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Aviation Finance and International Tax Reform

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FOREWORD

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Pieter Burger,
Partner, Deloitte

At the risk of stating the obvious, 2016 has been an astonishing year in terms of seismic unexpected political outturns and developments. But in addition to Brexit, the US presidential election and other events, even more surprising to international tax professionals (in practice, industry and government alike) has been the speed and extent of consensus reached amongst the world's leading nations to change the international tax rules.

To name but a few: In October 2015, a little more than 2 years after the BEPS Action Plan was delivered to the G20, consensus was reached amongst OECD, G20 and certain developing countries and the final BEPS papers delivered. On 21 June 2016 the EU Anti-Tax Avoidance Directive was unanimously approved for implementation in the EU. In addition, of significant importance to aircraft lessors and airlines is that on 24 November 2016 the OECD released the widely anticipated text of the Multilateral Convention to Implement Tax Treaty-Related Measures. More than 100 countries participated in its negotiation. A significant group of countries are expected to sign this convention on 5 June 2017 and more than 2,000 double tax treaties (about two-thirds of the worldwide total) could be amended through this new convention. The first changes following from this convention are likely to have effect from as early as 1 January 2018.

If there is one clear message from the above it is that there is strong world-wide political support for the reform of the current global tax system. And just as the world's perception of what is in fact politically possible has changed following 2016, the perception of business leaders and tax professionals of what further international tax reforms are in fact possible (in the US, in the EU, and elsewhere) will certainly also have changed.

These complex international tax changes bring about challenges and uncertainty for all businesses, including aircraft lessors, airlines and other aviation financiers. Given that these changes are, in light of the level of consensus reached in 2016, real as opposed to hypothetical, Deloitte and Euromoney Institutional Investor Thought Leadership felt that the time is ripe to prepare this report on Aviation Finance and International Tax Reform. The report contains the output from over 400 senior executives surveyed from the aviation finance industry as well as in-depth interviews conducted with senior industry executives and independent experts.

This report and survey provides useful insight into questions such as, amongst others:

- Will BEPS and related tax reforms change the current geographic footprint of aircraft lessor operations?
- Who will ultimately bear additional compliance and tax cost as a result of international tax changes, lessors or airlines?
- In light of ongoing uncertainty, what action can and should be taken now and what are others in the industry doing?
- Which jurisdiction will show the fastest growth over the next 5 years as a location of choice for basing aircraft leasing operations?
- Is Brexit a concern?
- Will tax reforms impact how and where leases are originated, negotiated and executed?

Looking forward, with the BEPS project essentially complete and the Anti-Tax Avoidance Directive agreed in the EU, what remains is the implementation of the revised tax rules in a number of countries, with uncertainty still remaining as to exactly how different countries will enact and interpret the measures. In addition, the Common Consolidated Corporate Tax Base (CCCTB) was re-launched in the EU for

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consideration in October 2016 but with scepticism remaining high as to its chances of success.

Across the Atlantic, developments in US tax reform under President-elect Trump will be closely followed. To repeat a famous Winston Churchill quote which seems very apt to describe the state of international tax reform at present: "Now this is not the end. It is not even the beginning of the end. But it is perhaps, the end of the beginning".

I trust that professionals and stakeholders in the aircraft leasing and wider aviation industry will find this work useful at a time when it is challenging for all businesses to make informed pro-active decisions and plot a course through the changing global tax landscape.

Pieter Burger is the Lead Tax Partner for the Deloitte Ireland Aircraft Leasing and Finance Advisory team

EXECUTIVE SUMMARY

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Implementation of the OECD's Base Erosion and Profit Shifting (BEPS) Action Plan is reshaping tax systems worldwide for every industry. The questions for aviation finance – with companies often doing global business from favourable tax jurisdictions – are particularly acute. Meanwhile, other vectors of uncertainty, such as Brexit, should be factored in as well.

For this report, Euromoney Institutional Investor Thought Leadership has worked with Deloitte to look at the current tax risks facing aviation finance, and how the industry is likely to respond.

Drawing on a worldwide survey of over 400 senior executives involved in the sector, as well as in-depth interviews with eight leading executives, regulators, and other experts, its key findings are:

KEY FINDING 1

BEPS will have a widespread, if largely moderate, effect on aviation finance. In our survey, 87% of respondents predict that international regulatory and legal changes to curb tax avoidance will have a noticeable impact on aircraft lessors, and 77% say the same about airlines. In most cases, however, these are expected to be "moderate" rather than "substantial" effects. Similarly, 72% believe they will drive up compliance costs, tax bills, or both.

KEY FINDING 2

BEPS will not dramatically shift the geography of aviation finance. A majority of aircraft lessors are currently based in favourable tax jurisdictions, with Irish companies providing half of the world's leased aircraft.

Lessors report an intention to move part of their operations as a result of new tax regulations – 28% on average for those who have plans in place. This is not, however, any higher than the airline companies which have a broader geographic spread.

Indeed, BEPS is unlikely to force restructuring of companies into different jurisdictions because – unlike allegations about other industries – aircraft lessors actually conduct most of their operations in the countries in which they are taxed. Moreover, interviewees note that leasing is not based on leveraging tax laws but provides real value to the market.

It is a quirk of the product which allows companies to choose their base of operations. Low corporate tax rates, as well as double treaty networks, will continue to be key factors in shaping that choice.

KEY FINDING 3

Current challenges should lead companies to be watchful but the risks should not be overestimated.

Lack of clarity is widespread over BEPS' practical implications: 72% of respondents say that it has created at least some uncertainty.

Amidst this, conventional wisdom appears to over-rate the dangers facing companies. Those surveyed from aircraft lessors and airlines – the companies directly engaged in much of aviation finance – are less likely to see substantial change for their own firms even while often sharing the conventional wisdom about their sectors. In other words, where respondents have more direct knowledge, they foresee less change.

This phenomenon is even more pronounced when it comes to Brexit, which 38% believe "will have an adverse effect on Ireland as an aircraft leasing location," compared to just 28% who disagree. Among Irish respondents, however, 70% disagree (a majority strongly), and only 5% believe this will happen.

Experts interviewed for this study also could not come up with any possible negative effect Brexit would have on Irish leasing. Again, knowledge reduces levels of concern. Uncertainty, then, should lead executives to be careful but not simply assume the worst.

KEY FINDING 4

Ongoing uncertainty makes it hard to take concrete actions, but in some key areas companies should be making preparations now. Adjusting to BEPS implementation rapidly will be challenging but necessary. Europe's Anti-Tax Avoidance Directive (ATAD) requires all necessary changes to be in effect by 1 January 2019 (subject to a few exceptions), but 41% of airlines and aircraft lessors believe that is not enough time for their companies.

On the other hand, only 20% of companies are implementing changes currently, and 35% planning them. The main difficulty is that the response to changes will depend significantly on the specific details of the implementing regulations and legislation – which are often not timeously available.

Companies should, however, be moving ahead where they can. Four such areas are:

1. implementing the processes and technology needed for country-by-country reporting, as well as addressing any consequences that may arise in light of this information, whether made available to tax authorities or the general public;
2. consider the creation of precise guidelines and procedures to ensure that activities are not undertaken in countries that will inadvertently trigger the creation of a permanent establishment under the new rules;
3. examine standard contracts and leasing structures, and evaluate possible restructuring (including substance enhancements) that may be required to reduce the risk of countries requiring withholding tax on lease payments;
4. examine the possible impact of interest deductibility caps.

KEY FINDING 5

It is unclear how the market will absorb the costs arising from BEPS. Opinion is split – and often not strongly held – on whether the expected compliance and tax costs of BEPS will ultimately be borne by aircraft lessors or airlines. The answer to that question may affect market behaviour, respondents believe.

Over half of those who think leasing costs will increase also believe that airlines will lease fewer planes. Similarly, 63% of all respondents think that the ATAD implementation will result in aircraft lessors creating new business models.

Experts interviewed for this study are less convinced. For some airlines, for example, leasing planes is the only option and will remain so even after a marginal cost increase. As for aircraft lessors, no new business models seem to be emerging, although they may rely less on borrowing and more on capital to avoid interest deductibility caps.

KEY FINDING 6

The geography of aviation finance may diversify, but more through competition than through tax.

Respondents believe that the fastest growing jurisdiction for leasing will be China's free trade zones. This, though, is likely to be high percentage growth relative to the current small base rather than a surge making the FTZs a world player. Instead, experts expect that they will service the growing Chinese domestic market.

After these areas, Singapore, Ireland, and Hong Kong are predicted to experience the most growth. In other words, the leading players are likely to remain so for some time.

Whether Ireland can maintain its dominance is another question. As one interviewee puts it, "Everybody in the world is looking to Ireland and seeing how well its strategy worked. You can expect others to copy it in an international race to become attractive."

introduction

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TAX IN A TIME OF UNCERTAINTY



"The political support underpinning BEPS (the OECD's Base Erosion and Profit Shifting Action Plan) can't be under-estimated," notes Haroun Asghar, Head of Tax at Etihad Airways.

"The speed and scope of these changes has been impressive. It is the most significant development to international tax architecture for over half a century."

It is hard to argue. In the space of just a few years, the project has moved from initial discussions to agreement by every major tax jurisdiction on convergence – in theory at least – toward minimum standards and best practice on a wide range of tax issues.

Looking ahead, Mr Asghar continues, the resulting regulations, when implemented, "are likely to change multinationals' behaviour toward tax risk management across diverse industries, including aviation".

Gavan Neary, Senior Tax Manager at Avolon, the aircraft lessor based in Ireland, agrees. BEPS and other changes – such as the US Foreign Account Tax Compliance Act and various new reporting requirements in key jurisdictions – "will have a significant impact because we are now operating in a more transparent tax environment with an increasing amount of tax reporting and compliance obligations," he says.

Further complicating matters, companies will have to address these changes at a time when political developments only add to the uncertainty. What the UK's decision to leave the European Union means, and even the still uncrystallised policies of the new Trump administration in the United States, are further wildcards in an already complex deck.

As with other parts of the economy, the aviation finance sector will feel the effects of change.

This is a rapidly growing industry: in the space of several decades it has gone from being the owner of just over 1% of the world's commercial aircraft to nearly 40%.

Chart 1

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



*approval with statement

Moreover, it is a sector that various jurisdictions are hoping to use in order to promote economic growth. Making sure that it continues on its recent, healthy trajectory amidst current turmoil is no small matter.

Among participants in a global survey conducted for this study, which involved over 400 executives from companies involved in the industry (see page 33 for details), one clear expectation was that BEPS and associated actions would have at least a moderate impact.

Moreover, the common expectation is that these changes will cost money. Seventy-two percent of survey respondents believe that they will need to spend more on tax, compliance, or both.

In fact, it is already starting. Mr Neary explains that his firm has increased the size of its tax team to deal with additional tax compliance obligations to be introduced.

Far less clear, though, are the wider implications of BEPS, and other causes of uncertainty, for the aviation finance sector. Will they kill a goose which has been laying such golden eggs in recent decades, or are they just another challenge facing an industry which – like all sectors – has coped with many?

Euromoney Institutional Investor Thought Leadership has worked with Deloitte to complete this study which digs into the tax and related regulatory challenges facing the industry. In particular, it looks at what these changes are likely to demand of airlines and aircraft lessors, how firms should be preparing now, and where the future will likely take us.



72%

expect that anti-tax avoidance measures will
DRIVE UP COSTS
for the aviation industry, through higher tax,
or increased compliance costs, or both

chapter 1

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BEPS: IS AVIATION FINANCE A PARTICULAR TARGET?



The BEPS Action Plan arose from concern over mismatches between where economic activity takes place and where companies report taxable profits and pay tax. Information technology companies were prominent, but far from the only, targets of criticism, with firms selling everything from coffee to pharmaceuticals coming under the media spotlight.

In recent decades, the aircraft leasing sector – the core of modern aviation finance – has grown up in many of the same favourable tax jurisdictions that have been associated with alleged profit shifting and base erosion by other industries.

In particular, about half of the world's leased aircraft are currently managed from Ireland, where the industry as we know it began with the founding of Guinness Peat Aviation in 1975. Other low-tax jurisdictions, such as Singapore, Hong Kong, Cyprus, Labuan and Malta have, with varying success, sought to develop their own aviation finance sectors as well.

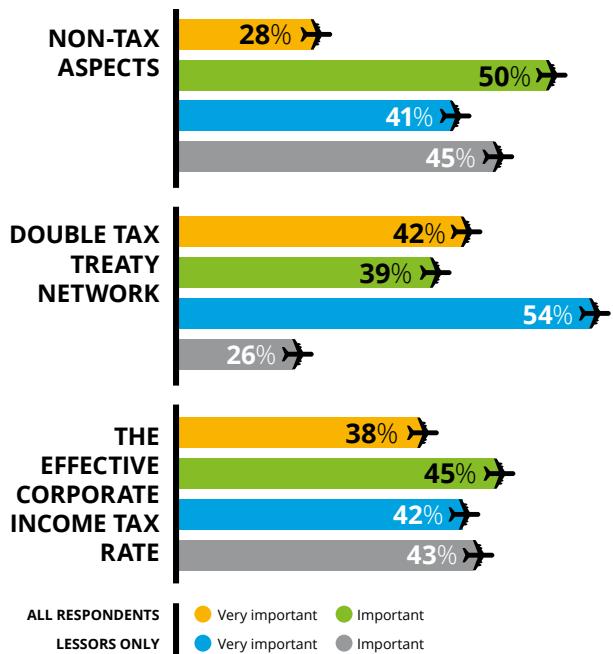
The geography of the aircraft leasing industry – with so much of its fleet owned in tax friendly jurisdictions – is no accident. The nature of the product being leased allows companies to service much of the world from low cost bases. Asked about considerations which shape the choice of location of an aircraft leasing operation, while half of survey respondents agree that non-tax issues are important, only 28% believe that they are “very important”. Corporate tax rates (38%) and double tax treaty networks (42%) are noticeably more likely to be deemed “very important”.

As Dewey Yee – a pioneer of aviation finance in Asia and one of the business community members of Hong Kong's Economic Development Commission's Transport Working Group – explains, tax concessions are a key way of attracting any kind of industry to a specific location.

Mr Yee calls tax policy “a major factor” in Hong Kong's rise to become a leading global financial centre. When

Chart 2

How important are the following when selecting where to establish aircraft leasing operations?





Lessors expect to **RELOCATE** **28%**

of their business in the wake of
anti-tax avoidance initiatives on average



43%

of lessors expect to
relocate at least a minority of their business
in the wake of anti-tax avoidance measures

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it comes to aircraft leasing specifically, he adds, "tax is very sensitive for the business because of its high impact on bottom line profitability. The role tax incentives play is a critical deciding factor for the international lessor to relocate here or not."

Given the importance of tax in shaping the jurisdictions in which aviation finance and leasing have prospered, to what extent is BEPS implementation likely to remould that geography? It certainly has the potential to exert some effect. Respondents at lessor companies which have taken a decision on the issue report that, on average, they expect to relocate 28% of their business in the wake of new anti-tax avoidance measures.

This, however, has to be put in perspective. Those surveyed who work for airlines – an industry with a much wider global spread – report that they will relocate the same proportion of their operations in the wake of BEPS implementation. Just as important, respondents report that a majority of leasing companies either have no plans to relocate any operations (29%) or are awaiting clarification on rules before deciding (27%).

Indeed, a closer look at the data indicates that BEPS is unlikely to bring about a wholesale geographic shift in the aviation finance industry. In particular, when asked about the importance of different considerations in deciding where to locate leasing operations, lessors differed from the overall survey group in two important ways: first, they assigned roughly equal importance to non-tax issues and corporate tax rates; second they pointed to the network of double tax treaties as the most important consideration.

These views militate against substantial movement away from today's leading aircraft leasing locations. Ireland is the clearest case in point. Edward Hansom – Chief Investment Officer at Seraph Aviation Management – explains that, in considering the country's attractions for the sector, "the natural tendency is to focus on the 12.5% tax rate".

"But," he continues, "that is a bit of a red herring in the context of aircraft leasing because companies anywhere tend to have enough legitimate capital allowances to defer tax liability. Really, Ireland's competitive strength is its double tax treaty network, which is hard to duplicate in a hurry." Most of these treaties were negotiated by Irish governments aware of the needs of the leasing industry.

Ireland also has other non-tax advantages which lessors value highly and which are not easy to build up. Eamonn Brennan, CEO of the Irish Aviation Authority, notes that these include a strong skill set that comes from over four decades of experience in aircraft leasing, an effective legal system, and a high-quality regulatory agency capable of overseeing planes worldwide.

Moreover, changes coming as a result of BEPS implementation will not affect certain basic tax advantages. "The low corporate tax rate is not going to go anywhere soon regardless of what the European Commission wants to do," he adds.

Other current major aviation leasing locations and aspirants have similar advantages. Singapore, for example, has nearly as large a tax treaty network as Ireland (although, when it comes to a Double Tax Treaty network, quality is often of greater importance than quantity), a solid legal system, a mature financial sector, and special tax discounts for certain leasing firms.

Hong Kong, meanwhile, is making a strong push to promote the sector by drawing on the same kind of assets. "Hong Kong is a globally recognised 'Rule of Law' jurisdiction," says Mr Yee from the local Economic Development Commission. Describing aircraft leasing as a "very high value, long term business proposition," he adds, "The creation of new aircraft leasing 'laws' addresses and removes the risk of uncertainty for leasing companies, whilst providing clarity and a high degree of comfort."

In the same way that the importance of these non-tax issues for the industry is sometimes understated, the

allure of low taxes absent these other assets can be overemphasised. "Tax driven structures were more important 20 years ago than today," explains Markus Ohlert, Head of Leasing at Deutsche Lufthansa. "Already in many countries *purely* tax driven aircraft investments are not attractive any more. You must have a real business case behind it."

This points to another important reason why BEPS will likely have a small effect at most on where aircraft leasing companies are based. As the accretion of skills required to run leasing operations show, these are not letter-box companies.

The Irish Aviation Authority's Mr Brennan insists that the services are being provided in Ireland. "We are not using smoke and mirrors," he says. "These are up front, legitimate transactions taxed in Ireland. Accordingly, they won't be on the OECD's radar."

Looking more globally, Bertrand Grabowski, at the time of being interviewed Managing Director, Aviation Finance, at DVB Bank, is "not aware of any aviation leasing company established in a tax jurisdiction where it doesn't have its own business operation".

"Leasing exists because it provides a fundamental service, not because it leverages specific tax regimes," Grabowski, who has since accepted a role as Senior Strategic Advisor at Dubai Aerospace Enterprise (DAE), adds. "If a business is at threat because of a change of tax law that means it is not based on the fundamental needs of the market. Leasing does provide a true service to the airline industry."

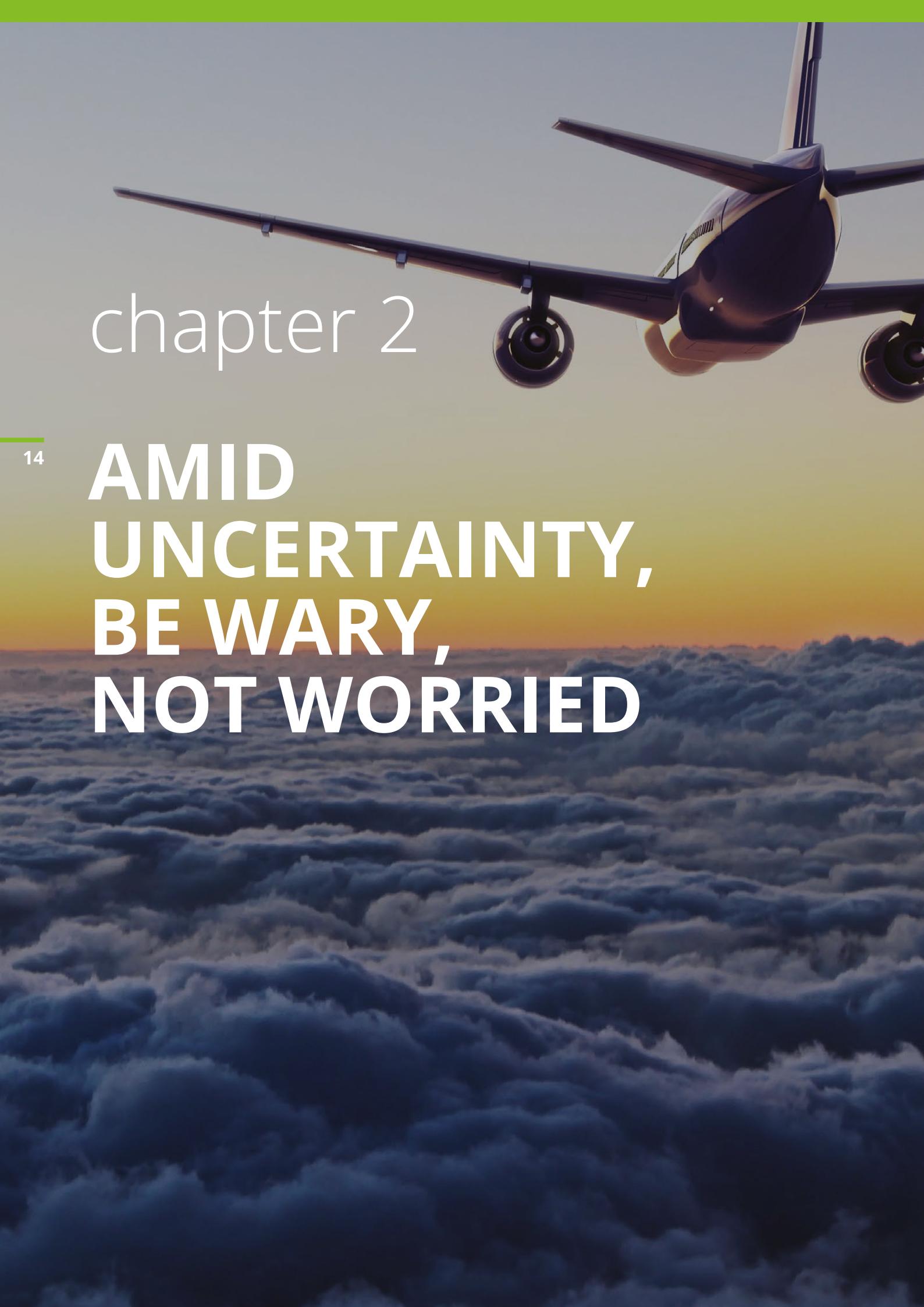
Etihad's Haroun Asghar agrees: "Leasing gives rise to significant benefits which are unlikely to tilt in favour of owning aircraft as a result of BEPS alone."

BEPS by itself, then, will not lead to a wholesale geographic shift in the aviation finance industry. The sector definitely thrives in low tax locales – however, leasing operations engage in substantial business activity which is, rightly, already taxed where it is performed.



..... 
"Leasing exists because it provides a fundamental service, not because it leverages specific tax regimes. If a business is at threat because of a change of tax law that means it is not based on the fundamental needs of the market."

BERTRAND GRABOWSKI • Managing Director,
Aviation Finance at DVB Bank

A photograph of a large commercial airplane in flight, viewed from below. The aircraft is dark-colored and is positioned in the upper right corner of the frame. It is flying over a layer of clouds, with a bright yellow and orange sunset or sunrise visible in the background.

chapter 2

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**AMID
UNCERTAINTY,
BE WARY,
NOT WORRIED**

Although not expected to change the geography of aviation finance, BEPS nevertheless will bring challenges.

BEPS

Complicating any discussion in this area is an ongoing lack of detail about how exactly the Action Points will translate into regulation and law. "Most businesses are looking for certainty," says Etihad Airways' Head of Tax, Haroun Asghar, something which BEPS implementation is yet to deliver. Seventy-two percent of survey respondents, and 84% from aircraft leasing companies, say that the Action Plan is creating at least some uncertainty for the international aviation finance industry.

"We've all read the new rules, but the big uncertainty is how they will be interpreted and implemented," Mr Hansom of Seraph Aviation explains. "How do you anticipate that? It's very, very hard."

Instinct might lead people to expect that such widespread uncertainty presages large upheaval. For international aviation finance, however, two things point in the opposite direction.

First, most respondents believe that the uncertainty itself is only moderate.

Even more important, those surveyed from aircraft lessors and airlines – the companies directly engaged in much of aviation finance – are less likely to see substantial change for their own firms even while often sharing the conventional wisdom about their sectors.

For example, when asked about the overall impact which international tax and related regulatory changes would have on aircraft leasing companies, the answers from the entire survey sample were similar to those from respondents who worked in the leasing industry itself. In each case 87% expected a moderate or significant impact.



"We've all read the new rules, but the big uncertainty is how they will be interpreted and implemented."

***How do you anticipate that?
It's very, very hard."***

EDWARD HANSOM • Chief Investment Officer
at Seraph Aviation Management



91%

of lessors expect
revised OECD Transfer Pricing guidance
to have a

**MODERATE OR
SIGNIFICANT IMPACT**
on their kind of firm

Is BEPS creating uncertainty for the international aviation finance industry?



When, however, lessor respondents were asked about the expected impact of these changes on their own companies, they were noticeably less likely to foresee an at least moderate effect (73%).

The same holds for respondents from airlines talking about their sector as a whole and their own firms, in which case the data shows a decline from 80% to 69%.

A similar pattern also occurs when respondents were asked about whether new OECD transfer pricing guidelines and rules on inter-company financing would affect lessors, airlines, and their own companies: 91% of lessors think that BEPS will have an at least moderate impact on their kind of firm, but only 77% see such an effect on their own companies; for airlines the equivalent figures are 77% and 58%.

This is not to suggest that respondents foresee no impact on their companies: in each case a majority still predict an at least moderate impact. On the other hand, they are less likely to expect to experience an effect themselves than conventional wisdom about the industry might suggest.

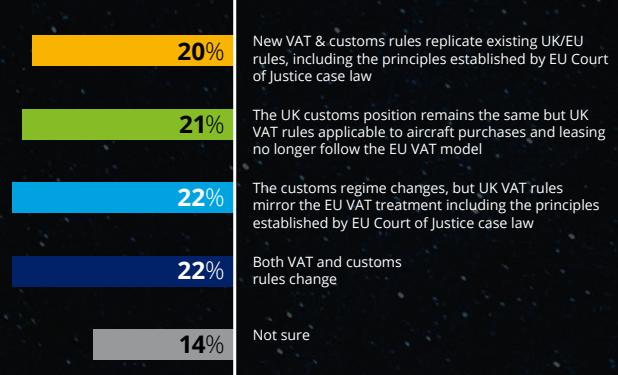
The reason for this dichotomy is that, while uncertainty inevitably brings with it potential exposure to higher tax risk, looking at specific companies often reveals that many in the aviation and leasing industries are already well placed to address a lot of these problems.

For example, aircraft lessors typically have substantial operations in the countries where they are tax resident. Speaking about airlines, Mr Grabowski says that an insignificant number "have complicated corporate structures designed to avoid tax. I don't expect any change in this area as a result of BEPS."

Moreover, he adds, even some of the world's largest airlines still have decades' worth of loss carry-forwards to use up. In such a situation, firms certainly must remain aware of major regulatory change but, while compliance and filing costs may increase, tax bills are less likely to jump noticeably.

Chart 4

Which is more likely?



Brexit

Although entirely independent of BEPS, the UK's planned departure from the European Union – Brexit – is another source of substantial uncertainty in today's marketplace. Here, even more so than with BEPS, respondents seem to be more concerned than a close examination of the situation might justify.

As with BEPS, the specific impact which Brexit will have on regulation remains unclear. Those surveyed certainly do not share any consensus – quite the opposite. When asked about the likely shape of the United Kingdom's post-Brexit VAT and customs regime compared to that of the European Union, respondents split almost exactly evenly between the options.

Nevertheless, 38% of those surveyed believe that "Brexit will have an adverse effect on Ireland as an aircraft leasing location," compared to just 28% who disagree.

Again, however, those closest to the situation have another view – in this case a starkly different one. Among respondents based in Ireland, 40% strongly disagree that Brexit will cause any adverse effects for them, and a further 30% disagree. Only 5% believe it is likely to hurt the industry in their country.

Experts interviewed for this study – both those based in Ireland and elsewhere – largely concur with the Irish respondents. They struggled to come up with any way in which Brexit could hurt the country's leasing industry. Mr Yee notes that, while Brexit's wider economic consequences – whatever those turn out to be – will affect the aviation finance sector in the same way they do other industries, "lessors are less likely to face a significant, specific impact, due to the global nature of aircraft leasing".

Moreover, the nature of the product involved makes complications less likely, even if issues should arise from a lack of harmony between UK and European customs and VAT issues post-Brexit. Airplanes are sufficiently mobile that moving them in and around the EU need not involve entering the UK's area of tax jurisdiction.

Mr Grabowski sums up the views of many: while airlines might see fewer flights should Brexit hurt economic growth, "I am at a loss to see any negative effect from Brexit on the Irish leasing industry".

This does not mean complications are impossible. Most respondents expect the UK to sign an Open Skies agreements with both the United States and the European Union sometime after Brexit. "It seems to make sense for all sides," says Mr Hansom. He adds, however, that "if it gets caught up in a bigger fight, who knows?"

The potential for such a fight likely explains one of the stranger findings of the survey. On average, respondents expect an Open Skies agreement between the UK and the United States to appear slightly before such a pact between the UK and the European Union, even though the latter are physically closer and have much more travel between them than do the US and UK. Indeed, in 2014, nearly a third of intra-EU international airline passengers were travelling from the United Kingdom. However sensible an agreement might be, divorces can be messy.

Chart 5

In light of Brexit, do you expect the UK to negotiate an agreement substantially similar to the US-EU Open Skies Agreement?

YES, WITHIN 2 YEARS



YES, WITHIN 4 YEARS



That said, the broader message from Brexit, and from BEPS, is that, while uncertainty – and therefore the potential for nasty surprises – exists, so long as companies involved in aviation finance remain watchful, they should be able to navigate whatever regulation-related changes arise in the coming years.

38% of those surveyed believe that “*Brexit will have an adverse effect on Ireland as an aircraft leasing location.*” Compared to just **28%** who disagree.

However, those closest to the situation have another view – in this case a starkly different one.

Among respondents based in Ireland, **70%** disagree that Brexit will cause any adverse effects for them, most of them strongly. Only **5%** believe it is likely to hurt the industry in their country.

Brexit will have an adverse effect on Ireland as a leasing location



chapter 3

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HOW CAN SECTOR COMPANIES PREPARE NOW?



Although the change may be more measured than for some industries, BEPS will have an impact on aviation finance. Most survey respondents expect the international tax law changes currently taking place to have an at least moderate effect on airlines and lessors.

It would be hard for it to be otherwise. As Haroun Asghar from Etihad puts it, "Certain measures may require some lessors to review how they fund, structure and report transactions."

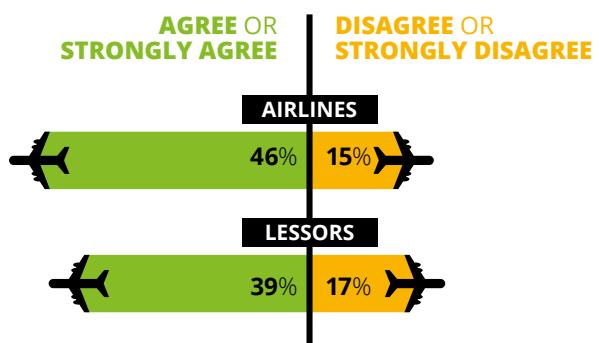
Unfortunately, companies may have trouble keeping up with these changes over the short to medium term. The EU Anti-Tax Avoidance Directive (ATAD), approved in June 2016, is implementing much of the BEPS Action Plan in the European Union, but 41% of airlines and lessors believe that companies in the industry do not have time to adapt to the mandated changes by the effective date of 1 January 2019.

This makes it all the more curious that so many companies are currently so tentative in preparing for BEPS in general. Only 20% of those surveyed report that their firms are now implementing the necessary changes. A further 35% are in the planning stages and the same number, 35%, have not even begun planning.

This apparent disconnect has a straightforward explanation: the uncertainty discussed in the previous sections makes specific actions very difficult to take. On the one hand, notes Giolla Kiely, Group Tax Manager at leasing firm AWAS, BEPS brings various challenges, "and we have to be sure we manage them". On the other, even where her company is planning what steps to take, she adds that it is often impossible to finalise things "until further guidance on the implementation of BEPS guidelines [from all governments] appears". Seraph CIO Edward Hansom is also "sympathetic to the wait and see attitude. I'm not sure how you can anticipate some of this in any meaningful way."

Chart 7

"Proposed double tax treaty changes will have an impact on the negotiation of aircraft lease agreements, in particular the provisions of tax gross-up clauses."



Nevertheless, interviewees believe that companies need to engage in some preparations because, says Mr Asghar, "if businesses are not engaged and reviewing the implications, their ability to comply when BEPS Actions become law will be impaired".

Between this rock and hard place, it makes sense for sector companies to focus efforts in several areas.

First, notes Etihad's Head of Tax, certain aspects of the OECD's BEPS project have set out minimum standards for certain Action Plans rather than best practice. The details of what will be expected for these minimum standards, while pending commentary and examples, are somewhat clearer and this has allowed his company to conduct some initial preparation and review already, Mr Asghar says.

In particular, numerous jurisdictions have already put in place country by country reporting standards. Meeting these will require important work on the data side. Although few companies think that gathering, producing, and protecting the necessary information will be very challenging, most describe it as a large or moderate challenge.



60%

agree that proposed double tax treaty changes aimed at **lowering the threshold of what constitutes a taxable presence in a foreign country** will result in

INCREASED SCRUTINY + CHALLENGES

for aircraft lessors.

Only 16% disagree.

22

Just as important, notes AWAS' Ms Kiely, is reacting to what the information might say about the company. "In advance of reporting, businesses will need to be prepared for increased scrutiny by tax authorities and ensure that they can explain the commercial reasons for their organisational structure," she says.

This becomes all the more important if the European Union proceeds with current proposals to make public information from country by country reporting. Such a step would, say 58% of respondents, create a competitive disadvantage for EU-based companies.

According to interviewees, however, the danger is more likely to be that of inadvertent reputational damage rather than the data revealing real issues. Mr Neary, the Senior Tax Manager at Avolon, speaks for most of them, when he expresses concern that "somebody without specialist tax knowledge might misinterpret the data."

The second area on which companies involved in aviation finance should focus now is making sure that they do not inadvertently fall foul of rules which might indicate their economic activity is taking place in a high tax jurisdiction.

Respondents are aware of the risk: 60% agree that proposed double tax treaty changes aimed at lowering the threshold of what constitutes a taxable presence in a foreign country will result in increased scrutiny and challenges for aircraft lessors. Only 16% disagree.

The opposite situation – a foreign presence which companies have established but the validity of which tax authorities might contest – is also a concern. ATAD, for example, may restrict the tax benefits of controlled foreign companies which do not carry out substantive economic activity of their own.

The sector, therefore, needs to ensure that it is engaging in real economic activity where it wishes to be taxed and not doing so where it does not. To avoid restriction of tax benefits, for example, 58% expect that

aircraft lessors will relocate more substance and senior staff to low-tax jurisdictions, and 50% expect airlines will do the same for their own captive leasing companies.

This is not to suggest that the industry currently operates to a large extent outside of the jurisdictions in which it pays tax. As discussed in the chapters above, this is not the case.

Instead, as with every other industry operating across borders, BEPS is creating new risks that individuals who travel for the company or agents who act on its behalf may – in certain circumstances – inadvertently trigger a deemed permanent establishment for tax purposes.

The problem is that, as Ms Kiely puts it, "because the industry is so international, certain staff need to travel". Face to face contact is a key part of building relations for many firms. As a result, she continues, once the exact rules are known, companies will "have to make sure strict guidelines are in place and adhered to about the activities taking place in the customer jurisdictions".



"The industry is so international, certain staff need to travel. Companies will have to make sure strict guidelines are in place and adhered to about the activities taking place in the customer jurisdictions."

GIOLLA KIELY • Group Tax Manager at AWAS

It will not be a question of changing the substance of how leasing takes place, but possibly tweaking, and definitely recording, the details of where people – usually the same ones as in the past – are physically sitting when key parts of the contract are agreed.

Avolon's situation is typical. It, says Mr Neary, "will need to keep track of activities carried out by our marketing team in the lessee jurisdictions to ensure that we are compliant with tax obligations in the relevant jurisdiction".

Companies will have to be more careful about documenting where key activities are taking place. Another option is to use new tools to change how deals are negotiated.

"Technology has reduced the requirement for face to face contact in some cases," argues Mr Hansom. "We recently signed a transaction with a new North American customer without any face to face meeting. You can do a lot more of this remotely."

This is a question not only for lessors. Etihad's Haroun Asghar believes that, "across the aviation industry, parties will need to review sales and contracting processes to understand these risks [of inadvertently creating a deemed permanent establishment] and to manage any audit reviews that result in subjective interpretations by tax authorities".

Finally, all parties should be considering how the details of standard lease agreements can best serve their interests. One issue is that of the tax gross-up clauses that exist in many aviation leasing contracts.

Common but rarely triggered in the past, BEPS might now create situations where those leasing aircraft are stuck with huge gross up payments as jurisdictions demand withholding tax. Almost half (46%) of respondents from airlines agree that "proposed double tax treaty changes will have an impact on the negotiation of aircraft lease agreements, in particular the provisions of tax gross-up clauses". Only 15% demur. From lessors, only 39% approve this statement, while 17% disagree.

Mr Hansom of Seraph Aviation Management, which does not itself own assets, notes that rather than



"We will need to keep track of activities carried out by our marketing team in the lessee jurisdictions to ensure that we are compliant with tax obligations in the relevant jurisdiction."

GAVAN NEARY • Senior Tax Manager • Avolon

arguing over who will be stuck with a large bill, "this is a situation where airlines and lessors are on the same side".

In his view, "any lessor with enlightened self-interest will work hard to structure deals around issues that arise." Airlines, meanwhile, want as much ability to access aircraft as they can possibly have. "Changes in gross up language do not do a lot for them. You want lessors to be enthusiastic about doing business in your country," he says.

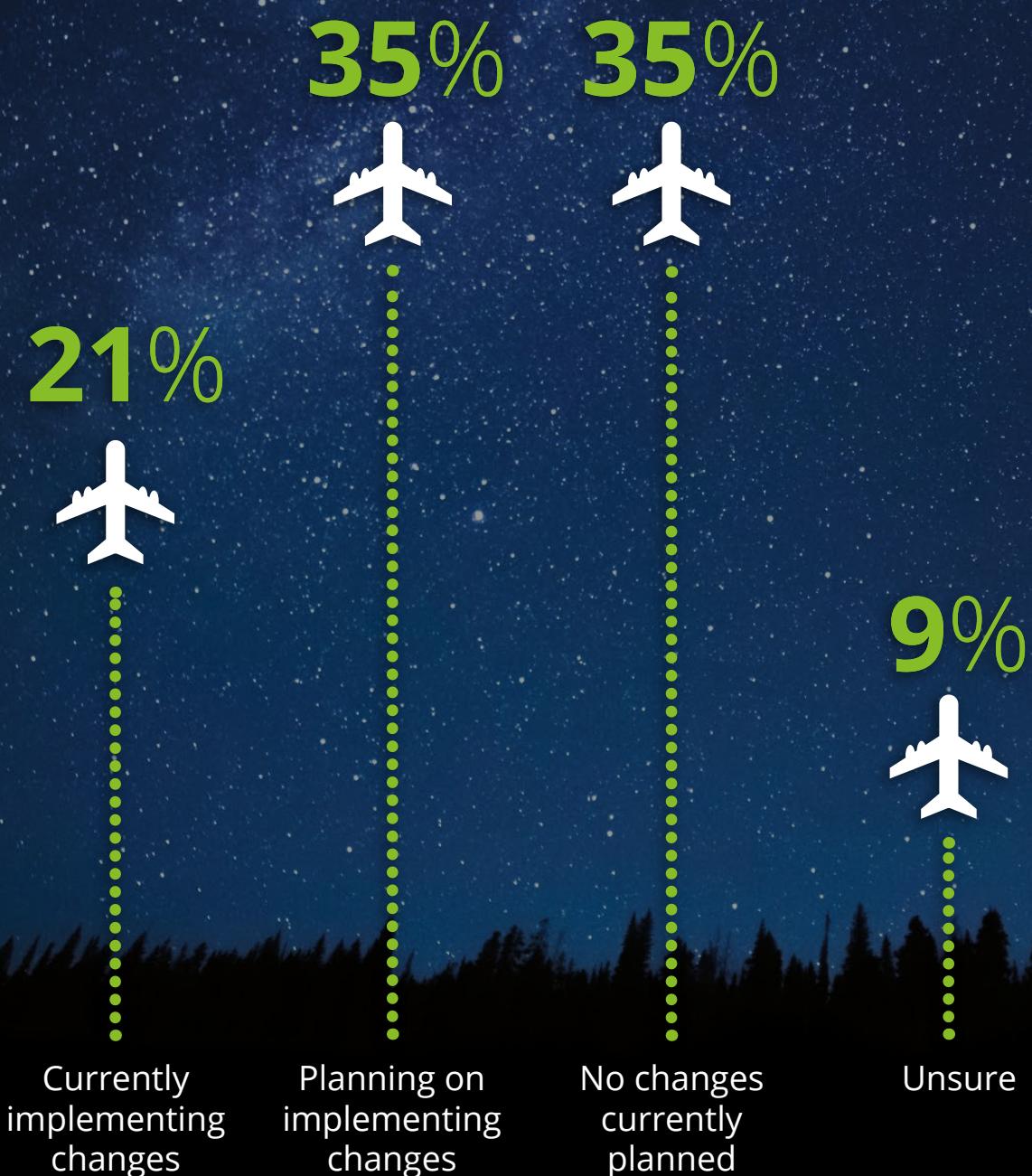
Markus Ohlert of Lufthansa adds that the underlying thinking behind most leasing contracts is unlikely to shift: "In cross-border lease agreements, the rule of thumb for tax provisions related to withholding tax is that the airline takes care of its jurisdiction and lessor takes care of its jurisdiction. There might be exceptions, but I do not expect that basic rule to change."

Until the new rules are in place, it is unclear what structural changes might be needed for the essence of everything to stay the same, but companies should be looking at ways to make their standard leases avoid causing unnecessary tax pain in the new environment.

Uncertainty may make it possible to get fully ready for BEPS, but in these areas at least preparation and, where possible, action now are vital.

Is your company preparing for upcoming regulatory and legal changes designed to curb tax avoidance?

24





chapter 4

25

WHAT DOES THE FUTURE HOLD?

Amid the uncertainty it seems clear that taxes, compliance costs, or both, are going up. The obvious question is "Who will pay?" After all, both aircraft leasing firms and airlines already operate on tight financial margins.

What will the marketplace look like?

Here respondents are split. One possibility is that lessors will absorb the costs themselves. When asked what effect BEPS implementation – via ATAD – would have in the European Union, more agreed that lessor profits will decrease than disagreed (41% vs 25%). This is also the view taken by respondents working for lessors.

But feedback from those working on the other end of leasing transactions suggests that they see themselves as being vulnerable: among respondents working for airlines 35% do not foresee a decline in lessor profits, while a smaller number of 34% does. This implies that airlines fear that lessors might pass on increased compliance costs.

Economics are on the side of this transfer happening. As aviation finance banker Bertrand Grabowski points out, "If everybody is confronted with the same cost, it will be passed on to the customer." AWAS' Giolla Kiely, though, believes lessors will be under pressure to absorb some of the expense, noting that they may need to look for efficiencies. Ultimately, though, the market will decide.

This also chimes with a widespread belief that airlines will be at least partly on the hook for expenses arising from the wider BEPS Action Plan being implemented. A majority (52%) believe that aircraft leasing costs will go up as a result of BEPS, indicating an attempt to pass on costs to the airlines, with only 13% disagreeing.

Respondents who see such change are also likely to expect adverse market effects as a result: 56% of



"If everybody is confronted with the same cost, it will be passed on to the customer."

BERTRAND GRABOWSKI • Managing Director, Aviation Finance at DVB Bank

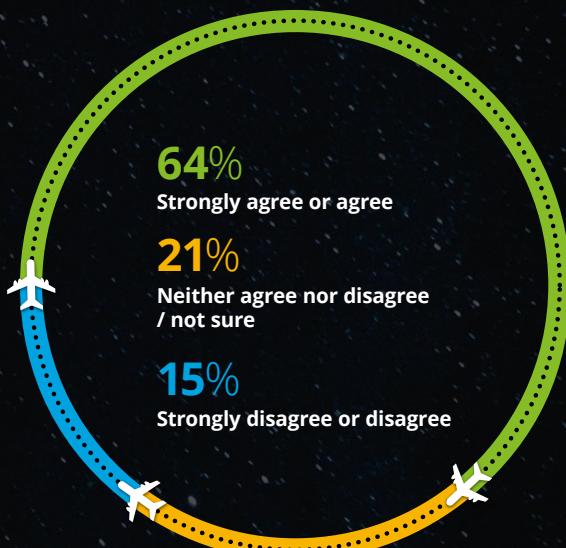


"Ultimately, the amount of leasing will depend on wider market and business factors."

HAROUN ASGHAR • Head of Tax at Etihad Airways

Chart 9

New lessor business models and structures will emerge to address challenges arising from the ATAD



those who think costs will rise also believe that airlines will lease fewer planes; among those who see no cost increases this figure is just 13%.

Mr Asghar of Etihad agrees that it may be challenging to decide what and how to pass on or whether to absorb additional costs, but “ultimately, the amount of leasing will depend on wider market and business factors”.

Lufthansa’s Head of Leasing, Markus Ohlert, adds that for companies with weaker balance sheets – who are among the most important clients for the lessors – “leasing may be the only way to get access to aircraft,” making it harder to walk away.

In conclusion, leasing gives rise to significant benefits, which are unlikely to tilt in favour of owning aircraft as a result of BEPS alone.

A more common expectation – held by almost two thirds of respondents – is that the challenges arising out of BEPS implementation, in particular the ATAD, will lead to lessors adopting new business models.

But experts suggest that the extent to which this is possible is limited. “New’ does not necessarily mean ‘viable’ for a business model,” warns Edward Hansom.

Mr Ohlert agrees. “I do not see changes in business models which would make leasing companies able to ignore the simple fact that they are investing in an asset and want to have a return,” he says. “In other asset classes, such as IT, you might think about additional services you can provide along with making the asset available to the lessee. But I don’t see that coming in aircraft leasing.”

Certainly no substantial new business models have appeared so far, although that may reflect the lack of certainty about the details of the new rules.

One possibility, however, may arise from the cap on interest deductibility foreseen under BEPS Action 4. Aviation and leasing are highly capital intensive, and it is



“I don’t see any real incentive for foreign lessors to relocate [to Chinese free-trade zones] unless they are focussed on competing only in the Chinese airline market.”

DEWEY YEE • Pioneer of aviation finance in Asia



not surprising that around 8 in 10 respondents expect this cap to have at least some impact on airlines and on lessors.

One possible reaction, notes Ms Kiely, is that this may lead to changes in how financing is structured. Companies will be “pushed to have more equity and reduce leverage,” adds Mr Grabowski. “As a banker, I would be happy with that.”

Which locations will see the most growth?

One of the biggest surprises in our survey was that respondents, overall, believe the locations where the aircraft leasing operations will grow the fastest in the next five years are China’s free-trade zones, followed by bigger current players such as Singapore, Ireland, and Hong Kong.

This does not mean, though, that current leaders are about to be supplanted. Dewey Yee, the Hong Kong based aviation finance pioneer, believes that, because of regulatory uncertainty and ongoing barriers to foreign entry, the free trade zones will have particular appeal for Chinese lessors leasing to domestic carriers. “I don’t see any real incentive for foreign lessors to relocate and operate there unless they are focussed on competing only in the Chinese airline market,” he says.

Similarly, Mr Grabowski says that he does not see the zones as “the next El Dorado of leasing”. With the Chinese domestic market growing, there is an appetite

for Chinese leasing companies. He expects that "the free trade aircraft rental there will be China to China." Because the leasing sector in the free trade zones is currently small, and Chinese aviation is expanding, they will see large percentage growth, but not displace market leaders.

Still, while it is impossible to say which location will do best, one thing is clear: the competition will be strong.

"There will be diversification among the leading locations," Mr Ohlert of Lufthansa expects. "Everybody in the world is looking to Ireland and seeing how well its strategy worked. You can expect others to copy it in an international race to become attractive – Singapore, definitely, and Hong Kong will make efforts to become even more interesting for aviation leasing companies."



"Everybody in the world is looking to Ireland and seeing how well its strategy worked. You can expect others to copy it in an international race to become attractive."

MARKUS OHLERT • Head of Leasing at Deutsche Lufthansa



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

29



25% Chinese Free Trade Zones

21% Ireland

13% United Kingdom

22% Singapore

16% Hong Kong

03% Other



conclusion

30

**KEEP CALM
AND CARRY ON**

BEPS and the other sources of uncertainty facing aviation finance will not induce revolutionary change. Sector companies, in particular aircraft lessors, lack the characteristics of the main targets of the OECD's Action Plan, even if they are concentrated in favourable tax jurisdictions. Brexit, meanwhile, is unlikely to have any marked effect on aircraft leasing, let alone aviation finance, even if the uncertainty it brings inevitably causes some concern among survey respondents.

Once the dust settles on the new rules, though, challenges will exist. In particular, companies will need to be sure that they do no fall foul of tax laws relating to where their economic activity should be taxed, and that they are not so structured as to suffer from caps on interest deductibility. Neither should be impossible as long as companies keep abreast of the changes and take steps as soon as practically possible.

The first will involve creating clear, well-enforced guidelines for employees; the second will depend on the specific rules which countries put in place. Indeed, because the interest cap is not a BEPS minimum standard (except in the EU, where the interest limitation rules have been agreed for implementation), some governments might be willing to put in place rules that acknowledge certain industries are frequently highly leveraged – such as property development and aircraft leasing – without this being a tool to shift profits to another jurisdiction.

Similarly, the EU ATAD interest limitation rules provide a degree of flexibility to member states to introduce certain relieving measures that could significantly reduce (or even eliminate) any adverse impact where a lessor's consolidated group as a whole is highly leveraged with third-party debt.

A more pressing issue than tax for companies in aviation finance is likely to be competition. Not only because this is a real – as opposed to tax-generated – industry, it is also a profitable one and demand is growing.

The sector's rapid evolution does not look set to slow down any time soon.

ABOUT THIS REPORT + APPENDIX



ABOUT THIS REPORT

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For this report, Euromoney Institutional Investor Thought Leadership surveyed 432 senior executives from the aviation finance industry. 43% of respondents hold C-level positions in their companies, a further 25% are vice presidents and senior directors. The others are senior managers in a variety of roles including regulatory, tax, finance, and compliance.

54% of respondents work for airlines, lessors, and services providers to the industry. About 18% are working for investors or other areas of the financial services industry to aviation finance. The remainder includes predominantly non-financial advisers, for instance from the legal community.

The largest number of contributions for this global survey comes from Europe, 29%, followed by 25% from Asia-Pacific. 23% of respondents are based in North America, and a further 19% in the Middle East & Africa.

In addition to the survey, in-depth interviews were conducted with 8 senior industry executives and independent experts.

Game Changer not Game Over: Aviation Finance and International Tax Reform is an Euromoney Institutional Investor Thought Leadership report, prepared in conjunction with Deloitte. The research was conducted by Euromoney Institutional Investor Thought Leadership.

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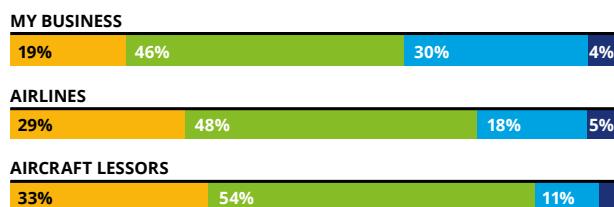
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APPENDIX

Q1

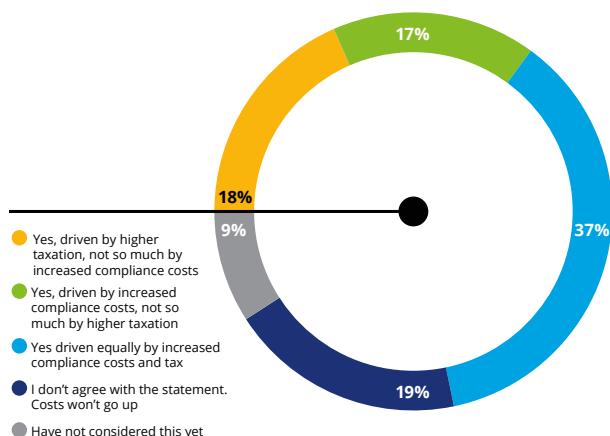
What level of impact will international regulatory and legal changes designed to curb tax avoidance have on...



● Significant impact ● Moderate impact ● No impact ● Have not yet considered this

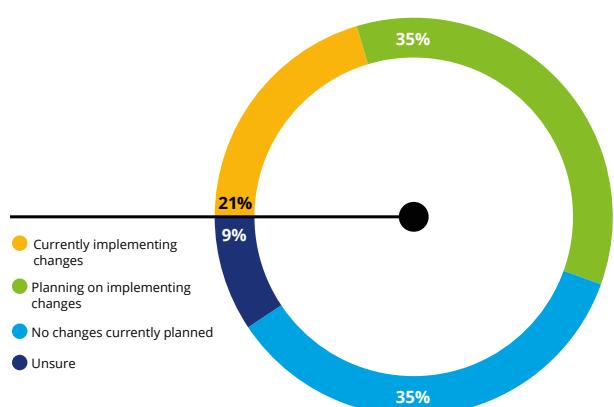
Q3

Global anti-tax avoidance measures will drive up financing costs for the aviation industry.



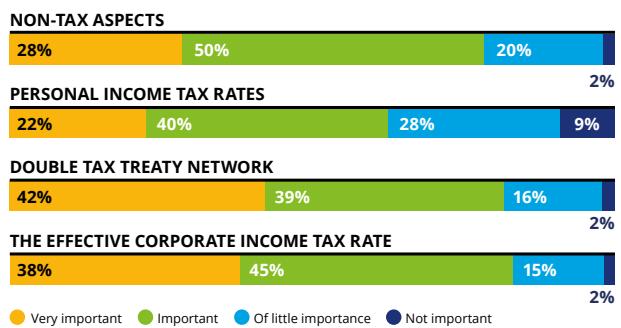
Q2

Is your company preparing for upcoming regulatory and legal changes designed to curb tax avoidance?



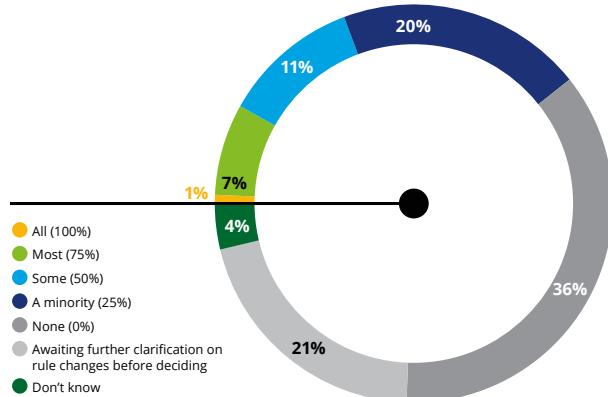
Q4

How important are the following considerations when picking a location in which to establish aircraft leasing operations (either as lessor or an airline captive leasing platform)?



Q5

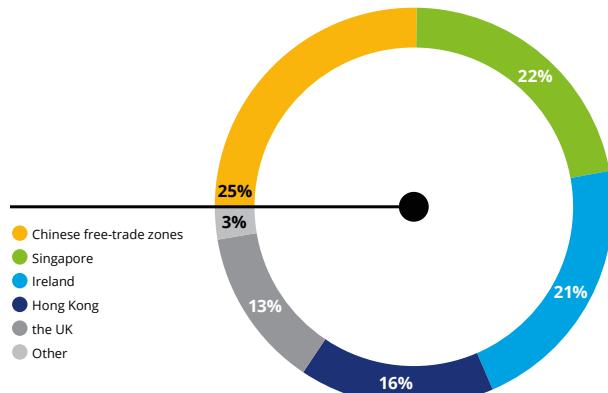
In the wake of new anti-tax avoidance measures, what proportion of your business, if any, are you thinking of relocating?



35

Q6

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



Q7

As a result of Brexit the application of customs duty & VAT with respect to the acquisition and leasing of aircraft might change. This will depend on the outcome of EU-UK negotiations and subsequent revisions to domestic legislation.

How would you describe the impact of the following possible outcomes:

Q7a

New VAT & customs rules replicate existing UK/EU rules, including the principles established by EU Court of Justice case law.

MY BUSINESS

14%	37%	42%	6%
-----	-----	-----	----

AIRLINES

23%	48%	22%	7%
-----	-----	-----	----

IMPACT ON AIRCRAFT LESSORS

21%	55%	18%	6%
-----	-----	-----	----

● Significant impact ● Moderate impact ● No impact expected ● Have not yet considered this

Q7b

The UK customs position remains the same but UK VAT rules applicable to aircraft purchases and leasing no longer follow the EU VAT model.

MY BUSINESS

13%	37%	43%	6%
-----	-----	-----	----

AIRLINES

22%	59%	12%	7%
-----	-----	-----	----

IMPACT ON AIRCRAFT LESSORS

21%	60%	12%	7%
-----	-----	-----	----

● Significant impact ● Moderate impact ● No impact expected ● Have not yet considered this

Q7c

The customs regime changes, but UK VAT rules mirror the EU VAT treatment including the principles established by EU Court of Justice case law.

MY BUSINESS

15%	35%	43%	6%
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AIRLINES

22%	54%	17%	8%
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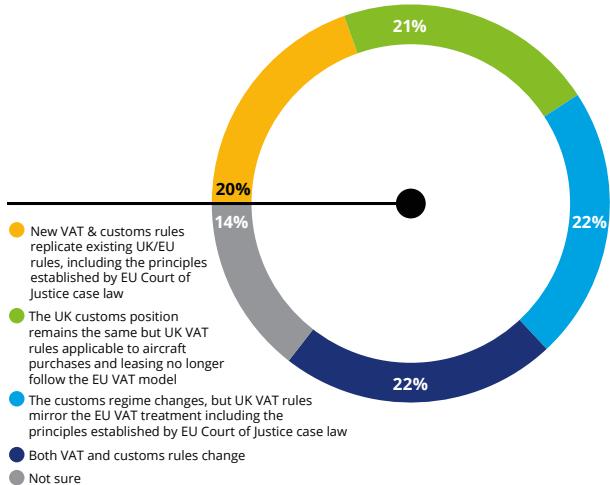
IMPACT ON AIRCRAFT LESSORS

19%	55%	20%	7%
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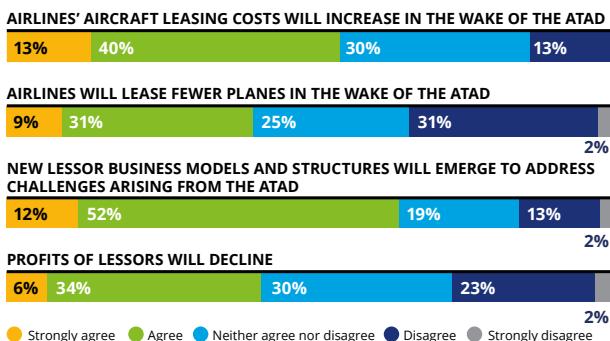
● Significant impact ● Moderate impact ● No impact expected ● Have not yet considered this

Q8

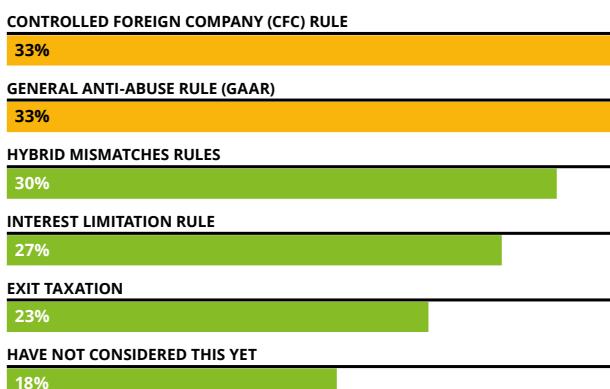
Which of the scenarios outlined in the previous question do you consider to be the most likely outcome of EU-UK negotiations?

**Q11**

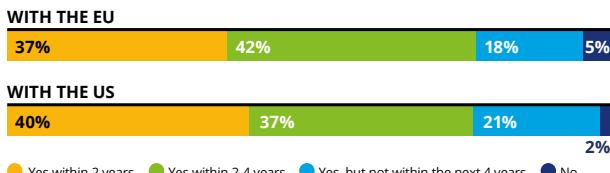
The EU recently agreed the Anti-Tax Avoidance Directive (ATAD). Please rate the following statements:

**Q12**

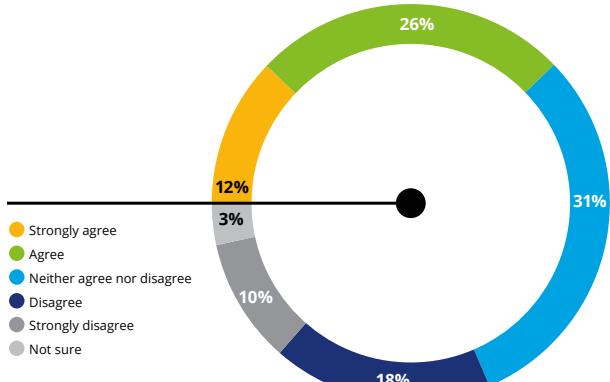
Which two of the following aspects of the ATAD will have the most significant impact on aviation finance?
(Pick up to 2)

**Q9**

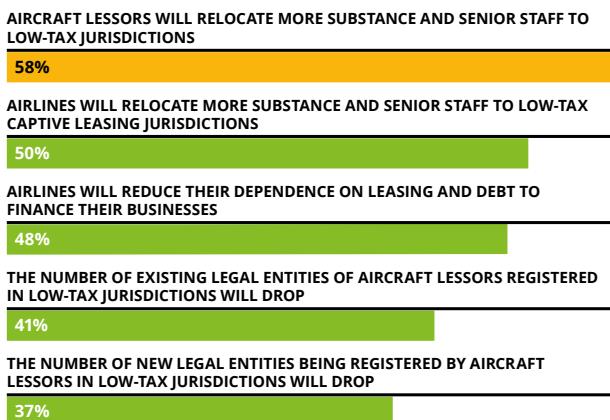
In light of Brexit, do you expect the UK to negotiate an agreement substantially similar to the US-EU Open Skies agreement...

**Q10**

Brexit will adversely impact on the attractiveness of Ireland as an aircraft leasing location.

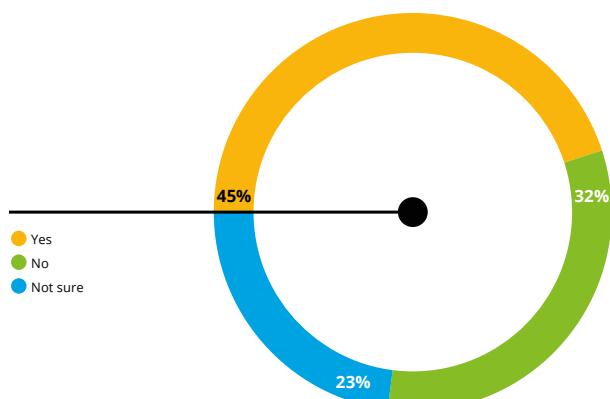
**Q13**

Only CFCs that, broadly, carry out substantive economic activity can take advantage of favourable tax rules and rates under the ATAD. What impact will this have on aviation finance? (Tick all statements you agree with)



Q14

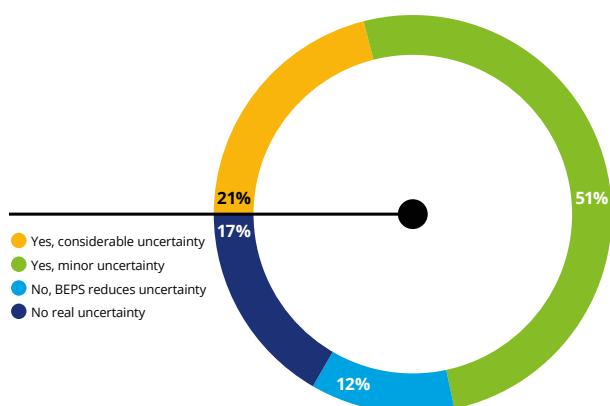
ATAD national implementations will, subject to a few exceptions, become effective as of 1 January 2019. Do you consider this timeframe sufficient for lessors and airlines to make necessary arrangement?



37

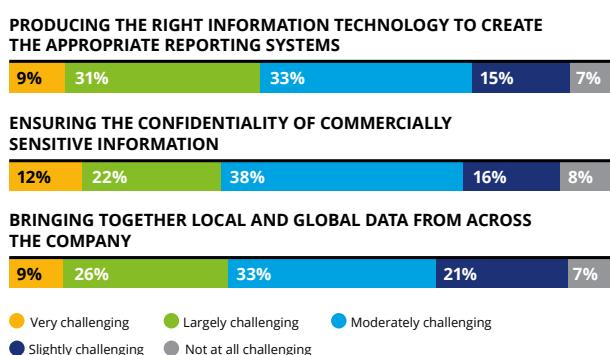
Q15

Is the BEPS Action Plan creating uncertainty for the international aviation finance industry?



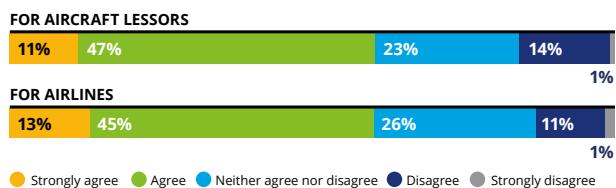
Q16

How challenging are the following factors for your company in preparing for the new BEPS country-by-country reporting standard?



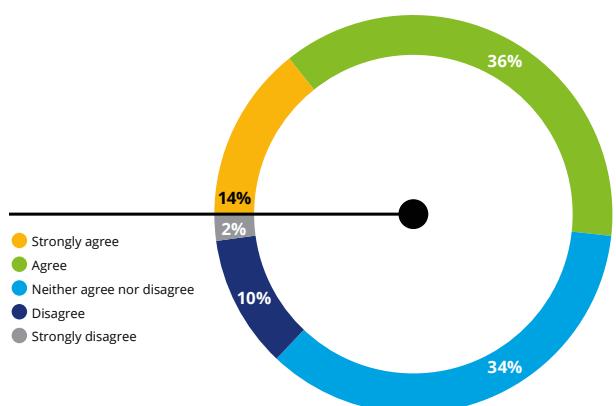
Q17

Public country-by-country reporting, as proposed by the EU, will result in a competitive disadvantage for EU-based businesses compared to non-EU-based businesses.



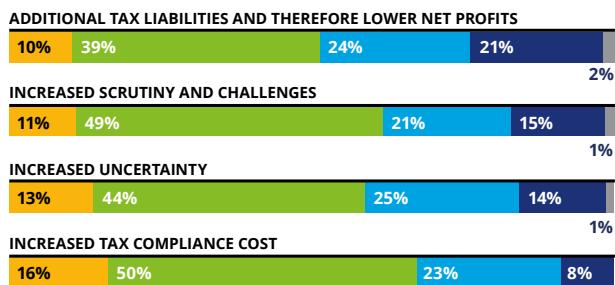
Q18

Proposed double tax treaty changes will have an impact on the negotiation of aircraft lease agreements, in particular the provisions of tax gross-up clauses.



Q19

Proposed double tax treaty changes aimed at lowering the threshold of what constitutes a taxable presence in a foreign country will result in the following for aircraft lessors:

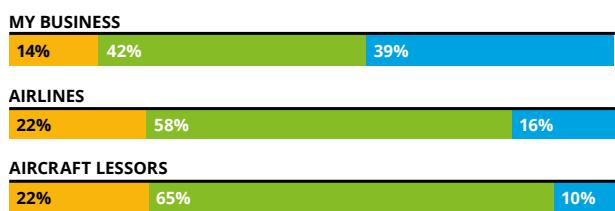


● Strongly agree ● Agree ● Neither agree nor disagree ● Disagree ● Strongly disagree

38

Q20

Revised OECD Transfer Pricing guidance and principles relevant to intercompany financing following the BEPS process will have an impact on...



● Yes, a significant impact ● Yes, a moderate impact ● No impact expected

* All percentages rounded up.

Deloitte.

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