

# *PwC Aviation Finance and Leasing Forum*

Hong Kong — Promising Asia's  
Aircraft Leasing Hub

8 February 2017



On 8 February 2017, PwC hosted its first Aviation Finance and Leasing Forum at our PwC office in Central. This forum, Hong Kong — Promising Asia's Aircraft Leasing Hub, examined the global market and growth of the aircraft leasing industry and an examination on the policy updates in Hong Kong.



From left to right, Tejaswi Nimmagadda, Dewey Yee, Thomas Kaplan, Clarence Leung, Liu Yi, William Ho, Patrick Liu, Catherine Tsang, Charles Chow, Monica Ng, Keith Chau

### ***Keynote address by Dewey Yee of the Working Group on Transportation***

Dewey, a member of the Working Group on Transportation under the Economic Development Commission appointed by the Chief Executive, Mr Leung Chun-Ying, recalled when he first received a call back in January 2013 inviting him to be on the Working Group examining the transport pillar of Hong Kong's future economic development, a call which he thought initially was a hoax. From that fateful night he elaborated on how he, other members of the Working Group together with the help from the Focus Group, had worked towards the goal of creating more wealth in Hong Kong through the establishment of an international aircraft leasing hub and attracting more aircraft leasing companies to establish operations here.

He was very pleased that after more than 4 years of hard work by the Working Group and the Focus Group, a paper outlining the proposed dedicated tax regime for aircraft finance & leasing was submitted to the Panel on Economic Development in the Legislative Council on 23 January 2017 which kicked start the legislative process to introduce the relevant legislative amendments for this brand new industry in Hong Kong.



Dewey Yee, Working Group on Transportation

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## Future Growth of Airline Industry

Thomas Kaplan from Flight Ascend Consultancy, a leading data provider and consultancy on the global aviation industry, shared his views on the outlook for the global aircraft leasing industry. He noted that growth rates for passenger traffic and capacity (ASK, which measures an airline's passenger carrying capacity) in 2016 were 6.3% and 6.2% respectively and forecast traffic growth for the airline industry in 2017 is expected to be 5.1%, which is still respectable growth for the industry.



Thomas Kaplan, Flight Ascend Consultancy

Profits for airlines in the last two years are at record highs — partly due to low oil price — and, whilst the industry understands that these circumstances can change rapidly, periods of sustained losses like those seen in the early 2000's are unlikely to eventuate in the near future. This means that the outlook for the airline industry remains robust which should also benefit the aircraft leasing market as the aircraft leasing industry is a part and parcel of the airline industry.

The airline jet fleet has been growing steadily in the last few years reflecting the growth of the airline industry and the value of the aircraft ordered in 2016 was a respectable US\$96 billion. Single-Aisle aircraft remains as the favourite aircraft with approximately 65% of the total order or equivalent to a value of US\$63 billion. The total backlog of aircraft to be delivered in the future as at 1 January 2017 was approximately US\$933 billion showing a healthy demand of new aircraft in the future, and the potential opportunities for aircraft leasing.

As of 31 December 2016, the global in-service jet fleet contained approximately 23,000 commercial aircraft and this figure will continue to grow into 2017, driven by delivery of current orders and the clearing of backlogged orders which, while at near-record highs, has slightly decreased since 2015. The total forecast deliveries of new aircraft from 2016 to 2035 is approximately 39,720 which should represent a lucrative opportunities for aircraft financing & leasing.

Upcoming introductions of next generation aircraft will have a sizeable impact on fleet compositions with the Airbus 320 "Neo" leading in orders and the Boeing 737 "Max" close behind. Next generation aircraft orders account for 83% of aircraft on order so their introduction will see substantial changes in the composition of fleets in the future.

Operating leases currently account for around 42% of aircraft, with the top 20 lessors having nearly 80% of the leased fleet. It is interesting to see that out of the top 20 lessors, 7 of these are from the Asia-Pacific region, including China, Japan and Hong Kong. Key profit drivers for the aircraft leasing industry are rental payments and the residual value of the asset, with the value of the asset — the aircraft — subject to macro-economic conditions among other factors.





## Update on Policy Address

Clarence Leung, Tax Director at PwC Hong Kong, discussed the proposed dedicated tax regime to develop aircraft leasing business by the Hong Kong Government as outlined in the paper submitted to the Panel on Economic Development of the Legislative Council on 23 January 2017. He noted that under the current taxation regime in Hong Kong, the high effective tax rate represents a significant hurdle for aircraft lessors to enter into cross border aircraft leasing transaction as Hong Kong aircraft lessors are not entitled to claim any depreciation allowances. The estimated effective tax rate for Hong Kong is over 33% whereas Ireland and Singapore are only 12.5% and 5% or 10% respectively, subject to certain assumptions. Therefore, coupled with the limited tax treaty network (Hong Kong has 36 Double-Tax Agreements compared to Ireland's 72 and Singapore's 80+), there is currently no such businesses in Hong Kong.

Proposed changes as outlined by the Hong Kong Government including only "20% of the adjusted profits or deemed profits" taxed at 8.25% (i.e. half of the standard rate of 16.5% in Hong Kong) will lower the effective tax rate to approximately 3 to 4% for aircraft leasing transactions booked in Hong Kong. The reason for only 20% of the income is effectively taxed is to compensate for the lack of depreciation allowances under the proposed tax regime. As no depreciation allowances will be available under the proposed regime, broadly speaking, there should be no recapture of depreciation allowances on the disposal of the aircraft. As Hong Kong does not have capital gains, any profits on the disposal of the aircraft should not be subject to any profits tax. Essentially, under the proposed tax regime, there is a small leakage of cash tax under the proposed regime by the Hong Kong Government but with "low effective tax rate". As the amount of cash tax is small, it seems that the proposed regime would still be competitive when time value of money is taken into account. From a sustainable tax policy perspective, this may consider to be more robust given many countries are now putting the OECD's Base Erosion and Profit Shifting ("BEPS") initiatives into place as they reform their domestic legislation, therefore a small amount of "cash tax" may be worth paying in this new post-BEPS environment.

It is important for aircraft lessors to review the proposed tax regime based on their own circumstances to determine how the proposed regime may impact their businesses including tax. Nevertheless, this should represent a real choice for aircraft lessors in the future in determining the location of the asset owning entity especially many of the new lessors in China and Hong Kong have IPO in their mind for their aircraft leasing business. A low effective tax rate from a profit and loss perspective should be one of the key considerations. It is also expected that the proposed tax regime will be BEPS compliant and anti-abuse measures will be introduced to ensure losses cannot be transferred amongst various structures and that transactions with associated companies are carried out at arm's length, and that firms operating in Hong Kong have a substantial presence in the territory.

These changes are designed to put Hong Kong on a more equal footing with other financial leasing centres like Ireland and Singapore and enable Hong Kong to share in the growing global market for aircraft leasing.

The draft regulations are likely to be made available in March or April 2017. It is important for the industry to study the draft regulations in details as our observations are based on our general understanding of the proposed regime for aircraft finance & leasing industry and are subject to change.



Clarence Leung, PwC

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## Market panel

Given Hong Kong's relative late arrival to the aircraft leasing scene, panelists discussed what role, if any, Hong Kong would play in the global scene, any difficulties or hurdles to be overcome, what sort of players are likely to be attracted to Hong Kong as their aircraft leasing base, and other points as well as taking questions from the floor.

The panel participants noted that it was difficult to place Hong Kong in the global market for now and that it would be most suited to a niche-player role to start with. The most attractive part of using Hong Kong as an aircraft leasing base was its legal system, its role as a prominent financial centre in Asia, the infrastructure, the ease of setting and doing business and simple taxation system, and, with China's aviation industry forecast to grow continuously over the next 10-20 years, Hong Kong's natural position as a gateway to China would be reasserted in the aviation leasing industry.

Discussion also touched-on financing options available to lessors, and it was agreed that the Financial Sector in Hong Kong would have an important role to play especially there is no monetary restriction here. The Finance Professionals in Hong Kong are already familiar with many options of financing including ECAs finance, tax equity finance, bank loans etc. Given that the Hong Kong Government has recently introduced new tax rules on Corporate Treasury Centre, it will create more opportunities for aircraft lessors and financial institutions to work together to create more financing opportunities for the aircraft leasing market.

Final messages from the panel were that success would be determined at the macro level by government policies; while it was important to know micro-level details for operational aspects, that the development of the industry would take time — and again, success would be determined by the amount of support received — and finally, that there would need to be a concerted push to attract industry professionals to Hong Kong to leverage their skills and expertise.



From left to right, Charles Chow of PwC, Patrick Liu of Asia Pacific Aviation Leasing Group, John Fulton of Avolon, Monica Ng of PwC

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## Tax and legal panel

The final panel of the event looked at the taxation and legal issues for Hong Kong and other aircraft leasing centres. Participants were quizzed on whether Hong Kong had waited too long to try to establish itself as an aircraft leasing hub and what benefits Hong Kong could expect, whether or not Hong Kong would be competing with Tianjin which has done a lot to establish itself as an aircraft leasing centre over the last five years, and what factors they thought were necessary for the initiative to succeed.

Panelists generally thought that it was not too late for Hong Kong to become an aircraft leasing hub; its role as a global finance centre, proximity to China and the expected growth in the aviation industry globally, and open economy stood it in good stead to succeed with adequate government backing and legislative change. The main advantages of Hong Kong's which were highlighted are that it is a free market economy with relatively little government regulation, has no exchange control restriction policies, and good overall tax conditions — including no withholding tax on payments out of Hong Kong and no capital gains tax.



From left to right, Clarence Leung of PwC, Tejaswi Nimmagadda of King & Wood Mallesons, William Ho of Berwin Leighton Paisner LLP, Liu Yi of PwC, Catherine Tsang of PwC

It was the open economy in particular which led panel participants to state that Hong Kong would not be directly competing with Tianjin or other free trade zones given the complexity of Chinese tax law and other legal issues. There was a general consensus that Chinese aircraft lessors or Chinese airlines are likely to be interested to set up an aircraft leasing business in Hong Kong under this new initiative proposed by the Hong Kong Government. This may create win-win opportunities for both Hong Kong and China.

In terms of factors needed to succeed, in addition to the taxation changes outlined by Clarence Leung in his presentation, panelists agreed that the proposed tax rules should be BEPS compliant, and also the Hong Kong government should increase efforts on signing more new tax treaties with different countries and to ensure specific clauses are in place to minimise withholding tax payable on lease rentals in order to promote Hong Kong as an aircraft leasing hub, and that there is a good basis of financial, and technical expertise to leverage into the aviation sector for Hong Kong to exploit their talents and attract more people — particularly Chinese investors. Already, many of the top aviation lessors have Asian investors and so should be familiar with — if not established in — Hong Kong as a financial centre.



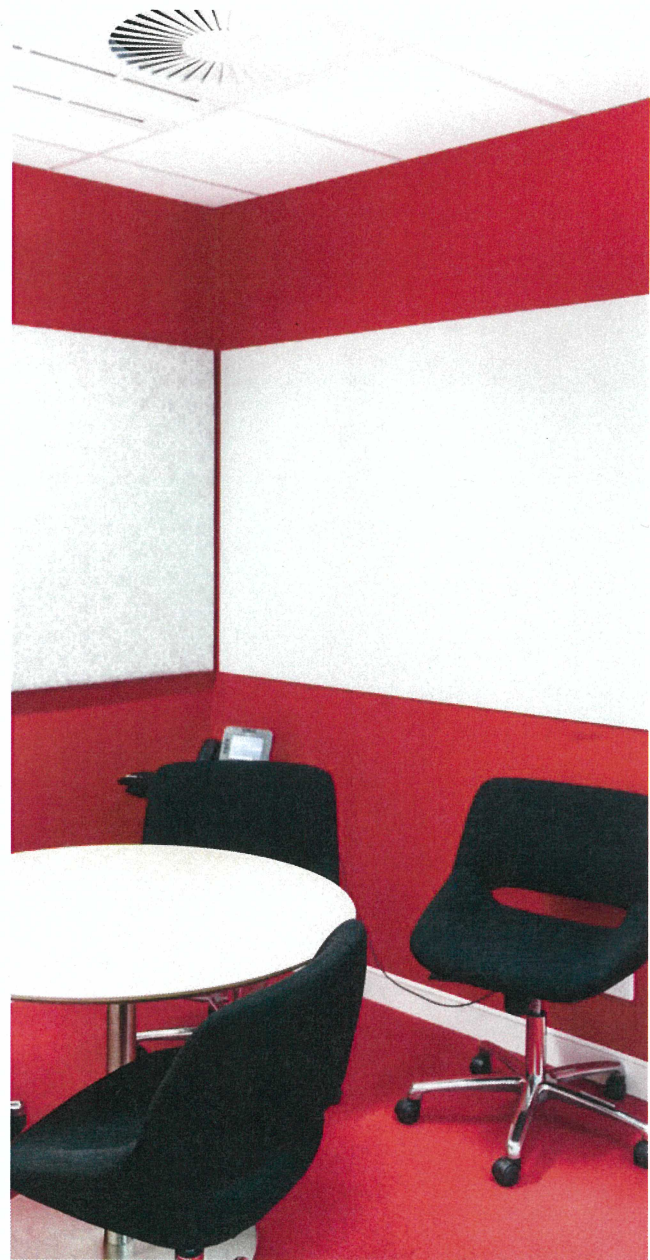
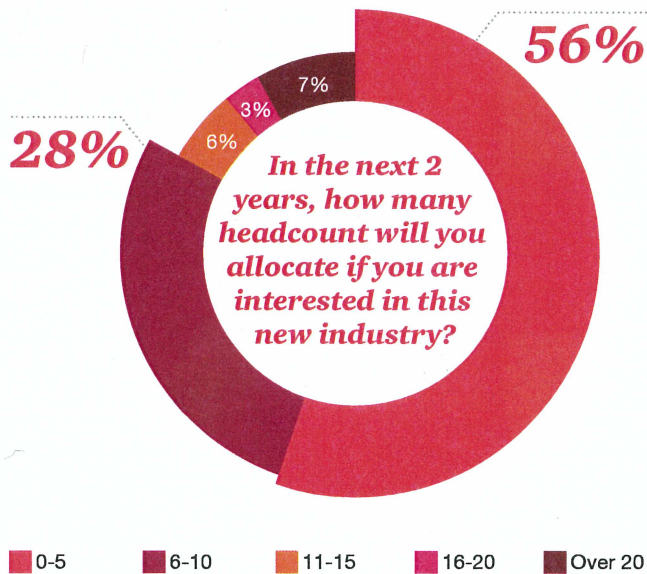
## Survey Results

# 93%

are confident that Hong Kong will become a promising Asia's aircraft leasing hub

# 91%

With the upcoming potential tax law changes in Hong Kong, 91% are attracted to this industry sector



## *A special thank you to all our speakers for sharing their insights*

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Working Group on Transportation

### **John Fulton**

Avolon

### **Patrick Liu**

Asia Pacific Aviation Leasing Group

### **Tejaswi Nimmagadda**

King & Wood Mallesons

### **Thomas Kaplan**

Flight Ascend Consultancy

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## *Who can help?*

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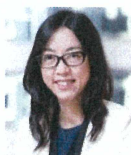
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