

HONG KONG TAX ALERT

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Tax Alert – IRD issues practice note on taxation of aircraft leasing activities

Summary

On 27 October 2017, the IRD released DIPN 54, which clarifies various tax issues concerning the new concessionary tax regime for aircraft leasing in Hong Kong.

Amongst other things, the DIPN 54 clarifies issues surrounding acceptable aircraft leasing structures, central management and control, use of SPVs, availability of concessions on certain types of leases as well as availability of tax credits.

Background

On 27 October 2017, the IRD released Departmental Interpretation and Practice No. Note 54 – Taxation of Aircraft Leasing Activities ("DIPN 54") (http://www.ird.gov.hk/eng/pdf/e_dipn54.pdf). DIPN 54 clarifies various tax issues concerning the application of the new concessionary tax regime for aircraft leasing which was introduced in July 2017. To recap, the main tax concessions are as follows:

- Aircraft leasing income earned by "qualifying aircraft lessors" is 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.)
- An 8.25% tax rate applies 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.

Additional Guidance

The business of aircraft leasing is complex, so there were a number of matters that required clarification as to how the new tax concession would be applied in practice. DIPN 54 addresses many practical concerns by providing the following guidance.

- Aircraft leasing activities is defined as the leasing of an aircraft by a corporation to an aircraft operator. A particular concern was that the tax

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concession would not apply to structures which interpose an intermediate lessor between the corporation and the aircraft operator. In DIPN 54, the IRD recognizes that commercial practices often involve interposing intermediate entities (whether owned by the lessor or lessee), and helpfully clarifies that these structures may still be eligible for the tax concession. The IRD states that it will consider all the facts and circumstances, including any tax motive surrounding the arrangement, in determining eligibility for the aircraft leasing concessions.

- To be eligible for the concessions, the corporation must have its central management and control ("CMC") in Hong Kong. DIPN 54 clarifies that an aircraft lessor or an aircraft leasing manager will have its CMC in Hong Kong if its executive officers and senior management predominantly exercise day-to-day responsibility for the strategic, financial and operational policy decision-making of the entity in Hong Kong and predominantly conduct the day-to-day activities necessary for making such decisions in Hong Kong.
- Special purpose vehicles ("SPVs") will often be incorporated to own the aircraft that are being leased. These SPVs may not have sufficient transaction history to obtain a Hong Kong Tax Residency Certificate ("TRC"). DIPN 54 provides guidance on the matters the IRD will consider when processing TRC applications for such SPVs. In particular, an applicant should provide supporting documents such as a five-year business plan and details of its expected future Hong Kong profits tax liabilities. The IRD is prepared to consider forecasted data for a SPV when assessing the SPV's eligibility to obtain a TRC. This represents a substantial and welcome deviation from the IRD's current practice.
- Lessors who make aircraft available under a funding lease are not entitled to benefit from the tax concession. This means that leases transferring title or giving an option to acquire the aircraft will not qualify for the concession. However, DIPN 54 clarifies that, where a separate agreement provides a purchase option which merely allows the lessee to acquire the aircraft at its fair market value at the end of the lease, this will be treated as a separate transaction not connected with the lease, thereby allowing the lessor to qualify for the tax concession.
- Amongst other requirements, the aircraft must be owned by the corporation claiming the concession in order to qualify for the concession. In DIPN 54, the IRD recognises that there may be a commercial need to separate legal and economic ownership through interposing an SPV (e.g. to isolate financial risks or to allow for transfer of the aircraft). If properly structured, the IRD may consider that the "ownership" requirement is satisfied.
- Finally, DIPN 54 confirms that tax credits will not be given to aircraft lessors if foreign withholding tax on the aircraft rentals is borne by the lessee.

Comment

The clarifications in DIPN 54 are welcomed. They resolve many uncertainties that were raised by concerned parties. Overall, the regime is a welcome change and represents another step in the Government's efforts to promote Hong Kong as a leading global financial centre. KPMG welcomes these efforts. We hope we will continue to see additional reforms to Hong Kong's tax laws to continue to make Hong Kong an attractive place to establish new businesses.

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