



Inland Revenue Department

The Government of the Hong Kong Special Administrative Region
of the People's Republic of China

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 4 (REVISED)

**LEASE PREMIUMS / NON-RETURNABLE DEPOSITS /
KEY OR TEA MONEY / CONSTRUCTION FEES ETC.**

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

These notes replace those issued in July 2005.

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Commissioner of Inland Revenue

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ASSESSABILITY OF LEASE PREMIUMS

Premiums on leases are frequently referred to as non-returnable deposits, key or tea money, construction fees, tenancy rights or other terms. Sometimes, taxpayers or their representatives are inclined to assume that receipts of lease premiums or of moneys of a similar nature are capital receipts, and consequently fail to show them separately in their accounts or computations. Such an assumption should not be made, because these receipts, by virtue of the nature of the trade or business carried on by the recipient, can often be, and more frequently are, revenue receipts. Moreover, the fact that premium under a lease or tenancy agreement is being regarded as capital expenditure by the payer does not necessarily turn it into a capital receipt in the hands of the recipient.

2. By the definition of "business" in section 2 of the Inland Revenue Ordinance (the Ordinance), corporations letting property are carrying on a business, and so are other persons sub-letting property held by them under a lease other than from the Government. Persons dealing in property are carrying on a trade. It is therefore important that all persons carrying on a property letting or dealing business should give full information concerning such receipts in their accounts supporting the tax returns filed with the Department.

3. Taxpayers or their representatives, if they claim the captioned receipts to be capital receipts, have to ascertain and report the precise facts and the exact legal relationship between the parties occasioned by any agreement to receive or pay such items.

4. In a property letting or dealing business, a lease premium is part of a payment for the use of the property and therefore is an income of a revenue nature. This view is supported by the Court of Appeal decision in the *East African Tax Case No. 37 - A.L. et al v. The Commissioner of Income Tax [E.A.T.C. Vol. 2 at page 148]* which held that the premiums in that case were received for the use of a capital asset and not for its realization and that they were therefore income receipts and taxable.

5. The editors of Halsbury's Laws of Hong Kong, at paragraph 370.174 of Vol. 24, expressed a similar view –

“Where a person dealing in land may be considered carrying on a business (and therefore subject to profits tax), the receipt of rent, lease premiums, construction fees and other miscellaneous sums arising from dealings with land should also be included as trading receipts irrespective of the possible capital nature from the viewpoint of the payee.”

6. Generally accepted accounting practice¹ requires that premium receipts be spread over the term of the lease for the purpose of recognizing them as income. If the accounts are prepared on such basis, the premium receipts will be assessed to profits tax accordingly.

INTERACTION WITH PROPERTY TAX

7. Under section 5B(4) of the Ordinance, a lease premium is deemed for property tax purposes to be payable in equal monthly instalments during the period of the right of use of the property subject to a maximum period of 3 years. Accordingly, property tax may be charged on such a basis. Nevertheless, any property tax so paid is available for set-off against the profits tax payable by the owner of the property under section 25 of the Ordinance. Any excess property tax paid will be refunded. Furthermore, where the owner is a corporation, the exemption from property tax provided under section 5(2)(a) may also be available.

EXAMPLES

8. The following examples illustrate the operation of paragraphs 6 and 7 above.

Example 1

Company H carries on a property letting business. While retaining substantially all the risks and rewards incidental to its ownership, it leases one of its properties for a term of 2 years at a premium of \$1,200,000. Assume that it closes its accounts on 31 March each year.

¹ Hong Kong Accounting Standard 17 – Leases, issued by the Hong Kong Institute of Certified Public Accountants.

According to Hong Kong Accounting Standard 17 (paragraphs 4 and 8), the lease will be an operating lease and hence the lease premium “shall be recognised in income on a straight line basis over the lease term” (paragraph 50), i.e. over the 2-year period. Therefore, half of the premium will be assessed to profits tax in Year 1 and half in Year 2.

Property tax assessments may be issued to Company H. Pursuant to section 5B(4), half of the premium will be charged to property tax in Year 1 and half in Year 2. Company H is entitled to set off the property taxes paid against its profits taxes payable on the premium for these 2 years and have the balance refunded, if any (section 25).

Alternatively, Company H can apply for property tax exemption under section 5(2)(a) of the Ordinance, leaving the premium to be assessed to profits tax.

Example 2

Same scenario as in Example 1 except that the lease is for a term of 6 years.

According to Hong Kong Accounting Standard 17 (paragraph 50), the lease premium will be recognised in income on a straight line basis over the 6-year period. Therefore, 1/6 of the premium (or \$200,000) will be assessed to profits tax in each of the years from Year 1 to Year 6.

Property tax assessments may be issued to Company H. Pursuant to section 5B(4), the premium will be deemed to be payable and hence assessed over a maximum period of 3 years. Hence, 1/3 of the premium (or \$400,000) will be charged to property tax in each of the Years 1, 2 and 3. Company H is entitled to set off the property taxes paid against its profits taxes payable for these 3 years respectively and have the balance refunded, if any (section 25). No question of set-off/refund will arise starting from Year 4.

The computation of taxes payable for the 6 years is as follows—

Year 1 (2005-06)	Property Tax paid: $\$400,000 \times 80\% \times 16\% = \$51,200$	Profits Tax assessment*: $\$200,000 \times 17.5\% = \$35,000$ Less: Property tax paid <u>$\\$51,200$</u> Tax refund <u>$(\\$16,200)$</u>
Year 2 (2006-07)	Property Tax paid: $\$400,000 \times 80\% \times 16\% = \$51,200$	Profits Tax assessment*: $\$200,000 \times 17.5\% = \$35,000$ Less: Property tax paid <u>$\\$51,200$</u> Tax refund <u>$(\\$16,200)$</u>
Year 3 (2007-08)	Property Tax paid: $\$400,000 \times 80\% \times 16\% = \$51,200$	Profits Tax assessment*: $\$200,000 \times 17.5\% = \$35,000$ Less: Property tax paid <u>$\\$51,200$</u> Tax refund <u>$(\\$16,200)$</u>
Year 4 (2008-09)	Property Tax paid: NIL	Profits Tax assessment*: $\$200,000 \times 17.5\% = \$35,000$ Less: Property tax paid <u>Nil</u> Tax payable <u>$\\$35,000$</u>
Year 5 (2009-10)	Property Tax paid: NIL	Profits Tax assessment*: $\$200,000 \times 17.5\% = \$35,000$ Less: Property tax paid <u>Nil</u> Tax payable <u>$\\$35,000$</u>
Year 6 (2010-11)	Property Tax paid: NIL	Profits Tax assessment*: $\$200,000 \times 17.5\% = \$35,000$ Less: Property tax paid <u>Nil</u> Tax payable <u>$\\$35,000$</u>
Total tax paid	Property Tax paid: <u>$\\$153,600$</u>	Net Profits Tax paid: <u>$\\$56,400$</u>
Grand Total of Tax Paid:	<u>$\\$210,000$</u> (or 17.5% on premium, representing the total Profits Tax charged)	

NB: * Assuming no other income chargeable to profits tax and no expenses claim.

Similarly, Company H can also apply for property tax exemption under section 5(2)(a) of the Ordinance.