Hong Kong Tax Alert

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Issues relating to the operation of the concessionary tax regimes for qualifying aircraft lessors and qualifying aircraft leasing managers and non-resident funds

In its 2018 annual meeting with the Hong Kong Institute of Certified Public Accountants (HKICPA), the Inland Revenue Department (IRD) indicated that:

(i) if qualifying aircraft lessors and qualifying aircraft leasing managers wish to qualify for the concessionary tax rate of 8.25%, they may not be able to sub-contract out part of their activities to be performed outside Hong Kong; and

(ii) transactions in virtual currencies and digital tokens would generally not qualify as "specified transactions" exempt under the tax regime for non-resident funds. Possible exceptions include situations where under certain specific Initial Coin Offering (ICO) arrangements, the digital tokens represent "shares", "debentures" or "interests in a collective investment scheme".

This alert discusses the issues involved. Clients who have questions on the views expressed by the IRD in the meeting, or would like to discuss in greater detail how such views might impact their business operations, should seek professional tax advice.

Qualifying aircraft lessors and qualifying aircraft leasing managers

Under the recently introduced concessionary tax regime for qualifying aircraft lessors and qualifying aircraft leasing managers, certain conditions must be satisfied before the relevant profits of such lessors and managers are eligible to be taxed at the concessionary tax rate of 8.25%.

One of these conditions is that the activities that produce the relevant profits in a year are either (i) carried out in Hong Kong by the qualifying aircraft lessors or the qualifying aircraft leasing managers themselves; or (ii) arranged by the qualifying aircraft lessors or the qualifying aircraft leasing managers to be carried out in Hong Kong – i.e., the so-called "substantial activity requirement in Hong Kong".

Questions raised by the HKICPA

Further to this "substantial activity requirement in Hong Kong", and given that Hong Kong as yet may not have established a critical mass of aircraft leasing management expertise in certain overseas aircraft leasing markets, the HKICPA raised the following questions in the meeting:

For a qualifying aircraft lessor in Hong Kong: whether such a lessor would still satisfy the "substantial activity requirement in Hong Kong" if the lessor appointed an overseas aircraft leasing manager to solicit lessees, negotiate lease term and provide other lease management services including those relating to aircraft acquisition and disposal matters etc. by way of activities performed outside Hong Kong, while the lessor evaluated and made the ultimate investment and leasing decisions in Hong Kong?

For a qualifying aircraft leasing manager in Hong Kong: whether such a manger would still satisfy the "substantial activity requirement in Hong Kong" if the manager sub-contracted out part of their aircraft leasing management services to an overseas aircraft leasing manager who performed the sub-contracted services outside Hong Kong?

IRD's reply

The response of the IRD was that if the sub-contracted out activities were not performed in Hong Kong by the service providers, the qualifying aircraft lessor or the qualifying aircraft leasing manager in the above example would not satisfy the "substantial activity requirement in Hong Kong". As such, the relevant profits would not qualify for the concessionary tax rate.

The IRD added that under section 26AB of the Inland Revenue Ordinance (IRO), the Commissioner of Inland Revenue (CIR) was empowered to prescribe a minimum threshold for the "substantial activity requirement in Hong Kong" for qualifying aircraft lessors or qualifying aircraft leasing managers.

Such a minimum threshold, if set, would be measured by various indicators such as (a) the number of full time employees in Hong Kong who carry out the activity and have the qualifications necessary for doing so; and (b) the amount of operating expenditure incurred in Hong Kong in performing the activity.

Commentary

The IRD's above response seems a bit too broad-brushed. Arguably, the relevant activities to be considered for the "substantial activity requirement in Hong Kong" are the activities of the qualifying aircraft lessors or the qualifying aircraft leasing managers themselves in Hong Kong that produce their relevant profits, rather than the sub-contracted out activities performed outside Hong Kong by the service providers.

This would particularly be the case where despite sub-contracting out part of their activities to be performed outside Hong Kong by an overseas aircraft leasing manager, the qualifying aircraft lessor in the above example would nonetheless still be required to evaluate and make the ultimate investment and leasing decisions in Hong Kong.

Similarly, the qualifying aircraft leasing manger in the above example may also be involved in various co-ordination and liaison work in Hong Kong between the clients and the overseas aircraft leasing manager, despite sub-contracting out part of their aircraft leasing management services to the overseas aircraft leasing manager.

Thus far the CIR has not prescribed any minimum threshold for the "substantial activity requirement in Hong Kong" for qualifying aircraft lessors or qualifying aircraft leasing managers. Conceivably, the qualifying aircraft lessor and the qualifying aircraft leasing manager in the above example could satisfy the minimum threshold when one is set by the CIR in the future.

It would be unusual if, having satisfied such a minimum threshold in the future, the qualifying aircraft lessor or the qualifying aircraft leasing manager in the above example would nonetheless be ineligible for the concessionary tax rate.

In such circumstances, the denial of their eligibility for the concessionary tax rate, simply because they have sub-contracted out part of their activities to be performed outside Hong Kong by an overseas service provider, does not seem justified.

Transactions in cryptocurrencies by non-resident funds

Section 20AC of the IRO provides that, subject to the satisfaction of certain conditions, all non-resident persons (including individuals, corporations, partnerships and trusts) will be exempt from profits tax in Hong Kong if their activities in Hong Kong are restricted to "specified transactions" and transactions incidental to the specified transactions.

For this purpose, there are six categories of specified transactions: (i) a transaction in securities; (ii) a transaction in future contracts; (iii) a transaction in foreign exchange contracts; (iv) a transaction consisting in the making of a deposit other than by way of a money-lending business; (v) a transaction in foreign currencies; and (vi) a transaction in exchange-traded commodities.

Question raised by the HKICPA

The question raised by the HKICPA was whether a transaction in cryptocurrencies falls within any one of the above six categories of specified transactions.

IRD's reply

In general, the IRD took the view that a transaction in cryptocurrencies would not be a specified transaction falling within any one of the above six categories of specified transactions.

Specifically, the IRD noted that cryptocurrencies were not "foreign currencies" because they did not constitute legal tender in foreign jurisdictions. Instead, cryptocurrencies offered in typical ICO were usually characterized as virtual commodities in Hong Kong (and not exchanged-traded), and a virtual commodity itself was not "securities" as defined.

Nonetheless, the IRD indicated that digital tokens offered or sold under an ICO in the following circumstances might be regarded as "securities" and subject to the securities law of Hong Kong:

- If digital tokens offered in an ICO represent equity or ownership interests in a corporation, these tokens might be regarded as "shares". For example, token holders might be given shareholders' rights, such as the right to receive dividends and the right to participate in the distribution of the corporation's surplus assets upon winding up.
- If digital tokens were used to create or acknowledge a debt or liability owed by the issuer, they might be considered as a "debenture". For example, an issuer might repay token holders the principal of their investment on a fixed date or upon redemption, with interest paid to token holders.
- If token proceeds were managed collectively by the ICO scheme operator to invest in projects with an aim to enable holders to participate in a share of the returns provided by the project, the digital tokens might be regarded as "an interest in a collective investment scheme".

The IRD noted that "shares", "debentures" and "interests in a collective investment scheme" were "securities' as defined. As such, a transaction in cryptocurrencies with the aforesaid features under the above circumstances might be regarded as a specified transaction under section 20AC of the IRO.

Where a transaction in cryptocurrencies is not tax exempt as a specified transaction, the IRD indicated that the IRD would apply the broad guiding principle of "what the taxpayer had done to earn the profit in question and where he had done it" to determine the source of the relevant profits.

The IRD added that where, under the broad guiding principle, the source rule of the place where "the contracts of purchase and sale were effected" was applied to the buying and selling of cryptocurrencies as a virtual commodity, the IRD would not merely look at the place where the contracts were signed. Instead, all the steps leading to the negotiations and conclusion and performance of the contracts would be looked at in determining where the relevant contracts were effected.

Many of the issues discussed above are complicated. Clients who have questions on the views expressed by the IRD in the meeting, or would like to discuss in greater detail how such views might impact their business operations, should seek professional tax advice.

EY Contacts

Hong Kong office

Agnes Chan, Managing Partner, Hong Kong & Macau
22/F, CITIC Tower, 1 Tim Mei Avenue, Central, Hong Kong
Tel: +852 2846 9888 / Fax: +852 2868 4432

EY Asia-Pacific Business Tax Services Leader

Tracy Ho
+852 2846 9065
tracy.ho@hk.ey.com

EY Greater China Business Tax Services Leader

Chee Weng Lee
+852 2629 3803
chee-weng.lee@hk.ey.com

Hong Kong Business Tax Services Partners, Ernst & Young Tax Services Limited

Agnes Chan
+852 2846 9921
agnes.chan@hk.ey.com

Wilson Cheng
+852 2846 9066
wilson.cheng@hk.ey.com

May Leung
+852 2629 3089
may.leung@hk.ey.com

Grace Tang
+852 2846 9889
grace.tang@hk.ey.com

Karina Wong
+852 2849 9175
karina.wong@hk.ey.com

Jo An Yee
+852 2846 9710
jo-an.yee@hk.ey.com

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