HONG KONG TAX ALERT

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Hong Kong launches new Ship Leasing Concession

Summary

The Hong Kong Government has introduced a concession for ship leasing and ship leasing management activities which was gazetted on 19 June.

The new provisions have the potential to provide an important exemption on income from ship leasing activity and a concession on management activities. However, they are very complex and contain a number of potential pitfalls. Taxpayers should review their current mix of business and consider the commercial and tax implications of any potential restructuring to meet the qualification requirements. Taxpayers should also review their operating protocols and Hong Kong presence to ensure that they meet the requirements. Some taxpayers may wish to consider applying for a ruling given the uncertain nature of some of the legislation.

It is said that the road to hell is paved with good intentions, and it can certainly feel that way looking at the stream of tax incentives which have been introduced in Hong Kong in recent years. With increasingly regularity we see a government initiative to bolster some or other section of the economy undermined as the needs of business get overtaken by poor drafting, uncommercial terms and onerous anti-avoidance provisions.

The latest in this succession of incentives is a concession for ship leasing and ship leasing management activities, which was gazetted on 19 June. The key difference between this incentive and the previous ones is that this legislation supersedes a regime that has worked well for many years. Although consultation took place, it did not seem to produce mutual understanding. In the end, the bill was passed without referral to the bills committee and haste at enacting the law appeared to supersede the meeting of industry concerns. While some issues may subsequently be addressed in Inland Revenue Department ("IRD") interpretations, these take time to produce and in any case are not a satisfactory way of drafting law. In the meantime, many in the industry may find themselves navigating their tax positions without a chart or compass.

Good intentions

On the face of it, there is much to welcome in the new rules. These establish:

- A tax exemption for the profits of a ship leasing business conducted in Hong Kong;
- A tax exemption for the profits of a ship leasing management business conducted in Hong Kong where that business in conducted for related parties;
- A reduced tax rate (of 8.25%) for other ship leasing management businesses;
- An exemption from tax on any gains arising on the disposal of ships used in a ship leasing business;
- The inclusion of hire purchase and other leasing arrangements which may result in a transfer of ownership within the exemption. This may create a significant tax advantage for lease purchasing arrangements over conventional bank loans.

As you would expect, each of these incentives is subject to conditions, but other things being equal it is a set of rules which sets up Hong Kong very well against other shipping centres in terms of its taxation rules.

So, what's not to like?

The drafting follows the now familiar route of firstly bringing a fairly broad category of activities into the charge to tax through a deeming provision, and then excluding a subset of activities from tax based on a much more limited definition. In this case, the following activities, where conducted by a Hong Kong business, will now be deemed to have a Hong Kong source:

a. granting a right to use a ship to another person even if the ship is used outside Hong Kong; and

b. the business of managing such a business.

This is a very wide definition and conceivably includes almost any activity to which a ship may be put, provided the activity is managed from Hong Kong; at a stroke, Hong Kong's territorial system has been abolished in relation to the use of ships and all worldwide profits from the use of ships in Hong Kong is potentially brought into the charge to tax.

Fortunately, the situation is not as bad as the language of the deeming provision taken in isolation would suggest. Hong Kong retains two significant shipping concessions that ought to take most ship owners and operators out of the charge to Hong Kong tax – the new rules applying to ship lessors and the old rules (Section 23B) applying to ship owners. The problems arise because the two regimes have been drafted to be mutually exclusive and because the distinction between a business of owning ships and a business of leasing ships is not as clear as the IRD would have us believe – indeed, many would suggest that the former is frequently a necessary factor in enabling the latter.

A problem in definitions

For many years (since its introduction in 1992) it was widely understood that Section 23B, which taxes the profits of a ship-owner carrying on business in Hong Kong, applied to income earnt from the chartering of ships. The section defines "business as an owner of ships" to mean "a business of chartering or operating ships". This view continued to be widely held until the annual meeting between the IRD and the Hong Kong Institute of Certified Public Accountants (HKICPA) in 2016, where the IRD put forward its view that the section could only apply to the operators of shipping, and that "leasing rental derived from a pure ship leasing business carried on in Hong Kong should be chargeable under section 14."

This view was so controversial that the HKIPCA took the unprecedented step of issuing an additional note after the meeting, setting out an alternative view. Nonetheless, the die was cast and the government set about introducing a new law to exempt income everybody had always thought was already exempt. The new rules were drafted around the IRD's dichotomy of "pure leasing" and "operating". In particular, the new rules expressly state that the exemption for ship leasing cannot apply to anyone who is an operator of a ship or who has income arising from any source other than qualifying ship leasing income.

Part of the problem is that the bifurcation of activities is not nearly so clear as the IRD would have us believe. Many ship owners have a fleet of ships that they deploy from time to time in various ways as market conditions dictate; they do not necessarily confine their activities solely to bare-boat charters or solely to voyage charters or the conveyance of goods. Furthermore, there are a large number of arrangements which could be considered to involve both leasing and operating, and a clear definition of the dividing line is therefore critical in understanding the position of individual taxpayers.

The new rules define a lease as being an arrangement under which the right to use a ship is granted by the owner of a ship to another person for a term exceeding one year. This follows the definition in the accounting standards. Therefore, a time charter in excess of a year (including a wet lease) will be a lease, but one for less than a year will not. Both will be deemed Hong Kong sourced by virtue of the deeming provision.

A ship operator is defined to provide "services for the carriage by ships of passengers, cargo or mail". This differs significantly from the definition used in Section 39E, which relates to the person "responsible for defraying all or a substantial portion of the expenses of operating the ship".

This leaves some questions regarding the treatment of wet leases. It is an issue on which the IRD has given conflicting views to date. Are ship operators limited to those who expressly charge for the uplift of passengers, cargo or mail, in which case anyone earning profits from charging time-based charter-hire should not be operating the ship within the meaning of the law? If so, ship owners who currently operate a mix of time charters for more than a year, time charters of less than a year and voyage charters may find themselves excluded from the exemption. Alternatively, is it the case, as the IRD has more recently suggested, that a wet lease goes beyond being a "pure leasing activity" because it involves providing the master and crew. In this case, no wet leasing activity would qualify for the new exemption and it would be necessary to move any ships on bare lease into a separate company.

The IRD's latest responses indicate that "the eligibility for s.23B or the new regime hinges on whether the person is a ship operator carrying out chartering activity incidental to the business of operating ships; or the person is a ship lessor carrying out ship leasing activities solely. This is a question of fact to be considered with regard to all relevant circumstances of each case, including the functions performed and risks assumed by the person. However, the new regime only applies to leases (other than a sublease which is an operating lease) with a term exceeding one year. In order to be eligible to elect for the new regime, a ship owner or ship operator carrying out other businesses may set up a standalone corporation as a special purpose vehicle engaging solely ship leasing activities."

This response overlooks the large number of ship operators for whom chartering is hardly an incidental activity. Urgent clarification on this dividing line is required, although wherever it falls, a number of ship owners will need to restructure their operations (and possibly change their commercial activities) if they are to ensure that their various activities, which are not supposed to be taxed in Hong Kong, are in fact not taxed in Hong Kong.

It is also noted that the interaction of Section 23B and the new deeming rule (section 15(1)(o)) is not expressly stated in law. Whereas section 15(1)(o) deems income from any granting of a right to use a ship anywhere in the world to be Hong Kong sourced, Section 23B sets out a formula for calculating the assessable profits arising to anyone carrying on business as an owner of ship in Hong Kong. This formula has the effect of excluding profits arising from ships navigating in or to international waters. It is clearly possible for a company to be taxable under both sections, and while Section 23B as the more specific provision ought to take priority, it would have been helpful for this to be made clearer.

Further requirements

The new rules also contain a number of other requirements that do not apply to shipping businesses operating under Section 23B. In particular, the exemption will only apply to businesses carried on in Hong Kong. This will require the core income generating activities to take place in Hong Kong, as well as at least two employees and minimum annual operating expenses (which the IRD has initially indicated may include interest charges) or at least HKD 7.8 million. Ship leasing management is subject to lower thresholds of one employee and HKD 1 million of expenditure. In response to feedback from the OECD, it has left to the discretion of the assessor whether these minimum thresholds are adequate to qualify the business concerned. This is an area that would benefit from further guidance. In any event, companies falling within the new regime will need to review their operating procedures to ensure that they have appropriate presence in Hong Kong.

The clear exemption from tax on disposals of ships held for 3 years or more and used in the leasing business is welcomed. However, its technical extent is limited to where it has been used in a qualifying leasing business continuously for three years immediately prior to disposal, so care must be taken over any periods of non-use, or where the lease comes to an end some time before the disposal can take place. The provisions contain various anti-avoidance clauses, including targeted rules around losses and capital allowance, rules relating to arm's length pricing and a general rule allowing the rules to be set aside where tax avoidance is the sole or main purpose for entering into an arrangement.

Conclusion

The new provisions have the potential to provide an important exemption on income from ship leasing activity and a concession on management activities. However, they are very complex and contain a number of potential pitfalls. Taxpayers should review their current mix of business and consider the commercial and tax implications of any potential restructuring to meet the qualification requirements. They should also review their operating protocols and Hong Kong presence to ensure that they meet the requirements. Some taxpayers may wish to consider applying for a ruling given the uncertain nature of some of the legislation.

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