HONG KONG TAX ALERT

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Proposed New Tax Regime for Ship Leasing in Hong Kong

Summary

The Hong Kong Government plans to introduce a new set of tax rules for certain ship leasing activities into the Legislative Council in February 2020.

The tax rate on the profits of qualifying ship lessors will be 0%.

The concessionary tax rate on the profits of qualifying ship leasing managers will be 0% where services are provided to an associate and 8.25% where those services are provided to a non-associate.

The Hong Kong Government gazetted the Inland Revenue (Amendment) (Ship Leasing Concessions) Bill 2020 on 17 January 2020 which formally introduces a concessionary tax regime for certain ship leasing activities. The law is expected to be introduced into the Legislative Council on 12 February 2020 for its consideration and for the most part is expected to apply to income earned from the 1 April 2020. The main features of the proposed regime are:

- Income from ship leasing and managing a ship leasing business carried on from Hong Kong will be deemed taxable. For ship leasing the taxable amount will include interest received under a funding or finance lease.
- The taxable income for qualifying lessors from operating leases will be calculated as 20% of the gross rentals (including sums payable under residual value guarantee) less deductible expenses, excluding tax depreciation.
- The taxable income for qualifying lessors from funding leases will be calculated as gross finance income (i.e. interest) under the lease less deductible expenses.
- The tax rate on the profits of “qualifying ship lessors” will be 0%.
- There is also a concessionary tax rate for “qualifying ship leasing managers” conducting “qualifying ship leasing management activities”. The range of “qualifying ship leasing management activities” is widely defined to include, in addition to the standard lease management activities of procuring and leasing ships, a range of financing activities such as providing loans to associated companies to acquire ships, providing loans to ship operator to acquire a ship from a ship lessor.
- The tax rate on the profits of “qualifying ship leasing managers” will be 0% where services are provided to an associate and 8.25% (i.e. half the normal tax rate) where those services are provided to a non-associate.

Draft legislation

The rules are closely modelled on the aircraft leasing concession although there are important differences in the scope and application of the two regimes. The regime is designed around a Hong Kong based manager using separate Hong Kong incorporated special purpose companies to own and lease ships for use outside Hong Kong waters. While it should be possible for Lessors to adopt a more integrated model with ship ownership and management in one company, it will be important that any corporations looking to take advantage of the new regime take careful note of the qualifying conditions imposed.

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“Qualifying ship lessors” and “qualifying ship leasing managers” as defined in the Bill must be corporations which conduct only qualifying activities, with some non-qualifying activity allowed for leasing managers. This precludes the regime applying to passenger or cargo shipping businesses. For both the manager and lessors they are required to be centrally managed and controlled in Hong Kong with all the profit generating activities conducted in Hong Kong and not attributable to any permanent establishment the company may have outside Hong Kong. They must also make an election in writing to apply the regime.

The proposed legislation also contains a provision that deems a ship to be a capital asset if it is held for 3 years as part of a qualifying ship leasing business. Conceptually, as with the similar rules in the aircraft leasing regime, this is a welcome addition as it provides some clarity to the position when a ship is sold. For a ship sold before the 3-year mark, the position will depend on the relevant facts and circumstances.

There is a safe harbour for qualifying ship leasing managers which allows them 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.

Common with all of Hong Kong’s new concessionary regimes there are several complex anti-abuse and anti-avoidance measures built into the regime. The key measures include rules to:

- require that any transactions between associated parties are conducted at arm’s length;
- require that certain substance “threshold requirements” be met;
- ring fence losses sustained where the qualifying lessor or qualifying lease manager qualify for the 0% tax rate;
- deny the benefit of the relevant concessions where one of the main purposes of an arrangement is to obtain a tax benefit including a benefit under one of Hong Kong’s double tax treaties.

The substance requirement is spelt out in a new schedule to the Inland Revenue Ordinance (“IRO”) and requires that for activities to be carried out or arranged to be carried out in Hong Kong they must meet two conditions requiring an adequate number of employees and adequate operating expenditure.

- for ship leasing activity the number of full-time employees is two and the minimum operating expenditure is HK$7,800,000;
- for ship leasing management activities, the number of full-time employees is at least one and the minimum operating expenditure is HK$1,000,000.

There are also several other consequential amendments to the IRO in relation to capital allowances and deductions.

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KPMG observations

The new regime is a change to Hong Kong tax law in that it now provides a tax concession to ship leasing managers and for finance leasing which has been potentially uncertain if key activities are conducted in Hong Kong. For operating leases, Section 23B of the IRO has for many years been clearly understood to apply to mean that charter hire income arising from the use of ships solely or mainly outside Hong Kong waters was effectively not taxed. Only a relatively recent complete change in IRD assessing practice has created uncertainty in this regard. That said the new regime provides certainty going forward.

Given the relative complexity of the regime and the need for enough substance in Hong Kong companies looking to apply the new regime should review the rules carefully.

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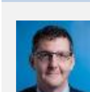

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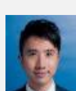

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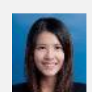

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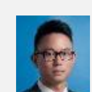

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