For discussion
on 26 November 2019

Legislative Council Panel on Economic Development

Proposed Tax Regime
To Promote Ship Leasing Business in Hong Kong

Purpose

This paper briefs Members on the legislative proposal to amend the Inland Revenue Ordinance ("IRO")(Cap. 112) to provide for a dedicated tax regime to attract ship leasing business to set up presence in Hong Kong, thereby enhancing Hong Kong's position as a ship leasing centre in the Asia-Pacific region and consolidating its position as an international maritime centre.

Background

Global trend

2. Notwithstanding some fluctuations in the global shipping market in recent years, the world fleet has largely grown at a pace on par with world seaborne trade growth over a long period of time, averaging around 3% per annum from 1980 to 2018 according to the United Nations Conference on Trade and Development. With some 80% of global freight volume carried by water today, the demand for water transport will likely continue to spur demand for ship financing. The "Maritime Leasing Paper" released by the Financial Services Development Council in May 2018 estimated that the capital expenditure for newbuilding vessels was about US$80-100 billion a year.

3. Among the different forms of ship financing, ship leasing is an emerging business model in the shipping industry compared to more traditional modes of ship financing such as bank loans. Advantages of leasing include better liquidity, greater flexibility in repayment options and cash expenses, and lower financing costs.

4. Meanwhile, the Organisation for Economic Co-operation and Development ("OECD")'s action in developing new international taxation

rules and principles to deal with tax abuses, notably the anti-base erosion and profit shifting ("BEPS") measures, has driven shipping and ship leasing companies currently based in some low-tax countries to look for opportunities to rebase their operations. This offers an opportunity for Hong Kong to attract companies with genuine business interest to come to operate in Hong Kong.

Regional landscape

5. With the shift of the global economic centre of gravity from the West to the East, and with the major contributor to shipowning and shipbuilding activities coming from Asia (e.g. around half of world fleet was owned by Asia, with China alone accounting for 15%; China, Korea and Japan together accounted for over 90% of global shipbuilding activity in 2018), ship financing activity is expected to see faster growth in Asia. According to the Seatrade Maritime News' estimates (May 2017), traditional banks (mainly those located in Europe) have gone from financing around 80% of the shipping industry in 2008 to about 60% in 2016, while Chinese leasing firms have grown their market shares to about 20%[1].

6. Having recognised the importance of the presence of a vibrant maritime cluster in enhancing their position as major maritime centres, other international maritime cities[2] have put forward tax measures and fiscal incentive schemes to proactively attract overseas companies to set up offices there, with a view to forming a strong maritime cluster of shipping groups and maritime services. Provision of tax incentives is a possible means for Hong Kong to stay competitive to effectively attract shipping-related companies to set up offices here.

7. With the support of suitable policy initiative, Hong Kong would stand to benefit from these growth opportunities. As ship leasing serves to facilitate ship ownership and operation, which also generate demand for other maritime business services, fostering the development of ship leasing business in Hong Kong is conducive to the growth of our shipping core and maritime cluster.

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[1] Source: Seatrade Maritime News: "China banking regulator voices support for financial leasing in shipping", 18 May 2017, http://www.seatrade-maritime.com/news/asia/china-banking-regulator-voices-support-for-financial-leasing-in-shipping.html.

[2] Notably, Singapore offers the Maritime Sector Incentive (MSI) Scheme, one of which is the Maritime Leasing (ML) Award. The MSI-ML Award encourages entities to use Singapore as their capital and funding base to finance their ships, by providing tax exemption for qualifying ship leasing companies and a concessionary tax rate of 10% for their approved leasing managers.

Hong Kong perspective

8. Hong Kong is an international maritime centre with over 150 years of maritime history. It enjoys competitive advantage in high value-added maritime services with a strong maritime cluster of over 800 shipping-related companies. Among the various maritime services, ship finance has demonstrated clear growth potentials, accounting for more than half of the value added of the maritime services sector and with growth (averaging at 9.6% per annum during 2014-2017, 2014 being the earliest available data) that far outpaced that of the maritime services sector as a whole (1.3% per annum over the same period).

9. Recognising the competitive landscape for maritime business in the region and having regard to the positive experience of introducing tax measures through the aircraft leasing regime, the Government announced in October 2018 a package of initiatives to support the development of maritime services in Hong Kong, one of which is to "*use tax measures to foster ship leasing business in Hong Kong … with a view to enhancing Hong Kong's position as a ship leasing centre in the Asia-Pacific region*". To take forward the initiative, a Task Force on Ship Leasing (Task Force), comprising tax, financial, legal and maritime experts as well as representatives from relevant Government bureau/departments, was set up under the Hong Kong Maritime and Port Board in late 2018 to devise the details of the proposed tax concessions for ship leasing business.

The Proposal

10. To promote the development of ship leasing business in Hong Kong and make our tax regime competitive vis-à-vis major competitors in the region, we propose incorporating in the IRO a new dedicated regime in which –

(a) the tax rate on the qualifying profits of qualifying ship lessors carrying out operating lease and finance lease activities (including subleasing and sale and leaseback arrangement) will be 0%;

(b) the tax rate on the qualifying profits of qualifying ship leasing managers carrying out ship leasing management activities for qualifying ship lessors will be 8.25% (i.e. half of the profits tax rate for corporations at 16.5%);

(c) the tax base in respect of an operating lease will be equal to 20% of rentals, after deduction of expenses (excluding depreciation), derived by a qualifying ship lessor; and

(d) the tax base in respect of a finance lease will be equal to finance charges or interest, after deduction of expenses, derived by a qualifying ship lessor.

Anti-abuse features

11. The dedicated regime will incorporate anti-abuse features so as to safeguard the integrity of the tax system and comply with international tax rules, including –

(a) requiring qualifying ship lessors and qualifying ship leasing managers to be standalone corporate entities to prohibit loss transfer via partnership; and ringfencing the preferential tax regime to the qualifying activities;

(b) requiring the central management and control of qualifying ship lessors and qualifying ship leasing managers to be located in Hong Kong and their substantial activities to be carried out in Hong Kong (see paragraph 12 below for the substantial activity requirement) to ensure that their business operations are domiciled in Hong Kong with substance;

(c) denying a qualifying ship lessor the 20% tax base concession if depreciation allowances in respect of the ship have been granted to the lessor or its connected person, or its connected or unconnected person under a sale and leaseback arrangement (i.e. following the existing treatment as provided in the IRO);

(d) ensuring that qualifying ship lessors and qualifying ship leasing managers conduct business transactions with their associated parties on an arm's length basis;

(e) introducing main purpose tests to prevent tax avoidance and treaty shopping; and

(f) reducing the tax deduction for payments made by a lessee to its connected qualifying ship lessor by an amount of tax saving obtained by the lessor to maintain tax symmetry and prevent revenue loss.

Substantial activity requirement

12. In determining whether a preferential tax regime meets the international standards on counteracting base erosion and profits shifting, the OECD will take into account whether the regime has incorporated a substantial activity requirement test to ensure that only those entities which undertake core income generating activities in a jurisdiction would benefit from the regime. The substantial activity requirement test requires the entities to satisfy two conditions in Hong Kong, namely (a) an adequate number of the full-time qualified employees and (b) an adequate amount of operating expenditure. After industry consultation, the minimum thresholds for the above two measurements for the ship leasing and ship leasing management tax regimes are proposed as follows (measured at the group company level) –

Qualifying activity	Number of full-time qualified employees	Annual operating expenditure ($)
Ship leasing	2	US$1 million
Ship leasing management	1	HK$1 million

Potential Benefits of the Proposal

13. The Task Force conducted an economic impact assessment with relevant inputs from experts in the shipping and ship finance industries. According to the assessment, if the proposed new tax regime for ship leasing is put in place, it is estimated that Hong Kong could capture 12% of the global ship finance market in ten years' time. This would mean (in 2018 dollars) –

(a) incremental ship finance business of about HK$265 billion to HK$460 billion cumulatively over 10 years compared to the status if no tax measure is introduced;

(b) direct employment of around 6 400 to 11 200 people cumulatively over 10 years, and 1 170 to 2 040 people by Year 10;

(c) Gross Domestic Product value added of around HK$20 billion to HK$35 billion cumulatively over 10 years, and HK$3.6 billion to HK$6.3 billion by Year 10; and

(d) about 23 000 to 40 000 indirect jobs cumulatively over 10 years due to the linkage effects.

14. Currently there is ship leasing business carried out by shipping companies or financial institutions in Hong Kong. It would be difficult to estimate the revenue forgone arising from the tax concessions proposal as the incentive intends to attract business which otherwise would not be domiciled in Hong Kong. That said, the tax revenue foregone due to the new tax concessions is expected to constitute only an insignificant portion of the total profits tax revenue of the Government. On the other hand, the tax measure may also attract other shipping-related companies pertinent to ship leasing business to establish and operate in Hong Kong, and will in turn generate additional tax revenue and bring positive economic impetus to Hong Kong.

Consultation

15. We have consulted individual industry stakeholders on the Task Force's proposal during July to August 2019 and they expressed support for the proposal. The proposal was also presented to the Hong Kong Maritime and Port Board and the Hong Kong Shipowners Association in early September and early November 2019 respectively. Industry stakeholders supported the proposal and opined that the proposed tax regime would be conducive to enhancing Hong Kong's attractiveness as a base for ship leasing business.

Way Forward

16. We plan to introduce the relevant legislative amendments into the Legislative Council in February 2020.

Transport and Housing Bureau
Inland Revenue Department
November 2019