

**For discussion on
23 January 2017**

Legislative Council Panel on Economic Development

**Proposed Dedicated Tax Regime
to Develop Aircraft Leasing Business in Hong Kong**

PURPOSE

This paper briefs Members on the legislative proposal to amend the Inland Revenue Ordinance (IRO) (Cap. 112) to create a dedicated tax regime to attract aircraft leasing business to Hong Kong and create a new professional service industry and job positions.

BACKGROUND

Global trend

2. Civil aviation is a long-term growth business, with global aviation passengers expected to grow at about 5% per annum while passengers in the Asia Pacific region growing by about 6% per annum over the next 20 years¹. New aircraft delivered worldwide and in Asia Pacific are estimated at over 39 000 (valued at about HK\$46.2 trillion or US\$5.9 trillion) and over 15 000 (valued at about HK\$18.3 trillion or US\$2.4 trillion) respectively².

3. Financing this growth presents major business opportunities open for financial and other professional services to grasp. According to analysis conducted by the industry, the proportion of new aircraft being financed by leasing rose from less than 1% 40 years ago to about 32% in 2011. This proportion is expected to grow about 40% by 2020³. Globally, demand for financing aircraft purchase is forecast to increase steadily at compound annual growth rate of about 6.7% between 2012 and 2019, with about HK\$952 billion (about US\$122 billion) financing requirement in 2016. Bank debts and capital market are the major sources of financing.⁴

¹ Source: *Current Market Outlook 2016-2035, World regions* published by Boeing Capital

² Source: *Current Market Outlook 2016-2035, World regions* published by Boeing Capital. All dollars values are in 2015 prices.

³ Source: *The Commercial Aircraft Leasing Market 2011-2021* by market consultant, Visiongain Ltd in 2011

⁴ Source: *Current Aircraft Finance Market Outlook 2017* published at Boeing's website

Market opportunities in the Mainland

4. Under the global trend, there has been sizeable growth in aircraft demand by mainland airlines, which in turn induces demand for aerospace financing. According to analysis conducted by the industry, from 2012 to 2032, mainland airlines will need nearly 6 000 new aircraft, valued at about HK\$6,100 billion (US\$780 billion), accounting for more than 40% of the forecasted deliveries to the Asia Pacific region⁵. While aircraft leasing business was originated in Ireland, there has been trendsetting migration of lessors to Asia in recent years, driven mainly by growth in the aviation sector in the Mainland. Intra-Asia activities are particularly noticeable.

Hong Kong perspective

5. Hong Kong is currently not a competitive location for aircraft leasing business. Out of the top 10 global aircraft lessors⁶, 10 have business presence in Ireland, eight in Singapore⁷ and only two in Hong Kong⁸. The lack of an attractive tax regime is a major factor. Aircraft leasing is an international and transregional business, which is not bound by location. Therefore, tax factor is one of the key considerations of aircraft leasing companies in selecting the place of domicile for their business.

6. When compared with Ireland and Singapore, our applicable tax rate is higher, and there is no depreciation allowance. Currently, applicable tax rates for aircraft leasing business in Ireland, Singapore and Hong Kong are 12.5%, 5% or 10%⁹ and 16.5% respectively. Furthermore, our tax treaty network is relatively limited. Currently, Ireland, Singapore and Hong Kong have concluded 72, 84 and 36 tax treaties respectively (including those which have been signed but yet entered into force).

7. However, as a successful international financial centre, Hong Kong already possesses favourable conditions necessary for developing aircraft leasing business, namely, our sound legal system, banking system, well-developed and diversified capital markets, excellent aviation infrastructure and talents and proximity to the mainland market. Hong Kong should not miss the opportunity of taking a share in the global aircraft leasing business to strengthen

⁵ Source: *Current Market Outlook 2012-2032, China* published by Boeing Capital.

⁶ The top 10 global aircraft lessors are GE Capital Aviation Services (GECAS), International Lease Finance Corporation (ILFC), AerCap, CIT Group, SMBC Aviation Capital (formerly RBS Aviation Capital), Babcock & Brown, BOC Aviation, Aviation Capital Group, AWAS and Macquarie AirFinance.

⁷ The eight top global aircraft lessors that have presence in Singapore are GECAS, ILFC, AerCap, CIT Group, SMBC Aviation Capital, Babcock & Brown, BOC Aviation and Aviation Capital Group.

⁸ Two aircraft lessors, namely GECAS and BOC Aviation, have offices in Hong Kong. However their operations are currently not based in Hong Kong.

⁹ Applicable tax rate is subject to the scale of aircraft leasing business.

Hong Kong's economic capabilities and position as a financial centre. A supportive tax regime is what we lack at the moment.

8. Incidentally, Hong Kong and the Mainland signed, in April 2015, the Fourth Protocol to the 2008 Double Taxation Arrangement between Hong Kong and the Mainland, which reduces the withholding tax rate from 7% to 5% on lease rentals derived from aircraft and ship leasing businesses covered under the Royalties article (lower than the 6% rate in the Mainland's double taxation agreements with our main competitors (Ireland and Singapore)). This provides a solid foundation for Hong Kong to attract global lessors, including those from the Mainland.

9. In the past two years, the Government discussed the proposal with the aviation and financial sectors through the Economic Development Commission (EDC)¹⁰ (see paragraph 13 below), which are very supportive of Hong Kong becoming an aerospace financing centre. Therefore, promoting aircraft leasing business in Hong Kong was among the initiatives of the Chief Executive's Policy Address in 2015 and 2016. The Financial Secretary also mentioned in the 2016-17 Budget that the Government will examine the use of tax concessions to boost related business.

THE PROPOSAL

10. To create a conducive environment for offshore aircraft leasing transactions in Hong Kong (i.e. the lessees are non-Hong Kong aircraft operators), we propose a new dedicated regime in which –

- (a) the tax rate on the qualifying profits of qualifying aircraft lessors and qualifying aircraft leasing managers will be 50% of the profits tax rate for corporations (i.e. half of the prevailing tax rate of 16.5%); and
- (b) the taxable amount of rentals derived from leasing of an aircraft to a non-Hong Kong aircraft operator by a qualifying aircraft lessor will be equal to 20% of the tax base i.e. gross rentals less deductible expenses (excluding tax depreciation).

¹⁰ The EDC was established in 2013 to provide visionary direction and advice to the Government on the overall strategy and policy to broaden Hong Kong's economic base and to enhance Hong Kong's economic growth and development; and, in particular, to explore and identify growth sectors or clusters of sectors which present opportunities for Hong Kong's further economic growth, and recommend possible policy and other support for these industries. Working Group on Transportation is one of the four working groups under the EDC.

11. The dedicated regime will incorporate anti-abuse features so as to maintain the integrity of the profits tax framework of the IRO, including –

- (a) ensuring that the half-rate concession will apply to assessable profits in respect of which the corresponding payments made are not fully tax-deductible in Hong Kong for preventing revenue loss;
- (b) requiring qualifying aircraft lessors and qualifying aircraft leasing managers to be standalone corporate entities to prohibit loss shifting; ensuring that they conduct business transactions with associated parties on an arm's length basis; and
- (c) requiring their central management and control as well as profit generating activities to be located in Hong Kong so as to ensure that they have commercial substance in Hong Kong, etc.

POTENTIAL BENEFITS OF THE PROPOSAL

12. According to the analysis conducted by the Focus Group on Promoting Aerospace Financing in Hong Kong (the Focus Group) under the Working Group on Transportation (TWG) of the EDC, if Hong Kong is able to develop a new tax regime for offshore aircraft leasing, Hong Kong could gradually capture up to about 18% of aircraft leasing business in the global aircraft leasing market in 20 years' time¹¹. This would mean (in Year 20 or before) –

- (a) financing for over 3 200 aircraft with an asset value of about HK\$707 billion;
- (b) direct employment of around 1 640 people and about HK\$2 billion in staff compensation;
- (c) profits tax paid by aircraft leasing companies of about HK\$1 billion in Year 20 and a total of more than HK\$10 billion over a 20-year period (the calculation was based on the proposed tax rate on qualifying profits (i.e. 8.25%) and proposed taxable amount of rentals (i.e. 20% of the gross rentals less deductible expenses (excluding tax depreciation) as proposed in paragraph 10 above).¹²;

¹¹ The figures depend very much on the extent of tax concessions, more particularly the adoption of the tax base percentage of 20% and the profits tax rate.

¹² The actual profits tax payable is subject to actual amounts of lease rentals, the tax base percentage and the profits tax rate.

(d) a cumulative Gross Domestic Product value added of over HK\$430 billion over a 20-year period; and

(e) over 13 700 indirect jobs due to the linkage and multiplier effects.

Currently, as there is no sizeable aerospace financing business in Hong Kong, the associated tax revenue is negligible. Providing tax concessions will, therefore, not create loss in revenue on the part of the Government. On the contrary, it will attract relevant companies to establish in Hong Kong, and will in turn promote economic developments and generate tax revenue.

CONSULTATION

13. We have consulted the EDC and the TWG under it. We have also incorporated technical input from the Focus Group on Promoting Aerospace Financing in Hong Kong under the TWG, which is represented by aviation industry stakeholders, legal professional and consultant specialising in large asset financing. We have, in the meantime, established initial contacts with some aircraft leasing companies. These companies indicated that they would actively consider setting up in Hong Kong should there be a competitive tax regime. It will help them to enter the aircraft leasing markets in the Mainland and in Asia more effectively.

14. As mentioned in paragraph 10 above, the proposed tax regime targets at offshore aircraft leasing transactions (i.e. the lessees are non-Hong Kong aircraft operators). Local airlines will, therefore, not directly benefit from the proposed dedicated tax regime. However, local airlines believe that promoting aircraft leasing business in Hong Kong will enhance the soft power of Hong Kong in being an international aviation hub. They are supportive of the proposal.

15. The Hong Kong Monetary Authority has conducted a reality check to assess the business case for attracting aircraft leasing business to Hong Kong, focusing on the banking and financial sectors. The reality check concluded that Hong Kong should be in a good position to capture opportunities arising from the growing aircraft leasing sector if the tax playing field is levelled.

16. Apart from consulting the Panel on Economic Development of the Legislative Council, we will also inform the Joint Liaison Committee on

Taxation¹³ of the above proposal with a view to gauging further views from stakeholders of the relevant industries.

WAY FORWARD

17. We plan to introduce the relevant legislative amendments into the Legislative Council in around April 2017.

Transport and Housing Bureau
Financial Services and the Treasury Bureau
Inland Revenue Department
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¹³ The Joint Liaison Committee on Taxation (JLCT) is a discussion forum set up on the initiative of the accountancy and commercial sectors in 1987. It discusses various issues and reflects the views of the industry to the Government. The JLCT is not an advisory body established or appointed by the Government, though Government officials are invited to attend its meetings. The JLCT is an umbrella organisation comprising private sector representatives nominated by chambers of commerce, the Hong Kong Institute of Certified Public Accountants, the Taxation Institute of Hong Kong, the Law Society of Hong Kong, and the International Fiscal Association.