

Recommendations for Developing Hong Kong as an Aircraft Leasing and Financing Hub



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I. Background

1. In its latest global market forecast, Airbus predicts that over the next 20 years (2017-2036), air traffic will grow at 4.4 per cent annually, requiring some 35,000 new passenger and dedicated freighter aircraft at a value of US\$5.3 trillion over the next 20 years. Traffic between emerging countries is forecast to grow at 6.2% per annum, and will represent a growing share of air traffic, from 29% of world traffic in 2016 up to 40% by 2036. Asia-Pacific will lead world traffic by 2036, with a threefold increase in the traffic serving this region by the end of the forecast period. Domestic China will become the largest traffic flow before the end of 2036 and is forecast to almost quadruple.

2. At present, approximately 42% of the aircraft operated by airlines are under operating leases. Eighty percent of the market is dominated by the top 20 aircraft lessors, of which seven are from Asia Pacific, including China, Japan and Hong Kong.

3. Aircraft leasing is a global business that is subject to geographic boundaries. As a result, many international aircraft lessors choose to register their businesses in the traditional aircraft leasing hubs, namely Ireland and Singapore, so as to benefit from incentive policies, and leverage on the better-developed financing tools and professional talents.

4. Compared to the traditional aircraft leasing hubs (Ireland and Singapore), Hong Kong is better positioned to develop its aircraft leasing industry. Strategically located at the heart of Asia Pacific, Hong Kong is a renowned metropolis with acclaimed free trade and legal systems, well supported by the unique principle of “one country, two systems”. If the Hong Kong Government is able to position the city as an international aircraft trading centre by providing new tax incentives that are comparable to or more competitive than those of other countries, many international aircraft lessors will be encouraged to redomicile to Hong Kong. Collaborating with the Tianjin Binhai New Area and the Shanghai Pudong New Area, which provide aircraft leasing services to mainly Chinese airlines, Hong Kong will be able to

dominate the business of aircraft leasing in Asia Pacific, thus capitalising on the rapidly-increasing demand for aircraft leasing and financing services on a global basis.

Passage of the Inland Revenue (Amendment) (No.2) Bill 2017

5. The development of the aircraft industry has in the past been constrained by the following tax issues:

i. High Corporate Tax Rate (16.5%)

Although the corporate profits tax rate of 16.5% in Hong Kong is lower than that of many other jurisdictions, the city does not offer any tax incentives for the aircraft leasing industry. However, aircraft lessors enjoy significant tax advantages at the two traditional aircraft leasing hubs, with corporate tax rates set at 12.5% in Ireland and 5% or 10% in Singapore (which is further streamlined to a single rate of 8% from 1 April 2017 onwards). Tax deductions on aircraft depreciation and interest expenses incurred by aircraft financing are also available for aircraft lessors.

ii. No Tax Deduction for Aircraft Depreciation for Aircraft leased to non-Hong-Kong Airlines

Pursuant to Section 39E of the Inland Revenue Ordinance, under certain circumstances, initial or annual tax allowances cannot be applied to the capital expenditure incurred by leasing parties on the provision of machinery or industrial equipment. For example, aircraft lessors cannot be awarded the prescribed initial or annual allowances for aircraft leased to air operators outside Hong Kong. As a result, the profits tax payable by aircraft lessors are calculated based on their gross lease income, instead of actual profit, thus leading to a significant reduction of their after-tax profit.

6. The Government has taken the initiative of introducing a concessionary tax regime for attracting more aircraft leasing groups to set up their aircraft leasing hubs

in Hong Kong. The Inland Revenue (Amendment) (No.2) Bill 2017 was recently passed at the Legislative Council on 28 June 2017, establishing a concessionary tax regime to reduce the profits tax of qualifying aircraft lessors and aircraft leasing managers. Details are as follows:

- i. Set the profits tax rate for qualifying aircraft lessors and aircraft leasing managers at 8.25%, which is half of the standard profits tax rate; and
- ii. Deem the taxable amount of profits derived by qualifying aircraft lessors from leasing of aircraft to non-Hong Kong aircraft operators to 20% of the gross lease payments less deductible expenses, excluding tax depreciation allowance.

7. In its preliminary analysis, PricewaterhouseCoopers noted that the new tax regime will result in a reduced effective tax rate of about 3-6% for aircraft transactions in Hong Kong, which is lower than that in Ireland (12.5%) and Singapore (8%).

8. The Government's initiative to introduce this concessionary tax regime is highly visionary and pragmatic, aiming to forge Hong Kong into an aircraft financing hub within a short period. According to Government estimation, with the introduction of the new tax regime, the market share of Hong Kong in the global aircraft leasing business will reach 18% in 20 years, offering over HK\$700 billion for aircraft financing (based on a total of 3,240 airplanes). 1,640 employees will be hired directly, and over 13,700 jobs will be created on an indirect basis. The profits tax generated will exceed HK\$10 billion, and over HK\$430 billion will be added to the GDP of Hong Kong. This will not only further diversify the financial service industry of Hong Kong, but also stimulate economic growth of the city, creating more employment opportunities. This will put Hong Kong into a more competitive position against the traditional aircraft leasing hubs. We are confident that there is enormous potential for Hong Kong to develop into a premier aircraft leasing and financing hub in international arena.

II. Recommendations

9. Backed by the Mainland, Hong Kong is the largest international financial centre of China. With its intrinsic strengths, such as a premium geographic location, well-developed legal system, reliable financial system, comprehensive infrastructure and high value-added products and services, the city plays a pivotal role in supporting the development of China. If Hong Kong can gradually develop into an international aircraft leasing and financing hub, it will complement the Tianjin Binhai New Area and Shanghai Pudong New Area to capture the robust opportunities in the pipeline, resulting in enhanced economic development and global influence of China. Through leveraging its strengths with those of the mainland aircraft leasing industry, Hong Kong will be able to attract more foreign companies to build their aircraft leasing business in Greater China. With this vision in mind, we set out below a number of recommendations:

A. Tax Treaty Network

10. The current tax treaty network of Hong Kong is relatively limited, with only 36 double taxation agreements signed, approximately half of that of Ireland (72) and Singapore (over 80). Generally speaking, foreign withholding taxes are applicable to Hong Kong aircraft lessors on the lease income generated from leasing of aircraft to foreign airlines, and the airlines are usually responsible for the tax payments. To the contrary, Ireland and Singapore have signed double taxation agreements with a large number of countries, effectively minimising the tax burden of cross-border aircraft leasing businesses. Because of this arrangement, many foreign airlines prefer leasing from aircraft lessors registered in Ireland or Singapore.

11. Against this background, Hong Kong should speed up the work of reaching double taxation agreements with more countries and regions, in which more favorable terms should be sought in order to meet the needs of the aircraft leasing industry. The Hong Kong Government can also explore the feasibility of placing a higher priority at reaching bilateral taxation agreements on cross-border aviation income (including income from leasing business) with countries with high aircraft growth rates (such as

the US and countries in Asia and South America), so as to reduce the withholding tax incurred by leasing income. We also hope that the efforts of Hong Kong in this aspect can receive generous support from the Central Government.

12. The Arrangement for the Avoidance of Double Taxation signed between Hong Kong and Mainland China in 2008 was revised on 1 April 2015 (effective from 29 December 2015). Pursuant to the new arrangement, the withholding tax payable from Mainland to Hong Kong is reduced from 7% to 5%, lower than that to Ireland (6%) and Singapore (6%), thus enhancing the competitiveness of Hong Kong.

B. Policy Reforms

13. Hong Kong is the only common law jurisdiction in China, with well-established legislation, legal protection, law enforcement and arbitration arrangements. Business and property laws are also meticulously developed, covering a wide array of areas such as intellectual property protection, contracts, company operations, finance and competition. In addition, as an official language in Hong Kong, English is widely used in the business sector. All these elements are well familiar and trusted among international business parties. In addition to these, in order to facilitate the development of the aircraft leasing industry, the following policy reforms and promotion also need to be considered:

Cape Town Convention

14. The Cape Town Convention (the “Convention”) is designed to facilitate the leasing and financing of high-value mobile assets (including aircraft) by creating rights recognised in all contracting states. Protection of the interests of creditors and lessors is enhanced, thus reducing the costs of aircraft purchase and leasing by lowering the transaction risks of creditors and lessors. The objective of the Convention is to establish an internationally-recognised legal framework, and provide default-related remedial solutions, so that all contracting states are obliged to protect the international interests of creditors and lessors. The Convention came into force in the People’s Republic of China (the PRC) in 2009, but the Convention did not apply to the Special Administrative Regions of Hong Kong and Macau. Given that default is

a major risk faced by aircraft lessors and financiers, the Hong Kong Government may consider exploring with the Central Government to extend the application of the Convention to Hong Kong. This will allow Hong Kong to level with Ireland and Singapore, allowing aircraft lessors and financiers registered in the city to enjoy lowered financing costs of aircraft leasing under the protection from contracting states.

Listing Rules

15. Currently, three aircraft lessors are listed in Hong Kong. They are China Aircraft Leasing Group Holdings Limited (listed in 2014), BOC Aviation Limited and China Development Bank Financial Leasing Co., Ltd. (both listed in 2016).

16. Given the relatively larger transaction amounts involved in aircraft purchase and leasing, aircraft lessors listed in Hong Kong are usually required to comply with fairly onerous continuing obligations under the Listing Rules. This not only includes the disclosure of a lot of operational and commercial information that is strictly confidential, but also leads to increased legal expenses, thus impacting the business efficiency of aircraft lessors. Having monitored compliance of the Listing Rules by the few listed aircraft lessors for a few years, the Hong Kong Exchanges and Clearing Limited (HKEX) has agreed to dispensed with certain continuing obligations under the Listing Rules, recognising the information sensitivity in aircraft transactions (including aircraft selling price and rental levels), and provided certain waivers for transactions defined as operating leases (not applicable to transactions related to financial leases). Despite so, compliance costs and time involved in seeking such waivers are still considerable and, as such, the operating cost of these listed lessors remains high. Considering the unique nature of the aircraft leasing industry, we recommend the regulators to revise the Listing Rules, so that all aircraft lessors can enjoy the same waiver and make better use of the HKEX platform to help develop Hong Kong into an aircraft leasing and financing hub..

Aircraft Investment Trusts

17. In recent years, as market participants continue to build up their knowledge

about the aircraft leasing industry, institutional investors demonstrate a fast-growing demand for aviation-related USD long-term fixed income products, especially investment products from aircraft securitisation. We recommend that the SFC considering allowing the listing of aircraft securitisation products in the form of investment trusts, so that they can appeal to institutional and retail investors, as in the case of real estate investment trusts (REITs). As a matter of fact, the length of aircraft leases normally ranges from eight to twelve years, much longer than the two to three years of local property leases. In addition, the clients of aircraft lessors, mainly airlines, are located across the world, contributing to a less concentrated default risk. All these elements make aircraft assets more suitable for securitisation. This initiative can further consolidate the position of Hong Kong as an international financial centre.

C. Aircraft Financing Arrangements

18. At present, there is only a handful of financial institutions participating in aircraft financing deals in Hong Kong. Many aircraft financing and leasing corporations operated in Asia choose to register in Singapore for tax and accounting reasons, there is, in turn, a lack of experienced local financial institutions in the aircraft financing sector.

19. A number of issues need to be resolved before Hong Kong can arrange aircraft financing in a more efficient manner. First, except for residential mortgages, local banks currently only offer short to medium-term loans with a repayment period normally not more than five years, which cannot match with the period of eight to twelve years required by standard aircraft leasing agreements. Second, the requirements of Hong Kong Monetary Authority on bank loans and loan-to-value ratio also pose an impact on the financing standards and lead to the issue of aircraft residual value. If the regulator can relax the loan requirements of banks, the aircraft leasing and financing industry will be benefited.

D. Talent Nurturing

20. Every November, *Airfinance Journal* and *Airlines Economics* organise a trade forum in Hong Kong to discuss the latest developments in the aircraft financing

industry. However, the forum tends to be foreign aircraft lessors and foreign banks oriented.

21. Based on the experience of hosting aviation forums in the Tianjin Binhai New Area, local aircraft lessors and Chinese banks are indeed well-placed to assist the Government in organising trade forums under the themes of aircraft leasing and financing. Following the success of foreign counterparts, these trade forums can focus on key issues relevant to the current development of the industry and explore ways to bring the domestic market in line with the international one through tax, legal, financial and trade regime. Trainings can also be provided to nurture local talents in aircraft financing.

22. The aviation industry has been highly monopolised by the western world. We hope that with the support from the Mainland market, Hong Kong can ride on its strengths in the areas of legal system, taxation, language and culture, which are closely integrated with the western countries. Coupled with its leading position as an international financial centre, the city can speed up the industry and finance combination of the aviation industry, playing an active role in the development of the global aviation sector. Since aviation players in different countries usually maintain close interactions with their governments, we hope that under the guidance of the Belt and Road Initiative of China, Hong Kong can bring together corporations in the region to contribute more to developing the aircraft leasing, new and used aircraft trading and spare parts dealing businesses in the city, and attracting more aircraft lessors to raise funds in the capital and bond markets of Hong Kong. This will create more employment opportunities and hence facilitate the economic growth of Hong Kong.

23. In addition, we recommend the establishment of aircraft financing and maintenance courses by universities and vocational education institutes in Hong Kong, and the provision of pilot training programmes by airlines. This will nurture a larger pool of professional talents and thus help Hong Kong develop as an aircraft financing hub.

About the Financial Services Development Council

The Hong Kong SAR Government announced in January 2013 the establishment of the Financial Services Development Council (FSDC) as a high-level and cross-sector platform to engage the industry and formulate proposals to promote the further development of Hong Kong's financial services industry and map out the strategic direction for development. The FSDC advises the Government on areas related to diversifying the financial services industry, enhancing Hong Kong's position and functions as an international financial centre of our country and in the region, and further consolidating our competitiveness through leveraging the Mainland to become more global.

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