The impact of the multilateral instrument within the world of aviation finance

On 7 June 2017 at the OECD in Paris, 68 countries signed the Multilateral Instrument (MLI), which provides a mechanism for countries to transpose Base Erosion and Profit Shifting (BEPS) recommendations into their existing bilateral tax treaties.

The MLI was designed to modify tax treaties between two or more parties to the MLI in line with measures arising from the G20/OECD BEPS Project. The MLI does not operate in the same manner as an existing treaty protocol amendment; rather, it will sit alongside the existing treaties to be interpreted in conjunction with those treaties.

At the outset of this article, it makes sense to provide a brief overview of the MLI.

It is expected that the participation of the 68 jurisdictions will result in the amendment of more than 1,100 treaties – this represents about one-third of the global total tax treaties. As noted, the MLI provides a mechanism to transpose BEPS recommendations into existing tax treaties. While there are a number of provisions contained within the MLI, and the BEPS Project identified 15 actions to address, there are only a small number of minimum standards within the MLI. The countries which have signed up to the MLI have committed to adopt such minimum standard recommendations. The minimum standard changes are in the areas of treaty abuse (Article 7), mutual agreement procedures (Article 16-17) and treaty preambles.

The purpose of this article is to discuss the impact the MLI will have on the aviation finance industry now that we are further down the path of understanding how different jurisdictions have elected to apply its provisions. In particular, we will focus on the impact of the treaty abuse provisions on the aviation finance industry.

Article 7 addresses concerns that double-tax treaties could be used to make available treaty benefits in unintended circumstances. Optionality is given to support the different approaches permitted under the minimum standard – namely, the adoption of a principal purpose test (PPT) or a PPT supplemented with a simplified limitation on benefits rules (LOB).

All 68 jurisdictions (including Ireland) have opted to include the PPT within their double-tax agreements. This was the minimum standard required on becoming a party to the MLI. Twelve jurisdictions, however, have also chosen to apply the simplified LOB rules – these are Argentina,

Armenia, Bulgaria, Chile, Colombia, India, Indonesia, Mexico, Russia, Senegal, Slovak Republic and Uruguay.

So what does the PPT look like? The text has broadly been agreed for some time and is included in the MLI as follows:

"Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement."

The PPT is in essence an anti-treaty abuse provision within the treaty itself. It seeks to disallow the benefits of a particular treaty where, broadly, the principal purpose of establishing a particular transaction was to obtain the benefits of a tax treaty. For example, a pure conduit company with no commercial substance which has been interposed into a transaction to benefit purely from the favourable terms of a double-tax treaty between two jurisdictions would likely not qualify for tax treaty benefits once the MLI is ratified into treaties.

As noted above, there are a number of jurisdictions which have, in addition to the PPT, included a simplified LOB provision. A natural question arises as to what happens when one party has signed up to the PPT and the counterparty to the double-tax treaty has included a simplified LOB clause?

There are a multitude of outcomes that are relevant depending on the reservations and options chosen by each party; however, broadly, and in most scenarios, where one party has included the PPT and the counterparty jurisdiction has included the PPT and simplified LOB, only the PPT will apply.

For example, Ireland has chosen to apply the PPT only. It has not made additional optional choices – for example, to allow a simplified LOB to apply symmetrically or indeed asymmetrically for the purposes of granting treaty benefits in a case where a counterparty to an Irish tax treaty has chosen to include a simplified LOB. As a result, the PPT should be the only test for Ireland's network of double-tax treaties going forward, unless Ireland in future agrees to the application of the simplified LOB to apply to treaties that it has concluded with those 12 countries that have opted for the simplified LOB.

The specific BEPS report (Article 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances) no doubt in the future be relevant to interpret how the PPT applies. The BEPS report states that it must be reasonable to conclude that one of the principal purposes of an arrangement or transaction was to obtain the benefits of the tax treaty. As can be seen, the treaty benefit does not have to be the sole or dominant purpose to fall foul of the PPT; if one of the principal purposes is obtaining the treaty tax benefit it would be sufficient for the benefit to be disallowed. Furthermore, it states that a purpose will not be a principal purpose when it is reasonable to conclude that obtaining the tax treaty benefit was not a principal consideration and would not have justified entering into any transaction or arrangement that has resulted in that benefit.

The BEPS report notes that it is important to undertake an objective analysis of the aims and objects of all persons involved in putting the arrangement or transaction in place when considering whether or not one of the principal purposes is to obtain tax treaty benefits.

The commentary goes on, however, to note that, where the only reasonable explanation for a particular transaction or arrangement being established in a certain way is for obtaining tax treaty benefits, then it will be concluded that one of the principal purposes of that arrangement was to obtain the benefits. This clearly points to the fact that, when undertaking an objective analysis of an arrangement or transaction, other reasonable explanations require consideration before making a determination.

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The OECD guidance highlights, however, that where an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a tax treaty benefit, it is unlikely that its principal purpose will be considered to be to obtain that tax treaty benefit.

The PPT is aimed at tackling artificial arrangements and so the OECD are, through the guidance, making it clear that where there is a core business activity and other reasonable explanations for setting up a transaction in a certain way (or in a certain jurisdiction) then the mere existence of a tax treaty benefit should not be sufficient to consider that such a benefit was one of the principal purposes.

Rather unhelpfully, though, the examples within the BEPS Action 6 Report of acceptable and unacceptable arrangements do not contain an example specific to the leasing of assets of any kind. However, there are a number of examples that outline the direction of thinking that one could reasonably expect would be followed by tax authorities in the future when determining whether obtaining treaty benefits was one of the principal purposes of a chosen arrangement (but, of course, only time will tell how different jurisdictions will interpret the guidance).

One example postulates the scenario where a group is considering establishing a regional company to provide group services to other subsidiaries. After reviewing a number of possible locations, it decides to establish this regional company in State "R". The example further states that the decision is mainly driven by the skilled labour force, reliable legal system, business-friendly environment, political stability, membership of a regional grouping, sophisticated banking industry and the comprehensive double-taxation treaty network of “R”, including its tax treaties with certain jurisdictions where related parties of the company are based.

In this example, the BEPS report suggests that merely reviewing the effects of the double-tax treaties of a country on future payments would not enable a conclusion to be drawn about the purposes for the establishment of this company in a particular state.

The example states that, assuming the functions to be provided, including the making of decisions necessary for the conduct of its business, constitute a real business through, which it exercises substantive economic functions, using real assets and assuming real risks, and provided that business is carried on in that particular state through its own personnel located there, it would not be reasonable to deny the benefits of the treaties concluded between the two states. This should be the case unless there are other facts that would indicate the company has been established for other tax purposes or unless the company enters into specific transactions to which the PPT would otherwise apply.

Other examples cite other useful non-tax considerations, which could reasonably be applied to a situation where a favourable location is chosen as an aircraft-leasing platform. They include transportation issues and time differences and developed international trade and financial markets.

The BEPS Action 6 Report also provides examples of transactions that may be considered conduit arrangements (again, unhelpfully not specific to leasing transactions although other types of financing transactions are mentioned).

TCO, a company resident of State T, which does not have a tax treaty with State S, loans 1,000,000 to SCO, a company resident of State S that is a wholly owned subsidiary of TCO, in exchange for a note issued by SCO. TCO later realises that it can avoid the WHT on interest levied by State S by assigning the note to its wholly owned subsidiary RCO, a resident of State R (the treaty between States R and S does not allow source taxation of interest in certain circumstances). TCO, therefore, assigns the note to RCO in exchange for a note issued by RCO to TCO. The note issued by SCO pays interest at 7% and the note issued by RCO pays interest at 6%.

In this example, the BEPS report notes that the transaction through which RCO acquired the note issued by SCO constitutes a conduit arrangement because it was structured to eliminate the WHT that TCO would otherwise have paid to State S.

Given the examples above, how is the impact on aviation finance determined and, in particular, the cross-border operating leasing of aircraft?

In a survey Deloitte conducted in conjunction with *Euromoney* in late 2016 (report published as Aviation Finance and International Tax Reform, January 2017), of more than 400 senior executives in the aviation finance industry, some 50% of respondents agreed that proposed double-tax treaty changes will have an impact on the

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negotiation of aircraft lease agreements – in particular, the provisions of tax gross-up clauses.

Among the top 50 airlines, the average proportion of aircraft leased (as a percentage of total fleet) is just below 40% and of the top 50 airlines globally, the value of their leased fleet is more than $140 billion (representing more than 4,200 aircraft). Clearly, access to double-tax treaties is of paramount importance to lessors and airlines alike. The mitigation or elimination of withholding taxes on lease payments can be a key determinant in whether a lease transaction is economically mutually beneficial.

Generally, in most standard lease agreements, the risk of WHT lies with the lessee as a result of the operation of WHT gross-up clauses. The gross-up clause broadly provides that in most instances, if WHT is required to be applied to a lease rental payment, the lessee is required to make an additional payment to place the lessor in the position it would have been had no WHT applied. In the Deloitte and Euromoney report, however, survey respondents were split when considering who ultimately would end up bearing additional tax costs arising from BEPS.

The first important point to note in evaluating the impact of the MLI is that the rules are new, untested and not yet in effect. The guidance issued by the OECD thus far is useful but ultimately the impact will depend on how different jurisdictions around the world apply the new provisions, and also how different jurisdictions react. For example, once the full impact of the MLI is understood, some jurisdictions may exempt lease payments for the use of commercial aircraft from local withholding taxes entirely (but perhaps that is wishful thinking).

However, despite this uncertainty there are a number of common themes emerging from the OECD guidance. Broadly, they come down to the use of real assets, exposure to real risks, and the location of the substantive economic functions relative to that particular business.

The three factors above can appear in different permutations and combinations in the context of different leasing structures and as such a range of substance types and possible outcomes can be identified.

In its simplest form, for example, at one end of the range is the situation where a leasing entity engages in substantive economic aircraft-leasing functions in its tax jurisdiction through a number of senior key decision-making executives and employees permanently based there. The leasing entity also owns the aircraft on its balance sheet and has raised the finance. The MLI is highly unlikely to have any impact on leases concluded by such a leasing entity, no matter how tax efficient the jurisdiction is where it is based.

At the other end of the range is the situation where the leasing entity does not own the aircraft (either legally or on its balance sheet), is not exposed to any risk relative to the aircraft or the financing raised, and also carries on no real functions in its jurisdiction of tax residence with no employees. Based on current OECD guidance, there is a clear risk such an entity would be denied the benefits of a tax treaty concluded by the jurisdiction in which it is tax resident under the PPT of the MLI.

The more uncertain or grey area lies between these two opposite ends of the range where different jurisdictions may have different interpretations of the PPT. Within this range, for example, could be leasing entities which own the aircraft, but lack substantive economic functions. Or an entity that carries on substantive functions through employees, but with the entity itself not owning the asset and with no real exposure to asset risk. It is within this uncertain area where further consideration and analysis is required and an action plan is required to move closer to the right side of the range to mitigate uncertainty.

Other considerations

Permanent establishments

While not a minimum standard, there were a number of proposed amendments to the threshold at which a permanent establishment (taxable presence) arose.

Article 12 of the MLI broadly sought to introduce a new test for when an agent could trigger a permanent establishment in a particular jurisdiction (with a particular focus on commissionaire arrangements). Specifically, Article 12 could apply where a person is acting in another jurisdiction on behalf of an enterprise and, in so doing, habitually concludes contracts or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise. In other words, under the new Article 12, the activities of a marketing team in the customer (eg, airline) jurisdiction will trigger an obligation to file tax returns (and pay tax) in that jurisdiction much more easily than under current law.

Many countries have, however, reserved the right not to apply this Article of the MLI. Ireland, for example, has reserved its right not to include this new test "due to continuing significant uncertainty as to how the test would be applied in practice". Consequently, this provision should not apply to any of Ireland's Covered Tax Agreements.

China has also reserved the right for the entirety of this article not to apply to its Covered Tax Agreements. Indonesia considers that it already has provisions within its Covered Tax Agreements that sufficiently capture the proposed language, as does Russia. From a European perspective, only eight countries opted for this change: Croatia, France, Lithuania, the Netherlands, Romania, Slovakia, Slovenia and Spain. Other major EU countries such as Germany and the UK did not include the provisions.

There was more uptake with respect to the other changes to permanent establishment definitions but none were as significant in terms of triggering permanent establishments as Article 12.

With respect to the effective date of the MLI, individual signatories will need to ratify the MLI in line with their domestic constitutional arrangements. The MLI must be ratified by at least five jurisdictions before it first enters into force. Following a period of three months after the date of ratification by the fifth state, the MLI will enter into force for those first five jurisdictions at the start of the subsequent calendar month. A three-month period will apply for all other jurisdictions that subsequently ratify the MLI. The MLI can enter into effect for a specific Covered Tax Agreement only after the three-month period has expired for all parties to the Covered Tax Agreement. Broadly speaking, in most instances the MLI will take effect from January 2019 onward.

Concluding remarks

Lessors and airlines should be considering the impact of the MLI on their business and the PPT, in particular. A review of the lease portfolio to determine those instances where double-tax treaty relief is being relied on to mitigate foreign withholding taxes on lease payments should be undertaken. If reliance is being placed on a double-tax treaty to reduce such withholding taxes, it should be considered whether suitable substance is present in such jurisdictions to support a position that the new PPT rule should not adversely impact the leasing entity's ability to avail of tax treaty benefits.

It is worth pointing out again that the PPT is aimed primarily at tax-driven conduit arrangements. While the PPT will give rise to a level of uncertainty and greater transactional analysis in future before lease agreements are entered into, there are often a number of strong commercial non-tax reasons to support the establishment of leasing operations in countries which could greatly mitigate the risk of denial of treaty benefits.

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