Hong Kong (SAR) Tax Alert

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Draft legislation on (1) deduction for lease reinstatement costs and (2) allowances for commercial / industrial buildings

Summary

The draft legislation on (1) introducing a tax deduction for lease reinstatement costs for leased premises and (2) removing the time limit for claiming the annual allowances for second-hand commercial and industrial buildings was gazetted on 18 October 2024.

In this tax alert, we summarise the key features of the proposed new profits tax relief measures and share our observations.

The 2024/25 Budget[1] announced that the HKSAR Government will (1) grant a tax deduction for reinstatement costs incurred for leased premises and (2) remove the time limit for claiming the commercial building allowance (CBA) and industrial building allowance (IBA). Subsequently, the government issued a Legislative Council briefing paper[2] in June 2024 discussing the proposals on the two tax enhancement measures.

On 18 October 2024, the Inland Revenue (Amendment) (Tax Deductions for Leased Premises Reinstatement and Allowances for Buildings and Structures) Bill 2024[3] (the Bill) was gazetted to set out the legislative amendments necessary to implement the above two measures. The Bill will be introduced into the Legislative Council on 30 October 2024. On the same day, the Inland Revenue Department (IRD) released its guidance on the two proposed profits tax relief measures[4], with FAQs on (1) and an illustrative example on (2) above.

1. The proposed tax deduction for lease reinstatement costs

Currently, taxpayers are not allowed to claim a tax deduction for reinstatement costs actually incurred for leased premises at the end or early termination of the lease as they are regarded as capital expenditures.

Effective from the year of assessment (YOA) 2024/25, taxpayers would be allowed to do so if all of the following conditions are met:

- the taxpayer is a lessee of the lease;
- the taxpayer has a reinstatement obligation for the premises;
- the reinstatement costs do not relate to any provisions made under the HKFRS 16 on Leases or other similar accounting standards (e.g., the amortisation and interest expenses of the capitalised reinstatement costs recognised in the financial statements); and
- the amount of the reinstatement cost is reasonable in the circumstances.

[1] The 2024/25 Budget Speech can be accessed via this link: https://www.budget.gov.hk/2024/eng/index.html
[2] The briefing paper for the Legislative Council's Panel on Financial Affairs can be accessed via this link: https://www.legco.gov.hk/yr2024/english/panels/fa/papers/fa20240603cb1-662-6-e.pdf. Please also refer to our Hong Kong (SAR) Tax Alert, Issue 6, June 2024 for more details.
[3] The Bill can be accessed via this link: https://www.gld.gov.hk/egazette/english/gazette/file.php?year=2024&vol=28&no=42&extra=0&type=3&number=18
[4] The IRD's guidance on the two proposed profits tax reliefs can be accessed via this link: https://www.ird.gov.hk/eng/tax/bus_rabs.htm

In this regard, the term "reinstatement costs" is defined to mean the costs of restating the premises to their original condition at the end or on an early termination of the lease and includes any amount paid or payable by the lessee to the lessor to discharge a reinstatement obligation. The term "reinstatement obligation" is defined to mean an obligation (whether expressed or implied and whether arising from the lease or from another arrangement between the lessor and the lessee) to reinstate, or pay in full or in part for the reinstatement of, the leased premises to their original condition at the end or early termination of the lease.

2. The proposed removal of the time limit for claiming CBA and IBA

Under the current CBA regime, taxpayers are entitled to annual allowances for the capital expenditure incurred on commercial buildings but the claim period is limited to 25 years starting from the year of first use of the building (i.e. the usage period).

This means that if a commercial building is sold after the usage period, the seller may be subject to a balancing charge whereas the buyer will be unable to claim any annual allowances[5]. There is a similar issue for aged industrial buildings under the current IBA regime.

To address the above issue, the Bill seeks to refine the existing CBA and IBA regimes with the following effects:

Scenarios	Annual allowances for the buyer
Commercial buildings	
1. A first-hand commercial building acquired by the buyer before, in or after YOA 2024/25	• No change - 4% of the construction costs for 25 years starting from the year of first use
2. A second-hand commercial building sold to the buyer before the YOA 2024/25	• No change - 4% of the residue of expenditure immediately after the sale* over the remaining usage period
3. A second-hand commercial building sold to the buyer in or after the YOA 2024/25	• If the usage period has expired in the sale year => **Refined rule** - 4% of the residue of expenditure immediately after the sale* from the year of acquisition till fully claimed (i.e. **not limited by the remaining usage period**) • If the usage period has not expired in the sale year => **Revised rule** – same treatment as the above, instead of claiming the allowance over the remaining usage period
Industrial buildings	
4. A first-hand industrial building acquired by the buyer before, in or after YOA 2024/25	• No change – Similar to CBA in (1) above
5. A second-hand industrial building sold to the buyer before the YOA 2024/25	• If the usage period has not yet expired in the sale year => No change – Similar to CBA in (2) above • If the usage period has expired in the sale year => **Refined rule** - 4% of the residue of expenditure immediately after the sale*, starting from the YOA 2024/25 till fully claimed
6. A second-hand industrial building sold to the buyer in or after the YOA 2024/25	• Similar to CBA in (3) above

** Including any balancing charge imposed on the seller*

We set out an example in the Appendix to illustrate the new rule under the refined CBA regime.

[5] For more details of the underlying issues and KPMG's submission to the government made in June 2022, please refer to our Hong Kong Tax Alert – Issue 12, August 2022.

KPMG Observations

The government's proposals to introduce a tax deduction for lease reinstatement costs and refine the existing IBA and CBA regimes are particularly encouraging. They demonstrate the government's commitment to responding to concerns raised by stakeholders (including KPMG) and enhancing the competitiveness of the Hong Kong tax system.

In particular, the proposed tax deduction for lease reinstatement costs is more business-friendly than the one in Singapore[6] in the following two aspects: (1) the lease reinstatement costs are not required to be contractually provided for in a tenancy agreement and (2) taxpayers are not prohibited from claiming the deduction in cases where the premises are vacated due to cessation of business.

However, under the current proposal, taxpayers can only claim a deduction based on the amounts of lease reinstatement costs actually paid or payable (normally at the end of the lease) and cannot claim a deduction based on the amounts of accounting provisions recognized in the financial statements[7] during the lease period. This means that taxpayers would need to make tax adjustments for profits tax filing purposes and provide for deferred taxes during the lease period. In addition, taxpayers would not be able to benefit from the deduction in cases where insufficient assessable profits are derived or losses are incurred in the year the lease is ended and the business is ceased upon the end of the lease.

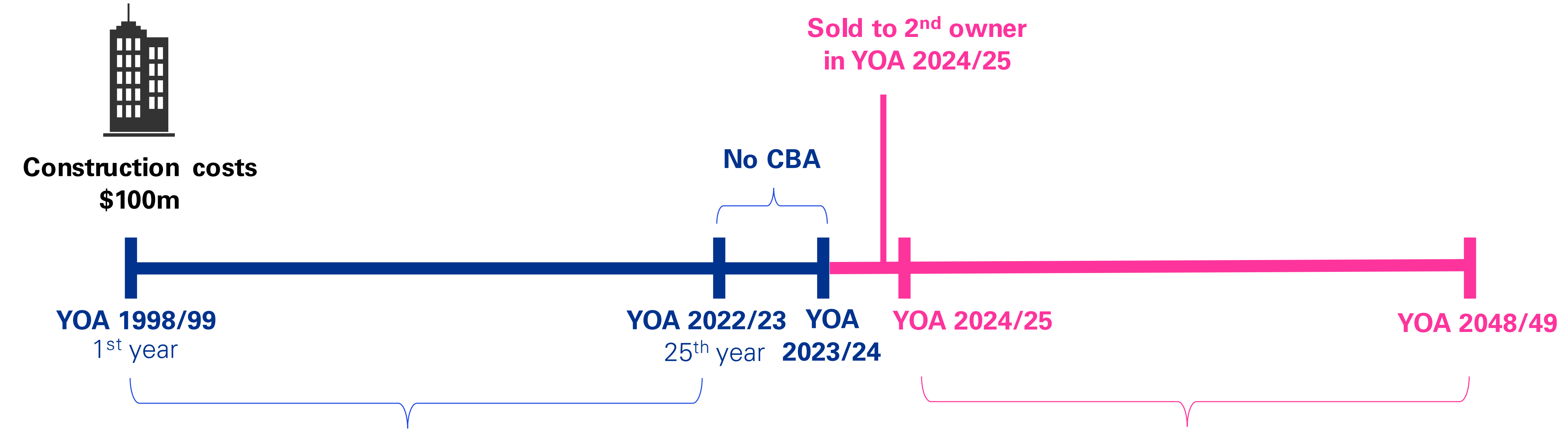
Taxpayers who have acquired or are planning to acquire a second-hand commercial or industrial building in or after the YOA 2024/25 should take note of the annual allowances available under the modified CBA/IBA regimes. For second-hand industrial buildings acquired before the YOA 2024/25 of which the usage period has expired at the time of purchase but there is unclaimed residual expenditure, the buyers should take note of the new 4% IBA available for such industrial buildings starting from the YOA 2024/25 and consider whether the back-year information necessary for ascertaining the IBA amount can be retrieved.

[6] For more details of the tax deduction for lease reinstatement costs in Singapore, please refer to the Inland Revenue Authority of Singapore's webpage via this link: https://www.iras.gov.sg/taxes/corporate-income-tax/income-deductions-for-companies/business-expenses/tax-treatment-of-business-expenses-(m-r)

[7] Under HKFRS 16, the cost of the right-of-use asset in respect of leased premises shall include a provision for the estimated costs to be incurred by the lessee in restoring the premises to the condition required by the terms and conditions of the lease (unless those costs are incurred to produce inventories) when the lessee incurs an obligation for such reinstatement costs. The provision made is subject to review and adjustment in each year during the lease term to reflect the latest estimate. Depreciation and interest expenses of the capitalised reinstatement costs will be recognised in the financial statements in each year during the lease term.

Illustrative example on the new rule under the refined CBA regime

Acquisition of a second-hand commercial building in or after YOA 2024/25



	1st owner	2nd owner
Annual allowance	\$100m x 4% x 25 years **= \$100m**	\$100m x 4% **= \$4m annually (till fully claimed or disposal)**
Balancing charge upon sale	**(\$100m)**	
Residue of expenditure for the 2nd owner immediately after sale		**\$100m**

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