

# HONG KONG TAX ALERT

ISSUE 1 | January 2017



## Proposed New Tax Regime for Aircraft Leasing in Hong Kong

### Summary

- The Hong Kong Government plans to introduce a new set of tax rules for offshore aircraft leasing into the Legislative Council in April 2017.
- The proposed tax regime will deem a taxable profit of 20% of the net rental income. A concessionary tax rate of 8.25% will apply to that income. The tax rate concession will also apply to leasing managers.
- At face value, these proposals should make the Hong Kong tax regime competitive globally.

On 23 January 2017, the Hong Kong Government briefed the Legislative Council Panel on Economic Development about a proposed new tax regime for aircraft leasing in Hong Kong. This is a very welcome development for which the Hong Kong Government should be commended.

### Background

Aircraft financing presents a major opportunity that complements Hong Kong's traditional strengths in the fields of financial and professional services. It's expected that over 6,000 commercial aircraft will be delivered globally over the next 20 years, with a high proportion being delivered to Asia. Hong Kong, with its established business infrastructure, should be a natural venue for aircraft operating lessors. However, the current tax law in Hong Kong is a major impediment, because it taxes the full rental income while denying deductions for aircraft depreciation and certain interest costs. Ironically, Hong Kong has the most competitive withholding tax rate for aircraft leases into China, but other jurisdictions such as Ireland and Singapore are currently much more attractive options overall.

### The proposal

To make Hong Kong more competitive for operating leases, a new set of tax rules for offshore aircraft leasing (i.e., leasing to non-Hong Kong airlines) is being proposed. The main features of the new regime are:

- the tax rate on the profits of "qualifying aircraft lessors" and "qualifying aircraft leasing managers" will be only 8.25% (i.e., one half of the normal Hong Kong Profits Tax rate); and
- this reduced tax rate for lessors will be applied to only 20% of the usual tax base (i.e., gross rentals less deductible expenses, excluding tax depreciation). Implicitly, this suggests a 1.65% tax rate on gross rental income before deductions.

The new regime will contain anti-abuse features including:

- measures to ensure that the concessions will not apply where the rental payments are tax-deductible in Hong Kong to the lessee;
- requiring qualifying aircraft lessors and qualifying aircraft leasing managers to be standalone corporate entities; they must also conduct business transactions with associated parties on an arm's length basis; and
- imposing a substance requirement, by stipulating that the central management and control of these entities, as well as their profit generating activities, must be located in Hong Kong

The Hong Kong Government proposes to introduce the necessary legislation into the Legislative Council in April 2017.

The briefing paper can be found here: <http://www.legco.gov.hk/yr16-17/english/panels/edev/papers/edev20170123cb4-410-8-e.pdf>

### **KPMG comments**

Overall, this is a welcome development. The current tax regime has needlessly impeded the development of the aircraft leasing business in Hong Kong. The proposal to effectively allow tax depreciation through a deemed profit of 20% of the net rental income is a simple solution to what has been a big problem. In addition, the tax rate concession is very attractive to leasing managers. At face value, these proposals should make the Hong Kong tax regime competitive globally, especially if foreign tax credits are allowed for withholding taxes paid outside Hong Kong by lessees.

As always, the "devil is in the detail", particularly around the issue whether the overall economics will make sense compared to operations in Ireland, Singapore and the special free trade zone regimes in Mainland China. Recent experience with enhancements to concessionary regimes such as the expanded offshore funds regime and Corporate Treasury Centres, while good proposals on paper, have proved to be less useful in practice due to the overly complex anti-abuse measures. We would hope that these new leasing proposals will not suffer the same fate.

It will be interesting to see how these new rules will tie with the existing aircraft owning provisions in Sections 23C and 23D of the Hong Kong Inland Revenue Ordinance. There is also an important issue relating to the distinction in the current law between operating leases and hire purchase agreements (i.e., finance leases), especially in light of the impending changes to the accounting rules for lessees in IFRS 16.

All in all, these proposals are a step in the right direction. Along with a continued focus on expanding Hong Kong's double tax treaty network, this proposal has the potential to finally make Hong Kong truly competitive in the global aircraft leasing market.

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