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10 May 2017

Mr Daniel Sin
Clerk to Bills Committee
The Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong
[By Fax: 3151 7052]

Dear Mr Sin,

**Inland Revenue (Amendment) (No.2) Bill 2017**
**List of follow-up actions arising from the discussion at the meeting on 26 April 2017**

I refer to your emails dated 26 and 27 April 2017.

The Administration's responses to the views expressed by deputations in the written submissions and in the meeting held on 26 April 2017 are set out at **Annex**.

Yours sincerely,

( Ms Candy Nip )
for Secretary for Transport and Housing

Enc
c.c. Financial Services and the Treasury Bureau (Attn: Mr Paul Wong)
Inland Revenue Department (Attn: Mr KK Chiu)
Department of Justice (Attn: Mr Henry Chan)
Legal Services Division, Legislative Council Secretariat (Attn: Ms Vanessa Cheng)

**Annex**

## The Administration's responses to the views of deputations

| Organisation | The Deputations' Views | The Administration's Responses |
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| General comments | | |
| Cathay Pacific Airways Limited,<br>Hong Kong Dragon Airlines Limited and<br>Allen & Overy LLP | The proposed tax regime appears to be well focused with the objective of attracting the aircraft leasing sector. Adoption of the Bill would be a positive development for Hong Kong. | The support is welcomed. |
| Hong Kong Aircraft Leasing and Aviation Finance Association and PricewaterhouseCoopers Limited ("PwC") | The new tax regime will make it possible for aircraft leasing companies to incorporate and set up their operation base in Hong Kong. It is a key step in the right direction for the development of an aircraft leasing industry in Hong Kong. It is however important for the Hong Kong Government to continue to give its support to the aircraft leasing industry in the future, and in particular, expand Hong Kong's tax treaty network with other countries around the world.<br><br>The Hong Kong Government should ensure that any withholding tax imposed by the tax treaty partners on lease rentals for equipment is reduced to "nil" or "the lowest rate possible" in order to further develop asset finance and leasing business in Hong Kong. | The support is welcomed.<br><br>The Administration will continue its efforts in expanding Hong Kong's tax treaty network and take into account the needs of the aircraft leasing sector when negotiating the terms of tax treaties. |

**The Administration's responses to the views of deputations**

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| Hong Kong Airlines Limited | The Government's initiative to promote aircraft leasing business in Hong Kong is supported. A prosperous aircraft leasing industry in Hong Kong will draw aviation talents to the city from around the globe, further consolidating Hong Kong as one of the largest international aviation hubs in the region. | The support is welcomed. |
| Hong Kong Exchanges and Clearing Limited ("HKEX") | HKEX supports the aircraft leasing tax amendments as an initiative to build Hong Kong as a global aircraft leasing centre. | The support is welcomed. |
| PwC | As special purpose vehicles ("SPVs") are normally being used for aircraft leasing, confirmation from the Inland Revenue Department ("IRD") that it will adopt a wider approach in practice to determine whether the SPVs are considered to be "centrally managed and controlled" and performing "profits generating activities" in Hong Kong is needed. We believe that the aircraft leasing industry would welcome some practical guidance from the IRD on this aspect. | The IRD would adopt a realistic approach in determining whether an aircraft lessor has satisfied the "central management and control" ("CMC") and "substantial activity" requirements after having had regard to the facts of the case. For example, the IRD would take into account, inter alia, whether the SPVs have substantial connections with a qualifying aircraft leasing manager in Hong Kong. That is, the SPVs are actually managed and controlled in Hong Kong. The IRD would provide guidance on this topic in a new Departmental Interpretation and Practice Notes ("DIPN"). |

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| PwC | The requirement of a certificate of resident ("COR") of a lessor is normally a condition precedent under a leasing transaction. The aircraft leasing industry would welcome some practical guidance from the IRD to apply for a COR and to allow an aircraft lessor to obtain a COR in a timely and efficient manner. | The IRD would provide guidance on the issue of COR in the DIPN and review its procedures to ensure that COR would be issued in a timely manner. |
| Section 14G | | |
| Deloitte Advisory (Hong Kong) Limited ("Deloitte"), Hong Kong Institute of Certified Public Accountants ("HKICPA"), The Taxation Institute of Hong Kong ("TIHK"), PwC, Baker & McKenzie ("Baker") and The Association of Chartered Certified Accountants ("ACCA") | The Bill has defined a non-Hong Kong aircraft operator as one "who is not chargeable to profits tax under the Inland Revenue Ordinance". This would mean that any aircraft operator whose aircraft lands in Hong Kong would likely not be considered a non-Hong Kong aircraft operator. It would seem to be contrary to the intention of the Bill.<br><br>While under the terms of Hong Kong's double taxation agreements ("DTAs"), in practice, non-resident operators may not be taxable in Hong Kong, the question of whether a person is chargeable to tax in Hong Kong should look first to the domestic legislation rather than to DTAs, which do not provide for chargeability as such, but instead allocate taxing rights between jurisdictions. In any event, it is possible that such airlines may have other activities in | Hong Kong has arrangements (including DTAs and Air Services/Shipping Income Agreements) with around 58 jurisdictions under which enterprises resident in these jurisdictions would not be charged to profits tax even if their aircraft land in Hong Kong. The DTAs have been given effect under our domestic legislation by virtue of section 49 of the IRO. If a non-resident aircraft operator is not charged to profits tax under a DTA, it would be regarded as a "non-Hong Kong aircraft operator" under the proposed tax regime. The Administration would continue to expand the tax treaty network so as to cover more non-resident aircraft operators in the future.<br><br>Income derived by aircraft operators resident in a treaty partner's jurisdiction from the sale of tickets and the provision of services incidental to the operation of |

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| | Hong Kong, such as ground handling or ticketing, for which they earn fee income that would not qualify for exemption under a DTA. A better approach may be to clarify through the definition that a non-Hong Kong aircraft operator is an aircraft operator which is not actually subject to profits tax on relevant carriage shipped in Hong Kong.<br><br>It would be preferable to explicitly specify in the proposed legislation that the condition of "not chargeable to profits tax under the Ordinance" would be satisfied where profits tax are subsequently exempted under any applicable DTAs.<br><br>It would be useful for the IRD to provide practical guidance on the interaction of section 23D(1) of the Inland Revenue Ordinance ("IRO") and the DTAs concluded by Hong Kong. | aircraft in international traffic would not be charged to profits tax in Hong Kong since such income forms part of the profits from the operation of aircraft in international traffic. The proposed tax regime should be able to cover those non-local airlines with income derived in Hong Kong which is incidental to the operation of their aircraft.<br><br>The IRD would elaborate the interaction between section 23D(1) of the IRO and DTAs in the DIPN. |
| Deloitte, HKICPA, TIHK and Baker | The definition of "lease" in section 14G(1) excludes finance leases (referred to by the Bill as "funding leases"). It would constrain the commercial terms on which aircraft leases may be entered into. If a finance lease contains an option to buy the aircraft, the application of the provisions of the Bill would be | A qualifying aircraft lessor may acquire an aircraft via a funding lease, a hire-purchase agreement or a conditional sale agreement. In short, a funding lease is similar to a finance lease, a hire-purchase agreement involves a bailment and a conditional sale agreement involves a retention of title. In order to accommodate |

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| | subject to the discretion of the IRD, which creates subjectivity and uncertainty and ultimately may require an advance ruling to be obtained.<br><br>A funding lease is defined to include leases that have the features of a finance lease and under which ownership will or may pass at the end of the lease. Given that the existing definition of a hire-purchase agreement already covers leases under which ownership will or may pass, and such agreements are already excluded from the definition of a lease in the proposed section 14G, the stipulation that a dry lease does not include a funding lease seems to impose an unnecessary further restriction.<br><br>As finance lease arrangements or hire-purchase agreements are not uncommon in the aircraft leasing and financing industry, TIHK would like to urge the government to consider expanding the scope of the concessionary tax regime to cover finance lease arrangements or hire-purchase agreements as both the tax regimes in Ireland and Singapore do not differentiate between operating leases and finance leases. | different forms of structure commonly used in the aviation finance industry, the word "own" is defined in the new section 14G(1) as including all these three concepts. Therefore, a qualifying aircraft lessor holding an aircraft as a lessee under a funding lease, as a bailee under a hire-purchase agreement or as a buyer under a conditional sale agreement will be regarded as the owner of the aircraft. Under the definition, if a qualifying aircraft lessor leases an aircraft to a non-Hong Kong aircraft operator under a funding lease, a hire-purchase agreement or conditional sale agreement, the qualifying aircraft lessor should no longer be regarded as the owner of the aircraft. Instead, the non-Hong Kong aircraft operator becomes the owner. The lease transaction is not a qualifying aircraft leasing activity as defined under the new section 14G(6) which stipulates that the aircraft must be owned by the qualifying aircraft lessor. The ownership requirement is necessary so as to ensure the compliance with the latest international standards to combat base erosion and profit shifting ("BEPS"). The qualifying aircraft lessor is expected to have substantial activities in Hong Kong, performing the relevant functions, using the relevant assets and assuming the relevant risks associated with the |

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| | | ownership of the aircraft.<br><br>In fact, most of the aircraft lessors' leasing transactions with aircraft operators are operating leases. The Bill should be able to achieve the policy objective of fostering the aircraft leasing sector in Hong Kong. |
| HKICPA | The requirement that, in many cases, the lease, or any arrangement or agreement in connection with it, cannot provide that the ownership of the aircraft will or may pass to the lessee at the end of the lease seems unduly restrictive. While it would seem to be possible to request a ruling from the Commissioner of Inland Revenue ("the Commissioner") that this will not apply in a particular case, pursuant to the proposed new section 14G(5), on the basis that the Commissioner considers it unlikely that ownership will pass to the lessee, this creates an additional administrative burden on the taxpayer and uncertainty in the application of the provisions. | Under a funding lease, the legal title of the aircraft would normally pass to the lessee at the end of the lease term. Thus, a funding lease with a passage of the title would not be eligible for the proposed tax concessions.<br><br>The new section 14G(5) provides that funding leases, hire-purchase agreements or conditional sale agreements would qualify as leases if, in the opinion of the Commissioner, the property in the aircraft concerned would reasonably be expected not to pass to the lessee, bailee or buyer (as the case may be). This should provide a certain degree of flexibility for the aircraft leasing industry. |
| TIHK | A qualifying aircraft lessor may enter into an operating lease of an aircraft with a non-Hong Kong aircraft operator for part of a year. However, as a means of | As explained above, a qualifying aircraft lessor who has disposed of an aircraft by means of a funding lease or a hire-purchase agreement would not be regarded as |

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| | disposing the aircraft, such qualifying aircraft lessor may then within the same year enter into a finance lease or hire-purchase agreement in respect of the same aircraft with a third party. TIHK considers that there should be provisions in the proposed legislation to cater for such situation so that the qualifying aircraft lessor would continue to enjoy the proposed tax concessions for the first part of the year during which the operating lease is in force. For the avoidance of doubt, the definition of "qualifying aircraft leasing activity" may also explicitly include the disposal of an aircraft by way of outright sale or entering into a finance lease or hire-purchase agreement. | the owner of the aircraft. The lessor should not be entitled to the proposed tax concessions in respect of such activities.<br><br>The Bill was designed to provide tax concessions for aircraft lessors rather than aircraft dealers. In their normal course of business, aircraft lessors would enter into operating leases for a fixed term of around 5 years in respect of their aircraft. The scenario mentioned by TIHK should be rare. |
| Berwin Leighton Paisner ("BLP"), PwC and ACCA | Pursuant to section 14G(6)(b), an aircraft leasing activity carried out by a corporation in respect of an aircraft will be regarded as a qualifying aircraft leasing activity if, inter alia, the aircraft is owned by the corporation, and is leased to a non-Hong Kong aircraft operator, when the activity is carried out. Intermediate lessors, who may not be aircraft operators, may be interposed between the corporation and the non-Hong Kong aircraft operator for various reasons. So long as the ultimate operator of the aircraft is a non-Hong Kong aircraft operator, the | IRD would carefully examine the facts of each case so as to ascertain if the lease transaction involved is the one intended to be eligible for the proposed tax concessions. In the absence of any tax avoidance arrangement, IRD may consider allowing a qualifying aircraft lessor to enjoy the proposed tax concessions if, for example, it leases an aircraft to a non-Hong Kong aircraft operator indirectly via a wholly owned SPV within the same group to which the non-Hong Kong aircraft operator belongs. IRD would provide guidance in the DIPN. |

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| | condition set out in section 14G(6)(b) shall be deemed to be satisfied. | |
| Sections 14H and 14J | | |
| PwC | There may be other "income" or "expenses" generated in an aircraft leasing and aircraft leasing management businesses including interest income, gains and losses arising from interest rate and foreign exchange swaps, termination payments, commissions, etc. PwC would like the IRD to clarify such incidental income or expenses arising from activities other than leasing should also fall under the proposed tax regime provided that they are part and parcel of the qualifying activities carried out by the aircraft lessors or aircraft leasing managers. | If such incidental income or expenses are generated from activities that are part and parcel of the qualifying activities carried out by qualifying aircraft lessors or qualifying aircraft leasing managers, the IRD would allow such income to be included in the qualifying profits eligible for the half rate concession under the proposed tax regime. The IRD would provide more guidance in the DIPN. |
| Deloitte, TIHK and Baker | Not all aircraft leasing vehicles are SPVs holding single aircraft; aircraft lessors that do not require bank financing may be set up with multiple aircraft in a large company. In these cases, requiring the lessor to be tax resident in Hong Kong means that a lessor with substantial substance in Hong Kong, but perhaps with greater substance and tax residency elsewhere, would not be able to benefit from the provisions of the Bill without creating a new Hong Kong tax resident entity | The Bill was introduced with the intention of attracting lessors to set up their business in Hong Kong and developing Hong Kong into an aircraft leasing hub. This CMC requirement makes sure that the proposed tax concessions only apply to companies with operations domiciled in Hong Kong. Such a preferential regime should comply with the substance requirement. Profits would not be shifted to Hong Kong for tax avoidance purposes. |

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| | and transferring planes to that entity. It also likely is unnecessary, given that the operational activity pertaining to leasing the aircraft must be undertaken from Hong Kong. As an alternative, this requirement could be replaced or supplemented with a minimum Hong Kong spending requirement, or a substance requirement.<br><br>The proposed legislation may need to explicitly allow for taxpayers to qualify for the concessionary tax regime for part of the year if the taxpayers' CMC is exercised in Hong Kong during part of the year.<br><br>It is proposed to have a grace period for aircraft leasing platforms newly set up in Hong Kong which may not have central management and control in Hong Kong during the early years. | In addition, this CMC requirement will enable a qualifying aircraft lessor to make use of Hong Kong's tax treaty network. Generally, the tax authority of a tax treaty partner would only agree to grant treaty benefits to an aircraft lessor in Hong Kong if the lessor is centrally managed and controlled in Hong Kong (i.e. a tax resident in Hong Kong).<br><br>Taking note that different companies may have different business models, the IRD will consider all the relevant facts and circumstances, including whether there is a concrete plan to set up a genuine aircraft leasing business in Hong Kong when determining whether the CMC requirement is satisfied, especially in the early years of operation. |
| HKICPA | The anti-avoidance provision requiring the aircraft leasing manager to be centrally managed and controlled in Hong Kong to qualify for the tax concession would appear to discriminate against non-resident companies operating in Hong Kong. Therefore, it may be inconsistent with the non-discrimination articles in Hong Kong's | The non-discrimination article under Hong Kong's DTAs prohibits discrimination based on nationality and requires that all other relevant factors, including the residence of the entity, be the same. Irrespective of the place of incorporation, qualifying aircraft lessors and qualifying aircraft leasing managers whose CMC is located in Hong Kong and thus are tax residents in |

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| | comprehensive DTAs with other jurisdictions. | Hong Kong are eligible for the proposed tax concessions. There is no discrimination against overseas incorporated lessors and managers. The CMC requirement does not breach the non-discrimination article as non-resident lessors and managers are not in the same circumstances. |
| Deloitte | The Bill provides that if an aircraft is continuously leased for a period of three years, it will be considered a capital asset, such that any gain or loss on the sale would not be taxable or deductible. However, the nature of aircraft is that they are assets that generally will lose value over time. Accordingly, it is far more likely that any disposal after a three-year period would lead to a loss, which would be non-deductible under the Bill, as a result of being capital in nature. If the aircraft is sold for a profit within the first three years of ownership, the lessor would still be required to undertake a capital/revenue analysis to determine whether the gain is taxable, leading to uncertainty. The Bill would provide more certainly if the aircraft were treated as capital assets throughout the entire period of ownership, such that lessors could freely sell aircraft without any concern of triggering a significant tax charge. | The new section 14H(8) provides certainty to qualifying aircraft lessors on the tax treatment of gains or losses upon disposal of aircraft. The three-year period is relatively short in the aircraft leasing industry since most of the aircraft are leased for a term of at least 5 years. The aircraft lessors should find it easy to satisfy this criterion. If a qualifying aircraft lessor sells an aircraft within the first three years of ownership, it can still argue that the aircraft is a capital asset. The Commissioner would consider all the facts and circumstances and apply common law principles in making decisions. |

**The Administration's responses to the views of deputations**

| Section 14I | | |
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| TIHK | To compensate for the loss of depreciation allowances (because of the current prohibition under section 39E of the IRO), the proposed legislation has adopted a deemed 80% deduction rule. An alternative and better legislative approach would be to amend section 39E such that depreciation allowances are granted to a qualifying aircraft lessor in respect of an aircraft leased to a non-Hong Kong aircraft operator because:<br>- Aircraft lessors in Hong Kong would likely need to pay a modest amount of taxes under the proposed tax regime whereas aircraft lessors operating in Ireland and Singapore would not normally need to pay taxes in their initial years of operation;<br>- The deemed 80% deduction could be perceived as an artificial definition of the tax base; and<br>Granting depreciation allowances will make the tax treatment for onshore and offshore aircraft leasing activities consistent. | Section 39E of the IRO was introduced as a measure to stop the abusive use of tax leverage leases of machinery or plant, including aircraft, which caused substantial tax losses with no compensatory macroeconomic benefits to Hong Kong. To amend section 39E will compromise the integrity of this anti-abuse provision. Therefore, a dedicated tax regime is proposed in the Bill for the offshore aircraft leasing industry, which is comparable to the existing regime for onshore aircraft leasing activities where lessors are entitled to depreciation allowances.<br><br>The 20% tax base is not arbitrarily decided, but represents the average profit margin of aircraft leasing business after consulting the aviation industry stakeholders. |
| BLP and Baker | If the corporation is a lessee under a funding lease, a bailee under a hire-purchase agreement or a buyer under a conditional sale agreement, it shall be deemed to have incurred capital expenditure on the provision of the aircraft concerned by virtue of its entry into the | BLP's understanding is correct. |

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| | funding lease, the hire-purchase or conditional sale agreement. | |
| Baker | Under the new section 14I(3)(b), no 20% tax base concession would be granted to a qualifying aircraft lessor if capital allowances have been previously claimed by a connected person in respect of the aircraft concerned. This condition should be removed if the aircraft was transferred by the connected person at an arm's length price. | The 20% tax base concession is to compensate for the loss of depreciation allowances. The new section 14I(3)(b) is an anti-abuse provision which prevents an aircraft leasing group from having depreciation allowances and the 20% tax base concession at the same time. That is, a connected person has obtained generous depreciation allowances (equivalent to 72% of the aircraft cost in the first year of ownership and 8.4% of the aircraft cost in the second year of ownership) before the disposal of the aircraft to the lessor who would enjoy the 20% tax base concession. Removing the condition in section 14I(3)(b) would easily result in tax abuses. |
| Section 14N | | |
| TIHK | In order to avoid any perceived possible conflict of interest, it appears that the Commissioner, being a tax administrator and collector, should preferably not be directly empowered to change Schedule 17F on his own. | The Commissioner has been empowered to amend similar schedules to the IRO, e.g. section 20AC(5). Moreover, any amendment order is subject to negative vetting by the Legislative Council. |

| Schedule 17F | | |
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| BLP | The definition of "aircraft leasing management activity" should also include the following:<br>- repossession of aircraft; and<br>- remarketing of aircraft. | Paragraph (m) of the definition of "aircraft leasing management activity" stipulates such activity includes the provision of services in relation to an aircraft leasing activity for or to a qualifying aircraft lessor. This paragraph should be wide enough to cover provision of services to qualifying aircraft lessors in connection with repossession of aircraft and remarketing of aircraft. The IRD would elaborate the application of paragraph (m) in the DIPN. |
| PwC | Another activity which may be carried out by an aircraft leasing manager may be providing advice to aircraft lessors in relation to disposals of aircraft. PwC would like the IRD to clarify that this activity or any related activities will be treated as qualifying leasing management activities for the purpose of the tax regime. | Paragraph (m) of the definition of "aircraft leasing management activity" should be wide enough to cover provision of advice to qualifying aircraft lessors in connection with disposals of aircraft. The IRD would elaborate the application of paragraph (m) in the DIPN. |
| Deloitte | Paragraph (j) of the definition of "aircraft leasing management activity" provides that the marketing of operating leases would be considered an aircraft leasing management activity. While, as a commercial reality, many aircraft leases are considered operating leases by market participants, a significant portion are | The list of aircraft leasing management activities is modelled on a similar aircraft leasing regime in Singapore. As the definition of "lease" under the new section 14G(1) has excluded finance leases, a qualifying aircraft lessor can only carry on an operating lease business. Therefore, a qualifying |

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| | finance leases, and these should not be excluded. Moreover, the term "operating lease" is not defined in the Bill. It would be helpful if the Bill included a definition to provide certainty. | aircraft leasing manager is expected to market operating leases for a qualifying aircraft lessor.<br><br>"Operating lease" is defined in Hong Kong Financial Reporting Standard 16 as a lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset (i.e. an aircraft under a lease in this proposed tax regime). This term is a commonly used commercial concept well known by the tax practitioners and aircraft lessors. The Administration considers it unnecessary to define this well-known accounting and commercial concept in the Bill. |
| Deloitte and HKICPA | Paragraph (k) of the definition of "aircraft leasing management activity" would allow financing to be provided to an airline enterprise for the purchase of an aircraft. However, the new section 14G(7) provides that an aircraft leasing management activity will be a qualifying activity only if it meets a number of criteria, including that the qualifying aircraft leasing manager must perform the activity for a qualifying aircraft lessor. A corporation can be a qualifying aircraft lessor only if it is not an aircraft operator. This means that paragraph (k) can apply only where a | Paragraph (k) would apply when a qualifying aircraft leasing manager provides, at the request of a qualifying aircraft lessor, finance to an airline enterprise for acquiring an aircraft from that lessor. By providing finance to the airline enterprise, the qualifying aircraft leasing manager is assisting the qualifying aircraft lessor to dispose of its aircraft. Hence, such activity is carried out for that lessor and would be qualified for the proposed tax concessions. |

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| | corporation provides financing to an airline enterprise, and that airline enterprise is not an aircraft operator. It seems highly unlikely that a company that is an airline enterprise and requires financing to purchase an aircraft would not also be an aircraft operator. The current drafting of the Bill would make it difficult to achieve its intended objectives. | |