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HONG KONG TAX ALERT

ISSUE 10 | May 2017

Hong Kong government introduces concessionary tax regime for certain aircraft leasing activities

The Hong Kong Government gazetted a bill on 10 March 2017 which introduces a concessionary tax regime for certain aircraft leasing activities. The new rules are expected to apply from the 2017/18 year of assessment.

Summary

- The main benefits of the concessionary tax regime for certain aircraft leasing activities are:
  - Aircraft leasing income earned by "qualifying aircraft lessors" will be taxed at 1.65% of net rental receipts; and
  - a concessional tax rate of 8.25% will apply to "qualifying aircraft leasing management activities".
- Overall, the new regime is a welcome change as Hong Kong should now be economically competitive with other leasing locations such as Ireland and Singapore. This is especially true where the lessee is resident in a jurisdiction with which Hong Kong has a favourable tax treaty such as the PRC, Japan and Russia.

Background

The Hong Kong Government gazetted a bill on 10 March 2017 which introduces a concessionary tax regime for certain aircraft leasing activities. The new rules are expected to apply from the 2017/18 year of assessment. The main benefits of the proposed regime are two-fold.

- Aircraft leasing income earned by "qualifying aircraft lessors" will be taxed at 1.65% of net rental receipts. (This is achieved by applying a tax rate of 8.25% - i.e. one half of the normal Hong Kong profits tax rate - to 20% of the gross rental receipts less deductible expenses such as funding costs, but excluding tax depreciation.)

- A concessional tax rate of 8.25% will apply to "qualifying aircraft leasing management activities". This is widely defined to include, in addition to the standard lease management activities of procuring and leasing aircraft, a range of financing activities such as providing loans to associated companies to acquire aircraft, providing loans to airlines to acquire aircraft from qualifying lessors and providing residual value guarantees.

Draft Legislation

The rules appear to assume a Hong Kong based manager will use a number of Hong Kong incorporated special purpose companies to own and dry lease aircraft to non-Hong Kong based airlines. However, it should be possible for lessors to adopt a more integrated model with aircraft ownership and management in one company. Corporations looking to take advantage of the new regime must take careful note of the qualifying conditions that are imposed.

"Qualifying aircraft lessors" and "qualifying aircraft leasing managers" must be corporations which conduct only qualifying activities, although leasing managers can conduct some non-qualifying activities. This means the new regime will not apply to passenger or cargo airlines.

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Both the lessor and manager must be centrally managed and controlled in Hong Kong, with all profit generating activities conducted in Hong Kong and not attributable to any permanent establishment the company may have outside Hong Kong.

The lessor and manager must specifically elect in writing that the new regime will apply to them.

Lessors

For lessors, the key restrictions are as follows:

- The aircraft must be leased to a "non-Kong Kong operator". This is defined as a non-Hong Kong based airline which is not chargeable to tax in Hong Kong. This restriction means that leases to many major global airlines that fly into and out of Hong Kong will not be entitled to the concessionary tax treatment. This is because airlines flying to Hong Kong are generally subject to Hong Kong tax. However, if a tax treaty applies between Hong Kong and the airline's country of residence, the airline will generally be exempted from tax on its profits from international traffic. (Even where a tax treaty applies, the new regime will not apply if the airlines earns fees from incidental activities such as ground handling or ticketing services conducted in Hong Kong which do not qualify for tax exemption under the relevant treaty. A better approach would be to exclude only aircraft operators who are actually subject to Hong Kong tax on their carriage income.)

- The lease must be a so-called "dry lease". This is defined as a lease for at least one year under which the lessor does not provide the crew and is not responsible for the maintenance of the aircraft. It also does not include leases (or wider arrangements) under which title to the aircraft will or may pass to the lessee. Most dry leases to non-Hong Kong airlines should qualify for the concessionary tax treatment, but the definitions in the draft law are detailed and require careful examination to ensure that a lease qualifies. In particular, the existence of even a market value purchase option would be problematic. Also, a dry lease which is a funding lease, hire purchase agreement or conditional sale agreement is excluded from the new concessionary tax treatment. (A funding lease is defined as a lease which is accounted for as a finance lease by the lessor, or for the substantial part of the economic value or life of the asset; and under which title to the aircraft will or may pass to the lessee.)

- The lease must be carried out in Hong Kong in the ordinary course of the lessor's business.

- The lessor must not carry on any other income producing activity in Hong Kong

The bill also contains a provision that deems an aircraft to be capital in nature if it is held for 3 years as part of a qualifying aircraft leasing business. This means that the lessor will not be taxed in Hong Kong on any gains from the sale of an aircraft that it has leased out for at least 3 years, but nor will it be entitled to a deduction for any loss on resale after this period. At least this provision provides some clarity to the position when an aircraft is sold, but the tax result might be undesirable. For aircraft sold before the 3 year mark, whether the aircraft is a capital or trading asset will depend on the relevant facts and circumstances. That said, it would be safe to assume that the Hong Kong IRD would be reluctant to allow a lessor to claim any loss on disposal.

Managers

There is a safe harbour for a qualifying aircraft leasing manager which allows it to carry on certain non-qualifying activities provided at least 75% of its profits arise from qualifying activities and the value of assets used by the company to carry out qualifying activities are at least 75% of its total assets.

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Anti-avoidance Provisions

As one would expect for any concessionary tax regime, there are a number of anti-abuse and anti-avoidance measures that will apply. The key measures include rules to prevent income subject to the concessionary tax treatment from being claimed by the payor as a tax deduction in Hong Kong. In particular, payments made by a Hong Kong based airline either directly or indirectly will not qualify for the new regime in the lessor's or manager's hands. The bill also requires that any transactions between associated parties are conducted at arm's length.

Comment

Overall, the new regime is a welcome change. Hong Kong's tax laws have to now preclude Hong Kong from being a preferred base for aircraft leasing and management activities. Hong Kong should now be economically competitive with other leasing locations such as Ireland and Singapore. This is especially true where the lessee is resident in a jurisdiction with which Hong Kong has a favourable tax treaty such as the PRC, Japan and Russia. There are some drafting issues which make the proposal less effective than it otherwise could be but, as the bill proceeds through the legislative process, hopefully some of the issues around the complex definition of qualifying leases, the target airline lessors and prescribed management activities will be addressed.

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