Global tax issues in aviation finance

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Agenda

BEPS 2.0

Progress towards implementation of Pillar Two

European Union
- Agreement reached since last forum
- Directive to be transposed by 31 December 2023 at latest

Irish Progress
- Effective 2024 implementation
- Fiscal years commencing on or after 31 December 2023
- Finance Bill 2023

Consultations
- Summer 2022
- Draft legislation; fresh consultation closed 8th May

DoF Feedback
- Early engagement is key
- Significant resources deployed
- Expect QDTT

How the BEPS 2.0 rules operate

Domestic minimum top-up tax

- Where local tax rate exceeds 15%, BEPS 2.0 rules should fall away
- Response to BEPS 2.0 proposals
- Ireland likely to introduce a top-up tax. As such, other rules should have less impact

"Subject To Tax Rule"

- A 9% target rate designed to protect developing countries
- Any tax paid under the STTR is creditable under the GloBE Rules
- Applies to related party transactions

"Income Inclusion Rule"

A form of CFC rule

- Imposes a top-up tax on a parent, where 'low-taxed' subsidiary earns income
- EU Directive substantially widens scope of this rule – can apply to domestic receipts.
- Will likely act as backstop to Ireland's likely higher domestic top-up tax

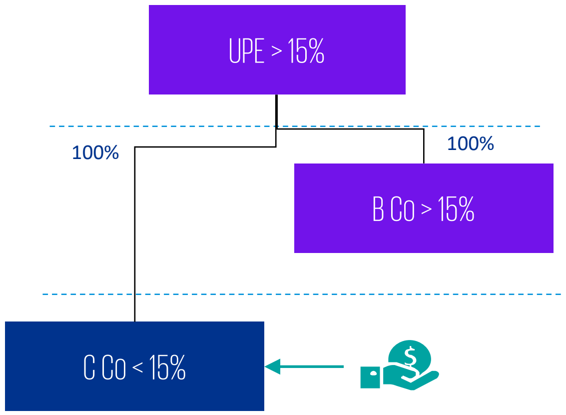
"Under-Taxed Payments Rule"

Denial of deductions

- Applies to both connected party and third party payments
- Back-stop to the Income Inclusion Rule
- Could theoretically capture cross-border payments made by Irish group, i.e. interest payments
- Backstop only – likely very limited application

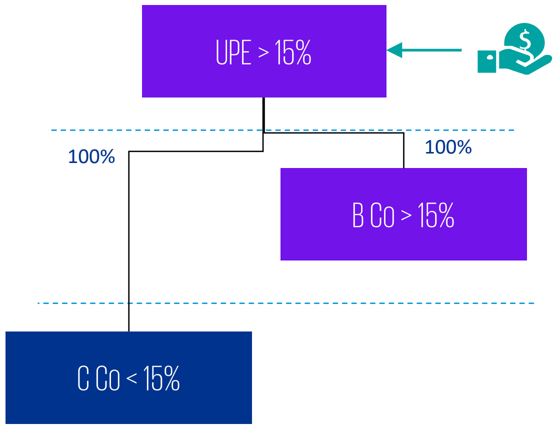
Operating mechanics of Pillar Two | High level overview

1. (Optional) Qualified Domestic Minimum Top-Up Tax



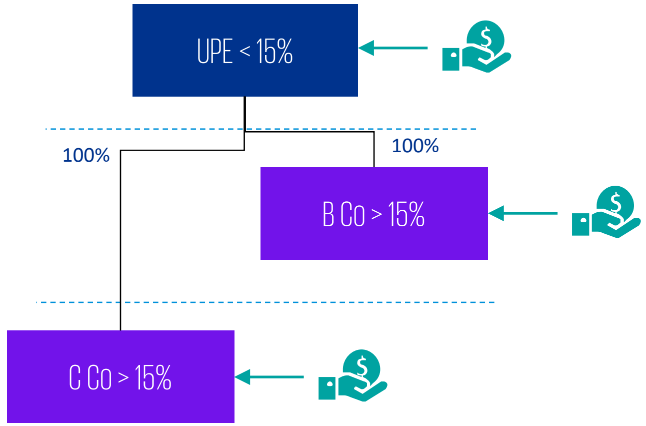
=> Top-up tax on low-taxed C Co is collected by C Co

2. Income Inclusion Rule



=> Top-up tax on low-taxed C Co is collected by Ultimate Parent entity **(UPE)**

3. Under Taxed Profits Rule (UTPR)



=> Top-up tax on low-taxed UPE is collected by jurisdictions B and C

Low-taxed

High-taxed

Pillar 2 | GloBE Model Rules | Workflow

1. Identification of in-scope entities

1) Assess whether Group is within scope
2) Identify Constituent Entities
3) Remove any Excluded Entities
4) Identify location of each Constituent Entity

2. ETR Calculation

Denominator

1) Determine amount of Financial Accounting Net Income
2) Adjust Financial Accounting Net Income or Loss to GloBE Base
3) Allocate GloBE Income or Loss to Permanent Establishments or Flow-through Entities, if necessary

Numerator

1) Identify Covered Taxes
2) Adjust Covered Taxes for temporary differences and prior year losses
3) Allocate Covered Taxes, as necessary
4) Take post-filing adjustments into account

3. Top-up tax calculation

1) Calculate the Top-up Tax Percentage for each Low-tax Jurisdiction (ETR < 15%)
2) Apply the Top-up Tax Percentage to the Excess Profits of the Jurisdiction
3) Deduct the amount of top-up tax imposed under a qualified domestic minimum top-up tax (QDMTT)
4) Allocate the Jurisdictional Top-up Tax to the Constituent Entities in the Jurisdiction in proportion to their GloBE Income

4. Impose and allocate top-up tax

1) Identify the Constituent Entities subject to QDMTT
2) Identify the Parent Entity liable for the Top-up Tax under the IIR
3) Determine the amount of Top-up Tax paid by the Parent Entity under the IIR
4) Identify the remaining amount, if any, that is allocable under the UTPR
5) Compute liability for residual Top-up Tax in the UTPR Jurisdictions through a UTPR adjustment

5. Filing obligation

1) Identify filing entities (UPE, Designated Filing Entity, each Constituent Entity)
2) Assemble reportable information
3) File the GloBE Information Returns within 15 months after the end of the Reporting Fiscal Year to the respective local tax authority

Key issues for aircraft leasing groups

1

In scope groups – confirm consolidations. Threshold of €750m of consolidated global revenues.

2

Availability of **substance based carveout:** question over availability to lessors

3

Consultation responses – carveout should be available to lessors of plant & equipment; lessees and lessors seeking carveout on very different assets

4

Assets **located in the jurisdiction –** need a definition of "located in" which works for lessors.

5

Impact of the **expected QDTT –** deferred tax uplift vs annual cash tax

6

Significant administrative burdens will be placed on in scope lessors

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Substance based carveout

How it applies

- Allows for a deduction from the profits taken into account for GloBE purposes.
- Where the carveout applies, and where consequently profit is reduced, the effective tax rate of the relevant group will naturally increase.
- The substance based carveout has two legs – one applying to a measure of tangible assets, and the other to a measure of payroll costs.
- The tangible assets carveout will allow groups to deduct 5% of the carrying value (NBV, not cost) of tangible assets they hold on balance sheet.

Worked example

Base case (no tangible assets carveout):

Lessor balance sheet: $750m NBV aircraft
Lessor profits: $50m
Tax charge: $6.25m
ETR: 12.5%

Top up tax required to get up to 15% (expect this to be a cash tax amount payable).

With tangible assets carveout:

Take off 5% of $750m ($37.5m)
Adjusted profit line: $50m - $37.5m = $12.5m
Tax charge: still $6.25m
New calculated ETR: $6.25m/$12.5m = 50%

15% threshold comfortably passed and this lessor falls out scope.

Challenges

- The carveout applies to the carrying value of tangible assets located in the jurisdiction. We need 'located in' to be defined with reference to the jurisdiction of tax residence of the owner of the assets. KPMG have requested this in recent submissions.
- While the Model Rules (and the EU Directive implementing them) seem to allow lessors of plant and machinery to benefit from the tangible assets carveout, there is one paragraph in the OECD's Commentary to the Model Rules which states that lessors will not be entitled to benefit from the tangible assets carveout (but that lessees will). We have asked for clarity.

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Leasing Specific Considerations

01

Accounting impact – GloBE calculations are very closely aligned with accounting position. Which accounting standard will be used for the purposes of the QDMTT/IIR calculation (e.g. IFRS, US GAAP or other)? What impact do permanent differences have? Does the group have significant valuation allowances?

02

Steps to take in 2023 – Consider key accounting policies (e.g. treatment of maintenance, impairment reviews, EIR accounting for interest etc). Any pending changes to accounting policy and what impact will these have?

Need to work through the GloBE income adjustments – take care on 10% threshold for excluded dividends or gains, no adjustment for traditional non-deductible items

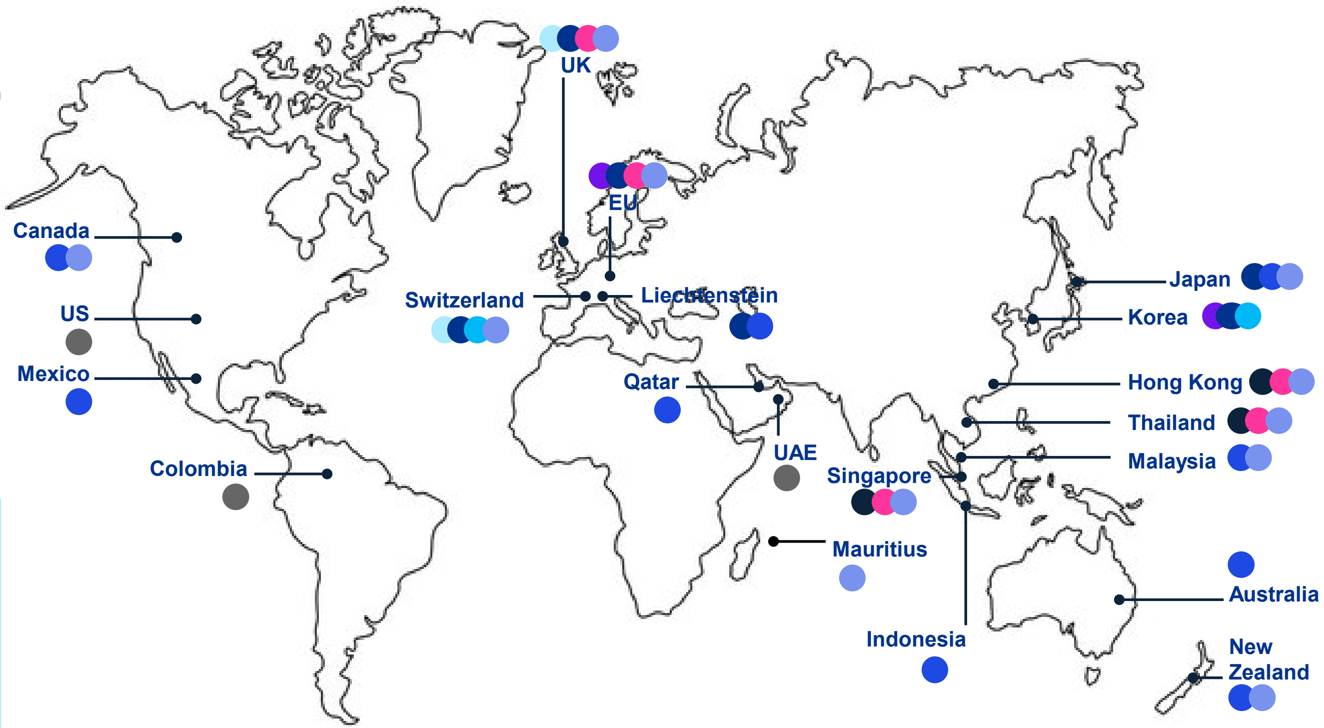
03

Compliance Burden – Potential for 3 separate tax returns - in Ireland alone. Form CT1, GloBE top-up tax return and the GIR. Need to consider the resources and information required to complete these returns. What about ETR guidance to board and markets?

04

Impact of Transition Rules – Some relieving measures based on "qualified" CbyC reports etc. Consider impact of the transition rule around intra-group transfers of assets post 30 November 2021 – were the assets transferred at their carrying value?

Change is coming across the globe...



Legislation enacted / approved

- Korea (December 2022) – implementation from 2024
- EU Directive (December 2022)

Draft legislation released

- Germany (March 2023) – implementation from 2024
- Japan (February 2023) – implementation from 2024
- Netherlands (October 2022) – implementation from 2024
- Sweden (March 2023) – implementation from 2024
- Switzerland (August 2022) – implementation from 2024
- UK (March 2023) – implementation from 2024

IIR (2024)

- EU (potential deferrals where few UPEs)
- Japan
- Korea
- Liechtenstein
- Switzerland
- UK

IIR (2025)

- Hong Kong (SAR), China
- Singapore
- Thailand

UTPR (2024)

- Korea (?)
- Switzerland (?)

UTPR (2025)

- EU –potential deferrals where few UPEs
- Hong Kong (SAR), China
- Singapore
- Thailand
- UK

Intention to apply IIR and UTPR (timing uncertain)

- Australia
- Canada
- Indonesia
- Japan (UTPR)
- Liechtenstein (UTPR)
- Malaysia
- Mexico
- New Zealand
- Qatar

Intention to apply QDMTT

- Canada
- EU (optional)
- Hong Kong (SAR), China (2025)
- Japan
- Liechtenstein (2024)
- Malaysia
- Mauritius
- New Zealand
- Singapore (2025)
- Switzerland (2024)
- Thailand (2025)
- UK (2024)

Other related announcements

- US corporate alternative minimum tax enacted 15% (not Pillar 2 compliant)
- UAE new corporate tax 9%
- Colombia 2022 tax reform – 15% minimum tax

BEPS 2.0 — Timeline

2022 (Jul – Dec) | **2023** (Jan – Jul – Dec) | **2024** | **2025–2030**

Sep 2022
Joint statement by DE, ES, FR, IT and NL

End of 2022
EU **Pillar 2** Directive adopted
Release of **Pillar 2** Implementation Framework components (e.g. transitional safe harbors)
Consultation on **Amount B** launched
Consultation on final **Amount A** building block launched

Feb 2, 2023
Pillar 2 – Release of Administrative Guidance

June 30, 2023
Commission report to the ECOFIN Council on **Pillar 1** expected

Somewhere in 2023
Pillar 2 – Release of further Implementation Framework components (e.g. additional admin guidance, QDMTT safe harbor, GIR)?
Amount A — signing ceremony of the MLC to be held in the **first half of 2023**
Amount B — Aim to release final deliverables by **mid-2023**

Dec 31, 2023
Pillar 1 - EC legislative proposal if international agreement is not reached
Pillar 2 — EU and UK implementation deadline and IIR targeted to be in effect

2024
Amount A — Intention that rules can come into affect
Amount B —Intention to implement via update of TP guidelines

Dec 31, 2024
Pillar 2 — EU UTPR targeted to be in effect

Dec 31, 2029
Pillar 2 optional EU deferral to apply IIR and UTPR

Treaty challenges

Treaty challenges

Multilateral instrument and its impact on aviation

- Following the first BEPS project, a multilateral instrument was implemented into most global treaties that included a Principal Purpose Test, which set out that:

  "A benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement."

- The MLI introduction has significantly impacted on lease in lease out structures, and those that are still prevailing are likely on the way out
- It has led/coincided with an Increased focus by airlines on the commercial substance of the lessor and around beneficial ownership concerns.

Treaty challenges

Australia

- 30% royalty withholding tax on lease rentals with strong anti-avoidance rules (Part IVA & MAAL)
- Prior to MLI, leasing structures that often relieve withholding tax: UK AOE; UK/French LILO; US lessor satisfying LOB
- Public and private rulings granted by ATO on leasing intermediaries in the past, no longer forthcoming
- Airlines often insulated from technical and contractual risks
- New deals / novations - MLI would likely deny treaty benefits to a UK sub-lessor under an Irish / UK LILO
- Lessors exploring direct Irish lease - practical issues where aircraft are used both domestically and outside Australia:
    - Australian income tax on assessment / tax adjusted profit basis if aircraft used domestically – deemed Australian PE
    - Tax adjusted loss in short/medium term due to tax depreciation and expense deductions
    - Australian balancing charge/allowance on aircraft disposal – even if after aircraft has left Australia.
    - Australian WHT at 10% if aircraft used internationally

Treaty challenges

Argentina

Argentina MLI

- There is domestic withholding tax of 14%
- We typically see leases to Argentinian airlines via Swedish intermediaries.
- MLI not yet a feature of the Sweden/Argentina tax treaty.
- However, in November 2022, a bill was approved to ratify MLI in Argentina.
- Further approval still needed in Argentina for formal ratification and subsequent deposit of the instrument with the OECD.
- While timing of MLI in Argentina/Sweden tax treaty still not clear, change is coming.

Ireland included on Low or Zero Tax Jurisdiction List

- The Argentinian tax authorities have published a list of Low or Zero Tax Jurisdictions (LZTJ) and Ireland is on the list.
- Argentinian entities paying amounts to LZTJs have additional considerations regarding transfer pricing reporting rules (even where unrelated), deductibility of lease rentals rules and potentially mandatory disclosure rules.
- Lease agreement between Argentinian airline and Swedish entity – Sweden is not on the list.
- Ireland status in Argentina and other South American locations – potential knock-on impact?

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Treaty challenges

Brazil

- A provisional measure regarding Brazilian WHT was published by the Brazilian government last year.
- Provisional measure references 0% WHT rate on rentals paid for the lease of aircraft from 1 January 2022 up until 31 December 2023 and an increase in rates from 1% in 2024, 2% in 2025 and 3% in 2026.
- Appears to be linked to lease rental payments rather than the time lease was executed.
- Position unclear post 1 Jan 2027.
- Airlines concerned with signing leases directly with Irish lessors – use of US trust structure?
- Unlikely to see movement on Ireland-Brazil DTA in the near term.

Treaty challenges

Indonesia

- There is domestic withholding tax of 20%
- Indonesian airlines typically lease aircraft from aircraft lessors via a French intermediary (either lessor or airline owned). The France / Indonesia DTA allows for a 0% rate of withholding tax to apply to aircraft lease rentals provided the French company does not have any sort of presence in Indonesia (beyond any leased aircraft).
- The MLI is now in effect and the LILO structure is becoming more challenging.
- There are disclosure requirements on lessors in relation to any leasing arrangements with Indonesian lessees.
- Some discussions taking place on restructuring existing leases.

Treaty challenges

Japan

- 20.42% domestic withholding tax on lease rentals
- Common leasing structures that historically relieved withholding tax: Norway LILO (also UK/HK LILO); UK AOE, US lessor satisfying LOB
- MLI now in effect – LILO structures via Norway no longer feasible
- Japanese WHT at 10% under Ireland / Japan treaty
- Irish direct lease option utilised by some lessors – can result in a tax cost that is less than 10% gross withholding, however it brings complexity, cost, administration challenges
- Ongoing discussions on new Japan/Ireland double tax treaty - some hope that BEPS 2.0 implementation may open a path to positive renegotiation

Jurisdictional updates

Jurisdictional Updates

Hong Kong

Hong Kong's revised proposal for aircraft leasing

- Hong Kong SAR plans to introduce a series of enhancements to its aircraft leasing preferential tax regime.
- Current regime offers 8.25% tax rate for qualifying leasing activities (based on 20% net lease payments, no depreciation deduction) - no deferral and ETR is around 4% to 6%.
- Proposals include:
  - Introduction of tax depreciation (100% in year of acquisition and clawback on disposal);
  - Extend to cover finance leases and lease to entities other than operators;
  - Extend the ability to get a tax deduction for interest payable to a financier outside HK who is not a financial institution;
  - BEPS 2.0 - Introduction of a threshold to comply with OECD substantial activities requirements; and
  - Extension of regime to qualifying lessors that use a bare trust model.

Jurisdictional Updates

India

GIFT City / IFSC

- India remains one of the most challenging jurisdictions – Recent Finance Bill proposed an increase of tax rate to 20% on aircraft lease rentals (current rate is 10%).

Some positive amendments in the Financial Bill 2023

- Potential exemption on capital gains on transfer of equity shares in an IFSC entity engaged in the business of aircraft leasing;
- Potential exemption from income tax on dividends received by an IFSC entity engaged in aircraft leasing business from another IFSC entity engaged in aircraft leasing business;
- Concessional tax rate for dividends earned by a non-resident shareholder from an IFSC entity engaged in aircraft leasing business (i.e., reduction from 20% to 10%).

Substance Requirements in Group Context

- Draft provision which appears to allow a GIFT company rely on substance of an affiliate when assessing whether the GIFT company meets the relevant criteria

Jurisdictional Updates

United Arab Emirates

UAE has introduced a corporate tax regime

- Effective for financial years starting on or after 1 June 2023
- *Key features of regime for lessors:*
  - Resident persons include UAE incorporated entities and entities M&C in UAE
  - Two tax rates: 0% (for qualifying income of Free Zone entities) and 9%. Can elect to be subject to CT in full
  - No tax depreciation (follow the accounts – cash tax / no deferral)
  - No withholding tax on aircraft lease rentals

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