Hong Kong Tax Alert

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Bill for enhancing aircraft leasing preferential tax regime gazetted

The bill[1] proposes to implement the commitment made by the Chief Executive of the Hong Kong Special Administrative Region, John Lee, in his 2022 Policy Address to enhance the existing aircraft preferential tax regime to make Hong Kong a preferred location for aircraft leasing in the region.

The enhancement measures proposed in the bill previously discussed in detail in a trade consultation paper issued by the government soon after the 2022 Policy Address have received wide support from the industry.

This alert discusses the enhancement measures contained in the bill as well as those that have already been implemented via administrative practice of the Inland Revenue Department (IRD).

Clients who wish to explore how they can benefit from these enhancement measures can contact their tax executive.

Note:
(1) The bill can be accessed from the below link:
The Government of the Hong Kong Special Administrative Region Gazette (legco.gov.hk)

Half-rate tax concessions under the existing aircraft preferential tax regime

Subject to certain anti-avoidance provisions, corporations that meet the specified conditions may make an irrevocable election in writing to avail themselves of the existing regime, which provides that:

(i) qualifying profits of qualifying aircraft lessors and qualifying aircraft leasing managers will be taxed at the concessionary tax rate of 8.25%, i.e., one-half of the normal corporate profits tax rate; and

(ii) in lieu of tax depreciation allowances[2], the deemed taxable amount in respect of income derived from the leasing of aircraft to an aircraft operator by a qualifying aircraft lessor will be equal to 20% of its gross rentals reduced by tax deductible expenses, but excluding tax depreciation allowances (i.e., a 20% tax base concession).

20% tax base concession versus a one-off tax deduction of the acquisition cost

Under the bill, for an aircraft that is acquired in the year of assessment beginning on or after 1 April 2023, a qualifying aircraft lessor, instead of the existing 20% tax base concession, will be granted a one-off deduction of the acquisition cost of the aircraft in the year of acquisition. The consideration for subsequent disposal of the aircraft will however be deemed as trading receipts, subject to a cap of the tax deduction previously allowed.

In respect of an aircraft that was acquired in a previous year, a qualifying aircraft lessor can either (a) continue to be taxed on the 20% tax base concession on an annual basis; or (b) elect to claim a one-off tax deduction of the residual value of the aircraft in the year of election. In the case of (b), the consideration for subsequent disposal of the aircraft will be deemed as trading receipts, subject to a cap of the tax deduction previously allowed. The election will be irrevocable and, once made, the taxpayer will no longer be entitled to the 20% tax base concession.

The proposal above is made in response to the expected soon implementation of the Pillar Two global minimum tax of 15% for in-scope multinational enterprise (MNE) groups. Under Pillar Two, constituent entities of such groups will be subject to a top-up tax up to the required minimum tax rate, if their jurisdictional effective tax rate (ETR) is below that level. Such a top-up tax can be levied by a jurisdiction(s) outside of Hong Kong where the ultimate parent entity or other constituent entities of the group are located, if Hong Kong does not introduce a qualified domestic minimum top-up tax of 15%.

The reason for the proposed change is that the current 20% tax base concession is a permanent difference for deferred tax purposes, thus giving rise to no deferred tax liabilities, thereby dragging down the ETR of the qualifying aircraft lessor. The proposed one-off tax deduction of the acquisition cost of an aircraft will however be a temporary difference, thus giving rise to deferred tax liabilities, which are added to the covered taxes for the calculation of the ETR.

An example is included in Appendix I to this alert to compare the jurisdictional ETR in Hong Kong under (a) the 20% tax base concession under the existing regime and (b) a one-off tax deduction of the acquisition cost of an aircraft, if elected, under the proposal contained in the bill.

No denial of the 20% tax base concession under specified scenarios

Instead of the current rule of a blanket denial of the 20% tax base concession for cases where capital allowances in respect of an aircraft have previously been claimed for tax purposes, the bill proposes certain carve-outs, e.g., the capital allowances previously granted have been clawed back, from such denial.

If the carve-outs apply, it would mean that the qualifying aircraft lessor will be eligible for the one-off tax deduction of the acquisition cost, or the residual value of an aircraft discussed above.

Note:

(2) Under section 39E of the IRO, a lessor would be denied tax depreciation allowances in respect of the cost they incurred on the acquisition of an aircraft if the aircraft is leased to an overseas aircraft operator. Leasing of an aircraft to a Hong Kong aircraft operator would normally be entitled to tax depreciation allowances

Expanding the scope of a qualifying lease and coverage of qualifying aircraft leasing activities to keep up with the latest practices of the industry

Recognizing that the mode of leasing and the sources of demand have changed substantially, partly due to the COVID-19 pandemic, the bill proposes to expand the scope of a qualifying lease and coverage of qualifying aircraft leasing activities to keep up with these developments.

Under the bill, a qualifying lease will no longer be confined to a dry lease of at least of one year but extended to cover a dry lease of less than one year, a wet lease[3] and a funding or finance lease[4] in respect of an aircraft.

In addition, the coverage of qualifying aircraft leasing activities will no longer be confined to leasing to aircraft operators only, but extended to include any other person, e.g., non-aircraft operators such as private companies, public organizations or individuals.

Relaxing the current stringent interest deduction rules in respect of interest payable on money raised to finance the acquisition of aircraft

Under section 16(2) of the Inland Revenue Ordinance (IRO), interest paid on money borrowed from an overseas lender to wholly and exclusively finance the acquisition of plant and machinery would only be deductible if the lender is (a) an overseas financial institution or (b) not an associate of the borrower. Where the financing is made by way of issuing debentures listed on a stock exchange, the stock exchange concerned must be recognized by the Commissioner of Inland Revenue (CIR).

To accommodate the different financing means for the acquisition of aircraft, the bill proposes that condition (b) above will not apply if certain anti-abuse provisions (e.g., a "subject to tax condition") are satisfied. In other words, interest paid to an overseas associate lender to finance the acquisition of aircraft wholly and exclusively would, subject to certain conditions, be deductible.

Noting that many qualifying aircraft lessors may issue bonds listed on the Irish Stock Exchange to finance their acquisition of aircraft, the IRD has now recognized the Irish Stock Exchange for the purposes of section 16(2)(f) for the tax deduction of such interest.

Introducing specified substantial activities thresholds to comply with Organization for Economic Co-operation and Development (OECD) requirements

All the preferential tax regimes contained in the IRO are subject to substantial activities thresholds in terms of number of qualified persons employed and annual operating expenditure incurred under the rules established by the OECD. The threshold requirements for the existing aircraft leasing preferential tax regime, however, has yet to be prescribed in the law.

After considering the views of the industry players expressed during the earlier trade consultation, the bill now proposes to

Qualifying activities	Full-time qualified persons employed in Hong Kong	Annual operating expenditure incurred in Hong Kong
Aircraft leasing	1	HK$2 million
Aircraft leasing management	2	HK$1 million

Notes:

(3) A dry lease generally means a lease of the aircraft, not including crew, insurance and maintenance, whereas a wet lease is a typically short-term lease for seasonal needs including the aircraft, crew, maintenance and insurance during the period of the lease.

(4) Funding lease is a financing arrangement under which the lessee is transferred the risks and rewards of the aircraft ownership and the aircraft lessor is the financier. The lessee is usually provided with an option to purchase the aircraft at the end of the leasing agreement.

Clarifying that a bare trust leasing model will qualify for the existing regime

As an industry practice, to provide flexibility for the transfer of leases upon changes in the beneficial ownership of aircraft, there has been an increase in the use of a bare trustee to hold the legal ownership of aircraft for aircraft lessors as beneficial owners. Such a leasing model may potentially not qualify for the existing regime. This is because the word "own" may be interpreted as covering both the legal and beneficial ownership of an aircraft for the purposes of the existing regime.

The Departmental Interpretation and Practice Notes No. 54 has now been updated to provide clarity and guidance to the industry that a bare trust leasing model will qualify for the existing regime, provided that other qualifying conditions are also satisfied.

A summary of the proposed enhancements is contained in Appendix II to this alert.

Commentary

We appreciate the government has been in touch with the industry and providing the above proposed enhancement measures.

By reducing the drag-down effect on the jurisdictional ETR of a qualifying aircraft lessor under Pillar Two, the proposal to replace the current 20% tax base concession with a one-off tax deduction of the acquisition cost or residual value of an aircraft is a welcoming move. Such a proposal could also be said to be fairer as a qualifying aircraft lessor will be taxed based on its actual operating profits, as opposed to the 20% tax base concession which was set by reference to the average net profit margin of aircraft lessors.

Similar consideration may also apply to other tax incentives such as whether to replace the current super tax deductions for qualifying research and development expenditure with qualified refundable tax credits so that the drag-down effect on the jurisdictional ETR of the entity concerned can be reduced.

Furthermore, the proposed relaxation of the current interest deduction rules for the acquisition of aircraft by qualifying aircraft lessors may also have scope to extend to other taxpayers more generally.

In the meantime, clients who have any thoughts or questions on the above proposed enhancement measures can contact their tax executives.

Appendix I

Example

In the year of assessment 2023/24, Qualifying Aircraft Lessor-HK acquired an aircraft at a consideration of HK$120 million and leased the aircraft under an operating lease for a term of five years.

The lease rental charged by Qualifying Aircraft Lessor-HK for the year was HK$11 million. Its operating expenses, excluding a 20-year straight-line annual depreciation expense of HK$6 million in respect of the aircraft, amounted to HK$1 million for the year.

For Global Anti-Base Erosion (GloBE) rules purposes, Qualifying Aircraft Lessor-HK is the only constituent entity of an in-scope MNE group in Hong Kong.

The calculation below compares the jurisdictional ETR of Qualifying Aircraft Lessor-HK in Hong Kong if (a) the 20% tax base concession under the existing regime is not replaced and (b) the 20% tax base concession is replaced by the one-off tax deduction of the acquisition cost of the aircraft in the year of acquisition under the proposal contained in the bill.

Qualifying Aircraft Lessor-HK – Statement of profit or loss for 2023/24

(in thousands dollars)

	HK$
Gross lease rental	11,000
Less: Direct operating expenses	(1,000)
Depreciation expense	(6,000)
Profit before tax	**4,000**

Under the current rule – 20% tax base concession in lieu of tax depreciation allowances under the existing regime

Hong Kong profits tax computation of Qualifying Aircraft Lessor-HK

	Calculations	Remarks
Assessable profits/ (adjusted loss)	(HK$11,000,000 - HK$1,000,000) x 20% = HK$2,000,000	Assume the operating expenses of HK$1 million are tax deductible under section 16(1) of the IRO.
Profits tax payable @8.25%	HK$165,000	

Computation of the jurisdictional ETR of Qualifying Aircraft Lessor-HK

Steps	Calculations	Remarks
GloBE income (Financial accounting net income or loss)	HK$4,000,000	
Covered taxes (Current tax expense)	HK$165,000	The 20% tax base concession is a permanent difference, and no deferred tax adjustment will be made.
Jurisdictional ETR (Adjusted Covered Taxes / GloBE Income)	HK$165,000 / HK$4,000,000 = 4.125%	

Under the bill, if implemented (i.e., the capital cost of the aircraft will be fully deductible in the year of acquisition)

Hong Kong profits tax computation of Qualifying Aircraft Lessor-HK

	Calculations	Remarks
Assessable profits/ (adjusted loss)	(HK$11,000,000 - HK$1,000,000 - HK$120,000,000) = (HK$110,000,000)	Assume the operating expenses of HK$1 million are tax deductible under section 16(1) of the IRO.
Profits tax payable	NIL	

For accounting purposes, Qualifying Aircraft Lessor-HK would recognize the following deferred tax asset and liabilities for financial accounting purposes:

- Deferred tax asset arising from the tax loss carried forward: HK$110 million x 8.25% = HK$9,075,000

- Deferred tax liabilities arising from the taxable temporary differences between the carrying amount of the aircraft (cost less accumulated depreciation) and its tax base (i.e., zero in this example): (HK$120 million - HK$6 million) x 8.25% = HK$9,405,000.

Computation of the jurisdictional ETR of Qualifying Aircraft Lessor-HK

Steps	Calculations	Remarks
GloBE income (Financial accounting net income or loss)	HK$4,000,000	
Covered taxes (Current tax expense + total deferred tax adjustment)	HK$0 + HK$**330,000** = HK$330,000	The net total deferred tax adjustment (HK$9,405,000 - HK$9,075,000) will be treated as an addition to adjusted covered taxes.
Jurisdictional ETR (Adjusted Covered Taxes / GloBE Income)	HK$330,000 / HK$4,000,000 = 8.25%	

Appendix II – Summary of the proposed enhancement measures contained in the bill

	Existing regime	Proposed enhanced regime
Aircraft acquisition cost	▸ No deduction of aircraft acquisition cost ▸ Taxable amount of lease payments equal to 20% of the tax base, i.e., gross lease payments less deductible expenses (excluding depreciation allowance)	<u>Aircraft acquired before 2023/24 – may elect (irrevocable election):</u> (1) To continue to be taxed on the 20% tax base concession; or (2) To be taxed on actual profits with deduction of the residual value of the aircraft <u>Aircraft acquired in or after 2023/24:</u> (1) To be taxed on actual profits – full acquisition cost will be deducted in the year in which the aircraft is acquired
Covered type of lease	Only apply to dry lease which is an operating lease	Apply to operating (dry and wet) lease as well as funding lease
Limitation on lease term	Not less than one year	No limitation
Covered leasing activities	Confined to leasing of aircraft to operators of aircraft	Leasing of aircraft to any person
Interest payment to non-financial institution financiers outside Hong Kong	Generally non-deductible	▸ Deductible if the loan is wholly and exclusively used to finance the acquisition of aircraft ▸ Subject to additional conditions if the financier is an associated person of the aircraft lessor
Threshold requirements for aircraft lessors and aircraft leasing manager	Not prescribed in law	To prescribe the following thresholds: (1) Aircraft lessors: One full-time qualified employees and annual operating expenditure HK$2 million (2) Aircraft leasing managers: Two full-time qualified employees and annual operating expenditure HK$1 million

Hong Kong office

Jasmine Lee, Managing Partner, Hong Kong & Macau
27/F One Taikoo Place, 979 King's Road, Quarry Bay, Hong Kong
Tel: +852 2846 9888   Fax: +852 2868 4432

Non-financial Services

Wilson Cheng
Tax Leader for Hong Kong and Macau
+852 2846 9066
wilson.cheng@hk.ey.com

Business Tax Services / Global Compliance and Reporting

Hong Kong Tax Services

Wilson Cheng +852 2846 9066 wilson.cheng@hk.ey.com	**Tracy Ho** +852 2846 9065 tracy.ho@hk.ey.com	**Jennifer Kam** +852 2846 9755 jennifer.kam@hk.ey.com
May Leung +852 2629 3089 may.leung@hk.ey.com	**Ada Ma** +852 2849 9391 ada.ma@hk.ey.com	**Ricky Tam** +852 2629 3752 ricky.tam@hk.ey.com
Grace Tang +852 2846 9889 grace.tang@hk.ey.com	**Karina Wong** +852 2849 9175 karina.wong@hk.ey.com	**Leo Wong** +852 2849 9165 leo.wong@hk.ey.com
Jacqueline Chow +852 2629 3122 jacqueline.chow@hk.ey.com		

China Tax Services

Ivan Chan +852 2629 3828 ivan.chan@hk.ey.com	**Sam Fan** +852 2849 9278 sam.fan@hk.ey.com	**Becky Lai** +852 2629 3188 becky.lai@hk.ey.com
Carol Liu +852 2629 3788 carol.liu@hk.ey.com		

Payroll Operate

Vincent Hu
+852 3752 4885
vincent-wh.hu@hk.ey.com

Accounting Compliance and Reporting

Linda Liu +86 21 2228 2801 linda-sy.liu@cn.ey.com	**Cecilia Feng** +852 2846 9735 cecilia.feng@hk.ey.com

International Tax and Transaction Services

International Tax Services

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

Transfer Pricing Services

Sangeeth Aiyappa +852 2629 3989 sangeeth.aiyappa@hk.ey.com	**Martin Richter** +852 2629 3938 martin.richter@hk.ey.com
Kenny Wei +852 2629 3941 kenny.wei@hk.ey.com	

Transaction Tax Services

David Chan +852 2629 3228 david.chan@hk.ey.com	**Jane Hui** +852 2629 3836 jane.hui@hk.ey.com	**Eric Lam** +852 2846 9946 eric-yh.lam@hk.ey.com	**Qiannan Lu** +852 2675 2922 qiannan.lu@hk.ey.com

Financial Services

Paul Ho
Tax Leader for Hong Kong
+852 2849 9564
paul.ho@hk.ey.com

Business Tax Services / Global Compliance and Reporting

Hong Kong Tax Services

Paul Ho +852 2849 9564 paul.ho@hk.ey.com	**Ming Lam** +852 2849 9265 ming.lam@hk.ey.com
Sunny Liu +852 2846 9883 sunny.liu@hk.ey.com	**Helen Mok** +852 2849 9279 helen.mok@hk.ey.com

Customer Tax Operations and Reporting Services

Paul Ho
+852 2849 9564
paul.ho@hk.ey.com

US Tax Services

Camelia Ho +852 2849 9150 camelia.ho@hk.ey.com	**Michael Stenske** +852 2629 3058 michael.stenske@hk.ey.com

International Tax and Transaction Services

China Tax Services

Cindy Li
+852 2629 3608
cindy.jy.li@hk.ey.com

International Tax Services

Sophie Lindsay +852 3189 4589 sophie.lindsay@hk.ey.com	**Stuart Cioccarelli** +852 2675 2896 stuart.cioccarelli@hk.ey.com
Rohit Narula +852 2629 3549 rohit.narula@hk.ey.com	**Adam Williams** +852 2849 9589 adam-b.williams@hk.ey.com
Maggie To +852 3752 4779 maggie.to@hk.ey.com	**Ruairi Lamb** +852 2846 9070 ruairi.lamb@hk.ey.com

Transfer Pricing Services

Ka Lok Chu +852 2629 3044 kalok.chu@hk.ey.com	**Justin Kyte** +852 2629 3880 justin.kyte@hk.ey.com

Transaction Tax Services

Rohit Narula
+852 2629 3549
rohit.narula@hk.ey.com

People Advisory Services

Robin Choi +852 2629 3813 robin.choi@hk.ey.com	**Mary Chua** +852 2849 9448 mary.chua@hk.ey.com	**Christina Li** +852 2629 3664 christina.li@hk.ey.com	**Jeff Tang** +852 2515 4168 jeff.tk.tang@hk.ey.com	**Winnie Walker** +852 2629 3693 winnie.walker@hk.ey.com	**Paul Wen** +852 2629 3876 paul.wen@hk.ey.com

Asia-Pacific Tax Centre

Tax Technology and Transformation Services

Agnes Fok
+852 2629 3709
agnes.fok@hk.ey.com

Robert Hardesty
+852 2629 3291
robert.hardesty@hk.ey.com

Albert Lee
+852 2629 3318
albert.lee@hk.ey.com

International Tax and Transaction Services

US Tax Desk

Jeremy Litton +852 3471 2783 jeremy.litton@hk.ey.com	**Peggy Lok** +852 2629 3866 peggy.lok@hk.ey.com
Winona Zhao +852 2515 4148 winona.zhao1@hk.ey.com	

Operating Model Effectiveness

Alice Chung +852 3758 5902 alice.chung@hk.ey.com	**Edvard Rinck** +852 9736 3038 edvard.rinck@hk.ey.com

Indirect tax

Shubhendu Misra
+852 2232 6578
shubhendu.misra@hk.ey.com

Andy Winthrop
+852 2629 3556
andy.p.winthrop@hk.ey.com

Tax and Finance Operate

Tracey Kuuskoski
+852 2675 2842
tracey.kuuskoski@hk.ey.com

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