

Russia's aircraft and airline industry is in a catch-22 situation created by sales and import taxes on aircraft. Will the Russian government do anything to reverse this situation? Paul Duffy reports from Moscow.

# Russia's burden of aircraft taxes

Russia's aircraft industry has one very major problem today – money. It is unable to win a flow of orders that will keep the workforce of close to two million employed. As the industry rides from crisis to crisis it may be near the end. Only 11 Russian aircraft have been sold to Russian airlines in the past two years.

The Russian government faces financial problems with the international monetary fund and is having to raise taxes. Two of these sources of revenue are sales taxes on Russian airlines for all new aircraft and import duties on western aircraft. Import duties were created to appease Russian aerospace manufacturers complaining that western manufacturers were likely to dominate the Russian market. This effectively means Russian airlines have no prospects of owning western aircraft.

The Russian government does not seem to realise that if it wants to expand its tax base then Russian industry must get back to work. Without a regular flow of aircraft orders this will not happen.

The need to acquire new aircraft has not been particularly high for airlines in Russia since the collapse of the Soviet Union. This situation is now changing.

In Soviet times annual Aeroflot traffic peaked at 137.5 million passengers flown some 243.8 billion passenger kilometres. In 1997 Russian airlines carried just 28% of the 1990 traffic.

Despite this apparent excess of aircraft capacity, by the end of 1998 the number of remaining serviceable aircraft will have fallen below the number required to carry Russia's passengers.

Virtually no airline has the money needed to pay even the \$15-\$30 million for almost any new aircraft. Financial institutions are too busy providing loans at very high rates of interest to the government, which persistently falls short of its budgeted tax revenue, to take on any higher risk and unprofitable loans.

## Aircraft purchase taxes

All aircraft bought by Russian airlines attract a sales tax of 20%. All imported aircraft are also subject to a 30% import duty. The gross amount of an imported aircraft is then subject to the 20% sales tax, taking the full tax burden for an imported aircraft to an equivalent rate of 56%.

In practice Russian customs will exempt imported aircraft if there is a presidential or government authorisation. The law states that any government owned airline is exempt from these taxes. There is no clear definition of what percentage ownership qualifies an airline as government owned.

To date only aircraft imported by Aeroflot and Transaero have been allowed exemptions; both companies have strong government connections. All other airlines have had to pay the taxes or have their aircraft confiscated. An aircraft remains exempt from these taxes for the first 364 days it operates inside and from Russia. Once it stays longer it automatically becomes liable for these taxes.

The few other western aircraft to enter service with Russian airlines were not exempted. Baikalavia's single 757 was

seized by the tax police and, after a short while, returned to its US lessor. Krasnoyarsk Avia's two DC-10-30s and Avcom's single DC-10-30F were returned to their lessors before the 364 day limit. Sakha Aviatrassi has paid the taxes on its two early 737-200s.

A US-Russian bi-lateral Gore-Chernomyrdin Commission, led by US vice-president Al Gore and the Russian prime minister, met every six months between 1993 and 1997 to review cooperation between the two countries. They discussed the issue of Russian import duties on western aircraft and agreed that there should not be any taxes on western aircraft, but no legislation has followed.

Tax authorities are entitled to waive their taxes and at a press conference in June the Ministry of Economics said, "The airline and aviation industries are currently producing very little in the way of taxes, so we have little opportunity to fund their development".

If there were no sales or import duties most Russian airlines would probably buy used DC-9s, 727s and 737-200s from the west for less than \$5 million. Although this is what the Russian government is afraid of, these aircraft would at least allow the airlines to start regular operations. Their financial strength would improve and so become attractive for banks to provide further funding for more aircraft purchases.

In the long-term, Russian airlines will still operate Russian built aircraft because they have lower purchase prices and will soon have the same fuel burn and maintenance efficiencies as western



aircraft. Russian airlines just need to get going. The current 20% sales tax makes even the purchase of Russian aircraft unattractive.

## Hybrids

The Russian programme that has attracted attention in the west is the Tupolev Tu-204, an aircraft similar in concept and appearance to the 757. The Tu-204 could become a worthwhile bridge between Russian and western industry but the Russian aviation industry has objected to its foreign engines, and even this programme is running into import duty difficulties.

This is because the Russian avionics and engine manufacturers have raised objections to the import of western substitutes for the Tu-204. That is, the avionics, engines and other components are equivalent to 50% of the full build cost of the Tu-204-120 with western components. These aircraft will therefore attract half the import duty that full western aircraft do as well as the sales tax of 20% on the total.

With the value of a westernised Tu-204-120 given at \$36 million, the resulting import tax would be \$5.4 million and the total value added tax would be \$8.28 million, giving a tax

figure of \$13.7 million. This compares to \$4.4 million tax for an all-Russian aircraft with a \$22 million list price.

In total, the acquisition of a Tu-204-120 is worth about \$50 million. This is unacceptable to any Russian airline since the resulting lease rate will make the aircraft uneconomical to operate. By preventing sales of westernised Tu-204s to Russian airlines, growth of Russian airlines and the development of Aviastar will be stifled.

Obviously Russia's aero engine manufacturers are concerned about maintaining their markets. They have new improved engines on the way but money shortages are causing them programme delays.

The Russian government had promised Perm \$140 million to develop the PS-90 engine, the powerplant for an indigenous Russian Tu-204. An improved engine would bring the aircraft's operating efficiencies up to the level of the westernised Tu-204. Russia's financial problems meant the government was not able to provide the funds.

Pratt & Whitney (P&W) has agreed to help Perm develop the PS-90 into a more efficient engine. This agreement was eventually signed in January 1998 and P&W will now provide technology as well as the \$140 million over three years.

*Transaero is one of only two Russian airlines granted exemptions from import taxes on western aircraft. The airline has been able to expand as a consequence.*

The work will be performed by Perm technicians and on this basis the new PS-90A2 engine will be exempt import duties. The PS-90A2 will then have an efficiency close to the level of the RB211-535.

Despite all this, the Russian government will still apply a 20% sales tax on a PS-90A2-powered aircraft, making it difficult for Russian airlines to afford the aircraft and new engines.

## Tit for tat

The tendency of US interests to object to CIS aircraft has also been well noted. Boeing objected to Exim bank funding the Il-96M programme and US government objected to An-32 sales to South America on the grounds (not visibly proven) that they were contributing to drug smuggling. These obstacles have given the Russian and CIS industry a strong platform to raise objections and to argue that America has no interest in seeing the Russian industry advance.

## Signs of progress?

At the beginning of July, Russia's new prime minister, Sergei Kirienko, on a visit to a major aircraft factory said that airlines taking delivery of foreign aircraft could avoid the taxes payable "by spending three times the amount of these taxes on Russian aviation industry products". For example, imported western equipment with a value of \$100 million would have a tax levy of \$56 million. This could be waived if \$168 million worth of Russian equipment is ordered by the same airline.

Following the announcement by Kirienko it was said that Aeroflot was ordering 10 IL-96s so that it could off-set the taxes that would have been due on the 777s and 737-400s it took delivery of in early 1998. This has not proved to be true. Aeroflot already had a government decree exempting it from the import duties on the 777 and 737-400.

It now appears that Aeroflot had been pushed into ordering 777s and 737-400s as an unpublicised condition to stop Boeing objecting to Exim Bank financing the purchase of 20 IL-96Ms by Aeroflot.

The wording of the exemption law referred to by Kirienko is not very clear. Some barristers have said that the law would apply to government owned airlines but this has not been tested in court. What percentage of ownership by the government is required for the airline to be considered exempt is also unclear.

Russia's aerospace manufacturers claim that a western engine aircraft should not be regarded as a Russian aircraft. If the courts came to same conclusion the Tu-204-120 would not be exempt the 30% import duty on its western components. The legal wording of tax exemptions is not very clear. There is no definitive legal opinion and the law has not yet been tested.

Ukraine and Belorussia are two former Soviet Union countries which do not have these import duties. There is a possible loophole for an aircraft lessor based in Minsk or Kiev. Aircraft would be exported to lessors in Belorussia or Ukraine and re-imported on leases to Russian airlines. This concept is just preliminary and the law has not been tested to any extent.

## Imminent problems

As the supply of Russian aircraft begins to dry up, answers will need to be found. Kirienko's speech has had little reaction and so far there is no sign of any legislative basis being prepared.

There has also been no indication that the Russian government would consider dropping sales taxes on Russian aircraft which would at least make acquisition of new local aircraft easier for airlines. It



also has to be said that the US is not helping the issue. If Boeing were to drop its objections of Exim Bank funding for the IL-96M, the Russian government then might review its import tax policy.

One possible answer to acquiring new western or Russian aircraft is the funding of some aircraft, airlines and programmes by western finance. Before this will happen, much more information on Russian aviation will need to become available for western specialists to be able to make considered judgements on risk analysis for financing transactions. This whole area of information was regarded as secret in Soviet times and it still is today.

Even if the sales and import duty issues were resolved, Russian airlines still have major problems with respect to their own financial strength and perceived risk. Most Russian and CIS airlines would not be regarded as 'bankable' by western financiers. Nor is there any financing structure available to acquire new aircraft. A new approach will need to be found to cater for this sizeable market, just as leasing was found in the 1970s to stimulate growth in the west's airline industry. This would best be done by a combination of local and foreign finance, probably combined with a shareholding stake.

*Aeroflot's order for two 777s and 10 737-400s was a condition to prevent Boeing blocking the Exim bank's financing of 20 IL-96Ms for Aeroflot.*

Certainly balance sheets, whether prepared in the old Soviet style or in western form, are unlikely to generate enthusiasm for fleet modernisation needs. There is also no ability to show mortgages on the air register. The register is important since it prevents aircraft being sold when the real owner, the financier, is not aware of the sale. The register will often note that an aircraft is listed on the central register of mortgages, although it is not a mandatory requirement.

With an adequate contingent of western legal and accounting personnel now in Moscow, mostly with a good understanding of Russia's laws and requirements, some of the risk of financing or investing in the region has faded. A new way to calculate risks will be needed before the much needed supply of capital can begin in earnest. This must include an adequate legal framework to ensure that risk is minimised.

When this finally happens, the airline and aviation manufacturing industries are likely to be beneficiaries as leaders in the economic growth that will follow. **AC**