

# US WITHDRAWAL FROM HONG KONG SHIPPING TAX TREATY: EFFECTS AND CONSIDERATIONS

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On August 19, 2020, the US Department of State notified Hong Kong authorities of the suspension or termination of the shipping tax treaty between the US and Hong Kong (the "Shipping Tax Treaty"). This step was mandated by Executive Order 13936, issued by President Trump on July 14, 2020, which ordered the State Department to send Hong Kong notice of intent to terminate the Shipping Tax Treaty. Termination of the Shipping Tax Treaty will affect Hong Kong and US taxpayers engaged in shipping.

"There are three ways a jurisdiction can grant an equivalent exemption: an exchange of notes, domestic law or an income tax treaty."

## SECTION 883 EXEMPTION

Section 883 of the US Internal Revenue Code provides a broad exemption from US taxation of income earned by a non-US person from the international operation of a ship. Absent the Section 883 exemption, a non-US entity treated as a corporation for US tax purposes that earns shipping income in the US is generally subject to a gross freight tax on income earned from voyages to or from the US, or in certain circumstances, the non-US corporation may be subject to net income taxation on shipping income that is effectively connected with its US trade or business. The gross freight tax also applies to non-US individuals, as well as the non-US owners of entities treated as fiscally transparent for US tax purposes. The tax is imposed at a

4% rate on US source shipping income, which is generally 50% of the income from a voyage to or from the US (so the tax is often thought of as a 2% gross tax on all income from voyages to or from the US).

Pursuant to Section 883, the US generally will not tax a foreign entity on shipping income if the foreign entity is organized in a jurisdiction that grants an "equivalent exemption" from taxation to US corporations. An equivalent exemption can be obtained in one of three ways:

- Domestic law (e.g., the jurisdiction generally does not tax any shipping income of non-US companies);
- Exchange of notes (essentially, a treaty that applies just to shipping or other transportation income); or
- Income tax treaty.

Whether an equivalent exemption exists is determined separately for each category of shipping income. For example, a non-US jurisdiction may exempt time or voyage charter income, but not bareboat charter income, in which case, Section 883 generally would exempt from US taxation time or voyage charter income, but not bareboat charter income, earned by a non-US corporation organized in such jurisdiction.

There are multiple other requirements needed to claim the Section 883 exemption. Most importantly, an entity treated for US tax purposes as a corporation that intends to qualify for the Section 883 exemption must satisfy one of three tests:

- The “qualified ownership test” — the entity must be owned more than 50% by owners who are themselves tax residents of jurisdictions that grant equivalent exemptions;
- The “controlled foreign corporation test” — the entity must be a “controlled foreign corporation” that is owned more than 50% by US taxpayers; or
- The “publicly traded test” — the entity’s shares must be publicly traded on a qualified US or foreign exchange.

Each of these tests has substantial additional requirements and qualifications. In certain circumstances, a non-US corporation that cannot claim the Section 883 exemption may still be able to claim another exemption from taxation under a US comprehensive income tax treaty.

## SHIPPING TAX TREATY

The Shipping Tax Treaty specifically references, and effectively works in conjunction with, Section 883. Unlike a comprehensive income tax treaty, which can be relied on independently, the Shipping Tax Treaty is purely a means of complying with Section 883 (from the US tax perspective). The Shipping Tax Treaty generally exempts from taxation time, voyage and bareboat charter income, incidental income from container leasing, pool income, and income from the sale of a ship. As a result, a corporation organized in Hong Kong that was eligible for the benefits of Section 883 generally was exempt from US income taxation on most shipping income attributable to the US.

**"US companies generally will be subject to Hong Kong taxation on voyages to or from Hong Kong, as determined under Hong Kong tax law."**

## TERMINATION OF SHIPPING TAX TREATY

As a result of the termination of the Shipping Tax Treaty, entities organized in Hong Kong and individual Hong Kong residents generally will no longer be eligible to claim the Section 883 exemption, and may be subject to the 2% US gross freight tax on voyages to or from the US (or in certain cases, to US net income tax at ordinary rates).

In addition, tax residents of Hong Kong will generally be counted as “bad owners” for purposes of the qualified ownership test (and in certain circumstances, the publicly traded test), so an entity organized outside Hong Kong with substantial Hong Kong ownership may find it more difficult to satisfy the Section 883 exemption.

Ship management companies organized in Hong Kong that earn only services income from the management of ships and have no US presence are generally unaffected by the termination of the Shipping Tax Treaty, since they do not generally earn income that is subject to US taxation (even if the ships they manage travel to the US).

US companies generally will be subject to Hong Kong taxation on voyages to or from Hong Kong, as determined under Hong Kong tax law. US corporations (and partnerships or other fiscally transparent entities with US taxpayers) may therefore effectively be subject to double taxation on voyages to and from Hong Kong: taxation related to the voyage by Hong Kong, and ordinary income taxation by the US.

**"Hong Kong entities may already be subject to US tax on US shipping income (and US entities may already be subject to Hong Kong tax)."**

## QUESTIONS AND UNCERTAINTIES

### *Timing*

Although subject to some uncertainty, it appears from the context of the State Department's announcement that the Shipping Tax Treaty has already been suspended or terminated, in which case, Hong Kong entities may already be subject to US tax on US shipping income (and US entities may already be subject to Hong Kong tax). The US Department of the Treasury has yet to issue guidance regarding the timing of the change. The timing may also affect shipping companies with substantial Hong Kong ownership, which often need to calculate both the timing and quantum of their qualified share ownership to claim the Section 883 exemption.<sup>1</sup>

### *Other Avenues for Claiming Section 883 Exemption*

As described above, there are three ways a jurisdiction can grant an equivalent exemption: an exchange of notes, domestic law or an income tax treaty. The Shipping Tax Treaty is an exchange of notes and there is no income tax treaty between the US and Hong Kong. However, it is always possible that a Hong Kong entity can claim the Section 883 exemption based on domestic law—i.e., arguing that Hong Kong domestic law generally exempts a particular item of shipping income from Hong Kong taxation, and therefore the Shipping Tax Treaty is not needed to claim the Section 883 exemption. It appears that this argument will, however, fail under current domestic Hong Kong law for most categories of shipping income, since Hong Kong currently taxes most shipping income from voyages to or from Hong Kong earned by non-Hong Kong companies. It is possible, however, that a change in Hong Kong domestic law or its interpretation will open up avenues in which taxpayers can claim the Section 883 exemption.

In addition, while Hong Kong is a Special Administrative Region of the People's Republic of China (PRC), it is not generally treated as part of the PRC for US tax purposes, including tax treaties. There is a separate income tax treaty between the PRC and the US that does not apply to Hong Kong. If Hong Kong were to be treated as part of the PRC for all US tax purposes, corporations organized in Hong Kong generally could continue to claim a US tax exemption under the US-PRC income tax treaty. There is no indication that the US will change its policy in this respect (and doing so would generally conflict with apparent US policy to punish Hong Kong companies), but it remains to be seen whether there will be continued changes in US tax policy towards Hong Kong and the PRC, and what their effect will be.

## CONCLUSION

Shipping companies based in Hong Kong or with a significant Hong Kong ownership or nexus should consider the effects of the termination on their tax structure, and may wish to consider restructuring their operations.

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For more information on how sanctions imposed by President Trump's Executive Order affect organisations in Hong Kong, please read our article authored by Hong Kong Partners Rosa Ng and Khin Voong, Senior Consultant Dean Young and Trainee Gabrielle Wong [here](#).

[1] Subsequent to this briefing, the US Department of the Treasury announced that the termination of the Shipping Tax Treaty will take effect on January 1, 2021, and will have effect for taxable years beginning on or after that date.

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