

The US notified Hong Kong of the termination of the shipping agreement

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In brief

The US Department of State officially notified¹ Hong Kong on August 19, 2020 of the suspension or termination of three bilateral agreements signed between Hong Kong and the US, including the Agreement concerning Tax Exemption from the Income Derived from the International Operation of Ships (the Shipping Agreement).

While the effective date and further execution details of the suspension or termination of the Shipping Agreement are yet to be clarified, this news flash highlights some of the considerations and potential impact for shipping groups that may be affected by this development.

In detail

Background

The US Department of State officially notified Hong Kong on August 19, 2020 of the suspension or termination of the following three bilateral agreements signed between Hong Kong and the US:

1. the Agreement on the Surrender of Fugitive Offenders;
2. the Transfer of Sentenced Persons Agreement; and
3. the Agreement concerning Tax Exemption from the Income Derived from the International Operation of Ships (the Shipping Agreement).

The HKSAR Government issued a press release on August 20, 2020 to respond to the US' decision to suspend or terminate the above three bilateral agreements².

The potential impact for shipping groups

Currently, there is not a comprehensive double tax agreement between Hong Kong and the US. The Shipping Agreement was the only bilateral agreement between Hong Kong and the US offering a reciprocal tax exemption on shipping income. We highlight below some of the considerations and potential impact of the imminent cancellation of the reciprocal tax exemption for shipping groups:

1. The Shipping Agreement provided reciprocal tax exemption on income derived from the international operation of ships by the US and Hong Kong residents, subject to fulfilment of certain conditions. Termination of the Shipping Agreement would potentially affect:

- a. Shipping companies incorporated or organised in the US claiming reciprocal tax exemption in Hong Kong;
 - b. Shipping companies incorporated in Hong Kong or managed or controlled in Hong Kong claiming reciprocal tax exemption in the US; and
 - c. Non-Hong Kong shipping companies formed in other countries that travel to or from the US, but relying on the ultimate ownership of Hong Kong residents to qualify for the US reciprocal tax exemption (e.g. some private equity groups / investment funds with portfolio investments in shipping companies).
2. It is worth noting that, even in the absence of the Shipping Agreement, companies under (1)(b) & (c) above may still be able to achieve reciprocal exemption under the domestic US income tax laws and regulations. Eligibility would be subject to the various conditions under the domestic US income tax laws (including but not limited to ultimate ownership, basis of income exemption under Hong Kong Inland Revenue Ordinance (IRO), etc). Detailed assessment and impact analysis would therefore be required on a case-by-case basis.
 3. In a nutshell, for companies that do not qualify for any exemption in the US, their US-sourced gross transportation income would generally be taxed on a gross basis at 4%, in lieu of regular income taxes on net income. Income from the carriage of cargo that originates or ends in the US is treated as 50% US sourced. Charter revenue is sourced based on how the ship is used by the lowest tier lessee. Incidental income would be taxed under the ordinary US tax rules. State and local taxes are not necessarily based on the federal tax law and may vary by locations.
 4. On the other hand, the Hong Kong profits tax position for companies under (1)(a) should be reviewed and assessed according to the domestic tax law of Hong Kong. Section 23B of the IRO offers profits tax exemption in Hong Kong for ship operating income, subject to certain specified conditions. To assess the eligibility for tax exemption under section 23B, it is required to consider the company's place of management and control, business models as well as business substance in Hong Kong. Depending on the business arrangements, it may also be possible to explore the applicability of the new tax incentives for ship leasing activities in Hong Kong.

The takeaway

While the effective date and further execution details of the suspension or termination of the Shipping Agreement are yet to be clarified, shipping groups with their vessels operating between Hong Kong and the US should take action now to assess the potential impact of the cancellation of the reciprocal tax exemption on them and consider what alternative business structures or operating models are feasible.

Endnotes

1. The press statement issued by the US Department of State can be accessed via this link:
<https://www.state.gov/suspension-or-termination-of-three-bilateral-agreements-with-hong-kong/>
2. The press release issued by the HKSAR Government can be accessed via this link:
<https://www.info.gov.hk/gia/general/202008/20/P2020082000265.htm>

Let's talk

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