Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/TXP, M34285

By fax (2877 1082) and by post

19 April 2005

Mrs. Alice Lau Mak Yee-ming
Commissioner of Inland Revenue
Inland Revenue Department
36/F, Revenue Tower
5 Gloucester Road
Wanchai, Hong Kong

Dear Mrs. Lau,

DIPN 42 - Taxation of Financial Instruments and Foreign Exchange Differences
DIPN 38 - Employee Share Option Benefits

A. DIPN 42 - Taxation of Financial Instruments and Foreign Exchange Differences

I refer to the draft DIPN 42 - Taxation of Financial Instruments and Foreign Exchange Differences, which has been issued for comment. The views of the Hong Kong Institute of Certified Public Accountants ("the Institute") on the DIPN are set out below. The draft was considered by the Institute's Taxation Committee and Financial Reporting Standards Committee and more detailed comments relating to the interpretation of HKAS 39, and other related accounting standards, are contained in the Appendix.

Timing of assessment

Taxation of unrealised accounting profits of marked-to-market financial instruments on revenue account

It is stated in DIPN 42 (paragraph 13) that the Inland Revenue Department (IRD) will generally follow the accounting treatment stipulated in HKAS 39 in the recognition of profits or losses in respect of financial assets of revenue nature. For financial instruments that are marked to market, the unrealised profits recognised in the profit and loss account would be taxable in the current assessment period.

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The DIPN refers to the principle that neither profits nor losses should be anticipated for tax purposes (“the non-anticipation principle”) in the *Willingale* case and suggests that the principle was based on the premise that there were two equally acceptable treatments to account for the taxpayer’s discount income on bills in the case. The DIPN (paragraph 18) seeks to distinguish the *Willingale* case from HKAS 39, suggesting that the *Willingale* principle would not apply as only one accounting treatment is allowed under HKAS 39 for each type of financial instrument. However, in our view, the basis on which the IRD seeks to distinguish the *Willingale* case from HKAS 39 is not correct, as explained under point (4) of the Appendix.

It should be noted that, in the *Willingale* case, the taxpayer’s discount income on bills was accrued and recognised in the accounts and yet it was held by the House of Lords that the profit could not be taxed until it was actually earned or realised on maturity or earlier upon sale of the bills.

The Institute is of the view that the non-anticipation principle should apply irrespective of the decision in the S*ecan* case. In commenting on the *Willingale* decision in the *Gallagher* case, Sir Thomas Bingham MR said that the overriding principle of tax law was that profits must not be anticipated.

In practice, in cases where certain hedging relationships may not qualify for hedge accounting, the problem is likely to be exacerbated, as there may be even more substantial unrealised profits. The application of *Secan* in such cases could cause significant hardship for taxpayers. It would be preferable if the IRD were to continue its current practice of allowing taxpayers to elect to be subject to the taxation of profits on either a realised or an unrealised basis. The IRD could formalise this process of election in the BIR form.

We do not believe that the UK Inland Revenue’s approach, to which the DIPN (paragraph 17) also refers as support for the timing of assessment, is necessarily appropriate for Hong Kong. Different policy considerations apply in the UK.

Unlike the UK, for example, Hong Kong does not have loss carry-back provisions. Taxing unrealised profits could create cash flow problems and undue hardship for many taxpayers in Hong Kong, particularly if they are not able to obtain any tax relief when losses are incurred on the subsequent settlement of the transactions.

We would submit that if unrealised profits arising from transactions to which HKAS 39 applies are to be taxed, as a minimum, legislation should be enacted to allow taxpayers in Hong Kong to carry back their tax losses to offset profits on the same instrument.

Legal form and economic substance

Preference shares classified as debts

According to the DIPN (paragraph 20), in analysing a financial instrument, the starting point is to decide its nature on the basis of its legal form rather than the accounting treatment or the underlying economic characteristics. The DIPN also suggests that, if the purported legal form of a financial instrument is not consistent with the legal rights and obligations that it has created, it is necessary to look beyond the label given to the instrument.

We should like to ask for clarification of the IRD's position in relation to paragraph 21 of the DIPN, which appears to imply that the analysis of the form of a preference share in HKAS 32 is flawed. We also consider that there may an inconsistency between the position taken by the IRD in this part of the DIPN and general argument advanced by the IRD as to the relevance of the ordinary principles of commercial accounting for determining the measurement of profit and the timing of income.

In addition, we should like to know whether, in principle, the IRD would regard a preference share as debt, such that the dividends would be classified as interest, if it possessed rights and obligations consistent with those of a debt instrument. If the answer is in the affirmative, we would request the IRD to provide example(s) of other financial instruments to which the debt/equity classification would also apply for tax purposes.

Capital/Revenue nature of the income

Paragraph 23 of the DIPN states: "The accounting treatment, by itself, cannot operate to change the character of an asset from investing to trading and vice versa." The experience of some tax practitioners is, however, that assessors tend to emphasise the accounting treatment rather than other factors, such as "badges of trade". Problems could arise, therefore, as HKAS 39 (paragraph 50) provides that an entity shall not make subsequent reclassifications of a financial instrument "into or out of the fair value through profit and loss category", even if, for example, the circumstances or management's intentions change later on.

In this connection, the Institute suggests that the IRD should consider updating its internal manuals so that assessors are reminded to adopt a pragmatic approach in dealing with capital/revenue issues in relation to DIPN 42.

The tax treatment of loans, receivables, held-to-maturity investments and available-for-sale financial assets held by financial institutions is explained in paragraph 25 of the DIPN. We believe that an explanation of the IRD's view regarding the situations where such assets are held by non-financial institutions would also be useful.

Deduction of expenses

Taxation of derecognised interest income/expenses

According to the DIPN, in Example 7, the interest received by Company H from Company G would be taxable and the interest payments made by Company H to Company I would not be deductible under section 16(2) of the Inland Revenue Ordinance. However, according to the facts of Example 7, Company H has derecognised from its accounts the advance to Company L (the reference here should probably be to "Company G" rather than "Company L"?), and the non-recourse loan from Company I, under HKAS 39.

If the advance and non-recourse loan have been derecognised from Company H's accounts, the corresponding interest income/expense would not be recognised in the profit and loss accounts of Company H. It is therefore difficult to understand the basis on which the derecognised interest income would be taxed. We request clarification, therefore, of the tax treatment of derecognised financial assets with reference to the example.

Embedded derivatives

Nature and locality of profits and loss arising from embedded derivative and the host contract

It is stated in the DIPN (paragraph 42) that the nature (i.e. capital or revenue) and locality of profit and loss of a hybrid instrument are determined on the basis that it is one single instrument.

However, according to paragraph 43 of the DIPN, in Example 13, a hybrid may be separated into its components, for tax purposes, in line with HKAS 39. We request clarification as to whether, in such situations, the entire gain would be taxed in the year in which the instrument is sold.

For the sake of clarity, we would appreciate it if the IRD could provide the relevant accounting entries under HKAS 39 for the liability and equity components in Examples 3, 11, and 12 of the DIPN, and the associated tax adjustments.

Transitional provisions

Prior period adjustments

In relation to paragraph 44 of the DIPN, as further explained in point (8) of the Appendix, the transitional provisions in HKAS 39 are conclusive for that standard and therefore, HKAS 8 cannot be used to justify a prior period adjustment in this case. Paragraph 44 should be amended accordingly.

In the 2004 Annual Meeting between the IRD and Institute, under Agenda Item A4, responding to a question on *SSAP 34 – Employee Benefits*, the IRD commented that "negative adjustment made to the opening retained earnings was not deductible as the adjustment was made through equity account… As the provision was not charged to the Profit and Loss account and was not treated as an operating expense of a company, the adjustment was not deductible".

However, according to the DIPN (paragraph 45), "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". In view of the apparent discrepancy between the comments made in the 2004 Annual Meeting and the DIPN, we request clarification on the tax position of prior year adjustments charged against retained earnings under HKAS 39.

As a practical matter, upon the implementation of HKAS 39, substantial transitional adjustments to retained earnings (as prior period adjustments) could result in taxes being payable and potential cash flow problems for taxpayers. Therefore, we suggest that, as a matter of practice, taxpayers be allowed an option to be taxed on the realisation basis for transactions entered into before 1 January 2005.

B. <u>DIPN 38 - Employee Share Option Benefits</u>

At the 2005 Annual Meeting between the IRD and the Institute the IRD indicated that a revised draft DIPN 38 – *Employee Share Option Benefits* had been issued for comment.

Following an invitation from the IRD to submit views, the Institute made a submission on the previous version of DIPN 38 in March 2004. The revised DIPN 38, published in March 2005, has taken into account most of the suggestions made by the Institute, in its submission of 5 March 2004, which we welcome. However, as pointed out at the Annual Meeting, it has not provided for the apportionment of taxable gains in situations involving Hong Kong employment, where a vesting period applies to right to exercise share options. The vesting period, which, according to paragraph 35(v) of the revised DIPN, "normally means the period from the date of grant of option, or such date as mentioned in the terms of the grant, to the first available date that an employee is entitled to exercise the option", is the relevant period for considering whether the gain from a share option is taxable or not.

Generally, exemption from salaries tax applies where the taxpayer has not rendered any services in Hong Kong on a year-to-year basis. We believe that it would be reasonable to provide for the possibility of apportioning a taxable gain from the exercise of a share option where the vesting period, for example,

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straddled two years of assessment, with the taxpayer being taxable in one year and exempt in the other.

Under the circumstances, we should like to reiterate our previous suggestion and to request that the issue of apportionment be re-considered when the DIPN is reviewed in the future.

I hope that you find our comments to be constructive. If you have any questions on our comments, please feel free to contact the undersigned at peter@hkicpa.org.hk or at 2287 7084.

Yours sincerely,

Peter Tisman
Director, Faculties & Advocacy

PMT/JT/ay
Encl.

APPENDIX

Comments on the interpretation of the HKAS 39, and other related accounting standards, as reflected in draft DIPN 42 – *Taxation of Financial Instruments and Foreign Exchange Differences*

(1) *Para. 8(d) and 13: impairment of available-for-sale financial assets*

Neither para. 13 nor para. 8(d) acknowledge that impairments on "available-for-sale" financial assets should be recognised in profit or loss prior to disposal of the asset. This is inconsistent with the level of detail given for "held-to-maturity" investments and loans and receivables (paras. 8(b), 8(c) and 13) and, prima facie, para. 13 would deny a deduction for these losses unless they were recognised in the year of disposal. Presumably this is an oversight in the drafting that needs to be addressed.

(2) *Para 14: example of the effective interest method*

Para 14. discusses the effective interest method. However, the example of "company A" given in para. 14 is actually of the fair value through profit and loss method, not the effective interest method. Presumably this is an oversight in the drafting that needs to be corrected.

(3) *Para 14: assertion concerning realised profits*

Following the example in para. 14, the DIPN asserts that the amounts recognised in the income statement are realised profits for the purposes of section 79A of the Companies Ordinance. Admittedly, section 79A refers to profits that are realised in accordance with accounting principles. However, as HKAS 39 deals with the "recognition" of gains and losses and not with the question of whether they are "realised", recognition under HKAS 39 should not be taken to indicate automatically that the profit is "realised". The DIPN should explain the basis for the above assertion.

(4) *Para. 18: assertion that under HKAS 39 there is only one accounting treatment for each type of financial instrument*

The DIPN asserts that, under HKAS 39, there is only one accounting treatment for each type of financial instrument. This is not correct as entities have a limited choice of designation between the four categories of financial instruments, as set out in HKAS 39.9, except in the case of financial assets and liabilities held for trading, derivatives not held for hedging purposes, and where the fair value cannot be reliably estimated. Admittedly, once the designation has been chosen, there is no longer any choice of accounting treatment, but given the choice of designation available, it is not accurate to state that, under HKAS 39, there is only one accounting treatment for each type of financial instrument.

For example, if an entity owns a quoted fixed income bond which it intends to hold until maturity, it can choose to account for this bond at either (i) amortised cost (i.e. by designating it as "held-to-maturity"), (ii) fair value with movements through equity (i.e. by designating it as "available-for-sale") or (iii) fair value through profit and loss (i.e. by designating it as such). This choice of designation is open to the entity on an investment-by-investment basis (HKAS 39.9).

(5) *Para. 21: rejection of the classification of preference shares as liabilities*

In para. 21 the DIPN rejects the accounting classification of the shares as liabilities (and dividends as deductible expenses) "because the relationship between the holders and the company is not a debtor and creditor relationship". This suggests that the accounting treatment is rejected because the IRD does not agree with the analysis of the relationship in HKAS 32. This seems to be inconsistent with the basic position in the DIPN that accounting rules should generally be followed in identifying the commercial substance.

(6) *Para. 41(a)*

Presumably 41(a) should read, "the hybrid instrument is not recorded at fair value through profit and loss..." (rather than "is not readily recorded..."), based on the requirements of HKAS 39.11(c).

(7) *Para. 42: examples of embedded derivatives*

Both Examples 11 and 12 assume that the hybrid instruments would be split into their components. However, given the facts supplied, it appears likely that such instruments would be regarded as being held-for-trading (and so be accounted for at fair value through profit and loss) and, therefore, they should not be split, according to HKAS 39.11(c) (as mentioned above in point (6)). We would suggest that the examples should clearly state, in addition to the reasons given, that the instruments would be split because they were classified as "available-for-sale" instruments rather than "held-for-trading".

(8) *Para. 44: assertion concerning transitional adjustments for trading financial assets and liabilities*

Para 44. asserts that HKAS 39 does not prescribe the transitional adjustments for trading financial assets and liabilities when a taxpayer first adopts HKAS 39 and, therefore, that HKAS 8 applies. This is incorrect as paragraph 104(d) of HKAS 39 indicates that such financial assets would be stated at fair value on the date of first adoption (e.g. 1 January 2005, for a December year end), with any differences being adjusted against retained earnings.

Therefore, while para. 44 reaches the correct conclusion in terms of adjustments to opening balances, the statement concerning HKAS 39 needs to be amended and the reference to HKAS 8 should be deleted. The transitional provisions in HKAS 39 are conclusive for that standard and, therefore, HKAS 8 cannot be used to justify a prior period adjustment in this case.

(9) *Para. 52: method to be used for presenting assessable profits or losses in Hong Kong dollars*

Para. 52 appears to indicate that irrespective of an entity's functional currency, assessable profits and losses are required to be expressed in Hong Kong dollar terms. It would seem appropriate for the DIPN to explain the method to be used for translating the financial statements prepared in terms of a foreign currency into Hong Kong dollar terms, and clarify whether this is the same method as would be applied when having financial statements prepared in a functional currency translated into a different currency, as set out in HKAS 21.38-40.