Inland Revenue Department

The Government of the Hong Kong Special Administrative Region
of the People's Republic of China

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 54 (Revised)

TAXATION OF AIRCRAFT LEASING ACTIVITIES

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

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Commissioner of Inland Revenue

June 2023

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INTRODUCTION

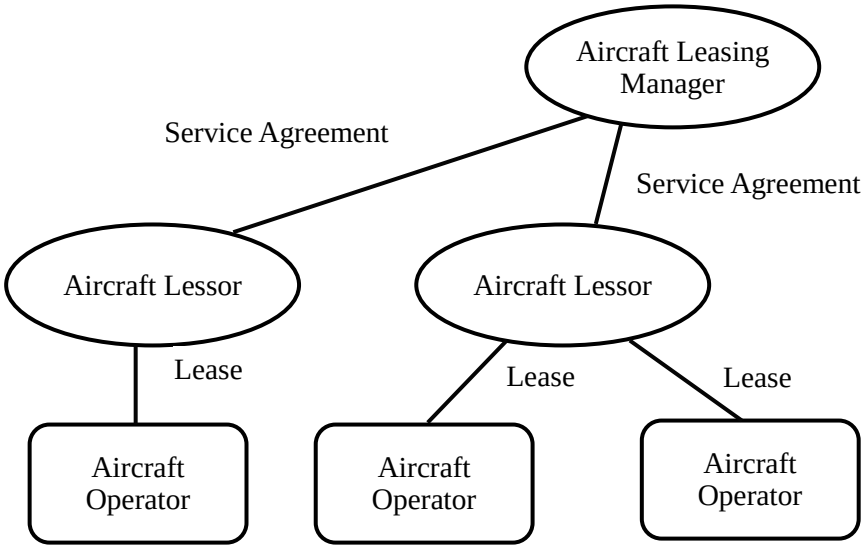
Background

Financing the global airline industry presents major business opportunities for the financial and professional service sectors in Hong Kong. The proportion of new aircraft being financed by leasing rose from less than 1% 50 years ago to about 51% in 2021. There are a myriad of factors contributing to the attractiveness of aircraft leasing, including: financial flexibility; avoidance of large upfront investments; fleet flexibility; reduced delivery lead time for new planes; preservation of capital; and capture of market share without significant capital commitment (popular among low cost carriers).

2. In recent years, there has been trendsetting migration of aircraft lessors to Asia which is driven mainly by growth of the airline industry in the Mainland. Intra-Asia leasing activities are particularly noticeable. It is estimated that a total of over 41,100 aircraft will be delivered in the next 20 years, over 20% of which will be delivered to the Mainland. The principal lessee's obligations are: pay rentals and any maintenance reserves on time and in full; operate and maintain aircraft in accordance with regulations; maintain aircraft to the maintenance schedule approved by the lessor; maintain insurance cover at all times; ensure continuous possession of the aircraft; settle all invoices related to the aircraft as they fall due; and return aircraft when and as agreed by the lessor.

3. The core business model of an aircraft lessor is focused on purchasing new, fuel-efficient, in-demand aircraft at competitive prices directly from aircraft manufacturers, financing those aircraft purchases efficiently, placing the aircraft on operating leases with a globally diversified customer base. The three key channels from which lessors typically acquire aircraft are: direct from OEMs; purchase-leaseback; and secondary market. In an operating lease, the risks and rewards of the aircraft ownership sit with the lessor and the risks and rewards of operation remain with the lessee. In essence, the lessee (i.e. the aircraft operator) pays the lessor (i.e. the owner of the aircraft) rental payments in order to operate the leased aircraft over an agreed fixed term.

4. In the aircraft leasing industry, a special purpose vehicle (SPV), which is a corporation, is normally used to hold an aircraft as owner and lessor for leasing. Activities incidental to aircraft leasing, such as evaluation of aircraft investment, fund raising, procurement of aircraft, soliciting lessees, etc., are carried out by an aircraft leasing manager remunerated by a service fee. The contractual arrangements among the aircraft lessors, aircraft leasing manager and aircraft operators are illustrated as follows:



5. Hong Kong as an international financial centre possesses favourable conditions necessary for developing aircraft leasing business, namely sound legal and banking systems, well-developed and diversified capital markets, excellent aviation infrastructure and talents, and proximity to the Mainland market.

6. In April 2015, the Mainland and Hong Kong signed the Fourth Protocol to the Double Taxation Arrangement between the Mainland of China and Hong Kong Special Administrative Region, which reduced the withholding tax rate from 7% to 5% on lease rentals paid to an aircraft and ship leasing business under the Royalties Article. This provides a solid foundation for Hong Kong to attract aircraft lessors to domicile their leasing operations in Hong Kong.

7. In July 2017, the Inland Revenue (Amendment) (No. 3) Ordinance 2017 (the 2017 Amendment (No. 3) Ordinance) was enacted. While aircraft lessors resident in Hong Kong continue to be denied depreciation allowance for aircraft leased to persons who are not operators of Hong Kong aircraft, tax concessions are given in respect of rentals derived from such aircraft leasing transactions. In effect, the gross rental income after deducting allowable expenses is taxed at a tax rate comparable to rental income derived from operators of Hong Kong aircraft.

8. The 2017 Amendment (No. 3) Ordinance provides a level playing field for aircraft leasing activities with persons who are not Hong Kong aircraft operators vis-à-vis those with Hong Kong aircraft operators. With the tax concessions, the way has been paved for grasping new business opportunities from the Mainland market. The purpose of this Note is to set out in detail the Department's views and practice on the tax concessions for qualifying aircraft lessors and qualifying aircraft leasing managers.

The 2017 Amendment (No. 3) Ordinance

9. The 2017 Amendment (No. 3) Ordinance amended the Inland Revenue Ordinance (the Ordinance) to give profits tax concessions to corporations carrying on certain businesses in connection with aircraft and to make provisions for profits tax purposes about such businesses. The main provisions are as follows:

Profits tax concessions for aircraft leasing

(a) Section 14G is added to provide for the interpretation of terms used in the provisions for the profits tax concessions, including the definitions of qualifying aircraft leasing activity and qualifying aircraft leasing management activity.

(b) Sections 14H and 14I are added to provide for the profits tax concessions for qualifying aircraft lessors –

(i) Section 14H(1) provides that a corporation that is a qualifying aircraft lessor for a year of assessment is entitled to have its profits derived from its qualifying

aircraft leasing activity for that year of assessment charged at one-half the profits tax rate specified in Schedule 8 to the Ordinance (i.e. the concessionary rate).

(ii) Section 14H(2) and (4) provides for how a corporation may be a qualifying aircraft lessor and how it can be entitled to the concessionary rate.

(iii) Section 14I provides that if the profits tax concession under section 14H applies to a corporation for a year of assessment, the net lease payments derived from its qualifying aircraft leasing activity are to be calculated in accordance with the formula set out in section 14I(2). The effect is that the taxable amount of the lease payments is to be equal to 20% of the tax base (i.e. gross lease payments less deductible expenses, excluding tax depreciation).

(c) Section 14J is added to provide for the profits tax concession for qualifying aircraft leasing managers –

(i) Section 14J(1) provides that a corporation that is a qualifying aircraft leasing manager for a year of assessment is entitled to have its profits derived from its qualifying aircraft leasing management activity for that year of assessment charged at the concessionary rate.

(ii) Section 14J(2) provides for how a corporation may be a qualifying aircraft leasing manager, namely –

- by satisfying the conditions specified in section 14J(3);
- by satisfying the safe harbour rule under section 14K; or
- by obtaining the determination of the Commissioner of Inland Revenue (the Commissioner) under section 14L.

(iii) Section 14J(5) is added to provide for certain conditions for the entitlement to the concessionary rate.

(d) Section 14K is added to provide for how a corporation may satisfy the safe harbour rule. There are two alternative safe harbours –

(i) The "1-year safe harbour" in section 14K(2) requires the corporation to satisfy certain conditions regarding its aircraft leasing management profits and aircraft leasing management assets for the year of assessment concerned.

(ii) The "multiple-year safe harbour" in section 14K(3) requires the corporation to satisfy similar conditions for the year of assessment concerned and the preceding one or two years of assessment.

(e) Section 14L is added to provide for the Commissioner's discretion to make a determination that a corporation, which is not otherwise qualified, is a qualifying aircraft leasing manager.

(f) Section 14M is added to provide for anti-abuse measures for preventing avoidance of profits tax by means of the profits tax concessions granted to qualifying aircraft lessors and qualifying aircraft leasing managers.

(g) Section 14N is added to empower the Commissioner to amend, by order published in the Gazette, Schedule 17F.

(h) Section 19CA is amended to cover the trading receipts in respect of which assessable profits are chargeable to tax at the concessionary rate under section 14H or 14J.

(i) Schedule 17F is added to define aircraft leasing activity and aircraft leasing management activity and specify the prescribed percentages relating to the calculation of net lease payments and the safe harbour rule.

Gains or profits arising through or from aircraft business

(j) Section 15(1)(n) is added to make it clear that sums received by or accrued to a corporation from carrying on certain businesses in connection with aircraft as having a Hong Kong source, even if the aircraft are used outside Hong Kong.

Anti-tax arbitrage provision

(k) Section 16(1A) is added to prevent tax arbitrage through aircraft leasing transactions between connected persons.

Notional depreciation allowances

(l) Sections 37, 38, 39B and 39D are amended to deal with computation of the cost and capital expenditure in relation to an aircraft that is used by a corporation for carrying out a qualifying aircraft leasing activity before being used in another trade, profession or business.

QUALIFYING AIRCRAFT LESSOR

Concession for qualifying aircraft lessor

10. While section 14H contains the specific provisions relating to the profits tax concession for qualifying aircraft lessors, the charging provisions in section 14 for profits tax continue to be applicable. Thus, a qualifying aircraft lessor is chargeable to profits tax under section 14 since it is carrying on an aircraft leasing business in Hong Kong.

11. By virtue of the provision in section 14H(1), a qualifying aircraft lessor is entitled to have its qualifying profits charged at one-half of the corporate profits tax rate. Qualifying profits would include income incidental to profits from an aircraft leasing business, like interest income, exchange gains or hedging gains, as long as the transactions are ancillary to the qualifying activities. The half rate concession applies to a qualifying aircraft lessor for a year of assessment only if:

(a) in that year of assessment –

(i) the central management and control of the corporation is exercised in Hong Kong (***the central management and control requirement***);

(ii) the activities that produce its qualifying profits in that year are carried out in Hong Kong by the corporation; or arranged by the corporation to be carried out in Hong Kong (***the substantial activity requirement***); and

(iii) those activities are not carried out by a permanent establishment outside Hong Kong (***the attribution to Hong Kong requirement***); and

(b) the corporation has made an election in writing, which is irrevocable, that the half rate concession applies to it.

12. The word "aircraft" under this concessionary tax regime has a wide meaning. Section 14G(1) stipulates that "aircraft" includes an aeroplane, airframe, aircraft engine and helicopter; but does not include an aircraft solely for military use, airship, spacecraft or satellite. Thus, this regime would cover leasing of standalone aircraft engines.

13. Under section 14H(2), a corporation is a qualifying aircraft lessor for a year of assessment if, in the basis period for that year of assessment:

(a) it is not an aircraft operator;

(b) it has carried out in Hong Kong one or more qualifying aircraft leasing activities; and

(c) it has not carried out in Hong Kong any activity other than a qualifying aircraft leasing activity.

14. An aircraft operator is not eligible to be a qualifying aircraft lessor. The term "aircraft operator" is defined in section 14G(1) as a person carrying on

an aircraft operation business which means a business of operating aircraft as an owner or a charterer for providing services for the carriage by air of passengers, cargo or mail; but does not include dealing in aircraft or agency business in connection with air transport. In effect, all aircraft operators are excluded from this preferential tax regime. The qualifying aircraft lessor under section 14H(2) must be a standalone corporation engaging solely in qualifying aircraft leasing activities. This standalone condition is consistent with the industry practice of using SPVs to hold aircraft for leasing.

15. For the purpose of determining whether a corporation has carried out any activity other than a qualifying aircraft leasing activity, only activities that generate income to the corporation are to be taken into account as explained in section 14H(3). That means expense transactions would be excluded. For example, taking a lease in respect of the business premises for carrying out qualifying aircraft leasing activities or sponsoring an international industry conference for marketing purpose would not preclude a corporation from being a qualifying aircraft lessor since the corporation would only incur rental expenses or sponsorship expenses in these transactions which do not generate income.

20% tax base concession

16. As a compensation for loss of depreciation allowances, a qualifying aircraft lessor is eligible for a 20% tax base concession. Section 14I(1) and (2) provides that if the half rate concession applies to a qualifying aircraft lessor, then the net lease payments for the right to use an aircraft under a lease that are to be included in the assessable profits derived from its qualifying aircraft leasing activity would be computed in accordance with the following formula:

$$A = (B - C) \times D$$

where: A means the net lease payments;

B means the aggregate amount of the gross lease payments (whether or not they are periodic payments and including any sum payable under a residual value guarantee) earned by or accrued to the qualifying aircraft lessor under the lease during the basis period for the year of assessment;

C means the aggregate amount of any outgoings and expenses deductible under Part 4 of the Ordinance to the extent to which they are incurred during the basis period for the year of assessment by the qualifying aircraft lessor in the production of those gross lease payments (***relevant outgoings and expenses***); and

D means the percentage prescribed in section 2 of Schedule 17F (i.e. 20%).

17. Such 20% tax base concession would not apply to a qualifying aircraft lessor for a year of assessment in the following circumstances under section 14I(3):

(a) The qualifying aircraft lessor has not incurred capital expenditure on the provision of the aircraft concerned. The term "capital expenditure" would include payments incurred for the purpose of obtaining ownership of an aircraft via a funding lease, a hire-purchase agreement or a conditional sale agreement.

(b) Depreciation allowances under Part 6 of the Ordinance have been granted to the qualifying aircraft lessor or its connected person in respect of the capital expenditure incurred on the provision of the aircraft concerned. For example, if a qualifying aircraft lessor previously leased an aircraft to a Hong Kong aircraft operator in respect of which it had been granted depreciation allowances, that lessor could not be entitled to the 20% tax base concession even if it elects into the aircraft leasing regime afterwards. Only half rate concession would be granted to it.

(c) Capital allowances are granted to a connected person of the qualifying aircraft lessor, whether in Hong Kong or in a territory outside Hong Kong, for that year of assessment in respect of the capital expenditure on the provision of the aircraft concerned.

The term "connected person" is defined in section 14G(1). The purpose of section 14I(3) is to prevent a qualifying aircraft lessor and its connected person from obtaining double benefits where they could obtain both the capital allowances in respect of the aircraft concerned and the 20% tax base concession which is actually a compensation for such allowances. Double dip should be disallowed.

18. If an aircraft is leased to an aircraft operator together with other dealings in pursuance of one bargain, section 14I(4) empowers the Commissioner to allocate an amount of gross lease payments for the right to use the aircraft under the lease having regard to all the circumstances of the bargain. The term "bargain" is defined in *Shorter Oxford English Dictionary* as "discussion between two parties over terms". Section 14I(4) would apply if the terms of the lease and other dealings are negotiated together such that the gross lease payments would not reflect the market rental of the aircraft.

Example 1

In a sale and leaseback transaction, an aircraft operator sold an aircraft to a qualifying aircraft lessor at a deflated price. In return, it could lease back the aircraft from the qualifying aircraft lessor at a deflated monthly lease payment for a fixed period of time.

Since the sale price of the aircraft and gross lease payments are negotiated together in pursuance of one bargain, the Commissioner could adjust the gross lease payments under section 14I(4).

19. Section 14I(5) specifies that if the 20% tax base concession applies, the relevant outgoings and expenses that are incurred for the production of the gross lease payments may not be claimed for deduction under profits tax otherwise than for calculating the net lease payments under section 14I(2). Thus, all the relevant outgoings and expenses must be netted off from the gross lease payments before applying the 20% tax base concession. Such outgoings and expenses could not be claimed for deduction against other income.

Irrevocable election

20. Before the half rate concession applies, the qualifying aircraft lessor has to make an election. Such election must be made in writing (e.g. in a tax return) as required by section 14H(4)(b). Once made, the provision in section 14H(5) makes it irrevocable. Thus, a qualifying aircraft lessor does not need to make an election for every year of assessment in which it is entitled to the half rate concession.

21. Under section 14H(6)(a), if section 14H(1) no longer applies to a qualifying aircraft lessor, then the election previously made by it ceases to be effective. In case the qualifying aircraft lessor is entitled to the half rate concession again, it is required to make a fresh election.

AIRCRAFT LEASING ACTIVITY

Definition of aircraft leasing activity

22. "Aircraft leasing activity" is defined in section 1(1) of Schedule 17F as leasing an aircraft by a corporation to an aircraft operator. The aircraft must be leased to an aircraft operator, whether in Hong Kong or elsewhere. In commercial practice, an intermediate lessor may be interposed between the corporation and the aircraft operator for various reasons, such as meeting requirements on aircraft registration. The intermediate lessor may be a related company of either the corporation or the aircraft operator. The Commissioner would carefully examine the facts, including any tax motives to avoid taxes, to ascertain whether such an arrangement should be eligible for the profits tax concessions.

Definition of lease

23. The term "lease" in section 14G(1), when used as a noun, is defined as a dry lease; but does not include a dry lease that is a funding lease, hire-purchase agreement or conditional sale agreement. When the term is used as a verb, it is to be construed accordingly. "Dry lease" means an arrangement under which:

(a) an aircraft is bona fide demised, let or hired out, or a right to use an aircraft is otherwise granted, by the lessor to another person for a term exceeding 1 year;

(b) the lessor is not responsible for ensuring the airworthiness of the aircraft; and

(c) no member of the crew of the aircraft is employed by the lessor.

In the leasing industry, a dry lease 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. The words "bona fide" in the above definition of "dry lease" are intended to require that the leasing arrangement is based on the honest intention of the lessor, rather than a means to escape the strict liability under the Civil Aviation Ordinance (Cap. 448). All forms of leasing arrangements are covered. Aircraft leasing involves complicated commercial arrangements and takes various forms, including a demise charter whereby the aircraft operator has the possession and control of the aircraft and the lessor remains the owner. Given the definition of "lease", only dry leases are covered by the profits tax concessions and wet leases are excluded.

24. Financiers are prevented from repackaging secured loans into aircraft leases to obtain the profits tax concessions since funding leases, hire-purchase agreements or conditional sale agreements are not regarded as leases. If an aircraft lessor grants a right to use an aircraft to an aircraft operator under a funding lease, hire-purchase agreement or conditional sale agreement, the ownership of the aircraft in effect is transferred to the aircraft operator and profits tax concession will not be given.

Funding lease

25. Funding lease, as defined in section 14G(1), means a dry lease of an aircraft:

(a) that satisfies one of the following conditions at its inception –

(i) the dry lease is accounted for as a finance lease or loan

by the lessor in accordance with the Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants or the International Financial Reporting Standards issued by the International Accounting Standards Board, as in force from time to time;

(ii) the present value of the aggregate minimum lease payments (whether or not they are periodic payments and including any sum payable under a residual value guarantee) during the term of the dry lease is equal to or more than 80% of the fair market value of the aircraft;

(iii) the term of the dry lease is equal to or more than 65% of the remaining useful economic life of the aircraft; and

(b) under which the property in the aircraft will or may pass to the lessee at the end of its term,

and includes an arrangement or agreement in connection with such a dry lease.

26. In a funding lease, all the risks and rewards incidental to ownership of an aircraft are substantially transferred to the lessee and the property in the aircraft would pass to the lessee at the end of the lease. In substance, a 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.

Example 2

Aircraft Lessor-HK leased an aircraft to Aircraft Operator-F for a term of 12 years under a dry lease. The lease was accounted for as a finance lease according to the Hong Kong Financial Reporting Standards. At the end of the lease term, the property in the aircraft would not pass to Aircraft Operator-F.

The lease would not be regarded as a funding lease since the property in the aircraft would not pass to the aircraft operator at the end of the lease term. If other requirements are fulfilled, Aircraft Lessor-HK would be entitled to the profits tax concessions.

27. The term "funding lease" has been defined in connection with a dry lease which satisfies certain conditions. The definition is extended to include an arrangement or agreement in connection with such a dry lease of an aircraft. Thus, any separate arrangement or agreement like purchase option agreement or rental rebate agreement may be regarded as forming part of the lease and will be taken into account when determining whether the lease together with the arrangement or agreement is a funding lease. If a purchase option merely allows the lessee to acquire the property in the aircraft at its fair market value at the end of the lease term, it would be treated as a separate transaction not connected with the dry lease. If the rental rebate received upon the aircraft's disposal represents no more than the costs of arranging a sale of the aircraft (e.g. a commission at market rate), it would be regarded as a separate transaction not connected with the dry lease. In short, the Commissioner has to decide whether the property in the aircraft, whether in form and in substance, will or may pass to the lessee at the end of the lease term.

Example 3

Aircraft Lessor-HK and Aircraft Operator-F entered into a dry lease under which Aircraft Operator-F was granted a right to use an aircraft for a term of 20 years. The aircraft had a useful economic life of 22 years. By a separate agreement, Aircraft Lessor-HK allowed Aircraft Operator-F to acquire the aircraft at market price at the end of the lease term or to sell the aircraft to a third party on its behalf. Proceeds from sale would be paid to Aircraft Operator-F as rental rebates.

The lease term was more than 65% of the remaining useful economic life of the aircraft. Though no purchase option was provided under the lease agreement, Aircraft Operator-F would be allowed to acquire the property in the aircraft concerned or the risks and rewards associated with the ownership of such an aircraft at no additional consideration under another separate agreement which was an arrangement or agreement in connection with the dry lease. In the circumstances, the dry lease would be a funding lease not eligible for the profits tax concessions.

Example 4

Aircraft Lessor-HK and Aircraft Operator-F entered into a dry lease under which Aircraft Operator-F was allowed to use an aircraft for a term of 8 years. The present value of the aggregate minimum lease payments was more than 80% of the fair market value of the aircraft. Under a separate purchase option agreement, SPV-F which was wholly owned or controlled by Aircraft Operator-F would be allowed to acquire the property in the aircraft at a nominal price of $100.

The present value of the aggregate minimum lease payments was more than 80% of the fair market value of the aircraft. SPV-F was allowed to acquire the aircraft at a nominal price at the end of the lease term under a purchase option agreement which was an arrangement or agreement in connection with the dry lease. Though the property in the aircraft would not pass to Aircraft Operator-F, the apparent intent was that SPV-F, wholly owned or controlled by Aircraft Operator-F, would acquire the property in the aircraft at the end of the lease term. Given such facts, the Commissioner would invoke the provisions in section 61A to treat the dry lease together with the purchase option agreement as a funding lease. Therefore, no profits tax concessions could be granted.

28. The provisions in section 14G(3) and (4) are aimed to prevent aircraft lessors from splitting a funding lease into various short-term leases so as to be eligible for the profits tax concessions. If, under two or more dry leases, an aircraft is demised, let or hired out, or a right to use an aircraft is otherwise granted to a corporation and/or its associates, regardless of whether the term of one of the dry leases is immediately followed by that of another, the dry leases are to be treated as one single dry lease:

(a) for computing the present value of the aggregate minimum lease payments; and

(b) for computing the term of the dry lease.

Since an aircraft lessor may renew an operating lease with the same aircraft operator after the expiration of the lease, section 14G(3) provides that the dry

leases would not be treated as a single lease if, in the opinion of the Commissioner, they do not form part of a single arrangement. That means successive genuine operating leases would not be regarded as one single funding lease.

Example 5

Aircraft Lessor-HK and Aircraft Operator-F entered into four continuous dry lease agreements at the same time. Under the four lease agreements, each with a lease term of five years, an aircraft having a remaining useful economic life of 22 years was leased to Aircraft Operator-F. That is, the aircraft would be leased to Aircraft Operator-F for a total of 20 years. Under the last agreement, Aircraft Operator-F was able to acquire under an option the property in the aircraft at a nominal price of $100 at the end of the lease term.

The four dry lease agreements constitute a single leasing arrangement. By virtue of section 14G(3) and (4), the dry leases should be treated as one single dry lease for the purpose of computing the term of the dry lease. Since the aggregate length of the lease terms was more than 65% of the remaining useful economic life of the aircraft and the property in the aircraft would likely pass to Aircraft Operator-F, the four dry leases would be regarded as a single funding lease. Aircraft Lessor-HK would not be entitled to the profits tax concessions in respect of the four dry leases.

Example 6

Aircraft Lessor-HK leased an aircraft to Aircraft Operator-HK for a term of 8 years. The aircraft had a useful economic life of 20 years. After 8 years, Aircraft Operator-HK exercised an option to renew the lease for another 5 years at the prevailing market rent. As a result, the aircraft would be leased to Aircraft Operator-HK for a total of 13 years which equalled 65% of the remaining useful economic life of the aircraft.

In the absence of any tax avoidance motives, the two lease agreements would not be regarded as constituting one single leasing arrangement. The terms of the two lease agreements would not be aggregated for the purpose of ascertaining whether they should be regarded as a funding lease.

Hire-purchase agreement and conditional sale agreement

29. The terms "hire-purchase agreement" and "conditional sale agreement" are defined in section 2 of the Ordinance. "Hire-purchase agreement" means an agreement for the bailment of goods under which the bailee may buy the goods, or under which the property in the goods will or may pass to the bailee. "Conditional sale agreement" means an agreement for the sale of goods under which the purchase price or part of the purchase price is payable by instalments, and the property in the goods remains in the seller (notwithstanding that the buyer is to be in possession of the goods) until such conditions as to the payment of instalments or otherwise as may be specified in the agreement are fulfilled. The bailee is given a purchase option under a hire-purchase agreement while transfer of title is conditional upon full payment of purchase price or other conditions (i.e. retention of title) under a conditional sale agreement. Similar to a funding lease, these financing agreements transfer substantially all the risks and rewards incidental to ownership of an aircraft to the bailee or buyer. The aircraft lessor is no more than a financier if the aircraft is leased to an aircraft operator by way of these financing agreements which do not fall within the scope of the profits tax concessions.

Qualifying aircraft leasing activity

30. Under section 14G(6), an aircraft leasing activity carried out by a corporation in respect of an aircraft is a qualifying aircraft leasing activity if:

(a) the activity is carried out in the ordinary course of the corporation's business carried on in Hong Kong; and

(b) the aircraft is owned by the corporation when the activity is carried out.

In the ordinary course of business

31. The aircraft leasing activities have to be carried out in the ordinary course of the qualifying aircraft lessor's business. As such, artificial transactions structured with a view to shifting profits from other tax jurisdictions would not qualify for the profits tax concessions. The Commissioner would examine the terms of the lease agreement, financing arrangement and all other

relevant circumstances to determine if the aircraft leasing activities are carried out bona fide in the ordinary course of the aircraft lessor's business in Hong Kong.

Ownership requirement

32. The aircraft has to be owned by the qualifying aircraft lessor. This requirement is to prevent treaty shopping through sub-leasing and to comply with the latest international standards to combat base erosion and profit shifting (BEPS). The qualifying aircraft lessor is expected to have substantial activities in Hong Kong, performing the relevant functions, using the relevant assets and assuming the relevant risks associated with the ownership of the aircraft. The word "own" in section 14G(1) normally refers to economic ownership. Thus, holding the aircraft in the following capacities is covered:

(a) as a lessee under a funding lease;

(b) as a bailee under a hire-purchase agreement; and

(c) as a buyer under a conditional sale agreement.

33. In substance, funding lease, hire-purchase agreement and conditional sale agreement are financing arrangements whereby the lessee, bailee and buyer are the economic owner of the aircraft. The word "own" is defined to incorporate these financing arrangements. If the aircraft lessor acquires an aircraft through these financing arrangements, the ownership of the aircraft would be regarded as having been acquired by the aircraft lessor even though legal title to the aircraft has not yet been transferred to the aircraft lessor.

34. It is made explicitly clear in section 14G(5) that in the definitions of "lease" and "own", a reference to a funding lease, hire-purchase agreement or conditional sale agreement does not include one under which, in the opinion of the Commissioner, the property in the aircraft concerned would reasonably be expected not to pass to the lessee, bailee or buyer, as the case may be. Therefore, if the property in the aircraft is expected not to pass to the aircraft operator, such a funding lease, hire-purchase agreement or conditional sale agreement may be treated as a lease.

35. If the aircraft lessor acquires an aircraft under a funding lease, hire-purchase agreement or conditional sale agreement and the property in the aircraft would unlikely pass to the aircraft lessor, the aircraft would not be regarded as having been acquired by the aircraft lessor. Thus, leasing of such an aircraft to an aircraft operator would fall outside the definition of qualifying aircraft leasing activity and no profits tax concessions could be granted to the aircraft lessor.

36. Besides financing arrangements, there has been an increase in the use of bare trust arrangements under which the trustee merely holds the legal ownership of an aircraft while the lessor possesses the beneficial (economic) ownership of the aircraft. Such an arrangement is becoming increasingly popular as it facilitates the trade of the leased aircraft by transfer of beneficial ownership, without the necessity to novate the underlying lease.

37. Provided that other relevant conditions are satisfied and the trustee merely acts as the registered or bare legal owner of the aircraft, a qualifying aircraft lessor, being the beneficial owner of the aircraft, will be entitled to the tax concession despite that the aircraft is held by a trustee in trust for the lessor. A typical trust arrangement is explained in Appendix 1.

Example 7

Trustee-HK, as a trustee, holds an aircraft in trust for Aircraft Lessor-HK pursuant to a trust arrangement. On behalf of Aircraft Lessor-HK, Trustee-HK grants the right to use the aircraft to Aircraft Operator-HK under a lease. The trust instrument provides that all right, title and interest in and to the aircraft, the lease and any other documents in connection therewith belong to Aircraft Lessor-HK. Other than the bare legal ownership to the aircraft, Trustee HK has no beneficial, equitable or other interest in the aircraft, the lease or any other documents in connection therewith. All amounts of rent, security deposits, proceeds of sale and other amounts in respect of the operating lease or the aircraft received by Trustee-HK will be distributed promptly to Aircraft Lessor-HK. Trustee-HK has no power or authority to deal with the aircraft, the lease or any other documents in connection therewith except as provided in instructions or authorisation from Aircraft Lessor-HK.

Aircraft Lessor-HK would be regarded as the owner of the aircraft. Provided that other relevant conditions are satisfied, Aircraft Lessor-HK could be entitled to the profits tax concessions under the aircraft lessor regime.

Transaction structuring

38. Under the Convention on International Civil Aviation 1944 (***the Chicago Convention***), an aircraft is required to be registered with a national civil aviation authority which operates either an operator-based registry or an owner-based registry. If it is an owner-based registry (e.g. Japan and the United States), an SPV is often set up in that jurisdiction to hold the legal title of the aircraft while the lessor retains economic ownership of the aircraft. The aircraft operated by an aircraft operator resident in a jurisdiction may be registered in another jurisdiction so as to reduce risks of repossession. Further, to secure a cheaper source of funding for financing the acquisition of an aircraft, export guaranteed financing and tax based structures may be required.

39. Common transaction structures include:

(a) Japanese conditional sale structure;

(b) Russian lease-in-lease-out structure;

(c) ECA/US EXIM guaranteed or supported financing;

(d) French or Japanese tax lease financing; or

(e) securitisation.

In these cross-border transactions, an SPV may be interposed so as to fulfil specific objectives, to isolate financial risks or to allow for easier transfer of the aircraft. If properly structured, the ownership requirement in section 14G(6)(b) will be regarded as having been satisfied. These structures, together with other business models, explained in Appendix 2 are for illustration purposes only. The application of the law may differ depending on the facts of each case.

QUALIFYING AIRCRAFT LEASING MANAGER

Concession for qualifying aircraft leasing manager

40. While section 14J contains the specific provisions relating to the profits tax concession for qualifying aircraft leasing managers, the charging provisions in section 14 for profits tax continue to be applicable. Thus, a qualifying aircraft leasing manager is chargeable to profits tax under section 14 since it is carrying on an aircraft leasing management business in Hong Kong. By virtue of the provision in section 14J(1), a qualifying aircraft leasing manager is entitled to have its qualifying profits charged at one-half of the corporate profits tax rate. The qualifying profits would include income incidental to profits from an aircraft leasing management business, like interest income, exchange gains or hedging gains, as long as the transactions are ancillary to the qualifying activities. The half rate concession applies to a qualifying aircraft leasing manager for a year of assessment only if:

(a) in that year of assessment –

(i) the central management and control of the corporation is exercised in Hong Kong (***the central management and control requirement***);

(ii) the activities that produce its qualifying profits in that year are carried out in Hong Kong by the corporation; or arranged by the corporation to be carried out in Hong Kong (***the substantial activity requirement***); and

(iii) those activities are not carried out by a permanent establishment outside Hong Kong (***the attribution to Hong Kong requirement***); and

(b) the corporation has made an election in writing, which is irrevocable, that the half rate concession applies to it.

41. Under section 14J(2), a corporation is a qualifying aircraft leasing manager for a year of assessment if:

(a) in the basis period for that year of assessment, it is not an aircraft operator; and

(b) for that year of assessment:

(i) it is a dedicated aircraft leasing manager in section 14J(3) that has satisfied the standalone corporation requirement;

(ii) it is an aircraft leasing manager that has satisfied the "1-year safe harbour" rule or the "multiple-year safe harbour" rule in section 14K though it has carried out in Hong Kong activities other than a qualifying aircraft leasing management activity; or

(iii) it is an aircraft leasing manager that has been determined by the Commissioner under section 14L(1) as a qualifying aircraft leasing manager though it satisfies neither of the conditions in (i) and (ii) above.

Dedicated aircraft leasing manager

42. The conditions specified in section 14J(3) are that, in the basis period for the year of assessment, the corporation:

(a) has carried out in Hong Kong one or more qualifying aircraft leasing management activities; and

(b) has not carried out in Hong Kong any activity other than a qualifying aircraft leasing management activity.

Similar to a qualifying aircraft lessor, only a standalone corporate entity carrying on the business as an aircraft leasing manager and engaging solely in qualifying aircraft leasing management activities can be a qualifying aircraft leasing manager. Section 14J(4) provides that in determining whether a corporation has carried out any activity other than a qualifying aircraft leasing management

activity, only activities that generate income to the corporation are to be taken into account.

Irrevocable election

43. Before the half rate concession applies, the qualifying aircraft leasing manager has to make an election. Such election must be made in writing (e.g. in a tax return) as required by section 14J(5)(b). Once made, the provision in section 14J(6) makes it irrevocable. Thus, a qualifying aircraft leasing manager does not need to make an election for every year of assessment in which it is entitled to the half rate concession.

44. Under section 14J(7)(a), if section 14J(1) no longer applies to a qualifying aircraft leasing manager, then the election previously made by it ceases to be effective. In case the qualifying aircraft leasing manager is entitled to the half rate concession again, it is required to make a fresh election.

Aircraft leasing management activity

45. Section 1(1) of Schedule 17F defines "aircraft leasing management activity", in relation to a corporation, as any of the following activities:

(a) managing a qualifying aircraft lessor;

(b) establishment or administration of a special purpose entity for the purpose of owning an aircraft by that entity;

(c) providing finance in obtaining the ownership of an aircraft by a special purpose entity wholly or partly owned by the corporation or its associated corporation;

(d) providing a guarantee in respect of a financial or performance obligation as regards the aircraft leasing business of a special purpose entity wholly or partly owned by the corporation or its associated corporation, or granting security in respect of that business;

(e) managing leases;

(f) arranging for the procurement or leasing of aircraft;

(g) arranging for the operation, maintenance, repair, insurance, storage, scrapping or modification of aircraft;

(h) arranging for the evaluation, appraisal, provision or inspection of aircraft, airline facilities or maintenance facilities for aircraft;

(i) arranging for the assessment of the aviation and aircraft market conditions;

(j) marketing of leases that are operating leases;

(k) providing finance in obtaining the ownership of an aircraft by an airline enterprise from a qualifying aircraft lessor;

(l) providing a residual value guarantee or contingent purchase arrangement;

(m) providing services in relation to an aircraft leasing activity for or to a qualifying aircraft lessor.

46. Residual value guarantee or contingent purchase arrangement may be provided by an aircraft leasing manager so as to reduce the risk of the lessor in respect of the residual value of the aircraft at the end of the lease term or its useful economic life. The term "residual value guarantee", in relation to an aircraft, is defined in section 14G(1) as a financial commitment to pay a sum by reference to the amount by which the estimated residual value of the aircraft exceeds the actual residual value of the aircraft. By virtue of section 1(3) of Schedule 17F, the term "contingent purchase arrangement" means an arrangement under which a person is required to purchase an aircraft at a pre-determined amount if the actual residual value falls below the estimated residual value.

47. When a qualifying aircraft leasing manager, at the request of a qualifying aircraft lessor, provides finance to an airline enterprise for acquiring an aircraft from the qualifying aircraft lessor, the qualifying aircraft leasing manager is assisting the qualifying aircraft lessor to dispose of its aircraft. Such activity is regarded as having been carried out for the qualifying aircraft lessor and would qualify for the profits tax concession if other criteria are satisfied.

48. The expression "services in relation to an aircraft leasing activity for or to another corporation that is a relevant qualifying aircraft lessor" is wide in its meaning. It would include provision of services to qualifying aircraft lessors in connection with repossession of aircraft and remarketing of aircraft. It would also cover provision of advice on the disposals of aircraft.

Qualifying aircraft leasing management activity

49. Under section 14G(7), an aircraft leasing management activity carried out by a corporation in respect of an aircraft is a qualifying aircraft leasing management activity if:

(a) the activity is carried out in the ordinary course of the corporation's business carried on in Hong Kong;

(b) the activity is carried out for another corporation in the basis period of the other corporation for a year of assessment;

(c) the other corporation is a qualifying aircraft lessor for that year of assessment; and

(d) the aircraft is owned by the other corporation, and is leased to an aircraft operator, when the activity is carried out.

50. Since an aircraft lessor is usually an SPV holding an aircraft, the aircraft leasing management activity has to be carried out by an aircraft leasing manager. Thus, the qualifying aircraft lessor and qualifying aircraft leasing manager become parties privy to an aircraft leasing arrangement. The qualifying aircraft leasing management activity must be carried out for a qualifying aircraft lessor, in respect of an aircraft owned by the qualifying aircraft lessor, in the ordinary course of the business carried on by the qualifying aircraft leasing manager in Hong Kong.

Safe harbour rule

51. Section 14K lays down the safe harbour rule, which seeks to allow corporations having profits and assets primarily for qualifying aircraft leasing management activities to be entitled to the half rate concession in respect of the qualifying profits. There are two alternative safe harbours:

(a) A corporation falls within the "1-year safe harbour" in section 14K(2) if, for the year of assessment concerned, the percentages of its aircraft leasing management profits (ALMP percentage) and aircraft leasing management assets (ALMA percentage) are not lower than the prescribed percentages as set out in sections 3 and 4 of Schedule 17F (i.e. 75%);

(b) A corporation falls within the "multiple-year safe harbour" in section 14K(3) if, for the year of assessment concerned and the preceding one or two years of assessment, the average percentages of its aircraft leasing management profits and aircraft leasing management assets are not lower than the prescribed percentages as set out in sections 3 and 4 of Schedule 17F (i.e. 75%).

52. The ALMP and ALMA percentages of a corporation for a year of assessment are calculated in accordance with the following formulas in section 14K(5) and (6):

(a) ALMP percentage

$$\frac{\text{ALMP}}{\text{P}}$$

where: ALMP means the aggregate amount of the aircraft leasing management profits of the corporation in the basis period for the year of assessment; and

P means the aggregate amount of profits accruing to the corporation from all sources, whether in Hong Kong or not, in the basis period for the year of assessment.

(b) ALMA percentage

$$\frac{\text{ALMA}}{\text{A}}$$

where: ALMA means the aggregate value of the aircraft leasing management assets of the corporation as at the end of the basis period for the year of assessment; and

A means the aggregate value of all assets, whether in Hong Kong or not, of the corporation as at the end of the basis period for the year of assessment.

53. The term "aircraft leasing management profits" is defined in section 14G(1). It means any profits of a corporation that are derived from a qualifying aircraft leasing management activity. In this context, "aircraft leasing management profits" will generally be based on the accounting profits shown in the audited income statement of the aircraft leasing manager, irrespective of the source of the profits.

54. An aircraft leasing manager has to follow the arm's length principle when transacting with an aircraft lessor that is an associate. It is expected that the aircraft leasing manager would make an arm's length profit from qualifying aircraft leasing management activity carried out for such an aircraft lessor. In exceptional circumstances, where an aircraft leasing manager incurs a substantial loss from a qualifying aircraft leasing management activity (e.g. the qualifying aircraft lessor has become insolvent and the debt has become bad), the Commissioner would consider excluding the loss when computing the aircraft leasing management profits percentage for the purpose of the safe harbour rule or exercising his discretion under section 14L.

55. The term "aircraft leasing management asset" means an asset of a corporation used by it to carry out a qualifying aircraft leasing management activity. It would include fixed assets such as business premises and office equipment used to carry out qualifying aircraft leasing management activities. The asset values will be based on the audited statement of financial position of

the aircraft leasing manager, regardless of the location of the assets. Generally, intangibles not recorded in the statement of financial position in accordance with generally acceptable accounting principles will not be taken into account.

56. Section 14K(7) provides for apportionment of the value of an asset which is used partly for carrying out a qualifying aircraft leasing management activity and partly for another purpose. In computing the aggregate value of the aircraft leasing management assets, only the part of the value of the asset that is proportionate to the extent to which the asset is used to carry out a qualifying aircraft leasing management activity is to be taken into account.

57. 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 is substantial or the dividend income is not insignificant, 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 Commissioner is prepared to exclude equity investment in group companies and dividends from the denominators in the above formulas for the calculation of the ALMA and ALMP percentages so that such an aircraft leasing manager may also be regarded as a qualifying aircraft leasing manager under the safe harbour rule.

58. Under the multiple-year safe harbour rule in section 14K(4), the "consecutive" years of track record of a corporation are to be examined. The average ALMP and ALMA percentages must be computed based on the financial statements for the subject year and the preceding two years of assessment. Where the corporation has carried on a trade, profession or business in Hong Kong for less than two consecutive years of assessment immediately before the subject year, only the corporation's profits and assets for the subject year and the preceding year of assessment would be taken into account for computing the average ALMP and ALMA percentages.

Example 8

Aircraft Leasing Manager-HK claimed the half rate concession under section 14J(1) for Year 4. It had the following track record:

Year	*Business Activity in Hong Kong*
Year 1	*Active Business*
Year 2	*Dormant Business*
Year 3	*Active Business*
Year 4	*Active Business*

Though the aircraft leasing manager had three years of active business operations in Hong Kong, it was dormant in Year 2, leaving it with just one year prior to the subject year. Therefore, the aircraft leasing manager would be regarded as having two years of track record. The average ALMP and ALMA percentages would be computed based on the audited financial statements for Years 3 and 4.

Commissioner's determination

59. Section 14L allows the Commissioner to exercise his discretion to determine that a corporation is a qualifying aircraft leasing manager despite that it fails to satisfy the conditions specified in section 14J(3) and the safe harbour rule under section 14K. Such a determination would be made by the Commissioner under section 14L(3) if he is of the opinion that the conditions specified in section 14J(3), or the safe harbour rule, would, in the ordinary course of business of the corporation, have been satisfied for the year of assessment.

60. When exercising the discretion under section 14L, the Commissioner would look into the totality of facts, in particular, the types of qualifying aircraft leasing management activities that the aircraft leasing manager would carry out in the ordinary course of its business. The Commissioner may consider the following factors:

(a) the activities carried out by the corporation;

(b) the assets and liabilities of the corporation;

(c) the capacities, roles and responsibilities of the corporation's employees;

(d) the functions and risks undertaken by the corporation; and

(e) the operational history of the corporation.

SUBSTANTIAL BUSINESS PRESENCE

Tax treaty benefits

61. Hong Kong's tax treaty partners have been very concerned about treaty shopping. They have expressed their views that a corporation without business substance in Hong Kong should not be entitled to any tax treaty benefits. The Final Report of BEPS Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances) has identified tax treaty abuses, and in particular treaty shopping, as one of the most critical concerns of BEPS. Hong Kong is committed to implementing the minimum standard on Action 6, which entails the inclusion in Hong Kong's tax treaties an express statement that the common intention of the contracting parties is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements), and the implementation of this common intent through, among others, the principal purposes test (PPT).

62. Though there is no restriction on the place of incorporation, qualifying aircraft lessors and qualifying aircraft leasing managers need to ensure that they have a substantial business presence in Hong Kong. Any artificial arrangement to transfer existing leasing arrangements from other jurisdictions to Hong Kong for the purpose of obtaining unintended tax treaty benefits might not be accepted by Hong Kong's tax treaty partners. It is legitimate for Hong Kong's tax treaty partners to rely on the PPT to deny tax treaty benefits.

Central management and control

63. The central management and control (CMC) is located in Hong Kong if the executive officers and senior management employees of the qualifying aircraft lessor and 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.

64. The CMC test is a well-established common law rule adopted in many jurisdictions, such as Singapore, the United Kingdom and Australia, in determining the residence of a company. The common law rule was enunciated

by Lord Loreburn in *De Beers Consolidated Mines, Ltd. v Howe*, 5 TC 198 at page 213:

> "… a company resides, for purposes of Income Tax, where its real business is carried on. … I regard that as the true rule; and the real business is carried on where the central management and control actually abides."

65. The CMC refers to the highest level of control of the business of a company. Given the statutory requirements in sections 14H(4) and 14J(5), the CMC of the qualifying aircraft lessor and qualifying aircraft leasing manager must be exercised in Hong Kong which is also the place where the main operations of the qualifying aircraft leasing activities and qualifying aircraft leasing management activities are to be found.

66. The location of CMC is wholly a question of fact. Each case must be decided on its own facts. Factors that are decisive in one case may carry little weight in another. In general, if the CMC of a company is exercised by the directors in board meetings, the relevant locality is where those meetings are held.

67. The place of board meetings may not be conclusive. It is significant only in so far as those meetings constitute the medium through which CMC is exercised. In cases where CMC of a company is in fact exercised by an individual (e.g. the board chairman or the managing director), the relevant locality is the place where the controlling individual exercises his power. As CMC is a question of fact and reality, when reaching a conclusion in accordance with the case law principles, only factors which exist for genuine commercial reasons will be considered.

Substantial activity

68. The Final Report of BEPS Action 5 (Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance) contains detailed guidance on the application of the substantial activities criterion to Intellectual Property (IP) regimes as well as more general guidance for the application of the substantial activities criterion to non-IP regimes. The substantial activity requirement ensures that the aircraft leasing functions or the aircraft leasing management functions are performed in Hong Kong, the assets including the aircraft concerned are acquired or monitored in/from Hong Kong

and the risks associated with the aircraft leasing business or the aircraft leasing management business are undertaken in Hong Kong.

69. To satisfy the substantial activity requirement, 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 word "arranged" in sections 14H(4)(a)(ii)(B) and 14J(5)(a)(ii)(B) covers the situation where a qualifying aircraft lessor or a qualifying aircraft leasing manager arranges a third party or a group entity to carry out some of the core income generating activities in Hong Kong.

70. In the Harmful Tax Practices – 2017 Progress Report on Preferential Regimes (the Report) published in October 2017, it is explained that the core income generating activities presuppose having an adequate number of full-time employees with necessary qualifications and incurring an adequate amount of operating expenditures to undertake such activities. In an example provided in the Report, it is said that a financing and leasing regime satisfies the requirement for having substantial activities in the jurisdiction since the regime demonstrates that the core income generating activities occur in the jurisdiction and has a robust follow-up mechanism to ensure compliance. The regime requires:

(a) benefitting taxpayers to undertake the leasing activities and operations in the jurisdiction, including identifying and acquiring the assets to be leased, negotiating the leasing terms, and managing the leases;

(b) benefitting taxpayers incur at least EUR 5 million in annual business spending and employ an adequate number of qualified full-time employees to undertake the core activities (and at least three such employees) in the jurisdiction;

(c) benefitting taxpayers to report information annually on the income benefitting from the regime, as well as the type and level

of activity performed to generate the income; and

(d) denial of benefits if the taxpayers do not meet the requirements.

71. Commencing for fiscal years as from 2018, for the purpose of monitoring substantial activities in preferential regimes, qualifying aircraft lessors and qualifying aircraft leasing managers that are members of multinational enterprise groups with annual revenues in the preceding year of EUR 750 million (equivalent to HK$6.8 billion) or more will be required to provide information on the type and level of activities performed annually. Such information includes data on whether the lessors or managers perform the core income generating activities, the level of such activities undertaken, the number of qualified full-time employees and amount of operating expenditures associated with the activities. Such information is required to be reported to Forum of Harmful Tax Practices on an annual basis.

Facts and circumstances

72. Taking note that different corporations may have different business models, all the relevant facts and circumstances should be considered when determining whether the CMC and substantial activity requirements are satisfied. For the year in which the aircraft leasing activity commences, it is important to submit for the Commissioner's consideration a realistic business plan for carrying out aircraft leasing activity in Hong Kong. Since SPVs are often used 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.

Example 9

Overseas Trading Company-F set up SPV-HK, a qualifying aircraft lessor in Hong Kong, for holding a private jet which was leased to the company at a non-arm's length rent. SPV-HK did not have employees in Hong Kong. Nor was it managed by a qualifying aircraft leasing manager in Hong Kong. It had two nominee directors and used the business address of a Hong Kong secretarial firm as its registered address.

It seems that the above leasing arrangement might be used for shifting overseas income to the half rate regime in Hong Kong for tax avoidance purpose. SPV-HK did not have business substance in Hong Kong except merely owning the private jet. In the circumstances, the Commissioner would not accept that the CMC and substantial activity requirements were satisfied.

Example 10

Overseas Aircraft Operator-F set up SPV-HK, a qualifying aircraft lessor in Hong Kong, for leasing aircraft to it. All the directors of SPV-HK were non-Hong Kong residents. SPV-HK was not managed by a Hong Kong qualifying aircraft leasing manager and did not have employees and business premises in Hong Kong.

Clearly, SPV-HK did not satisfy the CMC and substantial activity requirements and could not be entitled to the profits tax concessions under this aircraft leasing regime. Further, Hong Kong's tax treaty partner would have great reservation regarding the purpose of such arrangement and might invoke the PPT to deny any unintended treaty benefits since its own tax resident was repackaged as if it was a Hong Kong tax resident. So there must be strong justification for such an arrangement from the perspective of Hong Kong's tax treaty partner. SPV-HK must have significant business substance in Hong Kong so as to be eligible for the profits tax concessions.

Attribution to Hong Kong

73. Apart from the CMC and substantial activity requirements, sections 14H(4)(a)(iii) and 14J(5)(a)(iii) stipulate that the profit-generating activities of a qualifying aircraft lessor or a qualifying aircraft leasing manager must not be carried out by a permanent establishment outside Hong Kong. If such activities are carried out in Hong Kong by employees of a non-Hong Kong permanent establishment and the relevant staff costs and associated expenses are attributed to such permanent establishment, the lessor or the manager would fail to satisfy this attribution to Hong Kong requirement.

DEPRECIATION ALLOWANCE AND DISPOSAL

Denial of depreciation allowance

74. An aircraft lessor leasing an aircraft to a Hong Kong aircraft operator is entitled to elect for this aircraft leasing regime. However, by virtue of section 14H(7), it would not be granted depreciation allowance under Part 6 of the Ordinance in respect of the capital expenditure incurred on the provision of the aircraft concerned for the year in which the half rate concession applies. Such aircraft lessor may either claim depreciation allowances or obtain the half rate concession under this regime.

75. In case a qualifying aircraft lessor leases an aircraft by way of an operating lease to a Hong Kong aircraft operator which then sub-leases the aircraft to a non-Hong Kong aircraft operator due to operational reasons such as surplus capacity, section 39E would operate to deny depreciation allowances as such provision also applies to sub-leases. In such a scenario, the qualifying aircraft lessor may consider electing into this aircraft leasing regime to take advantage of the half rate concession.

Example 11

Qualifying Aircraft Lessor-HK granted the right to use an aircraft to Aircraft Operator-HK under a hire-purchase agreement with a purchase option. Aircraft Operator-HK then leased the aircraft to Aircraft Operator-F, a non-Hong Kong aircraft operator.

Aircraft Operator-HK would be regarded as having obtained ownership of the aircraft. However, it would not be granted depreciation allowances under section 39E despite that section 23C would apply to assess the charter hire received from Aircraft Operator-F. As for Qualifying Aircraft Lessor-HK, the hire-purchase agreement would fall outside the definition of "lease" under section 14G(1) and hence Qualifying Aircraft Lessor-HK is not entitled to the profits tax concessions under the aircraft leasing regime. The interest element of the lease payments received would be assessed at full rate. If Qualifying Aircraft Lessor-HK granted the right to use the aircraft to Aircraft Operator-HK by way of an operating lease, Qualifying Aircraft

Lessor-HK could elect into the aircraft leasing regime to enjoy the profits tax concessions.

76. Since no depreciation allowances would be granted to a qualifying aircraft lessor under this aircraft leasing regime, certain provisions are thus added to sections 37 and 39B to provide for deduction of notional annual allowances when calculating depreciation allowances for an aircraft subsequently used in another trade, profession or business to produce chargeable profits. They are section 37(2B) to (2D) for the non-pooling system and section 39B(6A) to (6C) for the pooling system. Notional annual allowances would be deducted from the actual cost of the aircraft for the period during which the aircraft was owned and used by a corporation for carrying out a qualifying aircraft leasing activity in respect of which the half rate concession applies as if such annual allowances had been available to the corporation since it acquired the aircraft.

Example 12

Qualifying Aircraft Lessor-HK acquired an aircraft at a consideration of $300 million and used it for carrying out a qualifying aircraft leasing activity in Year 1 and Year 2 where half rate concession was granted. In Year 3, Qualifying Aircraft Lessor-HK ceased the aircraft leasing business and became dormant. In Year 4, it started an air transportation business and used the aircraft for such purpose.

Section 39B(6B) would apply since the aircraft has been used by Qualifying Aircraft Lessor-HK for carrying out a qualifying aircraft leasing activity in respect of which the half rate concession applied before being used in the air transportation business. Therefore, depreciation allowances of the aircraft for Year 4 would be computed as follows:

		$
Acquisition cost		300,000,000
Less:	Notional A.A. for Year 1	90,000,000
		210,000,000
Less:	Notional A.A. for Year 2	63,000,000
		147,000,000
Less:	Notional A.A. for Year 3	44,100,000
		102,900,000
Less:	A.A. for Year 4	30,870,000
		72,030,000

Disposal of aircraft

77. Section 14H(8) provides certainty to qualifying aircraft lessors on the tax treatment of gains or losses upon disposal of aircraft. The disposal gain in respect of an aircraft that has been used for carrying out a qualifying aircraft leasing activity for a continuous period of at least three years immediately prior to its disposal would be treated as a capital gain not chargeable to profits tax. However, a shorter period (say, two years) does not necessarily mean that such an aircraft is not a capital asset. The Commissioner would consider the totality of facts and apply common law principles in making decisions.

ANTI-AVOIDANCE PROVISIONS

Disqualified from tax concessions

78. Sections 14H(6)(b) and 14J(7)(b) provide that if section 14H(1) or 14J(1) does not apply to a corporation for a year of assessment (cessation year), such corporation is not allowed to re-enter the half rate regime for the year of assessment following the cessation year. These provisions are to prevent abuse and protect fiscal revenue as a corporation may opt in when it derives profits from qualifying operations in order for the concessionary half rate to apply; and then opt out when it suffers losses in a subsequent year of assessment in order to obtain deduction of losses at full rate.

79. If a qualifying aircraft lessor or a qualifying aircraft leasing manager merely incurs a tax loss from its qualifying operations, it would not be disqualified from being entitled to the half rate concession. Section 19D(1) of the Ordinance provides that the amount of loss incurred by a person chargeable to profits tax for any year of assessment shall be computed in like manner and for such basis period as the assessable profits for that year of assessment would have been computed. So if a qualifying entity incurs a tax loss for a year of assessment, section 14H(1) or 14J(1) still applies and the tax loss can only be set off against its other types of profits at half rate for the purpose of section 19CA of the Ordinance. Sections 14H(6)(b) and 14J(7)(b) would not be invoked to deny profits tax concessions to the qualifying entity for the subsequent year of assessment.

Arm's length principle

80. Section 14M(1) and (2) ensures that the chargeable profits from a transaction between a qualifying aircraft lessor and its associate in connection with a qualifying aircraft leasing activity will be determined by reference to the amount of profits that would have accrued had the same transaction been carried out at arm's length terms between parties who are not associates (i.e. arm's length principle). Such principle would also apply to a qualifying aircraft leasing management activity of a qualifying aircraft leasing manager by virtue of section 14M(3) and (4).

81. "Associate" has the meaning given by section 14G(1). Section 14M(1) to (4) sets out the conditions where the profits in respect of transactions in connection with a qualifying aircraft leasing activity or a qualifying aircraft leasing management activity between a qualifying entity and its associates may be subjected to adjustment.

Defeasance arrangement

82. Section 14M(5) forestalls defeasance arrangements. Under the aircraft leasing regime, a qualifying aircraft lessor can own an aircraft via a funding lease, a hire-purchase agreement or a conditional sale agreement. A qualifying aircraft lessor who owns an aircraft through such ownership arrangement may defease the funding lease, hire-purchase agreement or conditional sale agreement to a third party. The third party takes up the primary obligation under such ownership arrangement to make payments to the head lessor, bailor or seller. The effect of a defeased arrangement is that the qualifying aircraft lessor is no longer obliged to make payments under the ownership arrangement. In such a scenario, section 14M(5) would come into operation and the qualifying aircraft lessor would be treated as if it had ceased to own the aircraft. Hence, no profits tax concessions will be granted to it in respect of the leasing transaction with the aircraft operator as it is no longer a qualifying aircraft leasing activity as defined in section 14G(6).

Anti-tax arbitrage rule

83. Section 16(1A) is enacted so as to prevent tax arbitrage through aircraft leasing transactions between connected persons. If a Hong Kong aircraft operator (i.e. the lessee) pays a sum, whether directly or through an interposed person, to its connected qualifying aircraft lessor or qualifying aircraft leasing manager, who is

eligible to enjoy the half rate concession under the aircraft leasing regime, the relevant sum that could be deducted by the Hong Kong aircraft operator in computing its assessable profits would be reduced such that the profits tax payable by the Hong Kong aircraft operator is increased by reference to the amount of the reduction in the profits tax payable by the qualifying aircraft lessor or qualifying aircraft leasing manager in respect of the relevant sum for the year of assessment or any subsequent year of assessment. The expression "by reference to the amount of the reduction in the profits tax payable" refers to the reduction in the profits tax liability of the qualifying entity due to the reduced tax rate as mentioned in section 16(1A)(c), that is, the half rate concession. Thus, when ascertaining the amount of deduction that could be allowed to the connected person under section 16(1A), the 20% tax base concession would be ignored.

Example 13

Qualifying Aircraft Lessor-HK leased an aircraft to Aircraft Operator-HK which was a connected person within the meaning in section 14G(1). The lease payment charged by Qualifying Aircraft Lessor-HK for the year of assessment 2017/18 was $12 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 amounted to $7 million for that year.

The profits tax payable by Qualifying Aircraft Lessor-HK:
= ($12,000,000 – $7,000,000) × 20% × 8.25%
= $82,500

If Qualifying Aircraft Lessor-HK had been subject to full profits tax rate, its profits tax payable would have been $165,000. The tax saving due to the reduction in tax rate was thus $82,500 ($165,000 – $82,500). The amount of the lease payment that could be deducted by Aircraft Operator-HK would be calculated as follows:

$12,000,000 – ($82,500 ÷ 16.5%)
= $11,500,000

84. Section 16(1A) nullifies the tax benefits obtained when an aircraft operator subject to full tax rate shifts income to the half rate regime by making payments to its connected qualifying aircraft lessor or qualifying aircraft leasing

manager. Section 16(1A) will not be invoked to restrict deduction of management fees paid by a qualifying aircraft lessor to a connected qualifying aircraft leasing manager for qualifying aircraft leasing management services provided as their profits are assessed at half tax rate.

Sections 61 and 61A

85. The Commissioner will generally act in accordance with this Practice Note in granting profits tax concessions to qualifying aircraft lessors and qualifying aircraft leasing managers. However, in cases where tax avoidance is involved or this aircraft leasing regime is abused to secure a result which is not intended under the 2017 Amendment (No. 3) Ordinance, the Commissioner will consider invoking the general anti-avoidance provisions under section 61 or 61A of the Ordinance as appropriate to counteract the avoidance.

INCOME FROM AIRCRAFT BUSINESS OR MANAGING AIRCRAFT BUSINESS

Codification of case law principles

86. Section 15(1) of the Ordinance sets out various sums that are regarded to be trading receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong, and hence are chargeable to profits tax. The provisions in section 15(1)(n) ensure that sums received by or accrued to a corporation by way of gains or profits (other than those arising from the sale of capital assets) arising through or from the carrying on in Hong Kong by the corporation of its business of:

(a) granting a right to use an aircraft to another person (***aircraft business***); or

(b) managing a corporation carrying on an aircraft business or of managing an aircraft business.

are chargeable to profits tax even if the aircraft concerned is used outside Hong Kong.

87. Section 15(1)(n) makes it clear that the "operation test" applies in the determination of the source of income derived from an aircraft leasing business or an aircraft leasing management business. The principle of the "operation test" laid down in *CIR v Hang Seng Bank Limited*, [1991] 1 AC 306 and expanded in *CIR v HK-TVB International Limited*, [1992] 2 AC 397 is that "one looks to see what the taxpayer has done to earn the profit in question and where he has done it". Thus, the focus should be the place where the core income generating activities are performed by the aircraft lessor or aircraft leasing manager and not the place where the aircraft is used by the aircraft operator.

88. Given the CMC and substantial activity requirements, any qualifying profits derived from the qualifying aircraft leasing activities or the qualifying aircraft leasing management activities of a qualifying aircraft lessor or a qualifying aircraft leasing manager should be sourced from Hong Kong and chargeable to profits tax. The application of the "operation test" on income arising from an aircraft leasing business follows the current practice of the Department. Section 15(1)(n) merely codifies this practice and the legal principle in case law. No new taxation principle was introduced in the 2017 Amendment (No. 3) Ordinance and no change has been made to the source principles by section 15(1)(n).

COMMENCEMENT DATE

Commencement of profits tax concessions and taxation rule

89. Regarding the effective date, sums received by or accrued to a qualifying aircraft lessor or a qualifying aircraft leasing manager before 1 April 2017 are not to be taken into account for the purpose of computing the qualifying profits under section 14H(1) or 14J(1). In other words, sums accrued before 1 April 2017 but received after that day would not be eligible for the profits tax concessions. For the provision under section 15(1)(n), it does not apply to sums received or accrued before the commencement date of the 2017 Amendment (No. 3) Ordinance (i.e. 7 July 2017).

ADVANCE RULINGS

Ruling on specific transaction

90. To secure tax certainty, a request in respect of a specific transaction or structuring may be made to the Commissioner for a ruling on how the provisions of aircraft leasing regime are to apply to the applicant. The Commissioner requires maximum disclosure for advance ruling applications and a fee needs to be paid. Departmental Interpretation and Practice Notes No. 31 explains the procedures and requirements for making advance ruling applications. Such a ruling, if required, will be sent to the competent authority of the relevant jurisdiction with which Hong Kong has an arrangement for exchange of information. The information and documents required to be provided in an application for a ruling are set out in Appendix 3.

CERTIFICATE OF RESIDENT STATUS

Issuance of certificate of resident status

91. Since 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 lessee upon delivery of an aircraft so that treaty relief may be claimed in the jurisdiction in which the lessee resides. This may be a condition precedent to be satisfied by a lessor prior to the commencement of a lease if the lessee bears the obligation to pay the withholding tax. Qualifying aircraft lessors satisfying the CMC and substantial activity requirements should be able to obtain a certificate of resident status from the Department. The application form (IR1313A or IR1313B) can be furnished to the Department 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, submission of a five-year business plan and details of its liability to pay Hong Kong profits tax may be provided to the Department for determining whether it is a Hong Kong tax resident.

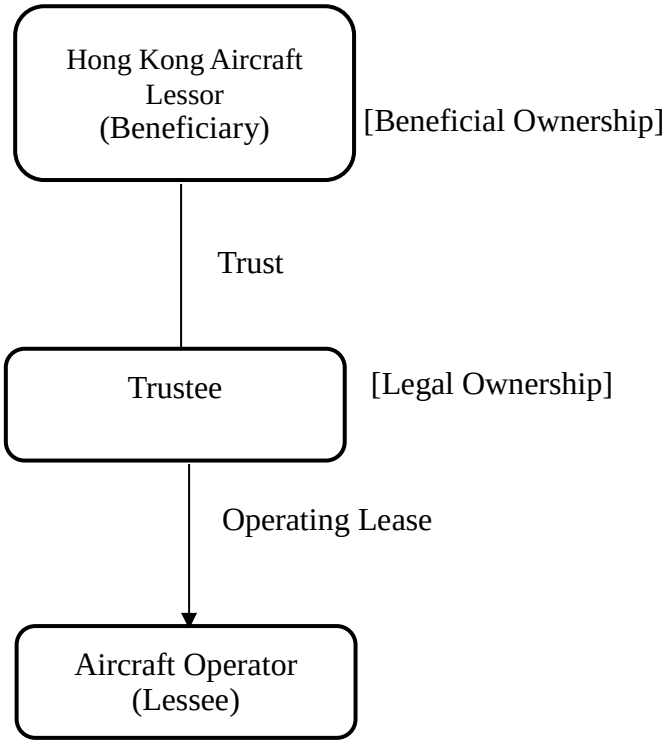
92. As a rule, tax credit would not be allowed to the qualifying aircraft lessor if the withholding tax on aircraft rentals is borne by the lessee.

Appendix 1

Trust Arrangement

1. In a trust involving a leased aircraft, the trustee holds either the ownership interest and/or the leasehold interest in the aircraft (which is subject to a lease) in trust for the beneficiary.

2. An example of leasing model involving bare trust is appended below.



3. The bare trustee and the beneficiary enter into a trust instrument, pursuant to which, among others:

(a) the beneficiary appoints the bare trustee to hold all right, title and interest in and to the aircraft (whether or not through a funding lease, hire-purchase agreement or conditional sale agreement), the operating lease and any other documents in connection therewith in trust for the beneficiary;

(b) other than the bare legal ownership, the bare trustee has no beneficial, equitable or other interest in the aircraft (or the funding lease, hire-purchase agreement or conditional sale agreement), the operating lease or any other documents in connection therewith.

4. In a typical trust structure:

(a) The bare trustee is a person established in or outside Hong Kong.

(b) The bare trust is a fiscally transparent entity. All amounts of rent, security deposits, proceeds of sale and other amounts in respect of the operating lease or the aircraft received by the bare trustee will be distributed promptly to the beneficiary.

(c) The bare trustee has no power or authority to deal with the aircraft (or the funding lease, hire-purchase agreement or conditional sale agreement), the operating lease or any other documents in connection therewith except as provided in instructions or authorisation from the beneficiary.

(d) Other than the bare legal ownership, the bare trustee has no beneficial, equitable or other interest in the aircraft (or the funding lease, hire-purchase agreement or conditional sale agreement), the operating lease or any other documents in connection therewith.

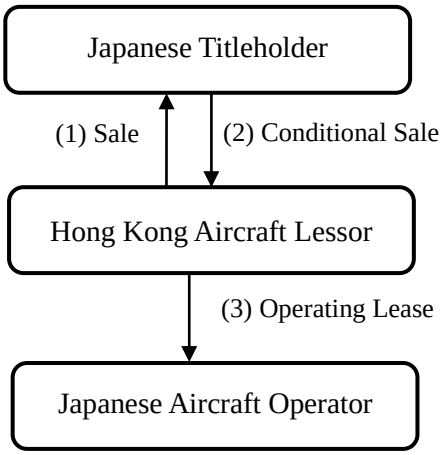
(e) It is the beneficiary who is carrying on qualifying aircraft leasing activities in Hong Kong.

5. While the bare trustee holds the bare legal ownership, the beneficiary, who carries on the qualifying aircraft leasing activities in Hong Kong, is regarded as the owner of the aircraft for the purposes of the aircraft leasing regime. Provided that other relevant conditions are satisfied, the beneficiary will be entitled to the tax concession.

Aircraft Transaction Structuring

A. Japanese conditional sale structure

1. While the legal title to an aircraft for leasing to a Japanese aircraft operator has to be held by a Japanese titleholder, an aircraft lessor resident in Hong Kong may be regarded as owning the Japanese-registered aircraft under a conditional sale agreement:



2. In a typical conditional sale structure:

(a) The aircraft is sold by an aircraft lessor resident in Hong Kong to a Japanese titleholder. By a conditional sale agreement, the aircraft is sold by the Japanese titleholder back to the aircraft lessor resident in Hong Kong. The aircraft lessor resident in Hong Kong is not expected to make a substantial profit in relation to the sale and buy-back of the aircraft.

(b) The legal title of the aircraft is kept by the Japanese titleholder while the risks and rewards arising from the ownership of the aircraft are transferred to the aircraft lessor resident in Hong Kong.

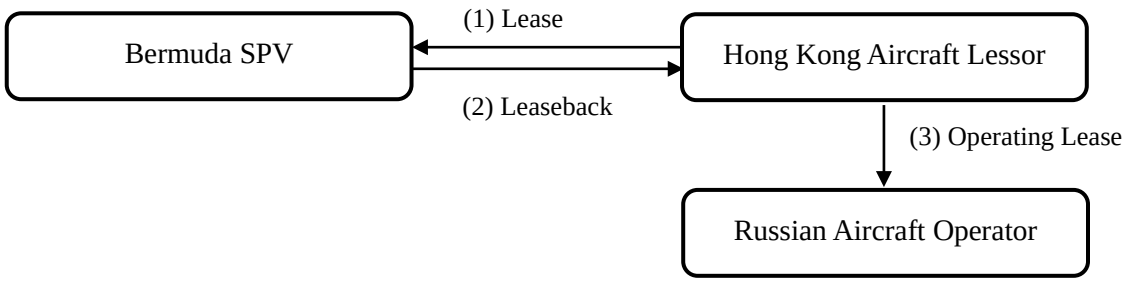
(c) The aircraft is leased by the aircraft lessor resident in Hong Kong to a Japanese aircraft operator under an operating lease.

(d) The legal title of the aircraft will pass to the aircraft lessor resident in Hong Kong upon payment of a nominal consideration to the Japanese titleholder at the end of the operating lease with the Japanese aircraft operator.

3. While the Japanese titleholder holds the legal title of the aircraft, the aircraft lessor resident in Hong Kong is regarded as having satisfied the ownership requirement since it has acquired the aircraft under a conditional sale agreement. The leasing of the aircraft by the aircraft lessor resident in Hong Kong to the Japanese aircraft operator is thus a qualifying aircraft leasing activity. If the property in the aircraft is reasonably expected not to pass to the aircraft lessor resident in Hong Kong under the conditional sale agreement, the aircraft lessor resident in Hong Kong will not be treated as the owner of the aircraft by virtue of the provision in section 14G(5) and the leasing of the aircraft to the Japanese aircraft operator will not be a qualifying aircraft leasing activity eligible for the profits tax concessions.

B. Russian lease-in-lease-out structure

1. Since Bermuda has concluded an agreement with Russia on maintenance of continuing airworthiness of aircraft and transfer of certain regulatory oversight functions and duties under the Convention on International Civil Aviation 1944, an aircraft operated by a Russian aircraft operator may be registered in Bermuda under a lease-in-lease-out structure:



2. In a typical lease-in-lease-out structure:

(a) The aircraft is leased by an aircraft lessor resident in Hong Kong to an SPV established in Bermuda. It is then registered in Bermuda. The aircraft lessor resident in Hong Kong and the SPV established in Bermuda may be part of a group of companies. The legal title and ownership of the aircraft are retained by the aircraft lessor resident in Hong Kong.

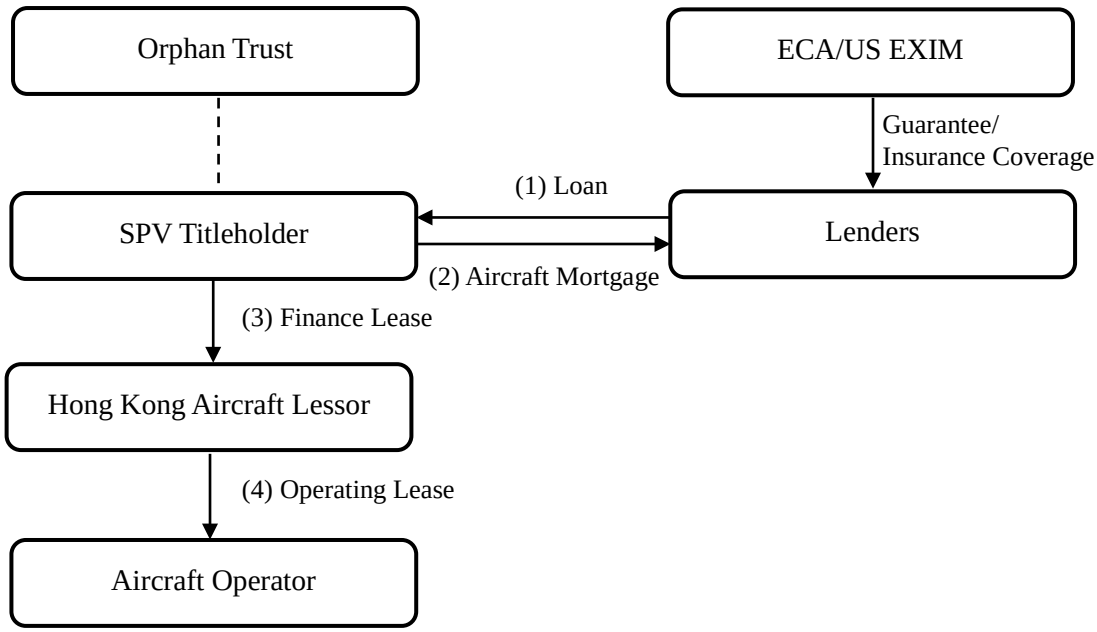
(b) The aircraft is leased by the SPV in Bermuda back to the aircraft lessor resident in Hong Kong at a nominal sum to substantiate such lease and/or cover its operating expenses. The SPV in Bermuda is in substance a pass-through entity purely for aircraft registration purposes and is not expected to retain a substantial profit.

(c) The aircraft is leased by the aircraft lessor resident in Hong Kong to a Russian aircraft operator under an operating lease.

3. The leasing of the aircraft by the aircraft lessor resident in Hong Kong to the Russian aircraft operator is a qualifying aircraft leasing activity since the ownership of the aircraft is retained by the aircraft lessor resident in Hong Kong.

C. ECA/US EXIM guaranteed or supported financing

1. ECA/US EXIM guaranteed or supported financing is used by aircraft lessors to lower their financing costs for acquisition of aircraft. "ECA" refers to Bpifrance Assurance Export of France, Euler Hermes Kreditversicherungs Aktiengesellschaft of Germany (Euler Hermes) and UK Export Finance of the United Kingdom (UKEF) for Airbus aircraft. "US EXIM" refers to the Export-Import Bank of the United States for Boeing aircraft. In an ECA/US EXIM guaranteed or supported financing structure, the ownership of an aircraft is often required to be vested in a bankruptcy-remote SPV under an orphan trust. Where a lessor borrows a loan to finance the purchase of an aircraft, the lender may require the aircraft to be held by a bankruptcy-remote SPV so as to provide greater security to the lender in case of default by the lessor.



2. In a typical ECA/US EXIM guaranteed or supported financing structure:

(a) The SPV titleholder, which is unrelated to the aircraft lessor resident in Hong Kong, is set up under an orphan trust in a jurisdiction like the Cayman Islands and the State of Delaware in the United States.

(b) The lenders advance a loan to the SPV titleholder as borrower. The repayment obligations of the SPV titleholder are guaranteed or supported, subject to certain conditions, by ECA/US EXIM.

(c) The SPV titleholder has legal title of the aircraft and it gives an aircraft mortgage to the lenders as security.

(d) The aircraft is leased by the SPV titleholder to the aircraft lessor resident in Hong Kong under a hire-purchase agreement or a finance lease. On the exercise of an option, the aircraft is purchased by the aircraft lessor resident in Hong Kong at a nominal consideration at the end of the lease term or in the event of an early termination. The legal title to the aircraft can also be automatically transferred to the aircraft lessor resident in Hong Kong at the end of the lease term or in the event of an early termination.

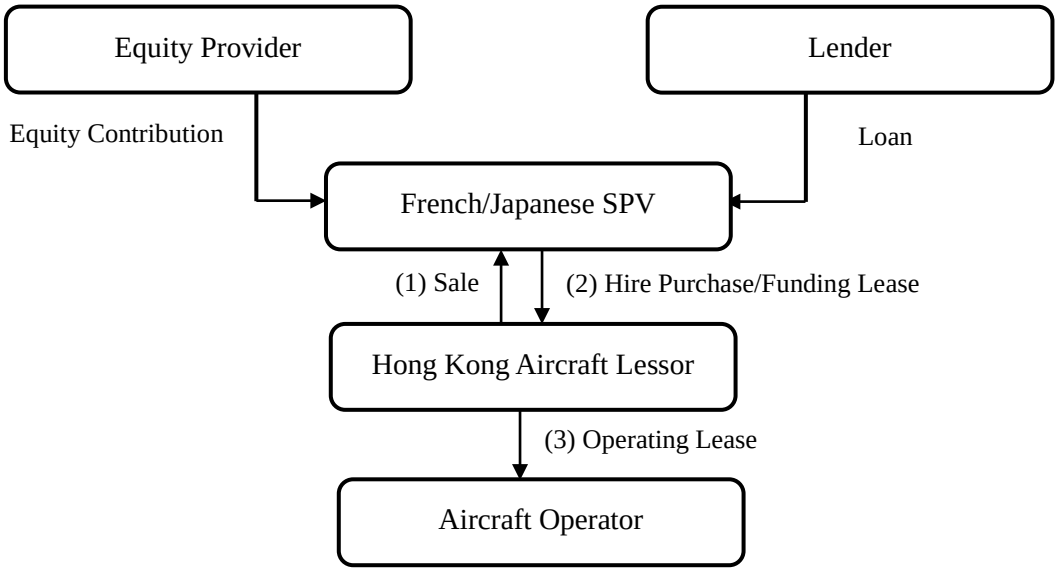
(e) The aircraft lessor resident in Hong Kong then leases the aircraft to an aircraft operator under an operating lease.

3. The aircraft lessor resident in Hong Kong holds the aircraft as a bailee under a hire-purchase agreement or as a lessee under a funding lease. As such, the leasing of the aircraft by the aircraft lessor resident in Hong Kong to the aircraft operator is a qualifying aircraft leasing activity.

D. French or Japanese tax lease financing

1. French tax lease and Japanese tax lease are used in the big ticket leasing market, including aircraft, as a means to lower the cost of financing of lessors or airlines.

2. In a French or Japanese tax lease financing structure, the aircraft is owned by an SPV established in France or Japan. Accelerated tax depreciation will be passed through the SPV to equity providers. Tax deferral benefits will be partly shared by the lessor to lower its financing costs for acquisition of the aircraft.



3. In a typical French or Japanese tax lease financing structure:

(a) The aircraft is sold by the aircraft lessor resident in Hong Kong to an unrelated SPV set up in France or Japan by the equity provider.

(b) The lender advances a loan and the equity provider makes an equity contribution to the SPV in France or Japan so that it can acquire legal title and/or ownership of the aircraft.

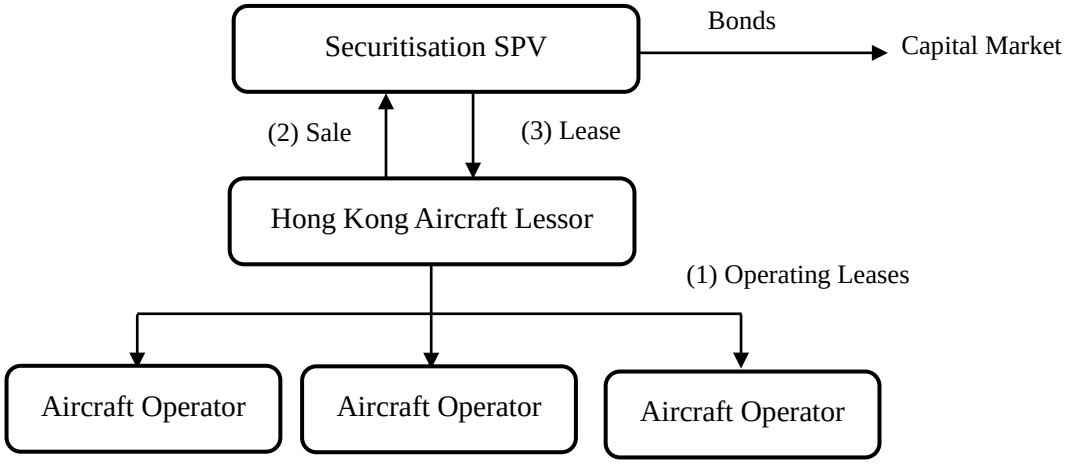
(c) The aircraft is leased by the SPV in France or Japan to the aircraft lessor resident in Hong Kong under a hire-purchase agreement or a funding lease. Tax deferral benefits from the arrangement shared by the aircraft lessor resident in Hong Kong will reduce the financing costs incurred by the aircraft lessor resident in Hong Kong for acquisition of the aircraft.

(d) The aircraft is sub-leased by the aircraft lessor resident in Hong Kong to an aircraft operator.

4. By virtue of the definition of "own" under section 14G(1), the ownership requirement will be regarded as having been satisfied since the aircraft lessor resident in Hong Kong holds the aircraft as a bailee under a hire-purchase agreement or as a lessee under a funding lease. The leasing of the aircraft by the aircraft lessor resident in Hong Kong to the aircraft operator is a qualifying aircraft leasing activity.

E. Securitisation

1. Securitisation may be used by an aircraft lessor resident in Hong Kong to raise funds from the capital market in Hong Kong for acquisition of aircraft. The securitisation structure used by the aircraft lessor resident in Hong Kong may involve a sale and leaseback arrangement.



2. In a typical securitisation structure:

(a) The aircraft lessor resident in Hong Kong owns a portfolio of aircraft which are leased to aircraft operators.

(b) The aircraft are sold by the aircraft lessor resident in Hong Kong to an SPV, which is set up as a securitisation vehicle, in a jurisdiction appropriate for raising funds from the capital market in Hong Kong.

(c) The aircraft are leased back from the SPV to the aircraft lessor resident in Hong Kong.

(d) The operating leases between the aircraft lessor resident in Hong Kong and the aircraft operators remain unchanged.

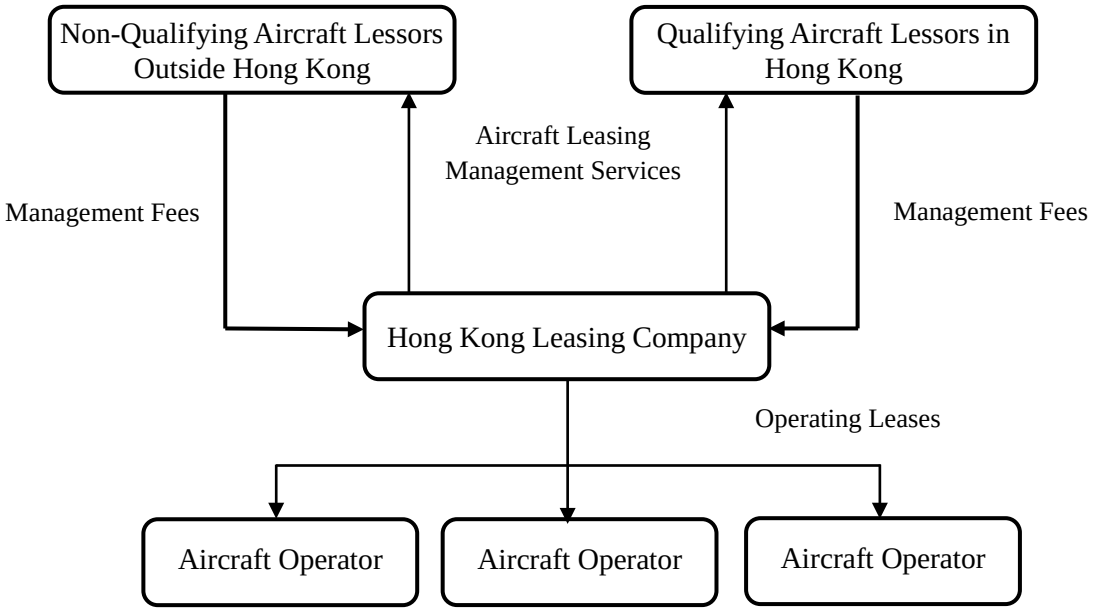
3. If a purchase option is given to the aircraft lessor resident in Hong Kong to acquire the aircraft at a nominal price or at a price below the fair market value, the lease will be in substance a hire-purchase agreement. The lease can also be structured as a funding lease such that the property in the aircraft would be transferred to the aircraft lessor resident in Hong Kong at the end of the lease term. In the circumstances, the aircraft lessor resident in Hong Kong will hold the aircraft as a bailee under a hire-purchase agreement or as a lessee under a funding lease. It will be regarded as having satisfied the ownership requirement by virtue of the definition of "own" under section 14G(1).

4. The SPV and the aircraft lessor resident in Hong Kong may enter into a lease arrangement prescribed in section 6(1) of Schedule 17A as part of a specified alternative bond scheme. If the conditions under section 13(1) and (2) of Schedule 17A are met, the bond arrangement (between the SPV and the bond holders) and the lease arrangement (between the aircraft lessor resident in Hong Kong and the SPV) will be treated as debt arrangements under sections 21 and 22 of Schedule 17A. The acquisition, leasing and disposal transactions involving the aircraft between the SPV and the aircraft lessor resident in Hong Kong will be disregarded. In such a lease arrangement, the aircraft lessor resident in Hong Kong will continue to be treated as having retained the ownership of the aircraft.

5. If the SPV is not to dispose of the aircraft back to the aircraft lessor resident in Hong Kong by the end of the specified term of the securitisation arrangement, the investment arrangement will not be a lease arrangement under section 6(1) of Schedule 17A and thus not a specified investment arrangement under section 5 of Schedule 17A. Section 22 of Schedule 17A will be inapplicable. The aircraft lessor resident in Hong Kong will not be regarded as owning the aircraft under section 14G(1) and the leasing of the aircraft by the aircraft lessor resident in Hong Kong to aircraft operators would not be a qualifying aircraft leasing activity eligible for the profits tax concessions.

F. Leasing and management activities in a single corporate entity

1. If an aircraft leasing company does not use special purpose vehicles to hold aircraft for leasing, it may adopt a centralised model. Both qualifying aircraft leasing activity and qualifying aircraft leasing management activity are carried out in Hong Kong by a single corporate entity.



2. In a typical centralised leasing model:

(a) The leasing company resident in Hong Kong carries out both aircraft leasing activity and aircraft leasing management activity.

(b) It is the owner of a number of aircraft and leases the aircraft to aircraft operators in various jurisdictions by way of operating leases.

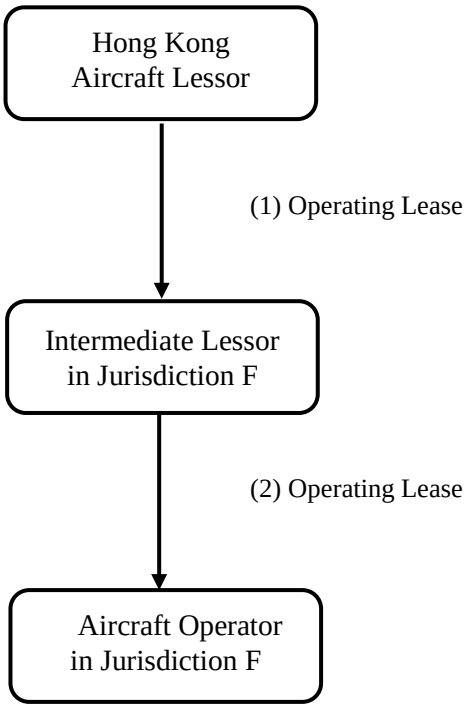
(c) It also provides aircraft leasing management services to qualifying aircraft lessors in Hong Kong and non-qualifying aircraft lessors outside Hong Kong. In return, it receives management fees.

3. Since the leasing company resident in Hong Kong is the owner of the aircraft, the leasing of such aircraft to aircraft operators is a qualifying aircraft leasing activity. Despite engaging in an aircraft leasing management activity, the leasing company resident in Hong Kong will be regarded as a qualifying aircraft lessor since the aircraft leasing management activity is an integral part of the aircraft leasing business. Thus, it should be eligible for the profits tax concessions in respect of the rental income derived from leasing of aircraft to aircraft operators.

4. Regarding the aircraft leasing management activity, provided that the leasing company resident in Hong Kong satisfies the safe harbour rule under section 14K with respect to such activity (i.e. the aircraft leasing management services rendered to non-qualifying aircraft lessors outside Hong Kong are no more than 25% of its aircraft leasing management activity in terms of both profits and assets), it can be regarded as a qualifying aircraft leasing manager. The management fees derived from the qualifying aircraft leasing management activity are eligible for the profits tax concessions. When computing the ALMP and ALMA percentages, profits and assets relating to the qualifying aircraft leasing activity may be excluded.

G. Leasing via an intermediate lessor in a free trade zone or a special economic zone

1. Aircraft operators of other jurisdictions may request the aircraft lessor resident in Hong Kong to lease an aircraft to them via an intermediate lessor established in a free trade zone or a special economic zone for the purpose of obtaining value added tax (VAT) refunds or other preferential tax benefits offered therein.



2. In a typical leasing structure involving an intermediate lessor in the home jurisdiction of the aircraft operator:

(a) The aircraft lessor resident in Hong Kong is the owner of the aircraft. It leases the aircraft to an intermediate lessor set up in a free trade zone or a special economic zone in the aircraft operator's home jurisdiction by way of an operating lease. The intermediate lessor may be associated with the aircraft lessor resident in Hong Kong, the aircraft operator or an unrelated party.

(b) The intermediate lessor then sub-leases the aircraft to the aircraft operator by way of an operating lease. If the intermediate lessor is associated with the aircraft lessor resident in Hong Kong and all the substantial activities are carried out in Hong Kong, the intermediate lessor should only make a nominal profit to cover its administrative expenses.

(c) The VAT refund or other tax benefits obtained in the free trade zone or special economic zone may then be shared with the aircraft operator, lowering its cost of leasing aircraft.

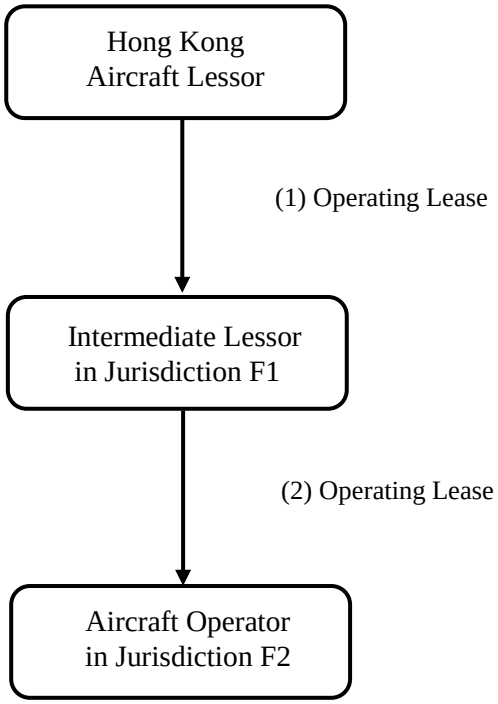
3. Strictly, the leasing of aircraft by the aircraft lessor resident in Hong Kong to the intermediate lessor does not fall within the definition of "aircraft leasing activity" under section 1(1) of Schedule 17F. If the arrangement is justified by commercial reasons (e.g. soliciting incentives provided to aircraft leasing business by a free trade zone or special economic zone of a jurisdiction), the interposition of an intermediate lessor may be accepted. If the intermediate lessor acts as the dependent agent of the aircraft lessor resident in Hong Kong, the intermediate lessor may trigger a permanent establishment in the free trade zone or special economic zone.

4. The aircraft lessor resident in Hong Kong is expected to receive an arm's length rent from the intermediate lessor. The leasing of aircraft to the aircraft operator indirectly via an intermediate lessor can be regarded as a qualifying aircraft leasing activity and thus eligible for the profits tax concessions.

5. Structures involving an intermediate lessor located in an overseas jurisdiction can be subject to scrutiny since it may be found to have been set up for the main purpose of obtaining tax benefits. The intermediate lessor may also be expected by the overseas jurisdiction to meet an activity threshold (i.e. the substantial activity requirement) and to receive an income commensurate with the value of the activities it performs. Such a structure may not satisfy the attribution to Hong Kong requirement.

H. Leasing via an intermediate lessor in a third jurisdiction

1. Under certain structures, if an aircraft is leased to an aircraft operator in a second jurisdiction via an intermediate lessor set up in a third jurisdiction, the withholding tax on lease rentals payable by the aircraft operator in the second jurisdiction may be reduced under the tax treaty between the second and the third jurisdictions.



2. In a typical leasing structure involving an intermediate lessor in a third jurisdiction:

(a) The aircraft lessor resident in Hong Kong is the owner of the aircraft. It leases the aircraft to an intermediate lessor set up in Jurisdiction F1 by way of an operating lease. The intermediate lessor may be associated with the aircraft lessor resident in Hong Kong or the aircraft operator in Jurisdiction F2.

(b) The intermediate lessor in Jurisdiction F1 then sub-leases the aircraft to the aircraft operator in Jurisdiction F2 by way of an operating lease.

3. Strictly, the leasing of aircraft by the aircraft lessor resident in Hong Kong to the intermediate lessor does not fall within the definition of "aircraft leasing activity" under section 1(1) of Schedule 17F. If the intermediate lessor in Jurisdiction F1 is owned by the lessor resident in Hong Kong or its associate and there are commercial reasons for the lease to be structured this way, the aircraft lessor resident in Hong Kong should not be regarded as engaging in treaty shopping or tax avoidance. However, there is a potential risk of removal of access to treaty benefits for non-owner lessors and low substance owner lessors.

4. The substance of the aircraft lessor resident in Hong Kong and its functional capability to acquire, manage and exploit aircraft assets more profitably than the intermediate lessor should make it unlikely that the transactions or the involvement of the intermediate lessor is designed to secure a tax reduction in Hong Kong. Even if that is not clear, the presence of those factors would point away from a conclusion that the transactions would not have taken place at all in the absence of the tax concessions. Thus, the aircraft lessor resident in Hong Kong should be eligible for the profits tax concessions.

5. If the decision to lease the aircraft to the aircraft operator via its wholly owned intermediate lessor is made at the request of the aircraft operator, the interposition of an intermediate lessor may be justified by commercial reasons. Where all the leasing activities are performed by the aircraft lessor resident in Hong Kong, the intermediate lessor is expected to earn a nominal profit to cover its administrative expenses. In such circumstances, the leasing of aircraft to the aircraft operator indirectly via an intermediate lessor can be regarded as a qualifying aircraft leasing activity eligible for the profits tax concessions.

Appendix 3

Advance Ruling Application

Required Information and Documents:

The leasing arrangement

1. Provide or describe:

   (a) the structure of the leasing arrangement (with a diagram);

   (b) the names of all the parties involved in the leasing arrangement including the financier, aircraft titleholder, aircraft lessor, aircraft leasing manager and lessee with their places of incorporation and residence, places of operations, Hong Kong business registration numbers (if any) and relationships (if any);

   (c) details of the aircraft involved including the model number, date and cost of acquisition, date of delivery and estimated useful economic life;

   (d) the terms of the lease including the amount of monthly lease rental and lease premium (if any), period covered, details of residual value guarantee (if any), early termination clause, renewal clause, options or rights in the lessee or an associate to purchase the aircraft, rental rebates, etc.;

   (e) a copy of the lease agreement entered into with the lessee showing the terms of the lease;

   (f) the expected residual value and how it has been determined;

   (g) copy(ies) of separate rental rebate agreement and/or purchase option agreement, if any, with a brief description of the terms;

(h) a copy of the management agreement entered into between the aircraft lessor and aircraft leasing manager; and

(i) the expected date of execution.

2. If the leasing arrangement is to be a sale and leaseback, advise the date on which the aircraft was first used or is proposed to be first used by the lessee and/or by any associate of the lessee.

Ownership of aircraft

3. Describe how the aircraft lessor acquires the economic ownership of the aircraft involved.

4. Explain how the aircraft lessor retains the economic ownership of the aircraft involved throughout the lease term.

Financing of aircraft

5. Describe how the aircraft involved is financed.

6. If the aircraft involved is financed by a loan:

(a) state the name, address and Hong Kong business registration number (if any) of the lender;

(b) state the relationship between the aircraft lessor and the lender;

(c) describe the terms of the loan including the date and amount of drawn down, interest rate, period covered, repayment terms, nature and value of the collaterals or securities, nature of guarantee given, etc.;

(d) provide a schedule of proposed repayments of principal and payments of interest, including dates and amounts;

(e) provide a copy of the loan agreement;

(f) where the loan involves a sub-participation arrangement, give the

same details as in (a) to (e) above for the sub-participation arrangement; and

(g) where the loan is borrowed from the lessee, provide the same details as in (a) to (e) above in respect of the reciprocal loan between the lessee and lender.

7. If the aircraft is financed by a funding lease/hire-purchase agreement/ conditional sale agreement:

(a) state the name, address and Hong Kong business registration number (if any) of the lessor/bailor/seller (as the case may be) under such agreement;

(b) state the relationship between the aircraft lessor and the lessor/bailor/ seller (as the case may be) under such agreement;

(c) describe the terms of such agreement including the period covered, amount of monthly lease payments/instalments, lease premium (if any), purchase options, rental rebates, etc.;

(d) provide a payment schedule showing the dates and amounts of monthly lease payments or instalments, lease premium (if any), etc.; and

(e) provide copies of the funding lease/hire-purchase/conditional sale agreement and all supplementary agreements.

<u>Depreciation allowance</u>

8. Confirm whether depreciation allowances under Part 6 of the Inland Revenue Ordinance (the Ordinance) have been granted to the aircraft lessor or its connected person in respect of the aircraft involved.

9. Confirm whether capital allowances are granted to, or will be claimed by, a connected person of the aircraft lessor, whether in Hong Kong or elsewhere, for the year of assessment that the aircraft lessor intends to claim the aircraft leasing tax concessions under section 14H(1) of the Ordinance.

Central management and control

10. State the exact location of the office for operating the aircraft leasing business.

11. Describe how the central management and control is exercised over the aircraft lessor and aircraft leasing manager.

12. State the names, places of residence and Hong Kong Identity Card Numbers (if any) of the directors of the aircraft lessor and aircraft leasing manager.

13. State where the meetings of the board of directors of the aircraft lessor and aircraft leasing manager are held and briefly describe the main issues discussed in the meetings with copies of the board minutes for the current year (if any).

14. State where the important business decisions affecting the business strategy and day-to-day business operations of the aircraft lessor and aircraft leasing manager are made and approved.

Substantial activity requirement

15. State where the following activities take place or will take place:

    (a) Raising funds;

    (b) Agreeing funding terms;

    (c) Identifying and acquiring aircraft to be leased;

    (d) Soliciting lessees;

    (e) Setting the terms and duration of leases;

    (f) Monitoring and revising lease agreements;

    (g) Managing any risks; and

    (h) Maintaining documentation.

16. Provide details of the bank accounts maintained by the aircraft lessor and aircraft leasing manager.

17. State the number of staff members employed to undertake the activities mentioned in question (15) above. For each employee, state:

    (a) the name, Hong Kong Identity Card Number (if any) and place of residence;

    (b) the post title and brief description of his/her duties;

    (c) academic and professional qualifications;

    (d) whether he/she is a full-time employee; and

    (e) whether his/her salaries costs would be borne by the aircraft lessor or aircraft leasing manager. If not, state the name, Hong Kong business registration number (if any) and places of incorporation and residence of the company which would bear his/her salaries costs.

18. State the estimated amount of annual business spending for the current year and confirm whether such business spending would be incurred in Hong Kong (i.e. borne by the aircraft lessor and aircraft leasing manager in Hong Kong and paid from their bank accounts in Hong Kong).

19. Furnish a five-year business plan covering the following aspects:

    (a) Number of the aircraft to be purchased;

    (b) Number of staff members to be employed and their capacities;

    (c) Amount of projected annual business spending;

    (d) Projected net asset value;

    (e) Projected turnover and net profit; and

    (f) Gross floor area of the office.