Reductions in tax benefits for aircraft in recent years have sent airlines in search of new financing techniques. Karen Floersch analyses the main finance lease structures available to airlines from major global debt sources, and summarises their benefits and applications.

Tax lease structures: a changing landscape

The validity of finance lease tax structures for aircraft ebb and flow at the whim of tax authorities, but never truly go away. They are either modified or arrangers find greener pastures in new financing products.

Changes to accounting treatments have proven devastating for German and Japanese leveraged leases (GLL and JLL). In other instances accounting changes have improved the benefits of the French leveraged lease market.

UK accounting changes have dampened the market for larger jets, but exempted smaller jets. Turboprops are beginning to fill the gap in the UK finance lease market.

In the US, Foreign Sales Corporation (FSC) structures, used by domestic and foreign carriers, face revision following an unfavourable ruling by the World Trade Organization (WTO).

Yet in the face of all these changes, there are always new financing products for airlines, such as hybrid lease structures, that are waiting in the wings.

In many of the tax jurisdictions or countries reviewed here, the biggest challenge will always be sourcing tax-based finance leases for assets operated outside the lease structure's jurisdiction. Domestic finance leases usually retain some tax and accounting benefits.

Japan

In 1998, Japan's National Tax Authority (NTA) eliminated the double-declining balance treatment of aircraft depreciation for non-Japanese operators of aircraft, effectively shutting down the cross-border market for the JLL.

Since then a handful of JLLs have closed for Japanese carriers, such as Japan Airlines (JAL) and JAL Express, which can still claim the accelerated form of depreciation. With fewer deliveries to Japanese carriers – only All Nippon Airways has any significant deliveries slated for 2000 – there will be slim pickings for JLL investors.

As the flow of JLLs reduces to a mere trickle, the heir apparent to Japanese tax leases is the Japanese operating lease (JOL). Although still a developing product with transactions tailored to the requirements of investor/lender and lessee, the JOL accounted for some $1billion worth of transactions in 1999.

The JOL structure is quite simple. The lessor, through a special purpose company, remote from any bankruptcy proceedings, acquires title to the aircraft and leases it to the airline/lessee on an operating lease.

The real attraction of the JOL is that cross-border operating leases can use the same double declining balance method of tax depreciation as used in the JLL. Coupled with the flexibility of shorter lease terms, the JOL offers maximum accelerated tax depreciation benefits to the lessor, which can be passed on as lower rentals to the lessee.

Unlike the JLL, which dictated pay-out terms of 10 years, there are no hard and fast rules for JOL leases. They can be as short as three to four years for used aircraft, or up to 10–12 years for new. For example, a JOL transaction completed for the UK airline Go was a three to four year JOL for used 737s.

The JOL shares a number of other features with the JLL. This includes equity investment, which is generally equal to at least 20% of the asset cost, and a requirement for the asset to be sold at the end of the term.

By contrast the JOL, although technically an operating lease, has been subject to certain risk transfer techniques. These have been used as a means of offering comfort to Japanese investors who are used to low asset risk transactions. These techniques include residual risk insurance, residual value guarantees and even the incorporation of other lease components, such as the purchase option.

However, David Power (general counsel and company secretary) of Orix Aviation Systems points out that it is still not certain whether the NTA will find these risk transfer techniques acceptable for a JOL.

The two main proponents of the JOL market are Orix and Nomura Babcock & Brown. This is probably not surprising when one considers their predominance in the JLL market. Orix has financed 23 aircraft at a total cost of $500 million, by way of JOLs in the past nine months.

Power acknowledges that the flexibility of the structure has enabled Orix to finance not only new jet aircraft, but also used jets and even turboprops.

So who are the users of JOLs? Giles Dealtry (director) of Deutsche Bank believes that, as in the case of the JLL, the brand name of the airline/lessee is very important. Top airline credits and the major aircraft operating lessors will then line up for JOLs. This is because, explains Dealtry, Japanese investors face both currency and asset risk.

The operating lease market demands rentals payable in US dollars, leaving investors open to currency exposure. As for the asset risk, few lessors want to contend with an early termination and remarket the aircraft. This latter problem is one of the reasons why operating lessors, such as Orix, with their ability to provide marketing, remarketing and

The JOL is still a developing product, but is basically an operating lease where the Japanese lessor can use the same double-declining tax depreciation benefits as the JLL. Go has used the JOL to acquire used 737s.

technical backup, are at the forefront of JOLs.

Most users of the JOL structure are good credit airlines located mainly in Asia and Europe. Orix, for example, has JOL leases into Go, British Airways, Maersk, Air New Zealand, Air Canada, SAS and GB Airways. The product has not yet gained a following in the US due to the 10% withholding tax between Japan and the US.

France

The French leveraged lease (FLL) market is limited, with much of the tax capacity for leases targeting shipping deals. Nevertheless, tax legislation that came into force in July 1998 to close certain tax loopholes also offered a number of enhancements to tax leases for qualifying transactions.

The two biggest tax benefits to arise out of the new measures involved increased depreciation benefits and exemption from capital gains tax on profits on sale of the asset.

In the case of declining balance depreciation, the factor to be applied to straight line allowances was raised from 2.5% to 3.5%. Over a period of 9–13 years, depending on aircraft type, 40–50% of the aircraft's value can be written down in the first two years of the lease, which translate into PV benefits of 6–10%.

Exemption from capital gains tax coupled with a more aggressive depreciation rate can push PVs as high as 10–15%.

So far, these capital gains benefits have only been available for ships, which helps to explain the greater activity in French ship leasing. Industry sources had difficulty in naming an aircraft deal that has benefited from the capital gains exemption. Only the more aggressive depreciation should be taken into account for aircraft.

Another new measure requires all transactions to apply for direct approval from the French tax authority (Direction Générale des Impôts or DGI) before the deal is signed. The approval process can be lengthy and take as long as four months. The usual procedure, according to Eric Ferguson, counsel at Watson, Farley & Williams in Paris is "to put in the request describing the transaction even before a term sheet is finalised". He explains the need to obtain a tax ruling for each transaction is a means for the French tax authorities to direct tax capacity to qualifying lessees and assets.

How does one qualify? First, unlike some current tax regimes, the full tax benefits can be exported for use by foreign carriers. The main prerequisite is that the investment must show a significant French economic and social interest. In the sector of aerospace, this could include the financing of Airbus, ATR or Snecma products for export or for airlines operating in France. It could also include an investment in non-Airbus/ATR aircraft by a French airline. There are even cases where the lessee and asset are foreign, although this has been applicable more to shipping.

Second, tax benefits must be shared between lessee (two-thirds) and lessor (one-third), and there is a requirement that the transaction must demonstrate that the lessee is taking risk, either with the asset or at a corporate level, although there are no set guidelines as to the exact level.

In addition, there are many of the normal prerequisites found in other leveraged lease structures around the world. These are that the asset must be moveable and with an economic life that can be depreciated over at least eight years.

In France, assets are depreciated on a double declining balance and, depending on type, aircraft will generally be depreciated over 9–15 years. The lessee must operate the aircraft as part of its normal business activity and have the option to purchase the aircraft either at the end of the lease or at some other point during the lease.

Guidelines for the FLL do not specify how that purchase option price is derived, although they are usually structured with a balloon option at the end. There are no set lease terms, but a larger jet will typically have a term of 18 years.

France has a basic corporate income tax rate of 33.33%, but with additional contributions for local taxes, it can rise to as high as 39–40%. Nevertheless, the pool of leveraged lease investors is fairly limited and given that a tax ruling is required to qualify for the new benefits, the investors in these particular leases tend to be banking syndicates. It is hardly surprising then that this narrow market typically favours the good credits and/or French airlines. Air France has been a regular user of the FLL, as have some of France's regional carriers.

FLLs outside the scope of July 1998's tax ruling are also still transacted, but do not benefit from the more favourable depreciation rates. These must have a single investor lessor taking the risk on its own balance sheet, or that of an entity in which it has 95% ownership.

Germany

Aviation bankers in Germany like to differentiate between two types of German leveraged leases (GLLs); those that have been grandfathered under the old GLL rules and those that will be done under the new section 2B of the German Income Tax Code.

There are approximately 90–100 eligible deals under the old GLL rules. To

For users of the FLL to qualify for French tax benefits the investment must show significant French social and economic interest. This can include ATR or Airbus aircraft, and is available for foreign or French airlines. The market for FLLs, however, is narrow.

qualify, the aircraft must be delivered before the end of 2000. While all indications suggest that 2000 will be a busy year for the grandfathered transactions, few expect that all 90–100 will close as GLLs. A better estimate is that one in nine or 10 of these aircraft will qualify, and most of these are expected to be for good credit airlines.

As for the new GLLs, do not expect to see any transactions too soon. Under section 2B rules, the ability to offset tax losses has been restricted to a ceiling of DM100,000 **(**$50,000). On top of this is a change in corporate tax reform in the writing down allowance from a triple declining to a double declining balance.

A Frankfurt-based banker suggests that it is unlikely any new GLL could compete with the grandfathered deals, and even in these later cases, current NPVs are only around 5%.

Also hovering in the background is the talk of changing Germany's accelerated depreciation schedules from 12 to 25 years, which would probably deal a death blow to the GLL.

Clare Gibbons (associate) of Allen & Overy in Frankfurt counters that one helpful announcement from the German tax authorities has been the offer of express protection for grandfathered transactions with respect to the depreciation rules. She says that a conditional contract will not be good enough and that a wise investor will ask for certification that the transaction falls within the grandfathering rules.

Another piece of good news, says Gibbons, was the removal of the threat announced last summer to disallow the offset of tax losses for leased aircraft used outside Germany. A corrective draft was issued in October which should prompt many of the stalled grandfathered transactions to go forward.

The rules for GLLs have never been explicit as to whether the objective of the GLL is to assist German exports (that is, Airbus products) or not. Historically, both Airbus and Boeing aircraft have been financed with GLLs and are typically structured over 10-year terms for widebody aircraft. Moreover, there is no stated operator/user qualifications, only that the lessor, who claims the tax benefits, is a German taxpayer.

Until an announcement is made on depreciation terms, which will determine the types of future investors and the length of the lease, few are prepared to comment on the future development of the GLL. Gibbons mentions there is talk of developing the German operating lease where real residual value asset risk is taken. However, she questions whether there is appetite for that type of risk among typical German leveraged lease investors, who are for the most part high income individuals.

United Kingdom

Not nearly as many UK tax leases for large jet aircraft are being done as was the case several years ago, following a number of changes to the UK tax code. Perhaps the most significant change was the reduction in writing down allowances.

Before then all leased aircraft to UK carriers qualified for a 25% reducing balance annual writing down allowance; leases to foreign carriers obtained write downs of 10% reducing balance. Then in 1997, UK tax authorities introduced the concept of long life assets (that is, those with a useful life in excess of 25 years) and significantly reduced the writing down allowances for such assets from 25% to just 6% reducing balance.

After consultations with UK tax authorities last year, a compromise was reached for jet aircraft over 60 seats to be classified as splitting the asset and tax benefits half into long life and the other half into non-long life. Half the asset cost qualifies for the 25% reducing balance writing down allowance, for non-long life, and the other half obtaining the lower 6% reducing balance write down for long life assets.

Unlike the FSC or FLL, which calls for some local manufacturing content in the aircraft, there is no such requirement in UK tax leases. Nevertheless, to qualify for a UK tax lease the qualifying lessor must be a UK taxpayer.

Another setback for the UK leasing industry arises from tighter rules on a lessor's claim to first year tax allowances in respect of finance lease accounting. At one time, even if the finance lease transaction for an aircraft was closed on the last day of the year, the lessor could still claim the full year's writing down allowances. This is no longer the case, and a finance lessor's entitlement for the first year's allowances is based on the date the transaction closed in relation to the year's 365 days of the lessor's accounting period.

Therefore, a deal closed on the final day of such a period would just be one day over 365 days and claim only a fraction of the first year's writing down allowances. Interestingly, the same rule does not apply to the airline if it buys the aircraft or the transaction is an operating lease. The airline or lessor with an operating lease can claim the writing down allowances in the first year regardless of when the transaction closed that year.

A rule on defeasance relative to sale and leaseback transactions was also issued by the UK tax authorities in 1997. Briefly, lessors can no longer claim tax allowances on the sale-leaseback of an aircraft if the greater part of the risk is removed. Lessors must take at least 50% of the risk, by half the loan value having full credit or asset risk exposure, to qualify. However, Pamela Smith, vice president of Deutsche Bank in London believes that few UK finance lessors today would take the necessary level of straight corporate risk on most UK airlines in a sale-leaseback.

Despite the new rules, aircraft are being financed with UK tax leases. A greater number of UK finance leases, however, have been closed for British Airways aircraft that were grandfathered under the earlier tax rules. Smith says that present value benefits under the new scheme will depend on the period of the lease term and interest rates at the time. Assuming a long lease period with current UK interest rates and the possibility of defeasing the lease, PVs could be in the range of 4% for the initial 12 years of the lease.

The main users of UK tax leasing today are the UK carriers, especially those which have done UK tax leases before and are comfortable with the structures. This last factor cannot be understated for, unlike most tax lease markets, in the UK the lessee must indemnify the lessor against all possible changes in tax laws.

UK section 42 cross-border leasing deals are no longer marketed, since the benefits are marginal following the decrease in writing down allowances.

The real area of growth for aircraft tax leases in the UK has come at the lower end of the aircraft spectrum, namely regional aircraft. Interestingly, the split compromise on writing down allowances only applies to aircraft with 60 seats and larger. This leaves the field open for the 50-seat and below regional jets as well as turboprops. Paul Clark (director) of UK-based arranger, MDT, says his company has completed UK tax operating leases covering some 30–35 aircraft (turboprop and regional jet) since the legislative change.

Perhaps another sector poised for growth is operating leasing, thanks in part to its more favourable tax treatment of a full year's writing down allowance compared to the finance lease. This is coupled with the trend towards greater fleet flexibility and off-balance sheet financing. Clark notes that with the move towards greater operating leasing of aircraft is a more knowledgeable investor base.

United States

US tax leases are very much alive and well, despite the reduction in certain benefits. The biggest market is still the domestic leveraged lease market, which offers the advantage of long-term finance with NPVs in the range of 20% for near investment-grade US carriers.

The majority of these transactions are plain 'vanilla' leases that fulfil three main requirements: 1) the lease term cannot be longer than 80% of the useful life of the asset; 2) the residual risk must be about 20% over the entire term of the deal; and 3) the purchase option at the end of the lease cannot be at a bargain price. Leveraged lease terms are generally in the range of 18–20 years. Lessors are US taxpayers and the basic equity to debt ratio is 20:80.

Foreign carriers can also undertake cross-border forms of the leverage lease, better known as the 'Pickle lease'. The structure is similar to the domestic leveraged lease and uses US equity. The main difference in the Pickle lease is the depreciation schedule for leases to foreign carriers. In contrast to the domestic leverage lease, which uses the accelerated MACRS double declining method, the lessor of a cross-border deal may only take the straight line method of depreciation, resulting in a longer depreciated life and lower tax write off benefits. For the lessee, this translates into lower NPVs at about 4–5%.

Cross-border leases were also hit again last year with the introduction of Section 467 tax legislation, which closed down the possibility of taking deductions for the prepayment of rent.

Ironically, what was disadvantageous for the foreign lessee has turned into more a favourable tax treatment for US lessees. Under the new rules, two different schedules of rental payments are juggled between cash payments versus allocated rental, so that deductions can be taken for cash purposes even though the rental has not been paid. For example, in cash terms this can mean savings of around $3,000–5,000 on a monthly rental of $110,000–115,000.

Airlines may also turn to securitised structures, such as the Enhanced Equipment Trust Certificates (EETCs), to fund the debt portion of a US leveraged lease. In an EETC with US leveraged leases, the issuer of the certificate/notes is the trustee of a trust created to acquire and lease the aircraft to a lessee. The trustee issues the certificates/notes as limited recourse obligations to the different classes of debt investors (that is, senior note holders and junior note holders). Certificates/notes are also issued to the beneficiary of the trust, or owner participant, which provides the equity portion of the purchase price of the aircraft.

The main benefit of EETC structures for airlines is gaining access to the cheaper debt available in the public markets. The longer terms of US leveraged leases are also not a problem for the EETC investor market. Moreover, if a lease needs to be terminated there are no breakage costs in public deals as there are in private deals.

EETCs can be used for aircraft either under existing leases that are then refinanced, or by first raising the debt and then finding equity to close US leveraged lease.

For all the benefits of the EETC arrangement, there are also detriments and it is certainly not an ideal transaction

The FSC structure is available to US and non-US carriers for new aircraft that are manufactured in the US and operated primarily outside the US. These are generally long-haul, widebody aircraft. The NPV of the structure for non-US carriers is about 6–8%, while much higher for US airlines.

for all carriers. Perhaps the biggest obstacle to EETCs is that critical mass is needed – generally at least $100 million – for the economics of the deal to make sense. In other words, airlines taking delivery of aircraft in ones or twos need not apply. Also, regional carriers often find the expense of the EETC transaction costs cancel out any benefits of lower debt costs.

Given the public market nature of EETCs, another drawback is an airline's inability to lock into a spread ahead of time of the issue.

Foreign Sales Corporation (FSC) transactions are another means to lease finance aircraft. Unlike the standard leveraged lease, this structure has evolved in response to US tax legislation designed to facilitate exports of US-manufactured products. There are two types of FSC structures currently used by airlines: 1) the Commission FSC or CFSC, which is primarily used by US carriers to lease aircraft they operate overseas; and 2) the Ownership or OFSC, used primarily for leasing aircraft to non-US entities.

Eligibility for both structures is straightforward in that the leased asset must be newly manufactured in the US and be operated primarily outside the US.

For US carriers in a CFSC structure this would mean aircraft for use on trans-Atlantic or trans-Pacific operations, which are generally carried out by widebody aircraft, such as 747s, 777s, 767s and MD-11s.

Foreign carriers have leased both widebodies and narrowbodies under the OFSC structure.

In spite of the apparently complicated nature of setting up FSCs, the CFSC has become a popular, commoditised product for US major carriers. According to Howard Weber, managing director of D'Accord in New York, "Assuming tax laws stay the same, FSCs will always remain economically attractive compared to a conventional US leveraged lease." Along with the lower cost of funding for the lessee, the terms are typically long, at 20–25 years. The structure may also provide an early buyout option for the lessee, but if the value from the sale of the aircraft is lower than the buyout value the lease will continue.

Weber says that although both structures realise their tax benefits from the partial exemption from federal income tax of profits earned by the qualifying asset, the mechanics of the CFSC and OFSC differ resulting in different NPVs. The NPVs for an OFSC generally ranges from 6% to 8%, with the NPV for a CFSC considerably above that.

Weber explains that in a CFSC structure, a corporation (the CFSC) is formed in an offshore jurisdiction, usually Bermuda or the US Virgin Islands, by the lessor who owns the aircraft. The corporation acts as the agent and collects lease rentals from the lessee. In return, the lessor pays the CFSC a commission equal to up to 23% of the net taxable income generated by the lease transaction. This fee is deductible, and 15% of the fee is also tax exempt at the CFSC level. "The net effect to the lessor," says Weber, "is a 15% reduction of its income from the US federal tax rate of 35%". A portion of the tax savings are passed on as benefits to the lessee in the form of lower cost of funding. In one example of a full-term CFSC lease with a single tranche of fully optimised debt, Weber says the lessee's NPV costs can be lowered by 149 basis points.

In an OFSC structure, an offshore subsidiary is also created, but unlike the CFSC, the OFSC actually owns the aircraft and claims a tax reduction of 30%. However, with a foreign carrier lessee, the OFSC must use the straight line method of depreciation which stretches out depreciation to 125% of the lease term. By contrast, a CFSC uses the more favourable seven-year MACRS double declining depreciation rate because the US lessee is a taxable entity.

The OFSC has been fairly quiet for several years, but as the doors to other cross-border tax leases are now closed, foreign carriers, especially those with deliveries of Boeing aircraft, are taking another look at the product. Cathay Pacific has recently closed a transaction as have Qantas, Lufthansa and Cargolux. These transactions have added a new twist to the OFSC structure by adding another level of comfort, through defeasance of third-party lender debt and, in some cases, the lessee providing some of the debt.

Philip Spector of Watson, Farley & Williams in New York says that while it is fair to say that OFSCs are targeted to better credit carriers, they do not need to be AA credits. "If US investors are not happy (with the credit) they may want a letter of credit, cash collateral or some other indemnity."

A WTO ruling last year declaring that FSC transactions are illegal subsidies might eventually curtail the growth of this financing tool. The US government has lodged an appeal and the results are awaited. However, most US observers believe the worst that could happen is an orderly revision of the structure.

As a lawyer who has worked on FSC transactions, Spector says he is not too concerned about possible changes to FSC rules on completed transactions. Moreover, it is unlikely that any changes to the US tax law affecting FSCs will happen before 2001. "If, and when it happens, the US government will likely provide liberal transition rules as was the case in the transition from DISC (the forerunner of FSCs) to FSC". He adds that "when DISC benefits had to be wound up they were done in a way to protect completed transactions". AC