Deloitte. 德勤

Deloitte Tax and Business Advisory
A division of Deloitte Advisory
(Hong Kong) Limited
35/F One Pacific Place
88 Queensway
Hong Kong

Tel: +852 2852 1600
Fax: +852 2541 1911
Email: enquiry@deloitte.com.hk
www.deloitte.com/cn

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19 April 2017

The Hon Kenneth LEUNG
Chairman of the Bills Committee on Inland Revenue (Amendment) (No.2) Bill 2017
Legislative Council
The Government of the Hong Kong Special Administrative Region
1 Legislative Council Road
Central
Hong Kong

Our Ref: ITSL - JC

Dear Hon Kenneth LEUNG,

Response to the Invitation for Submission of Comments in respect of the Inland Revenue (Amendment) (No.2) Bill 2017

We appreciate the opportunity given to Deloitte Advisory (Hong Kong) Limited for submitting our comments on the Inland Revenue (Amendment) (No.2) Bill 2017 ("the Bill").

We set out our comments on the Bill below for the Bills Committee's consideration.

Overall comments

The provisions contained in the Bill have been widely anticipated as a means to allow Hong Kong to be a credible aircraft leasing hub, and we welcome the intention behind the Bill. Specifically, the Bill provides for net aircraft leasing income to be taxed at an effective rate of 1.65% (as opposed to the standard rate of 16.5%), with profits from the management of an aircraft leasing activity to be taxed at 8.25%, which appears to be an appropriate incentive.

However, there is a concern that specific areas of the Bill are not drafted in a manner which will allow this policy intention to be widely realized. In particular, there are areas of the Bill which are not broad enough in their application and which appear to conflict with existing provisions of the Inland Revenue Ordinance (CAP. 112) ("IRO"), and which require taxpayers to rely on the discretion of the Commissioner of the Inland Revenue Department ("IRD").

Specific comments

1. Definition of "non-Hong Kong aircraft operator"

The provisions of the Bill apply where a corporation carrying on a qualifying aircraft leasing activity leases an aircraft to a "non-Hong Kong aircraft operator." It is submitted that the Bill is drafted this way because lessors to non-Hong Kong aircraft operators are currently disadvantaged under Section 39E of the IRO, which allows capital allowances to be claimed by an owner of aircraft only where the aircraft is leased to an operator of Hong Kong aircraft. The existing definition of "operator of a Hong Kong aircraft" in Section 39E requires the holding of an air operators' certificate issued under the Air Navigation (Hong Kong) Order 1995 (Cap. 448 sub. Leg. C), and for the business to be controlled and managed in Hong Kong. However, rather than simply adapting this definition for non-Hong Kong aircraft operators, for example, by suggesting that a non-Hong Kong aircraft operator is one that is managed and controlled outside of Hong Kong and that holds an alternative license, the Bill has defined a non-Hong Kong aircraft operator as one "who is not chargeable to profits tax under this Ordinance."

The issue with the above definition is that, under Section 23D of the IRO, on the ascertainment of assessable profits of a non-resident aircraft owner (where the IRD generally views an operator of aircraft to be an owner), any aircraft operator that lands at an aerodrome or airport within Hong Kong will be deemed to be carrying on a business in Hong Kong and, in principle, will be chargeable to Hong Kong profits tax. An exemption from such tax is normally provided under the relevant article of an

applicable tax agreement, such as Article 8 of the Hong Kong–China tax agreement. However, notwithstanding the exemption, the corporation would still arguably technically be chargeable to profits tax (as chargeability to tax is internationally recognized as a broad concept which may apply even where no tax is actually paid and is far wider than the concept of 'subject to tax' on which the IRD already has published views). This would mean that any aircraft operator that lands in Hong Kong would likely not be considered a non-Hong Kong aircraft operator, and so the provisions of the Bill would not apply to a lease of aircraft to that operator. It would seem to be contrary to the intention of the Bill for its provisions not to apply to any aircraft operator that lands in Hong Kong. It is important that this uncertainty be rectified through the drafting of the Bill, rather than through non-binding IRD issued Departmental Interpretation and Practice Notes ("DIPN").

2. Definition of "lease"

The definition of a lease is essential to the operation of the Bill, because the Bill applies to either an aircraft leasing activity itself or an aircraft leasing management activity. Therefore, it would be preferable for a "lease" to be defined widely to give flexibility to the commercial arrangements into which lessors and lessees could enter. However, this is not the case, and the Bill has sought to narrow the definition of a lease from that currently included in the IRO.

Hire-purchase agreements and conditional sale agreements currently are excluded from the definition of a lease in Section 2 of the IRO, so it would be reasonable to expect them not to be considered leases for the purposes of the Bill. However, the Bill has gone a step further and sought to exclude finance leases (referred to by the Bill as "funding leases", but defined on similar terms to finance leases) that have an option to transfer the aircraft, unless, in the opinion of the Commissioner of the IRD, it would be reasonable to expect that the aircraft would not transfer to the lessee. This definition gives rise two issues:

i. It would constrain the commercial terms on which aircraft leases may be entered; and
ii. If a finance lease contains an option to buy the aircraft, the application of the provisions of the Bill would be subject to the discretion of the IRD, which creates subjectivity and uncertainty and ultimately may require an advance ruling to be obtained.

It could be argued that many of the leveraged leasing structures currently used in Hong Kong involve leases structured to qualify for these terms. However, this may be because the majority of existing leveraged leasing activity being carried out in Hong Kong is ruled on by the IRD. To obtain an IRD ruling, the lease terms have to align with the IRD's views (including those espoused in paragraph 65, part H of DIPN 15 on what constitutes a lease). The IRD now appears to have sought to legislate those views through the Bill, which is intended to be incentive legislation.

It also is unclear why the definition of a lease would be narrowed in this manner as prescribed in the Bill, since lessors and lessees taking advantage of the Bill would not be able to benefit from Hong Kong capital allowances in any case, so the same avoidance opportunities that may arise in respect of Hong Kong leveraged leases should not be available under the Bill.

It seems that the Bill should seek to attract as many aircraft lessors as possible and, while the current definition of "lease" will cater to many lessors, there appears to be no reason that lessors providing finance leases should be excluded. The Bill should be flexible to accommodate the commercial arrangements of lessors and should provide certainty through appropriate legislative drafting, rather than through IRD rulings.

3. Need for the lessor to be Hong Kong tax resident

Given Hong Kong's favorable tax agreement with China, under which the withholding tax on royalties paid to an aircraft lessor is limited to 5%, it is likely that Hong Kong primarily will be seen as a venue to lease aircraft to China. To take advantage of the Hong Kong–China tax agreement, the lessor must be tax resident in Hong Kong. For residence to exist based on the lessor's management and control, it follows that company directors would have to be hired in Hong Kong, or at least base themselves in Hong Kong during the time they make board decisions, which would benefit Hong Kong's economy.

However, not all aircraft leasing vehicles are special purpose vehicles 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 benefit from the provisions of the Bill without creating a new Hong Kong tax resident entity and transferring planes to that entity.

While the Bill must seek to provide an economic benefit to Hong Kong, requiring the lessor to be tax resident makes the regime harder to comply with. It also likely is unnecessary, given that the operational activity pertaining to leasing the aircraft must be undertaken from Hong Kong (whether by the lessor or an agent). As an alternative, this requirement could be replaced/supplemented with a minimum Hong Kong spending requirement, or a substance requirement.

4. Treatment of aircraft as a capital asset if leased for a continuous period of three years or more

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. Other jurisdictions have similar provisions, although usually in respect of other asset classes, such as shares. For example, tax provisions in the UK and Singapore provide that, where shares are held for a certain period of time and other conditions apply, any gain will be exempt (UK) or considered capital in nature and not subject to tax (Singapore). Such provisions are typically helpful because they provide certainty of the tax treatment of substantial shareholdings and, if a gain is derived (as is usually the expectation when acquiring shares), the provisions are concessional. 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. However, 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 certainty 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.

If the aircraft is owned by an SPV, in practice, it may be easier for a lessor to simply sell the SPV as a means of transferring ownership of the aircraft. It seems that the Bill should have been drafted to provide greater certainty, so that tax planning is not required.

5. Provisions regarding aircraft leasing management activity

The Bill lists various aircraft leasing management activities, which, subject to other conditions, can be undertaken by a qualifying aircraft leasing manager; the profits from such activities would be subject to the 8.25% rate. There are 13 activities in total; however, they do not mesh well with the other provisions of the Bill.

For example, Schedule 17F, Section 1(1)(j) of the Bill provides that the marketing of operating leases would be considered an aircraft leasing management activity. First, it is unclear why marketing relating only to operating leases should 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 finance leases, and these should not be excluded. Second, despite the considerable attention given to defining leases, "dry leases" and "funding leases" in the definitions section of the Bill, the term "operating lease" is not defined in the Bill, nor is it defined anywhere else in the IRO—while the market will have its view on the definition of an operating lease, it would be helpful if the Bill included a definition, to provide certainty.

A further example of drafting issues can be found in Schedule 17F, Section 1(1)(k) of the Bill, which would allow financing to be provided to an airline enterprise for the purchase of an aircraft. At first glance, this is a simple and reasonable provision. However, per Section 14G(7) of the Bill, 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 another corporation and that

corporation must be a qualifying aircraft lessor. However, a corporation can be a qualifying aircraft lessor only if it is not an aircraft operator. This means that Schedule 17F, Section 1(1)(k) of the Bill can apply only where a corporation provides financing to an airline enterprise, and that airline enterprise is not an aircraft operator. While the Bill does not define an "airline enterprise," 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. While the policy objective of including financing extended to purchase aircraft within the provisions of the Bill is helpful, it appears that the current drafting of the Bill would make it difficult to achieve its intended objectives.

Summary

The policy objectives and intentions behind the Bill if implemented could make a significant different in improving Hong Kong as an aircraft leasing hub. However, specific issues with the current drafting of the Bill should be addressed in order to realize underlying policy objectives.

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If you would like to discuss any of the above aspects, please do not hesitate to contact us.

Yours sincerely,
For and on behalf of Deloitte Advisory (Hong Kong) Limited

Jonathan Culver
Partner, Tax & Business Advisory Services, International Tax