

IRD's Practice Note on Taxation of Aircraft Leasing Activities

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INTRODUCTION

In order to promote Hong Kong aircraft leasing to capture the opportunity in China, the government introduced new legislation to attract aircraft leasing and management businesses to Hong Kong.

On 27 October 2017, the Inland Revenue Department ("IRD") issued the Departmental Interpretations and Practice Note No. 54 ("DIPN 54") – Taxation of Aircraft Leasing Activities on the applications of the new concessionary tax regime for aircraft leasing and aircraft leasing management activities to explain how an aircraft lessor and aircraft leasing manager can obtain the profits tax concessions.

THE CONCESSIONARY TAX REGIME

Taxpayers that meet the specified conditions can make an irrevocable election in writing to enjoy the following concessionary tax regime.

- (a) Concessionary profits tax rate of 8.25% (50% of the prevailing tax rate) for qualifying profits derived from qualifying aircraft leasing activities and quality leasing management activities;
- (b) Taxable profits of qualifying aircraft lessors deemed from qualifying aircraft leasing activities is 20% of their gross rentals less deductible expenses, but excluding tax depreciation.
- (c) Gain on disposal of an aircraft which has been used for qualifying aircraft leasing activity for a continuous period of not less than 3 years where concessionary tax rate applies will be deemed as capital gain.

GUIDELINES AND CLARIFICATIONS IN THE DIPN 54

(1) Leasing of aircraft to an aircraft operator indirectly

Under the relevant provision, aircraft leasing activities is defined as leasing aircraft by a corporation to an aircraft operator. Strictly speaking, the aircraft leasing profits tax concession is not applied to the leasing of the aircraft by the qualifying aircraft lessor to the aircraft operator through an intermediate lessor.

However, the Commissioner of Inland Revenue ("CIR") indicates in the DIPN 54 that if the leasing of aircraft by the qualifying aircraft lessor to the aircraft operator through the intermediate lessor is justified by commercial reasons, the IRD may still consider that the lessor is eligible for the profits tax concession. The CIR further states that the IRD will consider all the facts and circumstances for determining the aircraft leasing profits tax concession under the above arrangement.

(2) Central management and control requirement

Amongst other requirements, a qualifying aircraft lessor or a qualifying leasing manager is required to have its central management and control ("CMC") exercised in Hong Kong.

The location of the CMC is a question of fact. The DIPN 54 states that the CMC is located in Hong Kong if the executive officers and senior management employees of the qualifying aircraft lessor or qualifying aircraft leasing manager exercise day-to-day responsibility for more of their 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 jurisdiction.

(3) Substantial activity requirement

The activities that produce the qualifying profits in that year have to be either (i) carried out in Hong Kong by the lessor or manager themselves; or (ii) arranged by the lessor or manager to be carried out in Hong Kong (substantial activity requirement) in order for a qualifying aircraft lessor or qualifying leasing manager to enjoy the profits tax concession.

To satisfy the substantial activity requirement, the DIPN54 explains that the core income generating activities which produce the qualifying profits of a qualifying aircraft lessor or a qualifying aircraft leasing manager need to be carried out in Hong Kong. Such activities include raising funds; agreeing funding terms; identifying and acquiring aircraft to be leased; soliciting lessees; setting the terms and duration of leases; monitoring and revising lease agreements; managing any risks and maintaining documentation. They need to be carried out by the qualifying aircraft lessor or the qualifying aircraft leasing manager in Hong Kong.

The DIPN 54 further states that for the aircraft lessor setting up a special purpose vehicle ("SPV") to hold an aircraft, it may be necessary to consider whether an SPV lessor has sufficient connection or nexus with the active conduct of aircraft leasing activity in Hong Kong, including the engagement of an aircraft leasing manager carrying on business in Hong Kong.

Nonetheless, as different corporations may have different business models, the DIPN 54 states that the IRD will consider all the relevant facts circumstances when determining whether the CMC and substantial activity requirements are satisfied.

The DIPN 54 further explains that for the year in which the aircraft leasing activity commences, it is important to submit for the CIR's consideration a realistic business plan for carrying out aircraft leasing activity in Hong Kong to assist the IRD in determining whether the CMC and the substantial activity requirements are satisfied.

(4) Safe harbor rule for an aircraft leasing manager

If an aircraft leasing manager has carried out activities other than qualifying aircraft leasing management activities in Hong Kong, a corporation can still be qualified as a qualifying aircraft manager under safe harbor rule.

The safe harbor rule is satisfied if both of its aggregate amount of the aircraft leasing management profits ("ALMP") and the aggregate value of the aircraft leasing management assets ("ALMA") are not lower than 75% of the total amount of profits and value of the assets of the corporation for the subject year or for the specified years (i.e. the current year and the preceding one or two years, where applicable).

The DIPN 54 further explains that ALMA and ALMP can be based on the amount shown in the audited accounts of the aircraft leasing manager, regardless of the location of the assets and whether the income has been derived offshore.

There may be cases whereby an aircraft leasing manager also acts as the holding company for a leasing group. Where the equity investment in group companies and/or dividend income is substantial, the safe harbour rule may not be satisfied since the equity investment in group companies and dividend do not fall within the definitions of aircraft leasing management asset and aircraft leasing management profits respectively.

As dividend income is generally not taxable in Hong Kong, the CIR is prepared to exclude equity investment in group companies and dividends from the denominators for the calculation of the ALMP and ALMA percentages so that such an aircraft leasing manager may also be regarded as a qualifying aircraft leasing manager under the safe harbour rule.

The DIPN 54 also indicates if a corporation carries out both qualifying leasing activity and qualifying management activity, profits and assets relating to the qualifying aircraft leasing activity may be excluded from computing the ALMP and ALMA.

(5) Certificate of Resident Status

As withholding tax is normally imposed on aircraft rentals, a Hong Kong aircraft lessor may be required to provide a Hong Kong certificate of resident status to the aircraft lessee so that treaty relief may be claimed in the jurisdiction in which the lessee resides.

The DIPN 54 indicates that qualifying aircraft lessors satisfying the CMC and substantial activity requirements should be able to obtain a certificate of resident status from the IRD.

In order to support the application for obtaining a Hong Kong certificate of resident status, the taxpayer can furnish the application form to the IRD together with supporting documents, such as a copy of the management agreement entered into with a Hong Kong qualifying aircraft leasing manager. If an aircraft lessor is newly established in Hong Kong, a five-year business plan and details of its liability to pay Hong Kong profits tax may be provided to the IRD for determining whether it is a Hong Kong tax resident.

The DIPN 54 also states that tax credit would not be allowed to the qualifying aircraft lessor if the withholding tax on aircraft rentals is borne by the lessee.

(6) Advance ruling

For tax certainty, a corporation can apply an advance ruling to the CIR on how the provisions of aircraft leasing tax regime apply to it. The information and documents required to be provided in the application for a ruling are set out in Appendix 2 of the DIPN 54.

COMMENTS

We welcome the government's move to introduce tax measures to promote specific industries. The government negotiated and signed the 4th protocol on the comprehensive double taxation agreement with the Mainland to reduce the withholding tax rate on aircraft and ship leasing to 5% which is the lowest among the CDTA signed by China, following by Singapore and Ireland of 6%. With the introduction of the new tax incentives for aircraft leasing, it can help to boot Hong Kong's development as an aircraft leasing hub.

The content of this newsletter is only for general guidance on matters of interest and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. Readers are advised to consult their tax advisors before making any business decisions.

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