Hong Kong Tax Alert

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Consultation on enhancing aircraft leasing preferential tax regime launched

In 2017, Hong Kong introduced an aircraft leasing preferential tax regime to provide half-rate tax concessions to qualifying aircraft lessors and qualifying aircraft leasing managers in Hong Kong (the Regime).

Chief Executive John Lee has already indicated in his 2022 Policy Address that the Regime will be further enhanced to develop Hong Kong into a preferred location for aircraft leasing in the region.

On 22 November 2022, the Transport and Logistics Bureau and the Inland Revenue Department (IRD) jointly issued a trade consultation paper[1] proposing certain measures to enhance the attractiveness of the Regime. Views of industry players are sought to ensure the practicality and applicability of the proposals.

This tax alert summarizes the proposed enhancement measures and our comments thereon. Clients who have any thoughts or questions on the proposals can contact their tax executives.

Tax concessions under the Regime

Subject to certain anti-avoidance provisions, corporations that meet the specified conditions may make an irrevocable election in writing to avail themselves of the Regime, which provides that:

(i) qualifying profits of qualifying aircraft lessors and qualifying aircraft leasing managers will be taxed at the concessionary tax rate of 8.25%, i.e., one-half of the normal corporate profits tax rate; and

(ii) in lieu of tax depreciation allowances[2], the deemed taxable amount in respect of income derived from the leasing of aircraft to an aircraft operator by a qualifying aircraft lessor will be equal to 20% of its gross rentals reduced by tax deductible expenses, but excluding tax depreciation allowances (i.e., a 20% tax base concession or an 80% deemed deduction).

1. The consultation paper can be accessed from the below link: https://www.tlb.gov.hk/eng/publications/transport/consultation/air02/index.html

2. Under section 39E of the IRO, a lessor would be denied tax depreciation allowances in respect of the cost they incurred on the acquisition of an aircraft if the aircraft is leased to an overseas aircraft operator. Leasing of an aircraft to a Hong Kong aircraft operator would normally be entitled to tax depreciation allowances.

Proposal 1 – Replacing the 20% tax base concession with a one-off 100% tax deduction of the acquisition cost of aircraft

In place of the current rule that only 20% of the net rental income of an aircraft is deemed as the tax base (as compensation for the denial of tax depreciation allowances), a qualifying aircraft lessor will instead be allowed a one-off tax deduction of the full acquisition cost of an aircraft in the year of acquisition, subject to a claw back mechanism upon disposal.

This proposal is made in response to the expected soon implementation of the Pillar Two global minimum tax of 15% for in-scope multinational enterprise (MNE) groups. Under Pillar Two, constituent entities of such groups will be subject to a top-up tax up to the required minimum, if their jurisdictional effective tax rate (ETR) is below that level. Such a top-up tax can be levied by a jurisdiction(s) outside of Hong Kong where the ultimate parent entity or other constituent entities of the group are located, if Hong Kong does not introduce a qualified domestic minimum top-up tax of 15%.

The reason for the proposed change is that the current deemed 80% deduction of the tax base is a permanent difference for deferred tax purposes, thus giving rise to no deferred tax liabilities, thereby dragging down the ETR of the qualifying aircraft lessor. The proposed one-off tax deduction of the acquisition cost of an aircraft will however be a timing difference, thus giving rise to deferred tax liabilities, which are added to the covered taxes for the calculation of the ETR.

An example is included in Annex I to illustrate the calculation of the jurisdictional ETR in Hong Kong under the current rule of the Regime and the rule under Proposal 1, if adopted.

Proposal 2 – No denial of the 20% tax base concession under specified scenarios

Instead of the current rule of a blanket denial of the 20% tax base concession for cases where capital allowances in respect of an aircraft have previously been claimed for tax purposes, two carve-outs from such denial are proposed. Namely, (i) where the lessor or its connected person is subject to extra-territorial taxation (e.g., through a controlled foreign company regime) in another jurisdiction whereby capital allowances have been taken into account; and (ii) the capital allowances on an aircraft granted to the lessor's connected person in a jurisdiction outside Hong Kong have been fully clawed back in that jurisdiction.

If Proposal 1 is adopted, the one-off 100% tax deduction will then not be denied in the above two carve-out situations.

Proposals 3 and 4 – Expanding the scope of a qualifying lease and coverage of qualifying aircraft leasing activities to keep up with the latest practices of the industry

Recognizing that the mode of leasing and the sources of demand have changed substantially, partly due to the COVID-19 pandemic, the government proposes to expand the scope of a qualifying lease and coverage of qualifying aircraft leasing activities to keep up with these developments.

Under these two proposals: (i) a qualifying lease will no longer be confined to a dry lease of at least of one year but extended to cover a dry lease of less than one year, a wet lease[3] and a funding or finance lease[4] in respect of an aircraft; and (ii) leasing of aircraft to non-aircraft operators including private companies, public organizations or even individuals will also be qualifying leasing activities (currently only confined to leasing to aircraft operators).

Proposals 5 and 6 – Relaxing the current stringent interest deduction rules in respect of interest payable on money raised to finance the acquisition of aircraft

Under section 16(2) of the Inland Revenue Ordinance (IRO), interest paid on money borrowed from an overseas lender to finance the acquisition of plant and machinery would only be deductible if the lender is an overseas financial institution or not an associate of the borrower. Where the financing is made by way of issuing debentures listed on a stock exchange, the stock exchange concerned must be recognized by the Commissioner of Inland Revenue (CIR).

Under Proposal 5, to accommodate the different financing means for the acquisition of aircraft, the condition of interest deduction under section 16(2) of the IRO will be amended such that interest payable on money borrowed from a non-associated financier outside Hong Kong (whether or not it is a financial institution) that is wholly and exclusively to finance the acquisition of an aircraft used by a qualifying aircraft lessor for producing its qualifying profits will be deductible. If the financier outside Hong Kong is an associate of the borrower, the interest deduction will be subject to certain anti-abuse provisions (e.g., a "subject to tax" condition).

Under Proposal 6, noting that many aircraft leasing groups raise bond financing or have notes in asset backed securitization structure that are listed in Ireland, the Irish Stock Exchange will be recognized by the CIR.

3. A dry lease generally means a lease of the aircraft, not including crew, insurance and maintenance, whereas a wet lease is a typically short-term lease for seasonal needs including the aircraft, crew, maintenance and insurance during the period of the lease.
4. Funding lease is a financing arrangement under which the lessee is transferred the risks and rewards of the aircraft ownership and the aircraft lessor is the financier. The lessee is usually provided with an option to purchase the aircraft at the end of the leasing agreement.

Proposal 7 – Introducing specified substantial activities thresholds to comply with OECD requirements

All the preferential tax regimes contained in the IRO are subject to substantial activities thresholds in terms of number of qualified persons employed and operating expenditure incurred under the rules established by the Organisation for Economic Co-operation and Development (OECD). The threshold requirements for the Regime, however, has yet to be prescribed in the law. As such, the government proposes to specify the following threshold requirements and seeks the industry's comments on whether the proposed requirements are appropriate:

Qualifying activities	Full-time qualified persons employed in Hong Kong	Annual operating expenditure incurred in Hong Kong
Aircraft leasing	1	HK$2 million
Aircraft leasing management	2	HK$10 million

Proposal 8 – Clarifying that a bare trust leasing model will qualify for the Regime

To provide flexibility for the transfer of leases upon changes in the beneficial ownership of aircraft, there has been an increase in the use of a bare trustee to hold the legal ownership of aircraft for aircraft lessors as beneficial owners. Such a leasing model may potentially not qualify for the Regime. This is because the word "own" may be interpreted as covering both the legal and beneficial ownership of an aircraft for the purposes of the Regime.

Under this proposal, Departmental Interpretation and Practice Notes No. 54 issued by the IRD will be updated to provide clarity and guidance to the industry that a bare trust leasing model will qualify for the Regime, provided that other qualifying conditions are also satisfied.

Commentary

We appreciate the government has been in touch with the industry for coming up with the above proposed enhancement measures for consultation.

By reducing the drag-down effect on the jurisdictional ETR of a qualifying aircraft lessor under Pillar Two, the proposal to replace the current 20% tax base concession with a 100% one-off tax deduction of the acquisition cost of an aircraft is also a welcoming move. Such a proposal may also be said to be fairer as a qualifying aircraft lessor will then be taxed based on its actual operating profits, as opposed to a deemed tax base which was set by reference to the average net profit margin of aircraft lessors.

Similar consideration may also apply to other tax incentives such as whether to replace the current super tax deductions for qualifying research and development expenditure with qualified refundable tax credits so that the drag-down effect on the jurisdictional ETR of the entity concerned can be reduced.

There may however be arguments that provided that an aircraft is transferred to a qualifying aircraft lessor in Hong Kong at full market value, the fact that the overseas associated transferor is not subject to a "full" claw back of the capital allowances previously claimed for tax purposes should not be excluded from the carve-out under (ii) of Proposal 2.

This is because a "full" claw back would conceivably only occur if the aircraft concerned is transferred to the qualifying aircraft lessor in Hong Kong at an amount not less than the original acquisition cost of the aircraft incurred by the overseas associated transferor. Any transfers at less than that amount may only lead to the overseas associated transferor being only subject to a "partial" or even "no" claw back.

Arguably, provided that the actual transfer value represents the full market value of the aircraft, the qualifying aircraft lessor in Hong Kong should not be denied the 20% tax base concession or a 100% one-off tax deduction if Proposal 1 is adopted.

Separately, the proposed relaxation of the current interest deduction rules for the acquisition of aircraft by qualifying aircraft lessors may also have scope to extend to other taxpayers more generally.

In the meantime, clients who have any thoughts or questions on the above proposed enhancement measures can contact their tax executives.

Annex I

Example

In Year 1, Qualifying Aircraft Lessor-HK acquired an aircraft at a consideration of HK$120 million and leased the aircraft to a non-Hong Kong resident Aircraft Operator-F for a term of five years under a dry lease. The lease rental charged by Qualifying Aircraft Lessor-HK for Year 1 was HK$11 million. Qualifying Aircraft Lessor-HK had not claimed depreciation allowances in respect of the aircraft before and elected for the half rate concession. Its operating expenses, excluding a 20-year straight-line annual depreciation expense of HK$6 million in respect of the aircraft, amounted to HK$1 million in Year 1.

For Global Anti-Base Erosion (GloBE) rules purposes, Qualifying Aircraft Lessor-HK is the only constituent entity of an in-scope MNE group in Hong Kong. The calculation of the jurisdictional ETR based on the current rule of the Regime and that based on the rule under Proposal 1, if adopted, is computed as follows:

<u>Qualifying Aircraft Lessor-HK – Statement of profit or loss for Year 1</u>
(in thousands dollars)

	HK$
Gross lease rental	11,000
Less: direct operating expenses	(1,000)
depreciation expense	<u>(6,000)</u>
Profit before tax	<u>4,000</u>

Under the current rule – 20% tax base concession in lieu of tax depreciation allowances under the Regime

Hong Kong profits tax computation of Qualifying Aircraft Lessor-HK

	Calculations	Remarks
Assessable profits/ (adjusted loss)	(HK$11,000,000 - HK$1,000,000) x 20% = HK$2,000,000	Assuming that the operating expenses of HK$1 million are tax deductible under section 16(1) of the IRO.
Profits tax payable@8.25%	**HK$165,000**	

Computation of the jurisdictional ETR of Qualifying Aircraft Lessor-HK

Steps	Calculations	Remarks
GloBE income (Financial Accounting Net Income or Loss)	HK$4,000,000	
Covered taxes (Current tax expense)	HK$165,000	The 20% tax base concession is a permanent difference, and no deferred tax adjustment will be made.
Jurisdictional ETR (Adjusted Covered Taxes / GloBE Income)	HK$165,000 / HK$4,000,000 = 4.125%	

Under Proposal 1, if adopted (i.e., the capital cost of the aircraft will be fully deductible in the year of acquisition)

Hong Kong profits tax computation of Qualifying Aircraft Lessor-HK

	Calculations	Remarks
Assessable profits/ (adjusted loss)	(HK$11,000,000 - HK$1,000,000 - HK$120,000,000) = (HK$110,000,000)	Assuming that the operating expenses of HK$1 million are tax deductible under section 16(1) of the IRO.
Profits tax payable	**NIL**	

For accounting purposes, Qualifying Aircraft Lessor-HK would recognize the following deferred tax asset and liabilities for financial accounting purposes:

- Deferred tax asset arising from the tax loss carried forward: HK$110 million x 8.25% = HK$9,075,000
- Deferred tax liabilities arising from the taxable temporary differences between the carrying amount of the aircraft (cost less accumulated depreciation) and its tax base (i.e., zero in this example): (HK$120 million - HK$6 million) x 8.25% = HK$9,405,000.

Computation of the jurisdictional ETR of Qualifying Aircraft Lessor-HK

Steps	Calculations	Remarks
GloBE income (Financial Accounting Net Income or Loss)	HK$4,000,000	
Covered taxes (Current tax expense + total deferred tax adjustment)	HK$0 + HK$330,000 = HK$330,000	The net total deferred tax adjustment (HK$9,405,000 - HK$9,075,000) will be treated as an addition to adjusted covered taxes.
Jurisdictional ETR (Adjusted Covered Taxes / GloBE Income)	HK$330,000 / HK$4,000,000 = 8.25%	

Top-up tax under subject to tax rule

In addition to a potential top-up tax levied under the GloBE rules noted above, the Pillar Two global minimum tax initiative also contains another rule called the subject to tax rule, i.e., the STTR. It is a treaty-based rule that allows source jurisdictions to impose limited source taxation on certain related party payments e.g., interest, royalties and a defined set of other payments that are subject to tax at below the minimum rate of 9% in the jurisdiction of a recipient.

Royalties are sometimes defined in a comprehensive avoidance of double taxation arrangement (CDTA) to include aircraft lease payments. As such, if the STTR applies to a Hong Kong's CDTA, a Hong Kong resident aircraft lessor may also be subject to top-up tax up to 9% under the STTR, notwithstanding that the CDTA concerned otherwise prescribes a lower withholding tax rate for such payments.

Any top-up tax imposed under the STTR will be taken into account in computing the jurisdictional ETR under the GloBE rules. In other words, the STTR operates in priority to the GloBE rules.

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