For discussion
on 25 April 2022

Legislative Council Panel on Economic Development

Proposed Tax Regime To Promote Ship Management, Ship Agency and Shipbroking Businesses in Hong Kong

Purpose

This paper briefs Members on the legislative proposal to amend the Inland Revenue Ordinance ("IRO")(Cap. 112) to provide for a dedicated tax regime to attract shipping commercial principals (namely ship managers, ship agents and ship brokers) to set up presence in Hong Kong, thereby enhancing Hong Kong's position as an international maritime centre in the Asia-Pacific region and promoting further development of the maritime sector.

Background

Hong Kong as an international maritime centre

2. Hong Kong is an international maritime centre with over 150 years of maritime history. It enjoys competitive advantage in high value-added maritime services with a strong maritime cluster of nearly 900 shipping-related companies. Among the various maritime services, ship managers, ship brokers and ship agents, which take up a significant portion of around 40% of the Hong Kong maritime cluster in terms of number of firms, have yet to enjoy any tax concession under the current shipping tax regimes in Hong Kong. Attracting the business presence of these drivers of shipping activities is paramount to enhancing the competitiveness of Hong Kong's maritime industry.

3. Recognising the competitive landscape for maritime business in the region and subsequent to the Government's announcement in October 2018 the tax measures used to foster ship leasing business in Hong Kong, the Government announced in October 2019 the initiative of "*tax concessionary measures to encourage more commercial principals of the maritime industry (such as ship managers, ship brokers and ship agents)*

to set up presence in Hong Kong". With reference to the ship leasing tax regime enacted in June 2020, a Task Force on Commercial Principals (Task Force), comprising tax, financial, legal and maritime experts as well as representatives from relevant Government bureau/departments, was set up under the Hong Kong Maritime and Port Board in late 2020 to devise the details of the proposed tax concessions for shipping commercial principals.

Seizing further development opportunities

4. With over 80% of global freight volume carried by water today, the demand for water transport will likely continue to spur demand for high-end maritime services. With the shift of the global economic centre of gravity from the West to the East, and with the major contributor to shipowning activities coming from Asia (e.g. around half of world fleet in terms of deadweight tonnes was owned by Asia, with Mainland China, Japan and Singapore accounting for 12%, 11% and 7% in 2021), maritime services is expected to see robust demand from Asia.

5. The "Outline of the 14th Five-Year Plan for National Economic and Social Development of the People's Republic of China and the Long-Range Objectives Through the Year 2035" as endorsed by the 13th National People's Congress in March 2021 supports consolidating Hong Kong's position as an international maritime centre and the development of high value-added maritime services in Hong Kong for better integration into the country's development course. The "Outline Development Plan for the Guangdong-Hong Kong-Macao Greater Bay Area" as promulgated in February 2019 also expresses such support.

6. The "Maritime Leasing Paper" released by the Financial Services Development Council in May 2018 suggested, among other things, that Hong Kong should attract more shipping commercial principals[1] such as shipowners, lessors, carriers, investors, operators, and ship management companies to base their operation in Hong Kong, in order to enhance the competitiveness of Hong Kong's maritime industry.

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[1] The Report noted that while Hong Kong is the 4th largest shipping register in terms of total gross tonnage (GT) (which has reached 113.2 million GT in 2017), the percentage of fleet owned by Hong Kong principals is only 24% (i.e. 27.3 million GT). In comparison, Singapore came as the 5th largest shipping register with 85.4 million GT, with 48% of the ships concerned owned by Singapore companies (i.e. with 41.2 million GT) according to Clarksons Research. At the same time, given the shift of the global economic gravity from the West to the East in the past years, and with major contribution to shipowning and ship building activities in Asia over the years, tonnage providers around the globe have been searching for an Asian base of operations. The Report suggested that there shall be room for Hong Kong to grow its own base of shipping commercial principals and attract those shipping players with vessels registered in Hong Kong Shipping Register but without a substantial local presence to base their operation in Hong Kong.

7. Ship management, ship agency and shipbroking businesses are important maritime business services supporting international shipping activities. Ship managers provide management services[2] for a ship to render it fit and safe for operation and voyage. Ship agents refer to parties who represent ship owners, charterers or ship lessors at ports to facilitate efficient port calls of ships[3]. Ship brokers act on the interests of different ship users including but not limited to ship owners, charterers, lessors, prospective ship buyers or lessees to facilitate the conclusion of business deals relating to a ship among different ship users.

8. Having recognised the importance of the presence of a vibrant maritime cluster in enhancing their position as major maritime centres, other international maritime cities[4] 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 commercial principals to set up offices here.

9. With the support of suitable policy initiative, Hong Kong would stand to benefit from these growth opportunities. As ship management, ship agency and shipbroking businesses serve to facilitate ship ownership and operation, which also generate demand for other maritime business services, fostering the development of shipping commercial principals in Hong Kong is conducive to the growth of our shipping core and maritime cluster.

10. Meanwhile, the Organisation for Economic Co-operation and Development ("OECD")'s action in developing new international taxation rules and principles to deal with tax abuses, notably the anti-base erosion and profit shifting ("BEPS") measures, has driven shipping commercial principals currently based in some low-tax countries to look for opportunities to rebase their operations. This offers an opportunity for Hong Kong to attract companies with genuine business interest to come to operate in Hong Kong.

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[2] Such services usually relate to the management of technical, crew and commercial aspects of a vessel, as well as its insurance arrangements.

[3] Typical ship agency services include handling cargo operation matters with the port, seeking clearance for ships from relevant authorities and provision of port and husbandry services.

[4] Notably, Singapore offers the Maritime Sector Initiative (MSI) Scheme, one of which is the Supporting Shipping Services (SSS) Award. The MSI-SSS Award promotes the growth of shipping service providers in Singapore by providing a concessionary tax rate on incremental income derived from the provision of approved shipping-related support services such as ship broking, ship management and ship agency.

The Proposal

11. To promote the development of shipping commercial principals in Hong Kong and make our tax regime competitive vis-à-vis major competitors in the region, we propose incorporating in the IRO a new dedicated regime under which –

(a) the profits derived by a qualifying shipping commercial principal (i.e. a ship manager, ship agent or ship broker) from carrying out a qualifying activity in Hong Kong will be subject to a profits tax rate at 8.25% (i.e. half of the profits tax rate for corporations at 16.5%).

(b) the profits derived by a qualifying shipping commercial principal from carrying out a qualifying activity for an associated shipping enterprise[5], which is entitled to tax concessions or income exemption under the IRO, will be subject to the same concessionary tax rate or income exemption rule as those applicable to the associated shipping enterprise.

Anti-abuse features

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

(a) <u>Entity Based Approach</u>: requiring a qualifying shipping commercial principal to be a standalone corporate entity pre-dominantly engaging in relevant qualifying activities to prevent loss transfer via partnership and ringfence the tax benefits to the corporate entity. In addition, under the **safe harbour** rules, the standalone entity may be allowed to engage in other non-qualifying profit generating activities subject to specified limits (e.g. the percentage of profits and assets related to those activities should be less than 25% of its aggregate profits and assets);

(b) <u>Central Management and Control ("CMC") Requirements:</u>

5 An associated shipping enterprise refers to a person who is a ship lessor, ship leasing manager, ship operator or ship owner entitled to tax concessions or exemption under section 14P(1), 14T(1) or 23B of IRO **and** (a) whom the qualifying entity has control over, (b) who has control over the qualifying entity, or (c) who is under the control of the same person as the qualifying entity.

requiring a qualifying shipping commercial principal to exercise its CMC (i.e. the highest level of control of its business)[6] in Hong Kong to ensure that its business operations are domiciled in Hong Kong with substance.

(c) Substantial Activity Requirements: requiring a qualifying shipping commercial principal to carry out the core income generating activities ("CIGAs") in Hong Kong by (a) employing an adequate number of full-time qualified employees in Hong Kong **and** (b) incurring an adequate amount of operating expenditure in Hong Kong, which are not less than the minimum thresholds to be prescribed so as to ensure that its operations are undertaken in Hong Kong with substantial business presence;

(d) Arm's Length Principle for Transfer Pricing: ensuring that the profits from a transaction between a qualifying shipping commercial principal and its associated party are determined on an arm's length basis by reference to the profits that would have accrued if the same transaction had been carried out by independent persons;

(e) Main Purpose Test: introducing a main purpose test to prevent tax avoidance and treaty shopping, under which profits tax concession in respect of profits accrued under an arrangement entered into by a qualifying shipping commercial principal would be denied if the main purpose, or one of the main purposes, of the arrangement is to obtain a tax benefit under the IRO or a tax treaty; and

(f) Anti-tax Arbitrage Rule[7]: reducing the tax deduction for service fee paid by a payer subject to full-rate (e.g. a non-qualifying ship lessor) to its connected qualifying shipping commercial principal subject to half-rate by reference to an amount of tax saving obtained by the qualifying shipping commercial principal, so as to maintain tax symmetry and prevent profit shifting from a high-tax regime to a low-tax regime.

6 Generally, the CMC of a qualifying entity is located in Hong Kong if the executive officers and senior management employees of the qualifying entity exercise day-to-day responsibility for more of strategic, financial and operational policy decision making in Hong Kong and conduct more of the day-to-day activities necessary for preparing and making those decisions in Hong Kong, than in any other jurisdictions.

7 To counteract the practice of obtaining tax benefits by using the differences in tax systems, tax treatments or tax rates in how transactions are treated for tax purposes, e.g. by recognizing income in a low-tax regime while recognizing expenses in a high-tax regime.

Substantial activity requirement

13. In determining whether a preferential tax regime meets the international standards on countering BEPS, the OECD will take into account whether the regime has incorporated a substantial activity requirement test to ensure that only those entities which undertake the CIGAs[8] in a jurisdiction would benefit from the regime. To satisfy the substantial activity requirements, an entity is required to (a) employ an adequate number of the full-time qualified employees and (b) incur an adequate amount of operating expenditure in a jurisdiction for carrying out the CIGAs in the jurisdiction. After industry consultation, the minimum threshold that a qualifying shipping commercial principal is required to meet for the above to aspects in Hong Kong are proposed as follows –

Number of full-time qualified employees	Annual operating expenditure
1	HK$1 million

Potential Benefits of the Proposal

14. The Task Force conducted an economic impact assessment with inputs from professional experts in the relevant fields. According to the assessment, if the proposed new tax regime for qualifying ship managers, agents and brokers is put in place, it is estimated that the following benefits would be brought about (in 2019 dollars) –

(a) cumulative incremental ship management, ship agency and shipbroking business of about HK$32.5 billion over 10 years compared to the status if no tax measure is introduced;

(b) cumulative value added of around HK$17.7 billion over 10 years, and HK$4.2 billion in Year 10;

(c) direct employment of around 27 600 jobs (in terms of man-years)

[8] CIGAs can be carried out by a qualifying entity itself or outsourced to a group company. When determining whether the threshold requirements are satisfied by a qualifying entity, the employees employed or operating expenditure incurred by a group company would be taken into account if (a) the CIGAs are carried out by the group company in Hong Kong through outsourcing arrangement; (b) a service fee is charged to the qualifying entity on an arm's length basis; (c) the number of employees and the amount of operating expenditure are commensurate with the level of the CIGAs carried out by the group company; and (d) the qualifying entity has exercised adequate monitoring of the CIGAs outsourced to the group company.

over 10 years, and 6 600 jobs in Year 10; and

(d) indirect employment of about 50 000 – 55 000 jobs (in terms of man-years) in the economic sectors/activities in support of the shipping principals' activities over 10 years due to the linkage effects.

15. According to the Inland Revenue Department, tax revenue generated from ship management, ship agency and shipbroking activities was about HK$140 million for the year of assessment 2020/21, equivalent to 0.1% of total profits tax revenue or 0.02% of total government revenue for the year. With the introduction of half-rate tax concessions for these businesses, the tax revenue foregone should constitute only an insignificant portion of the total profits tax revenue of the Government. On the other hand, the tax measure will help attract new ship management, agency and broking companies to establish and operate in Hong Kong, and hence in turn generate additional tax revenue and bring positive economic impetus to Hong Kong.

Consultation

16. The Task Force's proposal was presented to the Hong Kong Maritime and Port Board (HKMPB) in early September 2021. Comprising key industry stakeholders such as the Hong Kong Shipowners Association, Hong Kong Liner Shipping Association and the Hong Kong Sea Transport and Logistics Association, HKMPB supported the proposal and opined that the proposed tax regime would be conducive to enhancing Hong Kong's attractiveness as a base for shipping commercial principals.

Way Forward

17. Subject to the support of the Panel on Economic Development, we plan to introduce the relevant legislative amendments into the Legislative Council in June 2022.

Transport and Housing Bureau
Inland Revenue Department
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