BEPS 2.0 (Pillar 2)

How will the anticipated overhaul of international tax rules impact on aircraft leasing?

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Our newsletter released at the end of October provided an overview of the key BEPS 2.0 Pillar Two rules. Below, we consider the possible impact on specific structures and common aircraft leasing platform jurisdictions, illustrating the impact with some practical simplified examples. Some of the terms used below are described and defined within the prior article.

It is important to note that the comments herein are based on the OECD blueprint for Pillar Two released on 12 October 2020. Even if consensus is generally reached on the blueprints, changes to the proposed rules of relevance to the industry may occur prior to implementation.

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In brief (ish)

The GloBE Rules propose the introduction of a global minimum effective tax rate (the GloBE Minimum ETR) – likely set in the 10-15% range

While thresholds and carve-outs are proposed, from a review of a recent top 50 listing of aircraft lessors it would appear that ~60% of aircraft lessors fall within the scope of the proposed GloBE Rules. The application of the rules has the potential to materially impact on those lessor's cash tax liability position and effective tax rates (ETRs) to varying degrees. Broadly, **the rules may provide tax authorities** in the ultimate parent entity (UPE) jurisdiction of an MNE group, or even subsidiary or sister company jurisdictions, **with a right to apply a top-up tax** to bring the ETR of a group entity in another jurisdiction up to the GloBE minimum.

Ireland

As, at 12.5%, the trading tax rate in Ireland is squarely in the middle of the expected minimum rate, for lessors with an Irish platform, the key concern is likely how timing differences between local tax depreciation and accounting depreciation are dealt with. If a favourable option is not adopted, the impact could be drastic – ETR could be regarded as zero in the Irish platform with **ongoing top-up taxes equating to the full GloBE Minimum ETR** applied effectively eliminating cash tax deferral benefits and potentially increasing ETRs. However, it looks **likely that such timing differences will be appropriately accounted for in the GloBE ETR** calculation which may limit the concern for Irish leasing platforms to whether the GloBE Minimum ETR is set marginally above 12.5% and to the additional compliance requirements which will undoubtedly flow from the new rules if introduced.

Hong Kong & Singapore

For lessors with Singaporean and/or Hong Kong based platforms, the rate established for the GloBE Minimum ETR will be key (Singapore must also consider the timing differences issue referenced above).

In both jurisdictions, the ETRs are likely to be below the expected GloBE Minimum ETR. For in-scope MNE groups, considering their leasing platforms in those jurisdictions in isolation, there is a **heightened risk that the group's ETR could significantly increase in some instances.**

However, **if jurisdictional blending is adopted**, **the impact could be lessened** or offset to an extent by the higher general tax rates applying to other business in those locations (17% SG and 16.5% HK) where the group has other activity in those locations taxed at the higher rates**.** Such group consideration could result in the overall ETR for the relevant jurisdiction exceeding the GloBE Minimum ETR and thus no top-up taxes applying to the relevant leasing platforms despite tax rates therein dipping below that minimum.

Additionally, the Hong Kong and Singaporean tax authorities have taken early steps to evaluate measures to keep their tax regimes competitive which will hopefully ultimately be to the benefit of lessors based there.

Offshore low or no tax jurisdictions

For those MNE groups with operations in low or no tax jurisdictions such as the Cayman Islands, Bermuda, BVI etc., if the rules come through as proposed, **any tax benefit to locating activities in such locations could disappear overnight for in-scope groups** with the GloBE Minimum ETR applied to profits realised in such locations and annual cash tax liabilities arising on those profits in other group jurisdictions.

Other key higher tax jurisdictions – U.S., China, Japan, etc.

While we expect timing differences to be dealt with in a favourable manner, if they are not, common parent and generally higher tax jurisdiction may not be immune to the application of additional top-up taxes. It appears more **likely that the primary concern for parent companies in such jurisdictions will be administrative** – new compliance requirements will emerge from these rules which will necessitate the development of new processes and systems to monitor and adhere to a whole new set of filing and tax liability compliance requirements.

The subject to tax rule (STTR) is intended to apply or increase withholding tax on certain cross-border payments between related parties where the recipient is subject to tax below a minimum nominal rate (the STTR Minimum Rate)

Unlike the GloBE Rules, **no minimum revenue threshold has been referenced for the application of the STTR** – a revenue threshold below EUR750Mn may be set, or none may be set at all. The STTR therefore requires consideration by a much larger cohort of the aircraft leasing community. However, given its intended application to specified related party payments only, it is likely to be of relevance to a more limited number of structures – in particular, certain lease-in lease-out (LILO) structures and intra-group financing structures reliant on double tax treaty benefits.

In a bit more detail

The GloBE Rules

Ireland

On the face of it, for aircraft lessors based in Ireland, given the standard Irish corporation tax rate of 12.5% relative to the expected range for the GloBE Minimum ETR, it would appear that top-up tax applicable for Irish lessors would be limited, if any applies at all (the rate may yet be at or below 12.5%).

However, if one of the options for addressing the timing differences attributable to accelerated tax depreciation is not adopted, given aircraft in Ireland are generally depreciated for tax purposes over an eight year period (compared to the longer economic and accounting lives), MNEs with Irish lessor groups could lose out on cash tax deferral benefits in such structures and ultimately end up being taxed beyond the GloBE Minimum ETR due to proposed timing constraints on the carry forward of GloBE tax credits.

Example 1 in the appendix illustrates the potential impact on an Irish aircraft leasing structure without adjustment for timing differences

The example should demonstrate the significant potential negative consequences arising for aircraft lessors if the timing differences are not dealt with in a favourable manner.

Hong Kong

On the positive side for Hong Kong, as the aircraft leasing regime does not involve claiming tax depreciation, the potential issues arising from timing differences in the reporting of profits for tax and accounting purposes should not create significant cause for concern.

However, given the low nominal tax rates under the Hong Kong preferential tax regime (8.25% * 20% = 1.65%) and ultimately low estimated effective tax rates (often in the 3% - 8% range), MNE group's with a Hong Kong leasing platform could be susceptible to significant ongoing top-up tax under the GloBE Rules eroding some of the benefits of the regime.

Example 2 in the appendix illustrates the potential impact on the parent of a Hong Kong aircraft leasing group which has adopted the GloBE Rules.

One comparative mitigating factor for the Hong Kong regime may be that the standard Hong Kong statutory tax rate (16.5%) is higher than the Irish rate and above the higher end of the anticipated GloBE Minimum ETR. For MNE groups with a wider presence beyond an aircraft leasing platform in Hong Kong, this could mean that if they have excess tax paid in other elements of their Hong Kong group which, if jurisdictional blending is adopted, can be used to bring up the overall Hong Kong jurisdictional ETR for the MNE group.

Under jurisdictional blending, a single ETR would be calculated for an entire jurisdiction, e.g. if a banking group had both a leasing and banking presence in Hong Kong, the ETR of the total banking and leasing presence would be considered. This has the potential to eliminate or limit the application of the top-up tax which may apply to the leasing presence in Hong Kong if it existed in isolation.

The early engagement of the Hong Kong authorities to adopt changes to preferential tax regimes could also be helpful in keeping Hong Kong competitive as the process progresses.

Example 3 illustrates the potential offsetting effect stemming from an MNE having other business in Hong Kong taxed above the aircraft leasing regime rates.

An interesting unintended product of jurisdictional blending may be MNE groups having an additional driver to shift or establish activities taxed above the GloBE Minimum ETR into jurisdictions, such as Hong Kong, where certain business lines, such as aircraft leasing, are currently taxed below that rate.

Singapore

The structure of the Singaporean aircraft leasing scheme (ALS) means it is susceptible to a combination of the issues for Irish and Hong Kong aircraft lessors.

As with Ireland, Singapore could be adversely affected by the referenced timing differences issues. As the ETR would likely come out below the expected GloBE Minimum ETR by a greater margin than Ireland, though perhaps not to the extent of Hong Kong, MNE groups could ultimately be subject to top-up tax under the GloBE Rules on their Singaporean leasing platforms. Even if one of the proposed options for addressing timing difference (the inclusion of deferred tax in the ETR calculation) is adopted, the ETR of the Singaporean leasing platform would likely still be below the GloBE Minimum ETR. However, the mitigating factors for Hong Kong may also be applicable to Singapore given the general statutory tax rate of 17% and early engagement of the Singaporean authorities with the associated issues.

Offshore low or no-tax jurisdictions

Offshore low or no-tax jurisdictions, such as the Cayman Islands, Bermuda and BVI, which have taken significant steps to introduce substance and tax reporting measures to satisfy OECD and EU requirements in recent years, may feel rightly hard-done by as the carve-out from BEPS 2.0 Pillar 2 for economic substance and disclosure "compliant" regimes seems to have now been put on the shelf.

Many MNE groups with a presence in such jurisdictions which have taken steps to meet local substance and other requirements may now find that any profits realised in the locations ultimately end up being taxed under the GloBE Rules. While aircraft ownership in tax resident entities in these locations is not as widespread as it once was, there is still a sizeable number of aircraft owned or financed from these jurisdictions. Where an MNE group with a presence in these jurisdictions is in scope of the rules, profits realised in the jurisdictions may move from not being taxed at all, to being taxed at the new GloBE Minimum ETR through one or more other jurisdictions.

That being said, many entities and structures in such jurisdictions, such as investment funds and entities in groups below the thresholds referenced in subsequent sections, may not be affected by these proposals so efforts to comply with OECD and EU requirements will not have been in vain for some.

Other key higher tax jurisdictions – U.S., China, Japan, etc.

While the headline tax rates in such jurisdictions could mean that aircraft leasing platforms based there are unlikely to be subject to increased taxation under the STTR, the GloBE Rules could still adversely impact the structures, particularly if the referenced options for addressing timing differences are not adopted as most such jurisdictions also have some form of accelerated tax depreciation.

Outside of a possible increase in tax for affected MNE groups, the introduction of the GloBE Rules will inevitably lead to an increase in tax compliance costs and administration. While proposals aimed at limiting the compliance burden are contemplated, the rules could still require the production of separately computed GloBE tax computations under a distinct new set of rules for numerous companies across various jurisdictions – clearly this would represent a significant exercise for many MNE groups.

Application of the STTR

The potential application of an increased withholding tax to certain intra-group financing transactions and related party lease payments reliant on treaty benefits are likely the key concern arising from the STTR. The rule could adversely affect the tax outcome in certain intra-group lease-in lease-out (LILO) arrangements and, possibly disproportionately, for any captive cross-border airline owned leasing platforms.

While the proposals contemplate the use of the existing OECD Model Treaty for the purposes of defining royalties (which could be helpful in an aircraft leasing context as payments for the use of commercial equipment are excluded from such), payments for the use of mobile assets have specifically been identified as high-risk payments and are therefore expected to be within the scope of the rule.

The adoption of the rule could result in the application of withholding tax where none applied before, or, in the increase in the withholding tax rate where a rate below the STTR Minimum Rate was previously applied. As an example, the rule could potentially apply to payments from Mainland China based free trade-zone (FTZ) LILO entities (owned within a lessor group) to the overseas aircraft owners. While many of the common existing LILO structures are already under pressure as a result of the measures introduced in the original BEPS Action Plan, this could be the nail in the coffin for such structures and may impact certain structures which have thus far come through BEPS implementation largely unscathed e.g. the referenced Mainland China FTZ LILO structure.

Example 4 in the appendix illustrates the potential increased tax cost resulting for a common lessor owned LILO structure.

Jurisdictional impact

The impact of the STTR may be more pronounced for those tax regimes with lower nominal rates, i.e. Hong Kong and potentially Singapore. As the STTR's application is subject to the headline rate applying and given the STTR Minimum Rate is expected to be set below the GloBE Minimum ETR, Ireland and other common leasing platform locations with headline tax rates in the say, 10%+ range (the US, Japan, China, the UK, the Netherlands), may be lucky enough to avoid the application of the rule, though each case will still require consideration.

Even where the STTR comes into effect as proposed, there may still be alternative structuring options available to mitigate the effects of this rule, though the obvious solutions would require buy-in from airlines and will likely result in some loss of benefit or increased cost for affected lessors.

Possible Thresholds & Carve-outs

- The application of the GloBE Rules is expected to be limited to MNE Groups (as defined under the CbCR rules) that have total consolidated group revenue above EUR750 million.
- The STTR may apply to groups with related party cross-border transactions regardless of size or to groups with a lower revenue threshold than that applying for the GloBE Rules.
- The GloBE Rules are not intended to apply to certain UPEs such as investment and pension funds and government entities (including sovereign wealth funds (SWFs)), which typically benefit from an exclusion or an exemption from tax under the laws of the jurisdictions where they are incorporated. The exclusion, however, does not apply to underlying group structures of such entities which themselves have revenue exceeding the EUR750 million threshold i.e. if a SWF owns a leasing platform with revenue in excess EUR750 million the rules could still apply to that leasing platform.
- No general substance-based exclusion is expected to apply. A formulaic substance based carve-out for a proportion of the profit of a group in a particular jurisdiction is under consideration. The carve-out may be based on fixed percentages of relevant payroll cost and tangible assets. Such carve-out would exclude some of the profits in a particular jurisdiction from the application of the GloBE Rules however, of particular relevance to lessors, it is proposed that **tangible assets on lease will be specifically excluded from the calculation of that carve-out for the lessor.**
- Certain jurisdictions which have less than a referenced percentage of the MNE group's pre-tax profit may be excluded from the GloBE Rules entirely. The percentage has not yet been set. The usefulness of this exclusion will only be known when it is.

As noted, approximately 60% of the top 50 aircraft lessors by portfolio value appear to form or be part of MNE groups with revenue in excess of EUR750Mn. Others in that list are close to passing that threshold. As either no or a lower threshold is expected to apply for the STTR, the rules will clearly be of relevance and concern for a significant majority of aircraft lessors. That being said, the GloBE revenue threshold and general exclusion for pension and investment funds and SWFs should prove useful for a number of lessors and structures.

How might tax authorities / governments respond?

If there is wide adoption of the GloBE Rules and STTR internationally, it seems likely that tax authorities in impacted platform jurisdictions will need to respond to the changes in some form. There may be options for governments in jurisdictions such as Hong Kong and Singapore that will enable them to maintain the competitiveness of their tax regimes for aircraft leasing and/or to increase the attractiveness of their business environment through other means. The effect of increasing preferential tax regime rates to the relevant GloBE Minimum ETR for example, could be partially offset potentially by grants (though, depending on how the grants are awarded and accounted for such could be deducted from the covered taxes in the ETR calculation) or other forms of incentive for businesses.

If a favourable approach to timing differences for tax and accounting depreciation on tangible assets is adopted, the Irish tax regime may not be significantly impacted. However, if this is not the case, given aircraft leasing is taxed under the standard Irish tax rules, will have to take into account the consequences for all other industries in any contemplated changes to the Irish tax system.

Additionally, the Pillar 2 proposal documents contemplate the possible adoption by local tax jurisdictions (e.g. Hong Kong, Singapore, Ireland etc.) of a local “minimum top-up tax” approach, which would work in such a manner as to ensure that the jurisdictional ETR is at or above the GloBE Minimum ETR. Such an approach would result in the local jurisdiction applying any additional top-up tax before the group parent company or another group jurisdiction, removing the right of any such jurisdiction to apply the top-up tax. Assuming those jurisdictions adopt a rule which only applies in instances where the GloBE Rules would otherwise top-up tax (which may not necessarily be the case), the introduction of such local rules may not result in any additional tax cost beyond that which would have applied under the GloBE Rules. However, such additional local rules would undoubtedly increase complexity and add another layer of tax compliance costs and administration for affected tax payers.

Takeaway

The GloBE Rules, and to a lesser extent the STTR, could reduce the tax benefits on offer in certain key leasing locations through increases in ETRs and/or a reduction or loss of cash tax deferral benefits. However, there are a myriad of other factors, some still tax related (double tax treaty networks for one), which mean that the core leasing platform locations are likely to remain as is. The impact will be dependent on exactly what minimum rate is set, on other aspects of how the rules are introduced, and most importantly, on whether consensus can ultimately be reached on the introduction of the rules in the current format.

If leasing jurisdictions, such as Ireland, Hong Kong and Singapore, adopt local minimum top-up tax rates, in order to maintain their attractiveness to the widest range of groups, it will, in this author’s view, be critically important that they introduce such a local top-up tax system in a manner that applies only where the GloBE Rules would otherwise have applied. In addition, for regimes such as the Hong Kong regime, if a rate change (amongst other changes) is ultimately necessary to maintain attractiveness for in-scope MNE groups, it will be important for the Hong Kong tax authorities to make such rate change an option available to those affected.

As with the original BEPS Action Plan, a prolonged period of uncertainty with regards to MNEs tax affairs is ahead of us. Certainty is something we seek when estimating our tax costs, but it is something that is sadly increasingly difficult to achieve. The BEPS 2.0 proposals will ensure this uncertainty continues for several years to come.

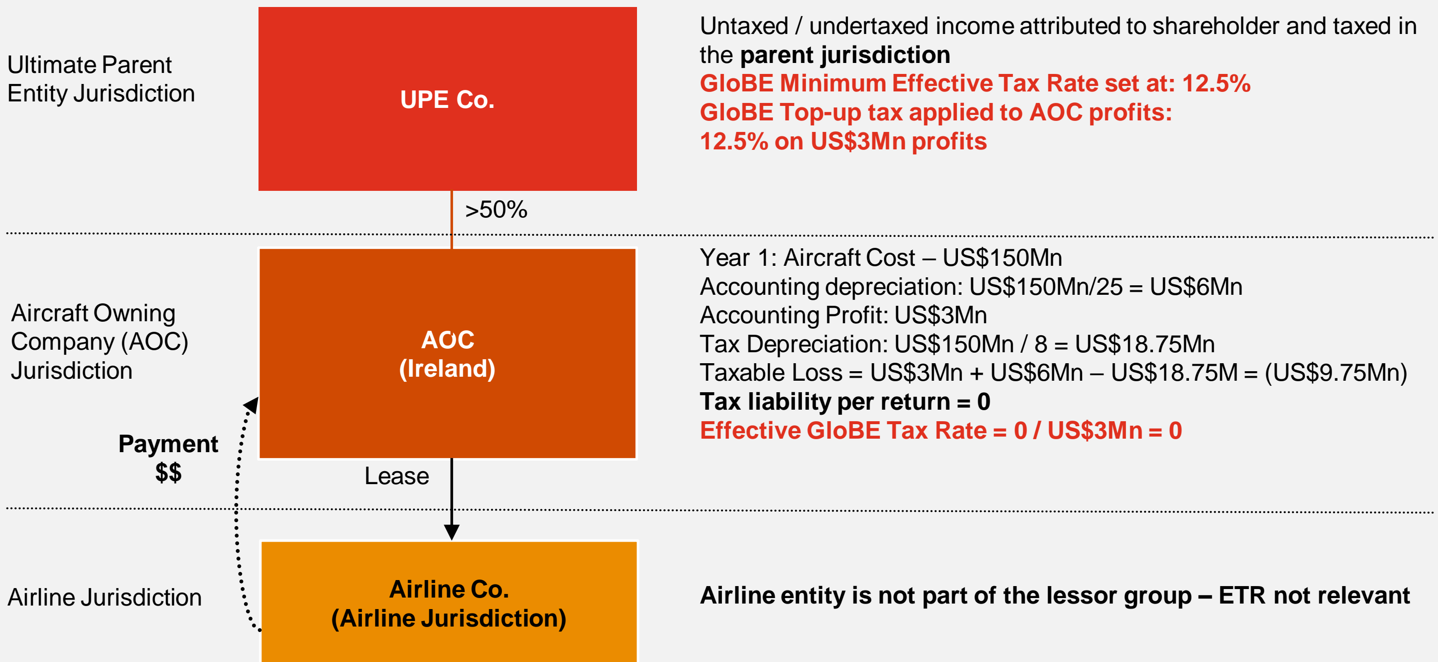
What can lessors do now?

Given the length of a standard lease, there is a tangible risk that tax liabilities on leases in existence already or being negotiated now, may well increase and the timing of tax payments in such may be accelerated compared to prior expectations. While it is still very difficult to accurately assess the impact, these possibilities should be factored into strategic platform decisions where possible and, more granularly, contemplated when evaluating pricing on leasing transactions.

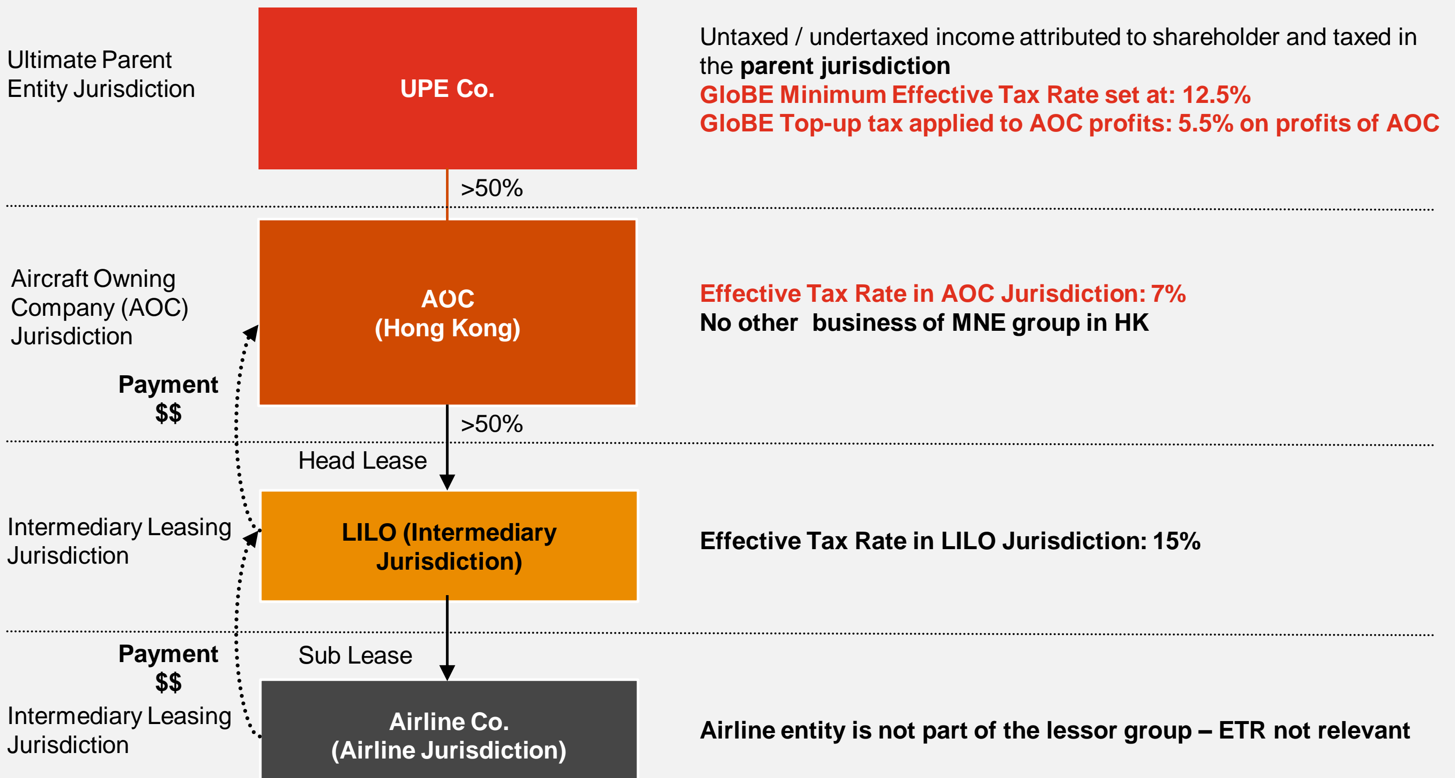
The key actions lessors can take now include:

- conducting an assessment of their structure to determine whether their business is in scope of the proposed GloBE Rules;
- if so, leveraging CbCR procedures and information to do high level modelling focusing on the ETR impact; and
- separately assessing the possible impact of the STTR.

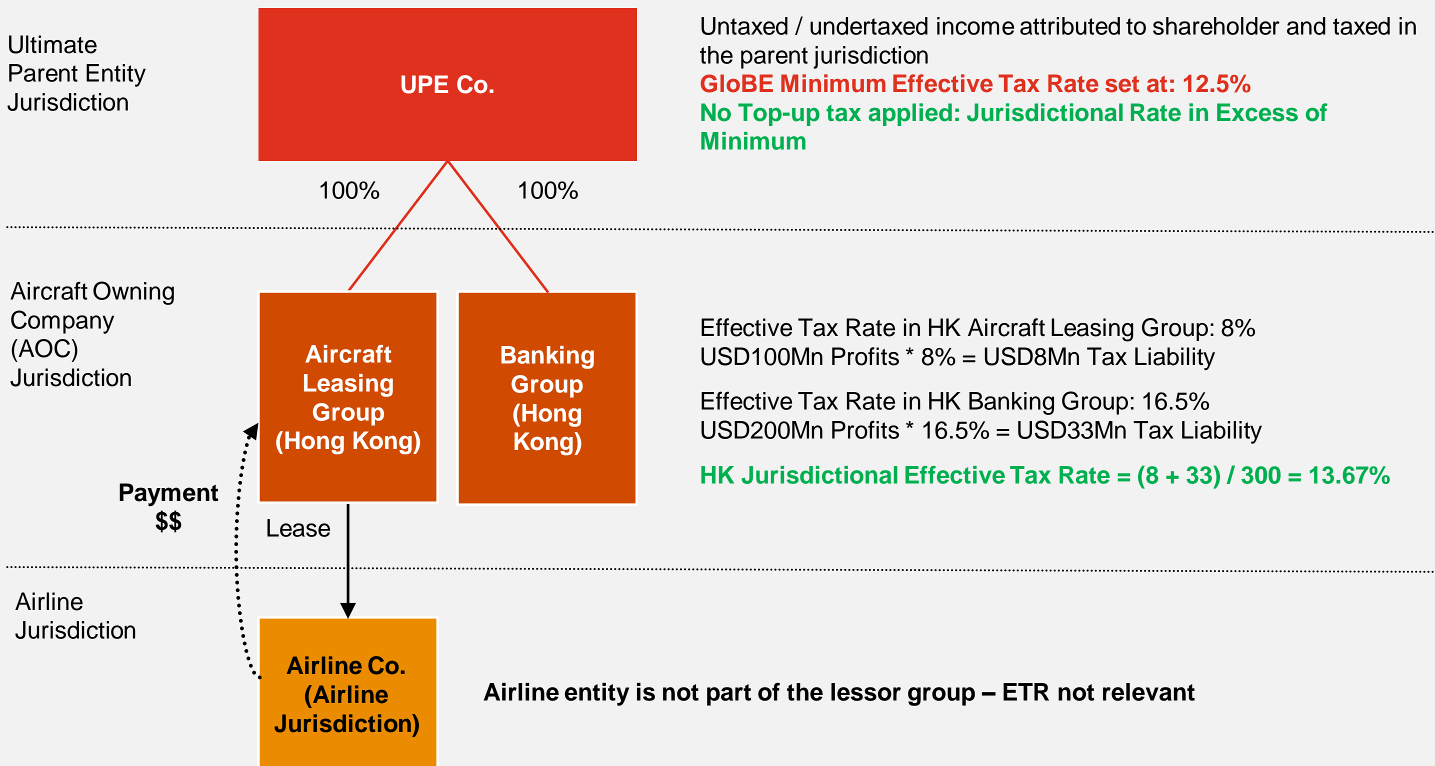
Example 1 – Application of GloBE Rules to Irish Leasing Platform – no accounting for local tax depreciation



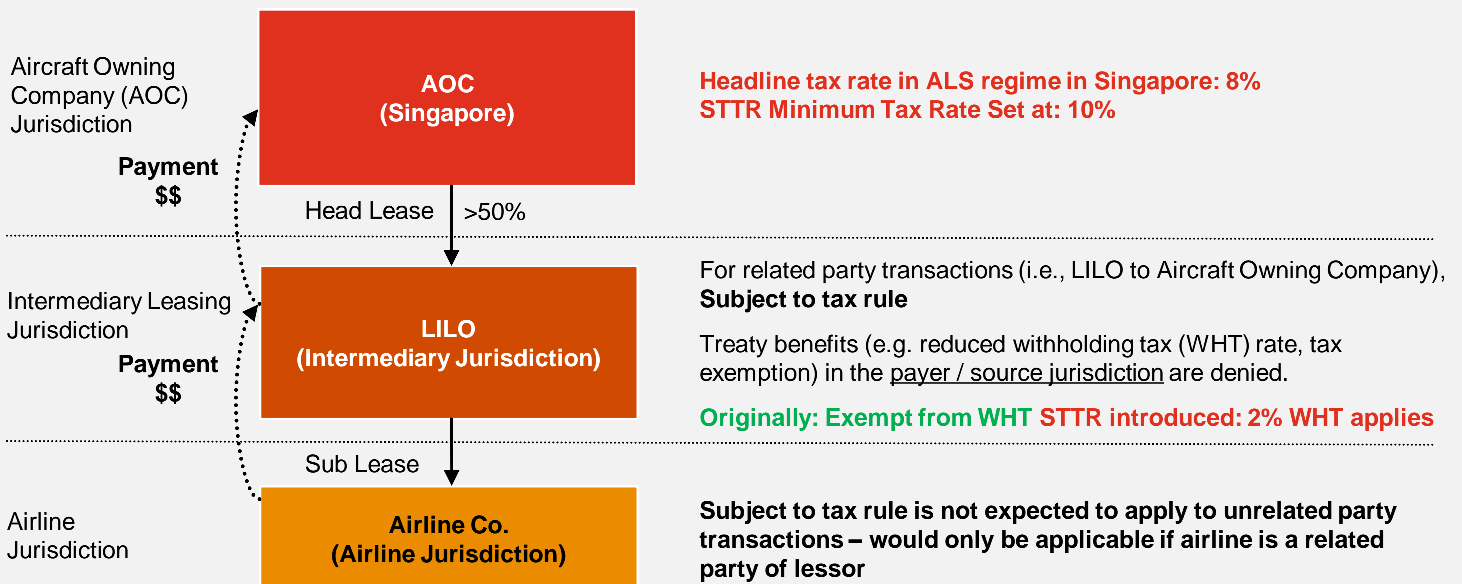
Example 2 – Application of GloBE Rules to HK Leasing Platform



Example 3 – Application of GloBE Rules to Hong Kong group with leasing & other business lines



Example 4 – Application of STTR in LILO structure



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