KPMG

HONG KONG TAX ALERT

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The IRD issues new guidance on the taxation of ship operators

Summary

The Inland Revenue Department has published new guidance on the taxation of ship operators. The guidance is of particular relevance to ship owners engaged in chartering operations who have historically been assessed to tax under section 23B of the Inland Revenue Ordinance.

Overview

Historically, most ship lessors have filed returns on the basis that charter hire income from ships used outside local waters are exempt from tax under section 23B. In recent years the IRD has challenged this position, claiming that the exemption only applies to ship operators. Last year, new legislation was introduced providing a specific exemption for ship leasing, but the exemption specifically excluded ship operators or others with income from activities other than ship leasing. As a result, although both the operation and leasing of ships used outside local waters was supposed to be exempt from tax, a risk arose that businesses with mixed operational and leasing income might end up being taxed. A fuller background is provided in our previous tax alerts (see Hong Kong Tax Alert Issue 12 and Hong Kong Tax Alert 17).

Meaning of "ship operator"

Since the introduction of the new ship leasing rules, the IRD has provided various pieces of guidance on the interpretation of the new rules. These include DIPN 62, a collation of FAQs on the taxation of ship operation activities and the new guidance on what you need to know as a ship operator.

The latest guidance draws on the definition of a ship operator from the new leasing rules (section 14O) and states that "in essence, a ship operator provides services for the carriage by sea of passengers and/or goods." It is worth noting that the legislation makes it clear that this definition only applies for the purposes of the ship leasing rules, and indeed, it does not align particularly well with section 23B, which expressly also includes income from dredging, towing and chartering operations within its remit. The guidance addresses this by adding that an operator's activities include "any chartering activities incidental or ancillary to the ship operation business, towage and dredging operations."

The guidance specifically addresses the three main types of charterparty:

- Voyage charterparties, where the owner will normally be operating the ship
- Bareboat charterparties, where the owner will normally not be a ship operator unless the activity is incidental or ancillary to its ship operation business
- Time charterparties, where the owner may be a ship lessor carrying out pure leasing activities or a ship operator carrying out time chartering activities in the course of its ship operation business or a ship operator carrying out time chartering activities which are incidental or ancillary to is ship operation business.

The first two positions are to be expected, although as we have previously noted there is no clear basis for attempting to impose the new definition of "ship operator" onto section 23B. Even if it is accepted that a company needs to be a ship operator in order for section 23B to apply, there is a separate definition in that section which is much wider and "includes the use or possession of a ship". The words "incidental or ancillary" are not taken from the legislation – the IRD considers them to be activities that make a relatively minor contribution to the business compared to the carriage of goods or passengers and are so closely related that they should not be regarded as a separate business.

The third definition gets to the crux of the difficulty with the new legislation. The comments imply that engaging in time charters would not in itself cause a ship owner to be a ship operator and may constitute pure leasing activity. In assessing whether a person is a ship operator the IRD places emphasis on there being a contact of affreightment, which may be contained in a charterparty or evidenced by way of a bill of lading. Although the IRD will also consider whether a person employs or engages captain and crew, defrays operating expenses and uses comparable assets, the IRD has not gone as far as to say that these typical features of a time charter are enough for the owner to be the operator. Indeed, it appears that they may place greater emphasis on whether the person is privy to a contract of affreightment and the different risk and return profile of a lessor to a person directly exploiting the earning capacity of the ship.

In many cases, the determination of whether someone is an operator or not may have little practical impact on the amount of tax payable – if they are an operator then they should be exempt under section 23B, if not then the prohibition on operators making use of the new leasing exemption should not apply. However, it is worth noting that an election has to be made in order for the new leasing exemption to apply, so a taxpayer who assumes section 23B continues to apply and is then challenged may find it difficult to amend their position.

It is also worth noting that as well as specifically excluding ship operators, the new ship leasing exemption also prevents a lessor from having any other taxable income (the IRD does not seem to be instituting an "incidental or ancillary" test for this). So, there may still be occasions on which the IRD refuses to accept that a person is a ship operator but where the person still falls outside the leasing exemption. The most obvious example is leases of less than one year.

While the IRD's comments will be of help to some businesses and help to narrow down the areas of uncertainty, there will still be many shipping businesses whose operations are too complex to fall neatly into the silos envisaged by the legislation. Such organizations may be well advised to seek a ruling.

Bareboat charter hire

The IRD explicitly states that "there is no distinction between charter hire attributable to a time charterparty and charter hire attributable to a bareboat charterparty" for the purposes of determining relevant sums. This may be of relevance to anyone currently subject to IRD queries on whether their charter arrangements qualify for section 23B. It appears that the IRD accepts that all charter hire income can qualify as relevant sums and their position rests entirely on whether a person needs to be a ship operator to fall within section 23B at all.

Substantial activities requirements

The IRD's guidance also provides comments on the degree of substance required to be able to exempt "exempt sums" from otherwise taxable shipping income under section 23B(4AA). This section requires that the activities that produce "exempt sums" must be carried out, or arranged to be carried out, in Hong Kong. The IRD interprets this to mean that the operator must have an adequate number of qualified full-time employees in Hong Kong and incur an adequate amount of operating expenditure to carry out the activities in Hong Kong. No further guidance as to what would be adequate is provided.

"Exempt sums" refers to an exemption that applies to income that would otherwise be taxable in Hong Kong that arises from relevant carriage or towage operations in Hong Kong waters and proceeding to see. It can apply in two situations:

1. Where the relevant operations are undertaken by a Hong Kong registered ship;
2. Where the relevant operations are undertaken by an operator who is resident in a jurisdiction which provides a similar exemption to Hong Kong ship operators.

While there may be a case for requiring substance in the first of these cases, the whole point of the second exemption is a recognition that shipping is by its nature international and there is little to be gained from the complexity of trying to tax a ship operator in every port they visit. The idiosyncrasies of international shipping were recognized by the OECD in its BEPS 2.0 blueprints, noting the widespread nature of alternative shipping taxes. It is precisely because shipping is international in nature that there is broad consensus on limiting the amount of tax that ship operators have to pay outside their jurisdiction of residence – this should not depend on their maintaining significant substance in every port they visit.

The IRD's summary of the legislation in this regard is accurate, although it should be noted that section 23B contains two routes by which the reciprocal exemption can be claimed – as well as falling under "exempt sums", a reciprocal exemption is also set out in section 23B(4A), which is not subject to the substance requirement in section 23B(4AA). It would be helpful if the IRD could clarify this point in their comments so that overseas ships arriving in Hong Kong can be clear that they do not need substance here in order to avail of reciprocal status.

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