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# Reclassification of assets

How accounting reclassification affects your deduction claim on the declining value of your financial assets, write *Philip Wong, Davy Yun and Finsen Chan*

**T**he global financial crisis has prompted the International Accounting Standards Board to reclassify financial assets under exceptional circumstances. On 13 October, the board released the *Reclassification of Financial Assets* (Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*). The next day, the Institute adopted the amendments for the corresponding Hong Kong

accounting standards.

One of the most important features of the amendments is the reclassification, in rare circumstances, of equity securities from the held-for-trading category (measured at fair value through the income statement) to the available-for-sale category (measured at fair value through equity). This will be allowed if the equity securities are no longer held for immediate sale.

The IASB acknowledged that the

unsettling market conditions in the third quarter of 2008 are a possible example of a rare circumstance and the reclassification can be retrospective to 1 July 2008. Any reclassification made on or after 1 November 2008 will take effect from the date of reclassification.

When a company acquires equity securities for short-term trading purposes, the securities generally would be accounted for using fair value through profit or loss (FVTPL) under HKAS 39.



“After the reclassification, the equity securities under the available-for-sale category would be valued at their fair value on each balance sheet date, with the changes in fair value recognized in equity except for impairment losses.”

Take as a hypothetical example the acquisition of equity securities by ABC Ltd. for short-term trading on 1 February 2007, for HK\$82 million. Those securities are accounted for using FVTPL. On 31 December 2007, the financial reporting date, the fair value of the equity securities increased to HK\$83.5 million. The unrealized gain of HK\$1.5 million would be reported in the income statement for the year ending 31 December 2007.

After the reclassification, the equity securities under the available-for-sale category would be valued at their fair value on each balance sheet date, with the changes in fair value recognized in equity except for impairment losses. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is an objective evidence of impairment loss, which would be recognized in the income statement.

Let us assume that ABC Ltd. no longer wanted to hold the equities for

short-term trading and reclassified them to available-for-sale on 1 July in preparing its financial statements for the year ending 31 December 2008. The fair value of the equity securities as of 1 July was HK\$81.6 million. Assume that the fair value of those securities will decrease to HK\$80.7 million on 31 December 2008, then the unrealized losses of HK\$1.9 million (HK\$83.5 million minus HK\$81.6 million) and HK\$900,000 (HK\$81.6 million minus HK\$80.7 million) would be reported in the income statement and equity, respectively, for the year ending 31 December 2008, provided that the loss of HK\$900,000 is not an impairment loss.

#### **Onshore vs. offshore sourced**

For listed equity securities, the related gain or loss would generally be regarded as offshore sourced if the securities are listed outside Hong Kong, and vice versa, according to the Inland Revenue Department's Departmental

Interpretation and Practice Note No. 21 on locality of profits.

For unlisted equity securities, the source generally would depend on the place where the purchase and sale contracts are effected, which does not merely mean legally executed, but the actual steps leading to the existence of the contract, including the negotiation and, in substance, the conclusion and execution.

If the unlisted equity securities have not been sold at the time the tax return is filed, it would be difficult to determine the source because the sale has not yet taken place. Nevertheless, the IRD would presume that the trading profits are onshore as long as the purchase contract is effected in Hong Kong in accordance with DIPN 21. Based on *Magna Industrial Co. Ltd. v. CIR 1 HKRC 90-082*, however, the place where a purchase contract is effected does not conclusively determine the source of the relevant trading profits.

Period	1 January 2008 to 15 May 2008	1 January 2008 to 1 July 2008	16 May 2008 to 31 December 2008	2 July 2008 to 31 December 2008
<b>Accounting</b> (HKD million)				
Loss recognized in income statement		1.9 (83.5-81.6)		
Loss recognized in equity				0.9 (81.6-80.7)
<b>Taxation</b> (HKD million)				
Deductible revenue loss	2.5 (83.5-81)			
Non-deductible capital loss			0.3 (81-80.7)	

**Timing of taxation or deduction of unrealized gain or loss**

Since the *CIR v. Secan Limited & Ranon Ltd. 5 HKTC 266* decision, the IRD has been applying the tax-follows-book principle and generally would not accept that booked gain is unrealized and non-taxable. This position on financial instruments is further confirmed in the IRD’s DIPN 42 *Profits Tax – Part A: Taxation of Financial Instruments and Part B: Taxation of Foreign Exchange Differences*.

In the ABC Ltd. example, if the firm did not reclassify its equity securities to available-for-sale and continued to hold them as trading assets for tax purposes, any reduction in fair value would be recorded in its income statement and would be deductible following the tax-follows-book principle. A taxpayer should analyze the tax impact when deciding whether to reclassify its financial assets under the new accounting rules.

Gain or loss arising from the sale of a capital asset is not taxable or deductible in Hong Kong. In the example, the gain of HK\$1.5 million booked in the income statement for the year that ended 31 December 2007 (year of assessment 2007-08) would likely be revenue in nature because ABC Ltd. acquired the equity securities for short-term trading.

Although ABC Ltd. later booked a revenue loss of HK\$1.9 million in its income statement for the year ending 31 December 2008 (year of assessment 2008-09), the loss could not be carried

back to offset the gain of HK\$1.5 million in 2007-08. The loss could, however, generally be used to offset the company’s other profits in 2008-09.

**Change of intention**

The accounting treatment or reclassification alone cannot determine the change in character of an asset from trading to long-term investment, or vice versa. For example, when a financial institution reclassifies its financial assets from held-for-trading to available-for-sale, it may not be necessary that the assets have been changed from trading to long-term investment in nature.

Whether an asset is capital or revenue in nature is a question of fact and degree, and all circumstances must be considered. Well-established tax principles, such as the six badges of trade (subject matter, motive, length of ownership, frequency of the transactions, supplementary activities and circumstances leading to the disposal) normally will be applied to determine whether an asset is capital or revenue in nature.

According to Hong Kong case law, a proven change of intention will trigger a deemed disposal for tax purposes and will have the following implications:

- If an asset acquired for trading is later changed to a capital asset, the gain or loss (that is, the difference between the cost on the date of acquisition and the open market value on the date of change of intention) would be revenue in nature. Any gain or loss on future disposal should be capital in nature.

- If an asset acquired for long-term investment is later changed to a trading asset, the gain or loss would be capital in nature. Any gain or loss on future disposal should be revenue in nature.

In the ABC Ltd. example, assume the IRD accepts that there has been a change of intention from trading to long-term investment on 1 July 2008, and treats the loss of HK\$1.9 million recognized under the income statement as revenue in nature, the IRD would likely treat the loss of HK\$900,000 booked in the equity as capital in nature and non-deductible.

The date when ABC Ltd. changes its intention, however, may not necessarily be 1 July 2008, as this is merely the earliest date of reclassification for accounting purposes. If ABC Ltd. held a directors’ meeting to determine the change of intention on 15 May 2008, when the fair value of equity securities was HK\$81 million, the tax loss for 2008 would be HK\$2.5 million (the decrease in value of HK\$83.5 million on 1 January to HK\$81 million on 15 May 2008). In this case, the tax loss should be even larger than the loss recognized in the income statement (*see table*). The IRD, however, may not accept this treatment as this is inconsistent with the tax-follows-book principle.

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