Inland Revenue Department
Hong Kong

# DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

## NO. 2 (REVISED)

## PROFITS TAX

## PART A : INDUSTRIAL BUILDINGS ALLOWANCES
## PART B : COMMERCIAL BUILDINGS ALLOWANCES

These notes are issued for the information and guidance of taxpayers and their authorised representatives. They have no binding force and do not affect a person's right of objection and appeal to the Commissioner, the Board of Review or the Courts.

These notes replace those issued on 20 July 1983.

WONG Ho-sang
Commissioner of Inland Revenue

April 1999

Inland Revenue Department
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Corrigendum

In line 5 of Example 8 (page 14 of the Appendix), kindly amend the word “December” to “March”.

SIN LAW Yuk-lin, Agnes
Commissioner of Inland Revenue

October 1999

**DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES**

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**CONTENT**

## INTRODUCTION

Whereas expenditure of a capital nature is generally not deductible, section 18F of the Inland Revenue Ordinance (the Ordinance) provides for the assessable profits of a person for any year of assessment to be decreased by the amount of any allowances made to the person under Part VI of the Ordinance, and to be increased by the amount of any balancing charge directed to be made on the person under the same Part. The relevant allowances and charges apply in respect of certain (a) industrial buildings and structures; (b) commercial buildings and structures; and (c) machinery and plant.

2. This Departmental Interpretation & Practice Note (DIPN) is concerned with the provisions of Part VI relating to (A) industrial buildings and structures, and (B) commercial buildings and structures. The provisions concerning machinery and plant are discussed in DIPN No. 7 (Revised).

## PART A : INDUSTRIAL BUILDINGS ALLOWANCES

### *Trades Which Qualify*

3. The term "industrial building or structure" is defined, for the purposes of Part VI, in section 40(1) of the Ordinance and commences with the following enumeration -

> " "industrial building or structure" means any building or structure or part of any building or structure used -
>
> (a) for the purposes of a trade carried on in a mill, factory or other similar premises; or
>
> (b) for the purposes of a transport, tunnel, dock, water, gas or electricity undertaking or a public telephonic or public telegraphic service; or

(c) for the purposes of a trade which consists of the manufacture of goods or materials or the subjection of goods or materials to any process; or

(d) for the purposes of a trade which consists in the storage -

(i) of goods or materials which are to be used in the manufacture of other goods or materials; or

(ii) of goods or materials which are to be subjected in the course of a trade to any process; or

(iii) of goods or materials on their arrival into Hong Kong; or

(e) for the purposes of the business of farming; or

(f) for the purposes of scientific research in relation to any trade, profession or business, ...” [“profession” has been included with effect from the year of assessment 1998/99.]

4. It should be noted that for a building or structure (or part of a building or structure) to qualify, it must be used for the purposes of a trade, undertaking, service, business or profession as specified in paragraphs (a) to (f) of the definition, and not be excluded under the proviso to the definition. In this regard it is pertinent that except for paragraphs (b), (e) and (f), only trades qualify. It should not be thought that a building or structure can only qualify under (c) if it is used for the purposes of a trade which involves a manufacturing process; allowances may also be granted if the trade consists of the subjection of goods or materials to any process.

5. Guidance in relation to the question of whether a trade consists of the subjection of goods or materials to any process can be obtained from the High Court decision in the case of *CIR v. Aberdeen Restaurant Enterprises Ltd (1988) 2 HKTC* 330. One of the issues considered in the case was whether a floating restaurant qualified as an industrial structure. The main thrust of the argument for the taxpayer was that cooking of food amounted to the subjection of goods or

material to a process or processes. In considering the issue, Jones J. referred to the Judgement of the Court of Appeal in *Vibroplant Ltd. v. Holland [1982] 54 TC 658* where it was accepted, in relation to the equivalent provision in the United Kingdom's legislation, that "'process' connotes a substantial measure of uniformity of treatment or system of treatment.". Jones J. went on to hold that the restaurant boat did not qualify for the allowances. In doing so he said, at pages 351 and 352, **-**

> " However, does the preparation and cooking of food come within the definition of the subjection of goods to any process. "Process" is defined in the shorter Oxford Dictionary inter alia as "a continuous and regular action or succession of actions, taking place or carried on in a definite manner; a continuous (natural or artificial) operation or series of operations. A particular method of operation in any manufacture."
>
> From the authorities, it is clear that in order to determine whether a building is an industrial building or structure, it is necessary to look at the legislation to ascertain its meaning. The words of the section show that the legislature intended allowances to be claimed by those engaged in the manufacture of goods or in the subjection of goods to a process. A restaurant has been described in the *Rael-Brook case [(1967) 2 Q.B. 65]* as a service industry, but it is plain that it is not a manufacturing industry. Nor, as was submitted by Mr Feenstra, is it akin to a factory or mill but rather to a retail shop. Again, I am unable to agree that the cooking of food results in a uniformity of treatment as urged upon me by Mrs Clough. Each individual dish is prepared separately depending on the order placed by the customer. I can see no distinction between the cooking of food and the carrying out of the repairs in the *Vibroplant case [(1982) 42 T.C. 658]***.** Repairs have no uniformity and are different in the same way as the cooking of food. It is again far removed from the *Kilmarnock case [(1966) 42 T.C. 675]* which encompassed a definite process and a trade of manufacturing. ...
>
> I do not consider that the legislation was ever intended to extend to the business of a restaurant. The trade of the restaurant has nothing to do with manufacturing or processing. Accordingly, I am satisfied that the

restaurant boat and kitchen boat, three bridges or gangways do not qualify for the allowances for they are not industrial buildings or structures. ”

6. The following are examples regarded as satisfying the test of “subjection of goods or materials to any process” -

- an explosives shed used in the trade of quarrying and mining;
- buildings used in the trade of motion picture procedures;
- buildings used for the purposes of the trade of fumigation and extermination (i.e. pest control which might be performed outside of the premises) - see Hong Kong Inland Revenue Board of Review decisions *D3/87 and D4/87*, Volume 2, page 329; and
- buildings used to screen and pack coal for sale – *Kilmarnock Equitable Co-operative Society Ltd. v. CIR, 42 T.C. 675*.

7. The following are examples of buildings which would not satisfy the test in question -

- buildings used for wage packeting, as notes and coins held as currency are not goods for processing - *Buckingham v. Securties Properties ltd., 53 T.C. 292*; and
- buildings used by banks for processing cheques and other documents, as these are not regarded as “goods or materials” – *Girobank plc v. Clarke, 1998 S.T.C. 182*.

***Storage***

8. In order to come within paragraph (d) of the definition, the trade itself must be one of storage. Godowns or warehouses for the storage of goods or materials which are to be sold by the storer or are for use or consumption within the trade of the storer would not rank for industrial building allowances under this paragraph.

***Part of a Trade***

9. There is no provision in the Ordinance for making an allowance where only part of a trade qualifies. In a case heard by the Supreme Court of Hong Kong, *Tai On Machinery Works Ltd. v. C.I.R. [H.K.T.C. 411],* allowances were refused to a retail distributor of goods who claimed to have subjected the goods to a process, it being held that the alleged processing was, at best, part of the trade and not the trade itself.

***Buildings Which Qualify***

10. The allowances can apply to all buildings and structures *used in qualifying trades,* other than categories specifically excluded by the second proviso to the definition of "industrial building or structure" (see paragraph 15 below).

11. The words "building" and "structure", which are not defined in the Ordinance, are construed as having their ordinary meanings. In practice the term "structure" is interpreted as covering artificial works that are not commonly regarded as buildings, such as walls, bridges, dams, roads, bore holes and wells, sewers, water mains, tunnel linings and wharves. In addition, the practice is to regard boundary walls, railway sidings and other works forming part of the premises as qualifying for the allowances.

12. Any buildings or structures provided for and in use for the welfare of workers, or for the housing of manual workers, employed in a specified trade, undertaking or business will also rank for allowances.

***Part of a Building or Structure***

13. The definition of "industrial building or structure" includes part of a building or structure. Where a building or structure is used only partly for the purposes of a qualifying trade, only the relevant proportion of the capital expenditure will generally qualify for allowances. However, proviso (i) to the definition stipulates that where the capital expenditure on the part of the building or structure which is not an industrial building or structure does not exceed

onetenth of the total capital expenditure, the whole building shall be treated as an industrial building or structure.

14. When additions are made to an existing building, the expenditure incurred ranks for separate allowances.

***Buildings Excluded***

15. The second proviso to the definition of “industrial building or structure” excludes from the meaning of the term any building or structure, or part of any building or structure, used as a -

(i) dwelling house (other than as a dwelling house for the housing of manual workers),

(ii) retail shop,

(iii) showroom,

(iv) hotel, or

(v) office.

It should, however, be kept in mind that even if part of a building is excluded by virtue of this proviso, the remainder of the building, or some part of it, may still qualify (see paragraph 13 above).

***Capital Expenditure Incurred on Construction***

16. The allowances (which are granted under sections 34 and 35) are based on the capital expenditure incurred on the construction of the building (or structure). Such expenditure does not include the cost of the site or that of the preparation and levelling of the land. However, it can include expenditure on ordinary work done preparatory to laying foundations, and on laying drains, sewers and water-mains to serve the building or structure.

17. The allowable expenditure does not include anything that is reimbursed by any grant, subsidy, or similar financial assistance, or any expenditure which is deductible under Part IV of the Ordinance (e.g. expenditure on building refurbishment under section 16F). On the other hand, it includes interest paid and any commitment fee incurred in respect of a loan obtained for the purpose of providing an industrial building.

***Persons Entitled to the Allowances***

18. Allowances are granted to any person who is entitled to an interest in an industrial building, where that interest is the relevant interest (see paragraph 21 below) in relation to the capital expenditure incurred on the construction of that building.

19. It is not necessary for the building to be used for a qualifying purpose by the owner himself. Accordingly, where a building is leased and used by the occupant for a qualifying purpose, the landlord, being the person having the relevant interest in the capital expenditure incurred on construction, is entitled to the allowances.

20. No allowances are due to a lessee who merely pays rent and/or a premium for the lease of a building and who has not himself incurred capital expenditure on construction or acquired the relevant interest of a person who did incur such expenditure. However, a tenant who incurs expenditure on a building which he occupies for the purposes of a qualifying trade, profession or business will have a relevant interest for the purposes of the allowances.

***Relevant Interest***

21. “Relevant Interest” is determined at the time when the capital expenditure is incurred. It is defined in section 40(1) in the following terms -

> “ “relevant interest” means, in relation to any expenditure incurred on the construction of a building or structure the interest in that building or structure to which the person who incurred the expenditure was entitled when he incurred it; ”

22. A relevant interest can be acquired where the person who incurred the expenditure sells the whole of his interest in (i) the building, or (ii) part of the building. For example, A holds a lease of land from the HKSAR Government for 99 years. He gives B a lease for 50 years and B erects an industrial building thereon at a cost of $10M. After some time B assigns the balance of his lease to C, who acquires the relevant interest which B had in the capital expenditure incurred on the construction of the building. C is entitled to annual allowances calculated under section 34(2)(b), and also to balancing allowances at the expiration of the lease under section 35(1)(b). If, however, B merely sub-let the premises to C for a term of years (i.e. the sub-lease expires before the end of B's lease from A), the relevant interest would not pass and C would not be entitled to any industrial building allowance. B, however, having retained the relevant interest would continue to be entitled to the allowances, provided C is carrying on a qualifying trade, profession or business.

***Buildings and Structures Bought Unused***

23. Where capital expenditure is incurred on the construction of a building and before it is used**,** the relevant interest therein is sold, section 35B provides that -

(a) no allowances may be claimed in respect of that expenditure by the seller and any initial allowances already made under section 34 shall be withdrawn, with additional assessments raised if necessary;

(b) the person who buys that interest is deemed to have incurred, on the date on which the purchase price is payable, capital expenditure on construction of an amount equal to -

(i) the net price paid by the purchaser for that interest if the interest is sold by a builder or developer in the course of his trade; and

(ii) in any other case, the lesser of the net price paid by the purchaser for that interest or the actual cost of construction.

24. Should there be more than one sale before the building is used, (b) above applies only in relation to the last sale so that the final purchaser who uses the building is entitled to the allowances. In the case of (b)(i), the final purchaser would get allowances based on the lesser of the net price of the first sale or the net price paid by him (see the proviso to section 35B). For example, in 1996 D constructs a building at a cost of $10M and sells it to E for a net price of $15M. E then sells it to F for a net price of $14M. F uses the building in his qualifying trade. Then, F would be the person entitled to the allowances calculated on an amount depending on whether D carries on a building trade and has sold the building in the ordinary course of his trade. If so, the allowances will be granted on $14M, the lesser of the net price paid by F and the net price of the first sale. In any other case, F would only be entitled to allowances based on $10M, being the actual cost of construction which is less than the net price of $14M paid by him.

25. The "net price" referred to in the two previous paragraphs excludes, of course, the price of the land on which the building stands.

***Initial Allowance***

26. Since the 1965/66 year of assessment, section 34(1) has provided for an initial allowance of one-fifth of the capital expenditure incurred on the construction of an industrial building to be made to the person who incurred the expenditure. The allowance is made for the year of assessment in the basis period for which the expenditure was incurred.

27. Initial allowance is granted as expenditure is incurred, and there is no requirement that the building must be in use. However, proviso (b) to section 34(1) stipulates that any initial allowance made under the section before a building is used shall be disallowed (and appropriate additional assessments made) if the building is not an industrial building when it first comes to be used.

28. Where the cost of construction is paid in instalments, initial allowance is made by reference to the instalments due for payment in the basis period of the year of assessment under consideration.

### *Annual Allowance*

29. Since the 1965/66 year of assessment, annual allowances have been computed in accordance with paragraphs (a) and (b) of section 34(2). Where the person claiming the allowance incurred the capital expenditure on the construction of the building, the annual allowance is 4% of the capital expenditure. However, if the person acquired the building after the capital expenditure on construction had been incurred (i.e. it was sold as an existing industrial building), the calculation of the allowance for the purchaser depends on when the building was first used as an industrial building, -

(a) if first used *before* the commencement of the basis period for the year of assessment commencing on 1 April 1965, the allowance is calculated by reference to the "residue of expenditure" (see paragraph 31 below) immediately after the sale. The allowance is arrived at by multiplying the residue of expenditure by two and dividing the resulting figure by the number of years of assessment comprised in the period which begins with the first year of assessment for which the buyer is entitled to an annual allowance (or would be so entitled if the building had at all material times continued to be an industrial building), and ends with the fiftieth year after the year in which the building was first used; or

(b) if first used *on or after* the commencement basis period for the year of assessment commencing on 1 April 1965, the allowance is arrived at by dividing the residue of expenditure by the number of years of assessment comprised in the period which begins with the first year of assessment for which the buyer is entitled to an annual allowance (or would be so entitled if the building had at all material times continued to be an industrial building), and ends with the twenty-fifth year after the year of assessment in which the building was first used.

30. Two conditions must be satisfied before a person becomes entitled to annual allowance in respect of an industrial building for any year of assessment -

(a) the building must be in use as an industrial building at the end of the person's basis period for the year assessment; and

(b) the person must be entitled to an interest in the building at the end of the basis period for the year of assessment (and that interest must be the relevant interest in relation to the capital expenditure for which the allowance is claimed).

***Residue of Expenditure***

31. The term "residue of expenditure" is defined in section 40(1) as meaning in relation to an industrial building, in effect, the amount of the capital expenditure incurred on the construction of the building, reduced by the amount of any initial, annual or balancing allowance made, and increased by any balancing charge made. The definition of the term also requires that in computing the residue of expenditure in relation to a building, there shall also be deducted in respect of any year in which no initial or annual allowance fell to be made (e.g. due to the building not being used as an industrial building), an amount equal to 2% of the capital expenditure for each such year prior to the year of assessment commencing on 1 April 1965, and 4% of the capital expenditure for that year or any subsequent year of assessment.

***Balancing Allowances and Charges***

32. Under section 35(1), when any of the following events occurs to an industrial building -

(a) the relevant interest in the building is sold; or

(b) that interest, being a leasehold interest, comes to an end otherwise than on the person entitled thereto acquiring the interest which is reversionary thereon; or

(c) the building is demolished, destroyed or, without being demolished or destroyed, ceases altogether to be used, a balance is struck between the residue of expenditure immediately before the event and the sale price, insurance, salvage or compensation moneys (if any). If the residue exceeds the sale price or other moneys, the difference is allowed as a balancing allowance. If the difference is the other way, it forms a balancing charge. A balancing charge is not to exceed the total of initial and annual allowances previously made to the person.

33. No charge or allowance falls to be made unless the building was an industrial building at the time of the event. Further, no balancing allowance is given where the building is demolished for purposes unconnected with the trade, profession or business for which the building was used. Thus, for example, where the land is ripe for re-development, and the building is demolished to enable the land to be sold unencumbered, no balancing allowance is given, even though the building was in use as an industrial building immediately prior to demolition.

***Termination of a Leasehold Interest***

34. If a lessee has incurred capital expenditure on a building, a balancing allowance or charge does not arise when the lease comes to an end if the lessee remains in possession with the consent of the lessor without a new lease being granted. His leasehold interest is treated as continuing (section 35A(a)). If a new lease is granted to the lessee, or if the old lease is extended by reason of an option available to the lessee, the second lease is treated as a continuation of the first lease (section 35A(b)). If the lessee buys the property from the lessor during the currency of the lease, the lessee’s interest in any capital expenditure incurred is deemed to continue unaltered, and accordingly no balancing allowance is applicable.

*Examples*

35. Examples 1 to 4 of the Appendix illustrate the calculation of allowances and charges in respect of industrial buildings.

## PART B : ALLOWANCES - COMMERCIAL BUILDINGS

### *Buildings Which Qualify*

36. For the purposes of Part VI of the Ordinance, a commercial building or structure is defined in section 40(1) to mean -

> "any building or structure or part of any building or structure used by the person entitled to the relevant interest for the purposes of his trade, profession or business other than an industrial building or structure;".

Provided that it is used for an appropriate purpose, part of a building may qualify as a commercial building (i.e. it is not necessary for the whole building to be used for a qualifying purpose).

### *Expenditure Which Qualifies*

37. As with industrial buildings, the allowances granted in respect of commercial buildings (and structures), under sections 33A, 33B and 36, are based on the capital expenditure incurred on construction. In this regard, the comments made in paragraphs 16 and 17 of Part A above, under the heading "Capital Expenditure Incurred on Construction", are also pertinent to commercial buildings. However, it should be noted that section 35B, which is concerned with buildings bought unused (see paragraph 23), does not have any application in relation to a commercial building.

### *Persons Entitled to the Allowances*

38. An allowance in respect of a commercial building or structure is granted to a person where at the end of a basis period for a year of assessment the person is entitled to an interest in the building, provided that the interest is the "relevant interest" in relation to the capital expenditure incurred on the construction of the building. The meaning of the term "relevant interest" in relation to commercial buildings is the same as for industrial buildings (see paragraph 21 above). Prior to the year of assessment 1969/70, an allowance in respect of a commercial building could only be made to the *owner* of the building. From 1969/70, however, a tenant

has been able to claim in respect of capital expenditure he has incurred on additions to a building, or for which he has thus acquired the relevant interest.

***Rebuilding Allowance - Years of Assessment Prior to 1998/99***

39. Section 36 provides for an allowance, known as "rebuilding allowance", to be granted where at the end of the basis period for a year of assessment prior to 1998/99 a person was entitled to an interest in a commercial building and that interest was the relevant interest in relation to capital expenditure incurred on the construction of the building. For each year of assessment from 1990/91 to 1997/98, the rebuilding allowance is 2% of the capital expenditure incurred on the construction of the building. For years of assessment prior to 1990/91, the rebuilding allowance rate is 0.75%.

40. Section 36(2) provides that that no rebuilding allowance may be made to a person in respect of any year of assessment after 1997/98 (i.e. where "the basis period for that year of assessment is subsequent to the basis period for the year of assessment commencing on 1 April 1997").

41. It should be noted that for assessments in respect of the 1997/98 and earlier years of assessment, the Ordinance does not provide for any balancing allowance or charge to be made where a person sold or otherwise ceased to use a commercial building.

***Allowances for 1998/99 and Subsequent Years of Assessment***

42. With effect from the year of assessment 1998/99, rebuilding allowance ceased to be applicable, and was replaced by a regime which is more closely aligned with that for industrial buildings - it likewise provides for "annual allowances", "balancing allowances" and "balancing charges". The amendments made to the Ordinance to implement the new regime did not affect the meaning of key terms such as "commercial building or structure", and "relevant interest". However, the definition of "residue of expenditure", which previously was only relevant to industrial buildings (see paragraph 31 above), was amended to also have a similar meaning in relation to commercial buildings. In particular, the expression is defined in section 40(1) in the following terms -

" "residue of expenditure" -

(a) in relation to a commercial building or structure, means the amount of the capital expenditure, incurred on the construction of the building or structure reduced by -

(i) the amount of any annual allowance made under section 33A;

(iii) the amount of any balancing allowance made under section 33B,

and increased by any balancing charges made under section 33B:

Provided that in computing the residue of expenditure there shall be written off, in respect of any year in which no annual allowance fell to be made under section 33A, an amount of one-twenty-fifth of the capital expenditure, and for the purposes of this proviso "year" means the period which would have comprised a year of assessment commencing on 1 April 1998 or any subsequent year of assessment in respect of which an annual allowance would have fallen to be made under section 33A if the building or structure had been in use as a commercial building or structure; "

***Annual Allowance***

43. Section 33A(1) provides for an allowance, known as "annual allowance", to be made to a person where at the end of the basis period for the year of assessment the person "is entitled to an interest in a building or structure which is a commercial building or structure and where that interest is the relevant interest in relation to the capital expenditure incurred on the construction of that building or structure".

*The Most Straightforward Situation*

44. The annual allowance made to a person is computed in accordance with the terms of section 33A. The most straightforward situation is where the capital expenditure on construction was incurred by the person on or after the

commencement of the basis period for the year of assessment 1998/99 and the relevant interest has not been sold by the person. For such a case, section 33A(1) provides for an annual allowance equal to one-twenty-fifth (i.e. 4%) of the capital expenditure incurred on the construction of the building. On this basis, and having regard to section 33A(3) (which provides, in essence, that the annual allowance granted for any year of assessment cannot exceed the residue of expenditure prior to the making of the allowance), the allowance can be claimed for a maximum of 25 years.

45. Section 33A(2) and (4) cater for circumstances which vary from the situation described in paragraph 44 above, i.e. they respectively have application where the relevant interest has been sold and where the capital expenditure was incurred prior to the commencement of the year of assessment 1998/99.

*Where the Commercial Building or Structure Was Constructed Prior to 1998/99*

46. Where the expenditure was incurred prior to the commencement of the basis period for the year of assessment 1998/99, section 33A(4) has application. In this situation, for the purpose of calculating annual allowances under section 33A (i.e. for 1998/99 and subsequent years of assessment), the actual capital expenditure incurred on construction is deemed to have been reduced. In essence, the figure used is the actual capital expenditure reduced by the aggregate of the rebuilding allowances which would have been made under section 36 to the person in respect of the building in all years of assessment prior to 1998/99 if at all times during the period of the person’s entitlement to the relevant interest the building was used for the purposes of producing chargeable profits.

47. The balance of the capital expenditure thus arrived at (which will generally be the capital expenditure incurred on construction less the aggregate of rebuilding allowances previously granted) is used to ascertain the annual allowance made under section 33A(1) (i.e. 4% of the balance). The annual allowance in respect of such transitional cases can be claimed for a period of 25 years, commencing with the year of assessment 1998/99. This follows from section 33A(4)(b) which provides that for such a building or structure, the year of assessment commencing 1 April 1998 shall be deemed to be the year of assessment in which the building was first used.

48. It should be noted that the application of section 33A(4) is not restricted to cases where a building was a commercial building or structure immediately prior to the commencement of the 1998/99 year of assessment. The provisions of the subsection also apply to cases where a building was put to some other use (e.g. as private accommodation unrelated to any trade, profession or business), or was vacant, as at the end of the 1997/98 year of assessment, and only subsequently came to be used as a commercial building.

*Where the Relevant Interest Has Been Sold*

49. Section 33A(2) provides that where the relevant interest in a commercial building is sold, the annual allowance is subsequently calculated by reference to the residue of expenditure immediately after the sale (rather than as 4% of the capital expenditure). The subsection specifies two methods of ascertaining the proportion of the residue of expenditure immediately after the sale to be claimed as an annual allowance.

50. The first method has application where the building was constructed prior to the commencement of the year of assessment 1998/99 (i.e. it is a building to which subsection (4) applies). For such a case, subsection (2) prescribes, in effect, that the annual allowance is the amount arrived at by dividing the residue of expenditure immediately after the sale by the number of years of assessment comprised in the period which begins with the year of assessment in which the sale occurred, and ends with the year of assessment 2023/24 (i.e. "the 25th year of assessment after the year of assessment in which this section commences").

51. The second method prescribed in subsection (2) applies in any other case (i.e. where subsection (4) does not apply to the building because it was constructed after the commencement of the year of assessment 1998/99). For such a case, subsection (2) provides that where the relevant interest is sold, the annual allowance is the amount arrived at by dividing the residue of expenditure immediately after the sale by the number of years of assessment comprised in the period which begins with the year of assessment in which the sale occurred and ends with the year of assessment which is the 25th year after the year of assessment in which the building was first used.

***Balancing Allowances and Charges***

52. Reflecting to a large extent the provisions of section 35 concerning industrial buildings, section 33B(1) provides for a balancing allowance or balancing charge to be made where any of the following events occurs to a building, while the building is a commercial building -

> “ (a) the relevant interest in the building or structure is sold;
>
> (b) the relevant interest in the building or structure, being a leasehold interest, comes to an end otherwise than on the person entitled thereto acquiring the interest which is reversionary thereon; or
>
> (c) the building or structure is demolished or destroyed or, without being demolished or destroyed, ceases altogether to be used. ”

The allowance or charge is made for the year of assessment in the basis period for which the event occurs.

*Balancing Allowances*

53. Section 33B(2)(a) provides that where the residue of expenditure immediately before the occurrence of an event referred to in subsection (1)(a) to (c) exceeds the sale, insurance, salvage or compensation moneys (if any) arising from the event, a balancing allowance shall be made. If the residue of expenditure immediately before the event is nil, a balancing charge is made on the amount of the sale or other moneys. Where the amount of such moneys exceeds the amount of the residue, a balancing charge is made in respect of the excess.

54. It should be noted, however, that section 33B(2)(b) stipulates that that no balancing allowance is to be made where the building in question is demolished for purposes unconnected with or not in the ordinary course of conduct of the trade, profession or business of the person in relation to which the building was used to qualify for an annual allowance under section 33A. Thus, for example, if a commercial building were to be demolished to enable land to be sold unencumbered, no balancing allowance would be made.

*Balancing Charges*

55. Where the sale, insurance, salvage or compensation moneys arising from the event exceed the residue of expenditure (if any) immediately before the occurrence of an event referred to in subsection (1)(a) to (c), section 33B(3)(a) provides that a balancing charge shall be made in respect of the excess. However, by virtue of section 33B(3)(b) the amount of a balancing charge is limited to the amount of the annual allowances, if any, made to the person under section 33A.

***Termination of a Leasehold Interest***

56. Section 33B(1)(b) covers the normal case where a leasehold interest ends on expiry of a lease. Thus if A agrees to lease a commercial building to B for a particular period, and B becomes entitled to a relevant interest in relation to capital expenditure incurred on further construction, B will generally become entitled to a balancing allowance where his leasehold interest terminates at the end of the lease period. This will also be the case if A and B agree to early termination of the lease, although a balancing charge could arise if compensation is paid by A to B.

57. However, a balancing allowance (or charge) will not be made where a lessee does not vacate a commercial building at the expiration of his leasehold interest. Section 33B(1)(b) excludes the case where the person acquires the reversionary interest (e.g. where the lessee purchases the property from the lessor). Where acquisition does not take place, but the lessee remains in possession of the building with the consent of the lessor without a new lease being granted, section 35A(a) provides that leasehold interest shall be deemed to continue (and accordingly a balancing allowance cannot be granted under section 33B(1)(b)). With the same result, section 35A(b) provides that where a new lease is granted to the lessee, the second lease is treated as a continuation of the first lease.

*Examples*

58. Examples 5 to 9 of the Appendix illustrate the calculation of rebuilding allowances, annual allowances, balancing allowances and balancing charges in respect of commercial buildings.

**APPENDIX**

**ALLOWANCES FOR INDUSTRIAL BUILDINGS AND STRUCTURES**

**Example 1**

**X** constructed a factory at a cost (excluding the value of the site) of $500,000. The amount was due when the factory was first used, in February 1992. **X** carries on a qualifying trade, and makes up accounts to 31st December each year.

The factory was sold on 31 October 1996 for $420,000 (excluding the value of the site), to **Y** who started a similar trade on the 10 November 1996**,** and makes up accounts to the 31st March. **X** continues to trade.

| | | $ | $ |
|---|---|---|---|
| **X:** | **1992/93** | | |
| | Cost | | 500,000 |
| | Initial Allowance @ 20% | 100,000 | |
| | Annual Allowance @ 4% | 20,000 | 120,000 |
| | | | 380,000 |
| | **1993/94 to 1995/96** | | |
| | Annual Allowance 3 years @ 4% | | 60,000 |
| | Residue before sale | | 320,000 |
| | **1996/97** | | |
| | Sale price | | 420,000 |
| | Balancing Charge | | 100,000 |
| **Y:** | **1996/97** | | |
| | Residue before sale | | 320,000 |
| | Add Balancing Charge made on **X** | | 100,000 |
| | Residue after sale | | 420,000 |
| | Annual Allowance* | | 20,000 |

* Calculation of Annual Allowance for **Y**

- Year of first use 1991/92 (Note that this is not necessarily the year for which Allowances were first given)
- 25th year after year of *first* use 2016/17
- **Y** is entitled to Annual Allowance from 1996/97 onwards
- Number of years from 1996/97 to 2016/17 = 21
- Amount of Annual Allowance to **Y** :

  1/21 x $420,000 = $20,000

[ Note that only **Y** gets an allowance for 1996/97.]

**Example 2**

**A** constructed a factory at a cost (excluding the value of the site) of $2,000,000. It was completed and brought into use in July 1992**.** The building contract provided that instalments should be paid monthly and $500,000 was due and paid before 31 March 1992. The balance was paid during the year ended 31 March 1993.

**A** has carried on a qualifying trade since 1985**,** and makes up accounts to 31 March each year.

The factory was sold to **B**, who had been carrying on a qualifying trade for some years, on 31 October 1995 for $5 million (including the value of the site). **B** makes up accounts to 30 June each year. The site value is estimated at $2.5M. **A** continues to trade.

| | | $ | $ |
|---|---|---|---|
| **A:** | **1991/92** | | |
| | Cost | | 2,000,000 |
| | Initial Allowance @ 20% of $500,000 | | |
| | (No Annual Allowance as Building not in use at 31.3.1992) | | 100,000 |
| | | | 1,900,000 |
| | **1992/93** | | |
| | Initial Allowance @ 20% of $1,500,000 | 300,000 | |
| | Annual Allowance @ 4% of $2,000,000 | 80,000 | 380,000 |
| | | | 1,520,000 |
| | **1993/94 & 1994/95** | | |
| | 2 Years' Annual Allowance | | 160,000 |
| | Residue before sale | | 1,360,000 |
| | **1995/96** | | |
| | Sale price ($5M less 2.5M) | | 2,500,000 |
| | Excess | | 1,140,000 |
| | Balancing Charge, limited to allowances given | | 640,000 |

| | | $ |
|---|---|---|
| **<u>B:</u>** | **1996/97** | |
| | Residue before sale | 1,360,000 |
| | Balancing Charge made on A | <u>640,000</u> |
| | Residue after sale | <u>2,000,000</u> |
| | Annual Allowance* | 90,910 |

* Calculation of Annual Allowance for **B:**

- Year of first use 1992/93
- 25th year after year of *first* use 2017/18
- **B** is entitled to Annual Allowance from 1996/97 onwards
- Number of years from 1996/97 to 2017/18 = 22
- Amount of Annual Allowance to **B**:-
  1/22 x $2,000,000 = $90,910
- Final year of allowance 2017/18 (Annual Allowance $90,890)

[Note that neither **A** nor **B** receives Annual Allowance in respect of 1995/96**.** There is, however, no Notional Allowance written off, as the building was an Industrial Building throughout.]

**Example 3**

**C** erected a building at a cost of $800,000 in September 1990 and straightaway used it as a workshop in his existing manufacturing trade. He makes up accounts to 31 December each year.

In January 1993 he sold the building for $700,000 to **D**, who used it for a time as a showroom in his existing manufacturing business. In May 1994 **D** re-converted it to a workshop. **D** makes up accounts to the 31 March each year. **C** continues to trade. [Site values are excluded throughout.]

| | | $ | $ |
|---|---|---|---|
| **C:** | **1990/91** | | |
| | Cost | | 800,000 |
| | Initial Allowance @ 20% of $800,000 | 160,000 | |
| | Annual Allowance @ 4% of $800,000 | 32,000 | 192,000 |
| | | | 608,000 |
| | **1991/92 & 1992/93** | | |
| | Annual Allowance - 2 years @ 4% | | 64,000 |
| | Residue before sale | | 544,000 |
| | **1993/94** | | |
| | Sale price | | 700,000 |
| | Balancing Charge | | 156,000 |

| | | $ |
|---|---|---|
| **<u>D:</u>** | **1993/94** | |
| | Residue before sale | 544,000 |
| | Balancing Charge made on **C** | <u>156,000</u> |
| | Residue after sale | 700,000 |
| | Notional Allowance* | <u>32,000</u> |
| | | 668,000 |
| | **1994/95 onwards** | |
| | Annual Allowance** | 29,167 |

* **D** did not qualify for Annual Allowance until 1994/95. However, a Notional Allowance has to be written off for 1993/94 (not 1992/93, as **C** received Annual Allowance that year). The amount of the Notional Allowance is 4% of the capital expenditure, NOT the amount of the Annual Allowance which would otherwise have been given.

** Calculation of Annual Allowance

- Year of first use 1990/91
- 25th year after year of *first* use 2015/16
- If **D** had used the building for a qualifying purpose throughout, his first year of allowance would have been 1992/93.
- From 1992/93 to 2015/16 inclusive is 24 years
- The amount of Annual Allowance to **D** :- 1/24 x $700,000 = $29,167
- Final year of allowance 2016/17 (Annual Allowance $26,326)

[Note that **D** would get Commercial Building Allowance for 1992/93 and 1993/94 equal to 2% of the $800,000 cost of the building (i.e. $16,000 each year)**.** This would have no effect on the Industrial Building Allowance.]

**Example 4**

Following Example 3, **D** instead used the building as a showroom and then, in May 1994, sold it to **E** for $750,000 (i.e. without converting it back to a workshop). **E** used the building for a qualifying trade and makes up accounts to 31 March each year.

| | | $ |
|---|---|---|
| **D:** | **1993/94** | |
| | Residue after the previous sale by **C** to **D** in 1992/93 while in use as industrial building | 700,000 |
| | Notional Allowance for 1993/94 * | 32,000 |
| | | 668,000 |

* **D** did not qualify for Annual Allowance for 1993/94, and thus a Notional Allowance has to be written off. The amount of Notional Allowance is 4% of the capital expenditure, NOT the amount of the Annual Allowance which would otherwise have been given.

| | | |
|---|---|---|
| **E:** | **1994/95** | |
| | Residue of expenditure (section 40(1)) | 668,000 |
| | Annual Allowance** | 29,167 |

** Calculation of Annual Allowance for Company **E**

- Year of first use 1990/91
- 25th year after year of *first* use 2015/16
- If **D** had used the building for a qualifying purpose, his first year of allowance would have been 1992/93
- From 1992/93 to 2015/16 inclusive is 24 years
- The amount of Annual Allowance to **E** :-
  1/24 x $700,000 = $29,167
- Final year of allowance 2016/17 (Annual Allowance $26,326)

[Note that if neither **C** nor **D** had used the building prior to its sale to **E**, **E** would be entitled to Initial and Annual Allowances. If **C** carried on a building construction trade and sold the building in the ordinary course of his trade the allowances would be based on capital expenditure of $700,000 (i.e. the lesser of the net price paid by **E** and the net price on the first sale - s.35B(b)(ii)(a)).

If **C** did not carry on a building construction trade, **E** would be entitled to allowances based on capital expenditure of $750,000 (i.e. the lesser of the net price paid by **E** and the original cost of construction of $800,000 (s.35B(b)(ii)(b)).]

## ALLOWANCES FOR COMMERCIAL BUILDINGS AND STRUCTURES

### Example 5

Computation of Annual Allowances in respect of a Commercial Building acquired before 1 April 1998 where ownership is retained by the same person during the 1998/99 year of assessment.

**Company F** purchased ***Shop 1*** from a developer at a price of $2,000,000 on 1 November 1988. ***Shop 2*** was purchased for $6,000,000 on 1 October 1994. The costs of construction of ***Shop 1*** and ***Shop 2*** are ascertained to be $1,000,000 and $2,000,000 respectively. **Company F** makes up its accounts to 31st March each year.

| | | $ | $ |
|---|---|---|---|
| **Company F** | | | |
| ***Shop 1*:** | **1988/89 to 1997/98** | | |
| | Cost of construction | | 1,000,000 |
| | Rebuilding Allowance | | |
| | • 1988/89 to 1989/90 - 2 years @ 3/4% of $1M | 15,000 | |
| | • 1990/91 to 1997/98 - 8 years @ 2% of $1M | 160,000 | 175,000 |
| | Residue under s.33A(4) | | 825,000 |
| | | | |
| | **1998/99 onwards** | | |
| | Annual Allowance* @ 4% of $825,000 | | 33,000 |
| | | | |
| * | Final year of allowance 2022/23 | | |
| | | | |
| **Company F** | | | |
| ***Shop 2*:** | **1994/95 to 1997/98** | | |
| | Cost of construction | | 2,000,000 |
| | Rebuilding Allowance - 4 years @ 2% of $2,000,000 | | 160,000 |
| | Residue under s.33A(4) | | 1,840,000 |
| | | | |
| | **1998/99 onwards** | | |
| | Annual Allowance* @ 4% of $1,840,000 | | 73,600 |
| | | | |
| * | Final year of allowance 2022/23 | | |

**Example 6**

Computation of Balancing Allowance, Balancing Charge and Annual Allowances in respect of an “old” Commercial Building (i.e. one constructed prior to 1998/99) sold in 1998/99.

***Scenario 1***

Following Example 5, assume **Company F** sold ***Shop 1*** to **Company G** for $750,000 (excluding site) on 28 February 1999. **Company G** makes up its accounts to 31st March each year.

| | | $ |
|---|---|---|
| **Company F** | | |
| ***Shop 1*:** | **1998/99** | |
| | Residue under s.33A(4) - see Example 5 | 825,000 |
| | Annual Allowance | NIL |
| | Residue before sale | 825,000 |
| | Sale price | 750,000 |
| | Balancing Allowance | 75,000 |
| | | |
| **Company G** | | |
| ***Shop 1*:** | **1998/99** | |
| | Residue before sale | 825,000 |
| | Balancing Allowance made to **Company F** | 75,000 |
| | Residue after sale | 750,000 |
| | Annual Allowance* | 28,847 |

* Calculation of Annual Allowance for **Company G**

- First year of Annual Allowance to **Company G** 1998/99
- 25th year after 1998/99 is 2023/24
- Number of years from 1998/99 to 2023/24 is 26
- Annual Allowance, 1998/99 onwards :-
  1/26 x $750,000 = $28,847
- Final year of allowance for **Company G** 2023/24 (Annual Allowance $28,825)

***Scenario 2***

Following Example 5, assume **Company F** sold ***Shop 1*** to **Company G** for $2,000,000 (excluding the value of the site) on 28 February 1999. **Company G** makes up its accounts to 31st March each year.

| | | $ |
|---|---|---|
| **Company F** | | |
| ***Shop 1*:** | **1998/99** | |
| | Residue under s.33A(4) - see Example 5 | 825,000 |
| | Annual Allowance | NIL |
| | Residue before sale | 825,000 |
| | Sale price | 2,000,000 |
| | Balancing Charge* | NIL |

* Note that under s.33B(3)(b), no Balancing Charge made on **Company F** since it was not entitled to any Annual Allowance in the year of assessment 1998/99.

| | | |
|---|---|---|
| **Company G** | | |
| ***Shop 1*:** | **1998/99** | |
| | Residue before sale | 825,000 |
| | Balancing Charge on **Company F** | NIL |
| | Residue after sale | 825,000 |
| | Annual Allowance 1998/99 onwards** - | |
| | 1/26 x $825,000 = $31,731 | 31,731 |

** Calculation of Annual Allowance for **Company G**

- First year of Annual Allowance to **Company G** 1998/99
- 25th year after 1998/99 is 2023/24
- Number of years from 1998/99 to 2023/24 is 26
- Annual Allowance, 1998/99 onwards :-
  1/26 x $825,000 = $31,731
- Final year of allowance for **Company G** 2023/24 (Annual Allowance $31,725)

**<u>Example 7</u>**

Computation of Balancing Allowance, Balancing Charge and Annual Allowances in respect of an old Commercial Building sold after 1998/99.

***<u>Scenario 1</u>***

Following Example 5, assume **Company F** sold ***Shop 2*** to **Company H** for $1,600,000 (excluding the value of the site) on 15 March 2000. **Company H** makes up its accounts to 31st March each year.

| | | $ |
|---|---|---|
| **<u>Company F</u>** | | |
| ***<u>Shop 2</u>*:** | **1998/99** | |
| | Residue under s.33A(4) - see Example 5 | 1,840,000 |
| | Annual Allowance | <u>73,600</u> |
| | | 1,766,400 |
| | | |
| | **1999/2000** | |
| | Residue before sale | 1,766,400 |
| | Sale price | <u>1,600,000</u> |
| | Balancing Allowance | <u>166,400</u> |
| | | |
| **<u>Company H</u>** | | |
| ***<u>Shop 2</u>*:** | **1999/2000** | |
| | Residue before sale | 1,766,400 |
| | Balancing Allowance made to **Company F** | <u>166,400</u> |
| | Residue after sale | 1,600,000 |
| | Annual Allowance 1999/2000 onwards* | 64,000 |

* Calculation of Annual Allowance for **Company H**

- First year of annual allowance to **Company H** 1999/2000
- 25th year after 1998/99 is 2023/24
- Number of years from 1999/2000 to 2023/24 is 25
- Annual Allowance, 1999/2000 onwards :-
  1/25 x $1,600,000 = $64,000
- Final year of allowance for **Company H** 2023/24 (Annual Allowance $64,000)

***Scenario 2***

Following Example 5, assume **Company F** sold ***Shop 2*** to **Company H** for $4,000,000 (excluding the value of the site) on 15 March 2000. **Company H** makes up its accounts to 31st March each year.

| | | $ |
|---|---|---|
| **Company F** | | |
| ***Shop2*:** | **1998/99** | |
| | Residue under s.33A(4) - see Example 5 | 1,840,000 |
| | Annual Allowance | 73,600 |
| | Residue before sale | 1,766,400 |
| | | |
| | **1999/2000** | |
| | Residue before sale | 1,766,400 |
| | Sale price | 4,000,000 |
| | Excess | 2,233,600 |
| | | |
| | Balancing Charge* | 73,600 |

* Balancing Charge made on **Company F** is restricted to Annual Allowance made in the year of assessment 1998/99

| | | |
|---|---|---|
| **Company H** | | |
| ***Shop 2*:** | **1999/2000** | |
| | Residue before sale | 1,766,400 |
| | Balancing Charge made on **Company F** | 73,600 |
| | Residue after sale | 1,840,000 |
| | Annual Allowance**, 1999/2000 onwards - 1/25 x $1,840,000 = $73,600 | 73,600 |

** Final year of allowance for **Company H** 2023/24 (Annual Allowance $73,600)

**Example 8**

Computation of Annual Allowances for Newly Completed Commercial Buildings acquired on or after 1 April 1998.

**Company J** acquired ***Office 3*** from a developer on 1 May 1999 at a price of $20M (including the value of the site). The cost of construction is ascertained to be $6,250,000. **Company J** makes up its accounts to 31st December each year.

| | | $ |
|---|---|---|
| **Company J** | | |
| ***Office 3*:** | **1999/2000 onwards** | |
| | Cost of construction | 6,250,000 |
| | Annual Allowance @ 4% of $6,250,000 | 250,000 |

## Example 9

Computation of Balancing Allowance, Balancing Charge and Annual Allowances for New Commercial Building Disposed/Acquired after 1998/99.

***Scenario 1***

Following Example 8, assume **Company J** sold ***Office 3*** to **Company K** for $4,000,000 (excluding the value of the site) on 2 January 2005. **Company K** makes up its accounts to 31st January each year.

| | | $ |
|---|---|---|
| **Company J** | | |
| ***Office 3*:** | **1999/2000 to 2003/04** | |
| | Cost of construction | 6,250,000 |
| | Annual Allowance - 5 years @ 4% of $6,250,000 | 1,250,000 |
| | | 5,000,000 |
| | | |
| | **2004/2005** | |
| | Residue before sale | 5,000,000 |
| | Sale price | 4,000,000 |
| | Balancing Allowance | 1,000,000 |
| | | |
| **Company K** | | |
| ***Office 3*:** | **2004/2005** | |
| | Residue before sale | 5,000,000 |
| | Balancing Allowance made to **Company J** | 1,000,000 |
| | Residue after sale | 4,000,000 |
| | Annual Allowance 2004/2005 onwards* | 190,477 |

* Calculation of Annual Allowance for **Company K**

- First year of Annual Allowance to **Company K** is 2004/05
- 25th year after 1999/2000 is 2024/25
- Number of years from 2004/05 to 2024/25 is 21
- Annual Allowance, 2004/05 onwards -
  1/21 x 4,000,000 = $190,477
- Final year of allowance for **Company K** 2024/25 (Annual Allowance $190,460)

***Scenario 2***

Following Example 8, assume **Company J** sold ***Office 3*** to **Company K** for $8,000,000 (excluding the value of the site) on 2 January 2005. **Company K** makes up its accounts to 31st January each year.

| | | $ |
|---|---|---|
| **Company J** | | |
| ***Office 3*:** | **1999/2000 to 2003/04** | |
| | Cost of construction | 6,250,000 |
| | Annual Allowance - 5 years @ 4% of $6,250,000 | 1,250,000 |
| | | 5,000,000 |
| | **2004/2005** | |
| | Residue before sale | 5,000,000 |
| | Sale price | 8,000,000 |
| | Excess | 3,000,000 |
| | Balancing Charge* | 1,250,000 |

* Balancing Charge made on **Company J** restricted to Annual Allowances allowed in the years of assessment 1999/2000 to 2003/04)

| | | |
|---|---|---|
| **Company K:** | | |
| ***Office 3*:** | **2004/2005** | |
| | Residue before sale | 5,000,000 |
| | Balancing Charge made on **Company J** | 1,250,000 |
| | Residue after sale | 6,250,000 |
| | Annual Allowance 2004/05 onwards** - 1/21 x $6,250,000 = $297,620 | 297,620 |

** Final year of allowance for **Company K** 2024/25 (Annual Allowance $297,600)