



HONG KONG TAX ALERT

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Changes to extend the scope of the proposed aircraft leasing regime

Summary

In the latest Hong Kong Legislative Council (LegCo) Bills Committee meeting, the Hong Kong Government proposed some favourable amendments to the new aircraft leasing regime proposals currently being considered by the committee.

In response to submissions and concerns that the regime may be considered as a harmful tax practice by the OECD, it is now proposed that the scope of the regime should be extended to cover operating leases to all airlines and not just ring fenced to airlines that are not subject to Hong Kong tax.

The draft legislation is expected to be given a second reading on 21 June 2017.

Background

Earlier this month, we issued an alert about the Hong Kong Government's proposal to introduce a concessionary tax regime for aircraft leasing activities (see [Issue 10](#)).

In summary, 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 8.25% tax rate 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.

A Bill to effect these concessions was gazetted on 10 March 2017, and the Bill has since been considered by a Bills Committee in the Legislative Council. In the course of this process, the Government has proposed changes to the Bill which will make the concessions more favourable to aircraft lessors.

Revised approach for target airlines

Most significantly, the requirement of leasing to a "non-Hong Kong aircraft operator" will be dropped. This means that leases to *all* airlines will qualify for the new regime.

The law will now effectively allow Hong Kong leasing companies to elect to:

- Apply the existing Section 23C of the IRO or the proposed Section 15(1)(n) (which taxes all income from aircraft leasing), and claim tax depreciation (however, the ability to claim tax depreciation is restricted by Section 39E of the IRO which denies depreciation where an aircraft is leased to a non-Hong Kong airline), or
- Apply the new regime and be taxed at the initially proposed rate of 1.65% of net rental receipts.

Once made, the election to apply the new concessional regime will be irrevocable.

As a consequence of this change, there has been a number of other amendments, including changes to the anti-round tripping rules which sought to prevent the concessions from applying where a Hong Kong tax deduction was claimed. A new provision will restrict deductions for payments between connected parties to which the tax concession applies.

Other matters

The Government also took the opportunity to comment on matters raised in submissions in earlier Bills Committee meetings. The matters covered included the importance of tax residency certificates and the list of aircraft leasing management activities. The Bills Committee is now aiming to report to the House Committee by 9 June with the aim of a second reading of the Bill on 21 June 2017.

Comment

The reason for these changes is informal feedback from the OECD that the Bill as originally proposed could be seen to constitute a "harmful tax practice" under the OECD's base erosion and profit shifting (BEPS) initiative. Careful efforts were made in the initial drafting to ensure the regime would require there to be real economic substance and activities in Hong Kong in order for the regime to be BEPS compliant. However, there continued to be a concern that the initially proposed concessions were targeted only at leases to foreign airlines which are not taxable in Hong Kong.

When leasing to an offshore airline, a leasing company would almost certainly apply the concessional regime. When leasing to a Hong Kong airline, given the relatively generous tax depreciation rates for aircraft, one would expect a lessor to apply the current regime.

The underlying concern was to make Hong Kong a more attractive base for aircraft leasing and management activities, and this has been achieved. The fact that the new regime will now extend to all aircraft leasing activity is a welcome change.

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