Hong Kong Tax Alert

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Profits tax treatment of lease payments under HKFRS 16

Last week, the Inland Revenue Department (IRD) published on its website a guidance on the "Profits Tax Treatment of Leases Where HKFRS 16 Applies" (the Guidance) [1].

The Guidance specifically provides that:

i. *Depreciation charges for a right-of-use (ROU) asset and imputed interest on the related lease liability recognized in the accounts under Hong Kong Financial Reporting Standard No. 16 (HKKFRS 16) in respect of an operating lease represent rental expenses that are revenue in nature and tax deductible;*

ii. *As an alternative to (i) above, taxpayers would generally also be allowed to instead claim tax deductions for the lease payments consistently based on the amounts that contractually fall due in the years of assessment concerned.*

iii. *An impairment loss in respect of a ROU asset generally represents anticipated losses not allowable for a one-off outright tax deduction, and would need to be spread over the remaining term of an operating lease on a straight-line basis for tax deduction;*

iv. *Fair value changes in respect of sub-leasing an operating lease that is valued as an investment property would be disregarded for tax purposes as being unrealized profits or losses. Instead, the ROU asset as initially recognized would be allowed to be spread over the term of an operating lease on a straight-line basis for tax deduction.*

Notwithstanding the issuance of the Guidance, whether and how tax adjustments are made in respect of a lease can be complicated in certain circumstances. Taxpayers should seek professional advice where necessary.

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1 The Guidance can be accessed from the following link: https://www.ird.gov.hk/eng/tax/bus_lease16.html

ROU and imputed interest in respect of an operating lease

HKFRS 16 introduces a single lessee accounting model and requires a lessee to recognize assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value.

Under HKFRS 16, the balance sheet of a lessee would recognize a ROU asset representing their right to use the underlying leased asset and a lease liability representing the present value of the future lease payments that the lessee is obliged to pay.

Depreciation charges for the ROU asset and the imputed interest on the lease liability would be reflected as an expense in the profit and loss account of the lessee of an operating lease. In other words, the accounting treatment reflects the economic substance of the transaction as being the lessee acquiring a ROU asset for use over the term of the lease.

Notwithstanding the aforesaid accounting treatment, the Guidance indicates that where the lease concerned is in legal form an operating lease, the combined depreciation expense and imputed interest charged to the profit and loss account represents rentals for the recurrent use of the asset.

As such, the two amounts as recognized in the accounts on an accrual basis are both revenue in nature and are tax deductible. This would be the case regardless of whether the two amounts represent lease payments that contractually fall due in the accounting period concerned.

In straightforward cases, the total amount of the depreciation of the ROU asset and the imputed interest on the related lease liability as recognized in the accounts will equal the total amount of the contractual lease payments over the term of a lease. However, the two total amounts may not be equal in one particular accounting period.

Given the matter is essentially only a timing issue, the Guidance indicates that, where no element of tax avoidance is involved, the IRD would also accept taxpayers instead claiming tax deductions consistently based on the lease payments that contractually fall due in the years of assessment concerned.

Impairment loss of a ROU asset in respect of an operating lease

HKFRS 16 requires a lessee to apply the Hong Kong Accounting Standard (HKAS) 36 Impairment of Assets to determine whether a ROU asset is impaired and to account for any impairment loss identified.

Where an impairment indicator is present, e.g., business operations are significantly curtailed or disrupted due to the coronavirus pandemic, an entity needs to estimate the recoverable amount of its ROU asset. This would involve the entity estimating the net cash flows expected to be generated from the use of the ROU asset over its remaining useful life. Impairment losses arise where the carrying amount of the ROU asset exceeds its recoverable amount.

The Guidance apparently presumes that such an impairment loss would represent anticipated losses in most cases and, as such, would not be tax deductible, based on the principles as established in *Nice Cheer Investment v CIR* (2013) 16 HKCFAR 813.

However, such an impairment loss would also reduce the carrying value of the ROU asset, the depreciation of which would have otherwise represented part of the total rental expense charged to the profit and loss account.

In other words, the depreciation charges in respect of the ROU asset, after its carrying value is reduced by the impairment loss, together with the imputed interest in respect of the related lease liability, would now only represent part of the total rental expense actually incurred.

As such, the Guidance indicates that the IRD would allow the impairment loss to be spread over the remaining term of the lease on a straight-line basis for tax deduction. Similarly, if the impairment loss is subsequently reversed, the reversal would likewise be spread over the then remaining term of the lease on a straight-line basis for tax assessment.

The combined effect of allowing (i) the tax spreading of an impairment loss and any subsequent reversal in the aforesaid manner; and (ii) the tax deduction of the depreciation charges in respect of the remaining carrying value of the ROU asset and the imputed interest on the related lease liability, would then approximate the total rental expense actually incurred for each of the years of assessment concerned.

Fair value changes in respect of sub-leasing an operating lease valued as an investment property

Under HKFRS 16, if an operating lease is sub-leased by an entity to another party (i.e., the entity becomes an intermediate lessor), the entity is required to account for the head lease and the sub-lease as two separate contracts.

Where the entity classifies the sub-lease as an operating lease, the entity would retain the lease liability and the ROU asset pertaining to the head lease. If the ROU asset in respect of the head lease meets the definition of an investment property, the entity can apply the fair value model to the ROU asset in accordance with HKAS 40 Investment Properties, i.e., the ROU asset would be valued based on its market value at each year-end, with any change in value being charged to the profit and loss account. As such, unlike the cost model, there would be no depreciation charges in respect of the ROU asset.

The Guidance indicates that such fair value changes in respect of the head lease would not however be taxable or deductible. This is because such gains or losses would not, based on the principles established in the *Nice Cheer* case, represent realized profits or losses.

Nonetheless, in order to approximate the rental expense actually incurred that would otherwise have been reflected through depreciation charges in respect of the ROU asset, the Guidance indicates that the amount of the ROU asset as initially recognized would generally be allowed to be spread over on a straight-line basis over the term of the head lease for tax deduction purposes.

Reproduced in Appendix to this alert is an example included in the Guidance to illustrate the above.

Commentary

Whilst an impairment loss in respect of an operating lease would represent anticipated losses which may not be ascertainable with sufficient accuracy, and hence not be deductible under the principle established in the *Nice Cheer* case, there could be exceptions.

For instance, in the UK case *Herbert Smith v Honour* 72 TC 130, the provision for losses in respect of vacated office premises that were sub-let for the entire remaining term of the leases at a rent substantially below the rent payable by the taxpayer, was held to be deductible.

The above indicates that despite the issuance of the Guidance, whether and how tax adjustments are made in respect of a lease can be complicated in certain circumstances. Clients should seek professional tax advice where necessary.

Appendix

Example

Head Lessor-HK owned an office building that it agreed to lease out to Sub-Lessor-HK under a lease with the following terms:

- The lease would be for a period of 5 years;
- The annual rental would be $200,000 payable annually in arrears.

Sub-Lessor-HK subleased the whole office building to 10 different tenants for 1 to 3 years with no renewable option. As the office building was located in a prime location, Sub-Lessor-HK was sure that it could find new tenants very soon upon expiry of the old leases.

Sub-Lessor-HK accounted for these sub-leases as operating leases. The fair value model was adopted to account for its ROU asset (i.e., office building lease) under HKAS 40. Sub-Lessor-HK's incremental cost of borrowing was 2%, and there were no initial direct costs, prepayments or restoration costs associated with the head lease.

For the purpose of computing the fair value of the ROU asset, it was assumed that:

- the interest rate implicit in the sub-leases was on average 2%.
- lease liability at the commencement of the head lease (i.e., the net present value of the lease payments): $942,692 at a discount rate of 2%.
- expected annual rental income was $400,000 receivable annually in arrears.

Initial recognition and measurement of the lease by Sub-Lessor-HK:

	Accounting entry	Dr	Cr
Start of Year 1	Dr. ROU asset Cr. Lease liability	$942,692	$942,692
End of Year 1	Dr. ROU asset Cr. Fair value gain of sub-lease (P/L)	$580,400	$580,400
	Dr. Interest expense Cr. Lease liability	$18,854	$18,854
	Dr. Lease liability Cr. Cash	$200,000	$200,000
	Dr. Cash Cr. Lease income (P/L)	$400,000	$400,000

Sub-Lessor-HK would recognize annual sub-leasing income of $400,000 in the profit and loss account for Year 1 to Year 5.

Sub-Lessor-HK would recognize the interest expense in the profit and loss account based on the following schedule:

	Lease payment	Interest expense	Repayment	Lease liability
	$	$	$	$
Start of Year 1				942,692
End of Year 1	200,000	18,854	181,146	761,546
End of Year 2	200,000	15,231	184,769	576,777
End of Year 3	200,000	11,536	188,464	388,313
End of Year 4	200,000	7,766	192,234	196,079
End of Year 5	200,000	3,921	196,079	0
Total	1,000,000	57,308	942,692	

The interest expense charged in the profit and loss account would be allowed for deduction.

Sub-Lessor-HK would account for the fair value changes of the ROU asset at the end of each year during the lease period, based on the following expected cash flows:

	Year 1	Year 2	Year 3	Year 4	Year 5
	$	$	$	$	$
Sub-leasing income	400,000	400,000	400,000	400,000	400,000
Rental payment	(200,000)	(200,000)	(200,000)	(200,000)	(200,000)
Net cash inflow	200,000	200,000	200,000	200,000	200,000
Fair value of ROU leased asset	1,523,092	1,153,554	776,625	392,157	0
Fair value gain/(loss) charged to profit and loss account	580,400	(369,538)	(376,929)	(384,468)	(392,157)

The annual fair value gain/(loss) charged to the profit and loss account would be ignored for profits tax purposes. Instead, the aggregate of the fair value changes of $942,692 (i.e.,$580,400 - $369,538 - $376,929 - $384,468 - $392,157), representing the value of the ROU asset at the initial recognition of the lease, would be spread and deducted over the term of the lease on a straight-line basis.

If information which impacts the calculation of fair value in each year (e.g. changes in interest rate/ occupancy rate) could not be ascertained, it might be difficult to determine the aggregate fair value changes of the ROU leased asset over the term of the lease accurately. In such situations, the ROU leased asset as recognized (i.e., $942,692) would be allowed for deduction on a straight line basis over the term of such a head lease. The straight-line tax depreciation of the ROU leased asset, together with the deductible interest on lease liability as reflected in the accounts would approximate the annual lease payments made under the head lease.

Deduction could be claimed for the rental payments in respect of the head lease based on contractual payments (i.e., $200,000) so long as the basis was consistently applied and there was no indication of any element of tax avoidance. If claimed, $200,000 would be allowed for deduction for Year 1 to Year 5 instead of the deductions for interest expense, depreciation or fair value change.

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