LC Paper No. CB(1)321/18-19(01)

香港稅務學會
THE TAXATION INSTITUTE OF HONG KONG
(Incorporated in Hong Kong as a company limited by guarantee)

10 December, 2018

The Hon Kenneth Leung
Chairman of the Bills Committee
Inland Revenue (Amendment) No. 7 Bill 2018
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Hong Kong

Dear Hon Kenneth Leung,

Inland Revenue (Amendment) No. 7 Bill 2018 (the Bill)

In response to your invitation for views on the subject matter, we would like to submit below our comments on the Bill. Our comments will focus on those provisions of the Bill which align the tax treatment of financial instruments with their fair value accounting treatment under Hong Kong Financial Reporting Standard No. 9 (HKFRS 9 or its equivalent under the international accounting stanadards IFRS 9).

Our comments

We welcome the introduction of the Bill which provides solid legal backing for the adoption of fair value accounting for tax reporting purposes by election. This legislative proposal for Hong Kong is more flexible than the corresponding legislation in Singapore where the adoption of fair value accounting for tax reporting purposes is mandatory.

1. *Expected credit losses (ECL)*

a. *Credit-impaired ECL for financial instruments acquired in the secondary market for trading purposes should also be tax deductible*

Based on its current provisions, the proposed sections 18K(3)-(5) of the Inland Revenue Ordinance (IRO) will effectively disallow tax deduction for credit-impaired ECL in respect of financial instruments which are not in the form of a loan made by a taxpayer in the ordinary course of their money-lending business or a trade debt in Hong Kong. For example, a taxpayer may acquire in the secondary market a debt instrument in the form of a bond and the taxpayer values the bond at amortized cost or at fair value through other comprehensive income, i.e. FVOCI under HKFRS 9.

In such a case, any credit-impaired ECL in respect of the bond which is charged to the income statement would apparently not satisfy the conditions specified in sections 18K(3)-(5) – i.e. the bond may not be regarded as a loan lent by the taxpayer in their ordinary course of money-lending business or a trade debt in Hong Kong.

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If so, the credit-impaired ECL may only be allowed for a tax deduction when the bond is ultimately sold or realized. This does not seem justified when compared to credit-impaired ECL in respect of a loan lent in the ordinary course of a money-lending business or a trade debt in Hong Kong (which are also valued at amortized cost or FVOCI).

We therefore propose that an additional condition be included in sections 18K(3)-(5) specifying that credit-imparied ECL in respect of financial instruments valued at amortized cost or FVOCI which are acquired for trading purposes or are held on revenue account by a taxpayer will also qualify for tax deduction.

b. Non-credit-impaired ECL should also qualify for tax deduction, particularly those made by financial institutions

As noted above, under the proposed section 18K(3)-(5), tax deductions for ECL in respect of a loan made in the ordinary course of a money-lending business or a trade debt in Hong Kong will only be granted when the loan or the debt is credit-impaired under HKFRS 9.

We consider that, to be more in line with the objective of this legislative exercise of aligning the accounting treatment under HKFRS 9 with the tax treatment, ECL which are not credit-impaired and charged to the income statement under the HKFRS 9 framework should also qualify for tax deduction.

Under this proposal, tax deductions for all stages of ECL under the HKFRS 9 framework, credit-impaired or not, will then be based on the objective accounting rules and evidence rather than the more subjective condition under section 16(1)(d) of the IRO. The subjective condition of section 16(1)(d) is that a taxpayer has to prove to the satisfaction of the assessor that the loan or debt has become bad during the year of assessment in question. We consider such objectivity is much more preferred.

In any case, tax deductions for ECL, credit impaired or not, would not ultimatelay lead to any tax leakage. This is because any subsequent write-back of ECL previously allowed for a tax deduction will be taxable income of the taxpayer.

In particular, we also note that Singapore has, under certain conditions, granted tax deductions for ECL to banks and qualifying finance companies in respect of their loans or debt securities that are not credit-impaired. Hong Kong's adoption of rules similar to those in Singapore would enable financial institutions in Hong Kong to compete with their counterparts in Singapore on a more level playing field.

c. Claw-back of ECL previously granted to the transferor in the proposed scenario unjustified

We consider that the proposed claw-back of tax deductions for ECL previously granted to the transferor as a financial institution where the transfer is not made by way of a sale in the ordinary course of business under sections 18K(6)-(8) unjustified and will give rise to unfair and unreasonable tax outcome.

The Financial Services and the Treasury Bureau (FSTB) in its letter to the Legislative Council Secretariat dated 29 November 2018 (LC Paper No. CB(1)241/18-19(04) explains that these provisions are to cater for the transfer of a credit-impaired loan in a merger situation whereby the transferee may not be subject to tax in Hong Kong when the ECL is subsequently reversed.

It however seems to us that the possible non-taxability of the transferee in respect of any subsequent recovery of the ECL should not lead to the claw-back of the tax deduction previously granted to the transferor where the carrying amount of the loan in the book of the transferor is the same as the market value of the loan at the date of transfer.

If the market value at the date of transfer is higher than the carrying amount of the loan, presumably the relevant provisions under the recently enacted transfer pricing regime in Hong Kong would apply such that the transferor would effectively be taxed on part or all of the ECL previously allowed for a tax deduction. As such, there would be no need to specifically enact sections 18K(6)-(8) which will claw-back the tax deductions for ECL in full in all such cases, regardless of the market value of the loan at the date of transfer. We consider that this is unjustified.

If for any reasons the current transfer pricing provisions cannot apply to the scenario as envisaged above, we consider that it would be more preferable to specifically enact a provision in the Bill whereby only the difference between the market value of the loan and its carrying amount in the book of the transferor, capped at the ECL previously allowed, will be deemed taxable income of the transferor. This would be more preferable than claw back all the ECL previously allowed under the proposed sections 18K(6)-(8) of the IRO in all such cases.

2. *Disallowance of part of the discount or premium in respect of convertible debt securities not justified*

We consider that the proposed disallowance of part of the amortization of the discount or premium of convertible debt securities under section 18L(6) as being attributable to the equity component of the securities not justified.

The FSTB explains in the aforesaid letter the rationale for the proposed section 18L(6) with an example of Company A issuing convertible bond at $10,000, redeemable at a premium of $1,000. The example assumes that the fair value of the liability component is $9,500 (i.e. the fair value of a similar bond without the option to convert into shares), the equity component will 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. in the amount of $1,500) will be amortized to the profit or loss account in accordance with HKFRS 9.

Based on the facts given in the example, the FSTB then takes the view that for "accounting purpose, the imputed premium is $1,500. However, for tax purpose, only the actual premium of $1,000 (being the premium on redemption per contractual terms) is allowable as a deduction. The remaining $500 is attributable to the equity component and will not be allowed as a deduction".

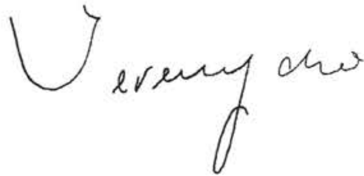
We disagree with the view taken by the FSTB above and consider that the imputed and actual premium in respect of the liability component are $1,500 (i.e. $11,000 - $9,500) instead of $1,000 (i.e $11,000 – $10,000).

It appears to us that the fact that the accounting evidence of amortizing the redemption premium of $1,500 as "interest" indicates that no part of the premium should be attributable to the equity component of the convertible bond. Accounting treatment normally represents the commercial reality of a transaction and "interest" by definition only relates to a debt.

We trust the above would be of use to the Bills Committee when it scrutinizes the Bill. Should you like us to elaborate on any of our above commets, please feel free to contact us.

Yours sincerely,

For and on behalf of
The Taxation Institute of Hong Kong



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