KPMG

HONG KONG TAX ALERT

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The IRD issues guidance on ship leasing tax concessions

Summary

The IRD has released Departmental Interpretation and Practice Note 62 (DIPN 62), setting out its views on the implementation of the ship leasing and ship leasing management concessions introduced in the Inland Revenue (Amendment) (Ship Leasing Tax Concessions) Ordinance 2020, which was enacted in June of this year.

Overview

We have previously set out some commentary on the basic features of the concessions and elaborated on some concerns raised by the new legislation when it was passed (see Hong Kong Tax Alert Issue 12). This tax alert will focus on the additional guidance issued by the IRD in the DIPN and comment on the extent to which it addresses the concerns raised previously.

What is a lease and what is a ship operator?

One of the biggest concerns raised in our previous tax alert was that the envisaged segregation of the activities of ship owners into "pure leasing" and "ship operating" is not as clear as the IRD would have us believe. Many ship owners engage in a range of activities, seeking to maximise the return on their vessels in whatever ways they can, according to the nature of the market at different points in time. The nature of the market in recent years has tended to require greater flexibility on the part of ship owners to consider short term charters or taking on greater operational risk.

Against this kaleidoscope of activities, the legislation sought to impose an all-or-nothing test, posing problems for more complex businesses. Unfortunately, the DIPN largely does not address these concerns. The DIPN reiterates that ship operators are not eligible for the exemption and that to be eligible a lessor must be acting as a standalone corporation engaging solely in ship leasing activities. It makes clear that the provisions can apply to both wet and dry leases.

Although not addressed in the DIPN, the IRD has indicated in correspondence with concerned parties that some leasing arrangements may continue to fall within section 23B. In particular, the IRD has stated that where a ship operator generates income from leasing a ship on a voyage charter or a time charter fully equipped, crewed and supplied, this will be treated as income of the ship operator's ship operations. They have also stated that income from bare boat charters which are an incidental or ancillary activity of the ship operator may also continue to be assessed in accordance with section 23B.

The test set out in the IRD's correspondence is not straightforward and leaves room for interpretation. Nevertheless, it does appear that the IRD has accepted that there is a need for flexibility in the application of the two sets of rules in order to avoid the situation where a taxpayer ends up paying tax despite conducting business which is supposed to fall entirely outside the tax net. The exact application of the rules and how best to apply them is likely to vary from business to business, and ship owners should pay careful attention to this. It may be that the best way to obtain certainty is to apply for a ruling.

It is disappointing that the IRD's wider comments on the distinction between operators and lessors did not make it into the DIPN. It is an important distinction for taxpayers to understand and one that the IRD is aware has caused concern. For Hong Kong to maintain its position as an international business hub, and for tax concessions designed to assist in that to be successful, it is vital that the IRD's interpretations are made available publicly to all so that investors can have a clear understanding of their position.

The IRD also reiterates the position, which is clear in the legislation, that to be a qualifying lease the term must exceed one year, unless it is a sublease. A ship owner engaging purely in a charter hire business would need to be careful that they did not lease ships out for periods of less than a year if they did not want to crash out of the regime. The IRD's solution appears to be to set up subleases, although clearly there would be commercial considerations to this.

In paragraph 7, the IRD has stated that qualifying profits would include income incidental to profits from a ship leasing business, like interest income, exchange gains or hedging gains, as long as the transactions are ancillary to the qualifying activities. This appears to be a concession as the legislation does not contain any mention of incidental profits, leaving the risk that a small amount of bank interest could have prevented the lessor from qualifying for the reduced tax rate. As such the comments are welcome.

Substance requirements

It is a condition of the concession that central management and control be exercised in Hong Kong. The DIPN gives the IRD's view of what this means, which stresses the role of day-to-day work by the directors in Hong Kong. Given the wider substance requirements, it is not clear why this should be an area of focus, and the IRD's comments seem to go beyond what is often considered necessary for demonstrating a place of effective management.

From a practical perspective, the IRD's comments show the importance of ensuring that the directors are competent to perform their role, that they are provided with the relevant information to make their decisions and are seen actively to investigate whether proposals are in the best interests of the company, and that board meetings are properly held and minuted.

Anyone claiming the concession is required to have substance in Hong Kong. This consists of at least two full-time employees in Hong Kong with appropriate qualifications (one employee for ship leasing management) and at least $7.8 million of operating expenditure in Hong Kong ($1.0 million for ship leasing management). In addition, the number of employees and the amount of the expenditure must be adequate in the opinion of the assessor and they must undertake the business's core income generating activities (CIGAs) in Hong Kong.

The CIGAs are defined to align with the definition of a ship leasing activity in schedule 17FA. These are: agreeing funding terms, identifying or acquiring ships to be leased, setting the lease terms and duration, monitoring or revising any funding agreements and managing any risks associated with leases

The IRD helpfully notes that a wide range of expenditure will be regarded as operating expenditure including staff costs, rental and admin costs. It also includes any finance costs directly related to the acquisition of a ship for use in the leasing business. Importantly, provided the loan is taken out for the purpose of acquiring a ship for use in a Hong Kong ship leasing business, the IRD will accept that it is incurred in Hong Kong even if it is borrowed from an overseas financial institution. The DIPN does not discuss the case where the money is borrowed from someone other than a financial institution, for example a related party, although logically the same test should apply.

The IRD has said that it will not allow depreciation on the vessel to be included as operating expenditure on the basis the ship is used for earning lease payments but not for carrying out CIGAs. It is a little hard to follow the logic here, given that they have accepted that interest payments on loans taken out to acquire the vessel can be included. Nevertheless, it is unlikely many lessors will need to rely on depreciation to meet the threshold, provided they have incurred sufficient interest expense.

The IRD does not go into detail about what qualifications it would regard as appropriate for employees of a ship leasing business, but notes they would be expected to include the leasing manager, marketing manager, legal counsel, financial controller and credit risk analyst. The test to be applied is based on average employees over a year– this should be given attention as it is possible that any enterprise operating on the minimum number of employees could crash out of the regime if it has a vacancy for any period of time after an employee leaves.

The comments on the adequacy test are concerning. The Commissioner will just each case on its facts and circumstances taking into account a range of factors and would deny any tax benefit that seems disproportionately large relative to the number of employees employed and the amount of operating expenditure incurred in Hong Kong. It goes on to give an example in which there are two ship leasing companies engaged in a similar business. One makes a larger profit, has lower operating expenses and employees fewer employees than the other. Based on this comparison, the IRD's view is that the more profitable company has prima facie failed the adequacy test and would be denied the concession unless sufficient evidence could be produced that CIGAs were being carried out in Hong Kong.

The example as set out suggests that running an efficient business is seen by the IRD as a risk factor. We do not know why one business is more profitable than another – it may have fewer employees because it makes better use of technology or it may make more profit because it is better at adapting to customer requirements. Given the international nature of shipping, it is unlikely that many businesses can be entirely conducted within Hong Kong, especially where they involve the provision of crew or the undertaking of port agency services. A working assumption that making too much profit is in itself problematic risks making the incentive unattractive to investors.

The DIPN confirms that outsourcing of CIGAs to an associated person in Hong Kong is allowed provided that an arm's length fee is charged and appropriate monitoring is undertaken by the SPV. In this case the number of employees employed by and the service fee paid to the associated person can be taken into account in determining whether the substantial activities requirement is met. The wording of the relevant section does not make it clear whether the total number of employees and expenditure is to be determined on a per-SPV basis or on a group basis. Provided the SPV is incurring interest on the acquisition of the ship, in most cases it will be a moot point as far as the expenditure is concerned. From any commercial perspective, the number of employees adequate to run a business is more closely related to the number of vessels operated than the number of SPVs that may hold them, and in the case of a long term bare-boat charter business would clearly be substantially less than two per vessel. Concerned taxpayers may wish to consider obtaining a ruling.

BEPS 2.0

The potentially fleeting nature of the exemption from tax on ship leasing activities is set out plainly in paragraph 27 et seq of the DIPN. Here, the IRD notes that the introduction of a minimum tax rate under BEPS 2.0 may mean that the 0% tax rate is unsustainable and may rise. Investors should factor this in to their projected returns.

While a fairly detailed blueprint for the minimum tax proposals under pillar two of BEPS 2.0 has been produced by the OECD, there are still many details to be finalised, not least the minimum tax rate itself. Discussion is still ongoing as to whether the shipping industry may be exempted from the minimum tax rules and if so what the scope of that exemption would be. Further, not all taxpayers and holding structures would necessarily be directly affected by the new rules.

However, the legislation and the DIPN both clearly lay the groundwork for the tax rate to increase, and have set out rules for the calculation of a tax base should it become relevant. Of particular interest here is the 20% concession on the tax base for lessors under an operating lease. It is explained as a substitute for deprecation allowances, which lessors of ships operating outside Hong Kong are not allowed to claim under section 39E. The minimum tax rules are likely to make some adjustment to exclude some or all of the effect of accelerated capital allowances from the calculation of the effective tax rate, as this is a common adjustment in most jurisdictions. Again, the details have not yet been finalised, but there is a risk that by disallowing deprecation and instead allowing a notional deduction against income the Hong Kong rules will not fall within the scope of the accepted adjustments to ETR. In this regard, the leasing regimes of other significant centres may more closely align with the BEPS model.

In the context of BEPS more widely, we also note that the DIPN spends a lot of time discussing various anti-avoidance provisions. While Hong Kong of course needs to be mindful of being seen to help profit shifting, the ship leasing rules have been reviewed by the OECD and it is important to remember that the purpose of the incentive is to encourage the ship leasing business in Hong Kong.

KPMG Observations

The IRD has provided a number of helpful clarifications on their interpretation of the legislation, although a number of uncertainties remain. Given the complexity of the arrangements and the IRD's form on applying concessionary rates, taxpayers should review their business models to ensure compliance and may be well advised to seek a ruling to ensure their proposals are in line with the IRD's view.

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