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Two-tiered profits tax rates regime

Accounting implications

May 2018

Contents

Introduction

The Chief Executive of the HKSAR signed the two-tiered profits tax rates regime (the 'tiered rates regime') into law on 28 March 2018. Under this regime, the Hong Kong profits tax for corporations has been revised as follows (subject to certain conditions and exceptions):

Assessable profits	Tax rate
First HK$2 million	8.25%
Remainder	16.5%

The tiered rates regime is applicable to years of assessment beginning on or after 1 April 2018.

Entities will need to assess whether they are within the scope of the tiered rates regime and, if so, whether its application will have a material impact on the entity's current and deferred tax positions. Although the actual cash tax savings is limited to HK$165,000 per year, the impact on deferred tax could significantly exceed that amount depending on facts and circumstances.

Observation

Only one entity in each group of companies is eligible for the tiered rates regime. As the main objective of the regime is to reduce the tax burden of SMEs and start-up enterprises, this restriction was introduced to avoid a group splitting income amongst numerous entities in order to enjoy the lower tax rate.

Entities should take this into account when determining whether the tiered rates regime will have a material impact on the entity's current and deferred tax positions.

Refer to *Tax Analysis* Issue H76/2018 *Two-tiered Profits Tax Rates Regime Introduced in Hong Kong* for further details.

This publication details the accounting implications of the tiered rates regime on an entity's current and deferred tax positions. It also includes a comprehensive example together with illustrative disclosures to reflect the application of IAS 12 *Income Taxes*.

Accounting implications

INTERACTION BETWEEN FINANCIAL YEAR AND YEAR OF ASSESSMENT

A year of assessment for tax purposes in Hong Kong begins on 1 April and ends on 31 March the following year. The period that is used to compute the taxable profits for a year of assessment is normally the financial year ending within that year of assessment.

Given the tiered rates regime is applicable to *years of assessment* beginning on or after 1 April 2018, the implication for companies with different *financial year-ends* is as follows:

Financial year ending	Falls within year of assessment	Tax rate for current tax computation
On or before 31 March 2018	2017/18 (or before)	Flat rate of 16.5%
On or after 1 April 2018	2018/19 (or after)	Tiered rates

Observation

It is important to note that the tiered rates regime is applicable to *years of assessment* (as opposed to *financial years*) beginning on or after 1 April 2018. Given the interaction between financial years and years of assessment for Hong Kong tax purposes, management should be aware that the tiered rates regime would apply to a qualifying entity despite the fact that the entity's financial year begins before 1 April 2018.

Take an entity with a 30 April 2018 financial year-end for example. This financial year (1 May 2017 to 30 April 2018) would fall within the 2018/19 year of assessment and thus be subject to the tiered rates regime, despite the fact that the *financial* year began before 1 April 2018.

RELEVANT DATES

- 21 March 2018: the Legislative Council ('Legco') passed in its third reading the Inland Revenue (Amendment) (No. 7) Bill 2017 (the 'Bill') which introduces the tiered rates regime
- 28 March 2018: The Chief Executive signed the Bill into law
- 29 March 2018: The tiered rates regime was gazetted

For the purposes of IAS 12, the tiered rates regime is considered to be:

- substantively enacted on 21 March 2018; and
- enacted on 28 March 2018.

IMPACT ON CURRENT TAX

In terms of paragraph 46 of IAS 12, an entity should measure current tax liabilities (assets) at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates that have been enacted or substantively enacted by the end of the reporting period.

The tiered rates regime was substantively enacted on 21 March 2018 and it is applicable to years of assessment beginning on or after 1 April 2018. As noted above, given the interaction between a financial year and a year of assessment for Hong Kong tax purposes, the tiered rates regime is effectively applicable to a qualifying entity with *financial years ending* on or after 1 April 2018, including interim periods within those financial years.

Take a December year-end entity for example. The first annual period in which it will measure current tax using the tiered rates will be the year ending 31 December 2018.

For annual reporting periods ending on or before 31 March 2018, current tax should be calculated using a flat rate of 16.5%.

IMPACT ON DEFERRED TAX

In terms of paragraph 47 of IAS 12, an entity should measure deferred tax assets and liabilities at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates that have been enacted or substantively enacted by the end of the reporting period.

The tiered rates regime was substantively enacted on 21 March 2018. The deferred tax impact on entities with different year-ends is as follows.

<u>Annual reporting periods ending before 21 March 2018</u>

If these entities authorise their financial statements for issue on or after 21 March 2018, the enactment of the tiered rates regime constitutes a non-adjusting event after the reporting date. As such, deferred tax balances at the reporting date should be calculated using a flat rate of 16.5%, being the rate in force at the reporting date.

If the effect of applying the tiered tax rates is expected to be material, an entity should disclose, in accordance with paragraph 22(h) of IAS 10 *Events after the Reporting Period*:

a) the nature of the event; and
b) an estimate of its financial effect, or a statement that such an estimate cannot be made.

Illustrative disclosure

Commentary: This disclosure could also be included in another note, e.g. the note on current tax expense or deferred tax assets/liabilities, as appropriate.

Note [x] Events after the reporting date

On 21 March 2018, the Hong Kong Legislative Council passed The Inland Revenue (Amendment) (No. 7) Bill 2017 (the 'Bill') which introduces the two-tiered profits tax rates regime. The Bill was signed into law on 28 March 2018 and was gazetted on the following day.

Under the two-tiered profits tax rates regime, the first HK$2 million of profits of qualifying corporations will be taxed at 8.25%, and profits above HK$2 million will be taxed at 16.5%. The two-tiered profits tax rates regime will be applicable to Company X for its annual reporting periods ending on or after 1 April 2018.

The application of the two-tiered profits tax rates regime is expected to [decrease the amount of current tax payable by Company X by a maximum amount of HK$165,000 per year with a corresponding decrease in current tax expense].

[The application of the average tax rates in the measurement of deferred tax balances is expected to result in a [decrease/increase] in [deferred tax asset] [and/or] [deferred tax liability] by [estimate of amount].]

OR

[Management is currently analysing the effect of the two-tiered profits tax rates regime on Company X's deferred tax balances and is not able to provide an estimate of the potential financial effect.]

<u>Annual reporting periods ending on or after 21 March 2018</u>

For these entities, the tiered tax rates would have been either substantively enacted or enacted at the reporting date. As such, closing deferred tax balances should be calculated using the tiered tax rates.

Paragraph 49 of IAS 12 requires that when different tax rates apply to different levels of taxable income, deferred tax assets and liabilities should be measured using the average tax rates that are expected to apply to the taxable profit of the periods in which the temporary differences are expected to reverse.

For entities that expect the application of the tiered tax rates to have a material impact on the financial statements, careful judgement should be exercised in determining the appropriate average tax rates to be used when measuring deferred tax assets and liabilities.

The determination of the appropriate average tax rates requires an estimate of (1) when the existing temporary differences (including carried forward tax losses) will reverse and (2) the taxable income for those years. The estimate of future taxable income includes:

a) income or loss excluding reversals of temporary differences; and
b) reversals of existing temporary differences.

The next section illustrates the measurement of deferred tax assets and liabilities using the 'average tax rate' concept.

Comprehensive example

Facts

Company X is subject to Hong Kong profits tax and has a 31 March year-end. As at 31 March 2017 and 2018, Company X has the following temporary differences:

		Taxable (deductible) temporary differences	
	Notes	**31/03/18**	**31/03/17**
		HK$'000	HK$'000
Accelerated tax depreciation	1	1,500	1,800
Prepayments	2	870	-
Deferred income	3	(250)	-
Allowance for doubtful debts	4	(780)	(570)
Tax losses carried forward	5	(2,000)	(2,300)
Total		**(660)**	**(1,070)**

Notes:

(The points below relate to temporary differences existing at 31 March **2018**):

1. This temporary difference is expected to reverse over the next five years at HK$300,000 per year.
2. This temporary difference is expected to reverse in 2019 when Company X receives the services to which the prepayments relate.
3. This temporary difference is expected to reverse in 2020 when Company X delivers the goods to which the deferred income (income received in advance) relates.
4. Management expects this temporary difference to reverse as follows, based on the expected settlement and/or write-off of the related debtor balances:
    - HK$200,000 in 2019;
    - HK$350,000 in 2020; and
    - HK$230,000 in 2021.
5. Tax losses carried forward will be offset against available future taxable profits.

Company X's estimates of pre-tax income for the years in which the above temporary differences will reverse are presented in the table below. These amounts exclude the effect of reversing any of the temporary differences noted above.

	Year ending 31 March				
	2019	**2020**	**2021**	**2022**	**2023**
			HK$'000		
Estimated pre-tax income	750	840	2,000	2,500	3,000

Profit before tax for 2018 is HK$410,000. Taxable income for the year is HK$ nil due to the utilisation of brought-forward tax losses.

Question

What is the deferred tax balance for Company X at 31 March 2018?

Answer

As the two-tiered profits tax rate regime has been enacted by 31 March 2018, Company X should measure its deferred tax balance using the average tax rates that are expected to apply to the taxable income of the periods in which the temporary differences are expected to reverse.

The estimated taxable income and income tax payable for those periods are shown in Table A on the next page.

TABLE A:

	Year ending 31 March				
	2019	2020	2021	2022	2023
	HK$'000				
Estimated pre-tax income	750	840	2,000	2,500	3,000
Reversing temporary differences (A)	970	(300)	70	300	300
- Accelerated tax depreciation	300	300	300	300	300
- Prepayments	870				
- Deferred income		(250)			
- Allowance for doubtful debts	(200)	(350)	(230)		
Estimated taxable income before subtracting tax losses carried forward (B)	1,720	540	2,070	2,800	3,300
Tax based on tiered rates:					
- HK$2m (limited to B) x 8.25%	142	45	165	165	165
- Excess over HK$2m x 16.5%			12	132	215
Estimated tax payable before subtracting tax losses carried forward (C)	142	45	177	297	380
Applicable tax rate (D = C/B)	8.25%	8.25%	8.53%	10.61%	11.50%
Utilisation of tax losses carried forward (E)	(1,720)	(280) [1]			
Estimated taxable income after subtracting tax losses carried forward	0	260	2,070	2,800	3,300
Deferred tax (asset) liability (F = (A+E) x D)	(62)	(48)	6	32	34
Deferred tax asset as at 31 March 2018 (sum of F)	**(38)**				

[1] By year 2020, only HK$280,000 of the HK$2m tax losses at 31 March 2018 remains unutilised.

As at 31 March 2018, Company X should recognise a deferred tax asset of HK$38,000.

Observation

Company X has a net deductible temporary difference of HK$660,000 at 31 March 2018. Under the flat rate system, this would have resulted in a deferred tax asset of HK$109,000 (HK$660,000 x 16.5%). However, under the tiered rates regime, the deferred tax asset recognised is HK$38,000.

The reduction in amount is expected. However, the amount of reduction depends on two things: (1) the timing of when the various temporary differences existing at 31 March 2018 are expected to reverse and (2) the average tax rate that is expected to apply in the respective years of their reversal.

Observation

The average tax rate for a particular year is calculated as:

- the tax payable before utilising carried forward tax losses, divided by
- the estimated taxable income after taking into account all originating and reversing temporary differences but before subtracting assessed losses.

This results in a rate at which tax would have been payable had there been no carried forward assessed losses, or where the reversal of deductible temporary differences (other than assessed losses) would reduce taxable income to zero or below. The lowest applicable average tax rate in these circumstances would be 8.25% under the tiered rates regime.

Take the 2019 year for example. If Company X did not have any carried forward assessed losses, it would have to pay tax at an average rate of 8.25%. Utilising the carried forward assessed losses would save Company X tax of HK$141,900 (HK$1,720,000 x 8.25%) for 2019. A similar calculation is made for 2020 (HK$280,000 x 8.25% = HK$23,100). Consequently, the deferred tax asset relating to assessed losses recognised at 31 March 2018 is HK$165,000 (HK$141,900 + HK$23,100), representing the expected tax savings arising from utilisation of these carried forward assessed losses.

The deferred tax balance for the other temporary differences existing at 31 March 2018 is calculated on the same basis. Refer to the next section for illustrative disclosures.

Observation

Table A includes five years of calculation. This is because the temporary differences existing on 31 March 2018 are expected to reverse fully within five years. If an entity has one or more types of temporary differences that will reverse over a longer period, the calculation should span over that longer period.

Observation

Depending on facts and circumstances, the use of average tax rates to measure deferred tax balances may or may not lead to a materially different deferred tax balance from that calculated using a flat rate of 16.5%.

For example, if an entity has estimated annual taxable income that significantly exceeds HK$2 million and has a net taxable temporary difference, measuring deferred tax using average tax rates will most probably not lead to a materially different deferred tax balance from that calculated using a flat rate of 16.5%. This is because the average tax rates will be close to 16.5% because taxable income significantly exceeds the HK$2 million threshold.

On the other hand, although the annual cash tax savings is limited to HK$165,000 (HK$2m x 8.25%), the impact on deferred tax could significantly exceed that amount. Consider a scenario where an entity expects to have a low level of estimated annual taxable income such that the average tax rate will be close to 8.25%. Deferred tax will be recognised for the temporary differences at around 8.25% as opposed to 16.5%. If the temporary differences significantly exceed HK$2m, the reduction in deferred tax balance will also significantly exceed HK$165,000.

Illustrative disclosures

This section illustrates the relevant financial statements note disclosures for the example above. It illustrates the disclosures for the following years:

- Year ended 31 March 2018 (Company X);
- Year ending 31 March 2019 (Company X); and
- Year ended 30 April 2018 (Company Y – see details in the corresponding section below).

The relevant illustrative disclosures for companies with different year-ends are as follows:

Annual periods ending	**Tax rate used for computing**		**Relevant illustrative disclosures**
	Current tax	**Deferred tax closing balance**	
Before 21 March 2018	16.5%	16.5%	Page 6: note on events after the reporting date
Between 21 to 31 March 2018 (both dates inclusive)	16.5%	Tiered rates	Year ended 31 March 2018 (Company X)
On or after 1 April 2018	Tiered rates	Tiered rates	Year ended 30 April 2018 (Company Y) (1)
Subsequent to the first set of financial statements in which the closing deferred tax balance reflects the tiered tax rates	Tiered rates	Tiered rates	Year ending 31 March 2019 (Company X) (1)

(1) These two sets of disclosures are different even though the tax rates used are seemingly the same. In the set for Company Y (30 April 2018), the opening deferred tax balance brought forward from prior year is calculated at a flat rate of 16.5%; whereas in the set for Company X (31 March 2019), the opening deferred tax balance brought forward from prior year is already calculated using the tiered tax rates. This will affect the calculation of the adjustment due to change in tax rates as well as the description of the line items in the tax rate reconciliation.

YEAR ENDED 31 MARCH 2018

1. Accounting policy: Taxation

When different tax rates apply to different levels of taxable income, deferred tax assets and liabilities are measured using the average tax rates that are expected to apply to the taxable income of the periods in which the temporary differences are expected to reverse.

The determination of the average tax rates requires an estimation of (1) when the existing temporary differences will reverse and (2) the amount of future taxable income in those years. The estimate of future taxable income includes:

- income or loss excluding reversals of temporary differences; and
- reversals of existing temporary differences.

2. Key sources of estimation uncertainty

Commentary

For entities that expect the application of the tiered tax rates to have a material impact on the financial statements, the determination of the appropriate average tax rates for future years will have a significant impact on the amount of deferred tax asset/liability recognised.

The determination of the appropriate average tax rates depends on an estimation of (1) when the existing temporary differences will reverse and (2) the amount of future taxable income in those years.

If these estimation uncertainties have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities (mainly deferred tax balances) within the next financial year, entities should provide the disclosures required by IAS 1.125.

Deferred tax balances measured at average tax rates

As at 31 March 2018, Company X has recognised a deferred tax asset of HK$38,000. This balance was measured using the average tax rates that are expected to apply to the taxable profit of the periods in which the temporary differences are expected to reverse. The determination of the average tax rates that are expected to apply depends, in turn, on an estimation of (1) when the existing temporary differences will reverse and (2) the amount of future taxable income in those years. These estimates and the resulting average tax rates will affect the amount of deferred tax asset/liability recognised. Where the actual timing of reversal of the temporary differences and/or the amount of future taxable income differ from what is expected, a material adjustment to the deferred tax balance may be necessary. [Disclose range of possible effects].

There is no such estimation uncertainty with regard to the deferred tax asset recognised at 31 March 2017 of HK$177,000 because that amount was measured using a flat tax rate of 16.5%. [There may be significant estimation uncertainty about whether there would be sufficient future taxable profits to justify the recognition of such a deferred tax asset; however, that consideration is outside the scope of this publication.]

3. Income tax expense

	Year ended 31/03/18	Year ended 31/03/17
	HK$'000	HK$'000
Current tax		
Hong Kong	-	X
Deferred tax		
Current year	33 [1]	X
Effect of change in tax rates	106 [1]	-
	139	X

Commentary

[1] See deferred tax note for calculation.

Hong Kong profits tax is calculated at 16.5% of the estimated assessable profits for both years.

On 21 March 2018, the Hong Kong Legislative Council passed The Inland Revenue (Amendment) (No. 7) Bill 2017 (the 'Bill') which introduces the two-tiered profits tax rates regime. The Bill was signed into law on 28 March 2018 and was gazetted on the following day.

Under the two-tiered profits tax rates regime, the first HK$2 million of profits of qualifying corporations will be taxed at 8.25%, and profits above HK$2 million will be taxed at 16.5%. [*Applicable to a group of companies:* The profits of corporations not qualifying for the two-tiered profits tax rates regime will continue to be taxed at a flat rate of 16.5%.]

The two-tiered profits tax rates regime will be applicable to Company X for its annual reporting periods beginning on or after 1 April 2018.

The tax charge for the year can be reconciled to profit before tax per the statement of profit or loss and other comprehensive income as follows:

	Year ended 31/03/18	Year ended 31/03/17
	HK$'000	HK$'000
Profit before tax	410	X
Tax at the HK profits tax rate of 16.5% (2017: 16.5%)	68	X
Effect of change in tax rates	106	-
Difference between average tax rates for deferred tax measurement purposes and current tax rate (1)	(35)	
Income tax expense for the year	139	X

Commentary

(1) This difference is caused by recognising the deferred tax charge on current year *originating* temporary differences at average tax rates as opposed to the actual applicable tax rate for the current year (16.5%). See note (2) to the deferred tax note for further explanation.

The amount is calculated as the amount of *originating* temporary differences in the current year multiplied by the difference between current tax rate and the average tax rate that is expected to apply when these temporary differences reverse. It is the sum of the following (see table under 'Facts' in Comprehensive Example for the amount of originating temporary differences in the current year and Table A for the applicable average tax rate):

- Prepayments: -HK$870,000*(16.5% - 8.25%)
- Deferred income: HK$250,000*(16.5% - 8.25%)
- Allowance for doubtful debts: HK$210,000*(16.5% - 8.53%) (assuming the amount originating in the current year will reverse last, i.e. in 2021)

4. Deferred tax asset

For the purpose of presentation in the statement of financial position, deferred tax assets and liabilities have been offset. The following is an analysis of the deferred tax balances for financial reporting purposes:

	31/03/18	31/03/17
	HK$'000	HK$'000
Deferred tax asset [1]	38	177

Commentary

[1] Assuming Company X met the probable realisation criterion under IAS 12 for recognising a deferred tax asset.

The following are the major deferred tax liabilities (assets) recognised and movements thereon during the current and prior years [comparative figures have not been illustrated as the change in tax rate has no effect on them]:

	Accelerated tax depreciation	Pre-payments	Deferred income	Allowance for doubtful debts	Tax losses	Total
			HK$'000			
At 1 April 2017 [1]	297	-	-	(94)	(380)	(177)
Charge (credit) to profit or loss [2]	(50)	72	(21)	(18)	50	33
Effect of change in tax rates [3]	(106)	-	-	47	165	106
At 31 March 2018 [4]	141	72	(21)	(65)	(165)	(38)

Commentary

[1] These amounts are calculated at 16.5% of the respective temporary differences at 31 March 2017.

[2] For *reversing* temporary differences (i.e. accelerated tax depreciation and tax losses), the charge (credit) to profit or loss is calculated at 16.5% because the opening temporary differences were recognised at this rate.

For *originating* temporary differences (i.e. prepayments, deferred income and allowance for doubtful debts), the charge (credit) to profit or loss is calculated at the average tax rates that are expected to apply when the related temporary differences reverse in the future.

Take the allowance for doubtful debts for example. The credit of HK$18,000 to profit or loss is calculated as HK$210,000*8.53% (assuming the amount originating in the current year will reverse last, i.e. in 2021).

(3) Any temporary difference at the beginning of the year that remains outstanding at the end of the year will be subject to a change in tax rate. The effect of the change is calculated as the opening temporary difference outstanding at the end of the year multiplied by the difference between 16.5% and the average tax rate that is expected to apply when these temporary differences reverse.

Take the allowance for doubtful debts for example. The HK$47,000 adjustment is calculated as the sum of:

- 2019: HK$200,000*(16.5% - 8.25%) (see Table A)
- 2020: HK$350,000*(16.5% - 8.25%)
- 2021: HK$20,000*(16.5% - 8.53%) (only HK$20,000 of the HK$570,000 temporary difference existing at 1 April 2017 remains outstanding in 2021.

(This calculation assumes that the temporary difference of HK$210,000 originating in the current year will reverse last, i.e. in 2021)

(4) The deferred tax balance at 31 March 2018 reflects the effects of the tiered tax rates. The balance for each type of temporary difference is calculated as:

a) the temporary difference that will reverse in a particular year,
b) multiplied by the applicable average tax rate for that year.

Take accelerated tax depreciation for example. The deferred tax liability of HK$141,000 is calculated as the sum of:

- 2019: HK$300,000*8.25% (see Table A)
- 2020: HK$300,000*8.25%
- 2021: HK$300,000*8.53%
- 2022: HK$300,000*10.61%
- 2023: HK$300,000*11.50%

At the end of the reporting period, Company X has unused tax losses of HK$2 million (31 March 2017: HK$2.3 million) available for offset against future profits. A deferred tax asset has been recognised in respect of all such losses using the average tax rates that are expected to apply to the taxable profits in the periods in which these losses are expected to be utilised (31 March 2017: 16.5%). All losses may be carried forward indefinitely.

Year ending 31 March 2019

The tiered rates regime will apply to Company X for its financial year ending 31 March 2019.

Assume that pre-tax income and the reversal of temporary differences for the 2019 year are as predicted at 31 March 2018 (i.e. the 2019 column in Table A became actual figures).

Extracts of the relevant disclosures are illustrated below (comparative figures have not been included for the sake of simplicity). Furthermore, the taxation accounting policy and the key sources of estimation uncertainty notes have not been re-produced.

1. Income tax expense

	Year ended 31/03/19
	HK$'000
Current tax	
Hong Kong	-
Deferred tax	
Current year	62 [1]
	62

> ***Commentary***
>
> [1] See deferred tax note for calculation.

For the year ended 31 March 2019, Hong Kong profits tax is calculated at 8.25% on the first HK$2 million of the estimated assessable profits and at 16.5% on the estimated assessable profits above HK$2 million.

For the year ended 31 March 2018, Hong Kong profits tax was calculated at a flat rate of 16.5% of the estimated assessable profits.

The tax charge for the year can be reconciled to profit before tax per the statement of profit or loss and other comprehensive income as follows:

	Year ended 31/03/19
	HK$'000
Profit before tax	750
Tax at the applicable HK profits tax rates	62
Income tax expense for the year	62

2. Deferred tax liability

For the purpose of presentation in the statement of financial position, deferred tax assets and liabilities have been offset. The following is an analysis of the deferred tax balances for financial reporting purposes:

	31/03/19
	HK$'000
Deferred tax liability	24

The following are the major deferred tax liabilities (assets) recognised and movements thereon during the current [and prior years]:

	Accelerated tax depreciation	Pre-payments	Deferred income	Allowance for doubtful debts	Tax losses	Total
			HK$'000			
At 1 April 2018 (1)	141	72	(21)	(65)	(165)	(38)
Charge (credit) to profit or loss (2)	(25)	(72)	-	17	142	62
At 31 March 2019 (3)	116	-	(21)	(48)	(23)	24

Commentary

(1) These are the same as the balances at 31 March 2018.

(2) These amounts are calculated by multiplying the movement of the respective temporary differences during the 2019 year by an average tax rate of 8.25%. Reversing these temporary differences at 8.25% is considered appropriate because these temporary differences were measured at this rate at 31 March 2018.

(3) These amounts are calculated on the same basis as the balances at 31 March 2018.

At the end of the reporting period, Company X has unused tax losses of HK$280,000 (31 March 2018: HK$2 million) available for offset against future profits. A deferred tax asset has been recognised in respect of all such losses using the average tax rates that are expected to apply to the taxable profits in the periods in which these losses are expected to be utilised. All losses may be carried forward indefinitely.

YEAR ENDED 30 APRIL 2018

Company Y has a 30 April year-end. Assume the same facts as in the comprehensive example above apply to Company Y except for the difference in year-end.

On 1 May 2017, Company Y estimates the pre-tax income for the year ending 30 April 2018 to be HK$410,000, which turns out to be the actual pre-tax profits for the year.

The tiered rates regime is applicable to Company Y for its year ended 30 April 2018 for both current and deferred tax purposes.

Based on the information in the comprehensive example above, the estimated taxable income and income tax payable for the relevant periods for Company Y are shown in the table on the next page. Except for the addition of the 2018 column, the table for Company Y is otherwise identical to Table A.

TABLE FOR COMPANY Y:

	Year ending 30 April					
	2018	**2019**	**2020**	**2021**	**2022**	**2023**
				HK$'000		
Estimated pre-tax income	410	750	840	2,000	2,500	3,000
Reversing temporary differences (A)	(110)	970	(300)	70	300	300
- Accelerated tax depreciation	300	300	300	300	300	300
- Prepayments	(870)	870				
- Deferred income	250		(250)			
- Allowance for doubtful debts	210	(200)	(350)	(230)		
Estimated taxable income before subtracting tax losses carried forward (B)	300	1,720	540	2,070	2,800	3,300
Tax based on tiered rates:						
- HK$2m (limited to B) x 8.25%	25	142	45	165	165	165
- Excess over HK$2m x 16.5%				12	132	215
Estimated tax payable before subtracting tax losses carried forward (C)	25	142	45	177	297	380
Applicable tax rate (D = C/B)	8.25%	8.25%	8.25%	8.53%	10.61%	11.50%
Utilisation of tax losses carried forward (E)	(300)	(1,720)	(280) [1]			
Estimated taxable income after subtracting tax losses carried forward	-	-	260	2,070	2,800	3,300
Deferred tax (asset) liability (F = (A+E) x D)	(34)	(62)	(48)	6	32	34
Deferred tax asset as at 30 April 2018 (sum of F from 2019 to 2023)		**(38)**				

[2] By year 2020, only HK$280,000 of the HK$2.3m tax losses at 1 May 2017 remains unutilised.

As at 1 May 2017, the revised opening deferred tax asset balance calculated using average tax rates is HK$72,000 (sum of F from 2018 to 2023). The adjustment to opening deferred tax balance is recognised as a current year adjustment and not as a restatement of prior year figures. As at 30 April 2018, the deferred tax asset is HK$38,000.

Extracts of the relevant disclosures for Company Y for its year ended 30 April 2018 are illustrated below.

1. Accounting policy: Taxation

When different tax rates apply to different levels of taxable income, deferred tax assets and liabilities are measured using the average tax rates that are expected to apply to the taxable income of the periods in which the temporary differences are expected to reverse.

The determination of the average tax rates requires an estimation of (1) when the existing temporary differences will reverse and (2) the amount of future taxable income in those years. The estimate of future taxable income includes:

- income or loss excluding reversals of temporary differences; and
- reversals of existing temporary differences.

2. Key sources of estimation uncertainty

Commentary

For entities that expect the application of the tiered tax rates to have a material impact on the financial statements, the determination of the appropriate average tax rates for future years will have a significant impact on the amount of deferred tax asset/liability recognised.

The determination of the appropriate average tax rates depends on an estimation of (1) when the existing temporary differences will reverse and (2) the amount of future taxable income in those years.

If these estimation uncertainties have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities (mainly deferred tax balances) within the next financial year, entities should provide the disclosures required by IAS 1.125.

Deferred tax balances measured at average tax rates

As at 30 April 2018, Company Y has recognised a deferred tax asset of HK$38,000. This balance was measured using the average tax rates that are expected to apply to the taxable profit of the periods in which the temporary differences are expected to reverse. The determination of the average tax rates that are expected to apply depends, in turn, on an estimation of (1) when the existing temporary differences will reverse and (2) the amount of future taxable income in those years. These estimates and the resulting average tax rates will affect the amount of deferred tax asset/liability recognised. Where the actual timing of reversal of the temporary differences and/or the amount of future taxable income differ from what is expected, a material adjustment to the deferred tax balance may be necessary. [Disclose range of possible effects].

There is no such estimation uncertainty with regard to the deferred tax asset recognised at 30 April 2017 of HK$177,000 because that amount was measured using a flat tax rate of 16.5%. [There may be significant estimation uncertainty about whether there would be sufficient future taxable profits to justify the recognition of such a deferred tax asset; however, that consideration is outside the scope of this publication.]

3. Income tax expense

	Year ended 30/04/18	Year ended 30/04/17
	HK$'000	HK$'000
Current tax		
Hong Kong	-	X
Deferred tax		
Current year	34 (1)	X
Effect of change in tax rates	105 (1)	-
	139	X

Commentary

(1) See deferred tax note for calculation.

On 21 March 2018, the Hong Kong Legislative Council passed The Inland Revenue (Amendment) (No. 7) Bill 2017 (the 'Bill') which introduces the two-tiered profits tax rates regime. The Bill was signed into law on 28 March 2018 and was gazetted on the following day.

Under the two-tiered profits tax rates regime, the first HK$2 million of profits of qualifying corporations will be taxed at 8.25%, and profits above HK$2 million will be taxed at 16.5%. [*Applicable to a group of companies:* The profits of corporations not qualifying for the two-tiered profits tax rates regime will continue to be taxed at a flat rate of 16.5%.]

For the year ended 30 April 2018, Hong Kong profits tax is calculated in accordance with the two-tiered profits tax rates regime. For the year ended 30 April 2017, Hong Kong profits tax was calculated at a flat rate of 16.5% of the estimated assessable profits.

The tax charge for the year can be reconciled to profit before tax per the statement of profit or loss and other comprehensive income as follows:

	Year ended 30/04/18	Year ended 30/04/17
	HK$'000	HK$'000
Profit before tax	410	X
Tax at the applicable HK profits tax rates	34	X
Effect of change in tax rates	105	-
Income tax expense for the year	139	X

4. Deferred tax asset

For the purpose of presentation in the statement of financial position, deferred tax assets and liabilities have been offset. The following is an analysis of the deferred tax balances for financial reporting purposes:

	30/04/18	30/04/17
	HK$'000	HK$'000
Deferred tax asset (1)	38	177

Commentary

(1) Assuming Company Y met the probable realisation criterion under IAS 12 for recognising a deferred tax asset.

The following are the major deferred tax liabilities (assets) recognised and movements thereon during the current and prior years [comparative figures have not been illustrated as the change in tax rate has no effect on them]:

	Accelerated tax depreciation	Pre-payments	Deferred income	Allowance for doubtful debts	Tax losses	Total
			HK$'000			
At 1 May 2017 [1]	297	-	-	(94)	(380)	(177)
Effect of change in tax rates [2]	(131)	-	-	46	190	105
Charge (credit) to profit or loss [3]	(25)	72	(21)	(17)	25	34
At 30 April 2018 [4]	141	72	(21)	(65)	(165)	(38)

Commentary

(1) These amounts are calculated at 16.5% of the respective temporary differences at 30 April 2017.

(2) The opening deferred tax balance is adjusted to reflect the effects of the tiered tax rates. Since current tax for the year is subject to the tiered tax rates, the opening (as opposed to the closing) deferred tax balance is adjusted to reflect the tiered tax rates so that temporary differences originating and reversing during the year will be subject to the same tax rates as other items subject to current tax.

The revised opening balance for each type of temporary difference is calculated as:

a) the temporary difference that will reverse in a particular year,
b) multiplied by the applicable average tax rate for that year.

Take accelerated tax depreciation for example. The revised opening deferred tax liability of HK$166,000 is calculated as the sum of:

- 2018: HK$300,000*8.25% (see Table for Company Y)
- 2019: HK$300,000*8.25%
- 2020: HK$300,000*8.25%
- 2021: HK$300,000*8.53%
- 2022: HK$300,000*10.61%
- 2023: HK$300,000*11.50%

The effect of change in tax rate is calculated as the difference between the revised opening balance for each type of temporary difference and the balance brought forward.

(3) These amounts are calculated by multiplying the movement of the respective temporary differences during the 2018 year by an average tax rate of 8.25%. Reversing these temporary differences at 8.25% is considered appropriate because the revised opening deferred tax balance at 1 May 2017 was measured at this rate.

(4) The deferred tax balance at 30 April 2018 reflects the effects of the tiered tax rates, calculated in the similar manner as per note (2) above.

At the end of the reporting period, Company Y has unused tax losses of HK$2 million (30 April 2017: HK$2.3 million) available for offset against future profits. A deferred tax asset has been recognised in respect of all such losses using the average tax rates that are expected to apply to the taxable profits in the periods in which these losses are expected to be utilised (30 April 2017: 16.5%). All losses may be carried forward indefinitely.

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