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Impact of Accounting on Taxation: Hong Kong Experience for Financial Instruments

By Daniel Ho*

Introduction

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The prevailing financial reporting and accounting standards in Hong Kong (*e.g.*, Hong Kong Financial Reporting Standard 9 *Financial Instruments* (HKFRS 9), Hong Kong Accounting Standard 32 *Financial Instruments: Presentation* (HKAS 32)) require entities to account for financial instruments on a fair value basis with the revaluation gains or losses recognized in profit or loss in the year they arise. However, the Court of Final Appeal ("CFA")'s judgment in *Nice Cheer Investment Ltd v. Commissioner of Inland Revenue (CIR)*[1] (*Nice Cheer*) held that the unrealized revaluation gains for marketable securities are not taxable at the time they are accounted for. *Nice Cheer* established that accounting treatments for financial instruments should not be followed for tax purposes and therefore tax assessment should be made on realization basis instead of fair value basis.

Despite the judgment in *Nice Cheer*, some taxpayers requested the Inland Revenue Department ("IRD") to allow them to adopt fair value basis because there are substantial costs involved and practical difficulties faced in re-computing their profits on realization basis for tax purposes. As an administrative measure, the IRD has allowed taxpayers to file their tax returns on either fair value basis or realization basis. In March 2019, a set of tax provisions was enacted to provide for a legal basis of allowing taxpayers to choose between the fair value basis and the realization basis to account for financial instruments for tax purposes.

This article investigates the accounting and tax treatments for financial instruments in Hong Kong. Firstly, the article briefly reviews the prevailing financial reporting and accounting standards for financial instruments. Secondly, the article explores the implications for assessment on fair value basis and realization basis. Thirdly, the article highlights the development of tax assessment basis. Fourthly, the article analyzes the set of tax provisions which provide a legal basis for assessment on fair value basis. Finally, the article concludes with implications.

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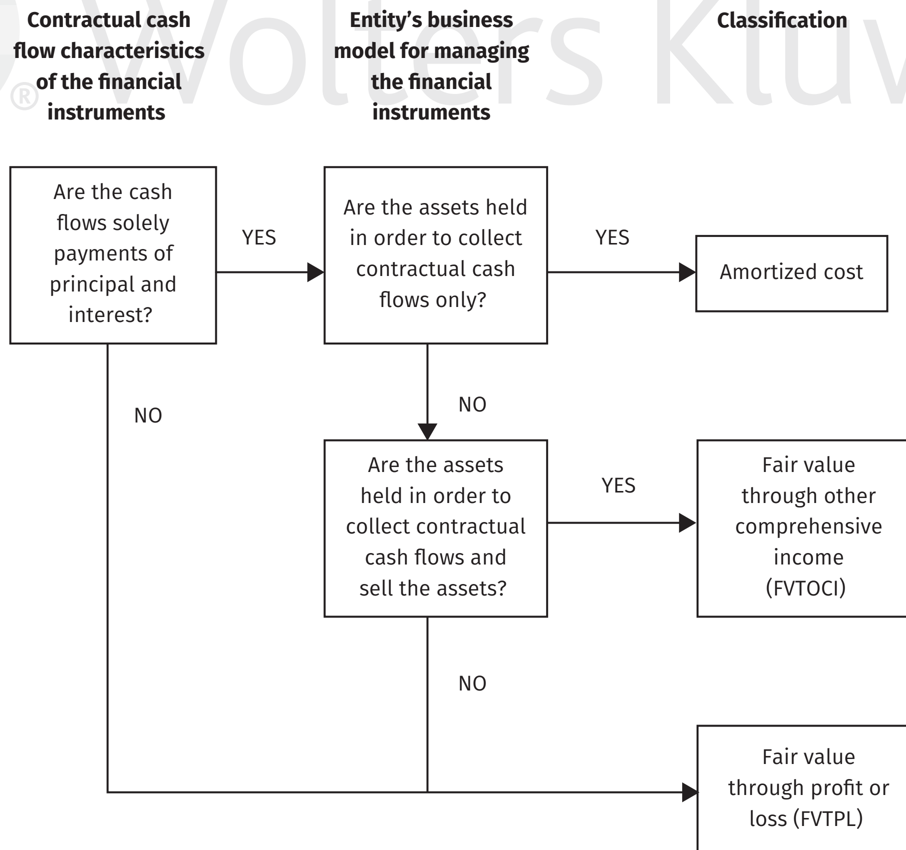
Accounting for Financial Instruments

HKFRS 9, which is the equivalent of International Financial Reporting Standard 9 ("IFRS 9"), is effective for accounting periods starting 1 January 2018 and has replaced Hong Kong Accounting Standard 39 *Financial Instruments: Recognition and Measurement* ("HKAS 39"). Financial instrument is defined in HKAS 32 as any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Under IFRS/HKFRS 9, most financial assets should be classified and measured at fair value,[2] with any fair value change recognized in profit or loss ("FVTPL") as they arise. Only when specific criteria are met, financial assets would be classified and measured at either amortized cost, or fair value through other comprehensive income ("FVTOCI"). The classification is based on the contractual cash flow characteristics of the financial assets and the entity's business model for managing the financial assets. Financial assets would be classified and measured at amortized cost when the asset's contractual cash flow represents solely payments of principal and interest and the asset is held to collect its contractual cash flow only. On the other hand, financial assets would be classified and measured at FVTOCI when the asset's contractual cash flow represents solely payments of principal and interest and the asset is held to collect its contractual cash flow as well as is to be sold. Figure 1 depicts the initial recognition process of financial assets.

When financial assets are classified at amortized cost, they are initially recognized at fair value and subsequently measured at amortized cost using the effective interest method.[3] When financial assets are classified at FVTOCI, they are initially recognized and subsequently measured at fair value. Carrying amount movements of these FVTOCI assets are recorded through other comprehensive income ("OCI"), except for the recognition of impairment gains or losses, interest revenue and foreign exchange gains or losses, which are recognized in profit or loss. When the FVTOCI assets are derecognized, the cumulative gains or losses previously recognized in OCI are reclassified from equity to profit or loss.

FIGURE 1. INITIAL RECOGNITION PROCESS OF FINANCIAL INSTRUMENTS UNDER IFRS/HKFRS 9



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The same approach is used in the classification and measurement of financial liabilities. All financial liabilities would be subsequently measured at amortized cost using the effective interest method except for some financial liabilities at FVTPL (*e.g.*, derivatives) which would be subsequently measured at fair value.

Fair Value vs. Realization Basis of Tax Assessment

The basis of profits tax assessment could be classified into fair value and realization. Under assessment on fair value basis, both realized and unrealized profits or losses on financial instruments will be brought into account for computing the assessable profits or adjusted losses if they are recognized in profit or loss. The timing in the recognition of profit, gain, loss, income or expense per IFRS/HKFRS 9 on financial instruments will normally be followed for profits tax purpose. On the other hand, under assessment on realization basis, *only* realized profits or losses on financial instruments will be brought into account for computing the assessable profits or adjusted losses if they are recognized in profit or loss. The timing in the recognition of profit, gain, loss, income or expense per IFRS/HKFRS 9 on financial instruments will *not* be followed for profits tax purpose.

Table 1 provides a simple scenario to compare and contrast the basis of profits tax on fair value and realization. The net total amount of assessable profit or adjusted loss with respect to the profit, gain, loss, income or expense per IFRS/HKFRS 9 on financial instruments will be the same no matter the basis of profits tax assessment is fair value basis or realization. It is essentially a matter of timing difference.[4]

Development of the Tax Assessment Basis in Hong Kong

In the past, the IRD adopted a rather pragmatic approach on unrealized items and accepted a profits tax filing position that the unrealized gains or losses were not assessable or deductible until realized provided that the filing position was consistently applied over a particular kind of transactions.[5] Such a pragmatic approach (*i.e.*, assessment on realization basis) was not controversial until the CFA's judgment in *CIR v. Secan Ltd & Another*[6] (*Secan*) which is the highest authority in Hong Kong on the relevance of commercial accounting principles in ascertaining profits for tax purposes.[7] The CFA's judgment in *Secan* 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 Inland Revenue Ordinance ("IRO"). Where the taxpayer may properly draw its financial statements on either of two alternative bases, the CIR is both entitled and bound to ascertain the assessable profits on whichever basis the taxpayer has chosen to adopt. Since *Secan*, the assessing practice of the IRD was to follow the fair value accounting treatment of financial instruments for tax purposes (*i.e.*, assessment on fair value basis).

The CFA's judgment in *Nice Cheer* held that there are two cardinal principles: "profit" connotes actual or realized and not potential or anticipated profits; and neither profits nor losses may be anticipated.[8] Also, the CFA's judgment in *Nice Cheer* held that the unrealized revaluation gains for marketable securities are not taxable at the time they are accounted for.[9] While *Secan* focused on how the profits for tax purposes were to be ascertained, *Nice Cheer* case focused on what profits are chargeable to profits tax in Hong Kong.[10]

Subsequent to *Nice Cheer*, there is no legal basis for the IRD to continue to follow the fair value accounting treatment of financial instruments for tax purposes. In other words, profits tax assessment should be made on realization basis and not on fair value basis. However, some taxpayers (*e.g.*, financial institutions and securities dealers), which marked their financial instruments to market, had requested the CIR to accept financial statements prepared on fair value basis for tax reporting as there were substantial costs and practical difficulties[11] involved in re-computing their profits on realization basis.[12]

With due respect to the CFA's judgment in *Nice Cheer*, the IRD requires taxpayers to file their tax returns on realization basis (*i.e.*, unrealized revaluation gains for marketable securities are not taxable at the time they are accounted for). However, the IRD also allows, as a concession, taxpayers to choose fair value basis (*i.e.*, all unrealized and realized revaluation gains for marketable securities are taxable) to file their tax returns since the year of assessment 2013/2014.

Although the administrative concession functioned well, it was an interim measure and required an annual refresh to provide certainty to taxpayers. Accordingly, a set of tax provisions (*i.e.*, s 18G–s 18L, IRO) was enacted and effective on 1 March 2019 in order to provide a legal basis of allowing taxpayers to opt for the fair value basis and aligning the tax treatment and accounting treatment of financial instruments. Following the enactment of these provisions, the IRD published a revised Departmental Interpretation and Practice Notes No. 42 (DIPN 42) in June 2020 to provide a detailed guidance on how these provisions would apply. Table 2 highlights

TABLE 1. TAX ASSESSMENT ON FAIR VALUE BASIS AND REALIZATION BASIS

- Company-HK carries a securities trading business in Hong Kong. It adopts 31 December as year-end and prepares its accounts in compliance with IFRS/HKFRS 9.
- On 1 January 2018, Company-HK acquired equity shares issued by Company-Kowloon at $10,000. The shares were measured at fair value through profit or loss (FVTPL).
- On 1 May 2019, Company-HK disposed the equity shares of Company-Kowloon at $11,000.
- The fair value of the shares was as follows:

At 1 January 2018	$10,000
At 31 December 2018	$13,000
At 1 May 2019	$11,000

- Company-HK recognized and measured the equity shares of Company-Kowloon as follows:

Year ended 31 December 2018:

Recognize the equity share acquisition on 1 January 2018

Dr Equity shares	$10,000	
Cr Cash		$10,000

Measure the fair value of the equity shares on 31 December 2018

Dr Equity shares	$3,000	
Cr Unrealized gain (profit or loss)		$3,000

Year ended 31 December 2019:

Recognize the equity share disposal on 1 May 2019

Dr Cash	$11,000
Dr Realized loss (profit or loss)	$2,000
Cr Equity shares	$13,000

Assessment on Fair Value Basis	Assessment on Realization Basis
Year of assessment 2018/2019 (Basis period: year ended 31 December 2018): The *unrealized gain* in fair value change of $3,000 recognized in profit or loss for the year ended 31 December 2018 would be *chargeable* to tax	*Year of assessment 2018/2019 (Basis period: year ended 31 December 2018):* The *unrealized gain* in fair value change of $3,000 recognized in profit or loss for the year ended 31 December 2018 would *not* be *chargeable* to tax.
Year of assessment 2019/2020 (Basis period: year ended 31 December 2019): The *realized loss* upon equity share disposal of $2,000 recognized in profit or loss for the year ended 31 December 2019 would be *deductible* (assuming the loss is revenue in nature and satisfies the deduction rules). During years of assessment 2018/2019 and 2019/2020 together, a *net total of $1,000 gain* ($3,000 gain assessed in 2018/2019 and $2,000 loss deductible in 2019/2020) is chargeable to tax.	*Year of assessment 2019/2020 (Basis period: year ended 31 December 2019):* When computing the assessable profits in respect of the equity shares, apart from bringing the *realized loss* upon equity share disposal of $2,000 recognized in profit or loss for the year ended 31 December 2019, the *unrealized gain* in fair value change of $3,000 recognized in profit or loss for the year ended 31 December 2018 would also be brought into account. Therefore, a *net total of $1,000 gain* ($3,000 — $2,000). is chargeable to tax in 2019/2020 (assuming the gain is revenue in nature and sourced in Hong Kong and the loss is revenue in nature and satisfies the deduction rules).

Implications

- Whether assessment is made on fair value basis or realization basis, the net total amount of assessable profit or adjusted loss with respect to the profit, gain, loss, income or expense per IFRS/HKFRS 9 on financial instrument is the same. In this case, a net total of $1,000 gain is chargeable to tax.
- It is a matter of timing difference. In this case, $3,000 gain is assessed in 2018/2019 and $2,000 loss is allowed in 2019/2020 under fair value basis whereas a net total of $1,000 gain is assessed in 2019/2020 under realization basis.

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TABLE 2. DEVELOPMENT OF PROFITS TAX ASSESSMENT BASIS		
Event (Time)	**Key Messages**	**Implications**
Assessing Practice (before 2000)	• The Inland Revenue Department (IRD) adopts a pragmatic approach towards income derived from unrealized transactions.	• The IRD accepts a profits tax filing position that the unrealized gains or losses are not assessable or allowable until realized so long as such a position was consistently applied over a particular kind of transaction. • In other words, *tax assessment on realization basis is generally accepted*.
The Court of Final Appeal (CFA)'s judgment in *Commissioner of Inland Revenue (CIR) v Secan Ltd & Another* (2000) 3 HKCFAR 411	• It is the highest authority in Hong Kong on the relevance of commercial accounting principles in ascertaining profits for tax purposes. • 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 Inland Revenue Ordinance (IRO). • Where the taxpayer may properly draw its financial statements on either of two alternative bases, the CIR is both entitled and bound to ascertain the assessable profits on whichever basis the taxpayer has chosen to adopt.	• The generally accepted position was that fair value gains or losses recorded in the financial statements would be taxable (when gains are revenue in nature and sourced in Hong Kong) or deductible (when losses satisfy the deduction rules). • In other words, *tax assessment on fair value basis is generally accepted*.
The CFA's judgment in *Nice Cheer Investment Ltd v CIR* (2013) 16 HKCFAR 813	• There are two cardinal principles of tax law: — The word "profit" connotes actual or realized and not potential or anticipated profits; — Neither profits nor losses may be anticipated.	• Unrealized fair value revaluation gains for marketable securities are not taxable at the time they are accounted for because the gains were not actual or realized profits. • Profits computed on fair value basis would have to be re-computed on realization basis for tax reporting. • In other words, *tax assessment should be on realization basis*.
Requests from some taxpayers since the CFA's judgment in Nice Cheer case (2013)	Some taxpayers (*e.g.,* financial institutions and securities dealers) had requested the CIR to accept financial statements prepared on fair value basis for tax reporting as there were substantial costs and practical difficulties faced in re-computing their profits on realization basis.	• The IRD has been accepting tax returns be computed on fair value basis as an *interim administrative measure* in view of the industry's request *for since the year of assessment 2013/2014*. • In other words, the IRD has been accepting *tax returns submitted on realization basis (i.e., following the Nice Cheer case) and on fair value basis (i.e., as a concession)*.
S 18G — S 18L of IRO, effective from year of assessment 2018/2019 (2019)	Tax provisions were enacted on 1 March 2019 to codify the IRD's interim administrative measure.	• These provisions form a legal basis for taxpayers to make a generally irrevocable written election to adopt fair value basis when preparing their tax returns. • In other words, *tax assessment on fair value basis can be elected*. • There are special treatments for certain *exceptional items where tax does not follow accounting*. Examples of exceptional items are: — Impairment loss of a debt instrument; — Debt security with an embedded derivative; — A non-arm's length loan/debt.
Revised Departmental Interpretation and Practice Notes No. 42 (DIPN 42) (2020)	On 12 June 2020, the IRD published a revised DIPN 42.	The IRD provides a detailed guidance to taxpayers on how the new provisions (*i.e.,* s 18G — s 18L of IRO) would apply in practice.

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the major events leading to the development of profits tax assessment basis in Hong Kong.

"Tax Follows Accounting" for Financial Instruments Upon Election

Effective from the year of assessment for which the basis period begins on or after 1 January 2018,[13] if a taxpayer prepares financial statements in accordance with a specified financial reporting standard (*i.e.*, IFRS/HKFRS 9 or a financial reporting standard which is equivalent to IFRS 9) and *elects* in writing for profits tax assessment on fair value basis,[14] the tax treatment of financial instruments aligns with their accounting treatment,[15] subject to the nature (*i.e.*, capital vs. revenue) and source/deduction rules of the recognized amounts.[16] Hence, the amounts recognized in the profit or loss in respect of the financial instruments will be brought into account for computing the assessable profit or adjusted loss in the year of assessment, but the taxability or deductibility will still be subject to the nature and source/deduction rules of the recognized amounts.

However, further clarifications (e.g., with respect to the impairment losses of debt instruments) would be helpful so that entities could better understand the interpretation and practice.

Generally, an election for profits tax assessment on fair value basis, once made, is irrevocable and has effect for the year of assessment for which the election is made and all subsequent years of assessment, until the entity ceases to prepare their financial statements under IFRS/HKFRS 9 (or IFRS 9 equivalence) or the CIR approves the entity's revocation of the election.[17]

For financial instruments measured at FVTPL, all gains or losses, including fair value changes and related exchange differences, will be assessed or deducted in the year in which they are recognized in profit or loss, even though they are not realized. Interest, discount or premium income from debt instruments will be assessed in the year in which it is recognized in profit or loss.[18] Likewise, interest, discount or premium expenses in respect of debt instruments will be deductible in the year in which it is recognized in profit or loss.[19]

For financial instruments measured at amortized cost, gains or losses on disposal will be assessed or deducted in the year in which the financial instruments are derecognized. Foreign exchange gains or losses will be assessed or deducted in the year in which they are recognized in profit or loss. Interest, discount or premium income from debt instruments will be assessed in the year in which it is recognized in profit or loss through the amortization process by using the effective interest method.[20] Likewise, interest, discount or premium expenses in respect of debt instruments will be deductible in the year in which it is recognized in profit or loss through the amortization process by using the effective interest method.[21]

For financial instruments measured at FVTOCI, gains or losses recognized in OCI will be assessed or deducted in the year in which the financial instruments are derecognized. The cumulative gain or loss previously recognized in OCI will be assessed or deducted in the year in which it is reclassified from equity to profit or loss upon derecognition. Foreign exchange gains or losses will be assessed or deducted in the year in which they are recognized in profit or loss. Interest, discount or premium income from debt instruments will be assessed in the year in which it is recognized in profit or loss through the amortization process by using the effective interest method.[22]

Table 3 summarizes the alignment of tax and accounting treatments for financial instruments when fair value basis is adopted for profits tax assessment.

Exceptions to "Tax Follows Accounting" for Financial Instruments

There are exceptions to the "tax follows accounting" for financial instruments. The exceptional items include impairment losses of debt instruments,[23] equity instruments that are measured at FVTOCI, financial liabilities that are measured at FVTPL and with changes in the issuer's own credit risk, debt securities with embedded derivatives, preference shares, non-arm's length loans, and hedging instruments. Tables 4 and 5 describe and discuss the exceptional items which tax treatments do not follow accounting treatments for financial instruments. Illustrations 1–4 show the accounting and taxation treatments of some exceptional items.

TABLE 3. "TAX FOLLOWS ACCOUNTING" FOR FINANCIAL INSTRUMENTS UPON ELECTION

	Financial instruments measured at fair value through profit or loss	Financial instruments measured at amortized cost or fair value through other comprehensive income
Interest income on debt instruments	Amount recognized in profit or loss = amount subject to tax*: s 18J(4)(a) of Inland Revenue Ordinance (IRO)	Amount recognized in profit or loss at the effective interest rate = amount subject to tax*: s 18J(5)(a) of IRO
Interest expense on debt instruments	Amount recognized in profit or loss = tax deduction amount**: s 18J(4)(b) of IRO	Amount recognized in profit or loss at the effective interest rate = tax deduction amount**: s 18J(5)(b) of IRO
Discount or premium income on debt instruments	Amount recognized in profit or loss = amount subject to tax*: s 18J(4)(c) of IRO	Amount recognized in profit or loss at the effective interest rate = amount subject to tax*: s 18J(5)(c) of IRO
Discount or premium expense on debt instruments	Amount recognized in profit or loss = tax deduction amount**: s 18J(4)(d) of IRO	Amount recognized in profit or loss at the effective interest rate = tax deduction amount**: s 18J(5)(d) of IRO

*: Assume that the income is revenue in nature and sourced in Hong Kong.

**: Assume that the expense is revenue in nature and satisfies the deduction rules.

TABLE 4. EXCEPTIONS TO "TAX FOLLOWS ACCOUNTING" FOR FINANCIAL INSTRUMENTS

Financial Instrument	Accounting Treatment	Tax Treatment
Impairment losses of debt instruments	*See* Table 5	*See* Table 5
Equity instruments	Equity instruments are generally measured at fair value through profit or loss (FVTPL). Any subsequent changes in fair value of equity instruments would be recognized in profit or loss. However, if an equity instrument is not held for trading, an entity would make an irrevocable election to present subsequent changes in fair value of equity instruments in other comprehensive income (OCI). Upon disposal, the cumulative gains or losses recognized in OCI are not recycled to the profit or loss.	If an equity instrument is measured at fair value through other comprehensive income (FVTOCI) but is *held on revenue account*, and is disposed of during the year, *any cumulative gain (loss) recognized in OCI is taxable* (deductible**)* in the year of disposal: s 18L(2) of Inland Revenue Ordinance (IRO).
Financial liabilities – changes in credit risk	For financial liability that is measured at FVTPL, the amount of fair value changes attributable to changes in the issuer's own credit risk of that liability would be presented in OCI and would not be recycled to profit or loss upon maturity, sale, buy-back or redemption of the financial instrument.	If such financial liability is *held on revenue account*, and is matured, sold, bought-back or redeemed during the year, *any cumulative gain (loss) recognized in OCI is taxable* (deductible**)* in the year of derecognition: ss 18L(3)-(5) of IRO.
Embedded derivatives – convertible debt security (*see* Illustration 1)	For debt securities with an embedded derivative to acquire shares/units in the issue (*e.g.,* convertible debt security), the issuer is required to split the embedded derivative into a "liability component" and "an "equity component" and present them separately in the statement of financial position. At initial recognition, the issuer is required to measure the "liability component" at fair value as if there were no "equity component"; and the "equity component" will be the difference between the fair value of the embedded derivative as a whole and the fair value of the "liability component".	An embedded derivative will be treated as debt before the right to convert is exercised. Any interest, discount, or premium, *after* deducting the value of the equity component, will be deductible**. Therefore, any *interest, discount, premium or expense* recognized by the issuer in respect of the embedded derivative that is *attributable to the "equity component" is not deductible*: s 18L(6) of IRO.
Preference shares (*see* Illustration 2)	Depending on the terms of the financial instrument, a preference share may be classified as an equity instrument or a financial liability. If a preference share is classified as a financial liability, any dividend declared would be charged as an interest expense to the profit or loss by the issuer.	Despite the accounting treatment, preference shares are treated as share capital for tax purposes because there is no debtor and creditor relationship between the holders and the issuer. Hence, *dividend declared (in form of interest expense) is not deductible by the issuer*. Likewise, dividend received (in form of interest income) is not taxable to the holders: s 18L(7) of IRO.

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TABLE 4. EXCEPTIONS TO "TAX FOLLOWS ACCOUNTING" FOR FINANCIAL INSTRUMENTS

Financial Instrument	Accounting Treatment	Tax Treatment
Non-arm's length loans (*see* Illustration 3)	If a loan or debt security does not carry interest, the fair value of such loan or debt security is measured as the discounted present value of future cash receipts using the prevailing market interest rate. There will be imputed gain or loss at initial recognition of the loan or debt security and a corresponding imputed interest income or expense for amortization.	Non-arm's length loan made or debt security issued to *associated persons without good commercial reasons*: para 56 of DIPN 42 (Revised) • The *imputed gain, loss*, income or expense in respect of the *non-arm's length* loan or debt security *recognized in the financial accounts is neither taxable nor deductible*: para 55 of DIPN 42 (Revised). • The *actual gain, loss*, income or expense in respect of the *non-arm's length* loan or debt security *computed in accordance with the contractual terms is taxable* or deductible***: s 18L(9) of IRO. In addition, the transfer pricing rules (under s 50AAF and s 50AAK of IRO) may apply to adjust the taxable/deductible amount for non-arm's length loan made or debt security issued to associated person: s 18L(8) of IRO.
Hedging instruments	Under a hedging arrangement, the hedging instrument is a hedge against any risk associated with the hedged asset or liability.	Any profit, gain, loss, income or expense recognized in respect of a hedging instrument will *not be taxable or deductible if*: • The hedging instrument is designated, under a hedging arrangement made in good faith, for hedging against any risk associated with a hedged item; and • The hedged item is of capital in nature: s 18L(10) of IRO (note: if the hedged item is of revenue in nature, then tax treatment will follow accounting treatment).

*: Assume that the income is revenue in nature and sourced in Hong Kong.
**: Assume that the expense is revenue in nature and satisfies the deduction rules.

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Some tax treatments of impairment losses of debt instruments (Table 5) are noteworthy. First, with regard to expected credit loss ("ECL") model to impairment, it is not clear why the ECL recognized in respect of a financial instrument that is not credit-impaired is not deductible.[24] Second, with regard to the ECL Stage 3, if a financial instrument is measured at amortized cost or FVTOCI, the associated ECL could qualify for a deduction if the IRD's assessor is satisfied that the financial instrument is acquired for trading purpose. But it is not clear what sort of evidence is required before the IRD's assessor would accept the financial instrument is acquired for trading purpose.[25] Finally, with regard to transfer of credit-impaired loans, it is also not clear why there will be a claw-back on the transferor, being a financial institution, for the impairment loss previously granted when the transfer is not by way of a sale in the ordinary course of the transferor's business and the transferor or the transferee, or both of them are, not in the business of lending money in Hong Kong on the date of transfer.[26] Further clarifications from the IRD to address these concerns would be helpful.

Conclusions

IFRS/HKFRS 9 makes significant accounting rules for financial instruments. A large proportion of financial instruments will be measured at FVTPL. Any changes in fair value of financial instruments will be included in profit or loss. Some financial instruments, however, will be measured at FVTOCI. Any changes in fair value of these financial instruments will be included in OCI instead of profit or loss. Also, based on a three-stage approach, ECL will be made on certain financial assets when they are initially recognized.[27]

Taxpayers who have been prepared their financial accounts in accordance with IFRS/HKFRS 9 might prefer

TABLE 5. IMPAIRMENT LOSSES OF DEBT INSTRUMENTS

Accounting Treatment	Tax Treatment
IFRS/HKFRS 9 applies an "expected credit loss (ECL)" model to impairment. A loss allowance for ECL is recognized on certain financial assets (*i.e.,* financial asset that is measured at amortized cost or at fair value through other comprehensive income (FVTOCI) (except equity instrument), a lease receivable, a contract asset or a loan commitment and a financial guarantee contract) when expected rather than when incurred. For ECL, IFRS/HKFRS 9 uses the three stages of credit risk of deterioration (three-stages approach) to determine the quantum of impairment losses.	Tax treatment of impairment loss does not follow accounting treatment. ECL recognized in respect of a financial instrument that is not credit-impaired is not deductible. ECL recognized in respect of a financial instrument that is credit-impaired is deductible with certain conditions.
ECL Stage 1: the credit risk on the financial instrument has not increased significantly since initial recognition, thus a loss allowance equal to 12-month ECL is applied. Interest revenue is computed based on the gross carrying amount of the financial asset.	For *ECL Stage 1*, the *impairment loss* recognized in respect of a financial instrument is *not credit-impaired* and is *not deductible*. Any subsequent reversal of any amount of the impairment loss (*i.e.,* impairment gain) is not chargeable to tax: s 18K(2) of Inland Revenue Ordinance (IRO).
ECL Stage 2: the credit risk on the financial instrument has increased significantly since initial recognition (*e.g.,* when contractual payments are more than 30 days past due), thus a loss allowance equal to the lifetime ECL is applied. Interest revenue is computed based on the gross carrying amount of the financial asset.	For *ECL Stage 2*, the impairment loss recognized in respect of a financial instrument is *not credit-impaired* and is *not deductible*. Any subsequent reversal of any amount of the impairment loss (*i.e.,* impairment gain) is not chargeable to tax: s 18K(2) of IRO.
ECL Stage 3: the financial instrument is credit-impaired, thus a loss allowance equal to the lifetime ECL is applied. Interest revenue is computed by applying the effective interest rate to the amortized cost instead of the gross carrying amount of the financial asset. A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flow of that financial asset have occurred. The following events provide evidence that financial assets are credit-impaired: • Significant financial difficulty of the issuer or borrower; • A breach of contract, such as a default or past due event; • The lender, for economic or contractual reasons relating to the borrower's financial difficulty, has granted a concession that the lender would not otherwise consider; • It is becoming probable that the borrower will enter into bankruptcy or other financial reorganization; • The disappearance of an active market for that financial asset because of financial difficulties; or • The purchase or origination of a financial asset at a deep discount that reflects incurred credit losses.	For *ECL Stage 3*, the impairment loss recognized in respect of a financial instrument is *credit-impaired* and is *deductible with certain conditions*: s 18K(3) of IRO. • If the instrument represents a debt that was included as a trading receipt in ascertaining the assessable profits for the basis period, the impairment loss is deductible up to the amount of the debt so included; • If the instrument represents a debt in respect of money lent, in the ordinary course of the business of lending money in Hong Kong, the impairment loss is deductible up to the amount of the debt; and • In any other case, the impairment loss is not deductible. If a deduction was previously allowed in respect of a bad/doubtful debt under s 16(1)(d) of IRO or in respect of an impairment loss under s 16K(3) of IRO, the subsequent reversal of any amount of the bad/doubtful debt or impairment loss is chargeable to tax: s 18K(4) of IRO. *Remark* • Although impairment loss in the form ECL is essentially a bad/doubtful debt, the deduction rule for impairment loss under s 18K(3) of IRO is not subject to the deduction rule for bad/doubtful debt under s 16(1)(d) of IRO: para 35 of DIPN 42 (Revised). • If a financial instrument is measured at amortized cost or FVTOCI, the associated ECL could qualify for a deduction if the Inland Revenue Department's assessor is satisfied that the financial instrument is acquired for trading purpose: para 37 of DIPN 42 (Revised).
Purchased or originated credit-impaired financial assets With regard to the purchased or originated credit-impaired financial assets (*e.g.,* junk bonds), the purchase price or fair value at initial recognition includes an expectation for credit losses which was priced into the instrument. No loss allowance is recognized at initial recognition.	If an impairment gain subsequently recognized in respect of the purchased or originated credit-impaired financial asset is not a reversal of any impairment loss which has been previously allowed, the impairment gain is not chargeable to tax. However, if the purchased or originated credit-impaired financial asset is *held on revenue account*, then any impairment gain is treated as the trading receipt for the year in which it is recognized: s 18K(5) of IRO.

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TABLE 5. IMPAIRMENT LOSSES OF DEBT INSTRUMENTS

Accounting Treatment	Tax Treatment
Transfer of credit-impaired loans (*see* Illustration 4) Where a credit-impaired loan is *transferred* by a transferor to a transferee *by way of sale in the ordinary course of the transferor's business*, the transferee will record the purchased credit-impaired loan at the purchase price in its account. In this situation, there is no transfer of loss allowance from the transferor to the transferee.	*Transfer is way of sale* • There is no transfer of loss allowance to the transferee. • S 18K(7) or s 18K(8) of IRO [discussed below] will not apply. *Transfer is not by way of sale* (*e.g.,* pursuant to a merger or restructuring) • If a tax deduction for impairment loss or bad/doubtful debt was previously allowed in respect of a credit-impaired loan and the loan is subsequently transferred from a financial institution to another person, the amount of *deduction previously allowed* to the transferor under s 16(1)(d) of IRO in respect of a bad/doubtful debt or under s 18K(3) of IRO in respect of an impairment loss will be *treated as having been allowed to the transferee if the transfer is not by way of a sale* in the ordinary course of the transferor's business; and *both of the transferor and the transferee are in the business of lending money in Hong Kong* on the date of transfer: s 18K(6) and (7). Any *subsequent recovery* of the bad/doubtful debt or reversal of the impairment loss will be *treated as a taxable trading receipt of the transferee* for the year in which it is recognized: s 18K(4) of IRO. • If a tax deduction for impairment loss or bad/doubtful debt was previously allowed in respect of a credit-impaired loan and the loan is subsequently transferred from a financial institution to another person, the amount of *deduction previously allowed* to the transferor under s 16(1)(d) of IRO in respect of a bad/doubtful debt or under s 18K(3) of IRO in respect of an impairment loss will be *deemed as a taxable trading receipt of the transferor* accruing on the date of the transfer if 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 (i.e., the deduction previously allowed to the transferor is clawed back): s 18K(6) and (8) of IRO.

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to file their profits tax return on the same basis of accounting for financial instruments due to time and cost concerns. However, the CFA's judgment in *Nice Cheer* held that the accounting treatment did not form an appropriate basis for computing the assessable profits where they contained unrealized profits. Although the IRD has concessionary allowed taxpayers to elect to be taxed on fair value basis in respect of financial instruments, the set of tax provisions enacted in March 2019 provides a legal basis for the IRD's administrative measure.

The flexibility to opt for aligning the tax and accounting treatments of financial instruments is generally welcome by the entities which prepare their financial statements in accordance with IFRS/HKFRS 9. Entities should carefully evaluate the costs and benefits of different basis of profits tax assessment. The basis of assessment on fair value or realization is essentially a matter of timing difference. An election for assessment on fair value basis, once made, is applicable for the year of assessment for which the election is made and all subsequent years of assessment. It is generally irrevocable unless there are good commercial reasons and the revocation is not driven by a tax avoidance motive.[28]

The "tax follows accounting" treatment for financial instruments should be handled with care. The general principles of taxation in Hong Kong still take precedence over accounting treatment.[29] When an election for assessment on fair value basis is made, the timing in recognition of profit, gain, loss, income or expense under IFRS/HKFRS 9 will generally be followed for tax purposes. Hence, both realized and unrealized gains or losses on a financial instrument will

ILLUSTRATION 1. EMBEDDED DERIVATIVES—CONVERTIBLE DEBT SECURITY

- Company-HK issued convertible bond at $10,000, redeemable at a premium of $1,000.
- The fair value of a similar bond without the option to convert into shares is $9,500.

Accounting Treatment	Tax Treatment
In accordance with Hong Kong Accounting Standard 32 *Financial Instruments: Presentation*, Company-HK will split the convertible bond into a "liability component" and an "equity component" and present them separately in the statement of financial position. At initial recognition, Company-HK will measure the "liability component" at fair value as if there were no "equity component" and the "equity component" at the difference between the fair value of the convertible bond as a whole and the fair value of the "liability component." Hence, at initial recognition, Company-HK will measure the "liability component" at $9,500 and the "equity component" at $500 ($10,000 — $9,500). During the tenure of the convertible bond, the difference between the redemption price of $11,000 ($10,000 + $1,000) and the fair value of the "liability component" at initial recognition of $9,500 (*i.e.,* $11,000 – $9,500 = $1,500 which is the imputed premium) will be amortized to profit or loss in accordance with Hong Kong Financial Reporting Standard 9 *Financial Instruments*.	• Only the *actual premium* of $1,000 (being the premium on redemption per *contractual terms*) *is deductible* if the deduction rules (*e.g.,* s 16(1) and s 17(1) of IRO) are satisfied. • The difference between the imputed premium ($1,500) and actual premium ($1,000) (*i.e.,* $1,500 – $1,000 = $500) is the *premium that is attributable to the "equity component"* and is *not deductible* under s 18L(6) of apply.

Source: Adapted from Example 4 of DIPN 42 (Revised), at 20.

ILLUSTRATION 2. PREFERENCE SHARES

- Company-HK issued preference shares with a par value of $100M and a dividend of 10% per annum.
- Puttable options attached to the preference shares allowed the redemption of the instrument for cash.
- The holders would have rights to attend members' meetings, to receive notices of general meetings and to approve resolutions.
- The directors would be allowed to omit the dividend without throwing the company into bankruptcy.

Accounting Treatment	Tax Treatment
In accordance with Hong Kong Accounting Standard 32 *Financial Instruments: Presentation*, Company-HK will classify the preference shares as financial liabilities and the dividends declared will be charged as interest expense to the profit or loss.	• The preference shares would be treated for tax purposes as share capital because the relationship between the holders and Company-HK was not a debtor and creditor relationship. • Dividends declared are not deductible as interest expenses by Company-HK and not taxable as interest income to the holders.

Source: Adapted from Example 2.6 of DIPN 42 (Revised), Appendix 2, at vii.

be taken into account when computing the assessable profits. However, the taxability or deductibility of these recognized amounts is still subject to the other provisions in IRO. The distinction between revenue and capital in nature of the recognized amounts is important. Also, the source rules (for gains) and the deduction rules (for losses) have to be examined. Furthermore, the legal form of an item takes priority over accounting—for example, preference share dividends are not treated as interest expenses for tax purposes even they are treated as interest expenses for accounting purposes. The IRD issued a revised DIPN 42 to provide guidance on the application of the set of tax provisions enacted in March 2019. However, further clarifications (*e.g.*, with respect to the impairment losses of debt instruments) would be helpful so that entities could better understand the interpretation and practice.

ILLUSTRATION 3. NON-ARM'S LENGTH LOANS

- Company-HK grants a four-year loan of $1M to Company-Kowloon on 1 January 2020.
- As Company-HK expects to generate more new business from Company-Kowloon, the contractual interest rate on the four-year loan is 3% per annum.
- The current market lending rate of a similar loan is 5% per annum.
- Company-Kowloon is one of the customers of Company-HK. Both companies are unrelated and carrying on businesses in Hong Kong with 31 December as year-end.

Accounting Treatment	Tax Treatment
• On initial recognition, Company-HK will recognize the four-year loan receivable at the fair value in accordance with IFRS/HKFRS 9. • The fair value of the loan receivable can be estimated as the present value of all future cash receipts discounted using the prevailing market rate for a similar instrument.	• S 18L(9) of IRO normally relates to a non-arm's length loan or debt security issued to associated persons without good commercial reasons. • *In this case, tax will follow accounting treatment* since Company-HK and Company-Kowloon are *unrelated companies*. Also, the off-market loan could be argued to have made with *good commercial reasons* since Company-HK expects to generate more business from Company-Kowloon.
1 January 2020 Company-HK will recognize an originated loan of $929,079. The difference of $70,921 ($1,000,000 — $929,079) would be charged to profit or loss (P&L) immediately. Dr Loan Receivable $929,079 (note 1) Dr Imputed interest (P&L) $70,921 Cr Cash $1,000,000 *31 December 2020* Company-HK will recognize the interest revenue and loan as follows: Dr Cash $30,000 Dr Loan Receivable $16,454 (note 2) Cr Interest income (P&L) $46,454 (note 2)	*Year of assessment 2020/2021 (Basis period: year ended 31 December 2020):* • The imputed interest of $70,921 in respect of the below market rate loan recognized in the profit or loss during the year ended 31 December 2020 would be deductible** by Company-HK. • The interest income of $46,454 in respect of the below market rate loan recognized in the profit or loss during the year ended 31 December 2020 would be taxable* to Company-HK.
31 December 2021 Company-HK will recognize the interest revenue and loan as follows: Dr Cash $30,000 Dr Loan Receivable $17,277 (note 2) Cr Interest income (P&L) $47,277 (note 2)	*Year of assessment 2021/2022 (Basis period: year ended 31 December 2021):* The interest income of $47,277 in respect of the below market rate loan recognized in the profit or loss during the year ended 31 December 2021 would be taxable* to Company-HK.
31 December 2022 Company-HK will recognize the interest revenue and loan as follows: Dr Cash $30,000 Dr Loan Receivable $18,141 (note 2) Cr Interest income (P&L) $48,141 (note 2)	*Year of assessment 2022/2023 (Basis period: year ended 31 December 2022):* The interest income of $48,141 in respect of the below market rate loan recognized in the profit or loss during the year ended 31 December 2022 would be taxable* to Company-HK.

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ILLUSTRATION 3. NON-ARM'S LENGTH LOANS

Accounting Treatment

31 December 2023

Company-HK will recognize the interest revenue and loan as follows:

Dr Cash	$30,000
Dr Loan Receivable	$19,049 (note 2)
Cr Interest income (P&L)	$49,049 (note 2)
Dr Cash	$1,000,000
Dr Loan Receivable	$1,000,000

Tax Treatment

Year of assessment 2023/2024 (Basis period: year ended 31 December 2023):

The interest income of $49,049 in respect of the below market rate loan recognized in the profit or loss during the year ended 31 December 2023 would be taxable* to Company-HK.

Remark

In case of Company-HK and Company-Kowloon are *associated* and the off-market loan is made *without good commercial reasons, s 18L(9)* of IRO could be *invoked* (*i.e., tax does not follow accounting treatment*). The *imputed interest of $70,921* in respect of the below market rate loan recognized in the profit or loss would *not be deductible* by Company-HK in year of assessment 2020/21. Instead, the *actual interest income of $30,000* computed in accordance with the contractual terms would be *taxable** to Company-HK during years of assessment 2020/2021 to 2023/2024.

*: Assume that the income is revenue in nature and sourced in Hong Kong.

**: Assume that the expense is revenue in nature and satisfies the deduction rules.

Note 1: The present value of all future cash receipts is computed below

Date	*Cash Inflow ($)*	*Discount Factor*	*Present Value ($)*
31 Dec. 2020	30,000	$1 \div (1 + 5\%)^{1}$	28,571
31 Dec. 2021	30,000	$1 \div (1 + 5\%)^{2}$	27,210
31 Dec. 2022	30,000	$1 \div (1 + 5\%)^{3}$	25,915
31 Dec. 2023	30,000	$1 \div (1 + 5\%)^{4}$	24,681
31 Dec. 2023	1,000,000	$1 \div (1 + 5\%)^{4}$	822,702
			929,079

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Note 2: The amortization schedule is shown below

Date	*Interest Revenue ($) (a)*	*Interest Received ($) (b)*	*Amortization ($) (c) = (a) — (b)*	*Carrying Amount ($)*
1 Jan. 2020				929,079
31 Dec. 2020	46,454^	30,000	16,454	945,533^^
31 Dec. 2021	47,277^^^	30,000	17,277	962,810^^^^
31 Dec. 2022	48,141#	30,000	18,141	980,951##
31 Dec. 2023	49,049###	30,000	19,049	1,000,000####
	190,921	120,000	70,921	

^: 929,079 × 5% = 46,454; ^^: 929,079 + 16,454 = 945,533; ^^^: 945,533 × 5% = 47,277; ^^^^: 945,533 + 17,277 = 962,810.
#: 962,810 × 5% = 48,141; ##: 962,810 + 18,141 = 980,951; ###: 980,951 × 5% = 49,049; ####: 980,951 + 19,049 = 1,000,000.

ILLUSTRATION 4. TRANSFER OF CREDIT-IMPAIRED LOANS

- Bank-HK (which is in the business of lending money in Hong Kong) had a credit-impaired loan portfolio of face value of $10 million in respect of which a loss allowance of $3 million was provided.
- Bank-HK transferred the credit-impaired loan portfolio in the ordinary course of its business to Company-HK *by way of sale* at a price of $7 million.

Accounting Treatment	Tax Treatment
In accordance with IFRS/HKFRS 9, Company-HK recognized the purchase price of $7 million as the value of the purchased credit-impaired loan portfolio but not any loss allowance.	• Loss allowance of $3 million was not transferred to Company-HK. • S 18K(7) or s 18K(8) of IRO (see below) will not apply. *Remark* • If the transfer is *not by way of sale* (*e.g.,* pursuant to a merger or restructuring) in the ordinary course of Bank-HK's business and *Company-HK is not in the business of lending money in Hong Kong* on the date of transfer, the *loss allowance $3M will be deemed as a taxable trading receipt of Bank-HK* accruing on the date of transfer if it had previously claimed deduction for the loss allowance of $3M as impairment loss or bad/doubtful debt: s 18K(8) of IRO. • If the transfer is *not by way of sale* in the ordinary course of Bank-HK's business and *Company-HK is in the business of lending money in Hong Kong* on the date of transfer, the *loss allowance $3M will be treated as having been allowed to Company-HK*: s 18K(7) of IRO.

Source: Adapted from Example 3 of DIPN 42 (Revised), at 17.

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ENDNOTES

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[1] *Nice Cheer Investment Ltd v. Commissioner of Inland Revenue (CIR)*, 16 HKCFAR 813 (2013).

[2] Hong Kong Financial Reporting Standard 13 *Fair Value Measurement* (HKFRS 13) defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

[3] Effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial instrument. It is used in the calculation of amortized cost of the financial instrument. It is also used in the allocation and recognition of interest income or expense in profit or loss over the term of the financial instrument.

[4] Johnson Tee, *Aligning Tax Treatment with Fair Value Accounting Under HKFRS 39*, Hong Kong Institute of Certified Public Accountants, Seminar Notes, April 2019, at 7.

[5] Davy Yun & Kelvin Mak, *Should the Hong Kong Tax Authority Rethink and Clarify How to Follow the Tax Follows Accounting Principle?*, 15 Asia Pacific Journal of Taxation 33 (2011).

[6] *CIR v. Secan Ltd & Another*, 3 HKCFAR 411 (2000).

[7] Inland Revenue Department (IRD), *Departmental Interpretation and Practice Notes (DIPN) No. 1 (Revised)*, September 2020, para. 13, available at *www.ird.gov.hk/eng/pdf/dipn01.pdf*.

[8] *See supra* note 7 for IRD (2020), para. 16. *See also* IRD, *Profits Tax Treatment of Leases Where HKFRS 16 Applies*, September 2020, at 2, available at *www.ird.gov.hk/eng/tax/bus_lease16.htm*.

[9] The issue of unrealized revaluation losses on marketable securities was not under dispute in *Nice Cheer*. The Court of Final Appeal judge, however, commented that a provision for diminution in value of trading stock would be tax deductible if the provision represented a "material and permanent fall in value" of the trading stock at the balance sheet date. If not, such a provision would only be anticipated losses and as such, would not be tax deductible as the loss has not been incurred for the purpose of section 16 of the Inland Revenue Ordinance (IRO).

[10] Wilson Cheng & Ada Ma, *Tax Treatment of Unrealized Gains and Losses in Hong Kong*, 16 Asia Pacific Journal of Taxation 19 (2012).

[11] A typical practical difficulty is to track transactions on realization basis for tax purposes. *See* Ernst & Young, *Hong Kong Introduces Use of Fair Value Accounting Treatment of Financial Instrument for Tax Purposes*, Global Tax Alert, November 2018, at 1, available at *www.ey.com/en_gl/tax-alerts/ey-hong-kong-introduces-use-of-fair-value-accounting-treatment-of-financial-instrument-for-tax-purposes*.

[12] PricewaterhouseCoopers, *Election to Adopt Fair Value Accounting for Financial Instruments for Tax Purposes Was Legislated*, News Flash, Hong Kong Tax, Issue 2, March 2019, at 1, available at *www.pwchk.com/en/hk-tax-news/2019q1/hongkongtax-news-mar2019-2.pdf*.

[13] The new provisions on assessment on fair value basis (which are effective for basis periods beginning on or after 1 January 2018) cover the first HKFRS 9 applicable period in Hong Kong (*i.e.*, accounting periods starting on or after 1 January 2018).

[14] S 18H(1), IRO.

[15] S 18J(1), IRO.

[16] S 18I(4), IRO. Realized and unrealized revaluation gains for financial instruments recognized in the financial statements are taxable at the time of recognition as long as they are revenue in nature and sourced in Hong Kong.

[17] S 18H(5) and s 18H(6), IRO. The Commissioner of Inland Revenue (CIR)'s approval to revoke the election could be obtained when (1) there are good commercial reasons for

the revocation and (2) the avoidance of tax is not the main purpose, or one of the main purposes, for the revocation. In a merger or an acquisition where a company which has elected to adopt the fair value basis has become part of a group that adopts the realization basis for tax filing purposes may obtain the CIR's approval to revoke the election on the basis of good commercial reasons. *See supra* note 12 for PricewaterhouseCoopers (2019), at 2.

[18] S 18J(4)(a) and s 18J(4)(c), IRO.

[19] S 18J(4)(b) and s 18J(4)(d), IRO.

[20] S 18J(5)(a) and s 18J(5)(c), IRO.

[21] S 18J(5)(b) and s 18J(5)(d), IRO.

[22] S 18J(5)(a) and s 18J(5)(c), IRO.

[23] The old accounting standard Hong Kong Accounting Standard 39 *Financial Instruments: Recognition and Measurement* (HKAS 39) was criticized as being too slow to recognize impairments which led to the impairment losses were not recognized in the financial accounts until it was too late for investors to understand what has been happening. To address this concern, the expected credit loss (ECL) approach in HKFRS 9 requires all financial instruments to suffer some forms of impairment in order to reflect the risk of non-payment. In accordance with HKFRS 9, an ECL approach is used to immediately recognize impairments for the risk of non-payment through a weighted probability methodology. However, only impairments arising in respect of financial assets which meet the definition of "credit-impaired" (as defined in IFRS/HKFRS 9) will be deductible when satisfying certain conditions. Hence, some impairment losses recognized in respect of financial assets are not deductible because these assets are not credit-impaired. *See* Deloitte, *Hong Kong Tax Newsflash: Taxation of Financial Instruments Under IFRS/HKFRS 9*, Issue 81, 7 November, at 3, available at *www2.deloitte.com/content/dam/Deloitte/cn/Documents/tax/hk-tax-news/deloitte-cn-tax-hktn-issue81-en-181107.pdf*.

[24] *See supra* note 4 for Johnson Tee (2019), at 31.

[25] KPMG, *The Inland Revenue Department Issues a Revised DIPN 42*, Hong Kong Tax Alert, June 2020, at 2, available at *www.assets.kpmg/content/dam/kpmg/cn/pdf/en/2020/06/tax-alert-11-hk-the-inland-revenue-department-issues-a-revised-dipn-42.pdf*.

[26] *See supra* note 12 for PricewaterhouseCoopers (2019), at 3.

[27] *See supra* note 23 for Deloitte (2018), at 1–2.

[28] PricewaterhouseCoopers, *The Revised DIPN 42 Provides Detailed Guidance on the Election for Financial Instruments Assessed on Fair Value Basis for Tax Purposes*, News Flash, Hong Kong Tax, Issue 10, June 2020, at 2, available at *www.pwchk.com/en/hk-tax-news/2020q2/hongkongtax-news-jun2020-10.pdf*.

[29] *See supra* note 25 for KPMG (June 2020), at 1.

A Note from the EIC

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ENDNOTES

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[1] Tax Cuts and Jobs Act, P.L. 115-97 (Dec. 22, 2017).

[2] Code Sec. 250(b).

[3] Code Sec. 951A.

[4] Code Sec. 250(a)(1)(B).

[5] Code Sec. 951(a)(1)(A).

[6] All of the foreign income taxes paid or accrued on FDII and deemed paid or accrued on Subpart F income can be used to reduce U.S. taxes on such income (Code Secs. 901 and 960(a)), and 80% of the foreign income taxes deemed paid or accrued on GILTI can be used to reduce U.S. taxes on GILTI (Code Sec. 960(d)), subject to limitations (Code Sec. 904).

[7] Code Secs. 959 and 245A.

[8] Also, in 2026 the BEAT tax rate is scheduled to increase from 10% to 12.5% (Code Sec. 59A), and in 2022 the Code Sec. 163(j) interest deduction limitation would change from 30% of EBITDA to 30% of EBIT.

[9] Biden also proposed an alternative minimum tax at 15% on a corporation's book income, potentially applicable only to companies with at least $100 million in book income. The minimum tax would take into account foreign income taxes (unlike the BEAT).

[10] Biden has not indicated whether any changes would be made to the BEAT or to the Code Sec. 163(j) limitations on the amount of interest deductions.

[11] There is no indication whether in 2026 there would be an additional increase in the effective tax rate on GILTI.

[12] Under current law, the limitation on the use of foreign tax credits to reduce U.S. taxes on GILTI is calculated on an aggregate basis taking into account a U.S. shareholder's GILTI and foreign income taxes from all CFCs (thus permitting averaging of low-taxed GILTI with high-taxed GILTI).

[13] There is no indication that, with the increased tax rate on GILTI, a foreign tax credit would be permitted for 100% of the foreign income taxes imposed on the GILTI inclusion (rather than 80%).

[14] *See* Reg. §1.904-1(a), -4(g); Reg. §1.861-8 through 17.

[15] If this proposal is enacted, electing the high-tax exception for high-taxed GILTI may be beneficial (with a 28% corporate tax rate the threshold rate would increase from greater than 18.9% to greater than 25.2%). Reg. §1.951A-2(c)(7). Yoder, *The GILTI and Subpart F Income High-Tax Exception(s)*, Int'l Tax J., Nov.–Dec. 2020, at 3.

[16] For example, excess foreign tax credits with respect to a GILTI inclusion of high-taxed income would be lost, whereas excess foreign tax credits associated with a Subpart F income inclusion of high-taxed income can be used to reduce U.S. tax on other foreign source business income, and carried back one year and forward 10 years. Code Sec. 904(c) and (d).

[17] The Biden proposals would also deny deductions for costs of "offshoring," such as costs arising from plant closures in the United States. On the other hand, Biden has proposed to provide a 10% credit for "reshoring" operations or reopening, retooling, or expanding U.S. manufacturing facilities.

Is Code Sec. 1291(f) Self-Executing?

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> is treated as a taxable sale at the time of the gift. On the other hand, the conferees do not intend this regulatory authority to be exercised in cases where there is no potential to avoid the deferred tax and interest. For example, the conferees generally do not believe that an otherwise nontaxable reorganization of a PFIC should give rise to a recognition event where a US person exchanges stock in a PFIC for stock in another PFIC and no step-up in basis occurs.

In contrast with the legislative history from 1986, the 1988 Conference Report clearly states that Congress intended the regulatory authority granted under Code Sec. 1291(f) to be exercised. In particular, the 1988 Conference Report provides that Congress intended that Treasury exercise its regulatory authority to

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