

Tax

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Hong Kong Tax Analysis

Inland Revenue Department updates guidance on revenue recognition under HKFRS 15 and appropriation of stock under HKAS 2

The Inland Revenue Department (IRD) recently released the updated [Department Interpretation and Practice Notes No. 1](#) (Revised DIPN 1) which replaces the old version issued in July 2006. Having considered the judgements in some recent court cases and implementation of Hong Kong Financial Reporting Standard (HKFRS) 15¹, the IRD almost re-wrote the whole DIPN trying to explain in more detail the tax principles in relation to computing assessable profits, and measurement of inventories or stock in the case of cessation of business and a change of intention in holding the asset. In this Tax Analysis, we will highlight the key updates on Revised DIPN 1.

Key updates

(a) Computing assessable profits – interaction between accounting and tax laws

The IRD clarifies how the principles derived from the tax cases, i.e., *Secan case*² and *Nice Cheer case*³, interact with the accounting standards.

In computing assessable profits, profits computed in accordance with generally accepted accounting principles (GAAP) form the starting point. In general, financial statements prepared in accordance with GAAP provide the basis for computing assessable profits. Adjustments may then need to be made to conform to tax laws and to give effect to more general tax principles (e.g. profits of a capital nature). This principle was reflected in the *Secan case*.

Authors:

Sarah Chan
Tax Partner
Tel: +852 2852 1628
Email:
sarahchan@deloitte.com.hk

Doris Chik
Tax Director
Tel: +852 2852 6608
Email: dchik@deloitte.com.hk

Carmen Cheung
Tax Manager
Tel: +852 2740 8660
Email:
carmcheung@deloitte.com.hk

For more information, please contact:

Global Business Tax Services
National Leader

Ryan Chang
Tax Partner
Tel: +852 2852 6768
Email: ryanchang@deloitte.com

Hong Kong
Raymond Tang
Tax Partner
Tel: +852 2852 6661
Email: raytang@deloitte.com.hk

¹ <https://www.hkicpa.org.hk/-/media/HKICPA-Website/Members-Handbook/volumell/hkfrs15.pdf>

² *CIR v Secan Ltd & Another* (2000) 3 HKCFAR 411

³ *Nice Cheer Investment Ltd v CIR* (2013) 16 HKCFAR 813

The IRD further explains that profits recognised on an accrual basis would only be taken to compute assessable profits provided that the accrual is not “anticipatory” but made to reflect the existence of a contract of sale. This is in line with the two cardinal principles introduced in the *Nice Cheer case*: (i) “profits” connotes actual or realized profits, not potential or anticipated profits; and (ii) neither profits nor losses may be anticipated.

Since accrual accounting is used for preparing financial statements, profits recognised on an accrual basis would be taken for computing assessable profits. The IRD normally does not accept cash basis for tax purpose.

(b) Revenue recognition under HKFRS 15

General practice

HKFRS 15 *Revenue from Contracts with Customers* took effect for accounting periods starting from 1 January 2018. Under HKFRS 15, revenue is recognized when the performance obligations under a contract for sale or service are satisfied (i.e., five-step/substance based approach when the control of goods or services has been transferred to the customer). Though profits tax is charged when the profit is derived and the expense is incurred, the difference, if any, between accounting and tax should not be significant. Therefore, accounting profits determined in accordance with HKFRS 15 would form the starting point for computing assessable profits.

Variable consideration

Where a contract includes variable consideration (e.g. price discounts, rebates, incentives and performance bonuses) which is recognised as revenue under HKFRS 15, the IRD would regard such revenue as having been realised (i.e. the revenue is not anticipated) and such revenue (after deduction of expenses, if appropriate) would be assessed accordingly.

Significant financing component

The timing of customer payment under a contract may provide benefit of financing the transfer of the good or service. Under HKFRS 15, if a contract contains a significant financing component, notional interest revenue for deferred payments and notional interest expense for advance payments would be recognised in the financial statements. The IRD takes that view that such notional interest revenue/expense should not be brought to tax when it is recognised in the financial statements as there is no actual interest receipt/payment.

Two examples are set out in Revised DIPN 1 to illustrate the tax treatments under deferred payment and upfront payment scenarios. In short, notional interest revenue / expense should be disregarded, i.e., non-taxable / non-deductible even they are recognized in the profit and loss account under HKFRS 15. In effect, the revenue being the contract price for the sale of goods or services will be treated as taxable in the year of assessment when the control of goods / services are transferred to the customer.

Transitional adjustments

Transitional accounting adjustments (e.g. upward / downward adjustment on the opening balance of retained earnings) would be made when HKFRS 15 is first applied. The IRD takes the view that any transitional adjustment that is revenue in nature should be subject to tax or allowed as a deduction in the year of assessment in which HKFRS 15 is adopted for the first time.

Construction contracts

An appendix is added to Revised DIPN 1 in relation to the application of the revenue recognition principles under HKFRS 15 on construction contracts. Similar to contract for sale of good or service, profits arising from a construction contract recognised in the financial statements in accordance with HKFRS 15 would generally be adopted for profits tax purposes. The tax treatments on variable consideration and significant financing component as discussed above are equally applicable to construction contracts.

For a loss making contract where the total contract cost exceeds the total contract revenue, the IRD explains that the amount of contract costs or provisions determined in accordance with HKFRS 15 would be deductible, subject to the conditions for deduction set out in the Inland Revenue Ordinance (IRO) being satisfied.

For costs incurred prior to commencement of a construction contract (e.g. mobilisation costs, site set up costs and costs of feasibility studies) which are capitalised and amortised over the course of the contract, the deduction of such costs would follow the amortisation treatment as required under HKFRS 15.

Real estate development

Another appendix is added to Revised DIPN 1 in relation to real estate development for sale. The IRD accepts that consideration from pre-completion sales of units in a multi-storey residential building with typical contractual terms would not be recognised as revenue for tax purpose until the point in time at which the developer fully satisfies the performance obligation (i.e. when the customer obtains control over the purchased unit). The tax treatments on variable consideration and significant financing component as discussed above are equally applicable.

(c) Measurement of inventories or stock

Hong Kong Accounting Standard (HKAS) 2 Inventories⁴ has been adopted for many years. It provides the GAAP for measurement of inventories and therefore forms the starting point for stock valuation for tax purposes. There is not much change with respect to the context of stock valuation but Revised DIPN 1 supplements the explanations of valuation/measurement of inventories in the case of cessation of business and change of intention in holding the assets.

Cessation of business

Section 15C of the IRO provides for the valuation of trading stock on cessation of business.

- If a trading stock is sold or transferred for valuable consideration to a person who carries on or intends to carry on a trade or business in Hong Kong so that the cost will be deductible when the profits of the purchaser's business are computed, the actual consideration should be brought into account as the receipt to compute the assessable profits.
- If a trading stock falls outside the above scope (e.g. stock is not sold, stock is transferred not for valuable consideration), the amount which it would have realized if sold in the open market at the date of cessation should be brought into account as deemed receipt when computing its assessable profits.

The IRD quotes a court case⁵ to illustrate that if a taxpayer was carrying on two different businesses and one of them subsequently ceased, section 15C will apply in respect of the one that ceased.

Change of intention

Section 15BA was introduced to the IRO in 2018 to codify the market value principle established in *Sharkey v Wernher* case⁶ that tax computation needs to be adjusted to reflect the market value of an asset with respect to a change of intention. Revised DIPN 1 explains the application of Section 15BA. The following situations are worth noting:

- Where trading stock is taken for private use or put into use in another business, the market value at the time of appropriation should be brought into account as receipt for computing the assessable profits.

⁴ <https://www.hkicpa.org.hk/-/media/HKICPA-Website/Members-Handbook/volumeII/hkas02.pdf>

⁵ *Southtime Limited v CIR* [2002] 2 HKLRD 275

⁶ *Sharkey v Wernher* [1956] AC 58

- Where trading stock is disposed of by way of gift or through a sale of business, the market value at the time of disposal (not the actual consideration) should be brought into account as receipt for computing the assessable profits.
- Where a person changes its intention of holding an asset as a capital asset to a trading stock, the market value of the asset as at the date it becomes a trading stock should be regarded as the cost of stock for computing the assessable profits.

Meanwhile, it should be noted where section 15C applies, section 15BA will not apply.

Key takeaways

Revised DIPN 1 provides a clear guidance on the tax implications arising from the adoption of the new accounting standard, HKFRS 15, on revenue recognition, as well as the application of section 15BA upon appropriation of inventories. Nevertheless, the fundamental principles of computation of assessable profits have not changed.

With the adoption of HKFRS 15, the tax treatment for revenue under contract with significant financing component (notional interest revenue/expense) will create complications from both accounting and tax perspectives. Since tax adjustments should be made to ensure that the full amount of "realised" revenue (i.e. notional interest revenue and expense being disregarded) would be included as assessable profits, taxpayers would need to keep separate records for the contract price, calculation and relevant adjustments of financing component, analysis of the five-step approach, timing when the goods / services are transferred to the customer, etc., for each contract for each basis period. Such information is equally important if being asked by the IRD to substantiate the tax filing position and adjustments made.

As notional interest revenue / expense are just accounting constructs as required under HKFRS 15, it is a reasonable understanding that such amount is not required to be reported as "interest income" / "interest expense" (Boxes 12.8 and 12.9) in the profits tax return.

On the other hand, we notice that, although not directly relevant to revenue recognition or computation of assessable profits, the IRD mentions in Revised DIPN 1 its view on the chargeability of a building site or construction or installation project. The IRD generally takes the view that a non-DTA territory⁷ resident person which undertakes construction or installation projects or performs activities at a site in Hong Kong (even it does not last not more than 12 months and is not regarded as a permanent establishment in Hong Kong) would be regarded as carrying on a business in Hong Kong and chargeable to profits tax. Foreign companies planning or having such site / project in Hong Kong should review their operational model and assess the potential tax implication accordingly.

Although Revised DIPN 1 is not legally binding, taxpayers should read the updated practices carefully and seek professional advice on the relevant tax treatments when adopting HKFRS 15 and upon appropriation of inventories.

⁷ A non-DTA territory means a territory with which Hong Kong does not have a double taxation agreement or arrangement (DTA).

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National Leader at Deloitte China

Eunice Kuo

Partner

Tel: +86 21 6141 1308

Fax: +86 21 6335 0003

Email: eunicekuo@deloitte.com.cn

Northern China

Andrew Zhu

Partner

Tel: +86 10 8520 7508

Fax: +86 10 8518 7326

Email: andzhu@deloitte.com.cn

Eastern China

Maria Liang

Partner

Tel: +86 21 6141 1059

Fax: +86 21 6335 0003

Email: mliang@deloitte.com.cn

Southern China

Victor Li

Partner

Tel: +86 755 3353 8113

Fax: +86 755 8246 3222

Email: vicli@deloitte.com.cn

Western China

Frank Tang

Partner

Tel: +86 28 6789 8188

Fax: +86 28 6500 5161

Email: ftang@deloitte.com.cn

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National Tax Technical Centre

Email: ntc@deloitte.com.cn

National Leader/Northern China

Julie Zhang

Partner

Tel: +86 10 8520 7511

Fax: +86 10 8518 1326

Email: juliezhang@deloitte.com.cn

Eastern China

Kevin Zhu

Partner

Tel: +86 21 6141 1262

Fax: +86 21 6335 0003

Email: kzhu@deloitte.com.cn

Western China

Tony Zhang

Partner

Tel: +86 28 6789 8008

Fax: +86 28 6317 3500

Email: tonzhang@deloitte.com.cn

Southern China (Mainland)

German Cheung

Director

Tel: +86 20 2831 1369

Fax: +86 20 3888 0121

Email: gercheung@deloitte.com.cn

Southern China (Hong Kong)

Doris Chik

Director

Tel: +852 2852 6608

Fax: +852 2851 8005

Email: dchik@deloitte.com.hk

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wandy Luk by either email at wanluk@deloitte.com.hk or by fax to +852 2541 1911.



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