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(English version only)

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**Written Submission on Inland Revenue (Amendment) (No. 2) Bill 2017**

Clerk to Bill Committee on the Inland Revenue (Amendment) (No. 2) Bill 2017
Legislative Council Secretariat
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Dear Sir

**Inland Revenue (Amendment) (No. 2) Bill 2017**

The Inland Revenue (Amendment) (No. 2) Bill 2017 (the **Bill**) was gazetted on 10 March 2017. The Bill proposes to create a new tax regime for offshore aircraft leasing. We feel honoured to have been given the opportunity to give our views on the Bill. We set out our comments as follows:

## 1. General comments

1.1 Prior to 1992, depreciation allowances were available to a Hong Kong partnership (in which an equity investor was the majority partner) engaged in an offshore aircraft leasing transaction. The depreciation allowances created substantial losses to the Hong Kong partnership during the early years of the lease. Such losses would be utilised by the equity investor in accordance with its shareholding in the partnership to set off against its taxable profits from other businesses. The tax benefits thus generated would be shared by the aircraft operator involved in such leveraged leasing structure. This Hong Kong leveraged leasing product was flexible. It was not necessary for the Hong Kong partnership to have the legal ownership of an aircraft to claim depreciation allowances, economic ownership would suffice. This flexibility caused an expansive use of such product by non-Hong Kong aircraft operators, combining a tax lease in another jurisdiction with the Hong Kong leveraged lease to form a double-dip. Though mainly a tax deferral arrangement, it was still considered as causing tax losses, with no compensatory macroeconomic benefits, to Hong Kong. This prompted the Hong Kong Government to take the view in 1990 that such product had been misused and caused "a major hemorrhage to the public revenue". Since 1992, Section 39E of Inland Revenue Ordinance (as amended in 1992) (together with IRD DIPN No. 15 (Revised)) have stemmed the abusive use of the Hong Kong leveraged leasing product. Depreciation allowances are denied to lessors in Hong Kong leasing aircraft to non-Hong Kong aircraft operators.

1.2 Section 39E, however, has given rise to unintended side effect. Group tax relief is not available in Hong Kong. A corporation cannot be used to achieve the purpose of transferring tax losses. Partnership is the only vehicle which may be used to transfer tax losses. The language used in Section 39E,

however, covers not only partnerships, but also corporations. This has created an anomaly. If an aircraft leasing company in Hong Kong, with no intention of using the Hong Kong leveraged leasing product, leased an aircraft to a non-Hong Kong aircraft operator, it would be denied depreciation allowances by virtue of the operation of Section 39E. Profits tax would be imposed on substantially the gross rental income of such aircraft leasing company. This has impeded the development of an aircraft leasing industry in Hong Kong.

1.3 Instead of amending Section 39E of the Inland Revenue Ordinance and making depreciation allowances available to aircraft leasing companies in Hong Kong leasing aircraft to non-Hong Kong aircraft operators, the Bill proposes that a new tax regime be created for offshore aircraft leasing. The two main features of the new tax regime are as follows:

(i) the applicable profits tax rate for qualifying aircraft leasing activities and qualifying aircraft leasing management activities will be one half of the standard profits tax rate; and

(ii) the assessable profits derived by a qualifying aircraft lessor from its qualifying aircraft leasing activities will be 20% of the gross lease payments less deductible expenses, excluding depreciation allowances.

1.4 The new tax regime will free Hong Kong from the shackles of the historical constraint on taxation of aircraft leasing. It aims at generating comparable or better economic benefits to aircraft lessors operating in Hong Kong than Ireland and Singapore. It is intended to be compliant with Base Erosion and Profits Shifting requirements and compatible with the financing structures commonly used by aircraft lessors, such as export credit agencies guaranteed finance lease, French tax lease, Japanese operating lease with call option, asset-based securitization.

1.5 The new tax regime proposed in the Bill will put Hong Kong on the same footing in terms of competition as the other aircraft leasing centres, such as Ireland and Singapore. It will create a favourable business environment for the development and growth of an aircraft leasing industry in Hong Kong.

1.6 We are in favour of and in support of the Bill.

## 2. Specific comments on the Bill

2.1 Section 14G(6)(b)

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 may be used in aircraft leasing structures for various reasons, such as meeting requirements on aircraft registration. Intermediate lessors may be interposed between the corporation and the non-Hong Kong aircraft operator. The intermediate lessors may not be aircraft operators. We

are of the view that in determining whether an aircraft leasing activity is a qualifying aircraft leasing activity, any intermediate lessors in the aircraft leasing structure shall be disregarded. So long as the ultimate operator of the aircraft is a non-Hong Kong aircraft operator, the condition set out in Section 14G(6)(b) shall be deemed to be satisfied.

2.2 Section 14I(3)(a)

In order that only 20% of the gross lease payments be subject to profits tax, Section 14I(3)(a) requires the corporation to have incurred capital expenditure on the provision of the aircraft concerned.

Section 14G(6)(b) requires the aircraft to be owned by the corporation. "Own" in Section 14G(1) includes (a) to hold as a lessee under a funding lease; (b) to hold as a bailee under a hire-purchase agreement; and (c) to hold as a buyer under a conditional sale agreement. The corporation may be a lessee under a funding lease, a bailee under a hire-purchase or a buyer under a conditional sale agreement. We are of the view that 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 funding lease, the hire-purchase or conditional sale arrangement.

2.3 Part 1, Schedule 17F, Definition of "aircraft leasing management activity"

Aircraft leasing managers may provide services on repossession and remarketing of aircraft to aircraft lessors upon default on the part of an aircraft operator. These activities are ordinary activities carried out by aircraft leasing managers and there is no reason why they cannot be included into the definition of "aircraft leasing management activity". We are of the view that the following activities be added to the definition of "aircraft leasing management activity" in Part 1, Schedule 17F:

"(n) repossession of aircraft;

(o) remarketing of aircraft."

Yours faithfully
For and on behalf of
Berwin Leighton Paisner

William Ho
Partner