AIRCRAFT LEASE FINANCE SERIES

THE ABC OF AIRCRAFT RETURNS

Everything you need to understand the legal, registration, and tax issues associated with aircraft transitions and returns

Mark Byrne

MARTYN FIDDLER AVIATION

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Foreword

Of all the historical challenges faced by the global airline industry, the ongoing Covid-19 situation is unprecedented.

Nothing, not the Global Financial Crisis, the Persian Gulf War that started in August 1990, Brent-Crude fuel at $150, the Boeing 737 Max issues - or even the 9/11 attacks - have caused such a precipitous change. For 2020, global passenger numbers are expected to decline by 55% compared to 2019. Over 25 airlines have collapsed - well ahead of the statistics typically associated with economic crises, leaving over 220+ aircraft without new homes.

Air travel's sudden collapse is reshaping a trillion-dollar industry. Major airlines are now questioning every aspect of their business, Lufthansa's CEO, Carsten Spohr commented:

> "We are convinced that the entire aviation industry must adapt to a new normal. The pandemic offers our industry a unique opportunity to recalibrate: to question the status quo and, instead of striving for growth at any price, to create value in a sustainable and responsible way."

Predictions that passenger traffic will be depressed until 2024 point to a radically different market for aircraft. In normal times and extraordinary times, the repossession of an aircraft by a lessor or financier gives rise to all sorts of issues, not least how to hold title to the aircraft and where to register it, and how to deal with any tax issues that may arise as a consequence of the change in the aircraft's circumstances.

Martyn Fiddler Aviation can provide a one-stop solution to these issues. Working with aircraft lessors and financiers across the globe, we see the same challenge come up again and again. Many lessors and financiers have not thought about how they can mitigate their risk, reduce their potential exposure and ensure they can make robust, realistic decisions.

This eBook attempts to address all of these challenges in the most straightforward way possible – hence why we call the 'ABC of Aircraft Returns'. Reading this eBook means you will understand all the legal, registration, and tax issues associated with aircraft transitions and returns. Our aim is to reduce the complexity and jargon for a typical lessor or financier. As a result, you should be able to identify and implement an optimal solution to allow the import, storage, and/or re-marketing of your aircraft assets.

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Introduction

Everyone who works in aviation is told that it is a “cyclical” business. In the years up to 2019, there was an unprecedented long run of profits and general good news for aviation. It was hard to see what event or series of events could bring that current cycle off its historic highs. In 2019, 100,000 commercial flights were scheduled to take off daily, catering for over 4.5bn passengers and driving revenues of $838bn.

Today airlines are waking up to radically different trends in passenger numbers. The collapse is startling.

IATA believe that global passenger will not return to pre-COVID-19 levels until 2024, a year later than previously projected. The recovery in short haul travel is still expected to happen faster than for long haul travel, but airlines expect to have to decrease air fares in order to help stimulate demand.

Fleet Reduction Impact

Aviation consultants Oliver Wyman believe that the global fleet will be 12% smaller in 2030 than if forecast growth had continued - 4,700 fewer aircraft. No wonder there are cuts to both wide-body and narrow production by the two major airframe manufacturers as well as regional jet makers, Bombardier and Embraer.

The number of new leases has also fallen sharply this year and industry analyst, IBA, predict that lease ends will exceed lease starts for the first time ever in 2020.

More will be asked of the current fleets because - at today's fuel prices – they will provide competitive economics.

Regional Airline Crisis

Even if traffic recovers faster than expected , plenty of aircraft will remain on the ground. Citigroup forecast excess capacity of 4,000 aircraft in 18 months' time. The biggest challenge of all is the regional airline fleet.

The largest lessor of regional aircraft is Nordic Aviation. They manage 490 aircraft made up ATR 42/ ATR 72 and Dash 8 turboprop, Bombardier's CRJs, Airbus A220 narrow-body jet and Embraer E-Jets. This fleet represents 8pc of the world's entire supply of regional aircraft, including 29pc of those owned by lessors. Nordic have now deferred loan repayments and had its repayments on more than €5bn in debts to be frozen for 12 months.

The legacy of the Flybe collapse at the start of the pandemic lingers. Eleven Dash-8 Q400 aircraft and two Embraer E175 jets, previously operated by Flybe, are immediately available for sale or lease.

Nowhere in the world do regional airlines play a key part of the fleet like they do in the U.S. and Canada. For example, regional airlines account for 10% of the traffic at major international hubs such as Dallas-Forth Worth and Atlanta. United Airlines regional carrier, Express Jet collapsed during summer 2020r, leaving 131 Embraer 145 jets on the ground. Alaska's largest regional carrier also collapsed: all 72 of its aircraft are no longer flying.

The availability is translating into falling regional aircraft prices and values quickly. Simple economics combined with the fact that with so many regional aircraft parked or in continuing storage mean downward pressure on lease rentals. The pressure on rentals mean that aircraft asset values will be impaired when valuation audits for this year and next are commenced.

Impact of Aircraft Return Liabilities

All aircraft transactions have multiple tax implications for the lessors, financiers and airlines. Since many transaction's financial outcomes are based on tax benefits, tax considerations are critical for lease structures, particular if the aircraft is being brought into a new jurisdiction. Diversity among different aircraft registries and their respective tax laws can amplify these tax advantages, creating the opportunity to maximise allocation of available tax allowances.

The pandemic is triggering a cascade of issues due to excess capacity. Lessors depend on the trading of used aircraft to make their return on investment. The value of used aircraft, whose leasing-contracts will come to an end, is likely to fall dramatically as finding new lessors for them will be challenging. More returns at end of leases means increased requirements for transitioning, importation, storage, and choices for aircraft registration. This, in turn, is creating multiple tax implications that could result in hefty – and immediate - financial liabilities for aircraft lessors and financiers.

Besides taking a chunk out of already strained cashflows, what is worse is that these tax issues can be avoided earlier. How? By researching, identifying and implementing solutions specific to that individual aircraft that will allow the import, storage, and re-marketing of aircraft assets without a ticking tax time-bomb.

The overwhelming lesson for all lessors, financiers and aircraft owners is that the complexities and risks involved mean that obtaining expert legal and tax advice is required for any regional aircraft owner facing challenges right now.

With this backdrop in mind, let's look at all the technical – and not-so-technical - phrases you will see in the complex world of aircraft returns.

A–Z of Aircraft Leasing, Financing, Returns and Taxation.

A

ACMI: ACMI is an abbreviation of aircraft, crew, maintenance and insurance lease – this is the same as a 'wet lease'. ACMI leases are normally used for short-term requirements such as during peak traffic seasons or annual maintenance checks or to initiate new routes. An ACMI aircraft may be used to fly services into countries where the lessee is banned from operating, or to replace unavailable capacity.

AIRCRAFT CERTIFICATION REQUIREMENTS: Aircraft manufacturers must demonstrate compliance of its product with regulatory requirements: Certification requirements for commercial aircraft are derived from the ICAO (see below) Each country then establishes its own legal framework to implement the internationally agreed ICAO standards and recommended practices. EASA (See below) is responsible for the certification of aircraft in the EU and for some European non-EU Countries.

ADJUSTED MARKET VALUE: The market value of an aircraft taking into account the individual aircraft's actual maintenance status, because the maintenance and quality of maintenance performed on an aircraft has an impact on its value.

AOC (Air operator's certificate): An AOC is the approval granted from a National Aviation Authority to an aircraft operator to allow it to use aircraft for commercial purposes. This requires the operator to have personnel, assets and systems in place. An AOC specifies the:

1. Name and location and principal place of business of the operator;
2. Date of issue and period of validity;
3. Description of the type of operations authorised;
4. Type(s) of aeroplane(s) authorised for use;
5. Registration markings of the aircraft e.g. G- (CAA), N- (FAA), or EI- (IAA)
6. Authorised areas of operation.

The requirements for obtaining an AOC include having personnel with the required experience for the type of operations requested, airworthy aircraft, training systems for crew and operation, quality systems, key accountable staff responsible for safety critical functions, insurance and funding.

AOG: Aircraft on ground - commonly referred to as AOG. Grounded aircraft can happen for many reasons such as engine problems. Aircraft lessors also use the term when they have aircraft off-lease.

AIRWORTHINESS DIRECTIVE: A regulation issued by an aviation authority, typically subsequent to a fault that has been found on an aircraft. Accurate and complete maintenance records (see below) include proper documentation of airworthiness compliance.

APPRAISER: A company or individual that provides aircraft valuations. Most lease (see below) deals require two independent valuations.

APPRAISAL: see also 'Financial Appraisal' 'Full Appraisal' and 'Comprehensive Appraisal'

ASSET VALUE GUARANTEES: Insurance provided by manufacturers that provide a guarantee to an airline or aircraft financiers with a certain value for an aircraft at a specific point or points in time. Asset Value Insurance is always subject to the aircraft meeting specific return or maintenance criteria.

B

BACK-TO-BACK LEASE: Where an aircraft is leased to an intermediate aircraft lessor and then sub-leased back to the lessee.

BASE VALUE: the ideal value in dollars set for an aircraft transaction in a 'perfect market'. In other words, where the buyer and seller are well-informed and the market is competitive. It is based on historical values as well as future trends. 'Base Value' assumes the aircraft is at the halfway point between all of its expected maintenance schedule. However, 'Base Value' almost never represents the actual price at which an individual aircraft is traded.

C

CAPITAL LEASE: See 'Finance Lease'

CHICAGO CONVENTION: The Convention on International Civil Aviation is known more commonly as the 'Chicago Convention', a landmark agreement in 1944 established the core principles permitting international transport by air, and leading to the creation of the specialised agency to oversee it - the International Civil Aviation Organisation (ICAO).

COMPONENTS: The main typical components of an aircraft include:

- Airframe
- Engines
- Modifications
- In-Flight Entertainment (IFE) and Buyer Furnished Equipment (BFE)
- Rotable assets – parts which are normally maintained and reused
- Repairables – parts which are capable of being repaired and reused
- Embedded maintenance (engine overhaul)

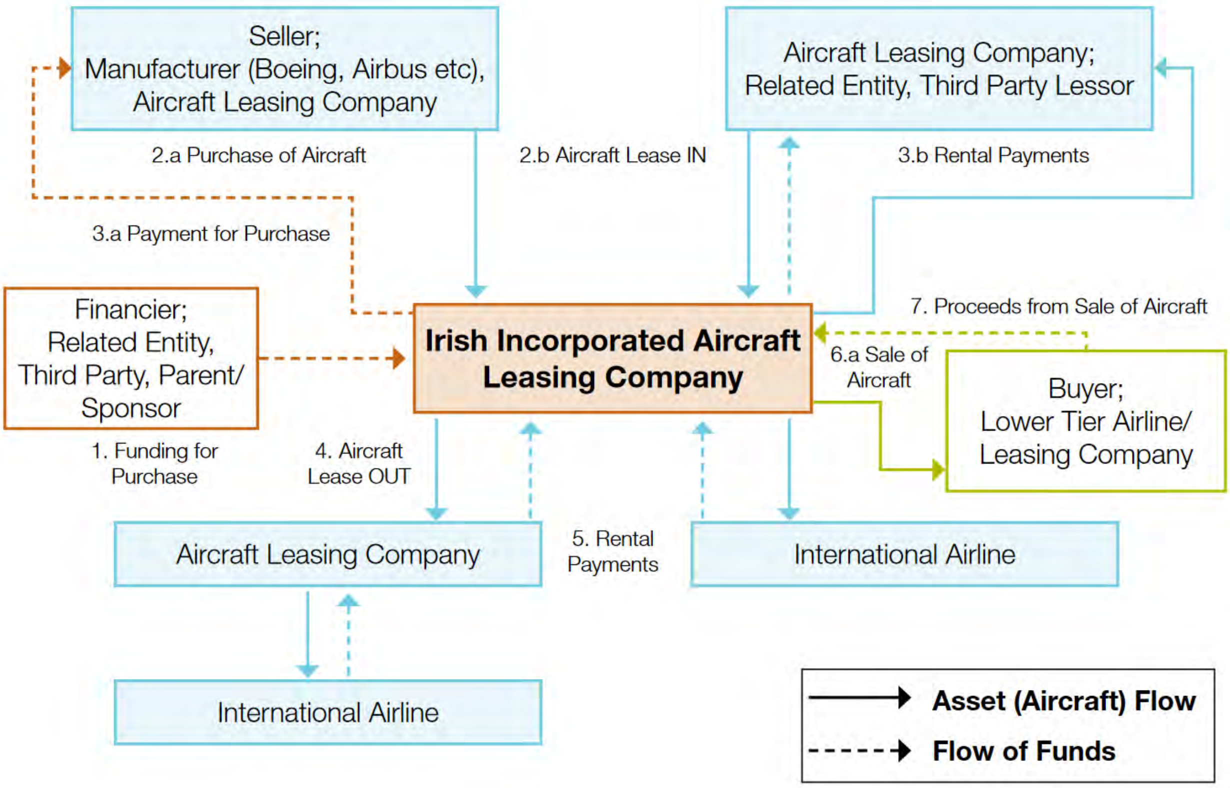
Each of these components are used to assess the value of second-hand aircraft, as well as the wider market valuation context.

CURRENCY: Most aircraft leases and aircraft fuel (kerosene) is denominated in US Dollars. This has a downside because of the impact of currency movement.

CURRENT MARKET VALUE (CMV): An aircraft appraiser's opinion of the most likely value for an aircraft under current perceived market conditions. Market values are often opinions based on analysis of information about recent transactions, demand for the aircraft type and aircraft availability.

COMPREHENSIVE APPRAISAL: an appraisal that includes a physical inspection and a review of an individual maintenance and other records (see below). A comprehensive appraisal is often needed for re-registration of the aircraft in a different country.

COMPLEXITY: Aircraft leasing takes multiple forms; its is not just a simple arrangement between a buyer an seller. There are multiple options for financing, ownership structure, registration location, lease type as well as special ownership structures called Special Purpose Vehicles (see below) created for tax efficiency. Here is an example of the funds flow for a sample aircraft leasing company in Ireland.



CURRENT MARKET VALUE: The actual trading price at which an aircraft is appraised. This takes into account the current, short-term market situation, fuel prices and wider economic events. For example, the market value of Boeing 737-800 aircraft would have gone up when the Boeing 737MAX was grounded.

D

DAMP LEASE: A damp lease is a mixture of both dry and wet lease. The lease deal includes a mix of aircraft, pilots and and / or insurance, with different 'mixes' of requirements. Typically, the term means 'without cabin crew' with the airline providing the cabin crew. Today, the term ACMI is used instead of damp lease.

DRY LEASE: A dry lease is when the aircraft is provided without crew, maintenance or insurance. Dry lease is the typical lease used by leasing companies and financiers. The airline or lessee must put the aircraft on its own air operator's certificate (AOC) and provide aircraft registration. A dry-lease agreement can also be between a major airline and a feeder regional airline, in which the major airline provides the aircraft and the regional operator provides flight crews, maintenance and other operational aspects of the aircraft, which then may be operated under the major airline's brand.

DIRECT PURCHASE AGREEMENT: Under a direct purchase arrangement the airline purchases the aircraft directly from the manufacturer or vendor using a loan or structured finance lease (see below). The amount of the advance for the aircraft can vary up to 90% depending on the airline and its available capital. These loans are generally structured as syndicate of banks, and with terms of up to 12 years.

Direct purchase of an aircraft allows the airline to build up equity in the aircraft as it pays down the loan or finance lease and as the airline is the owner of the aircraft, it can modify it to its own exact requirements. In addition, the airline is able to gain significant taxation benefits in most countries.

E

EASA: The European Union Aviation Safety Agency (EASA) is an agency of the European Union with responsibility for civil aviation safety to ensure common safety rules and measures. EASA carries out certification, regulation and standardisation and also performs investigation and monitoring. EASA uses National Aviation Authorities (See NAA) to implement its regulations.

F

FAIR VALUE: The fair value of an aircraft can be determined from the total price agreed as part of the purchase agreement. The agreement or purchase invoices may show the breakdown of items included within the purchase price and attribute cost values to them. The attributed values still need to be analysed to ensure they accurately reflected the fair value of the aircraft components (see above).

FINANCE LEASE: A long-term lease agreement that allows the airline ('lessee') to hold the aircraft on their balance sheet at the value of the lease payment and depreciate the asset as if they owned it. The airline can take advantage of the tax benefits of ownership such as depreciation and interest expense. Such leases typically include an option to purchase the aircraft at the end of the lease term at an agreed price.

FINANCIAL APPRAISAL: A method of aircraft valuation that values the aircraft upon the income potential from its lease and residual value, as opposed to its base value or current value.

FULL APPRAISAL: When an appraiser inspects an aircraft in detail and examines all the maintenance records.

I

ICAO: The International Civil Aviation Organisation is a specialised agency of the United Nations set up in 1947. ICAO's core mandate is to help countries and their individual aviation authorities have uniformity in civil aviation regulations, standards, procedures, and organization.

L

LEASE: The formal definition of a lease is a 'contract (or part of a contract) that conveys the right to use an asset for a period of time in exchange for a payment consideration. A contract contains a lease if fulfilment depends on a specific asset and conveys the right to use that asset throughout the period of use. The rationale for aircraft leasing is that an airline can operate aircraft without the financial burden of buying them and to provide temporary increase in capacity.

See also 'Finance Lease', 'Operating Lease', 'Wet Lease', 'Dry Lease'.

LEASE RATE FACTOR: The lease rate factor is the monthly payment to the lessor that is a percentage of the overall purchase price of the aircraft. The industry refers to lease rates in terms of lease rate factor.

LESSOR: The company that owns aircraft and leases them to airlines. There are around 150 aircraft leasing companies globally. In 2019 the world's five largest firms owned a total of over 3,860 planes. GECAS and AerCap are the most prominent players, both holding over a thousand aircraft. Other big names in the industry are Avolon, BBAM, Nordic Aviation Capital, and Air Lease Corporation.

LESSEE: The airline who leases the aircraft from the lessor.

LIST PRICE: The price that aircraft manufacturers quote for a particular type of aircraft. For example, the list price in 2018 for an Airbus A320 was US$101m. Airlines rarely pay the list price.

M

MAINTENANCE CYCLE: All aircraft go through a cycle of events known as the maintenance cycle, which is made up of flight cycle, inspection cycle, corrective actions, and modifications. For example, the flight cycle is accumulating hours for that aircraft, and the inspections are performed on a scheduled basis to ensure safe operation. The maintenance and quality of maintenance performed on an aircraft has an impact on its market value.

MAINTENANCE RECORDS: An aircraft owner is required to keep aircraft maintenance records on the airframe and engines with a description of the work performed on the aircraft, the date the work was completed, the signature and the certificate number of the person approving the aircraft for return to service. Incomplete or missing records greatly impact the value and ability to sell the aircraft.

N

NAA or National Aviation Authority: The agency of country or group of countries which are given responsibility for determining and administering the regulatory regime which is in place to ensure that aircraft can be operated safely. Examples in the CAA – Civil Aviation Authority in the UK, the FAA – the Federal Aviation Authority in the US and IAA – the Irish Aviation Authority.

O

OEM: Original equipment manufacturer, e.g. Airbus, Boeing, Embraer, de Havilland of Canada.

OPERATING LEASE: A lease where the lessor or financier retains the risks and rewards of ownership and where the aircraft will eventually be returned to the lessor at the end of the lease term. The aircraft is not held on the airline's (lessee's) balance sheet. Not having operating leases on an airline's balance sheet can make the airline's balance sheet more robust. An aircraft operating lease places full operational and maintenance responsibility for the aircraft on the airline, together with legal liability and insurance responsibility during the lease term. The aircraft remains the property of the Lessor who will use the aircraft asset value and income generating potential over the full useful life of the aircraft, which will usually span across multiple lease periods and Lessees.

OPTIONS: Airlines frequently acquire options to purchase aircraft in the future, the commercial rationale being to keep aircraft acquisition capacity as flexible as possible as well as establishing a position in the manufacturer's production queue. Options provide a variety of rights, including the timing of delivery or the price to be paid.

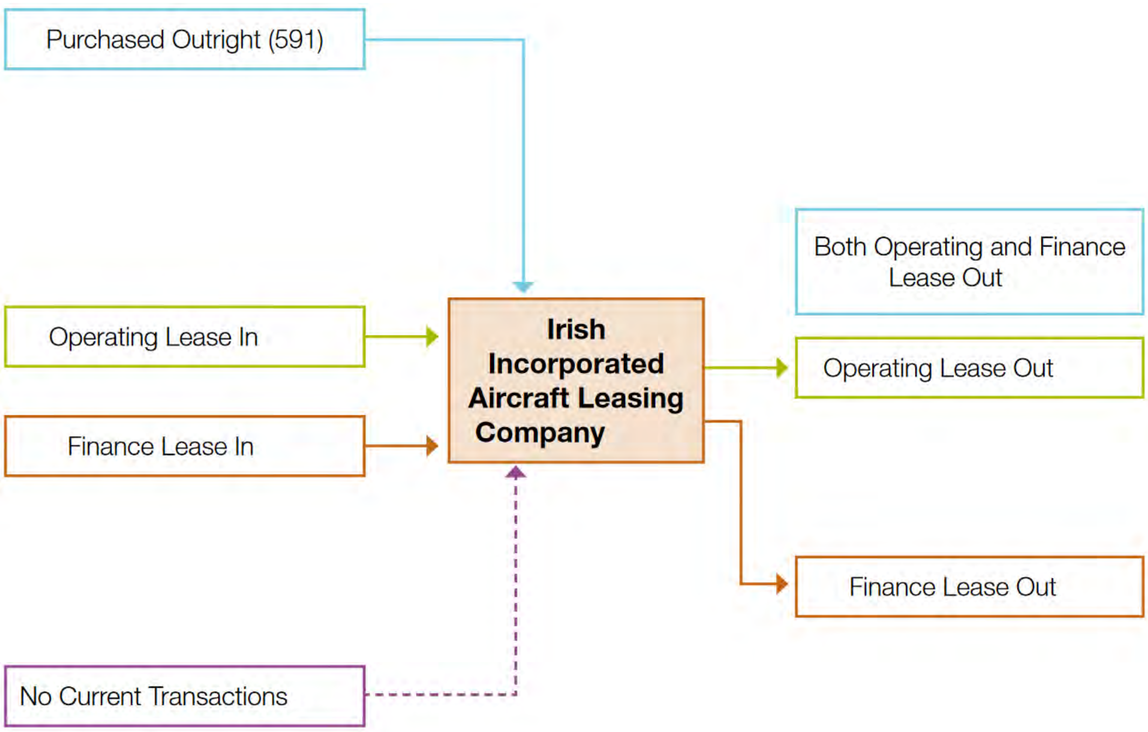
OWNERSHIP STRUCTURES: Owning and operating aircraft involves large initial investment and ongoing running costs. Structures are tailored to each aircraft's usage and location. Different ownership structures are put in place for individual aircraft for tax effectiveness, regulatory compliance or for liability exposure. There is no one-size-fits-all solution.

P

PERMANENT RECORDS: Permanent records are those maintenance records (see above) that must be kept and maintained for the aircraft indefinitely. They reflect the current "status" of the aircraft and are transferred with the aircraft at the time the aircraft is sold. Records could include the total time in service of the airframe, each engine, and landing gear.

PERMUTATIONS: Aircraft ownership can take multiple different ownership and operational structure. For example, aircraft can be leased to either an airline, or to another leasing entity. Leasing arrangements can take the form of either an operating or a finance lease. Different accounting frameworks also apply to operational and finance leases, again leading to further complexity.

An example in an Irish aircraft leasing company shows the multiple permutations possible for one individual aircraft and financing structure.



R

REGISTRATION: ICAO (see above) and country aviation authorities require all aircraft engaged in international flying to have an appropriate nationality mark. The aircraft registration number consists of two parts: a prefix consisting of a one - two - or three character alphanumeric code indicating nationality and a registration suffix of one to five characters for the specific aircraft. This registration number is issued relevant National Aviation Authority (NAA). An aircraft can only have one registration, in one jurisdiction, though it is changeable over the life of the aircraft.

Most aircraft are registered in the jurisdiction in which the airline is based. However, many airlines use offshore jurisdictions where they are leased or purchased but financed by banks in major onshore financial centres. The financing institution and lessors may prefer the aircraft to be registered in a location, for example, Ireland, that has a well-known rule of law, a respected governing aviation authority and favourable tax rates.

RE-REGISTRATION: Aircraft owners or lessors may have to re-register an aircraft and issue a new registration if the aircraft is going into new ownership or coming off lease and returning to a new jurisdiction, e.g. from Asia to Europe. During the period of change of ownership, an aircraft cannot be flown until the Registration Certificate is issued.

Where there is a change of registered ownership or for any change which may have critical implications for an operational aircraft (domestic or foreign operated), the applicants [registered owners and prospective owners] should liaise with the Authority [Aircraft Registration Department] well in advance of such change to ensure a smooth transfer of ownership.

REDELIVERY: When an aircraft has reached the end of its lease agreement, airlines must return the aircraft to the lessee in a condition which meets the requirements set out in the lease (see above) i.e. the ‘redelivery condition’. Precisely what this means will vary depending on the suitability and traceability of aircraft components and maintenance records (see above).

The processes for redelivery of an aircraft are clearly defined. Technical redelivery requirements include the physical condition of the airframe, the maintenance and regulatory records, performance requirements and certification compliance with local regulatory authority requirements.

RECORD KEEPING: Many aircraft contracts contain a “where is - as” clause which means you accept the asset as it is and so need strong technical advice to ensure compliance with all regulatory requirements. It’s also crucial that redelivery conditions and maintenance reserves are fully understood. Lessees unfamiliar with maintenance reserves can be ignorant of their precise workings.

REMARKETING: After the expiration of a lease, an aircraft will be offered – ‘remarketed’ – to other airlines. Aircraft remarketability considerations including age, condition, market demand, economic lifecycle, previous users, quality of maintenance and maintenance records. Apart from lease rates, the parties to a lease will have various priorities which will differ between lessors and lessees. One of the most important considerations for lessors will be the protection of their asset values and precise, efficient record keeping is key to this.

S

SALE AND LEASEBACK: The airline has already purchased the aircraft from the manufacturer, but they have decided to finance the aircraft through an operating lease structure (see above). The airline sells the aircraft to the lessor (see above) and immediately lease's it back. There is no interruption or disruption of aircraft operations, but the transaction gives airlines immediate cash to fund operations.

SHOP VISIT: When an aircraft or engine is sent to a workshop for maintenance or overhaul. Maintenance records (see above) must be scrupulously recorded during visits.

SPECIAL PURPOSE VEHICLE (SPV): A special purpose vehicle, also called a special purpose entity (SPE), is a financing structure where, instead of giving a loan directly to an airline, the lessor or financier will lend the money to a special purpose company. An SPV is a subsidiary created by a parent company to isolate financial risk, with its own balance sheet. Its legal status as a separate company makes its obligations secure even if the parent company goes bankrupt. SPV's are a very useful solution for aircraft ownership for a number of reasons including the fact that the liability rests in the SPV and shareholders are not deemed liable for the debts of the company. SPV's also enable access to different legal or tax systems. An SPV can claim tax deductions for all financing expenses.

STORAGE: Airlines may also choose to temporarily store aircraft due to economic conditions such as rising fuel costs – or a pandemic! Aircraft may be retired permanently and be snapped up by another airline or may only be stored temporarily until conditions improve.

T

TAX: Aircraft transactions – particularly leasing transactions - have multiple tax implications for the lessors and lessees. Since the financial outcome and return on investment for a given transaction are based on tax benefits, tax considerations are the most critical for aircraft lease structures, particularly if the aircraft is being brought into a new jurisdiction.

V

VAT: Value Added Tax is the goods and service tax used in the European Union and United Kingdom. VAT is payable on any aircraft imported into the EU. Aircraft that have previously been exported from the EU and are re-imported to the EU may be eligible for VAT or other tax relief.

VAT DEFERRAL: Certain EU jurisdictions allows some VAT registered business to defer VAT payment to a future date. VAT deferral can mean a significant cash flow saving as the VAT registered SPV can submit a return to reclaim all applicable VAT including the deferred VAT.

VIRTUAL CUSTOMS WAREHOUSE: A virtual customs warehouse is a solution whereby an aircraft can be stored without incurring a VAT liability if the aircraft is going to be sold or used outside the EU. A virtual warehouse is very useful if a lessor or aircraft owner is importing an aircraft from the United States or Asia into Europe and are unsure where the aircraft asset will go to next.

W

WHITE TAIL: An unsold aircraft that has been built by an OEM, e.g. an Airbus, Boeing, Embraer, de Havilland of Canada aircraft built and ready to fly, but not sold.

WET LEASE (See ACMI): When an airline wet leases an aircraft, the leasing company provides an aircraft, complete crew, maintenance, and insurance (ACMI). Wet lease/ACMI are charged per block hour with a minimum guaranteed block hours per month. Typical wet lease / ACMI are from a month to a few years. Everything less than one month can be considered as ad-hoc charter.

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