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LEGISLATIVE COUNCIL BRIEF

Inland Revenue Ordinance
(Chapter 112)

Inland Revenue (Amendment) (Ship Leasing Tax Concessions) Bill 2020

INTRODUCTION

A At the meeting of the Executive Council on 7 January 2020, the Council ADVISED and the Chief Executive ORDERED that the Inland Revenue (Amendment) (Ship Leasing Tax Concessions) Bill 2020 ("the Bill"), at **Annex A**, should be introduced into the Legislative Council to amend the Inland Revenue Ordinance ("IRO") (Cap.112) to give profits tax concessions to qualifying ship lessors and qualifying ship leasing managers, to make provisions for profits tax purposes about businesses in connection with ships, and to make related amendments.

JUSTIFICATIONS

Ship leasing is an attractive business to Hong Kong

Global trend

2. Notwithstanding some fluctuations in the global shipping market in recent years, the world fleet has largely grown at a pace on par with world seaborne trade growth over a long period of time, averaging around 3% per annum from 1980 to 2018 according to the United Nations Conference on Trade and Development. With some 80% of global freight volume carried by water today, the demand for water transport will likely continue to spur demand for ship financing. The "Maritime Leasing Paper" released by the Financial Services Development Council in May 2018 estimated that the capital expenditure for newbuilding vessels was about US$80-100 billion a year.

3. Among the different forms of ship financing, ship leasing is an emerging business model in the shipping industry compared to more traditional modes of ship financing such as bank loans. Advantages of leasing include better liquidity, greater flexibility in repayment options and

cash expenses, and lower financing costs. In particular, Chinese leasing as a source of ship finance has grown from US$8.2 billion in 2015 to US$20.2 billion in 2018, representing a strong growth of 35% per annum on average.

4. Given that the Organisation for Economic Co-operation and Development ("OECD") is developing new international taxation rules and principles to deal with tax abuses, notably the anti-base erosion and profit shifting ("BEPS") measures, some shipping and ship leasing companies are currently looking for opportunities to rebase their operations. In this connection, Hong Kong as an international maritime centre can provide a place where companies with genuine business substance can operate.

Regional landscape

5. With the shift of the global economic centre of gravity from the West to the East, and with the major contributor to shipowning and shipbuilding activities coming from Asia (e.g. around half of world's fleet is owned by Asia where China alone accounting for 15%; China, Korea and Japan together accounted for over 90% of global shipbuilding activity in 2018), ship financing activities are expected to see faster growth in Asia. According to the Seatrade Maritime News' estimates (May 2017), traditional banks (mainly those located in Europe) have gone from financing around 80% of the shipping industry in 2008 to about 60% in 2016, while Chinese leasing firms have expanded their market shares to about 20%.

6. Having recognised the importance of the presence of a vibrant maritime cluster in enhancing their position as major maritime centres, other international maritime cities have put forward tax measures and fiscal incentive schemes to proactively attract overseas companies to set up offices there, with a view to forming a strong maritime cluster of shipping groups and maritime services. Provision of tax incentives is a possible means for Hong Kong to stay competitive to effectively attract shipping-related companies to set up offices here.

Providing a conducive environment to promote ship leasing in Hong Kong

7. With the support of suitable policy initiatives, Hong Kong would stand to benefit from these growth opportunities. As ship leasing serves to facilitate ship ownership and operation, which also generate demand for other maritime business services, fostering the development of the ship leasing business in Hong Kong is conducive to the growth of our shipping core and maritime cluster.

8. Hong Kong has a strong maritime cluster of over 800 shipping-related companies. Among the various maritime services, ship finance has demonstrated clear growth potential, contributing more than half of the value added of the maritime services sector and registering a growth rate averaging at 9.6% per annum during 2014-2017, which far outpaced that of the maritime services sector as a whole (1.3% per annum over the same period).

9. Recognising the business opportunities arising from the growth of ship leasing as well as the competitive landscape for maritime business in the region, and having regard to the positive experience of introducing tax measures through the aircraft leasing regime, we propose to introduce profits tax concessions for qualifying ship lessors and qualifying ship leasing managers (see paragraphs 10 to 13 below) to provide a conducive environment for ship leasing business in Hong Kong. We also propose suitable anti-abuse features to guard against possible tax avoidance (see paragraph 14 below). Our vision is, through strengthening our competitiveness in attracting ship leasing activities, to enhance Hong Kong's position as an international maritime and financial centre.

The proposed dedicated tax regime

10. In order to raise the competitiveness of Hong Kong in attracting ship leasing activities and minimise the impact of the proposed tax measures on other parts of the existing tax regime, we propose providing for a new standalone tax regime under the IRO for qualifying ship lessors and qualifying ship leasing managers in which –

(a) the tax rate on the qualifying profits of qualifying ship lessors carrying out operating lease and finance lease activities (including subleasing and sale and leaseback arrangement) will be 0%;

(b) the tax rate on the qualifying profits of qualifying ship leasing managers carrying out ship leasing management activities for qualifying ship lessors will generally be 8.25% (i.e. half of the profits tax rate for corporations at 16.5%);

(c) the tax base in respect of an operating lease, other than a sublease, will be equal to 20% of rentals, after deduction of expenses (excluding depreciation), derived by a qualifying ship lessor; and

(d) the tax base in respect of a finance lease will be equal to finance charges or interest, after deduction of expenses, received by a qualifying ship lessor.

11. While setting up a special purpose vehicle with the only activity of holding a ship for leasing is a common form of structure for ship lessors in the ship finance industry, it may not be the case for ship leasing managers. Similar to the set-up in the aircraft leasing regime, a qualifying ship lessor should be a standalone corporate solely carrying out qualifying ship leasing activities, whereas for ship leasing managers, a safe harbour rule is prescribed to allow ship leasing managers having profits primarily from, and assets primarily for, their ship leasing management activities to enjoy the tax benefits. We also propose empowering the Commissioner of Inland Revenue ("CIR") to determine that a corporation is a qualifying ship leasing manager and hence eligible for the tax concessions if the CIR is of the opinion that the relevant conditions or safe harbour rule would, in the ordinary course of its business, have been satisfied.

12. Profits derived from a qualifying ship leasing activity or ship leasing management activity carried out by a corporation under specified conditions will be entitled to the proposed profits tax concessions if the corporation makes an election in writing. The specified conditions for a qualifying ship leasing activity are –

(a) the activity is carried out in the ordinary course of the corporation's business carried on in Hong Kong; and

(b) the ship is of over 500 gross tonnage navigating solely or mainly outside the waters of Hong Kong.

13. In addition to the condition specified in paragraph 12(a) above, a qualifying ship leasing management activity is subject to the following specified conditions –

(a) the activity is carried out for another corporation during the basis period of the other corporation for a year of assessment;

(b) the other corporation is a qualifying ship lessor for that year of assessment; and

(c) the ship is leased by the other corporation when the activity is carried out.

Anti-abuse features

14. The dedicated regime will incorporate anti-abuse features so as to safeguard the integrity of the tax system and comply with international tax rules. The features include –

(a) requiring qualifying ship lessors and qualifying ship leasing managers to be standalone corporate entities to prohibit loss transfer via partnership; and ringfencing the preferential tax regime to the qualifying activities;

(b) requiring the central management and control of qualifying ship lessors and qualifying ship leasing managers to be located in Hong Kong and their substantial activities to be carried out in Hong Kong (see paragraph 15 below for the substantial activity requirements) to ensure that their business operations are domiciled in Hong Kong with substance;

(c) denying a qualifying ship lessor the 20% tax base concession if depreciation allowances in respect of the ship have been granted to the lessor or its connected person, or granted to any person under a sale and leaseback arrangement (i.e. following the existing treatment as provided in the IRO);

(d) ensuring that qualifying ship lessors and qualifying ship leasing managers conduct business transactions with their associated parties on an arm's length basis;

(e) introducing main purpose tests to prevent tax avoidance and treaty shopping; and

(f) reducing the tax deduction for payments made by a lessee to its connected qualifying ship lessor by an amount of tax saving obtained by the lessor to maintain tax symmetry and prevent revenue loss.

Compliance with international standards

15. In determining whether a preferential tax regime meets the international standards on counteracting BEPS, the OECD will take into account whether the regime can meet the substantial activity requirements to ensure that only those entities which undertake core income generating activities in a jurisdiction would benefit from the regime. The substantial activity requirements involve two conditions in Hong Kong, namely (a) an adequate number of the full-time qualified employees and (b) an adequate amount of operating expenditure. After industry consultation, the <u>minimum</u> thresholds for the above two measurements for the ship leasing and ship leasing management tax regimes are proposed as follows (measured at the group company level) –

Qualifying activity	Number of full-time qualified employees	Annual operating expenditure
Ship leasing	2	HK$7.8 million (equivalent to US$1 million)
Ship leasing management	1	HK$1 million

16. The thresholds are proposed with the advice of the trade by reference to the actual operating statistics of ship leasing and ship leasing management companies. Given that the referenced companies are genuinely carrying out substantive businesses, while the proposed tax regime for qualifying ship leasing and ship leasing management activities is subject to the OECD's scrutiny, we are optimistic that the proposal featuring substantial activity requirements and without ringfencing from the domestic economy[1], would not be labelled by OECD as a harmful tax practice for the purposes of anti-BEPS measures.

Potential benefits of the proposal

17. According to the analysis conducted by the Task Force on Ship Leasing ("the Task Force") under the Hong Kong Maritime and Port Board, with relevant input from experts in the shipping and ship finance industries, if the proposed new tax regime for ship leasing is put in place, it is estimated that Hong Kong could capture 12% of the global ship finance market in ten years' time. This would bring about the following potential benefits (in 2018 dollars) –

(a) cumulative incremental ship finance business of about HK$265 billion to HK$460 billion over 10 years compared to the case if no tax measure is introduced;

(b) cumulative value added of around HK$20 billion to HK$35 billion over 10 years (from HK$0.4 billion to HK$0.6 billion in Year 1 to HK$3.6 billion to HK$6.3 billion in Year 10);

(c) direct employment of around 6 400 to 11 200 jobs (in terms of man-years) over 10 years (from 120 to 200 jobs in Year 1 to 1 170 to 2 040 jobs in Year 10); and

(d) indirect employment of about 23 000 to 40 000 jobs (in terms of

1 For the purpose of considering whether a tax regime constitutes a harmful tax practice, the OECD would consider various factors including the ringfencing issue. A preferential regime will be considered to be ringfenced from the domestic economy if (i) it excludes resident taxpayers from the benefits of the regime or (ii) an enterprise qualifying for the regime does not have access to the domestic market.

man-years) in the economic sectors/activities in support of the ship leasing business/activities over 10 years due to the linkage effects.

THE BILL

18. The Bill provides for the profits tax concessions for qualifying ship lessors and qualifying ship leasing managers, makes provisions for profits tax purposes about businesses in connection with ships, and makes related amendments to the IRO. The main provisions of the Bill are as follows –

(a) **Clauses 5, 18 and 19** add the new sections 14O to 14ZB and the new Schedules 8C and 17FA to the IRO to –

  (i) provide for the interpretation of terms, including "qualifying ship leasing activity" and "qualifying ship leasing management activity" for the proposed tax concessions provisions (the new section 14O and section 1 of the new Schedule 17FA);

  (ii) provide for profits tax concessions to qualifying ship lessors and qualifying ship leasing managers, the calculation of net lease payments for operating leases and net payments of finance charges or interests for funding leases, and certain tax treatments (the new sections 14P, 14Q, 14R, 14S and 14T and the new Schedule 8C);

  (iii) provide for the safe harbour rule for the qualification as a qualifying ship leasing manager (the new section 14U);

  (iv) provide for CIR's power to determine that a corporation is a qualifying ship leasing manager (the new section 14V);

  (v) provide for substantial activity threshold requirements, treatment of certain losses, anti-avoidance provisions and CIR's power to amend the new Schedule 17FA (the new sections 14W, 14X, 14Y, 14Z, 14ZA and 14ZB and the new Schedule 17FA);

(b) **Clause 6** amends section 15 of the IRO to deem sums received by or accrued to a corporation from carrying on certain businesses in connection with ships as having a Hong Kong source, even if the ships are used outside Hong Kong;

(c) **Clause 8** amends consequentially section 16 of the IRO and adds a new section 16(3D) to deem the payments of finance charges or interests for the right to use the ship under a funding lease as sums payable by way of interest on money borrowed for the purpose of producing the profits;

(d) **Clause 9** amends consequentially section 19CA of the IRO to provide for adjustments in respect of relevant losses to be set off against the concessionary trading receipt chargeable to tax under the new section 14P or 14T;

(e) **Clauses 10, 11, 12 and 13** amend sections 37, 38, 39B and 39D of the IRO respectively to deal with computation of the cost and capital expenditure in relation to a ship that is used by a corporation for carrying out a qualifying ship leasing activity before being used in another trade, profession or business;

(f) **Clauses 15 and 20** add a new Schedule to the IRO to deal with transitional matters; and

(g) **Clauses 4, 14, 16 and 17** are consequential amendments to sections 14, 63H and 100 of, and Schedule 8 to, the IRO respectively.

LEGISLATIVE TIMETABLE

19. The legislative timetable is as follows –

Publication in the Gazette	17 January 2020
First Reading and commencement of Second Reading debate	12 February 2020
Resumption of Second Reading debate, Committee Stage and Third Reading	To be notified

IMPLICATIONS OF THE PROPOSAL

20. The Bill is in conformity with the Basic Law, including the provisions concerning human rights. It will not affect the current binding effect of the IRO. It has no civil service, competition, environmental, family, gender or productivity implications. The financial, economic and
B sustainability implications of the proposal are set out at **Annex B**.

PUBLIC CONSULTATION

21. The proposed dedicated tax regime for the ship leasing business was developed by the Task Force, where tax, financial, legal and maritime experts as well as relevant Government bureaux/departments (i.e. Transport and Housing Bureau, Financial Secretary Office's Tax Policy Unit, and Inland Revenue Department) are represented.

22. We consulted individual industry stakeholders on the Task Force's proposal during July to August 2019 and they expressed support for the proposal. The proposal was also presented to the Hong Kong Maritime and Port Board and the Hong Kong Shipowners Association in early September and early November 2019 respectively. Industry stakeholders supported the proposal and opined that the introduction of tax concession would be conducive to enhancing Hong Kong's attractiveness as a base for the ship leasing business. We consulted the LegCo Economic Development Panel on the proposed tax regime on 26 November 2019. Members showed general support and urged the Administration to expedite work with a view to enacting the legislative proposals as soon as possible.

23. We have also established initial contact with some ship leasing companies. These companies indicated that they would actively consider setting up businesses in Hong Kong should there be a competitive tax regime. They considered that the measure would help them expand their businesses in the region more effectively riding on our strategic location and range of professional business services.

PUBLICITY

24. We will issue a press release upon gazettal of the Bill, and arrange a spokesperson to answer media enquiries.

ENQUIRIES

25. Enquiries may be directed to Miss Vicky Cheung, Principal Assistant Secretary for Transport and Housing (Transport), at 3509 8154.

Transport and Housing Bureau
January 2020