Hong Kong Tax Alert

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DIPN 62: The IRD clarifies how it will interpret and administer the concessionary tax regime for qualifying ship leasing activities

The Inland Revenue Department (IRD) has recently issued Departmental Interpretation and Practice Notes No. 62 (DIPN 62) explaining the provisions of a new law that grants concessionary tax treatment for (i) qualifying ship lessors and (ii) qualifying ship leasing managers in Hong Kong. Please refer to our Hong Kong tax alert issued on 11 June 2020 (2020 Issue No. 6) for details of the concessionary tax regime under the new law.

DIPN 62 contains the following noteworthy explanations:

i. activities including certain financing activities and a leasing manager's own sub-leasing business of a ship that may not normally be considered as "ship leasing management activities" do so qualify;

ii. the "adequacy test" for determining the threshold requirements for carrying out core income generating activities (CIGAs) in Hong Kong; and

iii. certain conventions or concessions adopted for determining whether a person qualifies as a qualifying ship leasing manager under a prescribed safe harbor rule.

Notwithstanding the issuance of DIPN 62, the application of the new law to certain situations could still be complicated. Where necessary, clients should seek professional tax advice.

Summary of the concessionary tax regime

Subject to certain anti-avoidance provisions, the new concessionary tax regime provides that:

i. the tax rate on the qualifying profits[1] of qualifying ship lessors derived from a qualifying ship leasing activity, in respect of both an operating lease or a finance lease, (including a sale-and-leaseback arrangement) will be 0%. A qualifying ship leasing activity is broadly defined to include leasing of a ship to a ship lessor (i.e., a sub-lessor), a ship leasing manager or a ship operator;

ii. the tax rate on the qualifying profits of qualifying ship leasing managers carrying out qualifying ship leasing management activities for a non-associated qualifying ship lessor will be 8.25% (i.e., 50% of the current normal corporate tax rate of 16.5%); and the tax rate will be reduced to 0% if the qualifying ship lessor is an associated corporation;

iii. in lieu of tax depreciation allowances[2], the deemed taxable amount in respect of the qualifying ship leasing income of a qualifying ship owner-lessor derived from an operating lease, will be equal to 20% of rentals less deductible expenses, but excluding depreciation; and

iv. the taxable amount in respect of income derived from a finance lease by a qualifying ship lessor, will be equal to the relevant finance charges or interest received from the lease less deductible expenses.

The notable clarifications made in DIPN 62 are discussed below.

Clarifications detailed in DIPN 62

What falls within the scope of "ship leasing management activities"?

DIPN 62 clarifies that amongst various other activities, the following activities also fall within the scope of the "ship leasing management activities" of a ship leasing manager:

a. The manager's own leasing of a ship from a ship owner and sub-leasing the ship to another person, in addition to the other ship leasing management activities undertaken by the manager. That means the manager would not then be regarded as carrying on both (i) a business of ship leasing and (ii) a business of ship leasing management. In other words, the manager's sub-leasing of the ship would simply be regarded as part of the overall ship leasing management activities of the manager. As such, it would be the overall ship leasing management activities of the manager that would need to satisfy one of the prescribed safe harbor rules in order that the manager qualified as a qualifying ship leasing manager;

b. Provision or arrangement for the provision of (i) finance in obtaining the ownership of a ship; or (ii) a guarantee in respect of a financial or performance obligations as regards the ship leasing business of a special purpose entity (SPE) which is wholly or partially owned by the manager or an associate of the manager. In other words, where such services are not performed by the manager for an associated SPE, the services would fall outside the scope of ship leasing management activities; and

c. At the request of a qualifying ship lessor, the manager providing finance to a ship operator to acquire a ship from the qualifying ship lessor. Such services would be regarded as the manager assisting the qualifying ship lessor to dispose of the ship. In this regard, the ship operator and the qualifying ship lessor need not be associated with the manager.

The "adequacy test" for determining the threshold requirements for CIGAs

One of the qualifying conditions for the eligibility for the concessionary tax regime under the new law is that the following minimum threshold requirements for carrying out CIGAs in Hong Kong are satisfied:

Qualifying activities	Threshold requirements	
	Average number of qualified full-time employees in Hong Kong	Total amount of operating expenditure incurred in Hong Kong
Qualifying ship leasing activity	2	HK$7.8 million
Qualifying ship leasing management activity	1	HK$1 million

In addition, the new law has an overarching requirement that the Commissioner of Inland Revenue (CIR) must be of the opinion that the amount of operating expenditure incurred, and the number of qualified persons employed, is "adequate". In other words, satisfying the above minimum threshold figures is only a prerequisite condition. Ultimately, the CIR must be satisfied that the actual amount of operating expenditure incurred, and the number of qualified persons employed, are "adequate" considering the mode and scale of operation of the taxpayer concerned.

1. DIPN 62 states that qualifying profits include incidental income such as interest income, exchange gains or hedging gains, to the extent that the relevant transactions are ancillary to the qualifying activities.

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 a ship if the ship is leased to an overseas ship operator. The lessor of a ship to a Hong Kong ship operator would normally be entitled to tax depreciation allowances. However, if tax depreciation allowances are claimed by a lessor in such situations, the lessor as a result will not be eligible for the concessionary tax rate and the deemed notional tax base.

The term "adequate" is however not defined in the new law. DIPN 62 indicates that if compared to a taxpayer in a similar position, the amount of profits claimed for the tax concession is disproportionate to the number of qualified persons employed and the amount of operating expenditure incurred, the CIR may presume that the "adequacy test" is not met. In such a case, the taxpayer concerned would need to produce relevant evidence to show that, notwithstanding the disproportionality, the required CIGAs are in fact carried out in Hong Kong. Otherwise, the taxpayer concerned would not be entitled to the concessionary tax treatment.

DIPN 62 also indicates that the IRD would adopt the following interpretation of the various terms employed to define CIGAs:

Key terms	Clarifications provided in DIPN 62
"Qualified full-time employees"	Includes leasing manager, marketing manager, legal counsel, financial controller and credit risk analyst.
"Average number of full-time employees"	The aggregate of the number of employees as at the end of each calendar month in the basis period as divided by the number of calendar months in the basis period.
"Operating expenditure incurred"	▸ Generally, includes rental expenses, staff costs and related expenses, other selling, general and administrative expenses. ▸ Also includes finance costs or interest expenses that are directly attributable to the acquisition of a ship for use in a qualifying ship leasing activity. ▸ Depreciation in respect of assets that are directly used for carrying out the CIGAs of a qualifying ship lessor or qualifying ship leasing manager in Hong Kong. ▸ However, depreciation of a ship acquired by a qualifying ship lessor for earning lease payments **would not** be accepted as an operating expenditure.

Prescribed safe harbor rules applicable to ship leasing managers

Where a corporation is not dedicated solely to undertaking ship leasing management activities, it must pass one of the prescribed safe harbor rules before it can qualify for the tax concessionary treatment under the new law.

One of the prescribed safe harbor rules under the new law requires that both the aggregate amount of the ship leasing management profits (SLMP) and the aggregate value of the ship leasing management assets (SLMA) for a year of assessment in question, are not less than 75% of the total amount of the profits and value of the assets of the corporation concerned.

As regards the application of the above SLMP and SLMA tests, DIPN 62 states that in general, the accounting profits and asset values as reflected in the audited financial statements of a corporation will be relevant, regardless of the source of the profits and location of the assets concerned.

DIPN 62 also indicates that where an asset which is used partly for carrying out a qualifying ship leasing management activity and partly for another purpose, apportionment of the value of the asset concerned by reference to the extent of the two respective uses would be required in determining the SLMA of a ship leasing manager.

In the case where a ship leasing manager also acts as the holding company for a leasing group, DIPN 62 states, apparently as an extra-statutory concession, that the IRD is prepared to exclude both equity investments in group companies and dividend income from the denominators for the calculation of the SLMA and SLMP percentages By way of the IRD adopting this approach, such a corporation would more readily qualify as a qualifying ship leasing manager under the relevant safe harbor rule.

Commentary

We welcome the clarifications and guidance provided by the IRD in DIPN 62. However, DIPN 62 has not provided guidelines on how the above objective minimum threshold figures for CIGAs are to be calculated where several group companies engage in qualifying ship leasing or ship leasing management activities and share a common pool of qualified full-time employees and operating expenditure.

For example, for various commercial reasons, a group that owns a large fleet of ships may decide to house each ship in a special purpose company, which would have no employees and operating expenditure of its own other than ship financing costs. The ship leasing businesses of these special purpose companies may then be centrally managed by a separate group ship leasing manager. In such circumstances, it is unclear how the number of qualified full-time employees and the amount of operating expenditure of the group ship leasing manager are to be attributed to these special purpose companies for the purposes of ascertaining each of their minimum threshold figures for CIGAs.

Notwithstanding the issuance of DIPN 62, the application of the new law to certain situations could be complicated, e.g., as noted above certain financing arrangements that normally might not be considered as "ship leasing management activities" may so qualify. Professional tax advice should be sought, where necessary.

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