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Moving mid-life aircraft from mainland China to HKSAR

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Background

Leasing is one of the key options for mainland Chinese airlines to finance the acquisition of new aircraft. Benefiting from the strong and steady growth in China's economy, the aircraft leasing market in mainland China has experienced rapid growth over the past 10 years, and mainland China has become one of the most promising aircraft leasing markets in the world.

Global aircraft lessors and Chinese aircraft lessors have adopted different strategies to excel in the booming aircraft leasing market in mainland China. Chinese lessors have built their portfolios primarily in the domestic market and then diversified with international transactions. As a result, Chinese lessors have a more significant exposure to mainland Chinese airlines. In terms of the leasing structures adopted by the aircraft lessors in the Chinese market, an offshore leasing structure (where legal and beneficial title of the aircraft is generally held by an offshore SPV/lessor, see diagram below) is preferred by the majority of global aircraft lessors, while a handful of global aircraft lessors and most of the Chinese aircraft lessors prefer to use onshore leasing structures set up in free trade zones ("FTZs") in mainland China (often known as "bonded leasing structures", see below diagram) to lease to mainland Chinese airlines. Under the bonded leasing structure, the legal and beneficial title of the aircraft is vested in an onshore SPV/lessor set up in the FTZ.

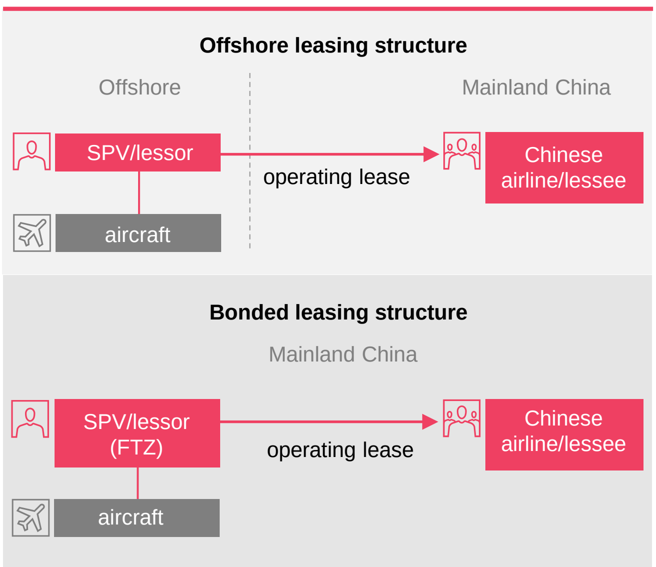
As explained by Tim Bacchus in our November 2019 issue "Challenges ahead for Chinese leasing company's aircraft remarketing? Not so fast…", the market for used or mid-life aircraft is largely offshore outside mainland China, but extricating the current onshore aircraft attached with leases offshore has notoriously been a struggle. The expected "remarketing wave" of the existing onshore aircraft portfolio, with the maturing of initial leases, has been a real challenge in aviation finance circles.

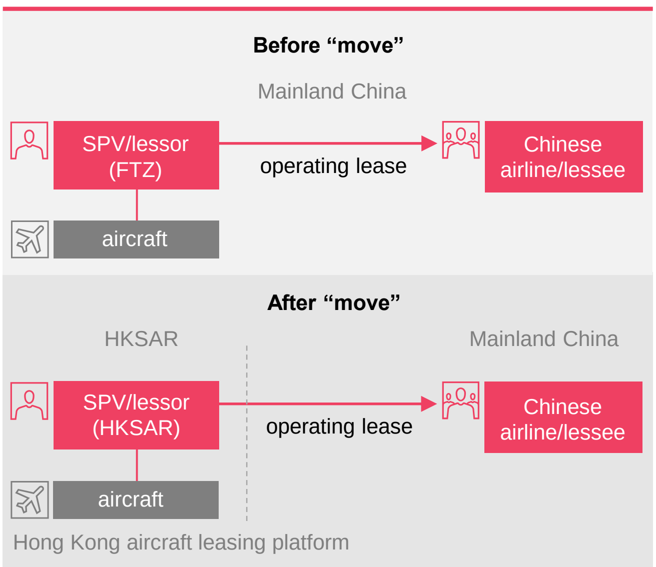
In this article, we share some of our legal and tax insights regarding one of the solutions to this challenge, and one we have been exploring with our clients since the Public Notice 2019 No.158 ("海关总署公告2019年第158号") issued by the PRC General Administration of Customs came into force – moving mid-life aircraft from mainland China to HKSAR.

While the use of this structure has been subdued by COVID-19's dampening of offshore financing solutions, offshore restructures will form part of many Chinese lessors' post pandemic plans.

The concept of moving mid-life aircraft from mainland China to HKSAR

The concept of moving mid-life aircraft from mainland China to HKSAR contemplates transforming the bonded leasing model, which dominates the current Chinese aircraft leasing market. More specifically, the ownership of an aircraft portfolio,(i.e. aircraft attached with leases to mainland Chinese airlines) currently held under the SPV/lessor set up in the FTZ, will be transferred to a Hong Kong SPV/lessor (or Hong Kong aircraft leasing platform) under the restructuring solution. As such, the Hong Kong SPV/lessor will continue to lease the aircraft to the mainland Chinese airline under an operating lease (see below diagram for illustration purposes).





Why move mid-life aircraft from mainland China to HKSAR

There are plenty of reasons to move mid-life aircraft with leases attached from mainland China to HKSAR. To name a few:

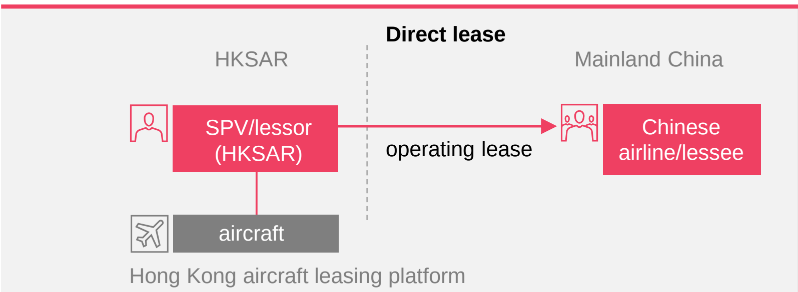
- The move can help the aircraft lessor remarket the mid-life aircraft, currently trapped onshore, to a wider international market with a smooth transition, in which the Hong Kong aircraft leasing platform can serve not only the needs of the existing onshore mainland Chinese market, but also the potential future international market. As at the date of this article, we have seen Hong Kong aircraft leasing platforms already serve lessee jurisdictions such as mainland China, Japan, Korea, Indonesia, Malaysia, Turkey, France and Qatar. We expect more lessee jurisdictions could be covered by Hong Kong aircraft leasing platforms soon, as we understand that the HKSAR government is gearing up efforts to expand the tax treaty network of Hong Kong and promote the overall development of the aircraft leasing industry in Hong Kong.
- Taking advantage of Hong Kong's role as an international financial centre and Hong Kong's initiative in developing aviation finance and aircraft leasing under the Greater Bay Area development scheme, the aircraft lessor can utilise a Hong Kong aircraft leasing platform to refinance its existing portfolio, with a potential opportunity to access cheaper financing (at least, as compared to Chinese financing solutions, where financiers are quite wedded to financing newer aircraft).
- The move allows the ownership of the aircraft portfolio to be transferred to the offshore ownership structure, thereby making it more accessible to international investors. Such a move may also facilitate the trading of the aircraft with leases attached among international investors.
- The move can help aircraft lessors to benefit from the Hong Kong aircraft leasing tax regime introduced in 2017. Under the Hong Kong aircraft leasing tax regime, a qualifying Hong Kong aircraft lessor can achieve an effective tax rate at around 3% to 7%, which is very competitive compared with the tax regime in other major global aircraft leasing centres such as Ireland and Singapore. In execution, we are pleased to see that the anticipated effective tax rate has been realised by our clients.

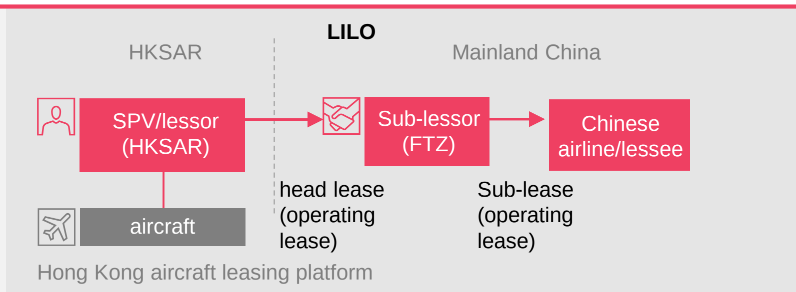
How to structure the move

Depending on negotiations with the mainland Chinese airline lessee and relevant FTZ government, a move of the aircraft attached with lease can be structured as either a direct lease or a lease-in lease-out ("LILO") into mainland China through a Hong Kong aircraft leasing platform (see below diagram for illustration purpose).

Although specific steps involved in moving the aircraft assets from mainland China to HKSAR will need to be assessed on a case by case basis, in general, they will involve the following steps:

- Setting up the Hong Kong aircraft leasing platform, including but not limited to setting up the holding structure of the Hong Kong SPV/lessor, as a way to build up the business substance (i.e. arranging board of directors, board meetings, employees, office, day to day management activities, etc.) of the Hong Kong aircraft leasing platform; arranging the aircraft lease management structure, where necessary;
- Transferring the legal and beneficial title of the aircraft with lease attached from the existing mainland Chinese SPV/lessor in the FTZ, to the Hong Kong SPV/lessor set up in the Hong Kong aircraft leasing platform;
- Novating the aircraft lease agreement concluded between the existing mainland Chinese SPV/lessor in the FTZ with the mainland Chinese airline to the Hong Kong SPV/lessor under the Hong Kong aircraft leasing platform;
- Arranging financing for the Hong Kong SPV/lessor, which can potentially be a combination of senior, mezzanine and junior loan financing. The junior loan financing can be structured in the form of either an inter-company loan provided by an affiliate company within the Hong Kong SPV/lessor group or through equity injection;
- Maintaining the Hong Kong aircraft leasing platform and fulfilling the regulatory compliance requirements in HKSAR and mainland China.





What to consider when making the move

Legal

The foremost question is whether such move is legally possible. Each step set out above in connection with the move of the aircraft, with lease attached from mainland China to HKSAR, involves a number of legal issues. This must be understood in the context of the Chinese legal system which is based on being permissive rather than a regulated form of free market philosophy and thereby quite different to the legal regime even in Hong Kong. Furthermore, not only should one consider mainland Chinese legal issues but also HKSAR law and English law issues when making the move. We would like to highlight the following major legal considerations, stressing that specific legal advice should be sought before considering a move:

- Setting up a Hong Kong aircraft leasing platform by mainland Chinese entities is deemed as an outbound investment, which is subject to the regulation and supervision of the by National Development and Reform Commission ("NDRC"), Ministry of Commerce ("MOFCOM") and State Administration of Foreign Exchange ("SAFE") of the PRC. In respect of financial leasing companies, apart from the regulatory regimes of NDRC, MOFCOM and SAFE, the setting up of the Hong Kong aircraft leasing platform is also subject to prior approval of China Banking and Insurance Regulatory Commission ("CBIRC"). The same may also apply to a finance lease company, which is now also under CBIRC oversight.
- Prior to November 2019, the aircraft was required to be first exported from mainland China (as a result of the sale),and then re-imported into mainland China (as a result of the new lease with the Hong Kong SPV/lessor) following the transfer of title from a mainland Chinese SPV/lessor to a Hong Kong SPV/lessor. For the purpose of re-importation, a new NDRC approval in respect of the importation of the aircraft was required by the Chinese customs authority, as they deemed this to be a new import under the novated lease. Mainland Chinese airlines were not willing to obtain such approval for an aircraft which had already been imported by them previously, as it was near impossible to get a new NDRC approval. On 17 November 2019, the Chinese customs authority released the Public Notice 2019 No.158. Pursuant to this notice, an aircraft does not need to be physically exported from and re-imported into China for the title transfer between onshore FTZ SPVs and offshore SPVs, rather, only customs formalities (i.e. customs declaration) need be completed. Therefore, a new NDRC approval in respect of the importation of the aircraft is no longer required for the title transfer from mainland Chinese FTZ SPVs to Hong Kong SPVs. As reported in our March 2020 issue, we note that there has been some first principles debate as to the status of a LILO involving Hong Kong; therefore, clear advice needs to be obtained as to what is feasible.
- Cape Town Convention should be applicable to a Hong Kong LILO structure. Thus, the Hong Kong SPV/head lessor can be protected by registering the head lease with the international registry and recording the IDERA with CAAC. As reported in our March 2020 issue, we note that there has been some first principles debate as to the status of a LILO involving Hong Kong; therefore, clear advice needs to be obtained as to what is feasible.
- Given that the lease between Hong Kong and mainland China is an aircraft operating lease, it will be deemed as a trade/current account/transaction, and unlike finance leases, it will not be subject to NDRC and SAFE foreign debt regime.
- It should be ensured that the mainland Chinese SPV/sub-lessor in FTZ is entitled to collect US dollars under the sublease so as to avoid any currency mismatch issues. Readers will also note that, only a few FTZs in mainland China have adopted a policy which allows the remittance of US dollars between the mainland Chinese airline lessee and the mainland Chinese FTZ sub-lessor under an operating lease.

Tax

Today's global tax environment is arguably more dynamic and challenging than it has ever been, with a direct impact to the aircraft leasing industry. The move of aircraft from mainland China to HKSAR is partly led by the needs of accessing the offshore market but it is also a trend involving the maturing of the Chinese leasing market which was underway pre-pandemic. Executing on the opportunity will require Chinese lessors to be capable of managing more complex tax related matters in an international tax environment.

We highlight below some of the major tax considerations when moving the aircraft with lease attached from mainland China to HKSAR:

- The move should not cause adverse mainland China tax impacts to mainland Chinese airline lessees. The transfer of the onshore ownership of aircraft to Hong Kong and the novation of the lease agreement should also not give rise to material mainland China tax impacts to the aircraft lessors. However, the aircraft lessors should carefully assess the potential impact on the local government subsidies granted under the bonded leasing structure as a result of the move. Also, it is recommended that aircraft lessors communicate the potential move with all the stakeholders (including mainland Chinese airlines and FTZ government authorities) at an early stage.

- The statutory withholding tax rate on rental payments from a mainland Chinese tax resident company to a non-tax resident company (e.g. a Hong Kong company) is at 10%. To be able to enjoy the reduced withholding tax rate at 5% on rental payments under the China Hong Kong Double Tax Arrangement, the Hong Kong SPV/lessor in the Hong Kong aircraft leasing platform should have sufficient business substance to qualify as the beneficial owner of the rental.

- To fully leverage the tax benefits under the Hong Kong aircraft leasing tax regime (that is, to achieve an effective tax rate of 3% to 7% for the Hong Kong SPV/lessor and be tax neutral on Hong Kong profits tax on the disposal of the aircraft), the Hong Kong aircraft leasing platform should also have sufficient business substance in place. The need to build business substance ought to be given due consideration as it requires more than a token effort. There needs to be a clear business plan that strikes a balance between the available resources and regulatory requirements, and is properly reviewed by tax advisors for an early assessment.

- The Hong Kong transfer pricing rules should not be neglected when structuring the junior loan financing (i.e. inter-company loan) and inter-company lease management services of the Hong Kong aircraft leasing platform, where applicable. Questions such as how to price and prove the inter-company loan and lease management services are on an arm's length basis should be properly dealt with in case of any potential challenges from the tax authorities.

Challenges

Although moving aircraft with lease attached from mainland China to HKSAR is feasible, some challenges remain when making such a move:

- In practice, CBIRC has suspended the approval procedures for setting up offshore aircraft leasing vehicles by financial leasing companies in mainland China.

- Public Notice 2019 No.158 is not applicable to transactions where a mainland Chinese airline (mainland Chinese airlines is the owner of the aircraft) transfers the title of the aircraft to a Hong Kong SPV and then leases it back. Therefore, in such cases, the aircraft needs to be first exported from China and then re-imported into China. As mentioned above, a new NDRC approval of the importation of the aircraft would be required in those cases. Based on our communications with airlines, lessors and FTZs, they would very much like to resolve this issue and are pushing the government to release a similar notice to Public Notice 2019 No.158. It remains to be seen if there will be any change of policy and practice in the near future.

- As mentioned above, we have seen cases where the CAAC has refused to issue AEP codes and record the IDERA for a Hong Kong LILO structure, as the CAAC continues to consider (i) whether the head lease is an internal transaction under the Cape Town Convention and (ii) whether the IDERA should be registrable for such structure due to its national interest nature.

Conclusion

The effectiveness of Public Notice 2019 No.158 opens up the possibility of moving offshore, with lease attached, the mainland Chinese onshore aircraft portfolio. Although there are still some regulatory uncertainties to be addressed, we believe more market participants will start to explore the possible routes for moving their aircraft portfolio offshore driven by different commercial needs. We also believe the idea of the move is not to replace the existing bonded leasing structure, which has been a remarkable success in the Chinese aircraft leasing industry, but rather the idea of a move will resonate the industry's need for a more diversified aircraft leasing market in mainland China. Last but not least, we always welcome your questions and thoughts.

Experience post - implementation of new lease standards under CAS 21

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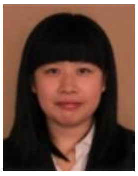

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On 1 January 2021, we witnessed the full implementation of the revised China Accounting Standards for Business Enterprises No. 21 – Leases ("the new lease standards"). The new lease standards, released by PRC Ministry of Finance on 7 December 2018, brought significant implications for the aviation industry with material changes in the accounting treatment of lease transactions.

Major accounting treatment changes for lessees will need to be managed

Off-balance sheet leases have been a common tool for the past few decades for aircraft financing. In addition to aircraft, airlines also lease important facilities from airports necessary for their daily operations - such as check-in counters, boarding gates and bridges. Under the new lease standards, and for almost all types of leases, lessees recognise on balance sheet the right-of-use assets and lease liabilities, regardless of whether the lease is finance or operating in nature.

For a single lease, the lessee recognises the depreciation of the right-of-use asset as a lease expense on the income statement, and an interest expense based on an effective interest rate in the lease payment, with the overall cost decreasing over the life of the lease. The impact of the new lease standards on the balance sheet and income statement will also influence key accounting indicators, including: asset-liability ratio, liquidity ratio, EBIT, net income, earnings per share, return on equity, and operating cash flow.

Tax implications for lessees

In accordance with Article 47 of the Implementation Regulations of the PRC Corporate Income Tax ("CIT") Law, rental expenses paid by an enterprise for leased fixed assets that are used for its production and business operation activities, should be deductible pursuant to the following methods:

- Rental expenses incurred on fixed assets under an operating lease should be deducted evenly throughout the lease term;
- For rental expenses incurred on fixed assets under a finance lease, the portion that contributes to the value of fixed assets pursuant to the regulations should be depreciated and deductible in instalments.

For **direct finance leases**, lease expenses recognised in the accounts may differ from the deductible amounts allowed for CIT purposes, resulting in a gap between the asset's tax basis and book value. In addition, the interest expenses recognised based on the effective interest rate method are not deductible from a CIT perspective. These book value-to-tax basis differences have existing routine adjustment items in the annual CIT filing for lessees, prior to the full implementation of the new lease standards. As only limited changes are brought to the accounting treatment for direct leases following the new lease standards, lessees would continue to make the above tax adjustments for their annual CIT filing.

For **sale-and-leaseback transactions**, from an accounting perspective, lessees will need to assess whether the arrangements constitute sale of assets in the first place. If the arrangement is considered to be a sale-and-leaseback transaction rather than an outright sale, lessees would continue to record aircraft assets and corresponding depreciation on their book value. The total amount of cash received would be recognised as a financial liability, while interest expenses are recognised on an effective interest rate basis. From the CIT perspective, depreciation of an asset's original tax basis, and the interest expense paid within the lease term are deductible against current period profit. In this respect, the new lease standards bring no additional book value to tax basis differences for sale-and-leaseback transactions.

For operating leases, prior to the full implementation of the new lease standards, the original accounting treatment for lessees was to recognize the lease expenses on a straight-line basis (without regard to any rent-free period), which is consistent with the tax treatment, that is, "deductible evenly throughout the lease term" as indicated in the CIT law, generally no additional tax adjustment is required. However, under the new leasing standards, lease expenses which were previously recognized by lessees for operating leases are replaced by two separate items, that is, depreciation of the right-of-use asset and interest expense (recognized on effective interest rate basis, decreasing through the lease term). That said, book value to tax basis differences would occur and necessary tax adjustments needed to be made against the lease expenses calculated on a straight-line basis.

Summary of the CIT implications for lessees imposed by the new lease standards:

Type of leases	Book to tax differences
Direct finance leases	No material changes compared with treatments prior to the new lease standards.
Sale-and-leaseback	No book value to tax basis differences under the new lease standards and the existing tax adjustments may need to be reversed (if any).
Operating leases	New book value to tax basis difference.

Tax implications for intermediate lessors under the lease-in-lease-out structure

In a lease-in-lease-out (“LILO”) structure, the intermediate lessor, as the lessee of the head lease arrangement with the head lessor, should be recognize the right-of-use asset, the unrecognised financing expense and the lease liability in accordance with the new lease standards upon the commencement of the lease. At the same time, taking into account the relevant factors, (e.g. the head lease term, the sublease term, the head lease rental and sublease rental), it is very likely that a sublease will be assessed to be a finance lease from an accounting perspective. The right-of-use asset shall be written off, and the finance lease receivable and interest income receivable shall be recognised in the first period.

In view of the above, for the intermediate lessor, the P&L implications will be interest income and interest expense. From the CIT perspective, the interpretation of the transaction might be different. Referring to Articles 18 and 19 of the Implementation Regulations of the CIT Law,

- "Interest income" shall refer to income derived from the provision of funds for other parties to use but not constituting equity investment, or from the possession of its funds by other parties, including deposit interest, loan interest, bond interest, arrear interest, etc. Interest income is recognised as income on the interest payment, due dates as agreed, with the debtor in the contracts.
- "Rental income" shall refer to the income derived from the provision of the right to use fixed assets, packaging materials, or other tangible assets. Rental income is recognised as income on the rental payment due dates as agreed with the lessee in the contracts.

In most cases, intermediate lessors shall recognise rental income for CIT purposes. Meanwhile, the amounts paid to head lessors should be deductible as rental expense evenly throughout the lease term.

In conclusion, under the new lease standards, intermediate lessors of a LILO arrangement might need to recognize interest income and interest expense periodically in their accounts. From the CIT perspective, taxable income of the current period should be calculated based on the rental income and rental expenses, resulting in a book value to tax basis differences on both income and cost. Although the differences are a temporary nature, the finance and tax personnel of enterprises engaged in LILO transactions would face greater workloads.

Our recommendations

For operating leases and LILO arrangements, the implementation of the new lease standards has resulted in significant changes to the accounting treatments; meanwhile, no particular CIT provisions are introduced. As a result, enterprises engaged in these two types of leases need to pay attention to the extra tax adjustments necessary in annual CIT filings.

In response to the changes, enterprises need to carefully assess the accounting treatments of the existing leasing contracts and keep track of the relevant tax adjustments, which, under particular circumstances such as the termination of leases, might be fully reversed. In view of complicated assessments and tax adjustments occurring, it is recommended that enterprises seek professional assistance from accounting and tax advisors to help navigate the first CIT annual filing, after a full implementation of the new lease standards resulting from CAS 21.

How will aviation finance groups be affected by the new Irish Interest Limitation Rule

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In December 2020, the Irish Department of Finance (the "Department") released a consultation document, the "Feedback Statement", considering how to approach the implementation of one of the remaining EU Anti-Tax Avoidance Directive ("ATAD") measures: the Interest Limitation Rule ("ILR").

The ILR requires EU Member States to introduce a fixed ratio rule which restricts a company's allowable net interest tax deductions to a maximum of 30% of its taxable EBITDA. This new approach to interest deductibility in Ireland will take effect on 1 January 2022.

Given the capital-intensive nature of the aviation finance industry and the high levels of relative leverage, such a limitation could have a significant impact for some in the industry, potentially increasing effective tax rates in certain platforms.

In addition to supporting the industry led submission by Aircraft Leasing Ireland, the PwC Ireland Aviation Finance team submitted a response to the Feedback Statement on the various steps and issues of interest for the aviation finance industry. In that submission, we have sought maximum flexibility and optionality in the adoption of the rules. As the rules are being layered on to Ireland's existing complex interest deductibility and withholding tax provisions, which Ireland views as providing sufficient protection to deal with base erosion concerns, such asks are necessary to keep Ireland's tax regime competitive.

We comment below on a selection of the key steps and issues in the Feedback Statement of relevance and the views of the PwC Ireland Aviation Finance team on the relevant matters. If you would like to view a copy of our full submission to the Department, please reach out to one of the team.

Interest equivalent implicit in lease rentals

The ILR is intended to limit the deductibility of in-scope taxpayers' net interest expense (taxable interest and other interest equivalent taxable revenues less deductible borrowings).

The greater the proportion of a company's income which is treated as taxable interest income and other interest equivalent taxable revenues, the lesser the effect of the ILR. The question for aviation finance taxpayers is whether an element of aircraft lease rentals can be regarded as equivalent to interest?

It is clear from the definition in the Feedback Statement, that finance lease income/expense would be considered interest equivalent. However, in an aircraft leasing context, a lessor involved in a trade of leasing, even where such leases are treated as operating leases from an accounting perspective, should essentially be viewed as carrying on a financing activity. Considering the activity over the life-span of an aircraft leased out by way of operating lease, it is clear that the lessor is essentially interested in earning a return on its capital akin to a financing return. As such, certain jurisdictions already recognise this in their tax legislation, splitting operating lease payments into a financing component and capital component for tax purposes. In our view, an aircraft lessor should be entitled to treat the implicit interest component included in operating lease rentals as interest equivalent for the purposes of the ILR. In order to appropriately identify this implicit interest component, similar principles to those applying under IFRS 16, which currently recognises the inherent financing charge / return included within operating lease rental income for the lessee, could be adopted. Alternatively, a simplified approach to the calculation could be considered leveraging an existing approach carried out by aircraft leasing companies, in assessing transactions from a commercial perspective.

While far from definitive, the Feedback Statement's potential definition of interest equivalent does appear positive in the sense that it is broadly defined so may be viewed as including the interest element implicit in operating lease rentals. However, given the importance of the matter to the industry, we have requested explicit legislative clarity or, failing that, acknowledgment of the position in Irish Revenue guidance on this matter in our submission.

Group ratios offer potential for increased interest deductibility

ATAD provides two possible modifications to the general fixed ratio rule where a taxpayer is a member of a consolidated group for financial accounting purposes:

(i) the “Equity Ratio Rule”, which would allow taxpayers to fully deduct exceeding borrowing costs without limit where the ratio of the taxpayer’s equity to total assets does not fall more than 2% below the equivalent ratio of the worldwide group as a whole; and

(ii) the “Group Ratio Rule”, which replaces the 30% EBITDA restriction with a percentage determined by reference to the consolidated group’s exceeding borrowing cost for third party loans divided by the group EBITDA.

The Feedback Statement indicates that consideration is being given to providing for both “group ratios” and allowing the choice of ratio to be at the discretion of the taxpayer, a really positive starting point. That said, the question being framed in the consultation does ask for an understanding of impact if Ireland were to offer only one option. In our submission, we have strongly recommended that both options are provided as the applicability of either ratio will depend on the facts within particular aviation finance groups based on their funding and capital structures. Considering the impact of COVID-19 alone, we are going to see huge volatility in earnings, interest costs and asset values in the aviation finance industry which may create difficulty in forecasting the impact of the application of one ratio over another.

For standalone aviation finance groups, the adoption of the group ratios could be of significant benefit. However, the application of either of the ratios may not be as beneficial for aircraft lessors, which are part of large diversified groups, as the equity to asset value ratios are generally lower and interest to EBITDA ratios are generally higher for aviation finance than most other industries.

ATAD allows Member States to provide optionality, we believe this flexibility should be provided to ensure that one group of taxpayers is not adversely impacted at the expense of another.

In addition, a number of fundamental questions related to the technical application of the rules have yet to be addressed in the context of group ratios and indeed, the definition of what constitutes a group for these purposes. These open questions are currently being advanced in the context of the next feedback statement on this matter (expected later this year). But his means that taxpayers are still significantly unclear on the likely impact of the overall rules.

PwC Ireland has sought maximum flexibility as to what approach can be adopted here as there is likely no one size fits all outcome - in short, providing for both group ratios would represent the optimal outcome here. We have also sought clarity on a number of other elements of the proposed means of applying the ratios.

Notional local group – treatment as a single taxpayer

ATAD provides an option to apply the ILR on a company-by-company basis or to a local group of companies as defined under domestic law. The Feedback Statement indicates that consideration is being given to the adoption of the group approach, at the discretion of the taxpayer. This would be welcomed by the aviation finance industry, as the application of the measures on an entity by entity basis could represent a significant compliance burden for lessors. It could result in increased restrictions on interest deductibility as excess interest capacity or restricted interest carried forward from a prior period could get trapped in individual entities. However, as with the group ratios, the detail on this element will be dealt with in the second feedback statement later in the summer. To further note, consultation leaves much of the detail on the rules outstanding, which will ultimately be crucial to the effectiveness of these provisions.

PwC Ireland welcomes the potential adoption of the group approach but we have also put forth requests for flexibility in defining the local group to take account of various commercially led structuring issues prevalent in the aviation finance industry.

Exempting "legacy debt" (if not materially modified)

Positively, an exemption to exclude loans which were concluded before 17 June 2016 from the ILR is proposed in the Feedback Statement.

However, to the extent that there is "*any modification to the terms of that debt on or after 17 June 2016, including modifications to the duration of that debt, the principal drawn down or the interest rate on that legacy debt*", the ILR would subsequently be imposed.

The fact that either an interest rate change, which could occur for any number of reasons including simply an opportunity (or requirement) to switch from a fixed to variable rate or vice-versa, or a drawdown of principal post 17 June 2016 could be viewed as constituting a modification could significantly curtail the benefit of the carve out. Such an approach, particularly on the principal drawdown, seems unfair as many transactions will have been contemplated or even committed to in advance of the cut-off date. That being said, the Feedback Statement did invite comments on the approaches to defining and exempting "legacy debt", and on the concept of "modification" in the context of these legacy loans. With this in mind, we and others in the industry have responded with these issues and other technical matters.. In addition, both the Department of Finance and Irish Revenue have indicated that, to the extent a modification does arise, the grandfathering can still apply to the original terms, so there may be some element of relief available.

'Long-term public infrastructure project' exemption

ATAD also provides that Member States may exclude both the income and associated expenses of certain 'long-term public infrastructure projects' from the scope of the ILR restriction. The Feedback Statement indicates that the Department is contemplating the introduction of such an exemption, but no detail on the possible scope and criteria for qualification has been put forward.

Ideally, we would like to see such an exemption included in Irish legislation, with the scope of application being sufficient to include the financing of aircraft operated in the EU which appear to meet the key conditions under ATAD for inclusion, being long-life, large scale assets with a general public interest purpose. As with other aspects, we encourage a wide adoption here, as a long-term exemption such as this will need to be flexible as public infrastructure requirements adapt over time.

Computational issues

The Feedback Statement outlines the approach to calculating the exceeding borrowing costs and applying the interest deductibility restriction.

In our view, the approach proposed is overly complicated and one aspect of the calculation in particular, gives some cause for concern. Under the proposed approach, if an interest deductibility restriction arises, the restricted amount will be subject to tax under Case IV with no ability to offset the charge with a loss. As an aviation finance entity will typically be in a Case I tax loss position in the early years of a transaction, the Case IV taxing mechanism could inadvertently accelerate a charge to cash tax which would not otherwise have arisen due to losses brought forward or excess capital allowances.

However, we do not believe that it is the intention to create rules which trigger a tax liability where one would not exist outside of any restriction of interest deductibility. In our submission, we have raised our concerns on the current proposals in particular, the level of complexity that it brings for a Case 1 trader, and sought clarity on the matter.

Key takeaways

With implementation of the ILR set for 1 January 2022, there will be limited time to assess the potential impact and consider options to mitigate any negative effects that could arise come the next feedback statement issuance set for mid-2021.

It will be necessary for aviation finance groups to consider the possible impact of these rules sooner rather than later. We are already working to model out the potential tax impact on aircraft leasing platforms across several scenarios, and to consider next steps once a clearer picture emerges as the year progresses. PwC Ireland have developed an ILR analysis tool specifically to illustrate the potential impact on the corporation tax position of groups in a visual and interactive manner. We would be happy to discuss how we can assist you in assessing the possible impact of the proposed rules, including modelling out the effects on your group.

The open consultation process run by the Department of Finance shows their commitment to getting stakeholder engagement. We would encourage aviation finance groups, either individually, or collectively, to continue to feed into the process with the Department. PwC Ireland will continue to engage with the Department and monitor developments as the process progresses and we approach the second consultation on this issue later this summer.

Pandemic driven permanent establishment and tax residence concerns – Aviation Finance Focus

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In brief

The outbreak of COVID-19 and the accompanying cross-border travel restrictions and quarantine requirements have had an unprecedented impact on business operations globally. Given the high level of mobility and the importance of travel in the aviation finance industry, such a change in business operations has created complicated commercial and tax challenges for many in the industry.

On 21 January 2021, the Organization for Economic Co-operation and Development ("OECD") published an update to their earlier April 2020 guidance on cross-border tax issues arising from the COVID-19 pandemic. In summary, the update extends previously provided guidance, given the longevity of the crisis. The latest guidance conveys the key message that exceptional and temporary changes to work location or arrangements arising directly as a result of the COVID-19 pandemic should not by themselves result in the creation of a permanent establishment ("PE") or a change of tax resident status of a company or an individual.

However, the OECD guidance is merely a view on the interpretation of various treaty provisions which is not legally binding. Jurisdictions may adopt a different view of the relevant treaty provisions from those expressed by the OECD. In situations where tax treaties do not exist, the relevant jurisdictions' domestic tax rules may still apply. It should therefore be clear that it is important for aviation finance industry participants to assess their circumstances and to proactively monitor and manage such tax risks.

In detail

Persistent restrictions on cross-border movement, quarantining, remote work arrangements – all playing havoc with workforce management and creating unfamiliar and complex tax challenges for every industry.

The potential tax issues associated with COVID-19 special work arrangements may be particularly pronounced for the aviation finance industry given the difficulties facing many parties in the industry right now. Such companies may be dealing with scenarios where dislocated top-level management and directors are making some of the most significant decisions their companies have ever faced from whatever location they happen to be based in. Commercially, that might be what needs to happen, but from a tax perspective, this has the potential to create a host of issues if not managed correctly. The actions may increase the risk of creating a PE or taxable presence in some jurisdictions and could even have an impact on the tax residence position of group companies in certain circumstances.

Permanent establishment risk

The OECD's guidance, as it relates to the potential PE issue described above, can be summarised as follows:

Fixed place PE: the exceptional and temporary change to work location as a COVID-19 public health measure imposed or recommended by at least one of the governments of the jurisdictions involved would not create a fixed place PE for the business or employer. If the employee continues to work from such exceptional or temporary work location after the cessation of the public health measures, the likelihood of constituting a PE will increase but thought should still be given to other criteria for a fixed place PE including whether the location is at the disposal of the business or employer.

Agency PE: The agent's activity in a jurisdiction should not be regarded as "habitual" if they have begun working at home in that jurisdiction on an exceptional basis as a result of a COVID-19 public health measure imposed or recommended by at least one of the governments of the jurisdictions involved and therefore, would not constitute a dependent agent PE, provided that the person does not continue those activities after the public health measures cease to apply.

The above OECD guidance provides a positive message that exceptional or temporary work arrangements as a direct result of COVID-19 should not by themselves lead to the creation of a PE. However, some terms are not explicitly defined (public health measures for one) which leaves key elements open to interpretation. Also, as noted, specific jurisdictions may take a different view on the interpretation of treaties and, for situations where there is not an applicable double tax treaty, domestic rules governing what constitutes a local taxable presence may still apply without concession.

Furthermore, companies should carefully assess whether their business activities or employees' unintended stay in a jurisdiction would trigger domestic tax reporting obligations, even though they may ultimately be able to claim a tax exemption under the applicable tax treaty.

Corporate tax residence concerns

The view of the tax authorities in three jurisdictions on the tax residence of aircraft owning companies is key in most leasing structures:

- the intended jurisdiction of tax residence of the relevant asset owning company;
- the jurisdiction of the parent company or indeed any other jurisdiction where directors or key management staff happen to be based; and
- the lessee jurisdiction.

While relevant for the wider aviation finance industry, aircraft lessors, in particular, commonly have resident individuals of their parent jurisdictions as directors and/or in senior management positions for their overseas group companies. Such staff would typically fly to the leasing hub locations for management and board meetings where they would participate in the key strategic decision for those companies.

Across last year, and for much of the year ahead, many of those trips may not be possible. While it varies greatly based on the local substance each group has in the relevant leasing platform location, for some aircraft lessors, the periodic physical presence of those individuals is key in ensuring that they are regarded as tax resident in those locations. With that travel no longer possible, actions to mitigate the risks around tax residence may be required.

The OECD guidance also addresses certain circumstances in which there is a residence issue for an entity as a result of a temporary displacement of board members or other decision-making executives as a result of an extraordinary situation due to the COVID-19 pandemic. The general message is again positive, suggesting that any such circumstances should not lead to a change in an entity's tax treaty residence status. The guidance indicates that under the tie breaker rule in treaties, all relevant facts and circumstances should be considered to determine the "usual" and "ordinary" place of effective management and not only those facts and circumstances that pertain to an exceptional and temporary period.

Aircraft lessors and others may be able to argue that the change of their decision-making location is only temporary or exceptional. However, care should still be taken to assess the potential risk to the tax residence status of group companies and proper actions should be adopted proactively, adapted to the locations in question. The same limitations on the applicability of this guidance are relevant for residence as they are for PE considerations – the views expressed by the OECD are not binding on any country, the lack of a definition for certain key terms and the guidance's limited applicability to situations with a tax treaty in place.

Other concerns

There are also some other concerns that could arise for certain aviation finance structures, including some industry specific issues. There may be certain concerns from a substance perspective in local leasing platform jurisdictions rules e.g. Hong Kong, Singapore or even Ireland in the context of maintaining trading status. Other concerns may be lease specific with certain leases, albeit a very limited number, including covenants that require varying degrees of activity and specific functions to be carried out in the location of the aircraft owning company.

While this article deals primarily with the corporate income tax considerations associated with dislocated employees, the tax residence of the individuals concerned could also be impacted and employer tax filing and payment obligations could arise if a dislocated individual begins to exercise their employment in a new host jurisdiction. Again, the OECD guidance expresses somewhat helpful views on the taxation of such income and administrative obligations but ultimately that may not eliminate obligations and liabilities triggered in particular countries.

Assessing and addressing the risks

There are concrete steps that aircraft lessors and others in the industry can take to mitigate the risks discussed and otherwise assess and adhere to any compliance requirements arising.

The starting point for any affected company should involve an assessment of their global presence and activities to identify any dislocated individuals and higher risk jurisdictions and leases. It may then involve moving on to renewing, or perhaps creating, operating guidelines aimed at managing risks factoring in the current mobility challenges.

Furthermore, close attention should be paid to any guidance issued by their local tax authorities in relation to tax issues associated with the COVID-19 pandemic and assess the impact of such guidance on their own business operations.

The OECD guidance is helpful as it provides an influential reference point for taxpayers and tax authorities alike. However, as mentioned above, it has its limitations and taxpayers would be wise not to be overly reliant on that guidance or hold expectations that tax authorities will be particularly lenient despite the circumstances being beyond their control.

Some legal lessons from COVID-19 pandemic enforcement – a walk through some fundamentals and the latest on the arguments around insolvency cram-downs and the Cape Town Convention and the Aircraft Protocol (“CTC”)

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Out of the adversity of the COVID-19 pandemic, there have been several Cape Town Convention legal developments or opportunities to test fundamental principles of aircraft and asset financing and leasing.

Not only is it incumbent upon the industry to be aware of these developments in shaping strategies to ride out the current pandemic but these developments will need to be factored into shaping the commercial transactions and the legal structures of the future, particularly from the perspectives of creditors (investors, financiers and lessors) in protecting their position in future downturns.

Hell or highwater clauses

As mentioned in our March 2020 Aviation Insider article, we expected that “hell or highwater” provisions in leases would (leaving aside airline insolvencies) be upheld, with English courts and English law leases having very little scope for the ability of lessees to be able to unilaterally amend their leases or to otherwise escape their obligations by making some sort of “force majeure” argument, and our experiences and recent cases in the COVID-19 environment have bolstered this expectation.

The issue was recently considered in *Salam Air v Latam Airlines Group ([2020] EWHC 2414 (Comm))*, where the court rejected the argument by the aircraft operator (Salam Air) that a lease agreement was frustrated due to the inability to fly during the COVID-19 epidemic. In reaching this decision, the court referred to the hell or highwater provisions in the lease as being a “challenging context in which to establish frustration”, as most risks are explicitly assumed by the lessee.

As we also mentioned, this puts the lessor in a position where any lease modifications have to be agreed on a consensual basis, and indeed, many financiers and lessors in the aviation industry have provided a vast amount of flexibility and support to the airlines by a variety of different means (including payment holidays, waivers, PBH arrangements, and subscribing to debt for equity or “equity like” swaps).

Insolvency proceedings, cram downs and the CTC

COVID-19 has also given jurisdictions all over the world the opportunity to test and consider the insolvency related provisions of the CTC. In a previous Aviation Insider newsletter, we looked at Australia,[1] and in this article, we discuss in further detail another aspect of the insolvency related provisions of the CTC, namely the “anti cram down” provisions set out in Article XI.

Article XI of the CTC provides:

- a choice for the contracting state to choose “Alternative A” or “Alternative B” in relation to insolvency related proceedings;
- a debtor’s obligations cannot be modified without the consent of the creditor (Article XI(10)); and
- nothing prevents insolvency administrator from terminating an agreement (Article XI(11)).

As such, Article XI has always been thought to prevent a cram down, in the sense that creditors cannot be forced to accept a re-written lease or loan in relation to an aircraft object that is presented to them as part of an insolvency restructuring procedure without their consent. If a debtor wanted to keep an asset, it would either need to cure all defaults (except the insolvency default) or it would be required to return the aircraft asset.

This is also the position that is strongly advocated by the Aviation Working Group, on behalf of creditors in these matters, on the basis that consensual work-outs are a fundamental aspect of asset financing principles and CTC creditors should not be subject to have their rights unilaterally adjusted without their consent.

The Article XI anti cram down provisions have recently come under scrutiny in a number of jurisdictions, where airlines have made various applications under their local equivalents of a “scheme of arrangement”. [2]

Schemes of arrangements in the UK and elsewhere

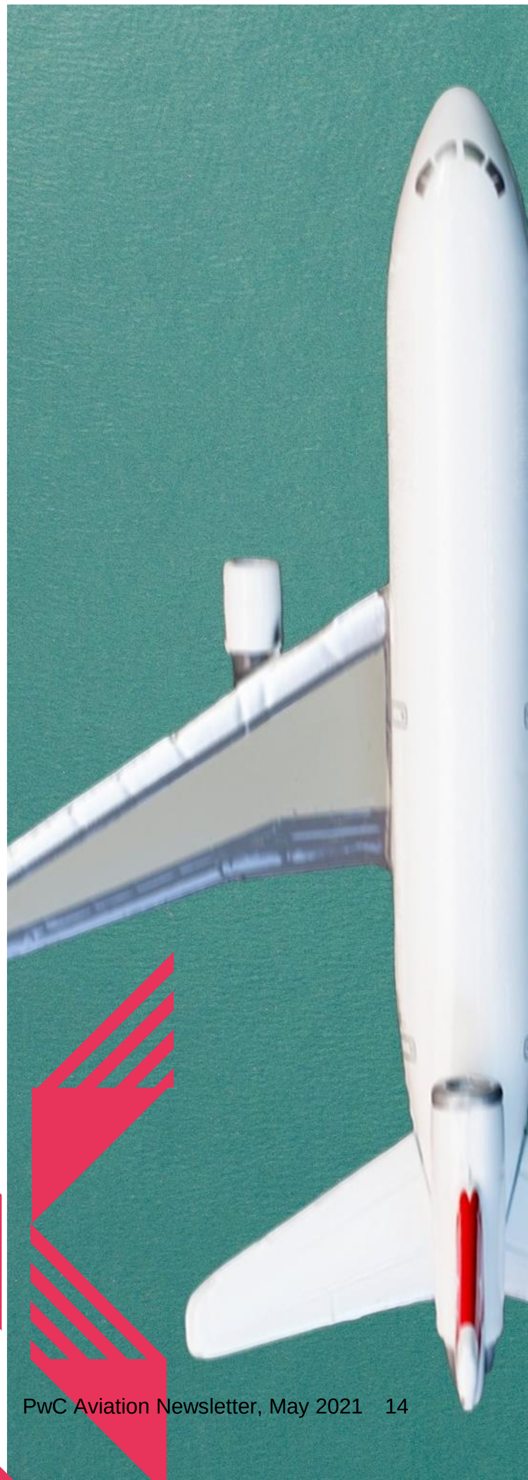
In the UK, Part 26 of the Companies Act (“**Part 26**”) contains the substantive provisions for schemes of arrangement which have been available historically. To put Part 26 into a global context, similar procedures have also been adopted in a number of other common law jurisdictions, including Australia and Malaysia.

Under Part 26, a company may propose an arrangement or compromise with their creditors (or classes of them), which of the minority creditors have to accept if such a scheme is approved by the required majority (being more than 75% by value and 50% by number) if sanctioned by the court (commonly known as a “cram down”). However, the scheme must be approved by the required majority of every single class, and if one class decides not to vote in favour of the scheme, then the scheme will not be approved.

The UK has also recently enacted Part 26A of the Companies Act (“**Part 26A**”) [3], which allows a court to sanction and bind all creditors in a class to a “plan” even if the required majority of creditors in a particular class did not meet that required majority, subject to certain conditions. As all the creditors in a class may be forced to accept a scheme even if the required majority is not achieved, Part 26A can be used to achieve a cram down of all creditors in a dissenting class (a “cross-class cram down”).

Against this backdrop, a number of airlines and leasing companies have availed themselves of the scheme of arrangement procedure under Part 26 or 26A of the Companies Act. This is to achieve a restructuring of the company’s debts in the backdrop of the COVID-19 pandemic and the complexities associated with enforcing under such environment.

Examples include Virgin Atlantic Airways (under Part 26A) and Malaysian Airlines (under Part 26). In other parts of the common law world, other companies have or are undergoing restructurings including Nordic Aviation Capital in Ireland and AirAsia X in Malaysia.



All the above countries have adopted Alternative A and one of the first questions that needed to be considered (or is to be considered) by the courts is whether a scheme of arrangement is an insolvency related event. If the scheme of arrangement is considered an insolvency related event, then Article XI would apply and the ability of debtors to achieve a cram down or cross-class cram down would be limited by the requirements of Article XI. On the other hand, if a scheme of arrangement was not an insolvency related event, then Article XI would not apply and courts would be free to sanction schemes which altered creditors rights by rewriting the terms of their contracts, and without regard to the CTC. For example, under Part 26A, it would be possible that a court could sanction a scheme approved by a required majority of creditors which require all lessors to agree to reduced rate of rent or a PBH arrangement, even if the entire class of lessors voted against it. As would be expected, the companies proposing the schemes are keen to maximise their flexibility and ability to restructure their affairs and leave the restructured company in a position as strong (and as debt-free) as possible after the restructuring. They would also argue that a majority of creditors who had confidence in a company's rehabilitation, should not be "held hostage" by a number of creditors who refuse to sanction a scheme.

The inclination of all these scheme proponents has therefore been to argue that Article XI does not apply at all, because a scheme of arrangement is not an insolvency proceeding. The reasons put forward have varied and can be quite technical. Perhaps the strongest of the arguments have been put forward by Professor Jennifer Payne, in expert evidence provided in a number of different proceedings (including in the Nordic, Malaysian Airlines and AirAsia X schemes). Professor Payne makes the following argument[4]:

A. under general insolvency law and the CTC, an "insolvency proceeding" has a number of requirements:

a. the proceedings have to be a collective proceeding;

b. the debtor's assets and affairs must be subject to control or supervision by a court; and

c. the purpose must be the reorganisation of the debtor, or immediate liquidation; and

B. while elements a. and c. are present in schemes of arrangements, element b. is not. This is because, although a scheme of arrangement must be sanctioned by a court, the possession and management of the debtor remains with the management of the company. In contrast to an administration or insolvency, a supervisor is not appointed to the company and the court does not take control of the company.

In the UK, while the court has been invited to make a decision on this aspect in the airline cases, neither the judges in the Virgin Atlantic nor the Malaysian Airlines schemes had ultimately decided to rule on this point, on the grounds that it would be moot as the schemes had the overwhelming approval of the scheme creditors.

In the AirAsia X case, the judge (Justice Ong) ultimately held that a scheme of arrangement under the Malaysia equivalent of a scheme of arrangement (under s. 366(1) of the Malaysian Companies Act) was an insolvency proceeding. In coming to this decision, Justice Ong of the High Court of Malaysia considered the expert evidence and the Nordic and Virgin Atlantic cases. Justice Ong reasoned that the argument as put forward by Professor Payne had construed requirement b. too narrowly. While the company continued to manage its own affairs outside of the scheme application, the scheme itself involved the assets and affairs of the debtors, and the scheme had to receive the sanction of the court, therefore, requirement b. was met.

This being the case, Article XI applied to AirAsia X's proposed scheme and the scheme could not be approved if it was inconsistent with the requirements of the CTC (in particular, the insolvency related provisions in Article XI).

The AirAsia X scheme included the options for a creditor to either agree to revised terms in their lease, or to terminate the lease and be paid a certain payment which was calculated to be a premium to what they would have received, if AirAsia X was put into liquidation.

The court held that this was consistent with the requirements of the CTC. In coming to this view, the court made a distinction between obligations under a lease and the debt claims for unpaid rent and other amounts following a default and lease termination.

The court considered Articles XI(10) and (11) together and held that under Article XI(10), the obligations that are not able to be amended are obligations under the lease agreement itself. On the other hand, once a lease is terminated, the remaining debt claims are separate from a lessee's obligations under a lease and not subject to the Article XI(10) restriction.

Accordingly, Justice Ong decided to allow the scheme of arrangement to move on to the next stage, which is for the creditors to determine whether the scheme should be approved.

Our take

In our view, this position is likely the correct one - a scheme of arrangement that purports to cram down lessors by unilaterally varying their rights under the lease agreement itself, without the consent of the lessor, we would have thought that this would be inconsistent with the requirements of the CTC. However, as Justice Ong noted, the AirAsia X scheme was not such a scheme. In fact, the scheme respected the rights of creditors by allowing them to refuse to consent to any such modification and the outcome of such refusal to consent would be a lease termination, with the lessor having the right to take possession of the aircraft. Accordingly, schemes proposed in such a manner would not conflict with the requirements of the CTC. This would also appear to be a solution that would be consistent with the objects of rehabilitation and insolvency law. It would allow the CTC to operate as intended in respect of the aircraft "metal" without interfering with the broader aspects of dealing with a debtor entity's wider liabilities and creditor dynamics, including the ability to agree a rehabilitation plan with its creditor group as a whole.

In the absence of any scheme, the only difference would be that a lessor would make a claim for unpaid rent and losses that the lessor would have suffered under the lease agreement (in accordance with the default provisions of the lease). If the lessee is unable to meet these payments, the lessee would have no choice but to enter into liquidation, or similar insolvency proceedings, where the lessor would need to prove its debts which would rank equally with all other unsecured creditors. From the lessee's perspective, a scheme that would leave a lessor in no worse a position than they would be in an insolvency, and with the ability to recover the aircraft, would arguably be a fair result.

[1] We had in previous Aviation Insider newsletters already looked at Australia as it was one of the first jurisdictions where a court had the opportunity to consider the Alternative A "give back" requirements in the context of local insolvency laws (Please scan the QR Code to read the article.)

[2] While Alternative A is modelled on Section 1110 of the US Bankruptcy Code, it is not exactly the same and discussing Section 1110 / Chapter 11 cases would be beyond the scope of this article.

[3] The newly enacted Part 26A was introduced by the Corporate Insolvency and Governance Act 2020, which was fast-tracked through the UK parliamentary process and included certain temporary COVID-19 measures.

[4] As summarised by Justice Ong in the AirAsia X case (AirAsia X Berhad v BOC Aviation Limited and Ors (Originating Summons WA-24NCC-467-10/2020))

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