

**For discussion
on 3 June 2024**

Legislative Council Panel on Financial Affairs

**Proposed Legislative Amendments on Deduction of Expenses and
Allowances under Profits Tax**

PURPOSE

This paper outlines the Government's detailed proposals to introduce tax deduction for expenses incurred for reinstating the condition of leased premises to their original condition ("lease reinstatement costs"), and remove the time limit for claiming annual allowance in respect of a commercial building or structure and that in respect of an industrial building or structure as announced in the Financial Secretary ("FS")'s 2024-25 Budget Speech.

GUIDING PRINCIPLES

2. The proposed new deduction for lease reinstatement costs and the removal of the time limit for claiming annual allowances for commercial/industrial buildings or structures are intended to maintain the competitiveness of our tax system and provide relief for taxpayers. Since the delivery of the Budget Speech, we have been gathering views from stakeholders concerned on these two proposed measures. In formulating the detailed proposals, the Government will adhere to the following guiding principles –

- (a) keeping Hong Kong's profits tax regime simple and competitive;
- (b) benefiting a wide scope of businesses with due regard to the risk of abuse; and
- (c) minimising the compliance burden of taxpayers.

PROPOSED TAX DEDUCTION FOR LEASE REINSTATEMENT COSTS

3. Generally, a lease which confers an exclusive possession of a property is a capital asset and any cost incurred for acquiring it is also of a capital nature. Where a lessee is obligated to reinstate the condition of the premises back to their original state at the end of the lease term, the lease reinstatement costs should be regarded as part of the capital cost of acquiring the lease. The lease reinstatement costs are therefore capital in nature and thus are currently precluded from deduction under section 17(1)(c) of the Inland Revenue Ordinance (Cap. 112) (“IRO”)¹.

4. It is commonplace for enterprises to lease premises (such as office and shop) to carry out their business in Hong Kong and they are generally required to be responsible for reinstatement of premises at the end of the lease term or upon an early termination of the lease. Despite that lease reinstatement costs are of capital nature, they are effectively ordinary business expenses and have to be incurred whenever enterprises need to relocate, upsize or downsize their operating sites. On this basis, we consider it justified to allow tax deduction for lease reinstatement costs subject to certain conditions.

5. Similar to Hong Kong, lease reinstatement costs are generally not deductible for the purposes of income tax in Singapore as they are considered as capital expenditures. However, Singapore provides tax deduction in respect of lease reinstatement costs subject to the following conditions –

- (a) the expense has been incurred²;
- (b) the costs claimed are contractually provided for in the tenancy agreement. These are considered as part of the costs of renting the property for use in the business in the first place; and

¹ Hong Kong has a simple and competitive tax system which does not tax income of a capital nature. Correspondingly, no deduction shall be allowed for any expenditure of a capital nature or any loss or withdrawal of capital.

² Under paragraph 16 of Singapore Financial Reporting Standard, the cost of an item of property, plant and equipment includes the initial estimate of the costs of dismantling and removing the item and restoring the site on which the item is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

- (c) the premises are not vacated due to any cessation of business.

6. We have gathered views from stakeholders concerned on the conditions for the proposed tax deduction for lease reinstatement costs. The stakeholders concerned expressed the following comments if the relevant regime in Singapore is directly applied to Hong Kong –

- (a) There may be circumstances where the requirement for reinstating the condition of leased premises is not explicitly stipulated in the tenancy agreement, but through a verbal agreement between the lessor and the lessee or other arrangements before the inception of the lease or during the term of the lease. The lease reinstatement costs incurred in such circumstances should also be covered by the proposed tax deduction.
- (b) A lessee who is obliged to reinstate the leased premises at the end of the lease term or upon the early termination of the lease must fulfil the obligation irrespective of whether the lessee's business would continue or cease after the premises are vacated. Thus, lease reinstatement costs incurred upon cessation of a business should also be eligible for the proposed tax deduction.
- (c) It is not uncommon for a lessee to fulfil its obligation to reinstate the leased premises by making a payment to the lessor in lieu of actually incurring costs for reinstatement works. Such payment should also qualify for the proposed tax deduction provided that the amount paid is reasonable in the circumstances.

7. Having balanced the need for a wide scope of application and the risk of abusive claims, we propose that lease reinstatement costs would be allowed for deduction in Hong Kong if –

- (a) the lease reinstatement costs claimed are actually incurred or the payment is actually made. No deduction will be allowed in respect of any provisions made in respect of lease reinstatement costs under the applicable accounting standards (e.g. amortization of reinstatement costs capitalized under the Hong Kong Financial Reporting Standard 16); and

- (b) the Inland Revenue Department is satisfied that the lessee has an obligation to reinstate the leased premises to the original condition at the end of the lease term, or upon an early termination of the lease. The obligation can be provided under the tenancy agreement, or through other arrangements between the lessor and the lessee. The proposed deduction will cover not only the reinstatement costs incurred by the lessee but also the payment made by the lessee to the lessor for discharging the lessee’s obligation to reinstate the leased premises, provided that the costs are actually incurred or the payment is actually made; and the amount of costs incurred or payment made is reasonable in the circumstances.

Whether the business concerned would cease after the lease reinstatement costs were incurred will not affect the deductibility of the costs.

8. Subject to passage of the proposed legislative amendments, we plan to introduce the proposed tax deduction for lease reinstatement costs with effect from the year of assessment (“YA”) 2024/25.

REMOVING TIME LIMIT FOR CLAIMING ANNUAL ALLOWANCES FOR COMMERCIAL/INDUSTRIAL BUILDINGS OR STRUCTURES

9. Currently, the IRO provides for the assessable profits of a taxpayer for any YA to be –

- (a) decreased by the following allowances in respect of capital expenditure incurred on the construction of commercial buildings or structures and industrial buildings or structures; and

	Commercial buildings or structures	Industrial buildings or structures
Initial allowance	-	20%
Annual allowance	4%	4%

- (b) adjusted by the balancing charge or allowance (i.e. thereafter referred to as the balancing adjustment)³ which has to be made where certain event (i.e. sale, demolition or cessation of use) occurs in relation to the commercial/industrial building or structure.

The annual allowances on commercial buildings or structures and industrial buildings or structures are hereinafter referred to as “Commercial Building Allowance” and “Industrial Building Allowance” respectively.

10. Claims for Commercial Building Allowance and Industrial Building Allowance are subject to a maximum limit of 25 years or 50 years⁴ starting from the YA in which the commercial/industrial building or structure was first used⁵ (“usage period”). If a commercial/industrial building or structure is sold before the end of the usage period, the seller will be subject to a balancing adjustment whilst the buyer will be able to claim Commercial Building Allowance or Industrial Building Allowance based on the residue of expenditure immediately after sale over the remaining years within the usage period. However, if the building or structure is sold after the end of the usage period, the seller will still be subject to the balancing adjustment, but the buyer will not be entitled to claim any Commercial Building Allowance or Industrial Building Allowance simply because the usage period has expired when the buyer purchased the commercial/industrial building or structure. An example of the calculation of Commercial Building Allowance to be allowed to a buyer who purchases a commercial building before and after the end of the usage period is at **Annex**.

³ If sale proceeds exceed the residue of expenditure immediately before the sale, the excess amount which is limited to the total amount of initial allowance and annual allowances previously granted in respect of commercial/industrial building or structure is taxable as a balancing charge. If the residue of expenditure exceeds the sale proceeds, the difference is deductible as a balancing allowance. Residue of expenditure means the amount of capital expenditure incurred on the construction of the commercial/industrial building or structure reduced by the amount of any initial allowance, annual allowance and/or balancing allowance made, and increased by any balancing charge made.

⁴ For an industrial building or structure that was first used on or after the commencement of the basis period for YA 1965/66 or a commercial building or structure, the maximum number of years for Industrial Building Allowance or Commercial Building Allowance claim is 25 years. But for an industrial building or structure that was first used before the commencement of the basis period for YA 1965/66, Industrial Building Allowance can be claimed for a maximum of 50 years starting from the year of the first use.

⁵ If a person was entitled to the relevant interest in relation to the capital expenditure incurred on the construction of a commercial building or structure before the commencement of YA 1998/99, YA 1998/99 will be deemed to be the YA in which the commercial building or structure was first used.

11. Having reviewed the Commercial Building Allowance and Industrial Building Allowance regimes, we consider that the time limit for claiming Commercial Building Allowance or Industrial Building Allowance will result in disparity of tax treatment for the buyers of commercial/industrial buildings or structures who incurred the same amount of capital expenditure before and after the end of the usage period. It will also give rise to disparity in the entitlements to Commercial Building Allowance or Industrial Building Allowance for the buyers of first-hand and second-hand commercial/industrial buildings or structures, discouraging buyers from acquiring second-hand commercial/industrial buildings or structures in the long run.

12. To maintain competitiveness of our Commercial Building Allowance and Industrial Building Allowance regimes and foster a business-friendly environment, we propose that the Government removes the time limit for claiming Commercial Building Allowance or Industrial Building Allowance. Under the refined regime, Commercial Building Allowance or Industrial Building Allowance allowable to a buyer will be calculated at 4% on the cost of construction or the residue of expenditure immediately after the sale, as the case may be, until the cost of construction or the residue of expenditure has been fully claimed. The calculation of Commercial Building Allowance to be allowed to the buyer on an annual basis of 4% without any time limit is at **Annex**.

13. We have also consulted stakeholders concerned on the proposed amendments to the Commercial Building Allowance and Industrial Building Allowance regimes. Stakeholders generally welcomed the proposal and provided comments as well on the transitional issues in relation to Industrial Building Allowance, which we will take into account when formulating the detailed legislative proposal. Subject to passage of the proposed legislative amendments, we propose that the proposal would take effect from YA 2024/25 to tie in with the expiry of the usage period of Commercial Building Allowance after YA 2023/24 for the first batch of taxpayers who commence claiming Commercial Building Allowance in YA 1998/99.

FINANCIAL IMPLICATIONS

14. Since taxpayers are currently not required to provide information on lease reinstatement costs in their profits tax returns, we do not have relevant statistics to estimate the revenue forgone arising from the proposed tax deduction. However, it is our understanding that lease reinstatement costs generally represent a fairly insignificant portion of a taxpayer's turnover, and therefore the proposed tax deduction should not give rise to significant revenue implications. On the other hand, the proposed tax deduction will maintain the competitiveness of our profits tax system, consolidating Hong Kong's role as a premier business hub in Asia.

15. Based on the statistics of the Commercial Building Allowance and Industrial Building Allowance regimes of YA 2021/22, the potential revenue forgone is estimated to be about \$159 million (Commercial Building Allowance: \$126 million, Industrial Building Allowance: \$33 million) per annum.

WAY FORWARD

16. Subject to Members' views, we will proceed with law drafting of the proposed legislative amendments with a view to introducing the amendment bill to Legislative Council in Q4 2024.

ADVICE SOUGHT

17. Members are invited to comment on the features of the proposed enhancement measures under profits tax as set out in paragraphs 3 to 15 above.

Treasury Branch
Financial Services and the Treasury Bureau
May 2024

Annex

Example: Commercial Building Allowance in relation to a commercial building

A seller constructed a commercial building at a cost of \$100 million, and sold it to a buyer at \$150 million subsequently.

The calculations of the balancing adjustment made to the seller and the Commercial Building Allowance granted to the buyer on the basis “with” and “without” time limit are illustrated in the following scenarios:

	With time limit		Without time limit
	Scenario A	Scenario B	Scenario C
	\$ million	\$ million	\$ million
<u>Seller</u>			
No. of years claimed for Commercial Building Allowance	10 years	25 years	25 years
Cost of construction of the building	100	100	100
Less: Commercial Building Allowance granted [A]	<u>40</u>	<u>100</u>	<u>100</u>
Residue of expenditure before sale [B]	60	0	0
Less: Sale proceeds [C]	<u>150</u>	<u>150</u>	<u>150</u>
Balancing charge (C-B but capped at A)	<u>40</u>	<u>100</u>	<u>100</u>
<u>Buyer</u>			
Residue of expenditure before sale	60	0	0
Add: Balancing charge made to the seller	<u>40</u>	<u>100</u>	<u>100</u>
Residue of expenditure after sale	<u>100</u>	<u>100</u>	<u>100</u>
Remaining entitlement years for Commercial Building Allowance	(25–10) years = 15 years	(25–25) years = 0 year	
Commercial Building Allowance to be allowed annually	$100 \times 1/15 = 6.7$	0	$100 \times 4\% = 4$