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. 62

TAXATION OF SHIP 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.

TAM Tai-pang
Commissioner of Inland Revenue

December 2020

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

No. 62

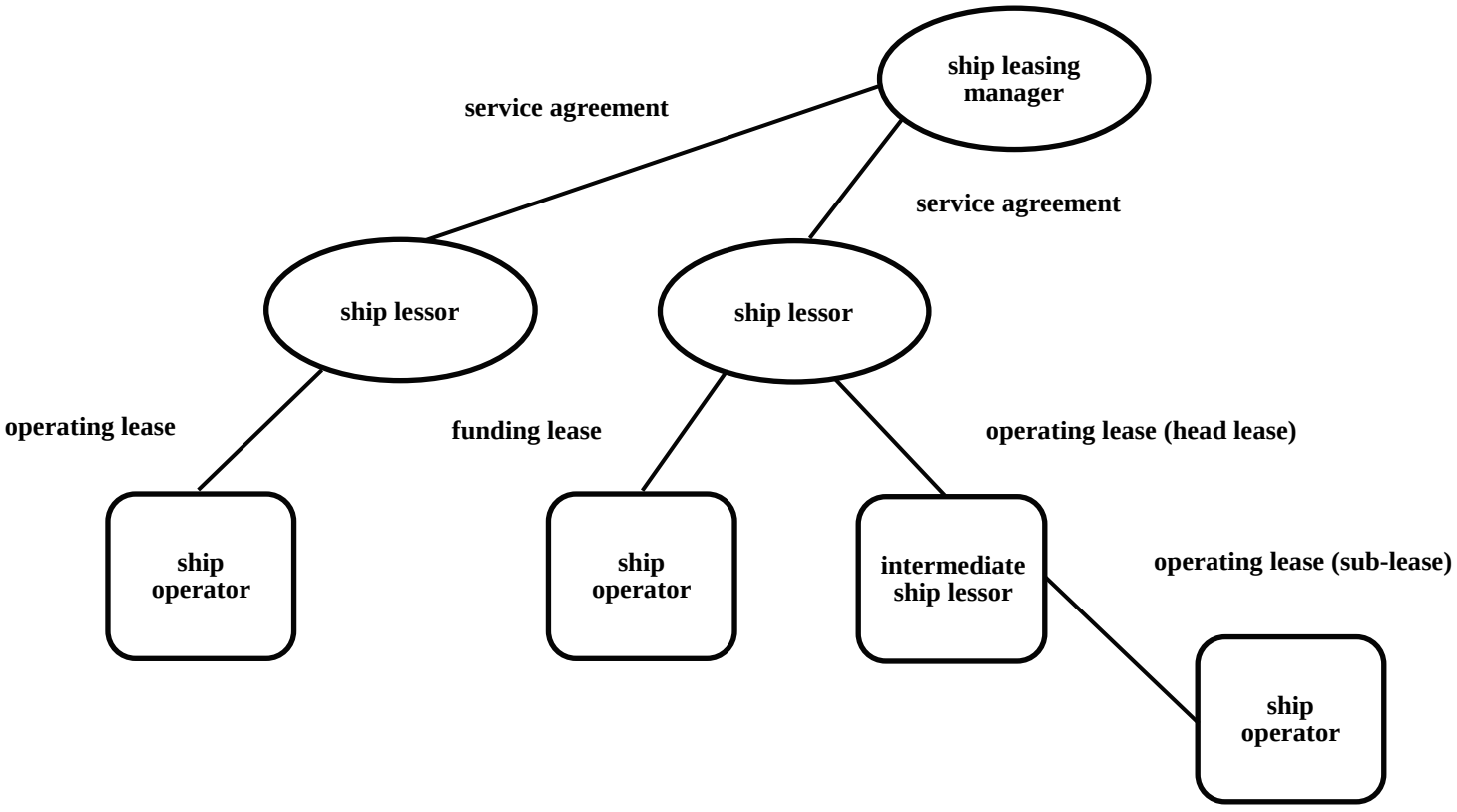
CONTENT

INTRODUCTION

Ship leasing arrangement

Ship leasing is an arrangement under which a lessor leases a ship to a lessee for use during an agreed period in return for regular lease payments. Leasing includes finance lease, operating lease, sale and leaseback, hire-purchase and conditional sale (retention of title). Two common types of arrangement are: operating lease; and finance lease. Depending on the operational needs (e.g. liquidity requirements), a lessee may choose to enter into an operating lease or a finance lease. Operating lease allows a lessee to use a ship on a short term basis without financing its purchase price. Finance lease is the main method of lease used to finance the acquisition of a ship.

2. In the ship leasing industry, a corporation is often used as a special purpose vehicle (SPV) to hold a ship. Incidental activities, including evaluation of ship investment, fund raising, procurement of ship, soliciting lessees, are carried out by a ship leasing manager remunerated by a ship lessor. Sub-lease arrangements (e.g. a ship is leased to a ship operator through an intermediate lessor) and sale and leaseback arrangements (e.g. a lessee buys a ship, sells it to a lessor and then leases it back again for a period) are also structured. Below diagram illustrates the relationships between the lessor, the leasing manager, the intermediate lessor and the lessee:



Hong Kong's competitive advantage

3. 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 under the Royalties Article to 5% on lease rentals paid to a ship leasing business. This has provided a solid foundation for ship lessors to domicile their leasing operations in Hong Kong.

The Ship Leasing Amendment Ordinance

4. In June 2020, the Inland Revenue (Amendment) (Ship Leasing Tax Concessions) Ordinance 2020 (the Ship Leasing Amendment Ordinance) was enacted to provide tax concessions for ship leasing and ship leasing management businesses. The purpose of this Note is to set out in detail the Department's views and practice on the tax concessions for qualifying ship lessors and qualifying ship leasing managers.

5. The Ship Leasing Amendment Ordinance amended the Inland Revenue Ordinance (the Ordinance) to give profits tax concessions to qualifying ship lessors and qualifying ship leasing managers and to make provisions for profits tax purposes about businesses in connection with ships. The main provisions are as follows:

Profits tax concessions for ship leasing and ship leasing management

(a) Section 14O provides for the interpretation of terms used in the provisions for the profits tax concessions, including the definitions of qualifying ship leasing activity and qualifying ship leasing management activity.

(b) Section 14P provides for the profits tax concessions for qualifying ship lessors:

(i) Section 14P(1) provides that a corporation that is a qualifying ship lessor for a year of assessment is entitled to have its profits derived from its qualifying ship leasing activity for that year of assessment charged at a

concessionary tax rate specified in Schedule 8C.

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

(c) Section 14Q provides for certain tax treatments in connection with allowance for capital expenditure on ship.

(d) Sections 14R and 14S provide for the calculation of tax bases:

(i) Section 14R provides that if the profits tax concession under section 14P applies to a corporation for a year of assessment, the net lease payments for operating leases derived from its qualifying ship leasing activity are to be calculated in accordance with the formula set out in section 14R(2) or (3).

(ii) Section 14S provides that if the profits tax concession under section 14P applies to a corporation for a year of assessment, the net payments of finance charges or interest in relation to funding leases derived from its qualifying ship leasing activity are to be calculated in accordance with the formula set out in section 14S(2).

(e) Section 14T provides for the profits tax concessions for qualifying ship leasing managers:

(i) Section 14T(1) provides that a corporation that is a qualifying ship leasing manager for a year of assessment is entitled to have its profits derived from its qualifying ship leasing management activity for that year of assessment charged at a concessionary tax rate. The concessionary tax rate is one-half of the profits tax rate specified in Schedule 8 if the activity is not carried out for an associated corporation, or the profits tax rate specified in Schedule 8C if it is.

(ii) Section 14T(2) provides for how a corporation may be a qualifying ship leasing manager, namely:

- by satisfying the conditions specified in section 14T(3);
- by satisfying the safe harbour rule under section 14U; or
- by obtaining the determination of the Commissioner under section 14V(1).

(iii) Section 14T(5) provides for certain conditions for the entitlement to the concessionary tax rates.

(f) Section 14U provides for how a corporation may satisfy the safe harbour rule. There are two alternative safe harbours:

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

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

(g) Section 14V provides for the Commissioner's discretion to make a determination that a corporation, which is not otherwise qualified, is a qualifying ship leasing manager.

(h) Section 14W provides that, for the purposes of sections 14P(4) and 14T(5), certain threshold requirements under Schedule 17FA must be met in order for a ship leasing activity or a ship leasing management activity to be considered to be carried out, or arranged to be carried out, in Hong Kong.

(i) Section 14X sets out the circumstances under which the losses sustained by a corporation are not available for set off against its assessable profits.

(j) Sections 14Y, 14Z and 14ZA contain certain provisions for preventing avoidance of profits tax by means of the profits tax concessions.

(k) Section 14ZB empowers the Commissioner to amend, by order published in the Gazette, Schedule 17FA.

(l) Schedule 17FA defines ship leasing activity and ship leasing management activity, specifies the prescribed percentages relating to the calculation of net lease payments and the safe harbour rule, and prescribes the threshold requirements for the purposes of section 14W.

Gains or profits arising through or from ship business

(m) Section 15(1)(o) and (1E) deems sums received by or accrued to a corporation from carrying on certain businesses in connection with ships as having a Hong Kong source, even if the ships are used outside Hong Kong.

Anti-tax arbitrage provision

(n) Section 16(1A) as amended prevents tax arbitrage through ship leasing transactions between connected persons.

Finance charges or interest in relation to funding leases

(o) Section 15G provides that receipts of finance charges or interest by a person in relation to a funding lease in the course of business are to be regarded as sums received by or accrued to the person by way of interest on money lent by the person.

(p) Section 16(3D) provides that payments of finance charges or interest by a person in relation to a funding lease in the production of profits are to be regarded as sums payable by way of interest on money borrowed by the person for the purpose of producing the profits.

Notional depreciation allowances

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

QUALIFYING SHIP LESSOR

Profits tax concession for qualifying ship lessor

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

7. By virtue of section 14P(1), a corporation that is a qualifying ship lessor is entitled to have its qualifying profits charged at a concessionary profits tax rate specified in Schedule 8C (i.e. 0% for the year of assessment commencing on or after 1 April 2020). The qualifying profits would include income incidental to profits from a ship leasing business, like interest income, exchange gains or hedging gains, as long as the transactions are ancillary to the qualifying activities. Section 14P(4) stipulates that the tax concession applies to a corporation for a year of assessment only if:

(a) during the basis period for 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 for 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 activities 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 tax concession applies to it.

8. "Ship lessor" is defined in section 14O(1) as a person carrying on a business of carrying out ship leasing activities. Under section 14P(2), a ship lessor is a qualifying ship lessor for a year of assessment if, during the basis period for that year of assessment:

(a) it is not a ship operator;

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

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

9. A ship operator is not eligible to be a qualifying ship lessor. "Ship operator" is defined in section 14O(1) as a person carrying on a ship operation business which means:

(a) a business of operating ships as an owner or a charterer for providing services for the carriage by ships of passengers, cargo or mail; but

(b) does not include dealing in ships or agency business in connection with sea transport.

In effect, ship operators are excluded from this preferential tax regime.

10. A qualifying ship lessor eligible for the profits tax concession must be a standalone corporation engaging solely in qualifying ship leasing activities. This standalone condition is consistent with the industry practice of using SPVs to hold ships for leasing. For the purpose of determining whether a ship lessor has carried out any activity other than a qualifying ship leasing activity, only activities that generate income to the ship lessor are to be taken into account as explained in section 14P(3). That means expense transactions would be excluded. For example, taking a lease in respect of the business premises for carrying out qualifying ship leasing activities or engaging a consultancy company for assessing market condition would not preclude a ship lessor from being a qualifying ship lessor since the ship lessor would only incur rental expenses or consultancy fee expenses in these transactions which do not generate income.

Irrevocable election

11. Before the profits tax concession applies, a qualifying ship lessor has to make an election in writing (e.g. in a tax return) as required by section 14P(4)(b). Once made, section 14P(5) makes the election irrevocable. Thus, a qualifying ship lessor does not need to make an election for every year of assessment in which it is entitled to the tax concession.

12. If section 14P(1) no longer applies to a qualifying ship lessor, section 14P(6) provides that the election previously made by it ceases to be effective. In case the qualifying ship lessor is entitled to the tax concession again, it is required to make a fresh election.

SHIP LEASING ACTIVITY

Definition of ship

13. Under section 14O(1), “ship” is defined as a vessel of any description capable of navigating in water and includes:

(a) a barge or lighter;

(b) an air-cushion vehicle (e.g. a hovercraft); and

(c) a dynamically supported craft as defined by section 2 of the Shipping and Port Control Ordinance (Cap. 313) (e.g. hydrofoil);

but does not include –

(a) a junk as defined by section 2 of the Merchant Shipping Ordinance (Cap. 281);

(b) a vessel propelled by oars; or

(c) a vessel solely for military use.

Thus, a seaborne unit not capable of navigating in water (e.g. drilling rig) is not included.

Definition of ship leasing activity

14. Section 1(1) of Schedule 17FA defines "ship leasing activity", in relation to a person, as an activity comprising:

(a) the leasing of a ship by the person to a ship lessor, ship leasing manager or ship operator; and

(b) any of the following activities carried out by the person –

(i) agreeing funding terms in relation to the lease concerned;

(ii) identifying or acquiring the ship to be so leased;

(iii) setting the terms and duration of that lease;

(iv) monitoring or revising any funding or other agreements in relation to that lease;

(v) managing any risks associated with that lease or with an activity mentioned in subparagraph (i), (ii), (iii) or (iv).

15. Apart from leasing a ship directly to a ship operator, a ship lessor can lease a ship to an intermediate ship lessor or a ship leasing manager. The ship operator, intermediate ship lessor or ship leasing manager may be carrying on business outside Hong Kong. Thus, ship leasing activity does not cover the leasing of a ship to a person other than a ship lessor, ship leasing manager or ship operator. Given that "ship lessor" in section 14O(1) means a person carrying on a business of carrying out ship leasing activities, the term "ship leasing activity" in section 1(1) of Schedule 17FA also covers the ship leasing activities of a person (e.g. the intermediate ship lessor) who may not be a qualifying ship lessor or may be carrying on business outside Hong Kong.

Meaning of lease

Lease as a generic term

16. Section 14O(1) provides that the word "lease", when used as a noun, means an operating lease or a funding lease. When the word is used as a verb, it is to be construed accordingly. Though the tax concession in section 14P(1) covers both operating lease and funding lease, calculations of their tax bases are different.

17. While generic definitions for operating lease and funding lease are provided in section 14O(1), no particular commercial requirements have been prescribed thereunder. In other words, the ship lessor and ship lessee are free to decide the terms of the lease (e.g. crew is provided under the lease). However, the person benefiting from the tax concession in section 14P(1) cannot be a ship operator whose profits are assessed in accordance with the provisions in section 23B.

Operating lease

18. "Operating lease", as defined in section 14O(1), means:

(a) an arrangement under which a right to use a ship is granted by an owner of the ship to another person for a term exceeding one year (***specified head lease***); or

(b) an arrangement under which a right to use a ship is granted by a lessee under a specified head lease (or by a sub-lessee or any other person deriving the right under the lessee) to another person; and

(c) does not include a funding lease.

An operating lease covers both a head lease (i.e. the ship is leased by an owner of the ship to another person) and a sub-lease (i.e. the ship is leased by an intermediate ship lessor to another person). While the term of a head lease has to exceed one year, there is no such requirement if the lease is a sub-lease.

19. An operating lease, unlike a funding lease, does not transfer substantially all the risks and rewards incidental to ownership of a ship to the lessee. The lessee under an operating lease pays the lessor lease payments in order to obtain the right to use the leased ship over an agreed fixed term.

Example 1

Head Lessor-HK leased a ship to Intermediate Lessor-HK for a term of two years under a head lease. Head Lessor-HK and Intermediate Lessor-HK were resident in Hong Kong. While the head lease remained in force, Intermediate Lessor-HK sub-leased the ship to Ship Operator-F, resident in Jurisdiction-F, for a term of six months under a sub-lease.

Since the term of the head lease exceeded one year, the head lease would be regarded as an operating lease if it was not a funding lease. The sub-lease would also be regarded as an operating lease though its lease term was less than one year.

If the head lease was terminated in less than one year because of the occurrence of a force majeure event, the head lease would still qualify as an operating lease. In deciding whether it is an operating lease or not, the provision of crew or other facilities might not be of much relevance.

Funding lease

20. "Funding lease", as defined in section 14O(1), means an arrangement:

(a) under which a right to use a ship is granted by a lessor to a lessee for a term exceeding one year;

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

(i) the arrangement 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 arrangement is equal to or more than 80% of the fair market value of the ship;

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

(c) under which the property in the ship will or may pass to the lessee, or an associate of the lessee, at the end of its term,

and includes an agreement or another arrangement in connection with such an arrangement.

21. In a funding lease, all the risks and rewards incidental to ownership of a ship are substantially transferred to the lessee and the property in the ship would pass to the lessee at the end of the lease term. The ship lessor, often a finance company, buys a ship from the shipbuilder and leases it to the lessee. The lessee pays the lessor lease payments equivalent to the substantial fair value of the ship plus a return on capital over a lease term, which often corresponds with the major part of the economic life of the ship.

Example 2

Ship Lessor-HK, resident in Hong Kong, leased a ship to Ship Operator-F, resident in Jurisdiction-F, for a term of 15 years. The present value of the aggregate minimum lease payments was more than 80% of the fair market value of the ship. At the end of the lease term, Ship Operator-F was given an option to purchase the ship 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 ship. At the end of the lease term, Ship Operator-F (i.e. the lessee) was allowed to acquire the ship at a nominal price and the property in the ship would probably pass to the lessee. In the circumstances, the lease would be regarded as a funding lease.

22. The term "funding lease" has been defined in connection with an arrangement which satisfies certain conditions. The definition is extended to include an agreement or another arrangement in connection with such an arrangement. A funding lease usually contains provisions which ensure that the lessee can exercise an option to purchase the ship at a price sufficiently lower than the market value of the ship at the date the option is exercised; or the lessee can require the lessor to sell the ship and pay most of the proceeds to it by way of a rental rebate at the end of the lease term. Thus, any separate agreement or arrangement like purchase option agreement or rental rebate agreement may be regarded as forming part of the lease and would be taken into account when determining whether the lease together with the agreement or arrangement is a funding lease. If a purchase option merely allows the lessee to acquire the property in the ship at its fair market value at the end of the lease term, it would be treated as a separate transaction not connected with the arrangement. If the

rental rebate received upon disposal of the ship represents no more than the costs of arranging a sale of the ship (e.g. a commission at market rate), it would be regarded as a separate transaction not connected with the arrangement. In short, the Commissioner has to decide whether the property in the ship, whether in form and in substance, will or may pass to the lessee at the end of the lease term.

Example 3

Ship Lessor-HK and Ship Operator-HK, both resident in Hong Kong, entered into a lease under which Ship Operator-HK was granted a right to use a ship for a term of 20 years. The ship had a remaining useful economic life of 22 years. By a separate agreement, Ship Operator-HK was entitled to require Ship Lessor-HK to sell the ship and pay 99% of the sale proceeds to Ship Operator-HK by way of rental rebate at the end of the lease term.

The lease term was more than 65% of the remaining useful economic life of the ship. By a separate agreement, which was an agreement or arrangement in connection with the lease, Ship Operator-HK (i.e. the lessee) was entitled to receive the majority of the proceeds of the ship after all the lease payments had been paid. All the risks and rewards associated with the ownership of the ship were substantially transferred to the lessee. In the circumstances, the lease would be treated as a funding lease.

Hire-purchase agreement and conditional sale agreement

23. The terms "hire-purchase agreement" and "conditional sale agreement" are defined in section 2(1). "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 a ship to the bailee or buyer. The ship lessor is no more than a financier if the ship is leased to a ship lessee by way of these financing agreements.

Qualifying ship leasing activity

Definition of qualifying ship leasing activity

24. Under section 14O(5), a ship leasing activity carried out by a corporation in respect of a ship is a qualifying ship 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 ship is –

(i) of over 500 gross tonnage as determined in accordance with the formula set out in regulation 6 of the Merchant Shipping (Registration) (Tonnage) Regulations (Cap. 415C); and

(ii) navigating solely or mainly outside the waters of Hong Kong.

In the ordinary course of business

25. A ship leasing activity has to be carried out in the ordinary course of a qualifying ship lessor's business carried on in Hong Kong. As such, artificial transactions structured with a view to shifting profits from other tax jurisdictions will 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 a ship leasing activity is carried out bona fide in the ordinary course of a qualifying ship lessor's business carried on in Hong Kong.

Size and navigation of ship

26. The ship has to be over 500 gross tonnage and navigating solely or mainly outside the waters of Hong Kong. Thus, the profits tax concession will not cover smaller size sea-going ships such as tugs, commercial yachts, pleasure vehicles and ships of any size navigating between any location within the waters of Hong Kong.

TAX BASE

The minimum tax rate

27. Under the global anti-base erosion rules (GloBE Rules) proposed by the Organisation for Economic Co-operation and Development (OECD), if the effective tax rate in respect of profits assigned to or payments (e.g. interest and royalties) made to constituent entities in Hong Kong is lower than the minimum tax rate, adjustments for charging further taxes may be required in respect of such profits or payments. Therefore, the tax base has to be defined since the concessionary tax rate for qualifying ship lessors may require an upward adjustment from the zero rate upon the introduction of a minimum tax rate.

Tax base for operating lease

Compensation for loss of depreciation allowances

28. Since depreciation allowances under Part 6 of the Ordinance in respect of the capital expenditure incurred on the provision of the ship concerned are not granted to a qualifying ship lessor by virtue of section 14Q(1), the qualifying ship lessor is eligible for a 20% tax base concession as a compensation for loss of the depreciation allowances. Section 14R(1) and (2) provides that if the profits tax concession applies to a qualifying ship lessor and the qualifying ship leasing activity concerned relates to an operating lease, the net lease payments for the right to use a ship under the operating lease that are to be included in the assessable profits derived from the qualifying ship leasing activity will 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 ship lessor under the operating 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 ship lessor in the production of those gross lease payments; and

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

29. Such 20% tax base concession will not apply to a qualifying ship lessor for a year of assessment in the circumstances under section 14R(4).

Not a ship owner

30. Under section 14R(4)(a), a qualifying ship lessor will not be entitled to the 20% tax base concession if it carries out a qualifying ship leasing activity other than as an owner of the ship concerned (e.g. sub-leasing by an intermediate lessor of a ship owned by a head lessor). The word "own" in section 14O(1) normally refers to economic ownership. Thus, holding the ship 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.

31. 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 ship. The word "own" is defined to incorporate these financing arrangements. If a ship lessor acquires a ship through these financing arrangements, the ownership of the ship would be regarded as having been acquired by the ship lessor even though legal title to the ship has not yet been transferred to the ship lessor.

32. For the purposes of the definition of "funding lease", section 14O(3) provides that it does not include an arrangement if, in the opinion of the Commissioner, the property in the ship concerned would reasonably be expected not to pass to the lessee or an associate of the lessee at the end of its term. Section 14O(4) provides that a reference to a hire-purchase agreement or conditional sale agreement in the definition of "own" does not include one under which, in the opinion of the Commissioner, the property in the ship concerned would reasonably be expected not to pass to the bailee or buyer, as the case may be. Therefore, if the property in the ship concerned is expected not to pass to the lessee, bailee or buyer, such a funding lease, hire-purchase agreement or conditional sale agreement may be treated as an operating lease.

33. If a ship lessor acquires a ship under a funding lease, hire-purchase agreement or conditional sale agreement and the property in the ship is expected not to pass to the ship lessor, the ship would not be regarded as having been acquired by the ship lessor and the 20% tax base concession would not be granted to the ship lessor.

No capital expenditure incurred

34. Under section 14R(4)(b), a qualifying ship lessor will not be entitled to the 20% tax base concession if it has not incurred capital expenditure on the provision of the ship concerned. The term "capital expenditure" includes payments incurred for the purpose of obtaining ownership of a ship via a funding lease, hire-purchase agreement or conditional sale agreement.

Depreciation allowances granted

35. Section 14R(4)(c) and (d) operates to deny the 20% tax base concession to a qualifying ship lessor for a year of assessment if:

(a) depreciation allowances under Part 6 of the Ordinance have been granted to the qualifying ship lessor or its connected person in respect of the capital expenditure incurred on the provision of the ship concerned; or

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

"Connected person" is defined in section 14O(1). Section 14R(4)(c) and (d) seeks to prevent a qualifying ship lessor and its connected person from obtaining both the depreciation allowances in respect of the ship concerned and the 20% tax base concession which is actually a compensation for loss of such allowances.

Example 4

Ship Lessor-HK, a qualifying ship lessor resident in Hong Kong, leased a ship to a non-Hong Kong ship operator. The ship was previously leased to a Hong Kong ship operator in respect of which Ship Lessor-HK had been granted depreciation allowances.

Ship Lessor-HK was not entitled to the 20% tax base concession and could only be granted the tax rate concession since it had previously been granted depreciation allowances in respect of the ship.

Example 5

Ship Lessor-HK, a qualifying ship lessor resident in Hong Kong, acquired ownership of a ship from Ship Lessor-F, its connected person resident in Jurisdiction-F, under a funding lease, and then leased the ship to Ship Operator-HK under an operating lease. Ship Lessor-F was granted capital allowances in Jurisdiction-F in respect of the ship while the ship was leased to Ship Operator-HK by Ship Lessor-HK.

Ship Lessor-HK was not entitled to the 20% tax base concession and would only be granted the tax rate concession for any year of assessment where Ship Lessor-F was granted capital allowances in Jurisdiction-F in respect of the ship.

Sale and leaseback arrangement

36. Under a typical sale and leaseback arrangement, a lessee (e.g. a ship operator) sells a used ship to a lessor and leases it back from the lessor under an operating lease. Substantial tax benefits can be obtained through such an arrangement:

(a) the capital gain accrued to the lessee on the sale of the ship may not be taxed or taxed at a reduced rate;

(b) the rentals paid under the operating lease by the lessee are deductible;

(c) depreciation allowances, based on an increased value of the ship, are granted to the lessor.

37. Section 39E(1)(a) can operate to deny a lessor depreciation allowances in respect of a ship to prevent an overall tax benefit being obtained through a sale and leaseback arrangement. Similarly, section 14(R)(4)(e) seeks to deny a qualifying ship lessor carrying out a qualifying ship leasing activity as an owner of a ship the 20% tax base concession, which is a compensation for loss of depreciation allowances, if the ship was, before the acquisition of the ship by the qualifying ship lessor, owned and used by the lessee (whether alone or with others) or an associate of the lessee (i.e. a sale and leaseback arrangement). The acquisition of a ship by a qualifying ship lessor includes the holding of the ship as a lessee under a funding lease, a bailee under a hire-purchase agreement and a buyer under a conditional sale agreement.

38. Section 14R(5) provides exception to the general rule that the 20% tax base concession will not be granted under a sale and leaseback arrangement. The exception applies in the following situation:

(a) the ship concerned was acquired by the qualifying ship lessor from the lessee or an associate of the lessee (***end-user***) with a consideration not more than the consideration paid by the end-user to another person (***supplier***) for acquiring the ship from the supplier; and

(b) no initial or annual allowances under Part 6 of the Ordinance have been granted to the end-user in respect of the ship before the acquisition of the ship by the qualifying ship lessor.

Example 6

Ship Operator-HK acquired a ship and used it in a marine transportation business. After revaluation, Ship Lessor-HK, a qualifying ship lessor resident in Hong Kong, acquired the ownership of the ship from Ship Operator-HK via a funding lease at monthly lease payments. The present value of the aggregate lease payments was much higher than the purchase cost of the ship paid by Ship Operator-HK. Ship Operator-HK then leased the ship back from Ship Lessor-HK under an operating lease. Before the sale and leaseback arrangement, depreciation allowances in respect of the ship had been granted to Ship Operator-HK.

By virtue of section 14(R)(4)(e), Ship Lessor-HK would be denied the 20% tax base concession since the ship was owned and used by Ship Operator-HK before acquisition of the ship by Ship Lessor-HK via the funding lease. The exception in section 14R(5) would not apply since: the consideration (i.e. present value of the aggregate lease payments) payable by Ship Lessor-HK was higher than the purchase cost paid by Ship Operator-HK; and depreciation allowances had previously been granted to Ship Operator-HK. Only the tax rate concession would be granted to Ship Lessor-HK.

Example 7

Ship Operator-HK purchased a ship at a price of $100 million from a shipbuilder. If the purchase was financed by a ship mortgage, the monthly instalments would be $1.2 million for ten years. Before

putting the ship into use, Ship Operator-HK sold the ship to Ship Lessor-HK, a qualifying ship lessor resident in Hong Kong, at a price of $100 million. Ship Lessor-HK then leased the ship back to Ship Operator-HK under an operating lease at monthly rentals of $1.1 million for ten years. Prior to the sale and leaseback arrangement, Ship Operator-HK was not granted any depreciation allowances in respect of the ship.

Ship Lessor-HK purchased the ship at the same price that Ship Operator-HK paid to the shipbuilder. No depreciation allowances in respect of the ship were granted to Ship Operator-HK. The conditions in section 14R(5) were satisfied. Ship Lessor-HK would not be denied the 20% tax base concession. In effect, Ship Operator-HK made use of the sale and leaseback arrangement to reduce the funding cost for acquiring the use of the ship. The arrangement was a normal commercial transaction.

39. If section 14R(5) is invoked, it will be necessary for the end-user to submit a disclaimer to the Commissioner in writing within three months of the date on which the ship was acquired, or within such further period as the Commissioner may permit. Generally, the Commissioner will not entertain requests for an extension of the three-month disclaimer period. A notice of disclaimer should be accompanied by the following information:

(a) a description of the relevant ship;

(b) the name and address of the supplier;

(c) the date of purchase from, and the price paid to, the supplier;

(d) the date of sale to, and the price paid by, the qualifying ship lessor; and

(e) the name and address of the qualifying ship lessor.

The above information must be supported by copies of purchase and sale agreements or invoices and the lease agreement.

40. After submitting a notice of disclaimer, the end-user might decide to retain the right to claim depreciation allowances and seek to cancel the sale and leaseback arrangement. The Commissioner is prepared to allow the withdrawal of a disclaimer provided that the relevant assessment has not yet become final and conclusive.

Tax base for funding lease

No tax base concession

41. In a funding lease, the lessor has transferred substantially all the risks and rewards incidental to ownership of a ship to the lessee. The ownership of the ship is regarded as having been acquired by the lessee. The 20% tax base concession, which is a compensation for the loss of depreciation allowances to the owner of the ship, is therefore not provided to the qualifying ship lessor under a funding lease.

Finance charges or interest

42. A funding lease may be regarded as a financing arrangement under which money is provided to the lessee to buy and use a ship in return for finance charges or interest. Section 15G deems the finance charges or interest received by or accrued to a ship lessor for granting a right to use a ship under a funding lease as sums received by or accrued to the ship lessor by way of interest on money lent by the ship lessor.

43. According to the Hong Kong Financial Reporting Standard 16: *Leases*, the interest rate implicit in the lease (i.e. the internal rate of return) would be used to compute the finance charges or interest derived from a funding lease. If the interest rate implicit in the lease cannot be readily determined, the lessee's incremental borrowing rate may be used.

44. Section 14S(1) and (2) provides that if the profits tax concession applies to a qualifying ship lessor and the qualifying ship leasing activity concerned relates to a funding lease, the net lease payments for the right to use a ship under the funding lease that are to be included in the assessable profits derived from the qualifying ship leasing activity will be computed in accordance with the following formula:

$$E = F - G$$

where: E means the net payments of finance charges or interest;

F means the aggregate amount of the gross payments of finance charges or interest (whether or not they are periodic payments) earned by or accrued to the qualifying ship lessor under the funding lease during the basis period for the year of assessment;

G 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 ship lessor in the production of those gross payments of finance charges or interest.

Example 8

Ship Lessor-HK, a qualifying ship lessor resident in Hong Kong, leased a ship to Ship Operator-HK for a term which equalled to 65% of the remaining useful economic life of the ship. The property in the ship would pass to Ship Operator-HK at the end of the lease term. The lease was accounted for as an operating lease by Ship Lessor-HK.

The lease term was equal to 65% of the remaining useful economic life of the ship and the property in the ship would pass to the lessee at the end of the lease term. The lease would be regarded as a funding lease though it was accounted for as an operating lease. The internal rate of return at which the present value of the aggregate lease payments and the unguaranteed residual value equalled to the fair value of the ship should be calculated. The internal rate of return would then be used to compute the gross interest payment eligible for the profits tax concession in accordance with section 14S(2).

Allocation of gross lease or interest payments

45. If a ship is leased under an operating lease or a funding lease together with other dealings in pursuance of one bargain, sections 14R(7) and 14S(3) empower the Commissioner to allocate an amount of gross lease payments, or an amount of gross payments of finance charges or interest, for the right to use the ship 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". Sections 14R(7) and 14S(3) will apply if the terms of the lease and other dealings are negotiated together such that the gross lease payments or gross payments of finance charges or interest do not reflect the market rental or interest charges for the right to use the ship.

Example 9

In a sale and leaseback transaction, Ship Operator-HK sold a ship to Ship Lessor-HK, a qualifying ship lessor resident in Hong Kong, at a price below the market value of the ship. In return, Ship Operator-HK leased back the ship from Ship Lessor-HK under an operating lease at a reduced monthly lease payment.

The difference between the market value and sale price of the ship represents a prepayment of lease payments. Since the sale price of the ship and gross lease payments were negotiated together in pursuance of one bargain, the Commissioner could adjust the gross lease payments to include the prepayment of lease payments under section 14R(7).

Example 10

In a sale and leaseback transaction, Ship Operator-HK sold a ship to Ship Lessor-HK, a qualifying ship lessor resident in Hong Kong, at a price above the market value of the ship. In return, Ship Operator-HK leased back the ship from Ship Lessor-HK under a funding lease at an inflated monthly interest.

The difference between the sale price and market value of the ship represents additional financing provided by Ship Lessor-HK to Ship

Operator-HK. Since the sale price of the ship and gross interest payments were negotiated together in pursuance of one bargain, the Commissioner could adjust the gross interest payments to exclude the portion attributable to the additional financing under section 14S(3).

DEPRECIATION ALLOWANCE AND DISPOSAL

Denial of depreciation allowance

46. Section 14Q(1) provides that a qualifying ship lessor (i.e. a head lessor as an owner of a ship under an operating lease) is not entitled to be granted depreciation allowances under Part 6 of the Ordinance in respect of the capital expenditure incurred on the provision of the ship concerned for the year of assessment in which the tax concession in section 14P(1) applies.

Example 11

Ship Lessor-HK1, a qualifying ship lessor resident in Hong Kong, leased a ship it acquired to Ship Lessor-HK2, an intermediate ship lessor resident in Hong Kong, under an operating lease. Ship Lessor-HK2, then sub-leased the ship to Ship Operator-F which was resident in Jurisdiction-F.

If the conditions in section 14P(4)(a) were satisfied and an election was made under section 14P(4)(b), Ship Lessor-HK1 would be given the profits tax concession provided in section 14P(1). Section 14Q(1) would operate to deny Ship Lessor-HK1 depreciation allowances in respect of its capital expenditure incurred on the ship but Ship Lessor-HK1 would be eligible for a 20% tax base concession under section 14R(2).

If Ship Lessor-HK1 was not assessed under section 14P(1), section 39E(1)(c) would operate to deny Ship-Lessor HK1 depreciation allowances in respect of the ship since Ship Lessor-HK2 was not an operator of Hong Kong ship.

Ship Lessor-HK2 would not be entitled to any depreciation allowances since it did not incur any capital expenditure on the provision of the ship. Even if Ship Lessor-HK2 was a qualifying ship lessor assessed under section 14P(1), its profits would be computed in accordance with section 14R(3) without any reduction in tax base.

47. Since the tax base is reduced under section 14R(2) to compensate for the loss of depreciation allowances in respect of a ship owned and used by a corporation for carrying out a qualifying ship leasing activity, provisions in section 37(2E) to (2G) and section 39B(6D) to (6F) are added to provide for deduction of notional annual allowances when calculating depreciation allowances for the ship subsequently used by the corporation in another trade, profession or business to produce chargeable profits. Notional annual allowances will be deducted from the actual cost of the ship for the period during which the ship was owned and used by the corporation for carrying out the qualifying ship leasing activity in respect of which the tax concession under section 14P(1) applies as if such annual allowances had been made available to the corporation since it acquired the ship.

Example 12

Ship Business-HK, a corporation resident in Hong Kong, acquired a ship at a consideration of $50 million. In Year 1 and Year 2, Ship Business-HK, a qualifying ship lessor resident in Hong Kong, used the ship for carrying out a qualifying ship leasing activity. Ship Business-HK elected for the profits tax concession provided in section 14P(1) and was assessed in accordance with section 14R(2). In Year 3, Ship Business-HK ceased the ship leasing business and used the ship in a transportation business within Hong Kong waters.

Section 39B(6E) would apply since the ship had been used by Ship Business-HK for carrying out a qualifying ship leasing activity in respect of which the tax concession under section 14P(1) applied before being used in a ship transportation business. Depreciation allowances of the ship for Year 3 would be computed as follows:

		$
Acquisition cost		50,000,000
Less:	Notional annual allowance for Year 1 ($50,000,000 × 10%)	5,000,000
		45,000,000
Less:	Notional annual allowance for Year 2 ($45,000,000 × 10%)	4,500,000
		40,500,000
Less:	Annual allowance for Year 3 ($40,500,000 × 10%)	4,050,000
		36,450,000

Disposal of ship

48. Section 14P(7) provides certainty to qualifying ship lessors on the tax treatment of gains or losses upon disposal of ships. The disposal gain in respect of a ship that has been used for carrying out a qualifying ship leasing activity for a continuous period of at least three years immediately prior to its disposal will be treated as a capital gain not chargeable to profits tax. However, a shorter period (e.g. two years) does not necessarily mean that such a ship is not a capital asset. The Commissioner would consider the totality of facts and apply case law principles when making a decision.

QUALIFYING SHIP LEASING MANAGER

Profits tax concession for qualifying ship leasing manager

49. While section 14T contains the specific provisions relating to the profits tax concession for qualifying ship leasing managers, the charging provisions in section 14 for profits tax continue to be applicable. Thus, a qualifying ship leasing manager is chargeable to profits tax under section 14 since it is carrying on a ship leasing management business in Hong Kong.

50. By virtue of section 14T(1), the qualifying profits of a corporation that is a qualifying ship leasing manager for a year of assessment are charged at:

(a) one-half of the corporate profits tax rate specified in Schedule

8 for the year of assessment if its qualifying activity is carried out other than for an associated corporation; or

(b) the same concessionary profits tax rate applicable to a qualifying ship lessor specified in Schedule 8C for the year of assessment if its qualifying activity is carried out for an associated corporation.

The qualifying profits would include income incidental to profits from a ship leasing management business, like interest income, exchange gains or hedging gains, as long as the transactions are ancillary to the qualifying activities. Section 14T(5) stipulates that the tax concession applies to a corporation for a year of assessment only if:

(a) during the basis period for 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 for 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 activities 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 tax concession applies to it.

51. A ship lessor can either carry out the ship leasing management services itself or engage an independent ship leasing manager or a ship leasing manager within its own group (i.e. outsourcing) to perform such services at a service fee. In effect, outsourcing such services to the group ship leasing manager is no different from performing such services by the qualifying ship lessor itself. Thus, the concessionary tax rate in respect of the qualifying profits derived by a

qualifying ship leasing manager from its associated corporation is the same as the concessionary tax rate in respect of the qualifying profits derived by a qualifying ship lessor for the year of assessment concerned.

Example 13

Ship Lessor-HK, a qualifying ship lessor resident in Hong Kong, carried out ship leasing activities and managed the leases itself in Year 1. In Year 2, Ship Lessor-HK engaged Ship Leasing Manager-HK, an associated corporation and a qualifying ship leasing manager resident in Hong Kong, to manage the leases, which was a qualifying activity, on its behalf at a service fee. The concessionary tax rate applicable to a qualifying ship lessor for Year 2 is 0%.

Since the qualifying activity was carried out by Ship Leasing Manager-HK for Ship Lessor-HK, an associated corporation, the service fee derived from such qualifying activity would be charged at the concessionary tax rate of 0% for Year 2.

52. "Ship leasing manager" is defined in section 14O(1) as a person carrying on a business of carrying out ship leasing management activities. Under section 14T(2), a ship leasing manager is a qualifying ship leasing manager for a year of assessment if:

(a) during the basis period for that year of assessment, it is not a ship operator; and

(b) for that year of assessment –

(i) it is a dedicated ship leasing manager in accordance with section 14T(3);

(ii) it is a ship leasing manager that has satisfied the "one-year safe harbour" rule or the "multiple-year safe harbour" rule under section 14U though it has carried out in Hong Kong activities other than those of a qualifying ship leasing management activity; or

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

Dedicated ship leasing manager

53. The conditions specified in section 14T(3) are that, in the basis period for the year of assessment, the ship leasing manager:

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

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

Similar to a qualifying ship lessor, only a standalone corporate entity engaging solely in one or more qualifying ship leasing management activities can be a qualifying ship leasing manager eligible for the profits tax concession. Section 14T(4) provides that in determining whether a ship leasing manager has carried out any activity other than a qualifying ship leasing management activity, only activities that generate income to the ship leasing manager are to be taken into account.

Irrevocable election

54. Before the profits tax concession applies, a qualifying ship leasing manager has to make an election in writing (e.g. in a tax return) as required by section 14T(5)(b). Once made, section 14T(6) makes the election irrevocable. Thus, a qualifying ship leasing manager does not need to make an election for every year of assessment in which it is entitled to the tax concession.

55. If section 14T(1) no longer applies to a qualifying ship leasing manager, section 14T(7) provides that the election previously made by it ceases to be effective. In case the qualifying ship leasing manager is entitled to the tax concession again, it is required to make a fresh election.

Ship leasing management activity

56. Section 1(1) of Schedule 17FA defines "ship leasing management activity", in relation to a person, as any of the following activities:

(a) managing another person that is a ship lessor;

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

(c) providing, or arranging for the provision of, finance in obtaining the ownership of a ship by a special purpose entity wholly or partly owned by the person or its associate (or if the person is a corporation, its associated corporation), or evaluating financial proposals from external financiers in relation to the obtaining of that ownership;

(d) providing, or arranging for the provision of, a guarantee in respect of a financial or performance obligation as regards the ship leasing business of a special purpose entity wholly or partly owned by the person or its associate (or if the person is a corporation, its associated corporation), or granting security in respect of that business;

(e) managing leases;

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

(g) arranging for the operation, crewing, voyage monitoring, maintenance, repair, certification, insurance, storage, scrapping or modification of ships, or the port agency services or security services for ships;

(h) arranging for the evaluation, appraisal, provision or inspection of ships or maintenance facilities for ships (including internal audits of ship quality);

(i) arranging for the assessment of the shipping market conditions;

(j) marketing of leases;

(k) providing, or arranging for the provision of, finance in obtaining the ownership of a ship by a shipping enterprise from another ship lessor;

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

(m) providing services in relation to a ship leasing activity for or to another person that is a ship lessor;

(n) overseeing the design and construction of newbuild ships.

57. "Ship leasing activity" in section 1(1) of Schedule 17FA includes leasing of a ship by a ship lessor to a ship leasing manager. Given that "ship leasing manager" in section 14O(1) means a person carrying on a business of carrying out ship leasing management activities, the term "ship leasing management activity" in section 1(1) of Schedule 17FA also covers the ship leasing management activities of a ship leasing manager who leases a ship from a ship lessor. The ship leasing manager may not be a qualifying ship leasing manager or may be carrying on business outside Hong Kong.

58. Provision of finance in obtaining the ownership of a ship by a special purpose entity or provision of guarantee in respect of a financial or performance obligation as regards the ship leasing business of a special purpose entity, or arranging for provision of such services, refers to intra-group financial-related activity carried out for the special purpose entity wholly or partly owned by a ship leasing manager. Pure financial-related activities performed by a ship leasing manager for a person, other than a special purpose entity wholly or partly owned by the ship leasing manager, would fall outside the scope of the ship leasing management activities.

59. Residual value guarantee or contingent purchase arrangement may be provided by a ship leasing manager so as to reduce the risk of the lessor in respect of the residual value of the ship at the end of the lease term or its useful economic life. "Residual value guarantee", in relation to a ship, is defined in section 14O(1) as a financial commitment to pay a sum by reference to the amount by

which the estimated residual value of the ship exceeds the actual residual value of the ship. In section 1(3) of Schedule 17FA, "contingent purchase arrangement" is defined to mean an arrangement under which a person is required to purchase a ship at a pre-determined amount if the actual residual value falls below the estimated residual value.

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

61. The expression "services in relation to a ship leasing activity for or to another person that is a ship lessor" is wide in its meaning. It would include provision of services to ship lessors in connection with repossession of ships and remarketing of ships. It would also cover provision of advice on the disposal of ships.

Qualifying ship leasing management activity

62. Under section 14O(7), a ship leasing management activity carried out by a corporation in respect of a ship is a qualifying ship 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 during the basis period of the other corporation for a year of assessment;

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

(d) the ship is leased by the other corporation to a ship lessor, ship leasing manager or ship operator when the activity is carried out.

63. A qualifying ship leasing management activity must be carried out for a qualifying ship lessor in the ordinary course of the business carried on by a qualifying ship leasing manager in Hong Kong. In such circumstances, the qualifying ship lessor and qualifying ship leasing manager become parties privy to the ship leasing arrangement.

Safe harbour rule

64. Section 14U lays down the safe harbour rule, which seeks to allow corporations having profits and assets primarily for qualifying ship leasing management activities to be entitled to the profits tax concessions in respect of the qualifying profits. There are two alternative safe harbours:

(a) a corporation falls within the "one-year safe harbour" in section 14U(2) if, for the year of assessment concerned, the percentages of its ship leasing management profits (SLMP percentage) and ship leasing management assets (SLMA percentage) are not lower than the prescribed percentages as set out in sections 3 and 4 of Schedule 17FA (i.e. 75%);

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

65. The SLMP and SLMA percentages of a corporation for a year of assessment are calculated in accordance with the following formulas in section 14U(5) and (6):

(a) SLMP percentage

$$\frac{\text{SLMP}}{\text{P}}$$

where: SLMP means the aggregate amount of the ship 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) SLMA percentage

$$\frac{\text{SLMA}}{\text{A}}$$

where: SLMA means the aggregate value of the ship 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.

66. "Ship leasing management profits", as defined in section 14O(1), means any profits of a corporation that are derived from a qualifying ship leasing management activity. In this context, "ship leasing management profits" would generally be based on the accounting profits shown in the audited income statement of the ship leasing manager, irrespective of the source of the profits.

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

68. "Ship leasing management asset", as defined in section 14O(1), means an asset of a corporation used by it to carry out a qualifying ship leasing management activity. It would include fixed assets such as business premises and office equipment used by a ship leasing manager to carry out qualifying ship leasing management activities. The asset values would be based on the audited statement of financial position of the ship leasing manager, regardless of the location of the assets. Generally, intangibles not recorded in the statement of financial position in accordance with generally accepted accounting principles would not be taken into account.

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

70. There may be cases whereby a ship 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 income do not fall within the definitions of "ship leasing management asset" and "ship 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 dividend income from the denominators in the above formulas for the calculation of the SLMA and SLMP percentages so that such a ship leasing manager may also be regarded as a qualifying ship leasing manager under the safe harbour rule.

71. Under the multiple-year safe harbour rule in section 14U(4), the "consecutive" years of track record of a corporation are to be examined. The average SLMP and SLMA percentages must be computed based on the audited financial statements of a corporation for the subject year and the preceding two years of assessment. Where a 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 SLMP and SLMA percentages.

Example 14

Ship Leasing Manager-HK claimed the half rate concession under section 14T(1)(a) 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 Ship Leasing Manager-HK had three years of active business operations in Hong Kong, it was dormant in Year 2. Ship Leasing Manager-HK would be regarded as having two years of track record. The average SLMP and SLMA percentages would be computed based on its audited financial statements for Year 3 (i.e. the preceding year) and Year 4 (i.e. the subject year).

Commissioner's determination

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

73. When exercising the discretion under section 14V, the Commissioner would look into the totality of facts, in particular, the types of qualifying ship leasing management activities that a corporation 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.

LOSS TREATMENTS

Losses sustained by a qualifying ship lessor

74. The treatment for losses sustained by a qualifying ship lessor is provided under section 14X(1). If section 14P(1) applies to a qualifying ship lessor for a zero-tax year of assessment (i.e. a year of assessment for which the concessionary tax rate applicable to a qualifying ship lessor is 0%), any loss sustained by the qualifying ship lessor in the year of assessment is not available for set off against its assessable profits for any subsequent year of assessment.

Example 15

In Year 1, Ship Lessor-HK, a qualifying ship lessor resident in Hong Kong, sustained a loss of $200,000 from qualifying activities. The concessionary tax rate applicable to a qualifying ship lessor for Year 1 was 0%. In Year 2, Ship Lessor-HK ceased to be a qualifying ship lessor and derived assessable profits of $300,000. Ship Lessor-HK elected to be chargeable at the two-tiered profits tax rates (the lower-tier profits tax rate was 8.25%) for Year 2.

Since section 14P(1) applied to Ship Lessor-HK for Year 1 which was a zero-tax year of assessment, the loss sustained by Ship Lessor-HK in Year 1 could not be used to set off against its assessable profits derived in Year 2. The tax payable by Ship Lessor-HK for Year 2 would be $24,750 ($300,000 × 8.25%).

Losses sustained by a qualifying ship leasing manager

75. The treatment for losses sustained by a qualifying ship leasing manager is provided under section 14X(2). If section 14T(1)(b) applies to a qualifying ship leasing manager for a zero-tax year of assessment (i.e. a year of assessment for which the concessionary tax rate applicable to a qualifying ship leasing manager is 0% in respect of profits derived from its qualifying activity carried out for an associated corporation), any loss sustained by the qualifying ship leasing manager in the year of assessment is not available for set off against its assessable profits for the year of assessment or any subsequent year of assessment.

Example 16

Ship Leasing Manager-HK, a qualifying ship leasing manager resident in Hong Kong, elected for the profits tax concessions provided in section 14T(1). Its trading results were as follows:

Year 1	*$*
Loss from qualifying activities carried out for an associated ship lessor	*(50,000)*
Profits from qualifying activities carried out for a non-associated ship lessor	*100,000*
Year 2	
Profits from qualifying activities carried out for an associated ship lessor	*30,000*
Profits from qualifying activities carried out for a non-associated ship lessor	*70,000*

For Year 1 and Year 2, the concessionary tax rates applicable to a qualifying ship leasing manager were: 0% if a qualifying activity was carried out for an associated ship lessor; and 8.25% (½ × 16.5%) if a qualifying activity was not carried out for an associated ship lessor.

Since section 14T(1)(b) applied to Ship Leasing Manager-HK for Year 1 which was a zero-tax year of assessment, the loss sustained by Ship Leasing Manager-HK from its qualifying activities carried out for an associated ship lessor in Year 1 could not be used to set off against its assessable profits derived in Year 1 and Year 2. The tax payable by Ship Leasing Manager-HK would be:

Year 1: $100,000 × 8.25% = $8,250

Year 2: $30,000 × 0% + $70,000 × 8.25% = $5,775

Cross loss set off

76. By virtue of sections 19CAB[1], 19CAC and 19CB, if a qualifying ship leasing manager has both concessionary profits or loss (derived from qualifying activities in respect of which the assessable profits are taxed at a concessionary tax rate specified in Schedule 8C other than 0%) and normal profits or loss (derived from non-qualifying activities in respect of which the assessable profits are taxed at a normal tax rate specified in Schedule 8) for any year of assessment, it is necessary to apply an "adjustment factor" (i.e. the ratio which the normal and concessionary tax rates bear to each other) to the profits or loss to be set-off for that year of assessment or any subsequent year of assessment.

Example 17

Ship Leasing Manager-HK, a qualifying ship leasing manager resident in Hong Kong, elected for the profits tax concession provided in section 14T(1)(a). It satisfied the safe harbour rule and carried out both qualifying activities for a non-associated ship lessor and non-qualifying activities. Its trading results were as follows:

[1] In the Inland Revenue (Amendment)(Profits Tax Concessions for Insurance-related Businesses) Ordinance 2020, sections 19CAB and 19CAC were added to the principal Ordinance to recast section 19CA(1), (2) and (3).

Scenario 1

	$
Concessionary loss from qualifying activities	*(70,000)*
Normal profits from non-qualifying activities	*30,000*

Scenario 2

	$
Concessionary profits from qualifying activities	*60,000*
Normal loss from non-qualifying activities	*(40,000)*

For Year 1 and Year 2, the concessionary tax rate applicable to a qualifying ship leasing manager carrying out a qualifying activity for a non-associated ship lessor was 8.25% (½ × 16.5%) and the adjustment factor was 2 (16.5% ÷ 8.25%).

The tax computation would be:

Scenario 1

	Qualifying activities	Non-qualifying activities
	$	$
(Concessionary loss)/normal profits [1]	(70,000)	30,000
Less: Cross loss set off	60,000 [2]	(30,000)
Loss carried forward [3]	(10,000)	
Assessable profits		Nil

Notes:

1. Section 19CAB(3) applies as the amount of concessionary loss exceeds the amount of normal profits as multiplied by the adjustment factor (i.e. $70,000 > $30,000 × 2).

2. Normal profits multiplied by the adjustment factor (i.e. $30,000 × 2).

3. Loss carried forward for set off against profits for subsequent years of assessment in accordance with sections 19C and 19CB.

Scenario 2

	Qualifying activities	Non-qualifying activities
	$	$
Concessionary profits/(normal loss) [1]	60,000	(40,000)
Less: Cross loss set off	(60,000)	30,000 [2]
Assessable profits	Nil	
Loss carried forward [3]		(10,000)

Notes:

1. Section 19CAC(3) applies as the amount of normal loss exceeds the amount of concessionary profits as divided by the adjustment factor (i.e. $40,000 > $60,000 ÷ 2).

2. Concessionary profits divided by the adjustment factor (i.e. $60,000 ÷ 2).

3. Loss carried forward for set off against profits for subsequent years of assessment in accordance with sections 19C and 19CB.

SUBSTANTIAL BUSINESS PRESENCE

Tax treaty benefits

77. The *2015 Final Report of Action 6 on Base Erosion and Profit Shifting – Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* released by the OECD has identified tax treaty abuses, and in particular treaty shopping, as one of the most critical concerns of base erosion and profit shifting. Hong Kong, as a member of the Inclusive Framework, 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.

78. Though there is no restriction on the place of incorporation, qualifying ship lessors and qualifying ship 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 acceptable under the terms of a tax treaty. It is legitimate for Hong Kong's tax treaty partners to rely on the principal purposes test to deny tax treaty benefits.

Central management and control

79. Given the statutory requirements in sections 14P(4)(a)(i) and 14T(5)(a)(i), the central management and control (CMC) of a qualifying ship lessor and qualifying ship leasing manager must be exercised in Hong Kong. The CMC is located in Hong Kong if the executive officers and senior management employees of the qualifying ship lessor and qualifying ship 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.

80. 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."

81. In *Bywater Investments Ltd and Others v Commissioner of Taxation of the Commonwealth of Australia; Hua Wang Bank Berhad v Commissioner of Taxation of the Commonwealth of Australia* 260 CLR 169, the High Court of Australia, in considering whether a company had its CMC exercised in Australia, held at page 208:

> "As a matter of long-established principle, the residence of a company is first and last a question of fact and degree to be answered according to where the central management and control of the company *actually* abides. As a matter of long-established authority, that is to be determined, not by reference to the constituent documents of the company, but upon a scrutiny of the course of business and trading … Each case depends on its own facts and circumstances, albeit that those cases that have been decided may provide a degree of guidance in relation to those still to come."

The High Court also rejected at page 202 the notion that a company should be taken to be resident where its board meetings are held even if the meetings are mere window dressing comprised of rubber-stamping decisions actually made elsewhere by others and held in that place in the hope of avoiding tax liability in the place where the decisions are actually made.

82. The CMC refers to the highest level of control and direction of the operations of a company. The key element in the control and direction of a company's operations is the making of the high-level decisions that set the company's general policies, and determine the direction of its operations and the type of transactions it will enter into. Mere implementation, or rubberstamping, of decisions made by others does not constitute the making of high-level decision.

83. 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. When reaching a conclusion in accordance with the case law principles, only factors which exist for genuine commercial reasons would be considered. 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. However, 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.

Substantial activities

84. The *2015 Final Report of Action 5 on Base Erosion and Profit Shifting – Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance* released by the OECD contains detailed guidance on the application of the substantial activities criterion to intellectual property regimes as well as more general guidance for the application of the substantial activities criterion to non-intellectual property regimes. The substantial activities requirement ensures that the ship leasing functions or ship leasing management functions are performed in Hong Kong, the assets including the ships concerned are acquired or monitored in/from Hong Kong and the risks associated with the ship leasing business or ship leasing management business are undertaken in Hong Kong.

85. To satisfy the substantial activities requirement under sections 14P(4)(a)(ii) and 14T(5)(a)(ii), the core income generating activities (CIGAs) which produce the qualifying profits of a qualifying ship lessor or qualifying ship leasing manager have to be carried out, or arranged to be carried out, by the qualifying ship lessor or qualifying ship leasing manager in Hong Kong. The word "arranged" covers the situation where a qualifying ship lessor or qualifying ship leasing manager arranges a third party or an associated person to carry out some of the CIGAs (i.e. outsourcing). If outsourcing takes place, the CIGAs must also be carried out by the third party or associated person in Hong Kong. The CIGAs include those activities listed out in the definitions of "ship leasing activity" and "ship leasing management activity" in section 1(1) of Schedule 17FA. While a qualifying ship lessor or qualifying ship leasing manager may perform different types of CIGAs to produce its qualifying profits, all these activities must be carried out or arranged to be carried out by the qualifying ship lessor or qualifying ship leasing manager in Hong Kong.

Facts and circumstances

86. 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 activities requirements are satisfied. For the year in which a ship leasing activity commences, it is important to submit for the Commissioner's consideration a realistic business plan for carrying out the ship leasing activity in Hong Kong. Since SPVs are

often used to hold a ship, it may be necessary to consider whether an SPV lessor has sufficient connection or nexus with the active conduct of ship leasing activity in Hong Kong, including the engagement of a ship leasing manager carrying on business in Hong Kong.

Example 18

Ship Lessor-F set up SPV-HK in Hong Kong for holding a ship which was leased to Ship Operator-F at a non-arm's length rent. Both Ship Lessor-F and Ship Operator-F were resident in Jurisdiction-F. SPV-HK did not have any employees in Hong Kong. Nor was it managed by a qualifying ship 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.

The leasing arrangement seemed to be used for shifting income from Jurisdiction-F to Hong Kong for tax avoidance purpose. SPV-HK did not have business substance in Hong Kong except merely owning the ship. In the circumstances, SPV-HK did not satisfy the CMC and substantial activities requirements and could not be entitled to the profits tax concession provided in section 14P(1).

Example 19

Ship Lessor-F set up SPV-HK in Hong Kong for leasing ships to Ship Operator-F. Both Ship Lessor-F and Ship Operator-F were resident in Jurisdiction-F. All the directors of SPV-HK were non-Hong Kong residents. SPV-HK was not managed by a Hong Kong qualifying ship leasing manager and had no employees and business premises in Hong Kong.

Clearly, SPV-HK did not satisfy the CMC and substantial activities requirements and could not be entitled to the profits tax concession provided in section 14P(1). Further, if Jurisdiction-F had concern regarding the purpose of such arrangement, Jurisdiction-F might invoke the principal purposes test under its double taxation agreement with Hong Kong to deny any unintended treaty benefits since Jurisdiction-F's resident was disguised as a Hong Kong tax resident.

There had to be strong commercial justification for such an arrangement from the perspective of Jurisdiction-F. SPV-HK had to have significant business substance in Hong Kong so as to be eligible for the profits tax concession.

Attribution to Hong Kong

87. Apart from the CMC and substantial activities requirements, sections 14P(4)(a)(iii) and 14T(5)(a)(iii) stipulate that the CIGAs of a qualifying ship lessor or qualifying ship leasing manager must not be carried out by a permanent establishment outside Hong Kong. If the CIGAs 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 ship lessor or ship leasing manager would fail to satisfy this attribution to Hong Kong requirement.

SUBSTANTIAL ACTIVITIES REQUIREMENT

Preferential regime

88. In the *Harmful Tax Practices – 2018 Progress Report on Preferential Regimes* published by the OECD in January 2019, it is explained that jurisdictions must require taxpayers to have an adequate number of full-time employees with necessary qualifications and to incur an adequate amount of operating expenditure to undertake the CIGAs associated with the income that may benefit from a preferential regime.

Threshold requirements

89. By virtue of section 14W and sections 5 and 6 of Schedule 17FA, a CIGA is not considered to be carried out, or arranged to be carried out, by a qualifying ship lessor or qualifying ship leasing manager in Hong Kong unless the following threshold requirements are met during the basis period for the year of assessment concerned:

CIGA	Threshold requirements	
	Average number of full-time employees in Hong Kong having the necessary qualifications to carry out the CIGA	**Total amount of operating expenditure incurred in Hong Kong for the CIGA**
Qualifying ship leasing activity	Adequate in the opinion of the Commissioner and in any event not less than 2	Adequate in the opinion of the Commissioner and in any event not less than $7,800,000
Qualifying ship leasing management activity	Adequate in the opinion of the Commissioner and in any event not less than 1	Adequate in the opinion of the Commissioner and in any event not less than $1,000,000

Qualified full-time employees

90. Full-time employees who carry out CIGAs for a qualifying ship lessor or qualifying ship leasing manager must be in Hong Kong and have the qualifications necessary for carrying out the CIGAs in Hong Kong. These qualified full-time employees include leasing manager, marketing manager, legal counsel, financial controller and credit risk analyst. The term "full-time" is not defined and should be given its ordinary meaning. According to the Oxford Dictionary of English, the word "full-time" means "occupying or using the whole of someone's available working time". Any full-time employee performing CIGAs outside Hong Kong, lacking the requisite qualifications to perform the CIGAs or performing only non-profit generating activities (e.g. clerical or support services) would not be taken into account.

91. The "average number of full-time employees" during a basis period shall be calculated as: the aggregate of the number of employees as at the end of each calendar month in the basis period as divided by the number of calendar months in the basis period.

Example 20

During the basis period from January to December for a year of assessment, qualified full-time employees employed by Ship Lessor-HK, a qualifying ship lessor resident in Hong Kong, for carrying out CIGAs in Hong Kong were as follows:

	Number of qualified full-time employees as at the end of each calendar month
January to April	*1*
May to August	*2*
September to December	*3*

The average number of full-time qualified employees in Hong Kong during the basis period would be computed as: (1 × 4) + (2 × 4) + (3 × 4) ÷ 12 = 2. The threshold requirement was satisfied.

Operating expenditure incurred

92. Operating expenditure must be incurred in Hong Kong for carrying out the CIGAs of a qualifying ship lessor or qualifying ship leasing manager in Hong Kong. The word "incurred" is not confined to actual payment and includes an accrued liability to pay. The activities giving rise to an accrued liability to pay must be undertaken in Hong Kong.

93. Operating expenditure is any expenditure incurred as part of the main business operations or principal revenue producing activities. In general, operating expenditure in relation to ship leasing profits or ship leasing management profits includes rental expenses, staff costs and related expenses, other selling, general and administrative expenses. Finance costs or interest expenses that are directly attributable to the acquisition of a ship for use in a qualifying ship leasing activity are considered as an operating expenditure.

Example 21

Ship Lessor-HK, a qualifying ship lessor resident in Hong Kong, incurred interest expenses on a loan taken out for acquiring a ship for use in qualifying ship leasing activities. The loan was provided to

Ship Lessor-HK by an overseas financial institution resident outside Hong Kong.

If the interest expenses were incurred for the purpose of acquiring a ship for use in carrying out qualifying ship leasing activities in Hong Kong, the interest expenses would be accepted as operating expenditure incurred by Ship Lessor-HK in Hong Kong though the loan might be provided by an overseas financial institution.

Example 22

The CIGAs of Ship Lessor-HK, a qualifying ship lessor resident in Hong Kong, were carried out in Hong Kong by the employees employed by an associated corporation resident in Hong Kong. The staff costs of the employees were fully borne by Ship Lessor-HK.

The employees employed by the associated corporation for carrying out the CIGAs in Hong Kong and the staff costs of the employees borne by Ship Lessor-HK would be taken into account in determining whether the threshold requirements were satisfied.

Example 23

The CIGAs of Ship Lessor-HK, a qualifying ship lessor resident in Hong Kong, were carried out in Hong Kong by the employees seconded to Hong Kong from an overseas associate. The staff costs of the seconded employees based in Hong Kong were fully borne by Ship Lessor-HK. The seconded employees were answerable to Ship Lessor-HK.

The employees seconded from the overseas associate for carrying out the CIGAs in Hong Kong and the staff costs of the employees borne by Ship Lessor-HK would be taken into account in determining whether the threshold requirements were satisfied.

94. Insofar as depreciation in respect of assets is concerned, it is not regarded as an operating expenditure unless such assets are directly used for carrying out the CIGAs of a qualifying ship lessor or qualifying ship leasing manager in Hong Kong. Since a ship acquired by a qualifying ship lessor is used for earning lease payments but not for carrying out the CIGAs, depreciation of the ship cannot be accepted as an operating expenditure. If a qualifying ship lessor or qualifying ship leasing manager acquired substantial assets in Hong Kong, the depreciation of these assets might well have exceeded the threshold requirement for operating expenditure. However, the substantial activities requirement would not be considered as having been satisfied unless an adequate number of employees are employed in Hong Kong to use the assets for carrying out the CIGAs in Hong Kong.

Adequacy test

95. The thresholds of the average number of qualified full-time employees and the total amount of operating expenditure prescribed in sections 5 and 6 of Schedule 17FA only serve as the minimum requirements that a ship lessor or ship leasing manager must satisfy in order that the CIGAs are accepted as having been carried out in Hong Kong. The ship lessor or ship leasing manager will not be entitled to the profits tax concessions under the preferential regime if any of the thresholds is not met. However, it does not follow that the ship lessor or ship leasing manager is entitled to the tax concessions if the thresholds are met. To be eligible for the tax concessions, the ship lessor or ship leasing manager has to demonstrate that the "adequacy test" has been satisfied (i.e. the number of qualified full-time employees in Hong Kong and the amount of operating expenditure incurred in Hong Kong must be adequate to carry out the CIGAs for the derivation of the income given the tax concessions). For the purpose of applying the "adequacy test", the Commissioner would consider the totality of facts of each case, including:

(a) business operation and strategy of the ship lessor or ship leasing manager;

(b) amount of assessable profits in respect of which tax concession is claimed;

(c) types and level of CIGAs undertaken by the ship lessor or ship leasing manager in Hong Kong;

(d) details of the employees employed in Hong Kong, including their level of experience and qualifications, position held and duties performed;

(e) amount and types of the operating expenditure incurred in Hong Kong;

(f) number of employees employed and amount of operating expenditure incurred by other ship lessors or ship leasing managers in Hong Kong that are comparable, in terms of scale of business operation or types and level of business activities, to the ship lessor or ship leasing manager concerned.

If the amount of assessable profits of a ship lessor or ship leasing manager to be benefited from the tax concessions is disproportionately large relative to the number of employees employed and the amount of operating expenditure incurred in Hong Kong, the ship lessor or ship leasing manager would not be considered as having carried out all the CIGAs in Hong Kong and cannot be entitled to the tax concessions.

Example 24

Ship Lessor-HK1, a ship lessor resident in Hong Kong, leased a large fleet of 20 ships to various ship operators under short term leases. Ship Lessor-HK1 derived assessable profits of $100 million from the ship leasing activities whilst it employed four full-time employees and incurred operating expenditure of $10 million. Ship Lessor-HK2, another ship lessor resident in Hong Kong comparable in terms of business operation and types of activities to Ship Lessor-HK1, derived assessable profits of $50 million whilst it employed 20 full-time employees and incurred operating expenditure of $50 million.

The amount of assessable profits of Ship Lessor-HK1 was disproportionately large relative to the number of full-time employees employed and the amount of operating expenditure incurred in Hong Kong, in particular when compared with that of Ship Lessor-HK2. Although the minimum requirements could be met, Ship Lessor-HK1 prima facie failed to satisfy the adequacy test and would not be considered as having carried out all the CIGAs in Hong Kong. If there is no sufficient evidence to support that the profits were produced by the CIGAs carried out in Hong Kong, Ship Lessor-HK1 would not be entitled to the profits tax concession provided in section 14P(1).

Outsourcing to associated person

96. Outsourcing of CIGAs is permitted by the OECD provided that the use of outsourcing is not for circumventing the substantial activities requirement. For the purpose of satisfying the substantial activities requirement, outsourcing of CIGAs by a qualifying ship lessor or qualifying ship leasing manager to an associated person is permitted if the following requirements are satisfied:

(a) the CIGAs are carried out by the associated person in Hong Kong;

(b) the CIGAs are carried out by the associated person at a fee charged to the qualifying ship lessor or qualifying ship leasing manager on an arm's length basis;

(c) the number of qualified full-time employees employed and the amount of operating expenditure incurred by the associated person are commensurate with the level of the CIGAs carried out by the associated person in Hong Kong; and

(d) the qualifying ship lessor or qualifying ship leasing manager has exercised adequate monitoring to ensure that the outsourced CIGAs are carried out by the associated person in Hong Kong.

A person is associated with another person if one of the relevant persons is participating in the management, control or capital of the other relevant person, or the same person or persons is or are participating in the management, control or capital of each of the relevant persons. If the above conditions are satisfied, the number of qualified full-time employees employed by, and the amount of service fee paid to, the associated person for carrying out the CIGAs in Hong Kong would be taken into account when determining whether the substantial activities requirement is met by the qualifying ship lessor or qualifying ship leasing manager.

Monitoring of substantial activities

97. The Forum on Harmful Tax Practices (FHTP) of the OECD requires substantial activities whereby:

(a) jurisdictions must require CIGAs to be performed and establish mechanisms to review compliance with this requirement; and

(b) the FHTP will monitor the jurisdiction's effective implementation of the substantial activities requirement.

98. For the purpose of reviewing compliance with the substantial activities requirement and monitoring the substantial activities requirement, ship lessors and ship leasing managers intend to be benefited from the profits tax concessions are required to provide the following information annually:

(a) whether the ship lessors or ship leasing managers perform the CIGAs in Hong Kong;

(b) the types of the CIGAs carried out in Hong Kong;

(c) the number of qualified full-time employees employed and the amount of operating expenditure incurred in Hong Kong for carrying out the CIGAs in Hong Kong; and

(d) the amount of assessable profits to be given the tax concession.

The information will be reported to the FHTP on an annual basis. If the

information shows that the substantial activities requirement is not satisfied, no tax concessions will be given.

ANTI-AVOIDANCE PROVISIONS

Disqualified from profit tax concessions

99. Sections 14P(6)(b) and 14T(7)(b) provide that if section 14P(1) or 14T(1) does not apply to a corporation for a year of assessment (***cessation year***), such corporation is not allowed to re-enter the preferential tax 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 tax 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.

100. If a qualifying ship lessor or qualifying ship leasing manager merely incurs a tax loss from its qualifying operations, it would not be disqualified from being entitled to the profits tax concessions. Section 19D(1) 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. Thus, if a qualifying ship lessor or qualifying ship leasing manager incurs a tax loss for a year of assessment, section 14P(1) or 14T(1) remains applicable and the tax loss would be dealt with in accordance with the provisions in sections 14X, 19CAB or 19CAC.

Arm's length principle

101. Section 14Y(1) and (2) ensures that the chargeable profits from a transaction between a qualifying ship lessor and its associate in connection with a qualifying ship leasing activity are 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). The same principle also applies to a qualifying ship leasing management activity of a qualifying ship leasing manager by virtue of section 14Y(3) and (4).

102. "Associate" is defined in section 14O(1) whereas section 14Y(1) to (4) sets out the conditions under which profits may be subjected to adjustment in respect of the transactions in connection with:

(a) a qualifying ship leasing activity between a qualifying ship lessor and its associate; or

(b) a qualifying ship leasing management activity between a qualifying ship leasing manager and its associate.

Defeasance arrangement

103. Section 14Z forestalls defeasance arrangements. Under an operating lease which is a head lease as defined in section 14O(1), a qualifying ship lessor carrying out a qualifying ship leasing activity has to be an owner of the ship concerned (e.g. the ship can be obtained via an ownership arrangement like a funding lease, hire-purchase agreement or conditional sale agreement). A ship lessor under an ownership arrangement, however, may be released from the primary obligation under the ownership arrangement to a third party (i.e. defeasance arrangement). The third party takes up the primary obligation to make payments to the head lessor, bailor or seller under the ownership arrangement. The effect of a defeasance arrangement is that the ship lessor is no longer obliged to make payments under the ownership arrangement. In such a scenario, section 14Z would come into operation and the ship lessor would be treated as if it had ceased to own the ship when applying the provisions relating to the profits tax concessions under the preferential regime.

Main purpose tests

The anti-avoidance provisions

104. Section 14ZA introduces main purpose tests to prevent tax avoidance and treaty shopping. If the Commissioner is satisfied that the main purpose, or one of the main purposes, of entering into an arrangement is to obtain a tax benefit in relation to a liability to pay profits tax under the Ordinance or under a tax treaty, no profits tax concessions will be granted in respect of the assessable profits accrued during the basis period in which the arrangement has effect. "Arrangement" is defined in section 2(1) to include:

(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied, and whether or not enforceable or intended to be enforceable, by legal proceedings; and

(b) any scheme, plan, proposal, action or course of action or course of conduct.

Tax benefit

105. "Tax benefit" is defined in section 14ZA(4) to mean an avoidance, postponement or reduction of a liability to pay tax. The definition contemplates the following situations:

(a) the avoidance of liability by getting out of the way of or escaping from or preventing an anticipated liability to tax in respect of income which has "accrued" to the taxpayer;

(b) the postponing of liability for tax by shifting the incidence of tax on an amount or stream of income to a later year or years; and

(c) the reduction in the amount of tax by altering the quantum of assessable income to a level lower than it would have been or might reasonably be expected to have been but for the arrangement.

Main purpose or one of the main purposes

106. The expression "main purpose or one of the main purposes" is widely used in the Ordinance and Double Taxation Agreements. Cases including *Marwood Homes Ltd v IRC* [1999] STC (SCD) 44, *Snell v RCC* [2008] STC (SCD) 1094, *Lloyds TSB Equipment Leasing (No. 1) Ltd v RCC* [2014] STC 2770 and *Travel Document Service & Ladbroke Group International v HMRC* [2018] STC 723 confirm that an arrangement can have more than one main purpose and obtaining a tax advantage can be a main object of an arrangement. In order for a purpose to be "main", it must have a connotation of importance. The reference to "one of the main purposes" means that obtaining tax benefit does

not need to be the sole or dominant purpose of a particular arrangement. An arrangement may have more than one main purpose and it is sufficient that at least one was to obtain the tax benefit, even if that was not the dominant purpose.

107. Before reaching a conclusion under the main purpose test, all relevant facts and circumstances have to be considered, including:

(a) the manner in which the arrangement was structured;

(b) the terms of the arrangement;

(c) the ways of implementing the arrangement;

(d) the result which the arrangement intended to achieve or achieved;

(e) the non-tax purposes of the arrangement and any alternative way that the non-tax purposes could be achieved;

(f) the form (i.e. contractual rights and obligations created) and substance (i.e. practical or commercial end result) of the arrangement;

(g) the functions, assets and risks of each entity in the arrangement; and

(h) the contractual rights and obligations normally created, and the commercial or financial relationships normally entered into, between independent persons under an arrangement of the kind in question.

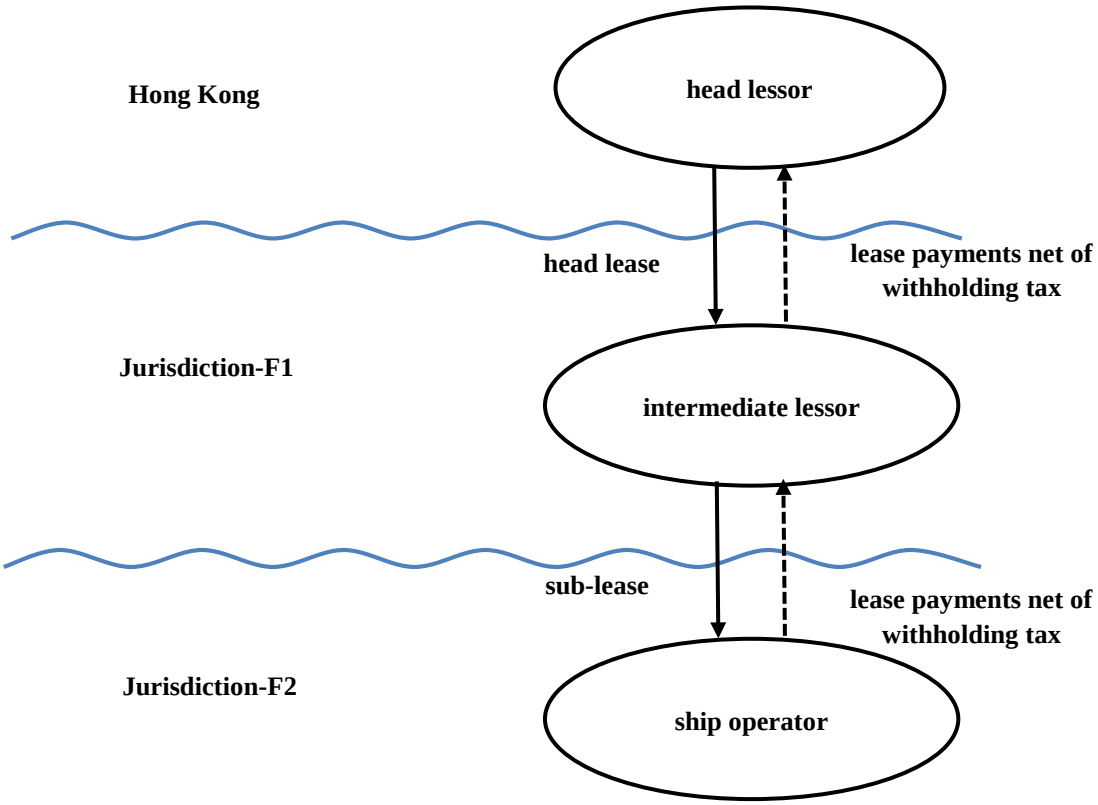
Tax avoidance arrangement

108. Section 14ZA(1) operates to deny profits tax concessions in respect of profits accrued under an arrangement entered into by a qualifying ship lessor or qualifying ship leasing manager if the main purpose, or one of the main purposes, of the arrangement is to obtain a tax benefit, whether for the qualifying ship lessor or qualifying ship leasing manager or another person, in relation to a

profits tax liability. The provision aims at those who seek to abuse the tax concessions by entering into a tax avoidance arrangement to avoid, postpone or reduce a profits tax liability.

Treaty shopping arrangement

109. In a cross border leasing arrangement, a sub-lease is often created or inserted for treaty shopping purposes without genuine commercial reasons. Tax administrations are often concerned about significant risks, emerging or recurring, arising from cross border leasing arrangements. The diagram below illustrates a cross border leasing arrangement in which a sub-lease is inserted for treaty shopping purposes:



110. A head lessor in Hong Kong intending to lease a ship to a ship operator in Jurisdiction-F2, which does not have a tax treaty with Hong Kong, would first lease the ship to an intermediate lessor (e.g. an associated corporation which is a conduit without commercial substance) set up in Jurisdiction-F1 which has a tax treaty with Jurisdiction-F2. The intermediate lessor in Jurisdiction-F1 would further sub-lease the ship to the ship operator in Jurisdiction-F2. Through such a treaty shopping arrangement, overall tax benefits may well be obtained as follows:

(a) withholding tax on the lease payments paid to the intermediate lessor by the ship operator in Jurisdiction-F2 would be reduced under the tax treaty between Jurisdiction-F1 and Jurisdiction-F2 (i.e. a tax benefit contrary to the purpose of the tax treaty);

(b) income tax is not likely to be imposed by Juridiction-F1 on the intermediate lessor in respect of the lease payments received since the income tax (computed on a net basis) would be wiped out by the withholding tax (computed on a gross basis) imposed by Juridiction-F2; and

(c) tax concession under section 14P(1) would be given by Hong Kong to the head lessor in respect of the lease payments received.

111. Section 14ZA(2) operates to deny profits tax concessions in respect of profits accrued under a cross border sub-leasing arrangement entered into by a qualifying ship lessor if the main purpose, or one of the main purposes, of the arrangement is to obtain a tax benefit under a tax treaty that is contrary to the purpose of the treaty (i.e. treaty shopping). "Tax treaty" is defined in section 14ZA(4) to mean an arrangement made between two or more jurisdictions (whether including Hong Kong or otherwise) with a view to affording relief from double taxation.

112. If an arrangement is used to secure a benefit by improper use of a tax treaty or treaty abuse, then the benefit obtained would be contrary to the purpose of the treaty. If a benefit obtained in the relevant circumstances is in accordance with the object and purpose of a tax treaty (e.g. bona fide exchanges of goods and services, and movements of capital and persons), there should not be any improper use of a tax treaty or treaty abuse.

Anti-tax arbitrage rule

113. Section 16(1A) as amended prevents tax arbitrage through ship leasing transactions between connected persons. "Connected person" has the meaning given by section 16(1C) and (1D). For example, if a Hong Kong ship operator (i.e. the lessee) pays a sum, whether directly or through an interposed person, to its connected qualifying ship lessor, who is eligible to enjoy the tax concession under section 14P(1), the sum that could be deducted by the Hong Kong ship operator in computing its assessable profits would be reduced such that the profits tax payable by the Hong Kong ship operator is increased by reference to the amount of the reduction in the profits tax payable by the qualifying ship lessor in respect of the 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), which includes a tax rate of 0% under section 16(3E). 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 25

Ship Lessor-HK, a qualifying ship lessor resident in Hong Kong, leased a ship to Ship Operator-HK, its connected person which operated a ship for transportation of goods between Hong Kong and Macau. For Year 1, the lease payments charged by Ship Lessor-HK were $12 million and the operating expenses incurred by Ship Lessor-HK were $7 million. Ship Lessor-HK had not claimed depreciation allowances in respect of the ship before and elected for the profits tax concession provided in section 14P(1). For Year 1, the concessionary tax rate applicable to a qualifying ship lessor was 0% and the lower-tier profits tax rate was 8.25%.

For Year 1, Ship Lessor-HK was exempt from the payment of profits tax in respect of its assessable profits of $1,000,000 (i.e. ($12,000,000 – $7,000,000) × 20%). If Ship Lessor-HK had been subject to tax at the two-tiered profits tax rates, its profits tax payable would have been $82,500 (i.e. $1,000,000 × 8.25%). The tax saving due to the reduction in tax rate was $82,500.

For Ship Operator-HK, half of its profits derived from uploading of goods in Hong Kong was assessed to profits tax whilst half of its profits derived from uploading of goods in Macau was not taxable. If Ship Operator-HK was subject to tax at the two-tiered profits tax rates in respect of the chargeable profits for Year 1, the amount of the lease payment allowed for deduction by Ship Operator-HK might be adjusted as follows:

($12,000,000 – ($82,500 ÷ 8.25%)) × ½
= $5,500,000

114. Section 16(1A) can nullify the tax benefits obtained when a ship operator subject to full tax rate shifts income to its connected qualifying ship lessor. By operation of section 16(1B), the provisions in section 16(1A) will not be invoked to restrict deduction of management fees paid by a qualifying ship lessor to its connected qualifying ship leasing manager for qualifying ship leasing management services provided if the qualifying ship lessor is subject to a concessionary tax rate lower than or the same as that applicable to the qualifying ship leasing manager.

Limitation of lessee's interest deduction

115. By virtue of section 16(3D):

(a) for the purposes of section 16(1)(a), the payments of finance charges or interest by a lessee for a right to use a ship under a funding lease in the production of profits are regarded as sums payable by way of interest on money borrowed by the lessee (***specified loan***) for the purpose of producing the profits; and

(b) the specified loan is regarded as money borrowed wholly and exclusively to finance capital expenditure incurred by the lessee on the provision of the ship and satisfies the condition under section 16(2)(e)(i)(A).

The effect of the provisions is that deduction of the finance charges or interest incurred by the lessee will be subject to the secured-loan test and interest flow-back test under section 16(2A) and (2B).

Secured-loan test under section 16(2A)

116. Deduction of finance charges or interest on a specified loan payable by a lessee will be restricted under section 16(2A) if at any time during the basis period of the lessee in respect of which the deduction is claimed:

(a) the payments of any finance charges or interest or the payment of any principal of the specified loan is secured or guaranteed, whether wholly or in part and whether directly or indirectly, by a deposit or loan;

(b) the said deposit or loan is made by the lessee or its associate with or to the lessor, a financial institution, an overseas financial institution or an associate of any of these parties; and

(c) the deposit or loan generates interest income that is not chargeable to tax in Hong Kong.

"Associate" is defined in section 16(3). Section 16(2A), if applicable, will reduce the deduction of finance charges or interest by an amount calculated on a basis as is most reasonable and appropriate in the circumstances of the case, having regard to the amount of interest income arising from the deposit or loan in question.

Example 26

Ship Lessor-HK and Ship Lessee-HK entered into a ten-year funding lease for the use of a ship with an annual lease payment of $5 million. The lease liability of Ship Lessee-HK (i.e. the present value of the aggregate lease payments, discounted at the interest rate of 5% per annum) was $35 million. For Year 1, the lease payment contained an interest expense at $1.7 million. As security for the acquisition of the ship under the funding lease, Ship Lessee-HK provided to an overseas associate of Ship Lessor-HK: a deposit of $20 million (earning tax-free interest of $200,000 per annum); and shares valued at $15 million.

For Year 1, the amount of interest deduction allowable to Ship Lessee-HK would be reduced by the amount of tax-free interest it earned from the deposit. In other words, the amount of allowable interest would be $1,500,000 ($1,700,000 – $200,000).

Interest flow-back test under section 16(2B)

117. Deduction of the finance charges or interest payable on a specified loan by a lessee will be restricted under section 16(2B) if at any time during the basis period of the lessee in respect of which the deduction is claimed:

(a) an arrangement is in place, whether between the lessee and the lessor or otherwise;

(b) the finance charges or interest payable on the specified loan or any part of the specified loan will be paid, directly or through an interposed person, back to the lessee or its connected person under the arrangement; and

(c) the lessee or its connected person is not an "excepted person" within the meaning of section 16(2E)(c) (i.e. a person who is charged to tax under the Ordinance in respect of the finance charges or interest in question, a financial institution, an overseas financial institution, etc.).

118. The provision in section 16(2B) applies where the said arrangement is in place, irrespective of whether the passing of finance charges or interest has actually occurred, at any time during the basis period concerned. Under section 16(2E)(b), any payment of finance charges or interest to a trustee or a corporation controlled by the trustee is deemed to be a payment to each of the trustee, the corporation and the beneficiary under the trust.

Example 27

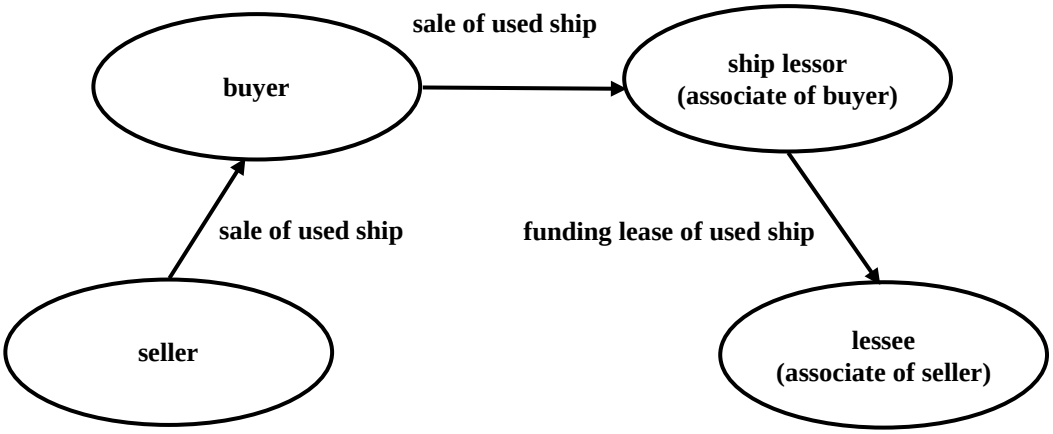
Under a funding lease of a ship, Ship Lessee-HK paid finance charges to Ship Lessor-HK, an unrelated person, on the condition that Ship Lessor-HK would pay an amount equal to the finance charges to Lender-F, a connected person of Ship Lessee-HK resident in Jurisdiction-F, by way of interest under a loan made to Ship Lessor-HK under a sub-participation arrangement. Lender-F was not an overseas financial institution.

The finance charges paid by Ship Lessee-HK in relation to the funding lease would be treated as sums payable by way of interest on a specified loan borrowed by Ship Lessee-HK for the purpose of producing profits. In this example, an arrangement was in place such that the tax-deductible finance charges paid by Ship Lessee-HK were paid back to Lender-F, its connected person who was not an excepted person. The finance charges paid by Ship Lessee-HK would be denied deduction.

Restriction of lessee's capital allowances

119. In a funding lease, the ownership of the ship is regarded as having been acquired by the lessee and depreciation allowances in respect of the ship are therefore granted to the lessee. In a sale and leaseback transaction where a seller-lessee sells a used ship that has appreciated in value to a buyer-lessor and leases the ship back from the buyer-lessor under a funding lease, depreciation allowances, based on the increased value of the ship, can be granted to the seller-lessee again under such transaction.

120. Section 14Q(2) seeks to prevent double benefits of capital allowances provided to the seller-lessee in a sale and leaseback transaction. If a person (i.e. a seller-lessee), whether alone or with others and whether directly or through an interposed person, transfers a ship by way of sale to a qualifying ship lessor (i.e. a buyer-lessor), and the qualifying ship lessor subsequently leases the ship to the person or an associate of the person under a funding lease, which is a qualifying ship leasing activity, the transfer is not treated as a sale of the ship concerned for the purposes of Part 6 of the Ordinance. The following diagram illustrates a typical sale and leaseback structure as envisaged under section 14Q(2):



121. If the transfer of the ship is not treated as a sale of the ship for the purposes of Part 6 of the Ordinance, the seller-lessee would continue to claim depreciation allowances on the reducing value of the ship as if the sale and leaseback transaction had not occurred and need not make balancing charge or balancing allowance adjustment in respect of the ship. On the other hand, the ship lessor would not be regarded as the owner of the ship.

Example 28

Ship Owner-HK1, a non-qualifying ship lessor resident in Hong Kong, acquired a ship at a price of $40 million and used the ship in its chartering business for two years. Under a sale and leaseback arrangement, Ship Owner-HK1 transferred the ship to Ship Lessor-HK, a qualifying ship lessor resident in Hong Kong, in the consideration of $50 million and Ship Owner-HK2, an associate of Ship Owner-HK1 resident in Hong Kong, leased the ship back from Ship Lessor-HK under a funding lease. At the time of transfer, the reducing value of the ship, after deduction of depreciation allowances granted to Ship Owner-HK1, was $13 million.

By virtue of section 14Q(2), the transfer of the ship from Ship Owner-HK1 to Ship Lessor-HK would not be treated as a sale of the ship for the purposes of Part 6 of the Ordinance. Ship Owner-HK1 would continue to be eligible for depreciation allowances in respect of the ship on its reducing value at $13 million. No balancing charge adjustment would be required. Ship Lessor-HK and Ship Owner-

HK2 would not be regarded as having acquired the ownership of the ship. Thus, Ship Owner-HK2 would not be entitled to claim depreciation allowances in respect of the ship.

INCOME FROM SHIP BUSINESS OR MANAGING SHIP BUSINESS

Codification of case law principles

122. Section 15(1) sets out various sums that are regarded as 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)(o) 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:

(a) its business of granting a right to use a ship to another person (***ship business***); or

(b) its business of managing a corporation carrying on a ship business or of managing a ship business

are chargeable to profits tax even if the ship concerned is used outside Hong Kong. Section 15(1E) ensures that the finance charges or interest received by or accrued to a corporation for granting a right to use a ship under a funding lease are treated as sums received by or accrued to the corporation by way of gains or profits.

123. Section 15(1)(o) makes it clear that the "operation test" applies in the determination of the source of income derived from a ship leasing business or ship leasing management business. The principle of the "operation test" laid down in *CIR v Hang Seng Bank Ltd*, [1991] 1 AC 306 and expanded in *CIR v HK-TVB International Ltd*, [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 CIGAs are performed by the ship lessor or ship leasing manager and not the place where the ship is used by the ship operator.

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

COMMENCEMENT DATE

Commencement of profits tax concessions and deeming provision

125. Regarding the effective date, sums received by or accrued to a qualifying ship lessor or qualifying ship leasing manager before 1 April 2020 are not to be taken into account for the purpose of computing the qualifying profits under section 14P(1) or 14T(1). In other words, sums accrued before 1 April 2020 but received after that day will not be eligible for the profits tax concessions. For the provisions in section 15(1)(o), they do not apply to sums received or accrued before the commencement date of the Ship Leasing Amendment Ordinance (i.e. 19 June 2020).

ADVANCE RULINGS

Ruling on specific transaction

126. 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 in sections 14P and 14T 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.

CERTIFICATE OF RESIDENT STATUS

Issuance of certificate of resident status

127. Since withholding tax is normally imposed on ship rentals, a Hong Kong ship lessor may be required to provide a Hong Kong certificate of resident status to the lessee upon delivery of a ship so that treaty benefits 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 ship lessors satisfying the CMC and substantial activities 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 ship leasing manager. If a ship 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.

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

Appendix

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, ship titleholder, ship lessor, head lessor (if any), intermediate lessor (if any), ship leasing manager (if any) 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 ship involved including the model number, gross tonnage, date and cost of acquisition, date of delivery, estimated useful economic life and the territorial waters where the ship would navigate;

   (d) the terms of the lease including the amount of monthly lease payment and lease premium (if any), amount of monthly finance charges or interest and internal rate of return, period covered, details of residual value guarantee (if any), early termination clause, renewal clause, options or rights in the lessee or its associate to purchase the ship, rental rebates, etc.;

   (e) copies of the lease agreements entered into with the lessee, head lessor (if any) and intermediate lessor (if any);

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

(g) copies 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 ship lessor and ship leasing manager; and

(i) the expected date of execution.

2. If the leasing arrangement is to be a sale and leaseback, in addition to the information required in item 1, provide:

(a) the name, address and Hong Kong business registration number (if any) of the seller-lessee;

(b) the relationship between the ship lessor and the seller-lessee;

(c) the date of purchase and price paid by the ship lessor;

(d) the bases on which the purchase price, amount of monthly lease payment, finance charges or interest, lease premium (if any), purchase options and rental rebates are determined;

(e) a copy of the sale and purchase agreement in respect of the ship; and

(f) a notice of disclaimer from the seller-lessee in respect of the depreciation allowances of the ship (if any).

Ownership of ship

3. If the ship lessor is a head lessor under an operating lease, explain:

(a) how the head lessor acquires the economic ownership of the ship involved; and

(b) how the head lessor retains the economic ownership of the ship involved throughout the lease term.

Financing of ship

4. Describe how the ship involved is financed.

5. If the ship involved is financed by a loan, provide or describe:

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

   (b) the relationship between the ship lessor and the lender;

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

   (e) a copy of the loan agreement;

   (f) where the loan involves a sub-participation arrangement, the same details as in (a) to (e) above for the sub-participation arrangement; and

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

6. If the ship is financed by a funding lease/hire-purchase agreement/conditional sale agreement, provide:

   (a) 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) the relationship between the ship lessor and the lessor/bailor/seller (as the case may be) under such agreement;

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

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

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

Depreciation allowance

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

8. Confirm whether capital allowances are granted to, or would be claimed by, a connected person of the ship lessor, whether in Hong Kong or elsewhere, for the year of assessment that the ship lessor intends to claim the ship leasing tax concession under section 14P(1) of the Ordinance.

9. If the leasing arrangement is to be a sale and leaseback, confirm:

(a) whether the ship was or would be acquired by the ship lessor from the seller-lessee or its associate at a consideration not more than the consideration paid by the seller-lessee to the supplier; and

(b) whether depreciation allowances under Part 6 of the Ordinance have been granted to the seller-lessee or its associate in respect of the ship involved.

Central management and control

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

11. Describe how the central management and control is exercised by the ship lessor and ship leasing manager.

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

13. State where the meetings of the board of directors of the ship lessor and ship 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 ship lessor and ship leasing manager are made and approved.

Substantial activities requirement

15. State the place where the following core income generating activities (CIGAs) take place:

    (a) agreeing funding terms;

    (b) identifying and acquiring ships to be leased;

    (c) setting the terms and duration of leases;

    (d) monitoring and revising any funding or lease agreements; and

    (e) managing risks associated with leases and ship leasing activities.

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

17. If any CIGAs are outsourced by the ship lessor or ship leasing manager, provide or describe:

    (a) the type of the outsourced CIGAs and the place where the CIGAs are carried out;

(b) the name, address, Hong Kong business registration number (if any), places of incorporation/establishment and residence of the person to which the CIGAs are outsourced;

(c) the relationship between with the ship lessor or ship leasing manager and the outsourced person;

(d) the amount of service fee charged by the outsourced person and the basis of calculation;

(e) the number of qualified full-time employees employed and the amount of operating expenditure incurred by the outsourced person in Hong Kong for carrying out the outsourced CIGAs;

(f) a copy of the service agreement entered into between the ship lessor or ship leasing manager and the outsourced person; and

(g) details of the control exercised by the ship lessor or ship leasing manager to ensure that the outsourced CIGAs are carried out by the outsourced person in Hong Kong.

18. State the number of staff members employed to undertake the CIGAs 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 the employee's duties;

(c) academic and professional qualifications;

(d) whether the employee is a full-time employee; and

(e) whether the employee's salaries costs would be borne by the ship lessor or ship leasing manager. If not, state the name, Hong Kong business registration number (if any) and places of incorporation/establishment and residence of the person which would bear the employee's salaries costs.

19. 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 ship lessor and ship leasing manager in Hong Kong and paid from their bank accounts in Hong Kong).

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

    (a) number of the ships 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.