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Hon Kenneth Leung
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Bills Committee on Inland Revenue (Amendment) (No. 7) Bill 2018
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Submission on the Inland Revenue (Amendment) (No. 7) Bill 2018

Dear Hon Kenneth Leung,

We refer to the Bills Committee's invitation for submission on the Inland Revenue (Amendment) (No. 7) Bill 2018 (the Bill), which seeks to implement the following tax measures:

1. to align the tax and accounting treatments of financial instruments in certain circumstances;
2. to provide for tax deduction of interest expenses payable to overseas export credit agencies;
3. to refine the provisions in the Inland Revenue Ordinance (IRO) that implement automatic exchange of financial account information in tax matters;
4. to avoid potential double non-taxation of income of visiting teachers and researchers; and
5. to revise the meaning of the sibling relationship for the purpose of claiming a dependent brother or sister allowance.

Specifically, we have the following comments and suggestions on measure (1) above:

Aligning the tax and accounting treatments of financial instruments in certain circumstances

Generally speaking, we welcome the HKSAR Government's proposal of allowing taxpayers a choice of adopting the fair value accounting for financial instruments (as governed by the Hong Kong Financial Reporting Standard (HKFRS) 9 – Financial Instruments) for tax reporting purpose despite the taxing principle established by the Court of Final Appeal's judgment in the *Nice Cheer* case[1]. We consider that such move is necessary to address the concerns of the taxpayers who have large volume of transactions in financial instruments, especially those in the financial services sectors. Aligning the accounting treatments with the tax treatments will definitely reduce the tax compliance burden on taxpayers who, without the election option proposed in the Bill, have to re-compute their accounting profits (or losses) for taxation purposes by distinguishing between unrealised revaluation gains (or losses) and gains (or losses) that are realised.

However, we suggest that the definition of "specified financial reporting standard" under the proposed section 18G be expanded to include the accounting/financial reporting standards adopted by other overseas jurisdictions that are a local equivalent of International Financial Reporting Standard (IFRS) 9. This will enable a Hong Kong branch of an overseas bank to make an election to

[1] *Nice Cheer Investment Limited v CIR (2013) HKRC 90-252*

adopt the fair value accounting for financial instruments for tax reporting purpose if the home jurisdiction of the overseas bank adopts a financial reporting standard that is equivalent to or substantially the same as IFRS 9. Note that the Hong Kong branches of overseas banks may hold a large number of financial instruments in their ordinary banking business in Hong Kong. If the Bill does not allow these Hong Kong branches to make the election, it would create tremendous compliance burden to those Hong Kong branches and would not create a level playing field to the Hong Kong branches of overseas banks and Hong Kong incorporated banks.

Apart from the general principle, the Bill also proposes special tax treatments of certain items arising from financial instruments. In this regard, we have the following comments and suggestions for the consideration of the Bills Committee.

1. Tax deduction for impairment losses

(a) Impairment losses in respect of non-credit impaired financial instruments

The proposed section 18K(2) stipulates that any impairment loss recognised in respect of a financial instrument that is not credit-impaired is not deductible whereas section 18K(3) states that an impairment loss recognised in respect of a financial instrument that is credit impaired may be deductible if certain conditions are met. The term "credit impaired" is not defined in the Bill but in IFRS/HKFRS 9.

On the other hand, under the existing section 16(1)(d) of the IRO, tax deduction is allowed for doubtful or bad debts if it can be proved to the satisfaction of the assessor that the debts have become bad during the relevant basis period.

We consider that (i) an election made by a taxpayer to adopt fair value accounting for financial instruments for tax purpose should not make the taxpayer better or worse off in terms of tax deduction for doubtful or bad debts and (ii) deductibility of such doubtful or bad debts should be governed by the specific provision in the IRO (i.e. section 16(1)(d)) instead of the accounting standards. Accordingly, we consider that a taxpayer should get a tax deduction for the impairment loss as far as the conditions in section 16(1)(d) are met regardless of whether the financial instrument is credit-impaired or the expected credit losses are recognised in Stage 1 or Stage 2 of the new impairment model under HKFRS 9. For this reason, we suggest that sections 18K(2) & (3) be reworded so that impairment loss may be deductible if the condition in section 16(1)(d) is met.

In addition, we note that although the tax law in Singapore[2] also take the position that no tax deduction will be allowed for impairment losses on non-credit-impaired financial instruments in general, there are special rules for banks and qualifying finance companies in Singapore[3] where a deduction of the impairment losses on non-credit-impaired financial instruments is allowed in accordance with an existing specific provision in the Singapore tax law[4] on deduction of provisions made by banks and qualifying finance companies for doubtful debts and diminution in value of investments. We consider that to maintain the competitiveness of the tax system in Hong Kong, at a minimum, tax deduction on impairment losses of non-credit-impaired financial instruments should also be granted to banks and other qualifying financial institutions in Hong Kong.

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[2] Section 34AA(3)(g) of the Income Tax Act of Singapore

[3] Section 34AA(3)(h) of the Income Tax Act of Singapore

[4] Section 14I of the Income Tax Act of Singapore

(b) Impairment losses in respect of credit impaired financial instruments

The proposed sections 18K(3)(a) & (b) impose certain conditions for deduction of impairment losses recognised in respect of credit impaired financial instruments, which mirror those conditions set out in section 16(1)(d)(i).

The proposed section 18K(3)(a) deals with an impairment loss in respect of a credit impaired financial instrument where the instrument represents a debt other than a debt in respect of money lent in the ordinary course of a money lending business in Hong Kong. Under the section, the impairment loss will be deductible only *"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 ......"*. With this condition, there will be situations where a taxpayer will not be able to get a tax deduction for the impairment loss in respect of a credit impaired financial instrument even though any gains derived from the trading of such instrument will be subject to Hong Kong profits tax, as illustrated in the following example:

Example:

A taxpayer is carrying on a business of bond trading in Hong Kong such that the bonds acquired by it will be treated as revenue assets in the accounts and any gains (or losses) arising from the trading of bonds will be taxable (or allowable). The taxpayer acquired a bond from the market with a fair value of $100 in Year 1. The bond became credit impaired in Year 2 and gave rise to an impairment loss of $20. The taxpayer will not be able to get a tax deduction in Year 2 for the impairment loss of $20 under the proposed section 18K(3)(a) because the principal of the bond was not included as a trading receipt of the taxpayer for the basis period in which it acquired the bond (i.e. when the debt arose).

Our comments:

Based on the above, we consider that the proposed section 18K(3) should be revised or a new subsection under section 18K(3) should be added to cater for allowing a tax deduction for an impairment loss in respect of a credit impaired financial instrument in the above situation.

2. Transfer of credit-impaired loans with provision for impairment loss by financial institutions

Under the proposed section 18K(6), if a tax deduction for impairment loss/bad or doubtful debt was previously allowed in respect of a credit-impaired loan and the loan is subsequently transferred from one person (transferor) to another person (transferee), the amount of deduction previously allowed to the transferor will be deemed as a taxable trading receipt of the transferor accruing on the date of the transfer if all of the following conditions are met:

- the transferor is a financial institution;
- the transfer is not by way of a sale in the ordinary course of the transferor's business; and
- the transferor or the transferee is, or both of them are, not in the business of lending money in Hong Kong on the date of the transfer.

While we note that the Government has indicated in its written response[5] to the views received during the stakeholders consultation conducted in mid-2018 that the reason for having such

[5] The Government's written responses are included in this Legislative Council Paper: https://www.legco.gov.hk/yr18-19/english/bc/bc03/papers/bc0320181130cb1-241-4-e.pdf

deeming provision is to protect revenue in the case where the transferee is not in the money lending business in Hong Kong and therefore any reversal of the impairment loss or recovery of the debt by the transferee may not be taxable, we are not fully convinced that the proposed deeming provision is justifiable as illustrated in the following example:

Example:

A financial institution with a loan of face value of $100 had made a provision for an expected credit loss of $40 on the credit-impaired loan and a tax deduction on such provision was previously allowed to it. The financial institution (i.e. transferor) then transferred the loan other than by way of a sale in the ordinary course of its business at net book value (i.e. net of the provision for expected credit loss) to an unrelated third party at $60 (i.e. $100 - $40). On the date of the transfer, the transferee is not carrying on a money lending business in Hong Kong.

Our comments:

- As the financial institution (the transferor) indeed suffered a loss on bad debt in the amount of $40 and only received $60 on transfer of the loan, we consider that the provision for expected credit loss previously allowed should not be treated as its trading receipt for the basis period in which the transfer took place. The provision was effectively written off when the financial institution received $60 from the transfer of the loan. The fact that the transferee may be able to recover a part or the whole of the $40 from the borrower and may not be subject to profits tax on the amount recovered should not be a valid basis of taxing the transferor.

- In addition, as Hong Kong has already enacted specific transfer pricing rules, any non-arm's length dealings between related parties on transfer of loans can be addressed through the transfer pricing rules.

- As "a sale in the ordinary course of the transferor's business" and "the business of lending of money in Hong Kong" are not defined in the Bill or the IRO, we suggest that guidance be given by the Inland Revenue Department (IRD) on what scenarios the first term is referring to and how the second term will be interpreted in practice.

Based on the above, we consider it is necessary for the Administration to reconsider if such deeming provision is necessary and justifiable.

3. Discount/premium, etc. attributable to the share conversion option of a debt security

The proposed section 18L(6) stipulates that if (i) a debt security is issued with an embedded derivative to acquire shares or units in the issuer and (ii) such embedded derivative is recognised as an equity component in accordance with the Hong Kong Accounting Standard 32 – Financial Instruments: Presentation, the part of the interest, discount, premium or expense recognised in respect of the debt security that is attributable to the embedded derivative (i.e. the share conversion option) is not tax deductible.

While we understand that the rationale of disallowing such discount/premium, etc. is it is attributable to the equity component and therefore is capital in nature, we suggest that more guidance be given by the IRD to taxpayers on how such portion of disallowable discount/premium

should be determined in different scenarios e.g. (1) the convertible bond is with zero vs non-zero contractual interest rate, (2) the right to exercise the conversion option vests on the issuer vs the subscribers and (3) the right for conversion is or is not exercised.

4. Preference shares treated as debt instruments

The proposed section 18L(7) stipulates that any interest, discount, premium or expense recognised in respect of a preference share is not tax deductible for the issuer of the share. To achieve tax symmetry, we consider that the corresponding income received by the holder of such preference share should be treated as non-taxable dividends.

Although we note that the Government has confirmed that distributions from preference shares will be treated as dividends in its written response[5], we suggest making it clear in the IRO that this is the case. This is necessary as it will provide taxpayers with clarity and certainty, just like section 18L(7) has clearly spelt out the non-deductibility of the expenses recognised in respect of the preference shares from the issuer's perspective.

If you have any questions on our submission, please feel free to contact me (charles.lee@cn.pwc.com) or Rex Ho (rex.ho@hk.pwc.com) or Anita Tsang (anita.wn.tsang@hk.pwc.com).

Yours sincerely,
For and on behalf of PricewaterhouseCoopers Limited

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