the exact tax impact of the new approach is uncertain because it is not yet final how credit losses will be presented in the income statement. One proposal is that the income statement should show two figures for interest revenue: a gross interest revenue figure before taking account of debits to the credit allowance account and a net interest revenue figure after an adjustment for movements on the credit allowance account. Arguably, under this approach, the movement on the credit allowance account is simply an adjustment in arriving at the revenue figure, not an expense for tax purposes. If this position can be supported, the profit calculated per the accounts would be the profit for tax purposes and the ordinance’s provision governing deductions for bad debts – section 16(1)(d) – would not apply to restrict the tax deduction allowed.

On the other hand, if the movement on the credit allowance account is treated as an expense for tax purposes, the manner in which section 16(1)(d) operates will almost certainly hinder the taking of deductions in practice. The provision allows bad or doubtful debts incurred to the extent they are estimated to the assessor’s satisfaction to have become bad. This section is enforced strictly in practice and the IRD requires evidence that the potential debt has become partly or wholly irrecoverable. The manner in which the new credit allowance account debits are calculated may come under close scrutiny by the IRD, because the absence of an identifiable impairment event may lead it to dispute the loss incurred. Certain international cases, such as the Privy Council decision in *CIR v Mitsubishi Motors New Zealand Limited* (1995; 17 NZTC 12,351), indicate that a statistically estimated expense can be considered as incurred. But given the requirements of section 16(1)(d) and the IRD’s history of denying general provisions for doubtful debts, it’s unlikely that the IRD will allow such provisions. Whether the IRD could be persuaded to allow credit allowance account adjustments in respect of the bad loans book on the basis that allowances are calculated after a consideration of individual loans, is a matter for further consideration.

The implementation of the new IFRS 9 may be a good opportunity to clarify the legislation and the administrative practice concerning the deductibility of bad debts. In the absence of changes to the IRD practice, taxpayers should consider the implications of having to calculate substantial deferred tax assets for inclusion in the financial statements.

**Capital versus revenue**

The accounting treatment of a transaction does not determine its tax treatment for the purposes of the distinction between capital and revenue, but it can be influential. Under IAS 39, entire portfolios of loans can be re-characterized as available-for-sale assets under tainting, but this is unlikely to occur under the new business model approach in IFRS 9. A taxpayer selling an asset classified as available for sale might find it hard to argue that the asset is held for the long term and that the gain is on capital account and not subject to tax. With the abolition of the tainting rules, it can be argued that the asset has remained part of a business model whose objective is to hold the assets for the long term and simply collect the contractual cash flows. This may aid the argument that the gains are on capital account, at least for taxpayers that aren’t in the money-lending business.

**Greater profits tax liability volatility**

The abolition of available for sale assets and bifurcation, and the establishment of
tighter criteria for assets to fall within the amortized cost business model, may lead to an increase in the number of fair value movements passing through the income statement. This will result in volatility in the accounting profit figure, forming the basis for assessable profits. But, in light of the decision in Nice Cheer Investment Ltd., it might be asked whether fair value gains on financial assets now need to be derecognized for tax purposes until realization.

**Equity instruments accounted for through reserves**

Gains on the disposal of certain non-trading equity instruments, where an election has been made to account for the fair value movements through reserves, are not recycled to the income statement. Equally, the fair value movements on financial liabilities, which arise from changes to an entity’s own credit risk, will be put through reserves and won’t be recycled to the income statement on the extinction of the liability. The IRD could take the view that annual fair value movements through reserves should be taxed in the year in which they arise to ensure that no amounts fall outside the tax charge.

The IRD has indicated, in notes from its 2005 meeting with the Hong Kong Institute of CPAs, that it had obtained legal advice from the Department of Justice indicating that an item reflected in an equity account, rather than the profit and loss account, was not decisive for determining its taxability or deductibility. The IRD’s attitude towards gains put through reserves as a result of an election may be influenced by the notion that taxpayers may keep gains outside the income statement of their own volition. This treatment would be considerably worse than the current treatment for assets for sale instruments, whereby fair value gains are taxed at the time of realization. But the law is unclear and it would be helpful if the IRD could clarify its technical basis for such treatment.

**Hedge accounting accessibility**

Changes to hedge accounting are intended to make this more widely applicable. While hedging for tax purposes may occur even without the use of hedge accounting, using hedge accounting more may help taxpayers argue that specific hedges are acceptable for tax purposes – i.e., that the gains and losses on the hedging and hedged instruments have the same source and nature – and thereby limit tax exposure. Current IRD practice, as set out in Departmental Interpretation and Practice Note No. 42, defines hedge accounting as matching the offsetting effects of the fair value changes in individual hedged items and hedging instruments. Concepts of macro, portfolio and other forms of net exposure hedging are proposed for introduction in the new standards. The IRD’s guidance and approach should be revised to deal with such new approaches.

**Increased tax liabilities in the transition year**

Substantial tax liabilities (or additional losses) may crop up if the IRD chooses to tax the entire prior-year adjustment during the transition to the new accounting standards. The case of Pearce v Woodall-Duckham (1978; 51 TC 271) gives the IRD a basis for adopting the position, as the IRD has noted in the section on transitional adjustments in DIPN 42. Whether the IRD will allow taxpayers to spread their tax liabilities arising on transition is open to question – jurisdictions such as the U.K. and Singapore allowed for the deferred recognition of adjustments on the transition to IAS 39, but Hong Kong didn’t. Taxpayers should expect a repeat of this policy on the transition to IFRS 9. The IRD should reconsider DIPN 42 to deal with the problems likely to arise on IFRS 9’s implementation, and revisions to the guidance should consider the IRD’s practice when it dealt with the implementation of IAS 39.

The new IFRS 9 is part of a wider programme of accounting reforms for the financial services industry and is likely to have a big effect on taxation. Changes to the accounting for financial instruments have yet to be finalized and further tax issues may be identified once the final standard is published. Nonetheless, it’s already clear that IFRS 9’s implementation will change the amount and timing of profits tax liabilities, resulting in a greater volatility of annual tax liabilities (although the final outcome of Nice Cheer Investment Ltd. will be highly relevant in this regard). Technical issues may also arise with the IRD in terms of tax deduction availability.

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