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PRIVATE AND CONFIDENTIAL
The Hon Kenneth Leung
Chairman of the Bills Committee on
Inland Revenue (Amendment) (No.2) Bill 2017
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road

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Inland Revenue (Amendment) (No 2) Bill 2017

Dear Hon Kenneth Leung,

We refer to your invitation for submission on the Inland Revenue (Amendment) (No. 2) Bill 2017 and would like to state our views and comments on the proposed legislation as follows.

Overall speaking, we support the HKSAR Government's initiative of introducing a dedicated tax regime to promote Hong Kong's aircraft leasing and financing industry under which tax concessions are offered to qualifying aircraft lessors and qualifying aircraft leasing managers operating from Hong Kong. We believe the proposed regime should enhance our tax competitiveness and should be implemented as soon as possible. However, we consider that the following issues in relation to the proposed tax regime would need further consideration or clarification by the HKSAR Government.

The legislative approach

To compensate for the loss of tax depreciation allowances (because of the current prohibition under section 39E of the Inland Revenue Ordinance (IRO)), the proposed legislation has adopted a deemed 80% deduction rule. In our view, an alternative and better legislative approach would be to amend section 39E such that tax depreciation allowances are granted to a qualifying aircraft lessor in respect of an aircraft leased to a non-Hong Kong aircraft operator because:

- Aircraft lessors in Hong Kong would likely need to pay a modest amount of current taxes on the remaining 20% of their net lease rentals under the proposed deemed 80% deduction rule whereas aircraft lessors operating in Ireland and Singapore would not normally need to pay current taxes in their initial years of operation (because of their entitlement to generous tax depreciation allowances) and such tax deferral may continue if they continue to acquire aircraft year after year.

- The deemed 80% deduction is not specially related to the actual acquisition cost of an aircraft incurred by an owner and could be perceived as an artificial definition of the tax base.

- Granting tax depreciation allowances in respect of aircraft leased to non-Hong Kong aircraft operators will make the tax treatment for onshore and offshore aircraft leasing consistent as currently, tax depreciation allowances are available for aircraft leased to domestic aircraft operators in Hong Kong.

With the current legislative approach, Hong Kong will need to get prepared to defend against any criticism on the deemed deduction rule and provide justifications that such rule does not make the regime a harmful tax practice under Action 5 of the Base Erosion and Profit Shifting (BEPS) Project of the Organization for Economic Co-operation and Development. This is particularly true as peer review of preferential tax regimes is being conducted by the OECD.

Definition of "non-Hong Kong aircraft operator"

Under the proposed legislation, a "non-Hong Kong aircraft operator" is defined to mean "an aircraft operator who is not chargeable to profits tax under this Ordinance".

However, many overseas aircraft operators would have some of their aircraft flying to Hong Kong to uplift passengers and goods. Such overseas aircraft operators would likely be chargeable to profits tax in Hong Kong as a non-resident aircraft operator under section 23D of the IRO. As such, they are technically chargeable to profits tax under the IRO even though they may subsequently be exempted from paying profits tax in Hong Kong under the applicable tax treaties or air services agreements (ASAs) signed between Hong Kong and the jurisdictions concerned.

As such, 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 tax treaties or ASAs.

Conceivably, the definition of a "non-Hong Kong aircraft operator" could possibly be defined along the lines of being one whose central management and control is not exercised in Hong Kong and who holds an overseas aircraft operator license.

If the HKSAR Government's concern is a qualifying aircraft lessor may enjoy the concessionary profits tax rate of 8.25% on its rental receipts whereas an overseas aircraft lessee can claim a profits tax deduction on its rental payments at the full tax rate of 16.5%, such concern can be addressed by including provisions dealing with asymmetrical tax treatment of receipts and payments such as the proposed sections 14H(7) and 14J(8).

Expanding the scope of the concessionary tax regime to cover finance leases

Based on the current definitions of "funding lease" and "lease" in the proposed legislation, it would appear that a Hong Kong qualifying aircraft lessor who enters into a finance lease arrangement (with a purchase option for the lessee to acquire the ownership of the aircraft

concerned at the end of the lease term) / hire purchase agreement with a non-Hong Kong aircraft operator will not be eligible for the tax treatment under the concessionary tax regime, unless the Commissioner is in the opinion that the aircraft concerned would reasonably be expected not to pass to the lessee / bailee.

As such finance lease arrangements / hire purchase agreements are not uncommon in the aircraft leasing and financing industry, we would like to urge the government to consider expanding the scope of the concessionary tax regime to cover finance lease arrangements / hire purchase agreements. In particular, as both the tax regimes in Ireland and Singapore do not differentiate between operating leases and finance leases and offer the same tax treatment for both types of lease, extending the concessionary tax treatment to finance leases in Hong Kong will definitely help to enhance the attractiveness / competitiveness of the concessionary tax regime and achieve the objective of promoting the aircraft leasing and financing industry in Hong Kong.

Doing so will also help address the problem discussed in "Disposal of aircraft by way of granting a finance lease within a year of assessment" below.

The central management and control requirement

One of the main objectives of the proposed legislation is to attract overseas aircraft lessors and aircraft leasing managers to operate in Hong Kong.

However, large multinational aircraft leasing groups may not necessarily wish to, or may not be able to, exercise the central management and control (CMC) of their new operating entities in Hong Kong, especially in their initial years of operation.

We understand that the requirement of having the CMC exercised in Hong Kong is mainly for making the proposed tax regime BEPS-compliant and not be regarded as a harmful tax practice i.e. satisfying the substance requirement.

It however appears to us that the substance requirement would have already been satisfied by the condition specified in the proposed legislation that the relevant profit-generating activities are required to be carried out in Hong Kong. It does not appear to us that the exercise of the CMC is one of the tests for the substance requirement stipulated in Action 5 of the BEPS Project.

If the HKSAR Government considers the CMC requirement in the proposed legislation is necessary, for the avoidance of doubt, 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.

Disposal of aircraft by way of granting a finance lease within a year of assessment

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 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.

Under the proposed legislation, such qualifying aircraft lessor would apparently not be entitled to the concessionary tax treatment, i.e. the deemed 80% deduction and the 8.25% tax rate. This is because during the year of assessment concerned, the said qualifying aircraft lessor has undertaken non-qualifying activities by way of granting the finance lease or hire purchase agreement to a third party which generates income to the qualifying aircraft lessor.

As such, we consider that there should be provisions in the proposed legislation to cater for such situation such that the above qualifying lessor would continue to enjoy the concessionary tax treatment under the proposed legislation for the first part of the year during which the operating lease is in force. In this regard, 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.

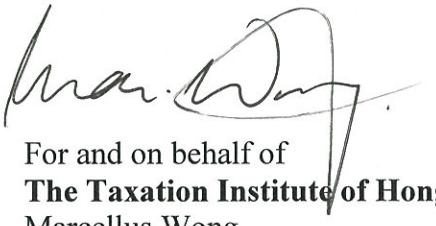
Power to amend Schedule 17F should preferably not be vested with tax administrator

We note that unlike other previous legislation, the power to amend a schedule to the IRO, in this case Schedule 17F in the proposed legislation, vests with the Commissioner of Inland Revenue (CIR) rather than the Secretary for Financial Services and the Treasury or the Financial Secretary. In order to avoid any perceived possible conflict of interest, it appears that the CIR, being a tax administrator and collector, should preferably not be directly empowered to change the law on his own.

Departmental Interpretation and Practice Note

As there are uncertainties as to the interpretation and application of some of the provisions in the proposed tax legislation, we recommend that an interpretation and practice note be issued by the Inland Revenue Department to set out the legislative intent, interpretation and application of the various key provisions of the concessionary tax regime in order to provide greater certainty and clarity for taxpayers and to make the regime more transparent.

Yours sincerely,



For and on behalf of
The Taxation Institute of Hong Kong
Marcellus Wong
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