The impact of BEPS on the aircraft leasing industry

by Pieter Burger, Deloitte Ireland

Since the G20 meeting in November 2012 and the June 2013 G8 summit, the agenda against tax avoidance has advanced rapidly and we now find ourselves more than halfway through the OECD's Base Erosion and Profit Shifting (BEPS) project with the final deliverables of the BEPS Action Plan due in September 2015 and December 2015.

With the release of further discussion drafts such as Action 4 (Interest Deductions and Other Financial Payments) in December 2014 and the more recent Action 3 (Strengthening CFC Rules) on April 3, 2015, the pieces are coming together and a clearer picture is starting to emerge of the potential impact of BEPS on certain parts of the financial services industry. More specifically, the deliverables issued and public consultation meetings held on Action 6 (Preventing Treaty Abuse), Action 7 (Preventing the Artificial Avoidance of PE Status) and Action 4 have since shed more light on the possible impact on the aircraft leasing and finance industry and the different types of lessors participating therein.

The BEPS process, however, still has a number of months to run and several key questions and BEPS Actions remain to be addressed. Nonetheless, it is worth taking a detailed look at this stage of the possible and (even likely) impact of the key tax changes expected as part of the BEPS process on the aircraft leasing industry.

In view of the high levels of leverage in the aircraft leasing industry, a BEPS Action that has caused particular widespread concern is Action 4 on the deductibility of interest and other financial payments. This article is primarily focused on the impact of BEPS Action 4 on the aircraft leasing industry, with some comments on other relevant BEPS Actions as well.

BEPS Action 4 on interest deductibility

Financing, and in particular inter-group financing, is one of the oldest and most well-known techniques that have been used by some multinational organisations to manage their tax liabilities. It is no surprise, therefore, that one of the key objectives of the BEPS project is to address base erosion achieved through claiming interest deductions and certain other expenses considered equivalent to interest. On December 18, 2014, the OECD released the discussion draft on Action 4 in relation to the deductibility of interest and other financial payments. It also summarises a number of areas where further work is needed, and sets out how Action 4 may interact with other BEPS measures, such as the hybrid mismatch proposals in Action 2 and the controlled foreign company (CFC) proposals in Action 3. Notably, it does not cover the transfer pricing aspects of interest deductibility, which will be covered in a separate consultation document.

At the outset, it should be pointed out that the expenses proposed to be disallowed as deductions for tax purposes under Action 4 are wider than interest and include the finance cost element of finance lease payments, interest rate swap agreements and similar derivatives/hedging instruments, foreign exchange gains/losses on borrowings, guarantee fees, debt raising fees, and others. References to "interest" below and the extent to which it might be disallowed as a tax deduction in future should, therefore, generally be understood to refer to all of the above items.

As with other discussion drafts, the proposals set out in Action 4 do not represent a consensus view from the G20/OECD governments, but were designed to provide preliminary, but substantive, proposals for public analysis and comment. The public consultation closed on February 6, 2015, with a number of submissions being received from the public. A public consultation meeting was also held in Paris on February 17, 2015.

The proposals as set out are far-reaching and, if ultimately agreed by the G20/OECD and implemented into domestic legislation, would bring about a major change to multinational financing. It is important to note that the proposed measures (as set out in further detail below) are not aimed to have an impact only on the deductibility of interest paid to connected parties; they will also affect interest paid to unrelated third parties, even where such borrowings have been obtained on normal arm's length terms. For this reason, companies operating in industries with high leverage ratios (such as aircraft leasing) need to take special note of the proposed measures at an early stage.

The discussion draft essentially outlines the following main alternatives to tackle base erosion through the use of interest deductions:

- deduction limitations based on group attributes;
- deduction limitations based on fixed economic ratios;
- a combination of the two approaches; and
- targeted anti-avoidance measures.

Each of the alternatives would affect different aircraft lessors in different ways, as set out below.

Group-wide allocation and ratio method

The main objective of the group-wide methods is to ensure that a multinational group does not claim an amount of interest as a tax deduction that is more than such group's net third-party interest expense. In other words, if a group as a whole has net third-party interest expense (i.e. total interest payable to third parties less interest received from third parties) of, say, US$20m, that is the total amount of interest that can be deducted by all entities within the group as a whole anywhere in the world. If a group has no net third-party interest expense, then no entity in the group is entitled to claim interest as a tax deduction anywhere (i.e. all interest incurred on inter-company borrowings, even if at arm's length, would be disallowed).

A portion of the total net interest expense would then be allocated to each entity in the group on the basis of economic activity (proposed to be measured in terms of revenue or assets) and that would constitute the cap or limit on the amount of interest deductible by that entity. In other words, the portion of the US$20m in our example of total interest that each entity is entitled to deduct will be determined with reference to the percentage share of that entity's revenue or assets relative to the total revenue or assets of the group. The aim, therefore, is to match net interest expense within a group to economic activity, so that the aggregate tax deductions do not exceed the group's actual third-party interest expense. The discussion draft suggests that disallowed interest could be allowed to be carried forward, but only for a limited period.

As an alternative, it also proposed a group ratio test. Under this method the relevant interest deductibility limit is determined by comparing a relevant financial ratio of an individual entity (such as net interest to earnings or net interest to asset values) with that of its worldwide group. To the extent that the relevant interest ratio of an entity exceeds that of the group, the excess is disallowed as a deduction.

From the above, it would appear that the impact of the group-wide tests on aircraft lessors that have a generally uniform leverage ratio throughout the group (e.g. if each entity has an interest to earnings ratio in line with the group as a whole), should not be that significant. However, where individual aircraft owning special-purpose vehicles (SPVs) have been funded by a combination of external debt and inter-group subordinated interest-bearing debt (i.e. if the lessor's equity in an aircraft acquisition has been funded by means of inter-company loans), such entities could suffer a substantial decrease in the amount of tax-deductible interest under this method. Also, groups with significant head-office interest deductions, but relatively small economic activity at the head-office entity level, could suffer loss of interest deductibility under the group-allocation method. To resolve this problem, a restructuring of debt within the group would be required, which may not be desirable or possible.

In addition, large groups that have operations in many different industries, but that also trade as aircraft lessors, may find that the leverage ratio of the group as a whole is significantly lower than that of the entities forming part of the aircraft leasing division. Under the group ratio method, the effect would be that interest deductions would only be allowed in the aircraft leasing entities up to the leverage ratio of the group as a whole, resulting in potentially substantial decreases in interest deductibility.

It is because of the above and a number of other reasons that business participants at the public consultation meeting in Paris on February 17, 2015 expressed serious concerns regarding the group-wide interest limitation methods. As a result, it appears unlikely that the group-wide method in isolation would end up being the OECD's final recommendation, although there is no certainty on the matter at present (particularly given that this method is favoured by certain significant member states of the OECD).

Fixed ratio method

Under the fixed ratio method of limiting interest deductions, each entity in the group would only be able to claim a tax deduction for interest up to a specified proportion of its earnings, assets or equity. The effect should be that at least a portion of an entity's profits remains subject to tax.

Although such a method would be relatively simple to operate (and certainly a lot simpler than the group-wide allocation method discussed above), it would clearly discriminate against highly leveraged industries.

A key question is at what level should the fixed ratio be set? The OECD evaluated fixed ratios (interest to earnings ratios) that are currently in operation in a number of countries and found that most countries allow interest expense to be deducted up to a maximum of 30% of earnings. The discussion draft, however, indicates that such a ratio is too high and it appears likely at this stage that any fixed ratio to be suggested in the final recommendation by the OECD would be below 20% (and possibly as low as 10%).

A further key aspect is how "earnings" would be measured. EBITDA is generally the more common measure currently used by countries with fixed ratio/ thin capitalisation rules, although EBIT is also used by a small number. Whether EBIT or EBITDA is used would make a big difference to the aircraft leasing industry, given the level of depreciation on aircraft, and it is acknowledged in the discussion draft that using EBITDA instead of EBIT potentially favours entities with high levels of fixed-asset investment. If regard is had, for example, to the interest cover ratios[1] of the five aircraft lessors quoted on the New York Stock Exchange[2], it is clear that a final recommendation in the form of an interest-to-EBIT deductibility cap of <20% would likely have a severe impact on aircraft lessors.

The rigidity of the fixed ratio approach and the inability to flex for different industry segments and market conditions does, however, make it unlikely to be finally recommended in isolation.

Combined approach

From the meeting in Paris, it is evident that taxpayers in general favour a combined approach to the limitation of interest deductibility and at this stage it appears that such an approach is the most likely to be finally recommended by Working Party 11.

Such an approach would entail that a fixed ratio limitation is applied to an entity first (e.g. an interest to EBITDA or EBIT ratio of, say, 20% or less). If the result is that an amount of interest is disallowed in the entity, such excess may still be allowable provided that the entity's interest ratio is not more than that of the group as a whole.

The result of this for aircraft lessors should be that entities should be entitled to claim interest deductions provided that such entity's interest/debt ratio (i.e. interest to earnings, assets or equity) is in line with that of its group as a whole. Again, however, where a group operates in many different industries and its aircraft leasing division has a significantly higher leverage ratio than the group as a whole, the combined approach may not prevent a potentially significant impact on interest deductibility.

Possible exclusion for the aircraft leasing industry?

The discussion draft acknowledges that there are groups with specific characteristics that may make the general approaches outlined above unsuitable and hence would require special attention. An approach is outlined for banks and insurance companies, with special mention also being made of other entities in the financial services sector such as asset management, leasing and other sectors. It is acknowledged in the draft that such entities may be affected by specific circumstances that need to be taken into account to ensure that any base erosion measures introduced would have an appropriate effect.

Unfortunately, no further clarity is available at present as to what specific interest-deductibility measures might be introduced to deal with the concerns of the aircraft leasing industry. At least one submission to the OECD in response to Action 4 has suggested a complete carve-out for aircraft lessors, with others pointing out the possibility of different thin capitalisation ratios for leasing companies. It remains to be seen, however, what special measures might be recommended for leasing companies; but hopes for a complete carve-out are perhaps somewhat optimistic. One possible option is for leasing companies to be excluded from the general rule and, rather, for such entities to be subject to targeted rules (e.g. in respect of interest payments to connected parties). Targeted rules should offer more flexibility for different market conditions and industry sectors.

Other BEPS Actions relevant to the aircraft leasing industry

Aircraft leasing groups are often multinational taxpayers, similar to many multinational groups operating outside the financial services industry. As such, they will likely be impacted by a number of aspects of the BEPS process. Actions such as Action 3 (Strengthening CFC Rules), Action 13 (Transfer Pricing Documentation), Action 2 (Neutralise the Effect of Hybrid Mismatch Arrangements), Action 6 (Preventing Treaty Abuse) and Action 7 (Preventing the Artificial Avoidance of PE Status) are all potentially relevant to aircraft lessors. In particular, Actions 6 and 7 are noteworthy and are further discussed below.

Action 6 (Preventing Treaty Abuse)

The deliverable on Action 6 was released on September 16, 2014 (with a follow-up discussion draft on November 21, 2014) and is largely aimed at putting a stop to the abuse of Double Taxation Agreements (DTAs) by interposing a company in a certain jurisdiction purely to avail of the benefits afforded by that country's DTA that has been concluded with another.

In an aircraft leasing context, withholding taxes can of course arise in the country of source of the lease payment (typically the country of residence of the airline) which can be reduced if the lessor has a tax presence in a jurisdiction that has a favourable DTA with the lessee's jurisdiction. Therefore, the question arises: to what extent, if any, could BEPS Action 6 have an impact on a lessor's ability to continue to access benefits under the DTAs concluded by the countries where its lessor entities are currently tax-resident?

The content of the Action 6 deliverable is technical and detailed but can be broadly summarised by saying that the proposal is for existing DTAs to be amended to include either a Limitation on Benefits (LOB) clause, a Principal Purpose Test (PPT), or a combined approach of both. The PPT involves a broadly drafted general purpose rule aimed at removing treaty benefits where one of the principal purposes of arrangements or transactions is to obtain treaty benefits.

Of particular interest is the LOB suggestion, which is largely based on similar clauses found in a number of US DTAs. Lessors that have leased aircraft into the US may be familiar with the operation of the LOB clause and the complexity and difficulty it can give rise to in order to establish whether DTA benefits are, in fact, available.

Broadly, the LOB clause is designed to limit treaty benefits to companies with sufficient presence in the relevant country of residence, based on their legal nature, ownership and activities. A detailed analysis of the functioning of the proposed LOB clause and its application to lessors is outside the scope of this article.

One could perhaps summarise by saying that the effect of the suggested LOB clause would be that where an aircraft lessor (not part of a group quoted on a recognised stock exchange in certain circumstances) has established a lease-in-lease-out (LILO) company in a third country purely to gain access to the relevant DTA (i.e. in the absence of leasing through such company, no DTA relief would have been possible for any other pre-existing entity in the group), such SPV would be unlikely to be entitled to DTA benefits. Regardless of the aforesaid, however, such SPV would still be entitled to DTA benefits if it is "engaged in the active conduct of a business" in its country of tax residence and the income derived from the other country is derived in connection with, or is incidental to, that business.

The discussion draft contains some commentary (not comprehensive) on the meaning of "active conduct of a business" which is based on and very similar (but not identical) to the 2006 US Model Technical Explanation of the terms "active conduct of a trade or business". It also contains commentary on the meaning of "income derived in connection with, or incidental to, that business".

The Action 6 discussion draft sets out that the term "business" is not defined and should be given the meaning that it has under domestic law. It then states that, "…An entity generally will be considered to be engaged in the active conduct of a business only if persons through whom the entity is acting (such as officers or employees of a company) conduct substantial managerial and operational activities". It is hoped that further clarity will be provided on this in the guidance to be released by the OECD in September 2015; in particular, what would be considered substantial managerial and operational activities by officers (e.g. directors) of a company?[3]

Action 7 (Preventing the Artificial Avoidance of PE Status)

Action 7 is essentially focused on the need to update the OECD tax treaty definition of a "Permanent Establishment" (article 5 of the OECD Model Treaty) to prevent abuses of the threshold allocating taxing rights for trading activities to different jurisdictions.

The proposals set out in the discussion draft (released on October 31, 2014 with public comments submitted by January 9, 2015) also do not yet represent a consensus view.

A key aim of the proposals is to lower the threshold of what constitutes a PE in a foreign jurisdiction and to broaden the circumstances under which activities of a sales force in a foreign jurisdiction would create a PE in that country. At present, for example, where employees of a lessor engage with an airline customer in a foreign jurisdiction and discuss broad contractual terms, but without the authority to conclude contracts or negotiate terms in a manner that is legally binding, the activities of such persons in the foreign jurisdiction would generally not constitute a PE (in the absence of the lessor having a fixed place of business or other type of PE in that country).

Of particular relevance and concern to the aircraft leasing industry are proposals in the discussion draft to broaden the circumstances that would give rise to a PE to activities such as "engages with specific persons in a way that results in the conclusion of contracts" or "negotiates the material elements of contracts". Representatives of the aviation finance and leasing industry made a comprehensive submission to the OECD in response to Action 7 and it is hoped that some of the suggestions made would be taken on board.

If the proposals as they currently stand were to be introduced into DTAs, it would likely result in uncertainty, additional compliance costs (in particular as a result of an increase in PEs around the world and additional tax-filing obligations), additional challenges by tax authorities, and probably very little additional tax payable as the level of profit attributable to such PEs might not be significant.

What happens next?

Important next steps are for the BEPS team to provide the final recommendation on Action 4 (due by September 2015 or at least one would expect at, or shortly before, the G20 Finance Ministers' meeting in Lima on October 8, 2015) and suggested changes to transfer pricing guidelines relating to interest that are due December 2015. Individual countries will then be in a position to implement the agreed Action 4 recommendations into domestic legislation, the timing of which may differ from country to country (possibly as early as 2016, but perhaps more likely from 2017 onwards).

As mentioned above, it is hoped that the final recommendations on Action 4 would contain special measures for taxpayers involved in leasing and other financial services activities outside of the banking and insurance space. However, lessors that rely heavily on inter-company lending structures and that currently claim interest deductions in excess of the group's third-party interest expenses are likely to be affected by BEPS Action 4.

The OECD's further guidance on Action 6 (Preventing Treaty Abuse), Action 7 (Preventing the Artificial Avoidance of PE Status) and other Actions (expected during September 2015) is also awaited with interest. The implementation of recommendations pursuant to Actions 6 and 7 is envisaged to occur by means of the conclusion of a multilateral instrument (Action 15) that would effect the changes required to the various DTAs. The timing of this is less certain and it possibly could occur much later even than the implementation of BEPS changes into domestic legislation.

Note about the author:

Pieter is a Partner in the Financial Services Tax department of Deloitte Ireland and currently leads the Irish firm's Aircraft Leasing & Finance Group. Pieter has more than 12 years' experience advising on international corporation tax and Irish domestic tax matters, including aviation finance, banking, corporate treasury and structured finance. During his professional career, Pieter has acted as tax adviser to a number of multinationals, public bodies, large indigenous corporates, and other clients in the Aviation, Financial Services, Shipping, Energy & Resources, and Food & Beverage industries. He is a qualified lawyer and Associate of the Irish Taxation Institute. Throughout his career, Pieter has contributed widely to a number of publications and has presented extensively on corporation tax matters both in Ireland and abroad. Pieter is also a lecturer on the Irish Taxation Institute's Certificate in Leasing Taxation programme.

Notes:

[1] The ratio of earnings before interest and taxes (EBIT) to annual interest expense.

[2] Based on 2014 data this is as follows (source: Nasdaq.com): AL.N (3.05); FLY.N (1.45); AYR.N (1.47); AER.N (2.17); AVOL.N (1.47). This translates to interest to EBIT ratios of AL.N (33%); FLY.N (69%); AYR.N (68%); AER.N (46%); AVOL.N (68%).

[3] Since completion of this article but before publication, the OECD on May 22, 2015 released a revised discussion draft on BEPS Action 6 (available at http://www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-6-prevent-treaty-abuse.pdf). Whereas the revised draft provides further clarification on certain aspects of the "active business" provision of the LOB rule, the question of what constitutes substantial managerial and operational activities is not clarified further.

Author:
Pieter Burger, Partner
Financial Services Tax
Deloitte Ireland
Earlsfort Terrace
Dublin 2
Ireland
Tel: +353 1 417 2446
Email: piburger@deloitte.ie
Website: www.deloitte.ie