Aoba Newsletter – Hong Kong

Aoba Business Consulting Limited
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Hong Kong (IFRIC) Interpretation (HK(IFRIC)-Int) 23 –
Uncertainty over Income Tax Treatments

【Background】

It is almost impossible to avoid uncertainty over whether the relevant taxation authority will accept the tax treatment used by an entity. The relevant taxation authority will only take decision in the future.

Uncertainty over income tax treatments may affect both current and deferred tax. Hong Kong Accounting Standard (HKAS) 12 "Income Taxes" governs the accounting treatment for current and deferred tax assets and liabilities. However, it does not specify how to reflect uncertainty.

HK(IFRIC)-Int 23 is introduced to support the requirements in HKAS 12 by specifying how to reflect the effects of uncertainty in accounting for income taxes.

【Highlight】

When uncertainty over income tax treatment exists, an entity should consider whether the relevant taxation authority is probable to accept the uncertain tax treatment.

If the uncertain tax treatment is probable to be accepted, no adjustment is required and the entity should determine the taxable profit, tax bases, unused tax losses, unused tax credits or tax rates consistently with the tax treatment used in its income tax filing.

If the uncertain tax treatment is not probable to be accepted, the entity should take into account the effect of uncertainty in determining the taxable profit, tax bases, unused tax losses, unused tax credits or tax rates.

There are two methods to deal with the effect of uncertainty, namely “the most likely amount” method and “the expected value” method.

“The most likely amount” represents the single most likely amount in a range of possible outcomes.

“The expected value” represents the sum of the probability-weighted amounts in a range of possible outcomes.

These two methods are not free choices. The entity should select the one which better predicts the resolution of the uncertainty. “The most likely amount” method should be adopted if the possible outcomes are binary or are concentrated on one value. If there is a range of possible outcomes that are neither binary nor concentrated on one value, “the expected value” method should be used.

The probability of examination by relevant taxation authority is not a factor to be considered in determining the acceptability of the tax treatment or the effect of uncertainty. An entity should assume the taxation authority will examine amounts it has a right to examine and have full knowledge of all related information.

Sometimes, there are more than one uncertain tax treatments. In this situation, the entity should determine whether to consider each uncertain tax treatment separately or together with one or more other uncertain tax treatments based on which approach better predicts the resolution of the uncertainty.

Determining the acceptability and the effect of uncertainty involves certain degree of judgement and estimate. Information available to an entity about uncertain tax treatments changes over time. An entity should reassess the judgement or estimate when there are changes in facts and circumstances on which the judgement or estimate was based or as a result of new information. The resulting effect is regarded as a change in accounting estimate.

【Example】

Entity A starts to carry out business with overseas companies this year. Revenue from the overseas companies is treated as non-assessable offshore income for the income tax filing. Since this is the first year for Entity A to have overseas transactions, the taxation authority may challenge the tax treatment for the transactions with each of the overseas companies. The uncertain tax treatment would affect only the determination of taxable profit for the current year. According to the income tax filing, the taxable profit for the year is HKD100,000.

Having consulted with professionals, Entity A concludes it is not probable that the taxation authority will accept 100% offshore claims for all the overseas transactions. Since the nature of the business with each individual overseas company is similar, Entity A believes all the transactions with the overseas companies to be considered together better predicts the resolution of the uncertainty. The probabilities of the possible additional taxable amount are as follows:

Outcome	Estimated additional amount (HKD)	Probability	Estimate of expected value (HKD)
Scenario 1	0	5%	0
Scenario 2	10,000	25%	2,500
Scenario 3	20,000	40%	8,000
Scenario 4	30,000	30%	9,000
		100%	19,500

As there is a range of possible outcomes that are neither binary nor concentrated on one value, the expected value (HKD19,500) instead of the most likely amount (HKD20,000) is considered better predicts the resolution of the uncertainty.

Accordingly, HKD119,500 (HKD100,000 + HKD19,500) should be the taxable profit amount in recognising and measuring the current tax liability.

【Effective date】

An entity shall apply this Interpretation for annual reporting periods beginning on or after 1st January, 2019. Earlier application is permitted.

【Transitional treatment】

Two approaches for transition are available. Entities are permitted to use the "modified retrospective" approach of which the comparative information is not restated. Cumulative effect of initially applying the Interpretation will be recognised as an adjustment to the opening balance of the retained earnings, or other component of equity, as appropriate.

"Full retrospective" approach in accordance with HKAS 8 "Accounting Policies, Changes in Accounting Estimates and Errors" is an alternative if that is possible without the use of hindsight.

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