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25 April 2017

Ms Vanessa Cheng
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Legal Services Division
Legislative Council Secretariat
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[By Fax: 2877 5029]

Dear Ms Cheng,

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

I refer to your letter dated 7 April 2017 on the subject. The consolidated response of the Administration is set out at Annex.

Yours sincerely

(Ms Candy Nip)
for Secretary for Transport and Housing

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)

Annex

The consolidated response of the Administration is as follows:

Clause 4 – new Section 14G

In relation to the definitions of “actual residual value”, “estimated residual value” and “funding lease” in the new section 14G(1), “useful economic life” refers to the period during which economic benefit is expected to be derived from using an aircraft. It is a well understood commercial concept. We consider it unnecessary to have a legal definition for this term.

2. Regarding the definition of “non-Hong Kong aircraft operator” in the new section 14G(1), it would cover aircraft operators resident in the jurisdictions with which Hong Kong has entered into a double taxation agreement (“DTA”). Under our DTAs, aircraft operators resident in our treaty partners’ jurisdictions are fully exempt from Hong Kong profits tax even if their aircraft land in Hong Kong.

Clause 4 – new sections 14H and 14J

3. The rationale for making the election irrevocable under the new sections 14H(5) and 14J(6) is to avoid the half-rate regime being abused by a corporation, which chooses to opt in or out of the regime in different years of assessment, depending on whether it makes a profit or incurs a loss. Without those provisions, a qualifying aircraft lessor or a qualifying aircraft leasing manager may elect for the half-rate regime when it makes chargeable profits in a year of assessment (so that the qualifying profits would be taxed at half rate), but may seek to opt out from the half-rate regime when it incurs tax losses in another year of assessment (so that the full amount of tax losses can be carried forward and set off against profits in subsequent years). This “irrevocable election” requirement has been adopted in other half rate regimes for captive insurers and professional reinsurers (section 14B(2)(b)) as well as corporate treasury centres (section 14D(6)).

Clause 4 – new section 14J

4. Under the new section 14J(8), if a sum payable to a qualifying aircraft leasing manager by a person for the qualifying aircraft leasing management activity is deductible for profits tax, such sum would be excluded from the qualifying profits and thus be taxable at the full profits

tax rate. This provision is similar to section 14D(8) under the corporate treasury centre regime. This is to achieve tax symmetry. It is imperative to prevent revenue loss arising from tax abuses, in particular, by connected persons where there could be half taxation on income but full deduction on corresponding payments.

5. Under the new section 14J(9), it is intended that a qualifying aircraft leasing manager can still enjoy the half rate concession in respect of the management fees received from a qualifying aircraft lessor whose qualifying profits are also subject to half rate. A qualifying aircraft leasing management activity, by definition in the new section 14G(7), is carried out for another corporation that is a qualifying aircraft lessor. The new section 14J(9) provides that the new section 14J(8) would not apply to such management fees paid by a qualifying aircraft lessor to a qualifying aircraft leasing manager for a qualifying aircraft leasing management activity carried out by it.

Clause 4 – new section 14L

6. The new section 14L is to enable the Commissioner of Inland Revenue (“the Commissioner”) to, in case a corporation fulfils neither the new section 14J(3) nor the safe harbour rule in the new section 14K, exercise a discretionary power to allow the corporation’s qualifying profits to be subject to the half-rate, provided that the Commissioner is satisfied that the corporation would (but for, say, extraordinary circumstances) have fulfilled in the ordinary course of its business either the new section 14J(3) or 14K. In making this determination under the new section 14L, the Commissioner may take into account the activities carried out by the corporation (such as its operational history, assets and liabilities, functions and risks undertaken, and the capacity, role and responsibility of the corporation, etc.) and all other relevant information. As we envisage that this may involve an assessment of the factual circumstances of a particular case, we do not consider it appropriate to make express provisions on such circumstances in the Bill. After the passage of the Bill, the Inland Revenue Department is prepared to explain the operation of this section through issuing Departmental Interpretation and Practice Notes.

Clause 4 – new section 14M

7. The new section 14M(7) is an anti-avoidance provision forestalling defeasance arrangements. Under the aircraft leasing regime, a qualifying aircraft lessor can own an aircraft via a funding lease, a

hire-purchase agreement or a conditional sale agreement (see the definition of "own" in the new section 14G(1)). A qualifying aircraft lessor who owns an aircraft through a funding lease may defease the lease to a third party. The third party takes up the primary obligation under the funding lease to make the lease payments to the head lessor. The effect of a defeased lease is that the qualifying aircraft lessor is no longer obliged to pay the lease payments under the funding lease. In such a scenario, the qualifying aircraft lessor should not enjoy the proposed profits tax concessions in respect of the rentals derived from leasing the aircraft to a non-Hong Kong aircraft operator. Under the new section 14M(7), the qualifying aircraft lessor would be treated as if it had ceased to own the aircraft in such a scenario. Hence, no profits tax concessions will be granted to it as the leasing transaction with the non-Hong Kong aircraft operator is no longer a qualifying aircraft leasing activity (see the new section 14G(6)).

Clause 15 – new Schedule 17F

8. The term "special purpose entity" refers to any entity that is established solely for the purpose of holding and administering an investment asset and does not carry on any trade or activities except for the purpose of holding and administering the investment asset. In the context of aircraft leasing, a special purpose entity would be used to hold and administer an aircraft. "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 in this regime). Both terms are commonly used commercial concepts well known by the tax practitioners and aircraft lessors. We consider it unnecessary to spell out these commercial concepts in the Bill.