立法會
Legislative Council

LC Paper No. LS84/19-20

Further Report by Legal Service Division on
Inland Revenue (Amendment) (Ship Leasing Tax Concessions) Bill 2020

Members may recall from LC Paper No. LS51/19-20 dated 20 March 2020 and issued to Members vide LC Paper No. LC Paper No. CB(2)744/19-20 that the Legal Service Division ("LSD") was scrutinizing the legal and drafting aspects of the Bill.

2. To recap, the Bill seeks to amend the Inland Revenue Ordinance (Cap. 112) to give effect to the policy initiative announced by the Chief Executive in the 2018 Policy Address and the Financial Secretary in the 2019-2020 Budget Speech to foster ship leasing activities in Hong Kong by giving 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. No Bills Committee has been formed to study the Bill.

3. LSD has made enquiries with the Administration on certain matters relating to the Bill. The major issues in the enquiries and the Administration's response are set out below.

Anti-avoidance provision (proposed new section 14ZA under Clause 5)

4. Under the proposed new section 14ZA(1), the assessable profits of a corporation that is a qualifying ship lessor or a qualifying ship leasing manager derived from an arrangement would not enjoy the concessionary rate if the Commissioner of Inland Revenue ("the Commissioner") is satisfied that the main purpose, or one of the main purposes, of the corporation in entering into the arrangement is to obtain a tax benefit in relation to a liability to pay profits tax under Cap. 112. Under the proposed new section 14ZA(2), the proposed tax concessions would not apply in relation to any assessable profits accrued to a qualifying ship lessor if the Commissioner is satisfied that the main purpose, or one of the main purpose, of the corporation in entering into the arrangement is to obtain a tax benefit under a tax treaty that is contrary to the purpose of the treaty.

5. LSD has asked the Administration to clarify the considerations that would be taken into account by the Commissioner in determining whether the main purpose (or one of the main purposes) of the corporation in entering into the

arrangement is to obtain a tax benefit in relation to a liability to pay profits tax under Cap. 112 or under a tax treaty[1] that is contrary to the purpose of the tax treaty. The Administration has responded that all relevant circumstances surrounding the arrangement would be considered on a case-by-case basis including:

(a) the manner in which the arrangement was structured;

(b) the background of the arrangement, the time at which the arrangement was entered into and the alternative purposes which could objectively be attributed to the corporation in entering into the arrangement;

(c) the form (i.e. contractual rights and obligations created) and substance (i.e. practical and commercial end result) of the arrangement;

(d) the commercial or financial relations between the connected persons in the arrangement; and

(e) the contractual rights and obligations normally created, and the commercial or financial relationships normally entered into, between independent persons under an arrangement of the kind in question.

Threshold requirements (proposed new section 14W and sections 5 and 6 of the new Schedule 17FA under Clauses 5 and 19)

6. The proposed new section 14W of Cap. 112 provides that unless the threshold requirements (i.e. requirements about number of employees and total operating expenditure in Hong Kong) are met, certain activities would not be considered to be carried out in Hong Kong by the corporation for the purposes of the ship leasing tax concessions. LSD has asked the Administration to clarify whether the new section 14W, as drafted, could reflect its policy intent that the threshold requirements would be measured at the group company level. The Administration has responded that irrespective of whether the ship leasing activities or ship leasing management activities are carried out by the corporation itself or arranged to be carried out in Hong Kong by an associated person under the same group, the core income generating activities have to be carried out in Hong Kong in order for the corporation to be eligible for the tax concessions. The activities carried out by the associated person would be taken into account when considering whether the threshold requirements by a qualifying ship lessor or a qualifying ship leasing manager have been met (i.e. at the group level). The relevant practice for measuring

[1] Tax treaty is proposed to mean an arrangement made between two or more jurisdictions (whether including Hong Kong or otherwise) with a view to affording relief from double taxation (see the proposed new section 14ZA(4)).

the threshold requirements at group level will be explained in the Departmental Interpretation and Practice Notes published by the Inland Revenue Department.

Amendments proposed by the Administration

7. It is noted that the Administration intends to move amendments to the Bill (at the Council meeting of 27 May 2020), including amendments to the definitions of "ship leasing activity" (to expand the scope of the activity) and "ship leasing management activity" (to change "corporation" to "person"), and certain textual amendments. The Administration has provided explanations for the proposed amendments in the Annex to their reply letter dated 19 May 2020 to LSD's letter dated 11 May 2020. The Administration's reply letter is at Appendix. It is noted that the Administration's proposed amendments are technical in nature or for the compliance with the OECD's latest requirements.

8. Subject to Members' views on the matters set out in this report, no difficulties have been identified in relation to the legal and drafting aspects of the Bill and the proposed amendments.

Encl.

Prepared by

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21 May 2020

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19 May 2020

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By Fax
(Fax No.2877 5029)

Dear Ms Cheng,

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

I refer to your letter dated 11 May 2020 which sets out a list of questions seeking clarifications on several clauses of the captioned Bill. Our replies are as follows.

Clause 5 – new sections 14Q and 14R

2. According to the new section 14Q(1), if a qualifying ship lessor is eligible for the profits tax concessions under the new section 14P(1) for a year of assessment, the qualifying ship lessor would not be granted depreciation allowances under Part 6 of the Inland Revenue Ordinance (IRO) in respect of the capital expenditure incurred on the provision of the ship concerned for the year of assessment. In light of such loss of depreciation allowances, the new section 14(R)2 provides that the assessable profits of the qualifying ship lessor are computed as 20% (prescribed in section 2 of the new Schedule 17FA) of the net lease payments (referred to as the 20% tax base concession). The new section 14R(4)(c) would deny the qualifying ship lessor the 20% tax base concession if depreciation allowances have been previously granted to the qualifying ship lessor or its connected person in respect of the capital expenditure incurred on the provision of the ship concerned. The rationale is that if depreciation allowance has already been claimed before in respect of a ship, there is no need to accord the same with the 20% tax base concession.

Clause 5 – new section 14T

3. A qualifying ship lessor, assessed at a profit tax rate of 0% under the new section 14P(1), can either perform the ship leasing management services by itself or engage a ship leasing manager to perform such services (i.e. outsourcing to an independent ship leasing manager or engaging the group ship leasing manager to perform the task). The qualifying ship lessor will need to pay a service fee to the ship leasing manager, be it independent from the ship lessor or under the same group. Outsourcing such services to the ship leasing manager under its own group is no different from performing such services by the qualifying ship lessor itself (which would be subject to zero tax rate), as there would be no profit gained from the group perspective. The concessionary rate applicable to the group qualifying ship leasing manager is therefore set as 0% under the new section 14T(1)(b).

Clause 5 – new section 14ZA

Question (a)

4. The new section 14ZA introduces a main purpose test to prevent tax avoidance and treaty shopping. The crux of the test is to determine whether the main purpose or one of the main purposes of a corporation in entering into an arrangement is to obtain a tax benefit in relation to a liability to pay profits tax under the IRO or under a tax treaty. This is a question of fact which can only be answered by considering all relevant circumstances surrounding the arrangement on a case-by-case basis, which include –

(a) the manner in which the arrangement was structured;
(b) the background of the arrangement, the time at which the arrangement was entered into and the alternative purposes which could objectively be attributed to the corporation in entering into the arrangement;
(c) the form (i.e. contractual rights and obligations created) and substance (i.e. practical or commercial end result) of the arrangement;
(d) the commercial or financial relations between the connected persons in the arrangement; and
(e) the contractual rights and obligations normally created, and the commercial or financial relationships normally entered into, between independent persons under an arrangement of the kind in question.

Question (b)

5. The new section 14ZA(2) is to counteract "treaty shopping" which is prohibited under tax treaties, whether including Hong Kong or otherwise, in relation to sub-leasing.

6. Under a treaty shopping arrangement, which is not uncommon in the international leasing market, a qualifying ship lessor in Hong Kong, who intends to lease the ship concerned to a person in Jurisdiction A which does not have a tax treaty with Hong Kong, will first lease the ship concerned to a sub-lessor (e.g. a conduit without commercial substance) set up in Jurisdiction B which has a tax treaty with Jurisdiction A , and the sub-lessor in Jurisdiction B will further sub-lease the ship concerned to the person in Jurisdiction A. Through such an arrangement, the qualifying ship lessor will be able to obtain benefit under the tax treaty between Jurisdiction A and Jurisdiction B (e.g. enjoying a lower withholding tax on rental paid by the person in Jurisdiction A) which is contrary to the purpose of the tax treaty.

7. To prevent our ship leasing regime from abuses, which will render the regime a harmful practice from the perspective of the Organisation for Economic Co-operation and Development (OECD), the new section 14ZA(2) will make the new section 14P(1) not applicable if the Commissioner of Inland Revenue is satisfied that the main purpose, or one of the main purposes, of an arrangement is for obtaining such tax benefit through sub-leasing of a ship. Since such tax treaty abuses are usually found in sub-leasing arrangements, the new section 14ZA(2) only applies to a qualifying ship lessor but not a qualifying ship leasing manager, as the sub-leasing concept is not relevant to leasing management services.

Clauses 5 and 19 – new section 14W and sections 5 and 6 of the new Schedule 17FA

8. The new sections 14P(4)(a)(ii) and 14T(5)(a)(ii) provide that the core income generating activities of a qualifying ship lessor or a qualifying ship leasing manager (as prescribed in the new Schedule 17FA) have to be "carried out in Hong Kong by the corporation" or "arranged by the corporation to be carried out in Hong Kong". The phrase "carried out in Hong Kong by the corporation" refers to the activities carried out by the corporation itself, whereas the phrase "arranged by the corporation to be carried out in Hong Kong" refers to the activities carried out by another person, i.e. an associated person under the same group or by a third party, through outsourcing. The new section 14W provides that for the purposes of the new sections 14P(4)(a)(ii) and 14T(5)(a)(ii), threshold requirements prescribed in sections 5 and 6 of the new Schedule 17FA must be met.

9. Outsourcing of core income generating activities is allowed by the OECD for preferential tax regimes provided that the outsourced activities are adequately monitored and conducted in the jurisdiction providing the tax regimes. Irrespective of whether the activities are carried out by the corporation itself or arranged to be carried out by another person, the core income generating activities have to be carried out in Hong Kong in order for the corporation to be eligible for the tax regime. Since the core income generating activities can be carried out by an associated person under the same group through outsourcing, and if so the qualifying ship lessor or qualifying ship leasing manager should exercise adequate

control over the outsourced activities and the relevant expenditure incurred should be re-charged as expenditure of the lessor or leasing manager concerned, the activities carried out by the associated person would be taken into account when considering whether the threshold requirements prescribed under the new Schedule 17FA have been met (i.e. at the group level). The relevant practice for measuring the threshold requirements at group level will be explained in the Departmental Interpretation and Practice Notes published by the Inland Revenue Department, which contain the Department's interpretation and practices in relation to the IRO and would be issued for information of the taxpayers and their representatives.

Clause 9 – section 19CA amended

10. Your proposed amendments to repeal the reference to section 23A(2) and (2A) is outside the scope of the present Bill. In any case, your proposed amendments would not affect the legal effect of our ship leasing tax regime and hence are not strictly necessary. That said, the Administration notes the issues raised, and the amendments of the relevant clauses will be dealt with in another occasion.

Clause 19 – section 1(1) of the new Schedule 17FA

Definition of "ship leasing activity"

11. Section 1(1) of Schedule 17FA generally defines "*Ship leasing activity*" which refers to the leasing of a ship by a ship lessor to another ship lessor. The other ship lessor, being also a lessee, may be a person (e.g. a partnership, trustee, etc.) which does not fall within the definition of a qualifying ship lessor (i.e. a corporation). Accordingly, "*ship lessor*" is generally defined in the new section 14O(1) as a person carrying on a business of carrying out ship leasing activities, and hence a reference to "a person" and "the person" is made in the definition of "*ship leasing activity*" under Schedule 17FA.

12. "*Ship leasing manager*" is defined in the new section 14O(1) as a person carrying on a business of carrying out ship leasing management activities, but a reference to "a corporation" and "the corporation" is made in the definition of "*ship leasing management activity*" under Schedule 17FA. In this regard, the Administration will move Committee Stage Amendments to the Bill to change the reference from "a corporation" and "the corporation" to "a person" and "the person" in the definition of "*ship leasing management activity*" in Schedule 17FA to align with section 14O(1).

Meaning of "special purpose entity"

13. Paragraphs (b), (c) and (d) of the definition of "*ship leasing management activity*" in section 1(1) of the new Schedule 17FA are modelled on

the same paragraphs of the definition of "*aircraft leasing management activity*" in section 1(1) of the Schedule 17F in which "*special purpose entity*" is not defined. No issue has arisen so far in relation to the interpretation of "*aircraft leasing management activity*" despite the absence of a legal definition.

14. "*Special purpose entity*" as referred to in the "*ship leasing management activity*" needs not be defined in the Bill and should be given its ordinary meaning. In general, the term "*special purpose entity*" refers a legal entity (e.g. a limited liability company) which is created to fulfil a narrow, specific or temporary objective (e.g. owning a ship) and is typically used by a group of companies to isolate the group from financial risks, whether expected or unexpected.

Amendments to be proposed by the Administration

15. The list of amendments to be moved to the Bill by the Administration is set out in **Annex**. We have given notice to the moving of the amendments separately in accordance with clause 57(2) of the Rules of Procedure of the LegCo.

16. If you have further questions, please contact the undersigned or Ms YM TO, Senior Assessor (Research) of the IRD, at 2594 6708.

Yours sincerely,

(Vicky Cheung)
for Secretary for Transport and Housing

c.c.

DoJ	(Attn:	Mr Manuel Ng, SGC	(Fax No.3918 4613)
		Mr Allen Lai, SGC)	(Fax No.3918 4613)
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Inland Revenue (Amendment) (Ship Leasing Tax Concessions) Bill 2020
Summary of Amendments

Item	Clause	Amendment Proposed	Explanation
1	5	In the proposed section 14T(1), in the Chinese text, in paragraph (a), by adding "或" after the semicolon.	Textual amendment to align with the English text.
2	5	In the proposed section 14W(4), in the Chinese text, in the definition of *門檻要求*, by deleting "requirement" and substituting "requirements".	Textual amendment to align with the English text.
3	19	In the proposed Schedule 17FA, in section 1(1), the definition of ***ship leasing activity*** is revised as marked up: ***ship leasing activity*** (船舶租賃活動), in relation to a person, means an activity comprising— (a) the leasing of a ship by the person to a ship lessor, ship leasing manager or ship operator; and (b) any of the following activities carried out by the person— (i) agreeing funding terms in relation to the lease concerned;	To address the recommendation of the Forum on Harmful Tax Practice (FHTP) of the Organisation for Economic Co-operation and Development (OECD) that qualifying ship leasing activities carried out by a qualifying ship lessor in Hong Kong should include the core income generating activities as set out in para. 8, p.41 (financing and leasing regimes) at Annex D (substantial activities in regimes

Item	Clause	Amendment Proposed	Explanation
		(ii) identifying or acquiring the ship to be so leased; (iii) setting the terms and duration of that lease; (iv) monitoring or revising any funding or other agreements in relation to that lease; (v) managing any risks associated with that lease or with an activity mentioned in subparagraph (i), (ii), (iii) or (iv);	other than IP regimes) of the 2017 Progress Report on Preferential Regimes (see attached).  Annex D of 2017 Progress Report.p
4-8	19	In the proposed Schedule 17FA, in section 1(1), the definition of ***ship leasing management activity*** is revised as marked up: ***ship leasing management activity*** (船舶租賃管理活動), in relation to a person~~corporation~~, means any of the following activities— (a) managing another person~~corporation~~ that is a ship lessor; (b) establishment or administration of a special purpose entity for the purpose of owning a ship by that entity; (c) providing, or arranging for the provision of, finance in obtaining the ownership of a ship by a special purpose entity wholly or partly owned by the person~~corporation or its associated corporation~~, or evaluating	To align with the definition of ship leasing manager in section 14O in relation to "a person".

Item	Clause	Amendment Proposed	Explanation
		financial proposals from external financiers in relation to the obtaining of that ownership; (d) providing, or arranging for the provision of, a guarantee in respect of a financial or performance obligation as regards the ship leasing business of a special purpose entity wholly or partly owned by the personcorporation ~~or its associated corporation~~, or granting security in respect of that business; (e) managing leases; (f) arranging for the procurement or leasing of ships; (g) arranging for the operation, crewing, voyage monitoring, maintenance, repair, certification, insurance, storage, scrapping or modification of ships, or the port agency services or security services for ships; (h) arranging for the evaluation, appraisal, provision or inspection of ships or maintenance facilities for ships (including internal audits of ship quality); (i) arranging for the assessment of the shipping market conditions; (j) marketing of leases; (k) providing, or arranging for the provision of, finance in obtaining the ownership of a ship	

Item	Clause	Amendment Proposed	Explanation
		by a shipping enterprise from another personcorporation that is a ship lessor; (l) providing a residual value guarantee or contingent purchase arrangement; (m) providing services in relation to a ship leasing activity for or to another personcorporation that is a ship lessor; (n) overseeing the design and construction of newbuild ships. (1A) In paragraphs (c) and (d) of the definition of ***ship leasing management activity*** in subsection (1), a reference to the person includes— (a) if the person is a corporation—an associated corporation of the person; or (b) in any other case—an associate of the person.	
9	19	In the proposed Schedule 17FA, sections 5 and 6 are revised as marked up: **5. Qualifying Ship Leasing Activity** For the purposes of paragraph (a) of the definition of ***threshold requirements*** in section 14W(4), the requirements are that—	To address the recommendation of the FHTP of the OECD that the adequate principle should be included in the threshold requirement in relation to the qualifying ship leasing activity

Item	Clause	Amendment Proposed	Explanation
		(a) during the basis period for the year of assessment concerned, the average number of full-time employees in Hong Kong who carry out the activity concerned and have the qualifications necessary for doing so is adequate in the opinion of the Commissioner and in any event not less than 2; and (b) the total amount of operating expenditure incurred in Hong Kong for the activity during the basis period for that year of assessment is adequate in the opinion of the Commissioner and in any event not less than $7,800,000. **6. Qualifying Ship Leasing Management Activity** For the purposes of paragraph (b) of the definition of ***threshold requirements*** in section 14W(4), the requirements are that— (a) during the basis period for the year of assessment concerned, the average number of full-time employees in Hong Kong who carry out the activity concerned and have the qualifications necessary for doing so is adequate in the opinion of the Commissioner and in any event not less than 1; and (b) the total amount of operating expenditure incurred in Hong Kong for the activity during the basis period for that year of	and the qualifying ship leasing management activity.

Item	Clause	Amendment Proposed	Explanation
		assessment is adequate in the opinion of the Commissioner and in any event not less than $1,000,000.	
10	19	In the proposed Schedule 17FA, in the Chinese text, in section 6, by adding "中" after "14W(4)條".	Textual amendment.

Transport and Housing Bureau

Inland Revenue Department

May 2020

creation. The effect of this new guidance is that it will be less likely for significant income to be allocated to an entity which lacks substantial activities and which was established in a jurisdiction merely to receive benefits under a non-IP regime.

- **Country-by-country reporting** – Action 13 established a minimum standard on country-by-country (CbC) reporting. This minimum standard reflects a commitment to implement the common template for CbC reporting. The effect of CbC reporting is that jurisdictions will have relevant information necessary to determine whether resident companies have related entities which lack substantial activities and which are established in a jurisdiction merely to receive benefits under a non-IP regime. In particular, CbC reporting will provide jurisdictions with country-by-country breakdowns of related party revenues, profits before income tax, income tax paid and accrued, number of employees, tangible assets, and other indicators of economic activities within large MNE groups.

5. Actions 8-10 and Action 13 do not eliminate the need for a substantial activities requirement, but they complement the substantial activities requirement by giving jurisdictions better tools to protect against profit-shifting to preferential regimes with little substance. The need for a robust substantial activities requirement for non-IP regimes therefore needs to be seen in light of the overall BEPS Action Plan.

Possible substantial activities analysis for preferential regimes other than IP regimes

6. Although the Actions discussed above may limit the need for a substantial activities requirement in non-IP regimes, they do not eliminate this need. Jurisdictions with such regimes must therefore implement the principles set out in the Action 5 Report (OECD, 2015a) to ensure that preferential regimes other than IP regimes require substantial activities in order to provide benefits. This section sets forth a two-step approach for the implementation of substantial activities in non-IP regimes under which (1) jurisdictions would require activities and establish mechanisms to review compliance with this requirement, and (2) the FHTP would monitor compliance.

Requiring substantial activities

7. In order to comply with the principles set out in the Action 5 Report (OECD, 2015a), non-IP regimes must be designed to ensure that benefits are available only when the core income generating activities are undertaken by the qualifying taxpayer (or, for regimes outside the European Union, when the core income generating activities are undertaken in the jurisdiction providing benefits).[3] Jurisdictions offering non-IP regimes that are in scope of the FHTP work therefore need to design the regime in a way that ensures that core activities relevant to the regime type are undertaken by the taxpayer wishing to benefit from the regime.

8. Core income generating activities presuppose having an adequate number of full-time employees with necessary qualifications and incurring an adequate amount of operating expenditures to undertake such activities. As set out in the Action 5 Report (OECD, 2015a), such activities could include the following.

- **Headquarters regimes** – The core income generating activities in a headquarters company could include taking relevant management decisions; incurring expenditures on behalf of group entities; and co-ordinating group activities.

- **Distribution and service centre regimes** – The core income generating activities in a distribution or service centre company could include activities such as transporting and storing goods; managing stocks and taking orders; and providing consulting or other administrative services.
- **Financing and leasing regimes** – The core income generating activities in a financing or leasing company could include agreeing funding terms; identifying and acquiring assets to be leased (in the case of leasing); setting the terms and duration of any financing or leasing; monitoring and revising any agreements; and managing any risks.
- **Fund management regimes** – The core income generating activities for a fund manager could include taking decisions on the holding and selling of investments; calculating risks and reserves; taking decisions on currency or interest fluctuations and hedging positions; and preparing relevant regulatory or other reports for government authorities and investors.
- **Banking regimes** – The core income generating activities for banking companies could include raising funds; managing risk including credit, currency and interest risk; taking hedging positions; providing loans, credit or other financial services to customers; managing regulatory capital; and preparing regulatory reports and returns.
- **Insurance regimes** – The core income generating activities for insurance companies could include predicting and calculating risk, insuring or re-insuring against risk, and providing client services.
- **Shipping regimes** – The core income generating activities for shipping companies could include managing the crew (including hiring, paying, and overseeing crewmembers); hauling and maintaining ships; overseeing and tracking deliveries; determining what goods to order and when to deliver them; and organising and overseeing voyages.
- **Holding company regimes** – For holding companies that hold a variety of assets and earn different types of income (e.g. interest, rents, and royalties), the core income generating activities would be those activities that are associated with the income that the holding companies earn, as determined by the discussion above. (For example, a holding company that receives benefits for banking income would be required to have the core income generating activities associated with banking companies.) For pure equity holding companies, which only hold equity participations and earn only dividends and capital gains, the Action 5 Report makes clear that there is less concern of such regimes being used for BEPS. The Report states that such holding companies must respect all applicable corporate law filing requirements in order to meet the substantial activities requirement, and suggests that they should have the people and the premises for holding and managing equity participations. Beyond this, because such regimes are provided in part to avoid double taxation, there should be no expectation of a correlation between income-generating activities and benefits. In other words, holding company regimes, including participation exemptions, are particular as the tax exemption / tax benefit is based on policy considerations other than notions of value creation.

9. For "internal" income shifting (i.e. the shifting of income from other domestic sources into the regime to avoid the otherwise applicable higher domestic tax rate), jurisdictions can be expected to already be addressing such problems in order to protect their own revenue