# *立法會*
# *Legislative Council*

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**Report of the Bills Committee on**
**Inland Revenue (Amendment) (No. 2) Bill 2017**

## Purpose

This paper reports on the deliberations of the Bills Committee on Inland Revenue (Amendment) (No. 2) Bill 2017 ("the Bills Committee").

## Background

2. The rapid growth in aviation industry in Asia and the Mainland China has brought about long-term market demand for aircraft leasing in the region. As an international financial centre and a major aviation hub, Hong Kong possesses competitive advantage in developing aircraft leasing business. Overseas experience has indicated that tax factor is one of the key considerations for aircraft leasing companies in selecting the place to domicile their business.

3. Promoting aircraft leasing business in Hong Kong was among the initiatives of the Chief Executive's Policy Address in 2015, 2016 and 2017. The Financial Secretary also mentioned in the 2017-2018 Budget that the Government planned to introduce a bill into the Legislative Council ("LegCo") in 2017 to amend the Inland Revenue Ordinance (Cap. 112) to create a tax regime for offshore aircraft leasing activities (i.e. aircraft are leased to non-Hong kong aircraft operators) in Hong Kong.

**The Bill**

4. The Bill seeks to amend Cap. 112 to:

(a) give profits tax concessions to qualifying aircraft lessors and qualifying aircraft leasing managers;

(b) make provisions for profits tax purposes about businesses in connection with aircraft; and

(c) make consequential and minor textual amendments.

Concessionary tax regime for qualifying aircraft lessors and qualifying aircraft leasing managers

5. The objective of the Bill is to provide for a regime in which the tax rate on the qualifying profits of qualifying aircraft lessors and qualifying leasing managers derived from qualifying leasing activities and qualifying aircraft leasing management activities respectively would be half of the prevailing profits tax rate for corporation as specified in Schedule 8 to Cap. 112 (i.e. 16.5% x 50% or 8.25%).

6. For the purposes of computation of the assessable profits of a qualifying aircraft lessor, the net lease payments derived from its qualifying aircraft leasing activities are proposed to be calculated in accordance with the formula in the proposed section 14I(2). The effect is that the taxable amount of lease payments derived from qualifying aircraft leasing activities would be equal to 20% of the tax base, i.e. gross lease payments less deductible expenses (excluding tax depreciation).

7. The major features of the Bill are highlighted in paragraphs 4 to 9 of the Legal Service Division Report (LC Paper No. LS49/16-17).

**The Bills Committee**

8. At the House Committee meeting held on 24 March 2017, a Bills Committee was formed to scrutinize the Bill. Hon Kenneth LEUNG was elected Chairman of the Bills Committee. The membership list of the Bills Committee is in **Appendix I**.

9. The Bills Committee has held three meetings with the Administration and received views from deputations at one of the meetings. A total of 11 written submissions on the Bill were received. The names of organizations

and individuals who have provided views to the Bills Committee are in **Appendix II**. Upon the request of the Bills Committee, the Administration provided a written response to the issues raised in the deputations' submissions, which is at **Appendix III** (English version only).

**Key provisions of the Bill**

10. The Bill provides for profits tax concessions for qualifying aircraft lessors and qualifying aircraft leasing managers on certain businesses in connection with aircraft, makes provisions for profits tax purposes regarding such businesses, and makes consequential and minor textual amendments to Cap. 112. The main provisions of the Bill are as follows –

(a) **Clauses 4 and 15** add new sections 14G to 14N and new Schedule 17F to Cap. 112 to –

(i) define what are the qualifying aircraft leasing activities and qualifying aircraft leasing management activities for the proposed tax concessions (new section 14G and new schedule 17F);

(ii) provide for profits tax concessions to qualifying aircraft lessors and qualifying aircraft leasing managers (new sections 14H, 14I and 14J);

(iii) provide for the safe harbour rule for being a qualifying aircraft leasing manager (new section 14K);

(iv) provide for the Commissioner of Inland Revenue's ("CIR") power to determine that a corporation is a qualifying aircraft leasing manager (new section 14L); and

(v) provide for anti-avoidance provisions (new section 14M);

(b) **Clause 5** amends section 15 of Cap. 112 to deem sums received by or accrued to a corporation from carrying on certain businesses in connection with aircraft as having a Hong Kong source, even if the aircraft is used outside Hong Kong;

(c) **Clause 6** amends consequentially section 19CA of Cap. 112 to provide for adjustments in respect of relevant losses to be set off against the concessionary trading receipt chargeable to tax under new section 14H or 14J, or vice versa;

(d) **Clauses 8 to 11** amend section 37, 38, 39B and 39D of Cap. 112 respectively to deal with computation of the cost and capital expenditure in relation to an aircraft that is used by a corporation for a qualifying aircraft leasing activity before being used in another trade, profession or business; and

(e) **Clauses 13 and 16** respectively amend section 89 of Cap. 112 and add a new Schedule 41 to Cap. 112 to provide for transitional matters.

## Deliberations of the Bills Committee

11. Members generally support the Bill and the objectives it seeks to achieve. The major issues and concerns members of the Bills Committee raised during the deliberation of the Bill are summarized in the ensuing paragraphs.

Impact of the Bill

12. Members enquire about public revenue that may be forgone and whether Mainland aircraft owners would stand to gain most from the proposed tax regime under the Bill. Some members express concerns on whether the environmental and air transport infrastructure costs associated with the implementation of the proposed tax regime may outweigh the economic benefits from the aircraft leasing business that may be attracted to Hong Kong.

13. The Administration explains that as there is at present no offshore aircraft leasing business in Hong Kong. The question of revenue forgone as a result of introducing the proposed tax concession would not arise. As regards which party may benefit most from the proposal, the Administration explains that there is no information on the ownership of such aircraft in the aircraft leasing business that would be transacted in Hong Kong following the implementation of the Bill. Furthermore, where an aircraft calls at Hong Kong, the aircraft operators would need to pay airport charges which would help offset the cost of airport operation. Measures are also put in place which would help reduce the environmental impact of air traffic in Hong Kong, especially along the flight path and in the area closest to the Hong Kong International Airport.

14. Dr KWOK Ka-ki queries whether the introduction of a tax regime for qualifying aircraft lessors and qualifying aircraft leasing managers carrying on an offshore aircraft leasing business in Hong Kong would set a precedent for other sectors, such as the maritime cargo carriage sector or pharmaceutical industry, to request for similar tax treatment. The Administration advises that offering tax concessions is only one of the means to create a favourable business environment to support the development of a certain sector. The

Administration would take into account the needs of the sector concerned and the impact on public revenue and the possible benefits to the society as a whole, among other factors, in considering whether a new tax concession regime should be set up for another sector.

Scope of the proposed tax regime

15. Members have sought clarification on whether the proposed tax regime should apply to aircraft leasing operations that involve part of an aircraft (such as the leasing of the propulsion engine). Some members have queried whether the definition of "aircraft" should include other vessels such as spaceship. The Administration advises that the definition of "aircraft" in the Bill, which includes aircraft engines and helicopters, etc., but excludes spacecraft, satellites, and airships, follows international conventions and practices.

*Lease*

16. The Bills Committee notes that, to be eligible for the proposed profits tax concessions, the lessor's aircraft must be leased to a "non-Hong Kong aircraft operator" under the proposed section 14G(6)(b) and (7)(d). As far as the concept of "lease" is concerned, the Bills Committee notes that the proposed tax regime applies only when the lease transacted is a dry lease and not a funding lease (so that there would be no transfer of asset ownership at the end of the lease terms), hire-purchase agreement or conditional sale agreement under the definition of "lease" as provided for in the proposed section 14G(1).

17. The Administration further explains that in the context of aircraft leasing business, a lessor may allow a lessee to use an aircraft without bearing responsibility for ensuring the airworthiness of the aircraft and without providing a crew for the aircraft. This is referred to as a "dry lease" under the proposed section 14G(1) of the Bill. The proposed section 14G of the Bill introduces a "funding lease" concept which is defined as a dry lease of an aircraft that satisfies one of the following conditions:

(a) the dry lease is accounted for as a finance lease[1] or loan by the lessor;

(b) the present value of the total lease payment would be equal to or more than 80% of the fair market value of the aircraft; or

(c) the lease term is equal to or more than 65% of the remaining useful economic life of the aircraft.

[1] There are situations where the lessor acquires an aircraft and rents it to the lessee for an agreed period during which the lessee practically owns the aircraft. The rental payment throughout the period would cover more or less the cost of the aircraft. Such agreement is understood to be a "finance lease". A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership.

Under a "funding lease", the property of the aircraft in question will or may pass to the lessee at the end of its lease term. For tax purposes, an aircraft leased under a "funding lease" would be considered as being owned by the lessee. This is also consistent with the meaning of "own" in the proposed section 14G of the Bill.

18. Members consider that such definition of "lease" unduly restrictive and it would constrain the commercial terms on which aircraft leases may be entered into. Some members query the need to introduce this concept of "funding lease" in the Bill as some deputations have pointed out that other tax jurisdictions such as Singapore do not distinguish between an aircraft transacted under an operating lease[2] and a finance lease for the purpose of granting tax concession for aircraft leasing business. Members also note that some deputations have suggested that the Administration should consider expanding the scope of the concessionary tax regime to cover finance lease arrangements or hire-purchase agreements.

19. The Administration explains that the intention of the Bill is to offer tax concession to a qualifying aircraft lessor who is not an aircraft operator (proposed section 14H(2)(a)), but who should own the aircraft being leased (proposed section 14G(6)(b)). For the purposes of the Bill, one way of determining ownership is whether a lessor is holding an aircraft as a lessee under a funding lease (proposed section 14G(1)).

20. A qualifying aircraft lessor may acquire an aircraft via a funding lease, a hire-purchase agreement or a conditional sale agreement. A funding lease is similar to a finance lease, a hire-purchase agreement involves a bailment and a conditional sales agreement involves a retention of title. In order to accommodate different forms of structure commonly used in the aviation finance industry, the word "own" is defined in the proposed 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.

21. 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

[2] Where the lessor retains some of the risks and rewards of ownership of the aircraft, and where there is a resale value at the end of the lease period, the arrangement is commonly described as an "operating lease". A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

defined under the proposed section 14G(6) which stipulates that the aircraft must be owned by the qualifying aircraft lessor.

22. The ownership requirement is necessary so as to ensure 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 ownership of the aircraft. The Administration points out that most of the aircraft lessors' leasing transactions with aircraft operators are operating leases.

*Qualifying leasing activities*

23. Mr Jeremy TAM queries the rationale for restricting a qualifying aircraft leasing activity to one where an aircraft is leased to a non-Hong Kong aircraft operator. The Administration explains that there is already a tax regime to cater for onshore aircraft leasing activities (i.e. aircraft are leased to Hong Kong aircraft operators). Subsequently, the Bills Committee notes that the Administration will propose amendments to the Bill in view of the latest requirements of the Organization for Economic Cooperation and Development ("OECD") and the deputations' concerns to widen the scope of the proposed tax concession regime to cover all offshore aircraft operators including those in a non-treaty partner jurisdiction having aircraft flying to Hong Kong, as well as to onshore aircraft leasing activities (see paragraphs 50 and 51 below).

*Aircraft leasing management activity*

24. Members note that deputations have raised concerns as to whether such activities as repossession of aircraft, remarketing of aircraft, an aircraft leasing manager providing advice to aircraft lessors in relation to the disposals of the aircraft would be considered as "aircraft leasing management activity" under section 1 of Part 1 of the proposed new Schedule 17F. The Administration advises that paragraph (m) of the definition of "aircraft leasing management activity" stipulates that such activity includes the provision of services in relation to an aircraft leasing activity for or to a qualifying aircraft lessor. Thus, paragraph (m) of the definition of "aircraft leasing management activity" should be wide enough to cover such activities.

25. Members also seek the Administration's clarification on "operating lease" as appeared in paragraph (j) of the definition of "aircraft leasing management activity" and whether a definition should be included in the Bill. The Administration explains that "operating lease" is defined in Hong Kong Financial Reporting Standard 16 as a lease which does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset (i.e. an aircraft in this regime). Such term is commonly used commercially by the tax

practitioners and aircraft lessors, and the Administration considers it unnecessary to define "operating lease" in the Bill.

*Central management and control in Hong Kong*

26. To be eligible for the proposed tax concession in Hong Kong in a year of assessment, an aircraft lessor and aircraft leasing manager are required to exercise its central management and control ("CMC") in Hong Kong and it is required that the activities that produce its qualifying profits in the year of assessment are carried out in Hong Kong by the corporation under the proposed sections 14H(4) and 14J(5). Members note that some deputations have expressed concerns that the requirement of CMC is not necessary as the substance requirement would have already been satisfied by the conditions specified in the Bill that the relevant profit-generating activities are required to be carried out in Hong Kong and that requiring the lessor to be tax resident in Hong Kong makes the proposed tax regime harder to comply with in certain circumstances.

27. The Administration responds that the Bill is 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 would ensure that the proposed tax concessions would only apply to companies with operations domiciled in Hong Kong. Such a preferential regime should comply with the substance requirement. Profits should not be shifted to Hong Kong for tax avoidance purposes. 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).

*Non-Hong Kong aircraft operator*

28. Members note that some deputations have pointed out that the proposed tax concession under the Bill applies to aircraft leasing activities and aircraft leasing management activities where the aircrafts concerned are leased to a non-Hong Kong aircraft operator. Under the proposed section 14G(1), a "non-Hong Kong aircraft operator" is defined as an aircraft operator who is not chargeable to profits tax under Cap. 112.

29. The Bills Committee invites the Administration to respond to enquiries from some deputations as well as the Legal Adviser to the Bills Committee on whether a "non-Hong Kong aircraft operator" would include those exempt from profits tax under a bilateral double taxation agreement ("DTA") concluded between Hong Kong and a foreign jurisdiction. Under the relevant provisions

of a DTA, income and profits derived from the operation of aircraft in international traffic by an airline of one contracting party which are subject to tax in the area of that contracting party, shall be exempt from income tax, profits tax and all other taxes on income and profits imposed in the area of the other contracting party.

30. Members also note deputations' concern on the ascertainment of assessable profits of a non-resident aircraft owner (owner includes a charterer of that aircraft under a charter-party) under section 23D of Cap. 112. Some deputations point out to the Bills Committee that 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. Deputations also point out that leasing of aircraft to an offshore aircraft operator in a non-treaty partner jurisdiction having aircraft flying to Hong Kong could not be eligible for the proposed profits tax concessions. As Hong Kong's treaty network is comparatively limited at present, the requirement of "non-Hong Kong aircraft operator" would make the proposed aircraft leasing regime less attractive. Members ask how the Administration would respond to deputation's request that the proposed tax regime could cover all offshore aircraft operators.

31. Furthermore, members ask the Administration to respond to deputations' queries whether an aircraft lessee would still be considered as a "non-Hong Kong aircraft operator" and hence the lessor would enjoy the proposed tax concession if the leased aircraft called at Hong Kong for carriage of goods or passengers. The Bills Committee note that deputations' comments that while, under the terms of Hong Kong's DTAs, non-resident operators may, in practice, 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 DTAs, which do not provide for chargeability as such, but instead allocate taxing rights between jurisdictions. Some deputations suggest to explicitly specify in the proposed legislation that the condition of "not chargeable to profits tax under the Ordinance" (i.e. Cap. 112) would be satisfied where profits tax are subsequently exempted under any applicable DTAs.

32. The Administration advises that 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. DTAs have been given effect under the domestic legislation by virtue of section 49 of Cap. 112. 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. 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 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. As the Administration intends to move Committee stage amendments to extend the proposed tax regime for offshore aircraft leasing activities under the Bill to onshore aircraft leasing activities, the term "non-Hong Kong aircraft operator" will no longer be defined under the Bill.

Requirement of the Organization for Economic Cooperation and Development

33. Subsequent to the second meeting of the Bills Committee on 26 April 2017, the Administration informed the Bills Committee on 18 May 2017 that OECD and the Group of Twenty released a package of 15 actions to combat BEPS in October 2015. According to the Administration, BEPS refers to tax planning strategies of multinational enterprises that exploit the gaps and mismatches in tax rules among economies to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. Hong Kong indicated to OECD in June 2016 its commitment to implementing the BEPS package.

34. According to the Administration, countering harmful tax practices is one of the four minimum standards of the BEPS package. The Forum on Harmful Tax Practice ("FHTP"), a working party under OECD, is responsible for reviewing the preferential tax regimes relating to income from geographically mobile activities (such as financial and other service activities) of all participating jurisdictions. In determining whether a preferential tax regime is potentially harmful, FHTP would take into account a number of factors, one of which is that "the regime is ring-fenced from the domestic economy".

35. In March 2017, the Administration was informed that FHTP would adopt a rigid and narrow interpretation on the "ring-fencing" factor when determining whether a preferential tax regime was potentially harmful. Failure to address OECD's concerns about harmful tax practices will jeopardize Hong Kong's reputation as an international financial centre. Meanwhile, the European Union ("EU") has kicked off an exercise to draw up a list of "non-cooperative tax jurisdiction" by the end of 2017 and the existence of harmful tax measures is one of its concerns. A jurisdiction listed as "non-cooperative" could be subject to defensive measures which will make it a less attractive place for investment and business. Given the latest development, the Administration considered it prudent for Hong Kong to revise the proposed aircraft leasing regime so that there will not be a perception issue on ring-fencing as the proposed tax regime would only be made applicable for offshore aircraft leasing activities.

36. In view of the latest development in OECD and the concerns from the deputations on the definition of "non-Hong Kong aircraft operator", the Administration proposes to revise the Bill so as to extend the proposed tax regime for offshore aircraft leasing activities under the Bill to onshore aircraft leasing activities as well (see paragraphs 50 and 51). Under the revised tax regime, companies engaging in onshore aircraft leasing activities will be assessed under the original regime as provided for in Cap. 112, i.e. they are entitled to obtain depreciation allowance in respect of the subject aircraft by default. Alternatively, they may elect for assessment under the proposed concession regime granted to non-Hong Kong aircraft operators (i.e. they are not entitled to obtain depreciation allowance but can enjoy 20% of the tax base for the computation of the taxable amount of lease payments and half rate of the prevailing profits tax rate for corporations). The election, once made, is irrevocable. Meanwhile, companies engaging in offshore aircraft leasing activities will remain entitled to 20% of the tax base for the computation of the taxable amount of lease payments and half rate of the prevailing profits tax rate for corporations but they are not entitled to obtain depreciation allowance.

37. The Bills Committee has sought the views of local aircraft operators on the Administration's proposed revision to the tax concession regime. All six local aircraft operators have responded and supported the Administration's proposal.

38. Members note that the Bill, having incorporated the above additional amendments, if passed, will be examined by FHTP. Subject to any comments from FTHP, further amendments to Cap. 112 may be necessary.

Safe harbour rule

39. The proposed section 14K sets out the safe harbor rule for aircraft leasing tax concessions. The proposed section 14K(2) stipulates that a corporation falls within the 1-year safe habour if, for the subject year, the percentages of its aircraft leasing management asset ("ALMA") and aircraft leasing management profits ("ALMP") are not lower than the prescribed percentage (prescribed at 75% under the proposed Schedule 17F). Members ask if both ALMA and ALMP would have to be assessed together to determine if the safe harbour conditions for a qualifying aircraft leasing manager could be met.

40. The Administration confirms that both the prescribed threshold percentages as stipulated in the Bill for ALMA and ALMP have to be satisfied to meet the safe habour rule. A corporation satisfies the safe harbour rule for a given year of assessment if it falls within the 1-year safe harbour or the multiple-year safe harbour. Even if a corporation's aircraft leasing

management profits are below the threshold in a particular year, it may still be considered as a qualifying aircraft leasing manager and be eligible for the proposed tax concession if CIR has determined that the conditions specified in the proposed section 14J(3) or the safe harbour rule under the proposed section 14K would in the ordinary course of business of the corporation has been satisfied for the year of assessment. Similar mechanisms of safe harbour rule and CIR's determination have been adopted in the tax concession regime for qualifying corporate treasury centres under Cap. 112.

*Commissioner of Inland Revenue's discretionary power*

41. Members note that the proposed section 14L of the Bill confers on CIR a discretionary power to determine whether an aircraft leasing manager may remain a qualifying aircraft leasing manager and enjoy the tax concession under the Bill even though the aircraft leasing manager does not, due to certain justified and unforeseen circumstances, meet the requirement to be a qualifying aircraft leasing manager for a year of assessment.

42. Members have expressed concern that the provision may give CIR too wide a power and they query whether there are objective criteria under which CIR may make the determination and whether the criteria should be stated in the Bill. The Administration advises that the new section 14L would enable CIR to exercise the discretionary power as described in paragraph 40 above. In making the determination under the proposed section 14L, CIR 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.

43. The Administration envisages that CIR's determination may involve an assessment of the factual circumstances of a particular case, it does not consider it appropriate to make express provisions on such circumstances in the Bill. The Administration also informs the Bills Committee that similar discretionary power is provided under the tax concession regime for qualifying corporate treasury centres under Cap. 112, although CIR has, so far, not even for once exercised this discretionary power.

<u>Measures against tax avoidance and abuse</u>

*Claw-back mechanism*

44. Mr Holden CHOW queries whether the aircraft lessors and aircraft leasing managers benefiting from the proposed tax regime should be required to conduct aircraft leasing activities in Hong Kong for a certain minimum period of time; and that lessors or leasing managers who failed to meet the condition

would have to pay back the Government all the tax benefits that they had received. The Administration considers it unnecessary to adopt a claw-back mechanism to penalize the withdrawal of investments.

45. The Administration explains that Hong Kong's tax regime is simple and transparent, and CIR has only limited discretion. Besides, Hong Kong already possesses many competitive advantages such as sound legal and taxation systems and well established financial infrastructure to attract overseas leasing companies to set up operation in Hong Kong.

*Tax evasion using overseas companies*

46. Members express concerns that companies may take advantage of the proposed tax regime for tax evasion. For example, a local corporation might set up companies overseas to carry out aircraft leasing activities, so that the company would enjoy the tax concession for the transactions that are to be conducted in Hong Kong.

47. The Administration responded that anti-tax avoidance mechanism was proposed in the Bill to guard against abuses. For example, qualifying aircraft lessors and qualifying aircraft leasing managers must be corporations with central management and control and substantial business presence in Hong Kong. It is a matter of fact as to whether a corporation carries on substantive business in Hong Kong. The Inland Revenue Department would conduct a comparability analysis to determine whether the corporation has incurred in Hong Kong similar types of expenditures normally incurred by other companies carrying on the same type of business.

*Associate, associated corporation and connected person*

48. The Bills Committee notes that, to address tax avoidance concerns, the Bill introduces the terms "associate", "associated corporation" and "connected person". Some members consider that these terms have similar and overlapping meanings; some have appeared in other parts of Cap. 112 with slightly different definitions and under different context. They query whether these terms are necessary in the Bill.

49. The Administration explains that some of the anti-tax avoidance measures may have broader application, while some are more restrictive. The use of "associate", "associated corporation" or "connected person" would depend how wide or narrow an anti-tax avoidance provision intends to cover. In the context of the Bill, as aircraft leasing and aircraft leasing management activities are carried out by aircraft lessors or aircraft leasing managers, the definitions of "associate", "associated corporation" and "connected person" are required to be given in relation to such an entity which may have different forms or structures of ownership.

## Committee stage amendments

50. The Administration intends to propose Committee stage amendments ("CSAs") to extend the proposed tax regime for offshore aircraft leasing activities under the Bill to onshore aircraft leasing activities for the reasons set out in paragraphs 28 to 37 above. The Bills Committee supports the Administration's proposed amendments.

51. A set of proposed CSAs, is in **Appendix IV**.

## Resumption of the Second Reading debate

52. The Bills Committee supports the resumption of the Second Reading debate on the Bill at the Council meeting of 21 June 2017.

## Consultation with the House Committee

53. The Bills Committee reported its deliberations to the House Committee on 9 June 2017.

Council Business Division 4
Legislative Council Secretariat
15 June 2017

**Appendix I**

**Bills Committee on Inland Revenue (Amendment) (No. 2) Bill 2017**

**Membership List**

| | |
|---|---|
| **Chairman** | Hon Kenneth LEUNG |
| **Members** | Hon James TO Kun-sun |
| | Hon Jeffrey LAM Kin-fung, GBS, JP |
| | Hon Paul TSE Wai-chun, JP |
| | Hon Charles Peter MOK, JP |
| | Dr Hon KWOK Ka-ki |
| | Hon Dennis KWOK Wing-hang |
| | Dr Hon Junius HO Kwan-yiu, JP |
| | Hon Holden CHOW Ho-ding |
| | Hon Jeremy TAM Man-ho |
| | (Total：10 members) |
| **Clerk** | Mr Daniel SIN |
| **Legal Adviser** | Ms Vanessa CHENG |

**Appendix II**

**Bills Committee on Inland Revenue (Amendment) (No. 2) Bill 2017**

**List of organizations which have provided oral or written representation to the Bills Committee**

| | | |
|---|---|---|
| ^ | 1. | Berwin Leighton Paisner |
| * | 2. | Cathay Pacific Airways Limited |
| ^ | 3. | Deloitte Advisory (Hong Kong) Limited |
| ^ | 4. | Hong Kong Aircraft Leasing and Aviation Finance Association |
| * | 5. | Hong Kong Airlines Limited |
| * | 6. | Hong Kong Dragon Airlines Limited |
| * | 7. | Hong Kong Exchanges and Clearing Limited |
| * | 8. | Hong Kong Express Airways Limited |
| ^ | 9. | Hong Kong Institute of Certified Public Accountants |
| # | 10. | Baker & McKenzie |
| ^ | 11. | PricewaterhouseCoopers Limited |
| # | 12. | The Association of Chartered Certified Accountants |
| ^ | 13. | The Taxation Institute of Hong Kong |
| # | 14. | Allen & Overy LLP |

\# Oral representation only
* Submitted written views only
^ Oral representation and submitted written views

**Appendix III**

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

| Organisation | The Deputations' Views | The Administration's Responses |
|---|---|---|
| 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**

| | | |
|---|---|---|
| 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"). |

| | | |
|---|---|---|
| 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. |

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

| 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. | |

**Bills Committee on Inland Revenue (Amendment) (No. 2) Bill 2017**

**Draft Committee Stage Amendments proposed by the Government**

## Purpose

The Government proposes to introduce Committee Stage Amendments ("CSAs") to the Inland Revenue (Amendment) (No. 2) Bill 2017 ("the Bill") in response to:

(a) the latest requirement of the Organisation for Economic Co-operation and Development ("OECD") in relation to harmful tax practices; and

(b) the submissions from the deputations.

This paper invites Members to consider the draft CSAs.

## Latest Requirement of OECD

2. OECD and the Group of Twenty released a package of 15 actions to combat base erosion and profit shifting ("BEPS") in October 2015. BEPS refers to tax planning strategies of multinational enterprises that exploit the gaps and mismatches in tax rules among economies to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. Hong Kong indicated to OECD in June 2016 its commitment to implementing the BEPS package.

3. Countering harmful tax practices is one of the four minimum standards of the BEPS package[1]. The Forum on Harmful Tax Practice ("FHTP"), a working party under OECD, is responsible for reviewing the preferential tax regimes relating to income from geographically mobile activities (such as financial and other service activities) of all participating jurisdictions. In determining whether a preferential tax regime is potentially harmful, FHTP would take into account a number of factors, one of which is that "the regime is ring-fenced from the domestic economy".

4. In March, we were informed that FHTP would adopt a rigid and

[1] The four minimum standards include countering harmful tax practice (Action 5), preventing treaty abuse (Action 6), imposing country-by-country reporting requirement (Action 13) and introducing dispute resolution mechanism (Action 14).

narrow interpretation on the "ring-fencing" factor when determining whether a preferential tax regime was potentially harmful. Failure to address OECD's concerns about harmful tax practices will jeopardize Hong Kong's reputation as an international financial centre. Meanwhile, the European Union ("EU") has kicked off an exercise to draw up a list of "non-cooperative tax jurisdiction" by the end of 2017 and the existence of harmful tax measures is one of its concerns[2]. A jurisdiction listed as "non-cooperative" could be subject to defensive measures which will make it a less attractive place for investment and business.

5. Given the latest development, we consider it prudent for Hong Kong to revise the proposed aircraft leasing regime so that there will not be a perception issue on ring-fencing as the proposed tax regime would only be made applicable for offshore aircraft leasing activities.

**Submissions from Deputations**

6. At present, companies leasing aircraft to a Hong Kong aircraft operator (i.e. onshore aircraft leasing activities) are entitled under the Inland Revenue Ordinance (Cap. 112) ("IRO") to obtain depreciation allowance in respect of the subject aircraft (i.e. referred to as **Scheme A** hereafter).

7. On the other hand, the proposed aircraft leasing regime under the Bill (i.e. referred to as **Scheme B** hereafter) aims to provide profits tax concessions in respect of offshore aircraft leasing activities. That is, to be eligible for the proposed profits tax concessions, the lessor's aircraft must be leased to a "non-Hong Kong aircraft operator", which does not include local aircraft operators and offshore aircraft operators having aircraft flying to Hong Kong.

8. Nevertheless, the industry stakeholders have some concerns on the above "non-Hong Kong aircraft operator" requirement. They commented that the proposed aircraft leasing regime would only cover non-resident aircraft operators carrying on business outside Hong Kong and those covered by Hong Kong's double taxation agreements and air services/shipping income agreements. Leasing of aircraft to an offshore aircraft operator in a non-treaty partner jurisdiction having aircraft flying to Hong Kong could not be eligible for the proposed profits tax concessions. As Hong Kong's treaty network is comparatively limited at present, this requirement would make the proposed aircraft leasing regime less attractive. They hope that the regime could cover all offshore aircraft operators.

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[2] EU will adopt three criteria in the screening process, namely (a) tax transparency; (b) fair taxation; and (c) implementation of anti-BEPS measures. In terms of fair taxation, the jurisdiction concerned should not have any preferential tax measures that are regarded as harmful by FHTP.

## Committee Stage Amendments

9. In view of the latest development in OECD and the submissions from the deputations, we propose to introduce the draft CSAs at **Annex A** so as to extend the proposed tax regime for offshore aircraft leasing activities under the Bill to onshore aircraft leasing activities as well. Under this revised tax regime, companies engaging in onshore aircraft leasing activities will be assessed under Scheme A by default. Alternatively, they may elect for assessment under Scheme B. The election, once made, is irrevocable. Meanwhile, companies engaging in offshore aircraft leasing activities will remain entitled to Scheme B only. A table summarising the tax assessment options under the proposed CSAs is at **Annex B**.

## Assessment of Stakeholders' Views

10. As stated in our Legislative Council Brief for the Bill (Ref: THB(T)CR 1/44/951/08), the Government has consulted local airlines on the original dedicated tax regime (i.e. only for off-shore aircraft leasing business) and all of them were supportive of the proposal. The proposed CSAs will provide all local airlines an additional option for their taxation arrangement. They can compare the pros and cons of Scheme A and Scheme B in accordance with their own business consideration/strategy and elect for assessment under the new tax regime or remain under the existing assessment arrangement by their own discretion. As such, we do not expect any objection from them.

## Advice Sought

11. Members are invited to note and comment on the draft CSAs.

**May 2017**

**Annex A**

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

**Committee Stage**

Amendments to be moved by the Secretary for Transport and Housing

| Clause | Amendment Proposed |
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| 4 | In the proposed section 14G(1), by deleting the definition of ***non-Hong Kong aircraft operator***. |
| 4 | In the proposed section 14G(6)(b), by deleting ", and is leased to a non-Hong Kong aircraft operator,". |
| 4 | In the proposed section 14G(7)(d), by deleting "a non-Hong Kong" and substituting "an". |
| 4 | In the proposed section 14H(1), by deleting "(4), (6) and (7)" and substituting "(4) and (6)". |
| 4 | By deleting the proposed section 14H(7) and substituting—<br>"(7) If subsection (1) applies to a corporation for a year of assessment, the corporation is not entitled to be granted any allowance under Part 6 for that year of assessment in respect of the capital expenditure incurred on the provision of the aircraft concerned.". |
| 4 | By deleting the proposed section 14I(3)(b) and substituting—<br>"(b) allowances under Part 6 have been granted to the corporation or a connected person of the corporation in respect of the capital expenditure incurred on the provision of the aircraft concerned; or". |

4 In the proposed section 14I(4), by deleting "a non-Hong Kong" and substituting "an".

4 In the proposed section 14J(1), by deleting "(5), (7) and (8)" and substituting "(5) and (7)".

4 By deleting the proposed section 14J(8) and (9).

4 By deleting the proposed section 14M(5), (6) and (8).

New By adding—

"**5A. Section 16 amended (ascertainment of chargeable profits)**

After section 16(1)—

**Add**

"(1A) In computing the amount of deduction of a person's outgoings and expenses for the purposes of subsection (1), if—

(a) the person is a connected person (as defined by section 14G(1)) of a corporation;

(b) a sum is payable by the person to the corporation, whether directly or through an interposed person; and

(c) the sum is included in the assessable profits of the corporation chargeable at a reduced tax rate under section 14H(1) or 14J(1) for a year of assessment,

the amount of deduction in respect of the sum is to be reduced such that the profits tax payable by the person is increased by reference to the amount of the reduction in the profits tax payable by the corporation

in respect of the sum for the year of assessment or any subsequent year of assessment.".".

8 In the proposed section 37(2B), by adding "in respect of which section 14H(1) applies" after "activity".

10(2) In the proposed section 39B(6A), by adding "in respect of which section 14H(1) applies" after "activity".

**Annex B**

## Summary of Tax Assessment Options under the Proposed CSAs

| | **Lease to HK Aircraft Operators** | **Lease to non-HK Aircraft Operators** |
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| **Tax Assessment under the Existing Bill** | **Scheme A** *(i.e. current tax treatment under the Inland Revenue Ordinance)*<br><br>✓ depreciation allowance<br>× 20% taxable base<br>× half rate | **Scheme B** *(i.e. proposed tax regime under the Bill)*<br><br>× depreciation allowance<br>✓ 20% taxable base<br>✓ half rate |
| **Tax Assessment Options under the Proposed CSAs** | Lessors are assessed under Scheme A by default –<br><br>**Scheme A:**<br>✓ depreciation allowance<br>× 20% taxable base<br>× half rate<br><br>Alternatively, they may elect for assessment under Scheme B –<br><br>**Scheme B:**<br>× depreciation allowance<br>✓ 20% taxable base<br>✓ half rate | Same as above<br>(i.e. Scheme B only) |