THE HONG KONG ASSOCIATION OF BANKS
香港銀行公會

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14 December 2018 By email: bc_03_18@legco.gov.hk

Bills Committee on Inland Revenue (Amendment) (No. 7) Bill 2018
Legislative Council
1 Legislative Council Road
Tamar
Hong Kong

Dear Sirs

Comments on Part 2 – Amendments for Aligning Tax Treatment of Financial Instruments with their Accounting Treatment under the Inland Revenue (Amendment) (No. 7) Bill 2018 ("the Bill")

We refer to the Bill gazetted on 2 November 2018, in particular, the proposed new Sections 18G to 18L to be added to the Inland Revenue Ordinance ("**IRO**").

We appreciate that some of our comments made in our letter of 2 November 2017 to the Financial Services and the Treasury Bureau ("**FSTB**"), our meeting with the Inland Revenue Department ("**IRD**") on 15 May 2018 and our letters dated 5 June 2018 and 15 June 2018 to the IRD in respect of Hong Kong Profits Tax implications to financial institutions ("**FIs**") in Hong Kong upon the implementation of Hong Kong Financial Reporting Standard 9 Financial Instruments ("**HKFRS 9**") / International Financial Reporting Standard 9 Financial Instruments ("**IFRS 9**") were considered in the crafting of the Bill.

In particular, the Bill aims to codify the IRD's interim administrative measures into the IRO to provide a statutory basis allowing taxpayers to make an election to compute assessable profits on a fair value basis. In this regard, amounts recognized on financial instruments in the profit and loss account under HKFRS 9 / IFRS 9 are the amounts that would be chargeable/ deductible for tax purposes, provided that they are revenue and onshore in nature. While the above tax treatment is subject to certain exceptions in the proposed Section 18L, on behalf of our members, we generally welcome the proposal as providing greater clarity and certainty for taxpayers.

That said, we would like to highlight the below requests and comments which have yet to be addressed in the Bill for the Committee's consideration:

1. Deductibility of impairment loss

HKFRS 9 adopts an "expected credit loss" ("**ECL**") model and impairment loss for a financial instrument which would be made under three stages:

Stage 1 – On initial recognition (and for subsequent reporting periods), a 12-month ECL is recognized where a financial asset has not had a significant increase in credit risk since initial recognition or have low credit risk at the reporting date

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根據條例第364章成立

Stage 2 – Life time ECL are recognized when the financial asset has had a significant increase in credit risk since initial recognition but that does not necessarily have objective evidence of individual impairment

Stage 3 – Life time ECL are recognized when a financial asset has objective evidence of impairment at the reporting date

Section 18K(3) as it is currently drafted means that any "impairment loss" recognized on a financial instrument is not tax deductible unless it is credit-impaired **and** satisfies the below conditions:

(a) the instrument represents a debt that was included as a trading receipt; or
(b) the instrument represents a debt in respect of money lent in the ordinary course of the business of lending money in Hong Kong.

Interaction between Section 18K(3) and 16(1)(d) of the IRO

Credit-impaired is not defined in the Bill but is defined in HKFRS 9. Under HKFRS 9, "a financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred..." In this regard, only ECL made at Stage 3 would be considered as credit-impaired. Effectively the proposed Section 18K of the Bill limits any deduction for impairment losses until the borrower has a significant financial difficulty.

We note that the proposed Section 18K(3) is an additional provision separate and independent from that of Section 16(1)(d) of the IRO which governs tax deductions for bad debts. Although Section 18I(3) specifies that Sections 18J, 18K and 18L apply despite any "other Part 4 provisions", which is defined in Section 18I(5) of the Bill (i.e., the proposed Section 18K(3) should override Section 16(1)(d) of the IRO), we suggest the IRD to clarify in a Departmental Interpretation and Practice Note ("**DIPN**") that an impairment loss made under Stage 3 is deductible even if it may not satisfy the criteria under the Section 16(1)(d) of the IRO.

Deductibility of Stage 1 and Stage 2 impairment loss

We have previously suggested to the FSTB and the IRD that the Government should also consider whether Hong Kong should follow other international financial centres, e.g. Singapore and the UK, to permit a tax deduction for the accounting recognition of impairment loss for non-credit impaired financial instruments (i.e., impairment losses made under Stage 1 and Stage 2). This is especially important for Hong Kong FIs because the mismatch between accounting profit and tax profit for FIs would impose additional regulatory capital and compliance costs on the FIs, which may ultimately pass such costs, in whole or in part, on to customers, thereby impacting the competitiveness of Hong Kong as an international financial centre. Therefore, to ensure tax policy and administration continue to support Hong Kong as a leading financial centre, we strongly recommend the Committee to consider allowing tax deduction for Stage 1 and 2 impairment loss to bring Hong Kong's tax treatment for FIs in this area at par with their peers in Singapore and UK.

Deductibility of credit-impaired debt securities

On the other hand, other than loans and advances, some of the debt securities/ instruments (e.g. bonds, notes or debentures) acquired by FIs or other institutions that make investment in financial assets/ securities in the ordinary course of their businesses (e.g. insurance or securities investment companies) may be classified as amortized cost or fair value through other comprehensive income ("**FVTOCI**") under HKFRS 9 (depending on the fulfillment of Solely Payments of Principal and Interest ("**SPPI**") test and the business model) and be subject to impairment assessment for accounting purposes. However, for profits tax purposes, it appears that the above debt securities/ instruments would not satisfy the conditions (a) or (b) under the proposed Section 18K(3) of the Bill and therefore, the impairment losses made for these debt securities/ instrument would be non-deductible.

Even if it is the Government's intention to limit tax deductions for impairment losses to credit-impaired debt instruments only, to ensure a fair and reasonable tax treatment for FIs and those taxpayers making securities investment in the ordinary course of their business, there is no reason why tax deduction on similar basis will not be allowed for these debt instruments. Therefore, we strongly urge the IRD to clarify in a DIPN that for debt securities acquired by taxpayers in the ordinary course of their business, to the extent that the instruments are on revenue account and their profit/ loss derived are taxable/ deductible, tax deduction would be allowed for the impairment loss that are credited-impaired. Otherwise, tax deduction on such loss would be further deferred until disposal or write-off of the debt securities/ instruments which would result in additional temporary difference between tax and accounting basis resulting in more deferred tax asset. This may give rise to regulatory capital impact for FIs given deferred tax assets must be deducted from a FI's Common Equity Tier 1 capital pursuant to Cap 155L Banking (Capital) Rules. Therefore, to ensure fair treatment and avoid any undesirable implications, we strongly urge the IRD to make the required clarification in the DIPN.

2. Transfer of credit-impaired loan

The proposed Section 18K(6) provides that Subsection (7) or (8) applies if the transferor transfers a credit-impaired loan to the transferee which is not by way of a sale in the ordinary course of the transferor's business. In particular, Section 18K(8) specifies that if either or both the transferor or the transferee is not in the business of lending money in Hong Kong on the date of loan transfer, the amount previously allowed as a tax deduction to the transferor under Section 16(1)(d) of the IRO or the proposed Section 18K(3) of the Bill is deemed to be a trading receipt of the transferor (i.e., the deduction previously allowed to the transferor is clawed back).

Given the nature of an FI's business, it is within its ordinary course of business to "de-risk" from time to time by transferring or selling off individual loan or loan portfolios (e.g. loan securitization) as part of its credit or market risk management or to meet with any regulatory requirements. In our view, the transfer of an impaired loan should crystallize the relevant gain or loss for the transferor which will be taxed or deducted if the transferor is in a money lending business. It will give rise to wrong economic result if the impaired loss is treated as a trading receipt of the transferor. In case the transferee subsequently recovers more/ less than the transfer amount, it will result in accounting gain/ loss which will be taxed/ deducted as appropriate in line with the accounting recognition. Please see numerical illustration in **Appendix** for ease of reference. The tax treatment should thus

follow the accounting treatment and no tax adjustments are necessary to achieve the right tax and economic outcome. Provided that the transfer is on arm's length terms under the transfer pricing regime recently enacted in Hong Kong, we cannot conceive of any examples where this provision is actually necessary to prevent any tax avoidance.

Should the proposed Section 18K(8) be kept, to avoid any disruption to the financial industry, the IRD should provide further clarification and practical examples in the DIPN to ensure that loan transfer/ sale in the ordinary course of an FI's commercial or banking business will not fall within the scope of this section or this section will only be invoked if the transfer is conducted with a tax avoidance motive.

3. **Embedded derivative**

Under Hong Kong Accounting Standard 32 Financial Instruments: Presentation ("**HKAS 32**"), an issuer of convertible debt securities (which provide an option to the holder of the debt securities to convert the securities into the issuer's own shares) is required to reflect the liability and equity components (i.e., the option rights) of such debt securities separately on the issuer's statement of financial position (or balance sheet), if the option rights are to exchange a fixed number of the issuer's shares for a fixed amount of cash.

At initial recognition, the issuer is required to measure the liability component at fair value (as if there was no equity component), and the equity component will be the difference between the fair value of the convertible debt securities as a whole and the fair value of the liability component. Thereafter, the issuer is required to amortize the discount/ premium so amortized being the difference between the redemption price and the debt liability component of the convertible debt securities initially recognized.

Under Section 18L(6) of the Bill, part of the interest, discount, premium or expense recognized under HKFRS 9 in respect of convertible debt securities would not be tax deductible as being attributable to the equity component of the securities.

Paragraph 42 of the DIPN 42 noted that in case where an embedded derivative is a component of a hybrid instrument (e.g. convertible debt securities) that contains a non-derivative host contract, 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 notwithstanding the accounting treatment. Section 18L(6) as currently drafted seeks to bifurcate the tax treatment for embedded derivative and the host contract which changes and complicates the existing tax treatment for hybrid instrument. It will also increase administrative and compliance burden of taxpayers. We therefore consider that this Section 18L(6) is unnecessary.

Otherwise, we suggest the IRD to elaborate the rationale of not allowing such interest, discount, premium or expense as tax deductible because they appear to relate wholly to the debt liability component of the convertible debt securities and should be allowed for deduction if conditions in Section 16(1) of the IRO are satisfied.

The overarching principle that we have sought to apply in making the above suggestions is to maintain Hong Kong's simple, transparent and straightforward, principles based tax system that has been such a key aspect of Hong Kong's attractiveness as a global financial centre.

We thank you for your consideration and would be happy to provide further information or address any questions by the Bills Committee. Please contact the Secretariat (Ivy Wong at 2526-8895) if required.

Yours faithfully

p.p. Steve Choi
Secretary

Enc.

c.c. Financial Services and the Treasury Bureau (Attn: Mr Andrew Lai)
Inland Revenue Department (Attn: Mr Brian Chiu)

Illustration example of Sections 18K(6) to 18K(8) on loan transfer

APPENDIX

Facts assumed:-

1. Transferor is carrying on a money lending business in Hong Kong.
2. Transferor has a loan receivable with principal amount of $100 but measured at NBV of $80 given $20 credit impairment loss for which tax deduction had been claimed.

If Transferee is not carrying on a money lending business, the credit impairment loss claimed by the Transferor is treated as a trading receipt of the Transferor for the basis period upon loan transfer under the proposed Section 18K(8).

	Current tax treatment in line with P&L impact on Transferor	Tax treatment on Transferee under proposed Sections 18K(6) and 18K(8)
Scenario 1 - Transferor transfers the loan receivable to Transferee at $80 (i.e. Transferor does not derive any gain/ incur any loss from the loan transfer)	Credit impairment ($20) Gain/ loss on transfer - Total tax deduction allowed ($20) *In line with the economic loss of $20 realized by the Transferor upon loan transfer*	Credit impairment ($20) **Tax adjustment on loan transfer $20** Total tax deduction allowed $nil *No deduction is allowed notwithstanding the economic loss of $20 realized by the Transferor upon loan transfer*
Scenario 2 - Transferor transfers the loan receivable to Transferee at $90 (i.e. Transferor derives a gain of $10 from the loan transfer)	Credit impairment ($20) Gain on loan transfer $10 Total tax deduction allowed ($10) *In line with the economic loss of $10 realized by the Transferor upon loan transfer*	Credit impairment ($20) Gain on loan transfer $10 **Tax adjustment on loan transfer $20** Total taxable income $10 *No deduction is allowed notwithstanding the economic loss of $10 realized by the Transferor upon loan transfer*
Scenario 3 - Transferor transfers the loan receivable to Transferee at $70 (i.e. Transferor incurs a loss of $10 from the loan transfer)	Credit impairment ($20) Loss on loan transfer ($10) Total tax deduction allowed ($30) *In line with the economic loss of $30 realized by the Transferor upon loan transfer*	Credit impairment ($20) Loss on loan transfer ($10) **Tax adjustment on loan transfer $20** Total tax deduction allowed ($10) *No deduction is allowed notwithstanding the economic loss of $30 realized by the Transferor upon loan transfer*