NEW HONG KONG TAX CONCESSION FOR AIRCRAFT LEASING BUSINESSES

The Inland Revenue (Amendment) (No. 3) Ordinance 2017 (the "**Ordinance**") was gazetted and came into effect on 7 July 2017. The Ordinance introduces a tax regime for Hong Kong's aircraft financing and leasing industry that will rival those of competitor jurisdictions such as Ireland and Singapore.

Key issues

- Hong Kong aircraft operators may elect to receive the tax concession under the Ordinance or continue to be assessed based on the existing Hong Kong aircraft operators regime.
- The Ordinance is applicable to operating leases but not finance leases.
- There is no tax depreciation allowance under the Ordinance unlike the Irish and Singaporean tax regimes.

APPLICATION

The Ordinance significantly lowers the current corporate tax rate from 16.5% to an effective tax rate as low as an estimate of 3% to 4%. The new tax rate applies to specific types of aircraft leasing businesses.

The Ordinance will halve the corporate tax rate from 16.5% to 8.25% for "qualifying profits" of the following entities:

1. Qualifying Aircraft Lessors ("**QAL**"); and
2. Qualifying Aircraft Lease Managers ("**QALM**").

QUALIFYING AIRCRAFT LESSORS

What is a QAL?

To be deemed a QAL the business must satisfy, among other things, the following criteria:

1. it is not an aircraft operator;
2. it carries out one or more "qualifying leasing activities"; and
3. central management, control and profit generating activities must be carried out in Hong Kong (the "**Substance Condition**").

What are "qualifying leasing activities"?

"Qualifying leasing activities" must meet the following criteria:

1. the activities are carried out in the ordinary course of business in Hong Kong; and

2, the aircraft is owned by the QAL.

Under the new regime, only 20% of "qualifying profits" (gross lease payments less deductible expenses excluding tax depreciation) derived from qualifying leasing activities of a QAL will be taxable.

Therefore the corporate tax rate in respect of the leasing activities for a QAL is reduced to just 1.65% (8.25% x 20%).

QUALIFYING AIRCRAFT LEASE MANAGERS

What is a QALM?

To be deemed a QALM the business must satisfy, among other things, the following criteria:

1. it is not an aircraft operator;
2. it may or will satisfy the "safe harbour rule";
3. it carries out one or more "qualifying aircraft leasing management activities"; and
4. it has not carried out in Hong Kong any activity other than a "qualifying aircraft leasing management activity"; and
5. the Substance Condition is satisfied.

What activities must the QALM conduct?

"Qualifying aircraft leasing management activities" must meet the following criteria:

1. the activity is carried out in the ordinary course of business in Hong Kong;
2. the service is for a QAL;
3. the aircraft is owned by a QAL;
4. the aircraft is leased to an aircraft operator.

Examples of these types of activities include:

- managing QALs;
- providing finance;
- providing guarantees;
- managing leases; and
- assessing market conditions.

The qualifying profits from these activities will be taxed at 8.25%. QALMs do not get the additional benefit of having only 20% of its qualifying profits being taxed as QALs do.

What is the "safe harbour rule"?

A QALM may or will satisfy the safe harbour rule if:

1. its aircraft leasing management profits ("**ALMP**") percentage is not lower than the prescribed profits percentage being 75%; and
2. its ALMP percentage is not lower than the prescribed asset percentage being 75%.

LEGAL IMPLICATIONS

To satisfy the "qualifying" requirements, the QAL and QALM will need to have its central management and control in Hong Kong. This is a question of fact and common law principles apply.

In addition, it is worth noting that the new regime places significant emphasis on the concept of "ownership". Whilst the Ordinance does not apply to finance leases, conditional sales or hire purchases arrangements, if the QAL is or will become an "owner" such that the QAL has the beneficial ownership of the aircraft and will receive legal title to the aircraft at the end of the lease term, the concession will likely apply.

OECD COMPLIANCE

To comply with the OECD's Base Erosion and Profit Shifting (BEPS) initiative, the Ordinance requires that the aircraft must be owned by the QAL. To avoid being considered a potentially harmful tax practice under the BEPS initiative, the Inland Revenue Department ("**IRD**") views the lessee as being the true owner of the aircraft in finance leases, hire purchases and conditional sales. Therefore these arrangements are not covered under the Ordinance.

The Substance Condition also ensures that the Ordinance is OECD compliant as it ensures that the QAL or QALM is actually based in Hong Kong.

Further anti-abuse rules ensure that profits cannot be eligible for the tax break as well as being tax deductible. The Ordinance also requires transactions between QALs, QALMs and other relevant parties to be at arm's length.

The first draft of the Ordinance excluded Hong Kong aircraft operators from the new tax regime. So as to avoid any instances of ring fencing from the domestic market, this exclusion has since been removed and gives Hong Kong aircraft operators the option of whether they would like to be considered under the Ordinance or whether they prefer to continue to be taxed at the prevailing 16.5% corporate tax rate and be entitled to tax depreciation allowances.

Comparison to Singapore and Ireland

	Hong Kong	Ireland	Singapore
QAL tax rate*	1.65%	12.5%	8%
QALM tax rate	8.25%	12.5%	8%
Depreciation	No	Yes	Yes
Withholding tax with China	5%	6%	6%
Double tax treaties**	37	72	82

*Not taking into account there is no depreciation allowance in Hong Kong.

**As of May 2017 and includes treaties not yet in force.

OTHER CONSIDERATIONS

Tax payment deferral

Hong Kong's tax regime requires tax to be paid in cash each year. There is no concept of tax deferrals as there is in Singapore and Ireland which can be an incentive for lessors to prefer those jurisdictions.

Depreciation

The Ordinance does not allow for tax depreciation allowances as is the case in Ireland and Singapore. The lack of depreciation allowances is compensated by the fact that only 20% of adjusted profit is taxable for QALs, which ensures that the effective tax rate in Hong Kong (estimated to be 3% to 4%) is still lower than Singapore and Ireland.

As discussed above, Hong Kong aircraft operators may choose to receive tax depreciation allowances (and be taxed at the prevailing corporate tax rate) instead of being assessed for tax under the Ordinance.

Double taxation treaty

As illustrated in the table above, Hong Kong has significantly less double taxation treaties compared with Singapore and Ireland. Therefore this will be a consideration for QALs and QALMs when deciding whether to set up a business in Hong Kong.

Withholding tax

Notwithstanding the lower number of double taxation treaties, significantly the withholding tax rate in respect of rental payments made from a key global aviation market, China, to Hong Kong is 5%, which is lower than the current 6% withholding tax rate applicable to rental payments from China to Ireland or Singapore.

CONCLUSION

The Ordinance will strengthen Hong Kong's ability to compete with key existing jurisdictions such as Ireland and Singapore in attracting capital and human resources dedicated to aircraft operating leasing and supporting industries, particularly those focussed on the continually expanding PRC market.

CONTACTS

Paul Greenwell
Partner

T +852 2825 8857
E paul.greenwell
@cliffordchance.com

Kenneth Leung
Consultant

T +852 2826 3565
E kenneth.leung
@cliffordchance.com

Hetty Lam
Senior Associate

T +852 2825 8982
E hetty.lam
@cliffordchance.com

Jeffrey Ip
Associate

T +852 2826 3536
E jeffrey.ip
@cliffordchance.com