The French tax lease has gained widespread approval from many airlines and lessors around the world. The lease is efficient and can be used to finance all types of commercial aircraft manufactured in any country. Its structure and benefits are examined.

The application of the French tax lease

Over the past two years a new financing lease structure, the French tax lease, has been gaining favour in some of the most important aircraft financing markets, particularly with Emirates and Chinese airlines. This article explores the lease structure of the French tax lease, its risks, limitations and attractions for lessees, and what grants the French banks an advantage.

Attractions

Any lease structure popular in the market needs a necessary advantage, namely a comparably low lease rental or lease rental factor. The French tax lease is no exception.

China Southern Airlines is believed to be paying interest equivalent to about 30 to 40 basis points over the London interbank offered rate (LIBOR), on a $400 million finance lease structure using a French tax lease to finance the purchase of 13 aircraft. Without a French tax lease, the company would probably have paid about 80 basic points, or 0.8%, over LIBOR for the loan using an alternative financing structure.

In 2005, Air China asked CCF, a French subsidiary of HSBC, to co-ordinate aircraft financing for $881 million structured with a French tax lease, for Air China to purchase six A330-200s, five A319-100s and three 737-700s. By using a French tax lease, Air China obtained a cheaper price than the market level using most other financing techniques. Furthermore, it was offered a lower monthly lease rate than China Southern due to its better credit rating.

The monthly lease rental, however, is not the only appeal of French tax leases. The first benefit enjoyed by airlines is a refund that is related to the net present value (NPV) of the financing structure to the lessees. In theory NPV is the difference between the present value of cash inflows and outflows. Traditionally in calculating NPV, a discount factor should be added to the formula. In terms of aircraft financing, the NPV is the difference between the gross price of the aircraft and the total cash outflow for payment of lease rentals over the term of the lease.

One of the most important features of the French tax lease is that after signing the lease contract with the lessor, a special purpose vehicle (SPV) is normally established by a group of banks. This SPV provides the airline with a refund of up to 6% of the NPV of the contract in cash.

The French tax lease contract, however, does not consider a discount factor when calculating the NPV. The airlines will therefore gain a higher amount of cash from the deal than if a discount factor had been used. The percentage of the refund varies between contracts and depends on the total value of the deal, the lessees' credit ratings, payment structure and both parties' intention of continuing a long-term co-operation. Whatever the percentage is, the most prominent advantage of the lease structure is that the deal relieves the airlines of a cash shortage. This immediate beneficial effect is the biggest attraction for those airlines in financial distress.

Another competitive advantage of the French lease is that it finances a larger percentage of the financing sum compared to other lease methods. The Japanese operating lease (JOL), a once popular lease method in the areas where the French tax lease is now dominant, usually financed up to 70% of the value of the aircraft. The lessees had to arrange the remaining 30% of the finance by themselves.

Normally this balance is generated by the airlines' internally generated cashflow. When the lessees are doing well, this prerequisite is not a problem. But in times of distress the lessees will struggle to generate enough funds internally to reach the threshold of 30%.

The French tax lease, however, is able to finance as much as 85% of the total financing requirement, which means that the lessees only have to provide the remaining 15% of the funds. This structure therefore significantly reduces the cashflow pressure on lessees.

The third benefit of the French tax lease is the massive capacity for financing aircraft. Lessors' concerns about exposure and regulation strains mean that they normally have limited financial capacity to provide for a specific lessee or those lessees based in a certain global region. The French tax lease, however, is able to arrange an unusually large capacity due to the backing of a syndicate of French banks, and the high tax allowances that make this structure so attractive.

This explains why HSBC was in a position to finance $881 million of aircraft for Air China. Nevertheless, the capacity has obvious limitations, as evidenced by the fact that HSBC was unable to offer any further aircraft financing deals to other Chinese airlines after its deal with Air China. As a result, other French banks, such as BNP Paribas, had the opportunity to conclude financing agreements with China Southern and China Eastern.

Although the banks risk putting all their eggs in one basket, the massive financing capacity provides considerable convenience and benefits for both lessors and lessees. These include significantly lower lease rates and costs relating to due diligence, negotiation and contract preparation.

The fourth extra benefit is the duration of the lease and disregard for the nationality of the aircraft producer. Finance leases are typically structured over 10-12 years. A French tax lease

One major attraction of the French tax lease is that at the end of lease term the lessee is required to purchase the aircraft for a nominal fee of 1% of the aircraft's value or simply a fixed price of $10,000.

contract can have a duration of 10 to 15 years, which considerably lowers a lessee's monthly lease rate and releases its cashflow pressure. Usually aircraft purchases financed by a tax lease are restricted to aircraft produced by those manufacturers domiciled in the same countries as the lease structure. The UK tax lease, for example, was only applicable to aircraft mainly built by UK manufacturers, but the French tax lease does not require the aircraft's manufacturer to be French. The purchase of Boeing aircraft can therefore be financed with French tax leases.

The fifth benefit is the purchase price of the aircraft at the end of the contract. Normally the lessee in a finance lease contract is required to purchase the aircraft when the contract terminates. The purchase price depends on the finance lease method, and the negotiation of lessors and lessees. The aircraft's residual value is also a contributory factor to the price. The French tax lease, however, defines that the lessee only need purchase the aircraft at a nominal price of 1% of the aircraft's value, or simply a fixed price of $10,000. This therefore means that, under the French tax lease, the purchase price of the aircraft is insignificant compared to the residual value.

Reasons for the viability

The viability and success of the French tax lease are attributable to various factors, some of which are available to western and Japanese banks. Others are unique to French banks.

Considering the nature and length of a finance lease structure and the size of the financing involved, no lenders would conclude the contract without a tax subsidy.

The first incentive to lenders is a tax allowance policy to encourage investments in fixed assets and renewals and upgrades of heavy equipment, which has been adopted by the governments of the USA, Germany, Japan, France and some other countries. The essence of the tax allowance policy is that a company can reduce its taxable income by investing its annual profits in fixed assets, a certain percentage of which should be manufactured in the country. This is the seed of the Japanese leverage lease (JLL), American tax lease, JOL and other tax leases. Until the mid-1980s UK companies were allowed 100% tax depreciation on assets. For approximately 10 years the UK tax authorities permitted an accelerated tax depreciation rate of 25% *(see Who's getting the best tax benefit on aircraft in Europe? Aircraft Commerce, November/December 1998 issue, page 8)*.

France has a territorial system of corporate income taxation. Corporations, wherever they may be resident, are subject to tax only on income derived from French sources. Certain partnerships may elect entity-level taxation as corporations in lieu of current attribution of their income to partners. Business income is subject to tax at the standard rate of 33.33% and long-term capital gains are subject to tax at a rate of 15%. A parent company and its subsidiaries, of which it owns at least 95%, may choose to be taxed as a single corporate entity. Certain special-purpose 'headquarters companies' and 'logistics centre companies' are subject to a simplified tax regime, where corporate tax at the normal rate is imposed upon an income corresponding to at least 6-10% of their annual operating expenses, with exemptions for certain employee allowances.

On the other hand, France has the most favourable capital allowance policy. In general, assets are depreciated using a straight line method. Qualifying industrial assets, however, are generally depreciated using the declining balance method. A straight line depreciation rate of 5-10% is applicable to commercial aircraft. Alternatively, the aircraft may be depreciated using the declining balance method at annual rates generally ranging from 12.5% to 50%. Nevertheless, the favourable tax policy by itself may not be sufficient to make the French tax lease viable.

The origin of the tax lease, however, also comes from various withholding tax treaties signed between the French government and other governments.

Before the current French tax lease, there was an old French tax lease structure, which was restricted to domestic aircraft financing. Companies dealing with these financing structures require specific authorisation from the Credit Institution Committee and are subject to certain conditions such as minimum capital requirements and restrictive financial ratios. The withholding tax treaties, however, provide French banks with new opportunities.

Under French domestic law, a 15% withholding tax is imposed on interest paid to non-residents. Interest paid by French companies on loans obtained abroad is exempt from withholding tax if certain conditions are met. The interest accrued on withholding tax may be reduced or eliminated by tax treaties. So far the French government has signed withholding tax treaties with more than 20 countries, including China and Malaysia. The USA has proposed an income tax treaty with France, which might make the French tax lease viable for American carriers. Under these treaties, the interest gained from the investments in the aircraft will be exempt from French withholding tax. This means that the rental gained from the loan and equity invested in purchasing the aircraft can be tax free. The special purpose companies, which are deliberately

The French tax lease does not exclude any types of commercial aircraft, whether manufactured in Europe or any other part of the world.

established by the banks and nominally are the owners of the aircraft, are thereby able to transform the tax-free policy into a pricing advantage and transfer it to the lessees. Although it has to return a certain percentage of the NPV to the lessee, the SPV still enjoys some of the benefits derived from the tax-free income.

How it works

Since the lease structure is partly derived from the exemption of French withholding tax, the banks must establish a special purpose company or SPV, which is responsible for borrowing and attracting equity investments from the French banks, purchasing aircraft from manufacturers, and leasing aircraft to its airline customers. The breakdown of the loan and equity, which varies between SPVs, is decided by the risk ratings and LIBOR estimates. The banks therefore do not have to pay any withholding tax for the interest gains.

The other benefit of the SPV is to bring all interested banks together in a deal, because they could not otherwise merge their financial and tax capacity and share the fruits and risks. The aircraft rental paid to the SPV is partly paid to the equity investors, and a certain percentage of rental is paid to the loan providers as principal and interest. When the lease contract terminates, the SPV will be closed and every bank involved will get their share of the profit. Obviously, an underlying benefit of the SPV is that it reduces the exposure of the banks to the airlines. In the worst-case scenario that the airline customer is in default, the SPV will file for bankruptcy, thereby minimising the interested parties' financial loss.

Risks and limitations

Although it has been popular in some countries that have signed withholding tax treaties with France, the French tax lease structure does have diverse inherent risks, which have come to be recognised by the lessors and lessees.

The first is the uncertain future of the lease structure. Although it is derived from the tax allowances and the withholding tax treaties between France and various countries, which have legally guaranteed the stability of the withholding tax exemption, the French tax lease might cause the French tax authorities concern due to the considerable size of the tax exemption. Furthermore, the various benefits enjoyed by non-French lessees may cause French taxpayers fury because, to some extent, the tax lease structure transfers the tax revenue to those companies residing outside France.

Meanwhile, the lease structure does not exclude any commercial aircraft, whether it is manufactured in Europe or elsewhere, which might impair its future. The purpose of the withholding tax treaties is to encourage mutual investments in the two countries in a treaty, and consequently raise employment rates and improve social wealth. When a non-American airline's Boeing aircraft are financed using a French tax lease structure, however, the tax treaty cannot be fulfiling its original aims.

The longevity of the lease structure is therefore doubtful, but this has not prevented airlines and French banks from signing lease contracts.

Their optimism is derived from two inherent conditions fixed in the contracts. The first is that the airline has the right to continue the contract with the same monthly lease rate, no matter how the tax law changes. This condition protects the airline from being hurt by changes in lease rentals and changes to the tax jurisdictions.

The second source of reassurance is the predefinition of the size of the refund of NPV to the lessors in case the tax law changes. Obviously the lessees will not return all the refund of the NPV to the banks. But the scale of refund varies from the airlines, mainly depending on the remaining duration and value of the contracts.

On the basis of these two conditions, the airlines are able to calculate and cap the risks they are taking. For those airlines, which are enjoying the benefits of the French tax loophole, the only concern is when the lease structure will come to an end.

The banks, however, not only have to handle the risks caused by any change in the tax laws, but also to control their airline customers' risk. The immediate refund of the NPV percentage in cash undoubtedly motivates airlines in financial distress to use the French tax lease where possible. Since the refund is relevant to the total contract value, the airlines prefer to sign a contract with the largest possible value. The airlines may not, however, carefully consider the risk of being in default or of being required to return the refund to the lessor. They may also try to have their aircraft delivered over a concentrated period, rather than optimise the delivery dates, in case the tax law suddenly changes. This could jeopardise the airlines' fleet planning and cashflow position. If the airlines find themselves in financial trouble, the banks will be damaged as a result.

Obviously the major limitation of the French tax lease structure is that lessors are only able to make deals with airlines based in countries that have signed a withholding tax treaty with the French government. This may make the French banks lose focus in other key markets and leave room for competitor banks to muscle in. The uneven distribution of their capacity may eventually increase their risks in some regions and jeopardise their future. AC