

Generous tax depreciation can provide airlines with substantial subsidies on the ownership of aircraft. Tax depreciation regimes on assets vary from country to country. Which airlines in Europe are getting the biggest benefits from aircraft ownership?

# Who's getting the best tax benefit on aircraft in Europe?

**T**he tax benefits of aircraft ownership have dwindled in many countries over the past few years. Nevertheless, there are still some states which provide generous tax shelters for aircraft ownership. Europe is a region with a strong contrast in the tax benefits between states. Considering that tax depreciation on assets provides an effective subsidy, which European countries provide the greatest benefit to aircraft owners?

## Tax capacity

Airlines in Europe have three basic choices for acquiring aircraft. They can buy, take out operating leases or use finance leases. Outright purchase and finance leases mean the tax depreciation policy in the jurisdiction of the owner affects the airline directly or indirectly.

Ten years ago rates of corporate tax, interest and tax depreciation on aircraft were generally high in western Europe and North America. These ingredients made finance leases an attractive option and the high rates of tax and tax depreciation regimes generated a large contribution in net present value terms to a finance lease.

Airlines also generally had low levels of profitability. Finance lease structures, which allowed lessors to benefit from tax depreciation, were the best option.

Airline aircraft ownership can only be justified if balance sheet leverage (level of borrowing) is not too high and there is sufficient tax capacity to make use of all the tax depreciation. That is, an airline

generating an annual profit of \$100 million and subject to a corporate tax rate of 31% could accommodate ownership of up to \$400 million worth of assets if the rate of tax depreciation is 25%. So, an annual tax depreciation of \$100 million on the assets could be just accommodated by the airline's operating profit and offset all tax liability during that year.

While tax capacity has always been minimal for most carriers, airlines in many countries could still take advantage of tax depreciation rates allowed by their countries. Ownership of a small number of aircraft therefore brought airlines direct savings.

The benefit of tax depreciation increases with higher tax depreciation rates and corporate tax rates. That is, the tax liability for the airline in the above example would be \$31 million if no assets were owned. Having \$200 million of assets on the balance sheet would generate a tax depreciation of \$50 million in the first year and a reduction in the tax liability of \$16.5 million: equal to 8.25% of asset value. A corporate tax rate of 20% and tax depreciation rate of 20% would mean the reduction in tax liability would only be \$8 million on the same \$200 million worth of assets: 4% of asset value.

In the past airline tax capacity was low. Not only did airlines barely have enough tax capacity to justify their own ownership of aircraft, but they had accumulated such losses in most years that taxable profit was minimal and their effective rates of tax were lower than the nominal rates of corporate tax.

With airline privatisation and drives towards efficiency, higher levels of profitability have become more common recently. This has come at the same time as a reduction in the rates of corporate tax and tax depreciation rates. With profitability, airline effective corporate tax rates have meanwhile risen to the level of national nominal rates. Higher profits have given airlines plenty of tax capacity. With a long-term reduction in global interest rates over the same period, operating leases have become the best option for many airlines.

There are still some European states where tax depreciation and corporate tax rates are high enough to allow airlines substantial benefits from ownership.

## United Kingdom

The United Kingdom is probably the best example of a European state where the benefits of aircraft ownership have all but disappeared in the past few years.

Until the mid 1980s UK companies were allowed 100% tax depreciation on assets. While this huge benefit encouraged early replacement of aircraft through excessive tax depreciation, most UK airlines had very little tax capacity to take advantage of the regime. For about 10 years the UK tax authorities permitted an accelerated tax depreciation rate of 25%. That is, a reducing balance rate of 25% provides tax benefits for more than ten years and the majority of the benefit during the first five years of ownership.

This was the foundation of the UK tax lease, which only UK lessees can take advantage of.



The last conservative government dropped tax depreciation rates to a 6% reducing balance. The purpose of this was to change the tax depreciation benefits of long life assets to match their useful economic life. The policy was not actually aimed at aircraft, but the UK tax authority has still not made it clear how it intends to treat aircraft.

Some lessors are confident that a tax depreciation rate of 25% will still be allowed, and some have even recently closed UK tax leases on this assumption. Others are convinced that the reducing balance rate of 6% will be applied to aircraft ordered after November 1996. The affect will only just start to be felt by the first assets ordered from this date.

"The new rate of 6% certainly makes life difficult," says Nigel Turner, finance director at British Midland Airways. "Clearly the benefits of owning aircraft are significantly reduced to such an extent that it is probably better not to own aircraft. UK airlines might be able to get better tax advantages in other jurisdictions. The effect on UK airlines will be to drive aircraft ownership abroad where it is still possible to get better tax benefits. The result may even make UK airlines less competitive and higher taxes will have to be paid."

UK airlines have collectively lobbied the UK government and tax authorities, and a ruling is expected soon. Most believe the 6% rate will be applied. This will lead to some carriers seeking the benefits of German tax leases, while

others will resort to operating leases which will be a financially more efficient way of acquiring aircraft. The policy will certainly leave UK airline profits more exposed to corporate tax which is charged at 31%.

Airlines also have to pay corporate tax on profits on disposal of aircraft after book depreciation. This profit contributes to new aircraft purchases. These disposal profits are taxed. However, at least this tax was compensated for in some way by the high tax depreciation allowances that were available on new aircraft.

## Netherlands

The Netherlands does not allow any tax depreciation for aircraft. "This punishing regime is compensated in a small way by allowing the deduction of book profits on aircraft disposal from the opening book value of an aircraft at purchase," explains Robert Van Der Burg, managing director of KLM Financial Services. "This avoids capital gains or corporate tax paid when the aircraft is sold. The profit used to reduce the purchase book value, however, means that the amount of book depreciation charged against an aircraft is smaller and so the operating profit is higher than it would otherwise be. The ability to offset disposal profits against new aircraft is therefore not a real advantage. The rate of corporate tax is 34%. We effectively end up paying the tax on the profit on disposal over a protracted period."

*The German tax depreciation regime provides the highest benefit in Europe. German tax leases have often favoured aircraft with German content.*

## Ireland

There are two tax regimes for aircraft in Ireland. One is for IFSC (International Financial Services Centre) and Shannon (Shannon Customs Free Airport), which are not permitted to lease aircraft to Irish companies. The other is for Irish airlines. While both regimes allow the same rates of tax depreciation, different rates of corporate tax are applied to each.

Tax depreciation rates are a straight line rate of 15% during the first six years and then a rate of 10% in the seventh year.

The situation for an Irish airline is simple and straightforward. Current rates of corporate tax are 32%, but will be reduced to 12.5% over the next five years at a rate of four percentage points per year. While the annual tax depreciation will not change over this period for an aircraft bought in 1998, the tax saving will fall together with the reduction in corporate tax rate.

The case for the IFSC and Shannon is different. These are subject to a corporate tax rate of 10%, which will be much more similar to the airline rate five years from now. IFSC and Shannon are exempted from withholding tax.

They are also free to choose the "free tax depreciation" method on new

## COMPARATIVE TAX BENEFITS OF AIRCRAFT OWNERSHIP IN WESTERN EUROPE

	United Kingdom	United Kingdom	Ireland	Germany	Sweden	Italy
Corporate tax rate	31%	31%	32%, reducing to 12%	45%	28%	36%
New aircraft value (\$ million)	100	100	100	100	100	100
Tax depreciation method	25% reducing balance	6% reducing balance	6 years at 15% straight line then 10%	4 years at 25% reducing bal. then 8.33%	2 years at 30% reducing bal. then 20%	3 years at 28% reducing bal. then 14%
Depreciation term	16 years	26 years	7 years	8 years	5 years	6 years
Depreciated value (\$ million)	1.0	20.0	0	0	0	0
Total tax benefit (\$ million)	30.69	24.8	21.0	45.0	28.0	36.0
Tax benefit in first year (\$ million)	7.75	1.86	4.8	11.25	8.4	10.08
Tax benefit in first five years (\$ million)	23.64	8.25	18.0	34.51	28.0	32.64

aircraft. The rules allow the owner to choose between a rate of 15% and 100% depreciation in the first year in respect of capital expenditure. If less than 100% is claimed in the first year then the balance of the asset can be depreciated in the second or third year, or any number of years up to seven. Faster depreciation usually results in a larger benefit. Although the depreciation rates are generous, the low rate of corporate tax means the overall benefit is minimised. An additional rule applied to IFSC and Shannon is that the lessor can only offset the tax depreciation against lease payments on the asset. Therefore, although a 100% tax depreciation in the first year may at first appear beneficial, the rate of depreciation chosen needs to be carefully chosen.

Income on lease rentals is taxed at 10%. This tax will be avoided for several years if the tax depreciation regime is chosen correctly.

The benefits IFSC and Shannon companies receive will expire at about 2010, although there will be extensions in some cases.

## Germany

Germany still has a beneficial tax regime with respect to owning assets and is one of the most advantageous regimes in Europe. Assets are treated as having a 12 year tax life by the tax authorities, which generates an annual straight line rate of 8.33%. Aircraft, however, are entitled to a triple declining balance rate, which equals an annual 25% reducing balance.

Airlines also have the option of starting with the triple declining balance of 25% and then switching to a straight annual rate of 8.33% to depreciate the rest of the asset after the point when the declining annual rate is less than 8.33%. The fastest way to depreciate an aircraft would be to use a 25% declining balance rate for the first four years when the fourth year's depreciation was 10.55%

and then switch to the straight line rate of 8.33% from the fifth year onwards.

Corporate tax rates are not straightforward, since companies have to pay federal tax, trade tax and local taxes. Together these total a final rate of between 45% and 50%. The tax rate an airline is subject to and rates of depreciation mean that the benefits of owning aircraft in Germany are one of the highest in Europe.

Unlike UK tax leases, German tax leases are available to any German tax investors (those with German tax capacity) for all aircraft types, providing their credit rating is sufficient. However, unofficially, German tax leases usually favour aircraft with a German content, that is Airbus.

The new German government will probably lower tax rates, although the past government has been saying that it will do so for years.

As German tax rates fall, tax depreciation rates will probably also fall at the same time, wiping out much of the current advantage of owning aircraft in Germany.

## Sweden

Along with Germany, Sweden is the European country with generous tax benefits for aircraft ownership. Swedish tax leases are, however, far less active than German tax leases. Like Germany, Sweden also allows investors to choose between systems of tax depreciation.

Investors can choose between 30% reducing balance method and 20% straight line. Investors and owners can therefore start with 30% reducing balance and switch to straight line when the annual depreciation on the declining balance method falls below 20%. For the fastest depreciation the change to straight line at 20% should be made from the third year onwards. The asset is then fully depreciated in five years.

Corporate tax is 28% and so aircraft investors can enjoy a generous benefit.

## Italy

Italy has a system which is fairly generous, although tax leases do not exist and the profitability of Italian airlines is not high enough to give them the tax capacity to take advantage of aircraft ownership. The benefit, however, is still substantial.

Italy also allows investors two choices: a 28% reducing balance or a 14% straight line over seven years. A switch from one to the other can be made. The most efficient way is to adopt the straight line rate of 14% in the fourth year. This fully depreciates the aircraft in six years.

The corporate rate of tax is complicated by two taxes. The total rate is 36%. Like Germany and Sweden, Italy has one of the most beneficial ownership schemes in Europe, but few are able to take advantage of it.

## Benefits in comparison

Individual airline profitability, tax capacity and aircraft acquisition techniques vary so much it is difficult to make generalisations about relative benefits of aircraft ownership.

By taking a set of hypothetical airlines with identical annual profitability and tax capacity to own some aircraft, we can compare the tax benefits in different states. Airlines usually have some tax capacity to be able take advantage of aircraft ownership, even if it is only a small number of their fleet.

Assuming an annual operating profit of \$100 million and investment in the same year of \$100 million in new aircraft, the tax benefit of owning those aircraft in the first five years can be calculated for countries with ownership tax benefits.

This analysis also has to make the broad assumption that the airline makes enough profit each year to maintain tax capacity to take full benefit of aircraft ownership. Profit however can fluctuate



*Tax benefits of aircraft ownership in UK will be so low that they will discourage aircraft ownership.*

and tax capacities fall after just two or three years. On a declining balance regime, there is not as great a need to maintain tax capacity after the third year of ownership. Airlines which are able to constantly generate profits can buy aircraft every year to maximise use of their full tax capacities.

With the old UK tax depreciation rate of 25% and current rate of corporate tax of 31%, the \$100 million of aircraft can be tax depreciated to \$23.73 million in five years, equivalent to a 23.73% benefit on the purchase value. As the net tax depreciation is reduced each year, the annual tax liability on the annual profit increases. Tax liability on an operating profit of \$100 million is still reduced each year from the full \$31 million due, if no assets were owned, to between \$23.35 million and \$28.55 million between the first and fifth years.

Under this regime aircraft are depreciated by 99% in the first 16 years and this generates a benefit of \$30.69 million over this period.

The reduction in tax liability in the first year is \$7.75 million, or 7.75% of the asset's value. In the first five years the accumulated benefit totals \$23.64 million in actual terms, or 23.64% of the cost of the aircraft. Although it will be less in net present value terms, the benefit still makes a healthy contribution to the ownership of the aircraft.

Under the new system in the UK of just 6% reducing balance the benefit is so small it is hardly worth having. The tax benefit in the first year generates a saving of just \$1.86 million and totals just \$8.25 million (8.25% of aircraft value) in the first five years. The rate of depreciation is so slow that it takes almost 30 years to fully depreciate the aircraft. The aircraft is depreciated to \$20 million in the first 26 years and a generates a benefit of \$24.8 million over the same time.

In net present value terms the benefit of ownership in the first five years is so small that it will virtually wipe out any incentive to own aircraft.

The benefit to an Irish airline using a straight line rate of 15% for the first six years is substantial compared to other European regimes, including the old UK regime of 25% reducing balance. The

benefit each year equates to \$4.8 million and over the first five years \$24 million. This, however, is with a tax rate of 32% applied throughout the period. The aircraft is depreciated to zero in seven years and the benefit generated is \$32 million, a healthy contribution to ownership.

With corporate tax rates possibly falling by 4% each year the annual benefit reduces by \$0.6 million. This still generates a benefit of \$18.0 million in the first five years. The total benefit is reduced to \$21 million over the seven years it takes to depreciate the aircraft.

The German regime provides the largest benefit of the countries analysed here. The high rate of tax and depreciation provide a benefit of \$11.25 million in the first year and \$34.51 million in the first five years. The aircraft is fully depreciated after eight years and the total benefit generated is \$45 million. Like the Irish system this is a large contribution, one which not only German airlines can take the opportunity of exploiting.

The Swedish system is the third most beneficial studied here. First year benefit is \$8.4 million and total benefit to depreciate the aircraft in the first five years is \$28 million.

Although few are able to take advantage of it, the Italian regime is the second most generous behind Germany. The high tax and depreciation rates mean the first year benefit is \$10.08 million. The aircraft is fully depreciated in six years and generates a benefit of \$32.64 million in the first five years and \$36.0 million in six years.

## Summary

The difference between these benefits is shown in the table (*see page 10*). The contrast between the old and new UK regimes is indicated by the threefold tax benefit difference between the two in the first five years. The table also clearly shows how the new UK regime has lost virtually all its benefit compared to Ireland, Germany, Italy and Sweden.

The total benefit provided by the German regime is huge compared to all others. Potential reductions in rates of corporate tax will erode some of this but there will still be good benefits. Despite reducing the rate of corporate tax, the Irish regime provides a generous shelter. The Swedish and Italian systems are also substantial.

It remains to be seen if aircraft ownership benefits will last in different European countries. Governments can change tax regimes without little warning and benefits can be lost overnight. The generous system in Germany and drop in benefits in the UK will mean German tax leases will increase in demand. **AC**