KPMG

Hong Kong (SAR) Tax Alert

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Enhancing profits tax reliefs for lease reinstatement costs and commercial/industrial buildings in Hong Kong SAR

Summary

The HKSAR Government has recently put forward the proposals aimed at enhancing the profits tax reliefs for (1) lease reinstatement costs and (2) the commercial building allowance (CBA) and industrial building allowance (IBA) regimes. The government plans to introduce a tax deduction for lease reinstatement costs and remove the time limit for claiming the annual allowances under the CBA and IBA regimes.

In this tax alert, we summarise the key features of the government's proposals and share our observations.

As announced in the 2024/25 Budget speech[1], the HKSAR Government will introduce enhancement measures to (1) grant a tax deduction for lease reinstatement costs and (2) remove the time limit for claiming the CBA and IBA. Subsequently, the government prepared a briefing paper[2] for the Legislative Council detailing the proposals on the two enhancement measures. The details of the government's proposals are summarised below.

1. Proposed tax deduction for lease reinstatement costs

Under the current tax framework, taxpayers are generally not allowed to claim deductions for lease reinstatement costs incurred at the end or early termination of a lease as they are regarded as capital expenditures. Considering that the concerned costs are effectively ordinary business expenses and need to be incurred in certain circumstances, the government proposed a tax relief to address this issue by allowing businesses to claim deductions on actual reinstatement costs incurred, subject to certain conditions:

- Tax deduction can only be claimed on the lease reinstatement costs **actually incurred or paid**. It cannot be based on the provision made under the applicable accounting standards (e.g., the amortisation and interest expenses of the capitalised reinstatement costs recognised in the accounts under *HKFRS 16 on Leases*).
- Tax deduction can be claimed as far as there is an obligation to reinstate the leased premises to the original condition upon the end or early termination of the lease. Such obligation can be provided under the tenancy agreement or through another arrangement between the lessor and the lessee.
- The tax deduction will cover not only the lease reinstatement costs incurred by the lessee, but also the payment made by the lessee to the lessor to discharge such an obligation.

[1] The 2024/25 Budget Speech can be accessed via this link: The 2024-25 Budget - Home
[2] The briefing paper presented in the Legislative Council's Panel on Financial Affairs meeting held on 3 June 2024 can be accessed via this link: https://www.legco.gov.hk/yr2024/english/panels/fa/papers/fa20240603cb1-662-6-e.pdf

- Whether the business concerned would cease after incurring the lease reinstatement costs will not affect the deductibility.

KPMG observations: The proposed tax deduction is more business-friendly than the one in Singapore[3] as (1) there is no requirement for the reinstatement costs to be contractually provided for in a tenancy agreement and (2) deduction is available even if the premises are vacated due to cessation of business.

On the other hand, the approach of allowing a tax deduction only when the reinstatement costs are incurred or paid at the end of the lease is similar to the one taken in Singapore[3]. However, there are concerns with this approach, for example:

- As no deduction is allowed for the accounting provisions recognised, taxpayers may need to make tax adjustments in their tax computations and provide for deferred tax during the lease period.

- Taxpayers may not have sufficient amount of assessable profits in the year the lease ends to fully utilise the one-off deduction, thus creating a tax loss. Since there is no loss carry-back under the Hong Kong tax system, the tax loss cannot be utilised in cases where the business is ceased upon the end of the lease.

2. Removing the time limit for claiming CBA and IBA

Under the current CBA regime, claims for the annual allowances are subject to the 25-year time limit (i.e., 25 years after the year of first use). If a commercial building is sold within the 25-year time limit, the seller would face balancing adjustments, and the buyer can claim annual allowances on the tax residual value plus any balancing charge imposed on the seller. However, if the commercial building is sold after the 25-year time limit, the buyer is unable to claim the allowances[4]. There is a similar issue for aged industrial buildings under the current IBA regime.

The government proposed to refine the existing CBA and IBA regimes to allow a buyer of a commercial or industrial building to claim the CBA or IBA on **an annual basis of 4% without any time limit**. The tax base for the buyer to claim the annual allowances would be the same as the current practice, i.e., the residue of expenditure immediately after the sale plus any balancing charge imposed on the seller.

KPMG observations: The refined regimes will result in consistent treatment for all commercial and industrial buildings, regardless of years of usage. Both first-hand and second-hand owners of the buildings will be entitled to the annual allowances without any time limit. Having said that, for taxpayers who acquired buildings and were able to claim capital allowances in the remaining years within the time limit, they might experience a longer claim period (i.e. 25 years) and thus a slower tax depreciation under the refined regimes.

3. Implementation timeline

Upon the completion of the legislative process, both government's proposals would take effect from the **year of assessment 2024/25**. The government plans to introduce a bill with the necessary legislative amendments to the Legislative Council in the 4th quarter of 2024.

KPMG Observations

The government's proposals represent a proactive approach to enhancing Hong Kong SAR's tax relief framework for commercial and industrial buildings. The introduction of a tax deduction for lease reinstatement costs is particularly encouraging and demonstrates that the government is actively responding to the concerns raised by stakeholders.

Given the wide application of these enhancement measures, we provided recommendations on the proposed enhancement measures for the government's consideration in May this year. Taxpayers should closely follow the development of these proposed changes in tax law and assess the potential impact on future investments or transfers of commercial and industrial buildings.

[3] For more details of the approach taken in Singapore to granting a tax deduction on reinstatement costs, please refer to the Inland Revenue Authority of Singapore's webpage via this link: IRAS | Tax Treatment of Business Expenses (M-R)
[4] For more details of the underlying issue and KPMG's submission to the government made in June 2022, please refer to our Hong Kong Tax Alert – Issue 12, August 2022.

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