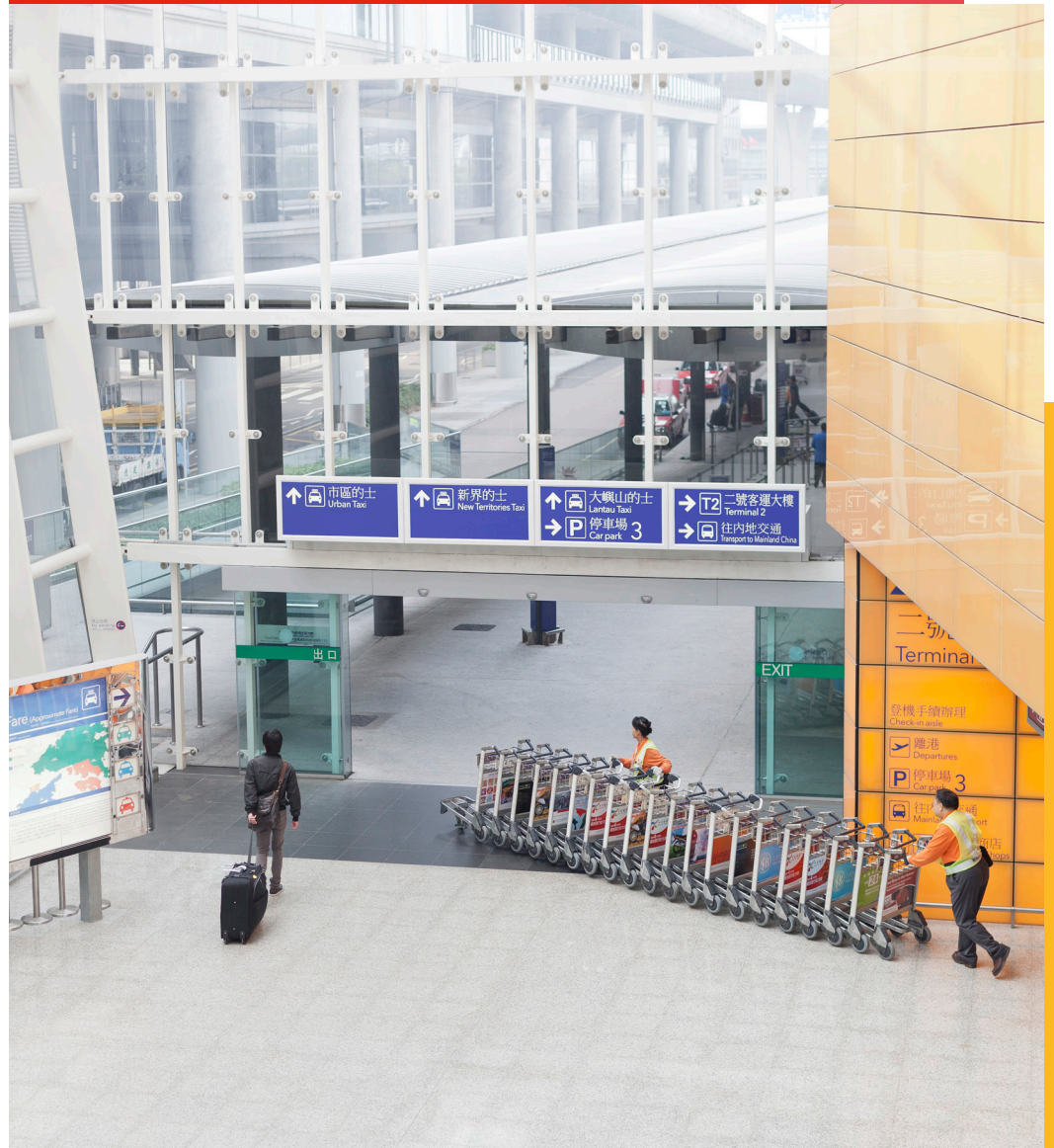


Aviation Leasing: Leveraging Hong Kong's Strengths





Background

Recent announced changes to taxation should allow Hong Kong to flourish as a centre for aviation leasing. In this way, Hong Kong will be able to make the most of two strategically important industries and areas of expertise: Financial Services and Logistics.

Potential changes to Hong Kong's taxation regime should pave the way for Hong Kong to establish itself as a leading aviation finance hub which can compete with such established centres as Ireland and Singapore.

This is a timely development: Globally, about a third of aircraft are now financed through leasing and China alone is forecast to need 6,000 new planes over the next 20 years.

According to the publication "Current Market Outlook 2013 – 2032" by Boeing, passenger traffic rose 5.3% in 2012. Furthermore, it is expected that over the next 20 years, world passenger travel would grow 5.0% annually. As a result, it is forecast by Boeing that 35,280 new aircraft, valued at US\$4.8 trillion will be required to meet growing demand.¹ Airbus has also forecast that the growth in passenger traffic will be at an average annual rate of 4.9%.²

The Asia Pacific economies are likely to play an important part in this growth, as it is forecast that during the next 20 years, nearly half of the world's air traffic will be driven by demands in the Asia Pacific region, with an

estimated growth rate of 6.3% per year. It is estimated that Asia Pacific airlines will need 12,820 aircraft, valued at US\$1.9 trillion, over the next 20 years. The number of aircraft in the Asia Pacific fleet will nearly triple, from 5,090 in 2012 to 14,750 in 2032.³ Similarly, Airbus has forecast that Asia Pacific will become the most important region for global air traffic at approximately 34%, followed by Europe at 22% and then America at 18%. The number of new aircraft deliveries to the Asia Pacific region is estimated to be 10,941 over the next 20 years.

World regions Key indicators and new airplane markets

Growth measures		New airplanes		Share by size
Economy (GDP)	3.2%	Large widebody	760	2%
Traffic (RPK)	5.0%	Medium widebody	3,300	9%
Cargo (RTK)	5.0%	Small widebody	4,530	13%
Airplane fleet	3.6%	Single aisle	24,670	70%
		Regional jets	2,020	6%
		Total	35,280	
Market size		2012 Fleet		2032 Fleet
Deliveries	35,280	Large widebody	780	910
Market value	\$4,840B	Medium widebody	1,520	3,610
Average value	\$140M	Small widebody	2,310	5,410
		Single aisle	13,040	29,130
		Regional jets	2,660	2,180
		Total	20,310	41,240

Current Market Outlook
2013 – 2032

Copyright © 2013 Boeing. All rights reserved.

Asia Pacific Key indicators and new airplane markets

Growth measures		New airplanes		Share by size
Economy (GDP)	4.5%	Large widebody	260	2%
Traffic (RPK)	6.3%	Medium widebody	1,470	11%
Cargo (RTK)	5.8%	Small widebody	1,860	15%
Airplane fleet	5.5%	Single aisle	8,810	69%
		Regional jets	420	3%
		Total	12,820	
Market size		2012 Fleet		2032 Fleet
Deliveries	12,820	Large widebody	330	350
Market value	\$1,890B	Medium widebody	500	1,550
Average value	\$150M	Small widebody	660	2,080
		Single aisle	3,470	10,350
		Regional jets	130	420
		Total	5,090	14,750

Current Market Outlook
2013 – 2032

Copyright © 2013 Boeing. All rights reserved.

¹ Current Market Outlook 2013 – 2032, World regions published by Boeing Capital

² Global Market Forecast Future Journeys 2013 – 2032 published by Airbus

³ Current Market Outlook 2013 – 2032, Asia Pacific regions published by Boeing Capital



China will continue to lead in the Asia Pacific region in terms of new deliveries. Over the next 20 years, Chinese airlines will need nearly 6,000 new aircraft, valued at US\$780 billion, accounting for more than 40% of the forecast deliveries to the Asia Pacific region.⁴ In short, China accounts for approximately 16% of the total world demand in terms of both new deliveries and market value.

As a result, there will be a significant need for aircraft leasing, financing and investment in order to meet the rapidly growing aircraft demand. Among the various types of aircraft financing, lease financing has grown substantially over the years. Currently, approximately 32% of the global air fleet are financed with leases, compared to less than 1% 40 years ago.

Such an increase in aircraft demand and reliance on lease financing has presented an attractive opportunity for global aircraft lessors to boost their presence in China and tap into the world's fastest growing aviation market. Consequently, many aircraft lessors are considering moving to an Asian aerospace hub, outside traditional jurisdictions like Ireland and the United States, to capture this potentially lucrative opportunity.

Market commentators have often stated that Hong Kong, Singapore and China will be the likely options. Indeed, Singapore has taken major steps in providing a more favourable tax regime and policy incentives for aircraft lessors to set up operations in Singapore. In an interview with the Financial Times in 2012, the Chief Executive of Hong Kong, CY Leung, pointed out that Singapore has caught up with Hong Kong and has grown as a global transportation centre and a leading international maritime centre. Analysts have indicated that this was to a large extent due to the general features of the tax system as well as the targeted tax incentives available in Singapore. While this may be true, it is important to appreciate that Singapore has other incentives such as international aircraft leasing and offshore leasing incentives. Although the headline tax rate in Singapore is 17%, which is higher than Hong Kong's 16.5%, companies engaging in approved aircraft leasing businesses can enjoy a tax rate of either 5% or 10%. All these policy incentives demonstrate that the Singapore Government is committed to appealing to international aircraft lessors to base their Asian operations in Singapore, which is clearly working ahead of Hong Kong.

⁴ Current Market Outlook 2012 – 2032 China published by Boeing Capital

The Chinese Premier Li Keqiang visited Tianjin in December 2013 to examine the growth of the aviation finance & leasing industry. During his visit, he said that the Chinese Government should foster the growth of the financial leasing industry, as it would make significant contributions to the economy in China.

At about the same time, “Opinions on Accelerating the Development of the Aircraft Leasing Industry” was issued by the State Council of the People’s Republic of China (国办法 [2013] 108 号) (“Circular No. 108”).

Circular No. 108 states that the aircraft leasing industry has an important role to play in providing the crucial supporting services to the aviation industry, including the aeronautical manufacturing industry, transportation industry, general aviation industry and the financial services sector. As China develops into a moderately prosperous society, the aircraft leasing industry possesses great development potential.

Circular No. 108 points out that the coming two decades will be the key period for the development of the Chinese aircraft market, including the aeronautical manufacturing industry. It will be the golden age for the growth of aircraft leasing industry. At present, China is at the critical stage of developing strategic industries. The aircraft leasing industry should play an important role in the China economy in the future.

Circular No. 108 provides a framework to map out the future development of the aircraft industry under a “3 step” strategy:

1. Before 2015, strive to create a conducive political environment for the aircraft leasing industry by understanding local conditions, respecting market rules and drawing on international experience.
2. From 2015 to 2020, optimize further the political environment, strengthen State guidance and cultivate leading enterprises. Support aircraft leasing companies to consolidate and expand the domestic market, and actively explore the international market.
3. From 2020 to 2030, build an aircraft leasing industry cluster. Establish a number of internationally competitive aircraft leasing enterprises, so that China will become an important cluster for the global aircraft leasing industry.

Under Circular No. 108, it proposes 7 specific policy measures to promote the healthy development of the aircraft leasing industry:



How the seven proposed policy measures may impact the landscape of aircraft leasing in China remains to be seen. The current regulations and the tax law in China for aircraft leasing are complicated and unclear. Apart from the indirect tax burden on VAT, the corporate income tax rate in China is 25%. Therefore, the overall tax burden for aircraft leasing companies doing business in China is significantly higher than that in other major leasing centres, including Ireland. Additionally, withholding tax is generally applicable to lease rentals under the double taxation treaty agreements entered into between China and other countries. These factors further hinder progress in development of the aircraft leasing industry in China.

Given Hong Kong's unique position with regard to China and its prominent role as a business hub in Asia, as well as its sophisticated financial markets and well developed legal system, international aircraft lessors looking to do more business in China naturally consider setting up bases in Hong Kong. One of the policy measures set out in Circular No. 108 is to make good use of Hong Kong's advantageous position as an international financial, trading and transportation centre and encourage aircraft leasing companies to set up operations in Hong Kong. However, the current Hong Kong tax rules on aircraft leasing make Hong Kong an unattractive location for aircraft leasing companies to establish bases in Hong Kong. In order for Hong Kong to compete in this potentially lucrative business in relation to the expanding aircraft market in China and Asia Pacific, it is paramount for the Government to revisit the existing tax rules to improve the overall business environment for aircraft lessors operating in Hong Kong. This will not only help Hong Kong maintain its competitiveness as Asia's key transportation and business hub, but also strengthen its position as a major international financial centre.

It is important for the Government to revise the tax rules and create conditions more conducive to development of aircraft leasing, financing and investment businesses in Hong Kong. Any such revision of tax rules will not result in tax losses to Hong Kong. Developing Hong Kong into an aircraft leasing, financing and investment centre will not require any Hong Kong Government subsidy.



Summary of current position compared to Ireland, Singapore and China

Tax

i. Hong Kong

A Hong Kong based aircraft lessor (“Hong Kong lessor”) is generally taxed on any lease rentals derived from the lease of aircraft entered into by the Hong Kong lessor.

The Hong Kong lessor is not entitled to claim tax depreciation on the cost of the aircraft, if it is leased to non-Hong Kong based airlines.

Therefore, the Hong Kong lessor is **taxed on its gross rentals rather than profits** arising from the leasing transaction at a rate of 16.5%.

This makes Hong Kong totally unattractive as a base for aircraft leasing to non-Hong Kong based airlines.

ii. Ireland

An Ireland based aircraft lessor (“Irish lessor”) is taxed on any lease rentals derived from the lease of aircraft entered into by the Irish lessor.

The Irish lessor is entitled to claim tax depreciation on the cost of the aircraft to offset its lease rentals received under the lease.

Therefore, the Irish lessor is **taxed on the profits** arising from the leasing transaction at a rate of 12.5%.

iii. Singapore

The taxation of a Singapore based aircraft lessor (“Singaporean lessor”) is similar to that of an Irish lessor, except that the Singaporean lessor is **taxed on the profits** at a rate of either 5% or 10%, dependent upon fulfillment of relevant conditions.

iv. China

The taxation basis in China for an aircraft lessor (“Chinese lessor”) is similar to Ireland and Singapore except that the profits derived from leasing business shall be subject to Corporate Income Tax at a rate of 25%. There are however special zones introduced by the Government in China such as Tianjin Binhai New District, Shanghai Pudong New District and Shenzhen Qianhai to facilitate the development of aircraft leasing businesses in China. Local financial incentives may be available to attract leasing companies to set up their operations in these areas. The incentives will generally be calculated with reference to VAT and Corporate Income Tax incurred by the leasing companies in a particular year. With the said incentives, the overall financial performance of the Chinese lessor will be improved significantly. In addition, the most attractive feature of China based leasing platform is no withholding tax payable on the leasing income derived by a Chinese lessor compared to a foreign lessor.

Whilst these local incentives appear to be attractive, these are not policies endorsed by the Central Government. Indeed, we understand Shenzhen Qianhai is not using these kinds of incentives to attract aircraft lessors to set up businesses operations in Qianhai. Furthermore, an aircraft lessor based in China may not be suitable to a lessor with foreign parent. Although it appears that a Chinese lessor is beneficial for Chinese airlines, there will be withholding tax payable by a Chinese lessor to its foreign parent when it distributes its profits to the parent company. The typical withholding tax rate on dividend in China is normally 5% (a reduced treaty rate) or 10%. Furthermore, if the Chinese lessor is required to be funded by a foreign loan, there will be withholding tax payable on the interest payments. The withholding tax rate on interest is normally between 7% (a reduced treaty rate) and 10%, which will have a significant impact on the overall profitability of the lessors in China. Furthermore, any agreements entered into between a Chinese lessor and a Chinese airline will be required to be governed by Chinese law rather than English law, which is often used in aircraft leasing. This further hinders the progress of attracting foreign lessors to set up leasing businesses in China.

Therefore, at first glance, a Chinese lessor may appear to be attractive but it has inherent uncertainty as described above. Having said that, a Chinese lessor will be beneficial for Chinese owned leasing companies as typically the funding and the dividends will not be required to go outside of China. We understand that most of the special purpose vehicles (“SPVs”) set up in Tianjin are set up by Chinese leasing companies. We further understand that currently only one foreign owned lessor has actually set up an aircraft leasing platform in Tianjin.



a. Financial analysis

Leases of aircraft to China or other overseas lessees will incur different taxation costs depending on the location of the lessors and the double taxation agreements between the lessor's and lessee's jurisdictions.

A summary of the total profit and loss accounts over the lease term of a typical narrowbody aircraft with a Chinese airline for a Hong Kong lessor, an Irish lessor and a Singaporean lessor is attached in Appendix I for illustration purposes.

	Hong Kong	Ireland	Singapore
	US\$	US\$	US\$
Lessor:			
Profit before tax	20,250,436	20,250,436	20,250,436
Corporation tax	(6,826,122)	(2,531,305)	(2,025,044)
Profit after tax	13,424,314	17,719,131	18,225,392
Lessee:			
Withholding tax	4,055,079	3,438,806	3,438,806
Lease Rentals payable	53,874,622	53,874,622	53,874,622
Total costs	57,929,701	57,313,428	57,313,428

The profit after tax of a Hong Kong lessor of the same lease is approximately 31% and 36% less than the Irish lessor and Singaporean lessor respectively.

The total costs to the Chinese airline with a Hong Kong lessor are approximately 1% higher than the Irish and Singaporean lessor is the withholding tax rate on lease rentals between the Hong Kong and China double taxation agreement is 7% compared to the 6% between the Ireland and China and Singapore and China double taxation agreements.

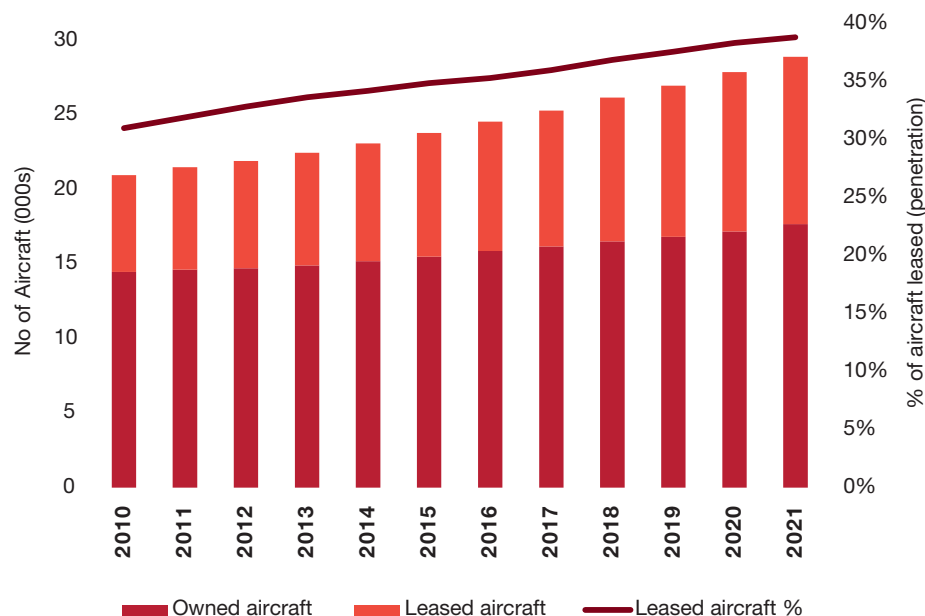
Therefore, there are currently no substantial operations of aircraft leasing in Hong Kong due to the existing tax provisions mentioned in section 2a above.

Please note that we have not modelled the profitability of a Chinese lessor based on our understanding that there is currently no significant number of foreign aircraft lessors set up in China.

Economic benefits

a. Developing Hong Kong as a Global Aircraft Leasing Hub

Leasing is now the preferred choice of aviation financing for most airlines these days, which is in sharp contrast to their preference of owning aircraft outright a couple of decades ago. There are clear operational benefits such as flexibility, access to delivery slots and also significant cash flow advantages. The forecasts from Vision Gain shown below suggest that the share of leased aircraft would rise from the current 32% to around 40% by 2020.⁵ Therefore, it is reasonable to assume that by 2032, lease financing will be responsible for approximately 50% of aircraft deliveries.



Boeing recently forecast that the total number of new aircraft deliveries will be approximately 35,280, valued at US\$4.8 trillion. Therefore, the aircraft leasing market by 2032 should be approximately half of the new deliveries i.e. 17,640 new aircraft, valued at approximately US\$2.4 trillion.

According to Ascend, a flight global advisory services provider, the number of aircraft under lease was just under 6,000 in 2008.⁶ According to the survey conducted by FAEI as shown in Appendix II, the number of aircraft managed in Ireland was 3,376 which is just over 55% of the worldwide aircraft leasing market at that time.

Assuming Ireland will continue to hold 55% of the world leasing market, out of the 17,640 new aircraft, the number of aircraft which may be financed through the Irish leasing platform will be approximately 9,702 (17,640 x 55%) aircraft or US\$1.32 trillion (2.4 trillion x 55%).

If Hong Kong has a share of 1/3 of this aircraft leasing and financing business, i.e. 3,234 aircraft (9,702/3), on the basis that the current major competitors are Singapore and Ireland, it will have a significant effect on the Hong Kong economy. For illustration purposes, assuming that these 3,234 aircraft are all narrowbody and will be acquired over the next 20 years, the projected aircraft value at the end of 2032 after depreciation is estimated to be US\$91 billion, together with total estimated profits before tax

⁵ Vision Gain 2011

⁶ Market Insight: Operating Lessors Q42010

of US\$40 billion and operating costs including interest of US\$37 billion. These are estimated on the basis that all these aircraft will be at an original cost of approximately US\$44m each with a funding cost of 5% over the next 20 years.

As the forecast figure for China's new aircraft demand is approximately 5,580 with a value of US\$780 billion, the estimated number of 3,234 above (i.e. 57% of the aircraft required by China) will be achievable, especially if the withholding tax rate on lease rentals between Hong Kong and China may be renegotiated to a rate lower than the 6% rate currently enjoyed by Ireland and Singapore.

Furthermore, it is well known that a number of Chinese aircraft leasing companies use Hong Kong as an international platform to raise funds for their leasing businesses. This is because interest rates in Hong Kong tend to be lower than that of China and Hong Kong is an efficient international financial centre. Hence, provided that the tax policy of aircraft leasing in Hong Kong is competitive, this should be an added incentive to encourage China's aircraft leasing companies to set up aircraft leasing businesses in Hong Kong and not just in the special zones in China.

In summary, the estimated position for Hong Kong is as follows:

Estimated number of aircraft to be managed in Hong Kong by 2032	3,234
Estimated value of aircraft in 2032	US\$91 billion
Estimated total profits before tax made by Hong Kong lessors by 2032	US\$40 billion

The above estimates seem to be reasonable if compared to the figures published by FAEI for Ireland in its 2008 survey.

Estimated number of aircraft managed in Ireland	3,376
Estimated value of aircraft	EUR€82.9 billion
Estimated total profits made by Irish lessors	Not published

Ireland has been developing its aircraft leasing business for approximately 35 years. On 22 January 2014 Enda Kenny, the Prime Minister of Ireland, praised the Irish leasing community in an opening speech at the 16th Annual Airfinance Conference Dublin. Mr Kenny described Ireland as "the best small country in the world to do business", and reiterated the Irish Government's support for the aircraft leasing sector. "We want to prove this particularly in the Airfinance industry. The growth of this industry has been one of the most successful success stories in the development of Ireland's global international financial services sector," stated Mr Kenny. "The Airfinance industry employs over 1,000 industry specialists and another 1,400 professionals are employed indirectly in an ecosystem that has been developed over time with the support of the Irish Government. "He urged Irish lessors to approach the Irish Government with ideas on how the Irish Government may best help the sector. "I say to the air leasing community whether it is only 10, or a 1,000 jobs, this Administration is interested".⁷

Therefore, given the predictions made by Boeing and Airbus on the growth of the aviation industry in the future, Hong Kong is well positioned to become an aircraft leasing, financing and investment centre provided that the Hong Kong Government develops coherent policies for this growing industry. It would be unimaginable that Hong Kong, as a well-established international financial, trading and transportation centre, would miss this opportunity.

Aircraft leasing is not just an asset financing business. It also demands an in-depth understanding of the various segments of the global aviation business. The business is knowledge intensive and global in nature. Business executives in the aircraft leasing industry have to build up global connections and business ties with people along the whole supply chain of aviation and aerospace industries. The establishment of Hong Kong as an important aircraft leasing centre will therefore help to promote and consolidate Hong Kong's position as a global business and financial centre.

⁷ Air Finance Journal

Direct Job creation and Salaries

The table below is extracted from the FAEI survey in relation to the total number of people directly and indirectly employed by the cross border aviation leasing industry in Ireland conducted in 2008.

	Year 2008	In 3 years assuming supportive tax regime	Expected increase	% increase
Direct sector	614	938	324	53%
Indirect sector	380	504	124	33%
Total number of employed	994	1442	448	45%

The average salary for the direct employees was €111,956 and indirect employees was €82,273. These salary levels are considerably higher than the average salary as it is a very niche industry with highly skilled employees.

Interestingly, 68% of the companies surveyed considered the aviation leasing business to be very mobile. Based on our understanding, some employees in Ireland would like to move to the Asia Pacific region given the potential enormous growth in the Asian aviation industry. Furthermore, personal taxation is also an important factor. For example, the personal tax rate of Hong Kong is effectively capped at 15%, which is significantly lower than that of Ireland.

Below is a high level summary of the 5 well known global lessors in the world based on their latest financial statements:

	AerCap	AWAS	BOC Aviation	AirCastle	ILFC
Number of aircraft	313	241	230	159	925
Number of employees	159	130	105	83	564
General expenses per aircraft per annum“US\$000”	141	173	121	137	112
Number of aircraft per employee	1.52	1.81	2.23	1.84	2.22
Estimated compensation and benefit per employee“US\$000”	135	159	179	174	142

Our high level research shows that the average general expenses of these 5 lessors per aircraft per annum is approximately US\$121,000, the average salary per employee is approximately US\$153,000 and the average number of aircraft per employee is approximately 1.97.

Therefore, based on an estimated number of 3,234 aircraft for Hong Kong in year 2032, the estimated number of employees which may be employed by the aviation leasing industry is just over 1,600. Compared to the figures in Ireland, these estimated numbers do not appear to be unreasonable.

For start up companies, we would however expect each group will require at least 4 to 5 people: CEO, CFO, marketing staff and 2 administrative assistants. The legal, technical and tax functions will probably be outsourced at the beginning. The projected number of employees will depend on growth but approximately 50 to 70 for a medium size company.

Based on our discussions with different industry participants, the estimated salaries per annum for direct employees for the aviation leasing industry for various posts are summarised as follows:

Title	US\$
CEO	300,000
CFO	150,000
Support staff	50,000
Marketing staff	200,000

There may be other expatriate costs associated with senior staff such as home leave tickets, housing and car allowances. With an estimated total employment of approximately 1,600, the estimated total salary cost per annum would grow to approximately US\$252 million in 2032.

Linkage Effects, Indirect Jobs and Benefits

Aviation lessors will demand local professional and business support such as legal and accounting services. Generally, estimated professional fees of approximately US\$200,000 will be spent in a typical aircraft leasing transaction including legal, tax and other corporate services. Using the assumption that there are 3,234 aircraft to be leased from Hong Kong or an average of about 186 aircraft per year, the professional fees required per year is approximately US\$37 million.

Apart from the salary costs, there will be other overheads such as office rentals, travel costs and IT systems. In Hong Kong, it is expected that the office rentals will be expensive. For a start up, an office area of approximately 2,000 sq ft should be sufficient and that can cost between HK\$50,000 and HK\$100,000 per month. Travel costs are also likely to be substantial as the business requires a lot of global networking. Other costs such as those related to engineers and risk management may be outsourced.

Taken as a whole, apart from direct employment costs, the operating cost of the aircraft leasing industry as a whole is estimated to grow to a total of around US\$ 390 million by 2032. This represents the business generated for various supporting sectors in the rest of the Hong Kong economy such as professional services.

b. Promoting and Consolidating Hong Kong's role as a global financial centre

Banking

Aircraft leasing requires substantial amounts of financing. On the assumption that the lessors would use a 25% equity and 75% loan model (which is a reasonable ratio for many existing lessors), the total loan demand from the aircraft leasing industry would amount to US\$53 billion by 2032. This large funding demand would promote development in the Hong Kong banking industry. More global banks will be attracted to build their aviation finance business in Hong Kong.

Private Equity; Asset Management; Equity Market

Aircraft belong to an asset class commonly invested by global private equity investors. Periodic lease rental income and fairly robust and ascertainable residual values of aircraft provide investors with the required returns. Well established market standards and practices on aircraft maintenance and legal documentation give comfort to investors on asset preservation. Private equity fund investments may take different forms, including direct investment in aircraft, equity investment in aircraft lessors, issuance of aircraft or lease asset-backed securities. We have already seen a number of financial investors backing aircraft leasing businesses with recent ventures e.g. Cinven, CVC, GIC and Oak Hill's Investment in Avolon, Carlyle's investment in RPK, Cerberus Capital's investment in AerCap and Terra Firma's investment in AWAS. We expect to see further deal activity in this space.⁸ Initial public offerings (IPOs) of aircraft-

related entities may provide exit strategies for private equity investors.

Funds for acquisition of aircraft may be raised by listing aviation-related securities in the equity market. The Irish Stock Exchange announced on 21 January 2014 that it would create a dedicated exchange for aviation-related debt as airlines and lessors increasingly look beyond banks for funding. The exchange will trade aviation-related debt and other instruments.⁹

Aircraft and aviation-related assets such as lease receivables in a portfolio of aircraft need to be professionally managed for value preservation and asset protection. This will further propel Hong Kong's development as a premier asset management centre.

Hong Kong possesses the infrastructure to become an international hub for aviation finance assets, bringing long-term benefits to Hong Kong's equity market and capital market and adding sophistication to Hong Kong as a world-class financial centre.

Over time, there is an increasing awareness that aircraft finance has been shown to be a good quality asset. Asset managers are showing an increasing interest in acquiring such assets as part of their portfolio. The growth of the aircraft leasing industry will help to generate more such assets and this would help to promote the development of the asset management industry in Hong Kong.

⁸ Aviation Finance Fasten your seatbelts published by PwC UK in January 2013

⁹ Irish Independent 21 January 2014

Capital Market

The large demand for aviation financing inevitably would lead to the growth in demand for capital market deals as the lessors seek diversification of their funding source. This applies not only to raising funds for aircraft leasing, but also the working capital of the lessors themselves.

Islamic Sukuk

Aircraft finance is traditionally provided by commercial banks. There is a growing demand by the aviation industry for alternative sources of finance. Leasing is extensively used in the aviation market. Aircraft is an ideal asset for Islamic Sukuk (asset-backed leasing bonds) issuances. It was reported that several aircraft leasing and financing transactions (the number was estimated to be at over 55 transactions) in amounts exceeding US\$5 billion have already used Shariah compliant structures. Typically, Shariah compliant investment funds, solely dedicated to aircraft assets have been launched to date by financial institutions, which were subsequently distributed to high net worth individuals in various countries.¹⁰ This is not surprising, as the aviation assets will spin off lease payments rather than interest to the investors, which is key to Islamic financing.

Hong Kong has put in place new tax law to facilitate Sukuk bond issuances. Aircraft (with leases attached) provide an excellent asset class for Sukuk investors. Hong Kong, as an aircraft leasing, financing and investment centre, will be well-placed to attract airlines, aircraft leasing companies and investors all over the world to issue, and invest in, Sukuk bonds in Hong Kong.

c. Benefits to the local aviation industry

Aircraft leasing is a global industry. Whether a lease originates out of Hong Kong or an overseas jurisdiction usually does not make much difference to the airline concerned.

However, if an active and deep aircraft leasing business is developed in Hong Kong, there will be some benefits to the local civil aviation industry:

- There will be more demand for international travel.
- It is likely that as the Hong Kong aircraft financing market develops, leasing denominated in RMB could arise. This would help the local airlines to have a natural hedge in their RMB currency exposure, as the local airlines will see more future income denominated in RMB.
- There would be some reduction in transaction and administration costs to the local airlines if their aircraft leases are managed in Hong Kong, even though such cost reductions may not be significant.
- The activities of various participants in the aircraft financing and leasing market in Hong Kong will add depth to the local banking market and capital market and will prompt development of financial products, providing local airlines with wide-ranging cost-effective sources of funds.

¹⁰ Islamic Finance News published by Novus Aviation Capital in February 2013



Withholding tax

As far as an aircraft leasing transaction is concerned, the tax which tends to attract most of transaction parties' attention is the withholding tax on the lease rentals. One of the key reasons that Ireland is such a successful aircraft leasing platform is because of (i) its extensive double taxation treaties network, a total of 66 double taxation agreements have been signed to date, and (ii) most importantly, the withholding tax on the lease rentals tends to reduce to zero or amongst the lowest in the world under the double taxation agreements with Ireland.

As a result, since the birth of Guinness Peat Aviation in Shannon, Ireland in 1975, Irish leasing expertise has developed enormously, and Ireland now boasts a portfolio of the world's largest aircraft financiers, lessors and operators.

The reason why withholding tax is such an important issue is that the market practice is for a lessor to pass on the withholding tax liability to a lessee by virtue of the gross-up provisions in an aircraft lease agreement. As a result, the higher the applicable withholding tax rate is, the higher the cost of leasing to the lessee becomes. To put it another way, if the lease rentals and other commercial terms are similar, a Hong Kong lessor may lose an aircraft leasing deal to another lessor based in a jurisdiction with a lower withholding tax rate, as from the lessee's perspective it will be less costly for it to enter into an aircraft leasing transaction with that other lessor.

Hence, it is paramount that the IRD should focus withholding tax issues on lease rentals in any future negotiations of double taxation agreements with other jurisdictions especially if aviation financing (including leasing) becomes one of the industries to be supported by the Hong Kong Government.

Assessable profits and tax calculations

Key Assumptions ¹¹ :			
Estimated cost	US\$44m	Estimated residual value	US\$22.88m
Lease Term	12 years	Estimated residual value	52.0%
Estimated Useful life	25 years	Estimated funding costs	5%
Lease rate factor	0.85	Debt: Equity	75%:25%

Corporation tax rates:		Withholding tax rates:	
Hong Kong	16.50%	Hong Kong	7%
Ireland	12.50%	Ireland	6%
Singapore	10%	Singapore	6%

Lessor	Hong Kong	Ireland	Singapore
	16.5%	12.5%	10%
Profit and Loss Accounts	US\$	US\$	US\$
Gross Rentals	53,874,622	53,874,622	53,874,622
Accounting Depreciation	(21,120,000)	(21,120,000)	(21,120,000)
Gross Profits	32,754,622	32,754,622	32,754,622
Interest Expenses	(12,504,186)	(12,504,186)	(12,504,186)
Profit before Tax	20,250,436	20,250,436	20,250,436
Corporate Tax	(6,826,122)	(2,531,305)	(2,025,044)
Profit after Tax	13,424,314	17,719,131	18,225,392

Lessee			
Withholding Tax	4,055,079	3,438,806	3,438,806
Lease Rentals payable	53,874,622	53,874,622	53,874,622
Total costs	57,929,701	57,313,428	57,313,428

¹¹ The key assumptions used for the calculations above are based on a typical narrowbody aircraft.

Benefits of aircraft leasing industry – Ireland

Federation of Aerospace Enterprises in Ireland (“FAEI”) carried a survey to examine the aircraft leasing industry in Ireland.

Summary – Aircraft finance in Ireland

Total fleets under management

	2008
Estimated value of aircraft under management	€82.9 billion
Estimated number of aircraft under management	3,376

	Average salary	% earning greater than €100K per annum
Direct employees	€111,956	61%
Indirect services providers	€82,273	21%

Increase in tax collection:

2007	Corporate tax	Income tax	Value added tax	Total
Tax collection	€268.5 million	€34.2 million	€4.9 million	€307.6 million

97% of companies in the cross border aircraft leasing industry stated that tax was the most important in their choice of location for a cross border leasing business

Source: FAEI – Cross Border Aviation Leasing Industry Survey Results

Contact

Catherine Tsang

Tax Partner

T: +852 2289 5638

catherine.tsang@hk.pwc.com

Clarence Leung

Financial Service Tax Director

T: +852 2289 3599

clarence.kf.leung@hk.pwc.com