Hong Kong Tax Alert

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Bill introduced to grant tax deduction for lease reinstatement costs and tax depreciation allowances for used buildings acquired after their usage period expired

Last Friday on 18 October 2024, the Inland Revenue (Amendment) (Tax Deductions for Leased Premises Reinstatement and Allowances for Buildings and Structures) Bill 2024[1] (the Bill) was gazetted.

The Bill seeks to amend the Inland Revenue Ordinance (IRO) to implement the following profits tax enhancement measures as proposed in the 2024-25 Budget starting from the year of assessment (YA) 2024/25:

(a) Introduction of a tax deduction for expenses incurred by a lessee for reinstating the condition of premises under a lease to their original condition (reinstatement costs); and

(b) Removal of the time limit for claiming annual allowances in respect of a commercial or industrial building or structure. The proposed removal would enable buyers who acquired an old building or structure after the expiry of its usage period of 25 or 50 years as specified under the current provisions of the IRO to claim annual industrial or commercial building allowances in respect of the building or structure.

This alert explains the background and major provisions of the Bill. Clients who have any questions on the Bill can contact their tax executives.

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[1] The Bill can be retrieved from the link below:
https://www.legco.gov.hk/yr2024/english/bills/b202410182.pdf

Tax deduction for reinstatement costs

Generally, a lease that confers an exclusive possession of a property is a capital asset of the taxpayer for tax purposes. As such, any cost incurred for its acquisition (including reinstatement costs) is of a capital nature. Hence, reinstatement costs are currently precluded from tax deduction under section 17(1)(c) of the IRO.

Various professional bodies have made submissions to the Financial Secretary that reinstatement costs are incurred whenever enterprises need to relocate, upsize or downsize their operating sites, thereby representing a normal operating cost of enterprises.

They also noted that it has been the assessing practice of Singapore to generally grant tax deduction for reinstatement costs since June 2015, submitting that adopting a similar practice in Hong Kong would enhance the tax competitiveness of Hong Kong.

As a positive response to the submissions, the Financial Secretary announced in the 2024-25 Budget earlier this year this measure to relieve the tax burden of enterprises.

Under the Bill, reinstatement costs incurred would be eligible for tax deduction if the following conditions are satisfied:

(a) the person claiming the deduction is a lessee of the lease;

(b) the person claiming the deduction has an obligation (whether express or implied, and whether arising from the lease or from another agreement between the lessor and lessee of the lease) to reinstate, or pay (whether in full or in part) for the reinstatement of the premises under the lease to their original condition at the end of the lease term, or on early termination of the lease;

(c) the reinstatement costs do not relate to any provisions made under Hong Kong Financial Reporting Standard 16 (Leases) as issued by the Hong Kong Institute of Certified Public Accountants and in force from time to time, or any other similar accounting standards. This requirement ensures that the reimbursement costs to be claimed have been incurred, i.e., a back-end deduction rather than based on the amortization of the provision of the costs as reflected in the accounts; and

(d) the amount of the reinstatement costs claimed is reasonable in the circumstances.

"Reinstatement costs" is defined in the Bill to include "any amount paid or payable by a lessee of the lease to the lessor of the lease in order to discharge the lease's reinstatement obligations for the premises". This means that a payment made by a lessee to a lessor in lieu of reinstating the premises would qualify for the deduction.

As regards to condition (d) above, the Frequently Asked Questions (FAQs) on the Tax Treatment for Reinstatement Costs posted on the Inland Revenue Department's (IRD's) website indicate that the IRD will consider the facts and circumstances of each case. It is considered that a "reasonable" amount is one which is made in accordance with the arm's length principle and would not significantly deviate from the market costs of reinstating similar leased premises (e.g. leased premises of similar nature and size) back to their original condition.

The FAQs also indicate that there are no restrictions on the types of premises (e.g. a rented employer's quarters) covered by the deduction for reinstatement costs.

The proposed tax deduction will apply to a YA beginning on or after 1 April 2024.

Granting annual commercial or industrial building allowances for used buildings or structures acquired after the expiry of their usage period

Current position

Under the current provisions of the IRO, where a buyer has incurred costs for acquiring a used building or structure after its usage period of either 25 years or 50 years as specified in the current provisions of the IRO expired, the buyer would not be entitled to any annual commercial or industrial building allowances in respect of the building or structure.

Buyers of old used industrial buildings or structures whose usage period had expired before the YA 2024/25 have already faced the situation that no annual industrial building allowances can be claimed, notwithstanding that they had incurred costs for the acquisition of the relevant interests in such buildings or structures.

This unfavorable tax treatment will also apply to any buyers who purchase old industrial buildings or structures whose usage period expires in or after the YA 2024/25.

For old used commercial buildings or structures, their usage period will start expiring from the YA 2024/25. Buyers of such buildings or structures would then not be entitled to claim annual commercial building allowances, notwithstanding that they would normally have incurred costs for the acquisition of the relevant interests in such buildings or structures.

Proposal under the Bill

Recognizing that in the long run, such tax treatment may discourage buyers from purchasing old or second-hand buildings or structures, the Bill proposes that,

(a) if a commercial or industrial building or structure (with an unexpired usage period) is sold and used by the buyer in the basis period for a YA before 2024/25, an annual allowance will be granted to the buyer for that YA in the same manner as that prescribed by the current provisions of the IRO;

(b) if -

  (i) an industrial building or structure (with an expired usage period) is sold and used by the buyer in the basis period for a YA before 2024/25; or

  (ii) a commercial or industrial building or structure (whether the usage period has expired) is sold or used by the buyer in the basis period for a YA beginning on or after 1 April 2024,

  an annual allowance of 4% on the residue of expenditure immediately after the sale will be granted to the buyer starting from the YA 2024/25 onwards, until the residue of expenditure immediately after the sale has been fully claimed; and

(c) in any of the cases referred to in paragraphs (a) and (b), the seller will continue to be subject to a balancing adjustment in accordance with the existing provisions of the IRO.

Appendix to this alert contains some illustrative examples which show why buyers who acquired old used buildings or structures after their usage period expired would not be able to claim annual commercial or industrial building allowances under the current provisions of the IRO and how the situation would be addressed by the Bill.

Commentary

We welcome the Government introducing the Bill to enhance the tax competitiveness of Hong Kong and address the anomaly that costs incurred for acquiring old used buildings or structures after the expiry of their usage period would not be entitled to annual commercial or industrial building allowances under the current provisions of the IRO.

One point of note is that the Government has accepted in the Bill the proposal made by the professional bodies that, unlike the assessing practice in Singapore, tax deduction for reinstatement costs incurred upon cessation of business should be granted.

Their submission on this point is that reinstatement costs are incurred when an enterprise enters into a lease contract for premises for their ongoing and continuous business operations. As such, reinstatement costs, just like severance payments incurred for employing a person, incurred upon cessation of business should be regarded as being incurred in the production of profits of the enterprise and therefore deductible.

Another point is that where a used building or structure with an unexpired usage period is acquired in or after the YA 2024/25, the buyer will then only be eligible for annual commercial or industrial building allowances based on 4% of the residue expenditure after sale (i.e., 25 years) instead of based on the remaining years of the usage period of the building under the current provisions of the IRO. This would mean that the amount of annual commercial or industrial building allowances that can be claimed by such a buyer under the Bill would be smaller than under the current legislation.

Clients who have any questions on the Bill can contact their tax executives.

Appendix – Examples illustrating (i) why buyers who acquired old used buildings or structures after their usage period expired would not be able to claim annual commercial or industrial building allowances under the current provisions of the IRO and (ii) how the situation would be addressed by the Bill.

Industrial buildings or structures

The usage period of industrial buildings or structures which were first used on or after the commencement of the basis period for the YA 1965/66 is 25 years.

	Current legislation		
	Example 1 – Industrial building with expired usage period is sold and used before the YA 2024/25	**Example 2a – Industrial building with expired usage period is sold and used in the YA 2024/25**	**Example 2b – Industrial building with unexpired usage period is sold and used in the YA 2024/25**
Property X			
Usage	Industrial building		
Year of first use	1990/91	1998/99	2009/10
25th year from the year of first use	2014/15	2023/24	2034/35
Year of sale from Company A to Company B	2020/21	2024/25	
Company A			
Qualifying capital expenditure	$1,000,000	$1,000,000	$1,000,000
Less: Initial allowance (IA) claimed ***[Note i]***	($200,000)	($200,000)	($200,000)
Less: Annual allowance (AA) claimed ***[Note ii]***	($800,000)	($800,000)	$1,000,000x4%x15 =($600,000)
Residue of expenditure immediately before sale	$0	$0	$200,000
Less: Sales proceeds	($500,000)	($500,000)	($500,000)
Balancing charge	$500,000	$500,000	$300,000
Company B			
Residue of expenditure immediately after sale ***[Note iii]***	$500,000	$500,000	$500,000
AA for the YA 2020/21 and thereafter	$500,000/(25-30) =Nil ***[Note v]***		
AA for the YA 2024/25 and thereafter		$500,000/(25-26) =Nil ***[Note v]***	$500,000/(25-15) =$50,000 ***[Note iv]***
	Proposed enhancement		
Company B			
AA for the YA 2024/25	$500,000 x 4% = $20,000		

Notes:

(i) IA is calculated based on 20% of the qualifying capital expenditure (i.e. $1,000,000 x 20% = $200,000).

(ii) AA is calculated based on 4% of the qualifying capital expenditure up to the year when the qualified capital expenditure has been fully claimed.

(iii) Residue of expenditure immediately after sale = Residue of expenditure immediately before sale ± Balancing charge / (allowance)

(iv) Company B in Example 2b is granted annual industrial building allowances based on the below formula prescribed under section 34(2) of the IRO:

$$\textit{Residue of expenditure immediately after sale } x \ \frac{1}{(25 - \textit{Number of years from the Year of first use to the Year of Sale})}$$

(v) No AA is granted to Company B in Examples 1 and 2a above according to the prescribed formula given that the denominator is a negative figure. This means that for a buyer who purchased an old used industrial building or structure after its usage period expired would not be entitled to any annual industrial building allowances.

Commercial buildings or structures

The usage period of commercial buildings or structures is 25 years.

	Current legislation	
	Example 3a – Commercial building with expired usage period is sold and used in the YA 2024/25	**Example 3b – Commercial building with unexpired usage period is sold and used in the YA 2024/25**
Property Y		
Usage	Commercial building	
Year of first use	1998/99	2009/10
25^{th} year from the year of first use	2023/24	2034/35
Year of sale from Company A to Company B	2024/25	
Company A		
Qualifying capital expenditure	$1,000,000	$1,000,000
Less: AA claimed ***[Note i]***	$1,000,000x4%x25 =($1,000,000)	$1,000,000x4%x15 =($600,000)
Residue of expenditure immediately before sale	$0	$400,000
Less: Sales proceeds	($500,000)	($500,000)
Balancing charge	$500,000	$100,000
Company B		
Residue of expenditure immediately after sale ***[Note ii]***	$500,000	$500,000
AA for the YA 2024/25	$500,000/(25-26) =Nil ***[Note iv]***	$500,000/(25-15) =$50,000 ***[Note iii]***
	Proposed enhancement	
Company B		
AA for the YA 2024/25	$500,000 x 4% = $20,000	

Notes:

(i) AA is calculated based on 4% of the qualifying capital expenditure.

(ii) Residue of expenditure immediately after sale = Residue of expenditure immediately before sale ± Balancing charge / (allowance)

(iii) Company B in Example 3b is granted annual commercial building allowances based on the below formula prescribed pursuant to section 33A(2) of the IRO:

$$\text{Residue of expenditure immediately after sale } x \frac{1}{(25 - \text{Number of years from the Year of first use to the Year of Sale})}$$

(iv) No AA is granted to Company B in Example 3a above according to the prescribed formula given that the denominator is a negative figure. This means that for a buyer who purchased an old used commercial building or structure after its usage period expired would not be entitled to any annual commercial building allowances.

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