

FOSTERING THE GROWTH OF SHIP LEASING IN HONG KONG – SHIP LEASING TAX CONCESSIONS

19 MARCH 2020 • ARTICLE



IN THIS ARTICLE WE DISCUSS THE KEY POINTS IN HONG KONG'S NEW INLAND REVENUE (AMENDMENT) (SHIP LEASING TAX CONCESSIONS) BILL 2020 (THE "BILL"), WHICH WAS GAZETTED ON 17 JANUARY 2020.

Ship leasing has become a significant and popular alternative source of financing for shipowners globally as liquidity concerns and cyclical downturns have caused many banks to reduce their shipping portfolios and loan tenures. To maintain Hong Kong's reputation as a major maritime and financial centre, as well as its competitive edge against rival Asian cities, the Hong Kong government has focussed on attracting ship leasing business to the territory by introducing tax concessions via the Bill.

If the Bill is passed by the Legislative Council of Hong Kong, the new measures could apply as early as April this year for the tax year 2020/2021.

This article is not intended to serve as a comprehensive guide or detailed advice on the subject – and should not replace the need for specific legal and tax advice for individual needs and arrangements.

"The tax rate on the qualifying profits of a qualifying ship lessor carrying on qualifying ship leasing activity will be 0%."

WHO BENEFITS FROM THE BILL AND WHAT ACTIVITIES ARE COVERED?

There are three beneficiaries of the Bill:

1. qualifying ship lessors;
2. qualifying ship leasing managers providing ship management services to qualifying lessors in the same group; and
3. qualifying ship leasing managers providing ship management services to third parties outside the same group, and where the activities covered are ship leasing

and ship leasing management activities.

SHIP LEASING ACTIVITY

The tax rate on the *qualifying profits* of a *qualifying ship lessor* carrying on *qualifying ship leasing activity* (regardless of whether the lease is a finance lease or an operating lease) will be 0%.

What constitutes “qualifying ship leasing activity”?

The activity must be conducted in the ordinary course of business in Hong Kong (including sale and leaseback activities regardless of whether they involve finance or operating leases or sub-leasing) and each ship must be over 500 gross tons and navigate solely or mainly outside Hong Kong territorial waters.

What constitutes “qualifying profits”?

In the context of a finance lease, the qualifying profits will be the gross finance charges or interest earned after deducting allowable expenses, whilst under an operating lease, the qualifying profits will be 20% of the gross leasing income (including sums payable under any residual value guarantees) minus deductible expenses (but excluding tax depreciation).

Who is a “qualifying ship lessor”?

To qualify, the ship lessor must carry on a business of leasing one or more ships to a ship lessor, a ship leasing manager or a ship operator. It must carry on that business only in Hong Kong and must not be engaged in any other business. Central management and control of the lessor must be exercised in Hong Kong and not, for example, by a satellite office set up outside Hong Kong. The lessor must prove its intention is to create a genuine business in Hong Kong and not for tax avoidance or “treaty shopping” reasons; an irrevocable election in writing must be signed agreeing to be taxed under the concessionary regime.

SHIP LEASING MANAGEMENT ACTIVITY

The tax rate on *qualifying profits* of *qualifying ship leasing managers* providing *qualifying ship leasing management activities* to:

- non-associated qualifying ship lessors will be 8.25% (which is half of the corporate profits tax rate, currently at 16.5%); and
- associated qualifying ship lessors will be 0%.

What constitutes “qualifying ship leasing management activities”?

A wide range of financing and management activities related to ship leasing falls within the scope of qualifying ship leasing management activities. They include the traditional technical management activities of supervising ships under construction, maintenance and repairs, crewing and general operation of ships such as arranging certification, insurance and handling scrapping. But the Bill expands these traditional roles to include providing corporate services (e.g. setting up and managing special purpose companies to own each ship), financial services (e.g. re-financing of any leasing arrangements/intra-group loans or performance guarantees), brokerage services (e.g. procuring ships for leasing or arranging their sale) and consultancy services (e.g. setting up group structures and marketing the ships for leasing).

What constitutes “qualifying profits”?

"The Bill expands these traditional roles to include providing corporate, financial, brokerage and consultancy services."

All income derived from its ship leasing management business.

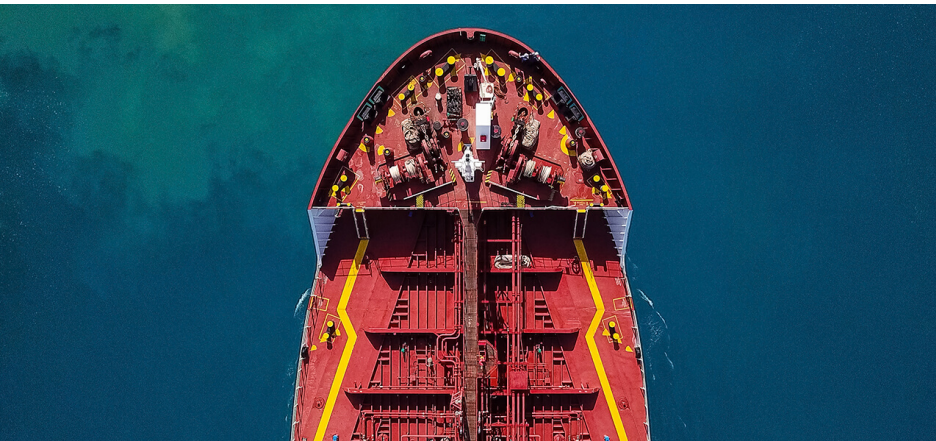
Who is a “qualifying ship leasing manager”?

To qualify, the ship manager must conduct only ship management activities from its Hong Kong office. Similar to a ship lessor, it is required to be centrally managed and controlled in Hong Kong with its profit generating activities conducted in Hong Kong.

As a qualifying in-house manager is essentially providing support services to its associated companies in the same group, it is treated in the same category as a ship lessor and receives the same concessionary tax rate of 0%. However, the in-house manager will have to conduct business with its associates on arms-length terms, which may mean separate staff and appointing separate lawyers to negotiate contracts.

WILL THE CONCESSIONS APPLY TO ALL TYPES OF SHIP?

The Bill is designed to capture large ocean-going ships proceeding to sea from Hong Kong rather than small locally operated vessels. A qualifying ship is carefully defined as a vessel of any description capable of navigating in water including a barge or lighter, an air cushion vehicle (like a hovercraft) and a dynamically supported craft (like a hydrofoil). It expressly excludes junks, rowing boats and military vessels.



THE BILL IS DESIGNED TO CAPTURE LARGE OCEAN-GOING SHIPS PROCEEDING TO SEA FROM HONG KONG RATHER THAN SMALL LOCALLY OPERATED VESSELS.

QUALIFYING CONDITIONS AND ANTI-ABUSE RULES

As is typical of any concessionary tax regime, these tax concessions come with various qualifying conditions to ensure that there is no abuse of the regime. These anti-abuse rules and conditions include the following:

- a) each ship lessor and ship manager must be a separate standalone entity so as to prevent losses being transferred – this requirement will be less onerous for lessors who have structured their vessel ownership in single purpose companies to avoid the risk of sister ship arrest, but will be more of a burden for managers who are not so accustomed to structuring their business in this manner;

b) there must be central management and control in Hong Kong with all profit-making activities being conducted in Hong Kong, although there is an exception for ship managers which allows them to carry on a limited amount of activities outside Hong Kong provided that at least 75% of their activities in terms of both profits and assets arise from qualifying ship lease management activities;

c) introducing a main purpose test to prevent tax avoidance and treaty shopping;

d) the 20% tax base concession for operating leases will be denied if the lessor or a connected person (including any person under a sale and leaseback arrangement) has previously claimed depreciation allowances, in respect of the ship; and

e) not allowing qualifying ship lessors or leasing managers to use losses sustained in the year of assessment where their profits are assessed at 0% to be set off against assessable profits for any subsequent year of assessment.

The Bill also sets out a substantial activity requirement test which obliges lessors and managers to satisfy two conditions: to have both a threshold number of (a) full-time qualified employees and (b) operating expenditure. The proposed minimum thresholds for the above two requirements are as follows:

Type of activity	Average number of full-time employees in HK	Annual operating expenditure incurred in HK
Qualifying ship leasing	Not less than 2	Not less than HK\$7.8 million
Qualifying ship leasing management	Not less than 1	Not less than HK\$1 million

These threshold requirements must be met in the year of assessment in order to ensure that the ship leasing activity is considered to be carried out or arranged by the qualifying ship lessor in Hong Kong.

It is however unclear whether these requirements will, in line with market practice, be considered on a group basis.

OBSERVATIONS

These rules are closely modelled on the aircraft leasing concessions introduced in July 2017 which, despite only offering tax concession of 8.25% as opposed to 0%, has proved an effective stimulus in the continued growth of the aviation business in Hong Kong. Given Hong Kong's ease of access to the Chinese mainland market, it is to be expected that a similar or greater level of growth will result for ship leasing business in Hong Kong also.

It is hoped that this proposed tax regime will enable Hong Kong to capture a significant share of the rapidly expanding Asian leasing market, especially in China, by attracting ship leasing companies to set up a presence in Hong Kong.

The existing section 23B of the Inland Revenue Ordinance ("IRO") presently provides tax exemption for shipping profits to ship owners, charterers and operators through tax treaties and/or domestic Hong Kong tax legislation. As it is unclear how this new regime would interact with the current shipping tax regime under Section 23B of the IRO, it is anticipated that the Inland Revenue Department will be providing more guidance on this point in time.

Dean Young, a former Senior Consultant in our Hong Kong office, also contributed to this article.

"Given Hong Kong's ease of access to the Chinese mainland market, it is to be expected that a similar or greater level of growth compared to the aviation industry will result for ship leasing business in Hong Kong also."

KEY CONTACTS



MADELINE LEONG
PARTNER • HONG KONG

T: +852 2168 6710
M: +852 6822 1255

MLeong@wfw.com

DISCLAIMER

Watson Farley & Williams is a sector specialist international law firm with a focus on the energy, infrastructure and transport sectors. With offices in Athens, Bangkok, Dubai, Dusseldorf, Frankfurt, Hamburg, Hanoi, Hong Kong, London, Madrid, Milan, Munich, New York, Paris, Rome, Seoul, Singapore, Sydney and Tokyo our 700+ lawyers work as integrated teams to provide practical, commercially focussed advice to our clients around the world.

All references to 'Watson Farley & Williams', 'WFW' and 'the firm' in this document mean Watson Farley & Williams LLP and/or its affiliated entities. Any reference to a 'partner' means a member of Watson Farley & Williams LLP, or a member, partner, employee or consultant with equivalent standing and qualification in WFW Affiliated Entities. A list of members of Watson Farley & Williams LLP and their professional qualifications is open to inspection on request.

Watson Farley & Williams LLP is a limited liability partnership registered in England and Wales with registered number OC312252. It is authorised and regulated by the Solicitors Regulation Authority and its members are solicitors or registered foreign lawyers.

The information provided in this publication (the "Information") is for general and illustrative purposes only and it is not intended to provide advice whether that advice is financial, legal, accounting, tax or any other type of advice, and should not be relied upon in that regard. While every reasonable effort is made to ensure that the Information provided is accurate at the time of publication, no representation or warranty, express or implied, is made as to the accuracy, timeliness, completeness, validity or currency of the Information and WFW assume no responsibility to you or any third party for the consequences of any errors or omissions. To the maximum extent permitted by law, WFW shall not be liable for indirect or consequential loss or damage, including without limitation any loss or damage whatsoever arising from any use of this publication or the Information.

This publication constitutes attorney advertising.