

The impact of international tax reform on aviation finance

Pieter Burger, tax partner at Deloitte, looks into the recent global tax developments and how they may affect lessors and airlines.

Last year was extraordinary in many, many respects. Apart from significant unexpected political developments, unprecedented sporting achievements, the hottest year on record, to name but a few, it was also a year marked by incredible leaps forward in international tax reform.

Following on from the issue of the final deliverables of the OECD's Base Erosion and Profit Shifting (BEPS) plan in October 2015, the EU Anti-Tax Avoidance Directive (ATAD) was unanimously approved in June 2016 – a consensus that seemed a long shot when the draft proposal was first published in January 2016.

In addition, of significant importance to aircraft lessors and airlines is that on 24 November 2016 the agreed text of the Multilateral Convention to Implement Tax Treaty-Related Measures was released. More than 100 countries participated in its negotiation with countries expected to sign this convention on 5 June 2017. More than 2,000 double tax treaties (about two-thirds of the worldwide total) could be amended through this new convention, with the first changes likely to have effect from as early as 1 January 2018.

The question naturally arises what the impact of these recent developments are on the aviation finance and broader aviation industry. In light of all of the above, Deloitte has been working with Euromoney Institutional Investor Thought Leadership in the background to conduct a comprehensive survey. This survey of more than 400 senior executives from the aviation finance industry, as well as in-depth interviews conducted with senior industry executives and independent experts, was recently completed. The full survey and accompanying report extends to over 35 pages and four chapters and is aimed at shedding further light on questions such as, among others:

- will BEPS and related tax reforms change the current geographic footprint of aircraft lessor operations?
- who will ultimately bear additional compliance and tax cost as a result of international tax changes – lessors or airlines?
- in light of ongoing uncertainty, what action can and should be taken now and what are others in the industry doing?
- which jurisdiction will show the fastest growth over the next five years as a

location of choice for basing aircraft leasing operations?

- will tax reforms impact how and where leases are originated, negotiated and executed? and,
- is Brexit a concern?

One of the main messages that came out of the survey was that while there was a general consensus that BEPS and the EU ATAD will have a widespread effect on aviation finance, the majority of respondents felt the impact would be largely moderate. Results suggest a perception that the changes will have more of an impact on aircraft lessors as opposed to airlines.

“Some 50% of respondents agree that proposed tax treaty changes will have an impact on the negotiation of aircraft lease agreements”

So why is it that the changes are perceived to have a moderate impact? A possible explanation could be the fact that airlines and aircraft lessors tend to have significant substance already in their headquarter jurisdictions.

A simplistic way of describing the aim of global tax reform is that it seeks to realign the taxation of profits with real economic substance – ie, tax profits in the jurisdictions in which they are earned. For real, substance-based operations the overall impact of BEPS and ATAD should generally not, in principle, be a concern. As Bertrand Grabowski, the former managing director, aviation finance, at DVB Bank, puts it in the report: he is “not aware of any aviation leasing company established in a tax jurisdiction where it doesn't have its own business operation”.

Aircraft leasing operations engage in substantial business activity that in the vast majority of cases is already taxed where such operations are performed. In such cases, the



Pieter Burger, tax partner, Deloitte.

impact is likely to be more in areas such as managing inadvertently creating permanent establishments in customer locations under new rules, assessing the possible impact of interest deductibility restriction rules, managing country-by-country reporting and other new transfer pricing rules and requirements, and the possibility of new EU controlled foreign company (CFC) rules applying to any subsidiaries owned in tax-free/very low tax jurisdictions. Also, additional tax reporting requirements and associated administrative costs may consume time and be burdensome but should not be calamitous.

Double tax treaty abuse

As mentioned above, a key outcome of the BEPS project is the finalisation of the Multilateral Convention to Implement Tax Treaty-Related Measures. This is the end result of a major aim of the BEPS Action Plan – namely to put an end to perceived double tax treaty abuse. A key objective of the changes is to put an end to situations where a company is interposed in a certain jurisdiction purely to avail of the benefits afforded by a double tax treaty that has been concluded by that jurisdiction with another.

A further important measure is that the circumstances giving rise to a permanent establishment (eg, a taxable presence in the form of a foreign branch) in a foreign country will be greatly expanded by the multilateral convention. In particular, certain sales and marketing activities by lessors in the country of the airline customer may potentially now

give rise to a taxable presence where under previous international tax rules this would not have been the case.

Some 50% of respondents agree that proposed double tax treaty changes will have an impact on the negotiation of aircraft lease agreements – in particular, the provisions of tax gross-up clauses. This is compared to only 12% who disagree or strongly disagree. Among respondents, airlines appear to feel stronger that aircraft lease agreements and tax gross-up clauses will be impacted by double tax treaty changes (46% agree or strongly agree) compared to lessors (39% agree or strongly agree).

Whether in the form of increased withholding taxes on lease payments, increased corporate income taxes on lessors, or increased compliance costs, international tax reform does give rise to the possibility of an increase in financing costs for the aviation industry.

Which jurisdiction will experience the fastest growth over the next 5 years as a location of choice for the establishment of aircraft leasing operations?



Source: Euromoney Thought Leadership/ Deloitte.

“International tax reform gives rise to the possibility of an increase in financing costs for the aviation industry.”

About 72% of respondents believe that the tax reforms will drive up financing costs for the aviation industry, driven by higher taxation or compliance costs, or both. Of all categories of respondents, however, airlines were the largest group to disagree with this statement – in particular, 24% of airline respondents felt that costs would not increase.

And who will bear the burden of any increased costs? About 32% of lessors believe that net profits of lessors will ultimately decline compared to 40% of airline respondents who believe the same thing. However, both lessors and airlines are in equal agreement (close to 40% agree or strongly agree) that airlines’ aircraft leasing costs will increase in light of international tax reform.

It is fair to say that overall there is still a lot of uncertainty as to where any additional costs arising from tax changes will be absorbed. Ultimately, however, a great majority (54% of airlines and 66% of lessors) agree that new business models and structures will emerge to deal with challenges posed by international tax reform.

International regulatory and legal changes to curb tax avoidance will have a significant or moderate impact on...



Source: Euromoney Thought Leadership/ Deloitte.

Jurisdictions

Another key finding is that BEPS is not expected dramatically to shift the geography of aviation finance. As mentioned above, BEPS is unlikely to force the major restructuring of companies into different jurisdictions because, unlike allegations about other industries, aircraft lessors conduct most of their operations in the countries in which they are taxed.

However, the geography of aviation finance may diversify. In response to the question “which jurisdiction will experience the fastest growth over the next five years as a location of choice for the establishment of aircraft leasing operations?” the answer was the Chinese free-trade zones would grow the fastest, followed by Singapore and Ireland close behind. In the case of the Chinese free-trade zones, though, this is likely to be high percentage growth relative to the current small base rather than a surge making the free-trade zones a world player. Instead, experts expect that the latter will service the growing Chinese domestic market. For international leasing operations, however, the leading players are likely to remain so for some time.

Other interesting findings include that, among aircraft lessors, non-tax attributes are more important than tax aspects in picking a location in which to establish aircraft leasing operations. In other words, more important than the country’s double tax treaty network, its effective corporate tax rate, or even personal income tax rates.

As alluded to, by Irish Aviation Authority chief executive officer Eammon Brennan, in the report, these non-tax advantages are not easy to build up and, in the case of Ireland, includes attributes such as a strong skill set from more than four decades of experience in

aircraft leasing, an effective legal system and a high-quality regulatory agency capable of overseeing aircraft worldwide, among others.

It is clear from the survey that there is still a great deal of uncertainty surrounding international tax changes, particularly for aircraft lessor respondents, 31% of which consider the uncertainty to be considerable. Although the OECD BEPS project is essentially complete, the EU ATAD agreed and the Multilateral Convention published for signing, there is still much uncertainty surrounding the implementation and future interpretation of the revised tax rules in different countries. Also, the Common Consolidated Corporate Tax Base was relaunched in the EU for consideration in October 2016 and we have to wait and see whether it may become a reality (significant doubts remain).

Given the speed with which international tax rules have changed and lingering international tax uncertainty, it is becoming increasingly challenging for businesses to see around the corner and make informed proactive decisions. But even with uncertainty remaining, there are a number of areas where pro-active action can be taken by aircraft lessors and others in the wider aviation industry to prepare for international tax reform impact. These include early consideration of what activities are currently undertaken in foreign jurisdictions and how that will impact on foreign tax compliance obligations under the new rules; close examination of existing cross-border leasing structures used (in particular lease-in-lease-out structures) and consideration of possible restructuring options if needed; analysis of the possible impact that the ATAD interest-deduction restriction rules may have on a group, as well as certain other areas that have emerged from the report.

According to the survey, close to 60% of airlines and lessors are already implementing action to prepare for tax reforms or are planning to make changes, which is encouraging. I hope that professionals in the aviation industry will find the survey and report useful as they continue to plot a course through the ever-changing global tax landscape. ▲