



HKAS 39

HKAS 21

IRD responds to **new accounting standards**

The IRD has issued a new Departmental Interpretation and Practice Note on the taxation of financial instruments and foreign exchange differences.

Profits tax is charged on every person carrying on a trade, profession or business in Hong Kong, in respect of his assessable profits arising in or derived from the territory. The Inland Revenue Ordinance (IRO) itself does not contain a comprehensive definition of the term “assessable profits,” but the Court of Final Appeal, in *CIR v Secan Ltd & Ranon Ltd* 5 HKTC 266, held that the assessable profits or losses of a taxpayer must be ascertained in accordance with the ordinary principles of commercial accounting, as modified to conform with the IRO.

Since 2004, the Hong Kong Institute of CPAs has issued a number of new accounting standards. HKAS 39 establishes principles for the recognition and measurement of financial instruments, while HKAS 21 deals with the effects of changes in foreign exchange rates. In response to the new accounting standards, the Inland Revenue Department (IRD) issued Departmental Interpretation and Practice Note (DIPN) No. 42 in November 2005 to set out the IRD’s views on the tax treatment

of financial instruments and foreign exchange differences. The salient features of the DIPN are as follows.

Financial instruments

HKAS 39 divides financial assets and financial liabilities among four broad categories, each with a different accounting treatment. On the whole, the IRD will follow the accounting treatment stipulated in HKAS 39 in the recognition of profits or losses in respect of financial assets or financial liabilities of a revenue nature. Accordingly, for financial assets or financial liabilities classified as those at fair value through profit or loss, any change in fair value is assessed or allowed when it is taken to the profit and loss account. For available-for-sale financial assets, the change in fair value that is taken to the equity account is not taxable or deductible until the assets are disposed of. The cumulative change in fair value is assessed or deducted at the time it is recognised in the profit and loss account. For loans and receivables, and held-to-maturity investments, the gain or loss is taxable or deductible when the financial

asset is derecognised or impaired, or through the amortisation process.

The IRD considers that the accounting treatments promulgated under HKAS 39 do not determine the nature of a financial instrument (e.g. debt or equity), the nature of an income or expenditure (i.e. capital or revenue) or the locality of profits. It is the IRD's view that the nature of a financial instrument must be determined by examining its legal rights and obligations, rather than the economic substance. Moreover, whether an asset or liability is of capital or revenue nature depends on whether it is acquired or incurred by way of trade or investment, which, in turn, is a question of fact and degree entailing the consideration of all the surrounding circumstances. The well-established test, the "badges of trade," will continue to be applicable for this purpose. As to the locality of profits, it will be decided according to the broad guiding principle: "One looks at what the taxpayer has done to earn the profit in question and where he has done it." The general principle of law in this area is not affected by the accounting practice under HKAS 39.

Hedge accounting means designating a hedging instrument, normally a derivative, as an offset to changes in the fair value or cash flows of the hedged item. As a practice, the IRD considers that the tax treatment of the hedged item and the hedging instrument should not be considered separately because hedging is an attempt to mitigate the impact of economic risks of the hedged item. Regarding the locality and nature of the profit or loss arising from the hedging

instrument, the IRD accepts that it depends on the nature of the hedged item.

An embedded derivative is a component of a hybrid instrument that contains a non-derivative host contract. Under HKAS 39, the embedded derivative and the host contract are required to be separated under certain circumstances. Since a hybrid instrument, in its legal form, is one single instrument, the IRD considers that, for tax purposes, the nature and locality of profit or loss of the hybrid instrument are determined on the basis that it is one single instrument.

According to HKAS 39, the cumulative change in fair value of the trading financial assets or financial liabilities in the periods prior to the adoption of HKAS 39 should be accounted for by adjusting the opening balance of retained earnings by way of a prior period adjustment. The IRD takes the view that a prior period adjustment for a trading financial asset or liability should be taxable or deductible, as the case may be, in the year of assessment in which the adjustment is recognised in the retained earning. This view is supported by the case of *Pearse v Woodall-Duckhall* [1978] 51 TC 271.

Since HKAS 39 is applicable for annual periods beginning on or after 1 January 2005, the assessing practices promulgated in DIPN No. 42 will apply starting from the year of assessment 2005/06.

Foreign exchange differences

The tax treatment of foreign exchange gains or losses that are revenue in

nature normally follows the accounting treatment. However, some taxpayers recognise exchange gains or losses in the profit and loss account but exclude them in the tax computation because they are unrealised. It has long been the IRD's practice to accept the taxpayers' tax computation provided that the treatment is followed consistently and that subsequent adjustment is made upon realisation. Following the general principle laid down in the *Secan* case that assessable profits must be ascertained in accordance with the ordinary principles of commercial accounting, the IRD has reviewed this practice and decided a change is needed. An adjustment in the tax computation on the grounds that a foreign exchange difference is not yet realised will no longer be acceptable. The IRD will apply the revised practice to any foreign exchange differences for the year of assessment 2005/06 and subsequent years. Where an unrealised exchange difference has been excluded from the tax computation in an earlier year, it should be adjusted in the tax computation for the year 2005/06.

For a fuller exposition of the assessing practice on financial instruments and foreign exchange differences, readers are invited to refer to DIPN No. 42 on the IRD website.

Quick link

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www.ird.gov.hk