HONG KONG TAX

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Contents

Inland Revenue (Amendment) (Tax Deductions for Leased Premises Reinstatement and Allowances for Buildings and Structures) Ordinance 2024

Following the announcement of new tax measure in relation to deduction of reinstatement costs and removal of the time limit for claiming commercial building allowance (CBA) and industrial building allowance (IBA) in the 2024/25 Budget Speech (see our newsletter in https://www.bdo.com.hk/getattachment/4d7f7085-6779-4d0c-9897-53cdb7873884/(FINAL)-Budget-Highlights-24-25.pdf), the Inland Revenue (Amendment) (Tax Deductions for Leased Premises Reinstatement and Allowances for Buildings and Structures) Bill 2024 was passed in the Legislative Council on 18 December 2024 and the ordinance gazetted on 27 December 2024. The Inland Revenue Department (IRD) has published in its website to provide explanation and illustrative example in relation to the enhancement measures.

Tax deduction for reinstatement costs

It is very common that a lease agreement contains terms that require the tenant to reinstate the premises to the original condition at the end of the tenancy or on an early termination of the lease. Historically, cost incurred on reinstatement of a building is considered capital in nature and non-deductible for profits tax purpose.

To relieve the tax burden of enterprises, the amendment seeks to allow tax deduction for reinstatement costs incurred starting from the year of assessment (YA) 2024/25 if all of the following conditions are met:

a) the reinstatement costs have been actually incurred by the person;

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

c) 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 an early termination of the lease;

d) 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. In other words, any accounting provisions recognising reinstatement costs as part of the right-of-use asset or the amortisation of such provisions is not eligible for deduction; and

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

There are no restrictions on the types of premises covered by the deduction for reinstatement costs, ie reinstatement costs on commercial, residential or industrial buildings are deductible provided that the premises are used in the production of the chargeable profits and the required conditions are met. The deduction is only available for actual reinstatement costs incurred but not provisions for accounting purposes.

In determining whether the amount of reinstatement cost claimed is 'reasonable', in particular where the amount represents payment in lieu of reinstating the premises, the IRD explained in its website that it will consider the facts and circumstances of each case. 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 (eg leased premises of similar nature and size) back to their original condition.

Taxpayers will be required to complete the Profits Tax return and fill in the information in respect of the deduction for reinstatement costs. Taxpayers are recommended to maintain all necessary supporting documents (eg copy of tenancy agreement, copy of bank statements and invoices showing the payment for reinstatement work, photos of the premises before and after reinstatement work, etc) to substantiate the deduction claim upon review of the IRD.

Removal of the time limit for claiming CBA and IBA

Currently, claims for annual CBA and IBA are subject to a maximum limit of 25 years (or 50 years for an industrial building or structure that was first used before the commencement of the basis period for the YA 1965/66) starting from the YA in which the building or structure was first used (Time Limit). If a commercial or industrial building or structure is sold before the end of the Time Limit, the buyer will be able to claim annual allowances based on the residue of expenditure immediately after the sale over the remaining years within the Time Limit. However, if the building or structure is sold after the end of the Time Limit, the buyer will not be entitled to claim any annual allowance.

In the long run, such disparity may discourage buyers from purchasing old or second-hand buildings or structures. To foster a business-friendly environment, the amendment seeks to remove the time limit for claiming CBA and IBA starting from the YA 2024/25 to the effect as follows –

a) if an industrial building or structure is acquired after the expiration of the Time Limit and used by the buyer in the basis period <u>before</u> the YA 2024/25; or

b) a commercial or industrial building or structure (whether the Time Limit has expired) is acquired and used by the buyer in the basis period for a YA beginning <u>on or after</u> 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. There will no longer be any fixed time limit.

The balancing adjustment to the seller remains the same in accordance with the existing provisions under the Inland Revenue Ordinance.

Please refer to the Appendix for the illustrative example provided by the IRD.

BDO comments

We welcome the amendment which is just in time to remedial the disparity as the 25 years Time Limit for CBA has just lapsed in 2023/24. The granting of tax deduction on reinstatement cost and the removal of time limit for claiming CBA and IBA will alleviate the tax burden of taxpayers and enhance the business environment.

BDO's support and assistance

BDO Limited
25th Floor, Wing On Centre
111 Connaught Road Central
Hong Kong
Tel: +852 2218 8288
Fax: +852 2815 2239
info@bdo.com.hk

Carol Lam
Director and Head of Tax
Tel: +852 2218 8296
carollam@bdo.com.hk

Abigail Li
Director
Tel: +852 2218 3372
abigailli@bdo.com.hk

Cecilia Ho
Principal
Tel: +852 2218 2776
ceciliaho@bdo.com.hk

Celestine Yeung
Principal
Tel: +852 2218 2773
celestineyeung@bdo.com.hk

Silent Li
Principal
Tel: +852 2218 8983
silentli@bdo.com.hk

Michelle Cheng
Principal, Transfer Pricing
Tel: +852 2218 2755
michellecheng@bdo.com.hk

Shirley Yu
Principal, China Tax
Tel: +852 2218 4904
shirleyyu@bdo.com.hk

APPENDIX

The IRD provided the following example on its website to illustrate the difference before and after the amendment:

Fact pattern

- Owner A incurred cost of $250 million on the construction of an industrial building and started to use the building on 1 April 1970. It is assumed that no initial allowance was claimed by Owner A.
- Owner A sold the building to Owner B for $300 million on 1 April 2017.
- Owner B sold the building to Owner C for $400 million on 1 April 2030.
- Owners A, B and C all close their accounts on 31 March. Owners B and C acquired the building for business use since the year of acquisition.

IBA available

Owner A		**$ million**
1/4/1970	Cost of construction	250
1970/71 - 1994/95	Annual allowance ($250 million x 1/25 x 25)	(250)
1/4/2017	Residue of expenditure immediately before the sale	0
	Sale proceeds	(300)
	Balancing charge on Owner A (limited to the aggregate of allowances granted)	250
Owner B		
1/4/2017	Residue of expenditure immediately before the sale	0
	Balancing charge on Owner A	250
	Residue of expenditure immediately after the sale (restated upon Owner A being subject to balancing charge)	250
2017/18 - 2023/24	Annual allowance prior to the amendment (Note 1)	0
2024/25 - 2029/30	Annual allowance upon the amendment ($250 million x 4% x 6) (Note 2)	(60)
1/4/2030	Residue of expenditure immediately before the sale	190
	Sale proceeds	(400)
	Balancing charge on Owner B (limited to the aggregate of allowances granted)	60
Owner C		
1/4/2030	Residue of expenditure immediately before the sale	190
	Balancing charge on Owner B	60
	Residue of expenditure immediately after the sale (restated upon Owner B being subject to balancing charge)	250
2030/31	Annual allowance ($250 million x 4%)	(10)
		240

Notes:
1. No annual allowance was granted to Owner B as the 25-year period after the year of first use has lapsed.
2. Under the amendment, the buyer will be entitled to an annual allowance of 4% on the residue of expenditure immediately after the sale from 2024/25.