

Aviation finance M&A activity – investor considerations

Matt Dolan, partner in the financial services tax department at Deloitte Ireland, looks at the key tax considerations in aircraft leasing mergers and acquisitions.

As we head towards 2020 the aircraft leasing market continues to be buoyant, albeit with an acknowledgement that we may have reached the peak of this particular cycle. From an airline perspective, the forecast is less positive because International Air Transport Association downgraded its 2019 airline profitability forecast by \$7.5 billion. The ongoing trade war between the US and China and, at the time of writing, the ambiguity surrounding the timing and specifics of Brexit continue to cause uncertainty.

Despite this, there continues to be ample liquidity available to the aircraft leasing industry as investors continue to flock to the asset class in a variety of investment formats.

There has been continued M&A activity over the past few years with an expectation of more activity into 2020. New leasing platforms continue to be established, investors still find attractive returns in aviation funds, aircraft asset-backed security (ABS) investment opportunities are abundant, joint-venture/sidecar deals continue in numbers and portfolio acquisition availability is healthy.

KKR will invest up to \$1 billion in partnering with and investing in Altavair Airfinance. In the fund space, Falko, WNG and SMBC, among others, launched dedicated aviation funds. Elsewhere, GIC invested into Nordic Aviation, Orix acquired a 30% interest in Avolon, the SKY Leasing fleet was acquired by Goshawk, while the Carlyle Group took over Apollo Aviation Group. More recently, Tokyo Century Corporation has entered into an agreement to acquire 100% of Aviation Capital Group (Tokyo Century Corporation already being a shareholder in ACG). There was and continues to be unrelenting launches

of aircraft ABS and additional aviation fund structures.

Industry commentators agree that this M&A activity will continue because participants are looking for scale as well as access to new financing opportunities and markets. Investors continue to see attractive returns.

There is also an expectation of consolidation within the Chinese leasing company fraternity given there are more than 60 leasing companies in China which some consider unsustainable. The ultra-competitive marketplace is also likely to see a number of lessor casualties, which have found the challenging market conditions and weakening airline profitability too much to contend with, the result being they are consumed by a larger competitor.

With that landscape in mind, the focus of this article is to outline the key tax considerations in an aircraft leasing M&A scenario. There are, of course, common issues in an M&A tax scenario which are well understood, but other considerations have been brought about by the rapidly evolving global tax reform agenda punctuated in recent times by the OECD Base Erosion and Profits Shifting programme, the EU Anti-Tax Avoidance Directive and recent US tax reform. This article will conclude by highlighting some areas to consider for purchasers/investors with respect to the human capital side of M&A.

As outlined above, there are a number of forms of M&A activity in an aircraft leasing context but primarily they can be simplified into two classic M&A categories: a share acquisition or asset acquisition. Each alternative has its own intricacies and are likely to have two very different purchaser profiles.



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Tax due diligence

Diligence is a prerequisite in an M&A context – as a purchaser you need assurance that there are no surprises in what you are buying and/or that you are appropriately protected from any latent liabilities. For larger M&A in a share acquisition context, a vendor due diligence (VDD) or tax fact book is usually prepared by the seller.

In theory, this should reduce the time target's management spends on the sale process and ideally streamline the diligence process for the purchaser as well. In practice, a

purchaser would generally have their own advisers undertake a certain level of diligence or at least stress test the VDD or tax fact book content by way of a red flag report.

Positive tax attributes

A key consideration in a share acquisition is the ability for an investor to preserve positive tax attributes that a target group may hold. This is generally in the form of deferred tax assets driven by tax losses and additional tax depreciation which are usually available for carry forward to shelter future income from the leasing activity of the group. Clearly, such a benefit needs to be preserved. As such, it is necessary to understand the tax rules governing the carry forward of tax losses in the vendor jurisdiction of residence and, more importantly, how a purchaser may forfeit or jeopardise the continued availability of such losses in a takeover/investment scenario.

From an Irish tax perspective, if a purchaser was taking over a leasing platform, generally the tax losses should continue to be available for carry forward against future leasing profits where there is no change in the nature or conduct of the trade (which is generally the case) and there are no fundamental alterations to, for example, the customer profile or markets served. However, this is not always the case, and rules can be complex in jurisdictions such as China.

Crystallisation of deferred tax charges

Many jurisdictions (including Ireland) offer group relieving provisions whereby taxable gains which may have arisen on intergroup transfers of assets are deferred for a period of time. Similarly, indirect tax/stamp duty exemptions can apply on intergroup transfers of assets but generally would be subject to clawback provisions within certain timeframes and subject to certain conditions.

For example, in an Irish group context, it is usually possible to transfer capital assets, trades, etc, intergroup and to mitigate capital gains tax and stamp duty implications. However, where there is a cessation in the group relationship (which could, of course, occur on a subsequent third-party sale of some or all of the entities involved) then it is imperative that a prospective buyer understands the quantum of potential exposures, to who the liability may rest with and to ensure that the purchaser is appropriately indemnified in the sale and purchase agreement (SPA) documentation.

Tax management function

A basic consideration when undertaking a tax due diligence is to verify the overall compliance of the target group in terms of tax return filings as well as whether the group has a dedicated tax function or relies on external tax advisers (and if so to what extent).

Does the group have a history of filing returns or making tax payments late? If so does this increase the chance of tax authority intervention or have they been subject to a tax audit to date? In an aircraft leasing context, given the cross-border nature of the business, it is recommended that a general understanding of how the target approaches tax risk is sought. In particular, in respect of buy, sell and lease transactions – how often does the target obtain tax advice?

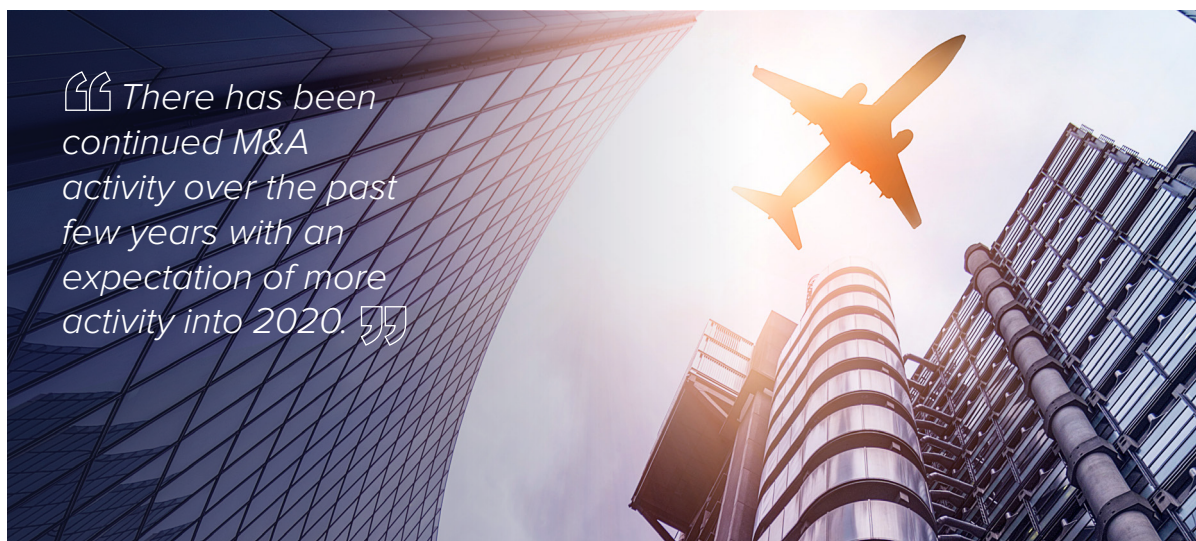
Is there evidence that the tax advice received is adhered to with any requisite registrations or filings completed? Does the target group take an aggressive position where there may be, for example, a technical tax registration obligation in a certain jurisdiction but where in practice the group does not so register? It is important for a potential buyer to understand the risk profile of how the group manages its global tax exposures – particularly given the potential costs of, for example, VAT on the acquisition of an aircraft which could be in the millions of dollars.

In a similar vein, additional comfort can be gained from understanding whether the target group utilises the services of a reputable and experienced tax adviser in assisting with its tax compliance and international tax advisory requirements.

Employment taxes

Where an investor is acquiring or investing in an existing platform,

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an area that routinely gives rise to issues is employment and payroll taxes. This is a particular focus area of a lot of tax authorities because it generally generates tax revenues for tax authorities on the back of interventions and tax audits given the propensity for errors in this specific tax area.

In an Irish context, a key question for a target group would be how it has managed the recent pay as you earn (PAYE) modernisation programme introduced by the Irish Revenue – it is effectively real-time reporting of employee remuneration.

It can be a complex area and penalties for failing to adhere to real-time reporting can be punitive. For aircraft leasing companies, another area of focus should be the taxation of a director's remuneration in various jurisdictions where the group may hold special purpose companies. Many jurisdictions would seek to challenge arrangements whereby an internal group director was not remunerated for holding the office of director of a company in a particular jurisdiction.

Tax residence and double-tax treaty relief

While historically always an important focus area, the above topic is now a key consideration for investors looking to invest into an existing platform on the back of the introduction of the principal purpose test (PPT) under the OECD BEPS initiative.

The nature of the industry is such that invariably double-tax treaty access will be required in order to mitigate withholding taxes on lease rental income paid from one jurisdiction to another. Whereas, in the past, the provision of a tax residency certificate may have been sufficient for an airline to get comfortable on the right to treaty access, the PPT has placed additional emphasis on the rationale for the use of a company in a particular jurisdiction with the aim being to ascertain whether treaty access was one of the principal purposes in entering into an arrangement or transaction.

An in-depth analysis of the impact of the PPT is outside the scope of this article and has been discussed in detail in other articles we have

written but, in an M&A context, there are some key PPT-related matters to consider:

- does the target have sufficient substance in the jurisdiction (by way of functions, assets and risks) from which it is seeking to claim tax treaty benefits?
- does the target lease to any jurisdiction where tax authorities are particularly aggressive in targeting perceived treaty shopping or have unique local beneficial ownership requirement rules?
- is the investor investing into a fund or platform where the servicer sits outside of the group structure (an ABS, fund or joint-venture/sidecar structure) and what does that mean for treaty access? and
- does the investor profile strengthen or weaken treaty access (for example, for satisfying the Limitation on Benefits clause present in US tax treaties among others)?

From a practical perspective, the tax due diligence should encompass a review of lease agreements which the target has entered into to determine whether any particular risks exist vis-à-vis change in law risk or where the target may have made representations around being a “beneficial owner” of the lease rental income. The latter concept is one that is continually evolving but which remains undefined with guidance being drawn from case law in the area as well as OECD commentary.

The use of “lease in lease out” vehicles should also be examined in the course of a tax due diligence as to the long-term viability of a particular structure. Where an entity does not own the aircraft, has no exposure to credit or financial risk and has no employees/functions residing within that entity, it may come under pressure in accessing tax treaty benefits in future. This should clearly be a factor in the investor's evaluation of the opportunity the target represents.

Whereas the relevant lease agreement may contain protections for the lessor against future withholding taxes that may arise, whether commercially such additional taxes could be absorbed by the

lessee should be evaluated.

The area of treaty access is one that needs to be considered in depth at the outset of an investment. While there is no bright line test at present, and tax jurisdictions will invariably interpret the PPT in differing ways, tax practitioners should have a good sense of what substance is the right substance in order for a platform to be in a position to avail of tax treaty benefits or recommend steps to bridge any potential gap.

Similarly, protecting tax residence is also of increasing importance. With a seemingly ever-increasing number of avenues in relation to the exchange of information between tax authorities, it is likely that challenges to the likes of the tax residence of a company will become more commonplace. Cementing tax residence in a particular jurisdiction by ensuring management and control or the place of effective management resides in that jurisdiction and that jurisdiction alone is important.

Limitations on the deductibility of interest

Thin capitalisation rules or interest-limitation rules are a feature of many tax regimes around the world; however, the introduction of such rules under the EU ATAD has brought such restrictions into the remit of many EU tax regimes where no such rules existed before.

The leasing industry is by its nature highly leveraged and so a fundamental question for investors into a leasing platform should be: “how do the new rules impact the tax profile of the target group?” Investors should probe and determine whether existing models take into account such interest deductibility limitations, whether models require stress testing or whether new financing structures need to be considered completely.

From an Irish aircraft leasing perspective, this may not have been a focus in a tax due diligence process before but will certainly become more and more prevalent going forward.

Permanent establishments and foreign taxable presence

Similar to the interest deductibility and treaty access discussions, this should be nothing new in terms of

being a topic for consideration in an M&A context; however, the OECD BEPS initiative has resulted in a number of jurisdictions lowering the threshold for which a permanent establishment may be triggered under the terms of a double-tax treaty.

While many jurisdictions, including Ireland, made the decision to forgo any changes to the permanent establishment threshold, leasing groups with non-Irish servicing entities should consider the impact having sales and marketing personnel in various jurisdictions may mean – in particular, where such employees are negotiating the material terms of a contract in a particular jurisdiction.

It is important that as part of the diligence process, an investor gains an understanding of the processes a target group has in place to monitor, evaluate and manage foreign tax exposure risk. The outcome should impact the risk level attributed to tax in the overall target evaluation.

Controlled Foreign Companies (CFC)

Many jurisdictions are very familiar with the concept of CFC rules, having had such rules in their domestic tax law for some time. For other jurisdictions, the introduction of EU CFC rules effective 1 January 2019 was a fundamental change in how and on what income a company could be subject to tax.

As part of a tax due diligence, it is important to understand, particularly if the target group is in a jurisdiction for which CFC rules are relatively new, what work the target group had undertaken in ascertaining the impact of CFC rules on their group and the effective tax rate. Particular attention should be paid to any financing structures which fall within the remit of the CFC rules.

Transfer pricing

In many EU jurisdictions the CFC rules introduced broadly refer to safe harbours where the arrangement between a company and its CFC has been appropriately transfer priced.

Transfer pricing is an extremely important component of a tax due diligence process. The intergroup transactions within a leasing group can have a fundamental impact on

the tax profile of a group and so it is necessary for a potential investor to be fully comfortable that intergroup transactions are appropriately priced and that there is sufficient transfer pricing documentation in place to support the positions should the need arise during the course of a tax authority intervention.

Given the availability of readily transferable information between tax authorities, it is likely that tax payers can expect increased interventions from tax authorities in respect of cross-border transactions. Transfer pricing will be a key element of this and so the importance of a target group having appropriately priced intergroup transactions cannot be underestimated. If no such documentation is in place or there are what the investor determines to be weak controls in place, the cost of rectifying the position should be considered in terms of acquisition price and the overall transaction.

Substance requirements – low/no tax jurisdictions

The use of Cayman Islands, BVI, Bermuda, and Channel Islands incorporated companies is relatively common within the aircraft leasing industry. The EU intergovernmental Code of Conduct Group on Business Taxation introduced a number of substance requirements aimed at jurisdictions with low or zero rates of corporate income tax. As a result of this pressure, many jurisdictions, including those outlined above, introduced economic substance rules into their respective domestic legislation.

The rules are broadly similar across the jurisdictions involved and essentially require entities tax resident in those jurisdictions to have minimum substance requirements in those jurisdictions where relevant activities are taking place. “Finance and leasing” is generally considered a relevant activity.

As such, in a tax diligence scenario it is important for potential investors to inquire as to substance footprint or future substance plans in any target group entities that are resident in such jurisdictions.

There are further considerations for a potential investor where a

target group has entities which are incorporated in a low tax/no tax jurisdiction but are tax resident elsewhere (which is quite common). Let us take the Cayman Islands as an example and the guidance issued by their authorities.

A key point discussed within the guidance was in respect of entities which are Cayman incorporated but tax resident outside of the Cayman Islands. The guidance notes that (author’s emphasis):

“A company, limited liability company or limited liability partnership incorporated or established in the Islands is not regarded as a relevant entity for the purposes of the ES (Economic Substance) Law if it is tax resident outside the Islands. The Authority will regard an entity as tax resident in a jurisdiction other than the Islands if the entity is subject to corporate income tax on all of its income from a relevant activity by virtue of its tax residence, domicile or any other criteria of a similar nature in that other jurisdiction.”

As such, provided a Cayman incorporated and, for example, Irish tax resident company engaged in leasing activities can produce satisfactory evidence demonstrating that all of the leasing income it earns is subject to corporate income tax in Ireland, then such a company should not be considered a “relevant entity” for the purposes of the Cayman Economic Substance Law.

However, if in a particular structure involving a Cayman incorporated entity that is not tax resident in Cayman, some of the income from a “relevant activity”, as defined, is not subject to corporate income tax in another jurisdiction (eg, if it is completely exempt) then the entity in question may need to consider the impact of the Economic Substance rules.

As noted, the use of Cayman incorporated vehicles which are tax resident outside of the Cayman Islands is relatively common. As such, investors should consider whether any such entities are within a potential target group and ascertain what risks this may present, if any.

Structuring considerations

The structure of the deal from a tax perspective will also be influenced by the form of the deal – namely, whether it is an acquisition of assets or shares.

There are a number of considerations for a purchaser in a process whereby a trade or assets are being acquired. The acquisition of assets can be beneficial in that the aircraft are generally rebased for tax purposes (ie, tax depreciation should be able to be claimed on the purchase price of the aircraft) versus a share deal where the investor is stepping into the shoes of the previous owner.

The issues identified above as part of the diligence process become equally important where the investor is establishing their own holding/ investment platform on the back of an asset or portfolio acquisition. Questions to ask include: will treaty access be an issue? How will interest limitation rules impact my financial models? How do I ensure sufficient substance in the holding company jurisdiction?

Of course, of significant importance for any investor is the tax implications that may arise on exit from the structure. Many jurisdictions exempt capital gains arising from the disposal of shares, subject to conditions being met. A key consideration on exit should be the potential tax cost for a future purchaser. Indirect taxes such as stamp duty can be extremely costly for a purchaser (in Ireland, for example, stamp duty on share transfers is 1%) if it cannot be mitigated. Setting up the structure correctly from the outset considering cash repatriation, treaty access, tax-efficient funding and ensuring a commercially viable exit strategy are all very important.

From a commercial perspective, in an asset acquisition scenario consideration could be given as to whether the aircraft should be acquired into a trust which is “GATS ready”. GATS is the Global Aircraft Trading System due to be launched in 2020. The system has the backing of a number of major lessors which are active in the aircraft trading market and the goal of the system is to make the acquisition of aircraft, and an

associated lease novation, a far more straightforward process for the buyer, seller and the airline.

The people-side of M&A

Ensuring due consideration is given to the management and employee impact of M&A can greatly increase the ultimate success of the investment.

Where an investor is acquiring an existing platform complete with management team, a pivotal area to consider is employee and management incentivisation. Ensuring key personnel remain in their roles can be a key consideration, particularly in scenarios for example whereby the investor is a private equity firm which is not looking to merge the target with an existing leasing platform.

Consideration should be given as to whether there is an existing employee incentivisation scheme and the tax implications for existing staff should this need to be wound up or replaced with a new scheme. Management incentivisation programmes are now commonplace in aviation M&A and are generally by way of share options schemes, restricted stock units (locking in management for a particular time) or classic private equity-style carried interest returns, which are more common where an investor is providing funding for a servicer platform.

For those investors looking to establish their own platform, they face a unique war for talent. The Irish marketplace is particularly competitive and employees with industry experience are in high demand. The wider financial services employment market continues to be very active from a recruitment perspective and so new lessors face competition not only from other lessors but also larger banks, investment managers, private equity firms and others in the race to attract top talent.

When looking to attract top talent across international borders consideration needs to be given to a number of factors including the personal income tax regime in the country in which the target employee is being asked to move to, the availability of affordable residential housing, the education system

(including availability of international schools) and the standard and cost of living. It is imperative that a robust and appropriate talent management programme is in place to attract top talent.

There is an expectation of continued M&A activity between lessors. Many lessors see M&A an efficient and rapid method of achieving scale. For those lessors in acquisition mode, employee integration is of paramount importance; indeed, this is a facet of M&A that is routinely overlooked and one which can make or break the success of an acquisition. In such scenarios, it is necessary to identify where the expanded organisation wants to be in terms of its structure and to scope fully the impact of the merger on new and existing roles within the group. It will be important to identify the key, critical workforce and develop a best-in-class retention and talent strategy.

Given the competitive employment environment this is easier said than done. From the outset, the human resource department will need to support the transition, determining the appropriate process that needs to be in place to reach the desired organisation structure and culture goals. Communication is key in any change management process. Engagement with specialist providers such as Deloitte can greatly enhance the success of an employee-integration process.

Regardless of the direction in which the industry will travel, consolidation and M&A activity is anticipated to continue. Numerous lessor platforms are looking to boost their scale; other lessors may face stress in the near to medium term as airline profitability continues to come under pressure, impacting airline credit risk and potentially resulting in defaults, or as a result of remarketing pressures. The latter will be prime M&A targets for the former.

There are myriad considerations in an M&A process across tax, accounting, financial, commercial, legal, regulatory and more. Advanced planning on both the part of vendor and purchaser can greatly reduce the pain that can come with such work streams. 