The future of flying

The international tax landscape is changing rapidly, and there are a variety of tax and accounting changes on the horizon that lessors should be aware of. We outline some of these tax developments here as well as significant accounting changes impacting the leasing industry. See pages 3 and 4 of this report for a handy pull-out timeline for these changes.

Anti-Tax Avoidance Directive (ATAD)

The EU Anti-Tax Avoidance Directive (ATAD) aims to address the EU Commission's concerns that an individual approach by Member States to their implementation of certain BEPS action points could lead to a distortion of the common market. The ATAD provides for a more harmonised approach to BEPS and proposes tax law changes in five different areas as described below. In particular, the interest deductibility and hybrid changes provide for restrictions on interest deductions for tax purposes. This could lead to an increase in the effective tax rate in certain circumstances.

Interest Deductibility

The ATAD provides that the net interest cost (i.e., interest expense minus interest income) in excess of 30% of EBITA will not be deductible for tax purposes in any EU jurisdiction subject to certain exemptions. The restriction applies to 'exceeding borrowing costs' (EBC). EBC shall be deductible in the tax period in which they are incurred up to a limit of 30% of the taxpayers EBITDA.

- Recognising that some groups may have high external gearing for genuine commercial purposes, the ATAD contains a Group Ratio Rule based on the net interest to EBITDA ratio for the worldwide group. The ATAD allows Member States to exclude financial undertakings (for example banks and insurance companies) from the scope of these rules. Leasing companies which are part of a consolidated group which includes such financial undertakings may therefore be excluded from the rules.

The interest limitation provisions in the ATAD must be implemented by 1 January 2019. However, derogation from rules are allowed, until 1 January 2024, where Member States have equally effective national targeted rules. The Irish Government have stated that they intend to avail of this derogation to allow taxpayers time to plan for the changes. However, if the OECD publish minimum standards in respect of Action 4 (the specific BEPS action plan dealing with interest deductibility restrictions) prior to 2024, the interest deductibility restrictions in the ATAD must be implemented by the end of the first full fiscal year following such publication.

Hybrid Mismatches

A hybrid arrangement is defined as a situation between a taxpayer in one Member State and an associated enterprise in another jurisdiction or a structured arrangement, where a double deduction or a deduction without inclusion outcome is attributable to differences in the legal characterisation of a financial instrument or entity.

The ATAD establishes that where a hybrid mismatch results in a double deduction, the deduction should be granted only in the Member State where the payment has its source. Similarly, where a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment.

It will be important that aircraft leasing structures are reviewed in the context of these changes in order to assess their impact.

General Anti Avoidance Rules (GAAR)

The GAAR in the ATAD follows the GAAR already put in place in the EU Parent Subsidiary Directive. It applies to arrangements or a series of arrangements the main purpose or one of the main purposes of which is obtaining a tax advantage that defeats the object or purpose of the otherwise applicable tax provisions, and are non-genuine having regard to all relevant facts and circumstances. Arrangements are considered non-genuine if they have not been put in place for valid commercial reasons reflecting economic reality.

The impact of ATAD GAAR will need to be considered in the context of pre-existing Irish domestic GAAR provisions.

Controlled Foreign Company (CFC) Rules

The ATAD provides that an entity or a permanent establishment (PE) of which the profits are not subject to tax, or are exempt from tax, in that Member State should be treated as a Controlled Foreign Company (CFC) if:

- A resident taxpayer, directly or indirectly, owns greater than 50% of the entity's capital or is entitled to receive greater than 50% of the entity's profits; and
- The actual tax paid by the entity or permanent establishment on its income is less than 50% of the tax that would have been suffered had the income been taxed in the resident taxpayer's jurisdiction.

While we do not anticipate that the implementation of CFC rules in Ireland will have a significant impact for leasing groups, it is possible that the manner in which other Member States implement these rules could impact and so it will be important to assess any possible impact.

Exit Taxation

The ATAD introduces an exit taxation rule whereby Member States will be obliged to impose an exit tax (a tax on the difference between the market value of the assets and the value of the assets for tax purposes) under four circumstances, including the migration of tax residency to another jurisdiction.

Similarly to GAAR provisions, changes to the exit taxation rules will need to be considered in the context of pre-existing Irish exit tax rules.

Multilateral Instrument (MLI)

The MLI is designed to update over 2,000 double tax treaties over the next two years with the stated aim of counteracting treaty shopping by ensuring that tax treaties meet certain minimum standards.

It will be important that lessors understand the impact of these changes given the importance of treaty access relief for lessors. The MLI provides a new minimum standard for treaty abuse requiring tax treaties to include:

1. A principal purpose test (PPT); or

2. A PPT supplemented with a Limitation of Benefits (LOB) clause.

Where a taxpayer in a contracting state does not satisfy the appropriate MLI minimum standard, it will not be entitled to treaty relief.

PPT

Ireland has chosen to adopt a PPT only approach. The PPT denies a treaty benefit if it is reasonable to conclude that obtaining that tax benefit was one of the principal purposes of an arrangement or transaction that resulted in that benefit. An analysis of the entitlement to treaty benefits will be based on a full examination of the facts of each case.

There are supporting examples provided by the OECD in BEPS Action Plan 6 that outlines cases where the tax benefit will and will not be viewed as a principal purpose of the transaction. However, this list is not exhaustive in nature.

LOB

Seven of Ireland's tax treaty partner jurisdictions who have signed the MLI are opting for the LOB clause supplementing the PPT. As the position taken by these countries is inconsistent with the approach taken by Ireland, the go forward position will need to be determined and agreed through bilateral discussions with these countries. This could result in a PPT and LOB clause being included in Ireland's double tax treaties with those countries.

The LOB clause restricts treaty benefits to taxpayers with a certain ownership or substance profile (in terms of people and activities). The LOB clause lists several objective tests that must be complied with by the person claiming the benefit. If none of these tests are met, the corresponding person will not be deemed a 'qualified person' and, therefore, will not be entitled to the benefits of the treaty, even if that person qualifies as a resident.

Lessors should carry out an impact assessment to determine the likely short and medium term impact. Lease origination, lease remarketing and legal teams need to be made aware of the changes and the likely impact on lease arrangements and structures.

Common Consolidated Corporate Tax Base (CCCTB)

In October 2016, the European Commission released the revamped draft proposal for the Common Consolidated Corporate Tax Base (CCCTB) project in a two-step approach, with the publication of two interconnected proposals on a Common Corporate Tax Base (CCTB) and also a Common Consolidated Corporate Tax Base (CCCTB). The proposal is a further step by the European Commission towards establishing the link between taxation and the place where profits are made.

The CCTB provides for the determination of a single set of rules for calculation of the corporate tax base. Companies operating across borders in the EU would no longer have to deal with 28 different sets of national rules when calculating their taxable profits. The CCCTB proposal contains an apportionment formula that would allow companies to file one tax return for all their EU activities, and offset losses made in one Member State against profits earned in another. Each Member State would then tax its share of the profits at its national tax rate.

The CCCTB rules would be mandatory for large multinational groups with global sales of at least €750 million. If approved by all EU Member States, the CCTB proposal would apply from 2019 and the CCCTB proposals from 2021. It remains unclear whether unanimous agreement among the EU member states is achievable.

IFRS 16

IFRS 16 requires lessees of all assets (including aircraft), for periods beginning on or after 1 January 2019, to account for leases under a single on-balance sheet model. At the commencement of a lease, a lessee will recognise a liability to make lease payments and an asset representing the right to use the underlying asset during the lease term. Lessees will separately recognise the interest expense on the lease liability and the depreciation expense on the right-of-use asset, and will have to re-measure the lease liability upon the occurrence of certain events.

IFRS 16 will result in the acceleration of lease expense recognition for lessees in their financial statements.

Transfer Pricing (TP)

An independent review of the Irish corporate tax code was completed in late 2016 and included recommendations relating to transfer pricing, suggesting that the following changes should be implemented no later than 2020:

- Implementing BEPS Actions 8 - 10 in Irish legislation;
- Removing the pre-July 2010 grandfathering provisions for TP regimes; and
- Extending TP rules to SMEs and non-trading transactions.

In the context of BEPS Actions 8-10, certain challenges relating to appropriately allocating profit within a multinational by way of transfer pricing were highlighted; specifically the alignment of risk and decision making around the management and control of those risks. Increasingly within the transfer pricing landscape there has been a shift towards ensuring that the transfer pricing profit of entities within a multinational is reflective of their functional profile, the risks borne by the entities, and their capacity to manage and control those risks.

Action 13 of the BEPS Action Plan contains a three tiered standardised approach to transfer pricing documentation made up of the Master File, Local File and Country-by-Country Report (CbCR). CbCR has been introduced into Irish legislation and provides a template for multinational enterprises to report specific information annually and for each tax jurisdiction in which they do business.

Leasing groups should consider reviewing existing related party arrangements in the context of the proposals.

US Tax Reform

The US President signed the much anticipated US tax reform into law on December 22, two days after it was approved by the US House and Senate. The centrepiece of the Act is the significant reduction in the corporate income tax rate from 35% to 21% and moving from the current system of worldwide taxation towards a 'territorial' tax system. Furthermore, the Act includes limitations on interest expense deductions for tax purposes.

For more information on these topics, contact

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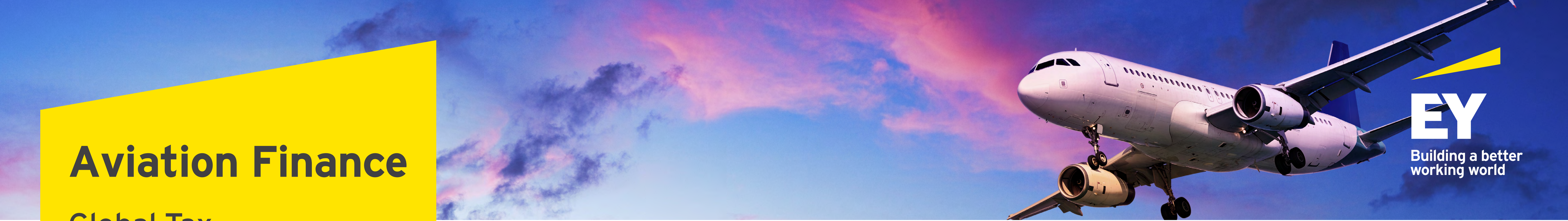

Aviation Finance

Global Tax Developments

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New legislation start date | Possible legislative start date

2017 | June 2017 | 2018 | June 2018 | 2019 | June 2019 | 2020 | June 2020 | 2021 | June 2021 | 2022

Anti-Tax Avoidance Directive 1 & 2

1 January 2019 implementation date for:
- Interest limitation: 30% EBITDA (2024 if equivalent rules in place)
- CFC
- GAAR

1 January 2020:
- Anti- tax free exit rules
- Anti-Hybrid mismatch rules

1 January 2022:
- Anti-reverse hybrid taxation

Common Corporate Tax Base/Common Consolidated Corporate Tax Base

1 January 2019: Possible introduction of mandatory CCTB:
- For groups with turnover>€750m
- Broadly defined base (NID regime, participation exemption, NOL c/f, R&D)
- TP (upwards only)
- Includes ATAD measures

1 January 2021: CCTB converts into CCCTB:
- One tax return for EU companies
- Profits shared across EU in accordance with allocation by (sales, labour, assets (excluding intangibles)): 1/3 each according to where value is created

Transfer Pricing

In the lead up to 2020: Continued Adoption of new OECD Transfer Pricing Documentation Standards and 2017 Guidelines:
- Countries which have not already adopted the new documentation standards are expected to do so in the next number of years
- The 2017 guidelines incorporates the OECD BEPS Actions 8-10 which envisages a new approach to assessing the risk profile of an entity

By the end of 2020: Review of Transfer Pricing Documentation Standards
- Countries participating in the BEPS Project will monitor the implementation of new standard
- An assessment of whether modifications should be made to require reporting of additional data

OECD Multi-lateral Instrument

June 2017:
Signing ceremony. 68 countries sign. More follow through 2017.

Late 2017/ 2018:
MLI Takes effect 3 months after five countries ratify.

2018 onwards:
MLI enters into force for specific treaties 3 or 4 months after ratification in those states.

Late 2018 onwards:
MLI begins to 'take effect' for relevant treaties. Exact dates depend on tax head applicable.

US Tax Reform

US Tax Reform Bill signed December 2017
- Reduction in corporate income tax rate from 35% to 21%.
- Introduction of worldwide taxation system replacing the old 'territorial' system.
- Limitations on interest expense deductions for tax purposes.

IFRS 16

Accounting periods beginning on or after 1 January 2019:
- Lessees to account for leases under a single on-balance sheet model
- Must recognise a liability to make lease payments and an asset representing the right to use the underlying asset
- Acceleration of lease expense recognition for lessees in their Financial Statements