Article 4 Interest Limitation Feedback Statement July 2021

16 August 2021

Aircraft Leasing Ireland

Ibec

Introduction

Dear Sir / Madam,

As representatives of the aircraft leasing industry, we welcome the opportunity to respond to the public consultation by the Department of Finance on the implementation of Article 4 Interest Limitation under the EU Anti-Tax Avoidance Directive ('ATAD').

Aircraft Leasing Ireland (ALI) was launched in July 2018 as Ireland's first representative body for the aircraft leasing industry. Comprising 32 members, ALI's primary objectives are to maintain and develop Ireland's position as the leading global centre for aircraft leasing and to be the central representative voice on behalf of the industry; this includes to co-ordinate relevant stakeholder input in formulating industry positions.

Our key asks for your consideration as part of the consultation process as set out in this paper are as follows:

- Recognition that operating leasing should be considered a financing activity, the return on which should include an amount that is economically equivalent to interest. This is further to our previous discussions and submissions on this point given its importance to the industry.
- Implementation of the ILR legislation in a way that minimises complexity and compliance costs for Irish taxpayers and in particular Irish aircraft leasing groups. This includes allowing provision for an 'aggregation approach' when calculating the relevant metrics for an interest group.
- Implementation of the ILR legislation in a way that maximises flexibility for Irish taxpayers in the operation of the regime and within the confines of ATAD. This includes provision to allow Irish groups to form multiple interest groups for ILR purposes and acknowledgment that the commercial terms of some debt instruments should not preclude them from being covered by the 'legacy debt' provisions.

We hope that the points outlined below will be of assistance. Please feel free to contact us if you would like us to elaborate on or clarify any of the issues raised.

Question 2 – Definition of Interest Group

The current proposal for the definition of an ILR group in the Feedback Statement is that it would include all members of a Section 411 group but with the ability for individual companies to elect out of the ILR group. We welcome the fact that the definition of group provides for entities to opt out of an interest group.

However, we would ask for the following two enhancements to the definition of the ILR group:

Ask No 1 : We would request that the legislation provide for the ability to form two (or more) interest groups so that a sub-group of companies in a wider tax group may form and operate for ILR purposes as a separate group.

- The reasons for this are twofold:

1) Some larger corporate groups may have two or more independently run businesses / divisions that are operationally separate but may share a common parent. For tax loss group purposes, the divisions can, from a practical perspective (e.g. when claiming group relief), be kept separate but this would not appear to be possible for ILR purposes as the application of the grouping provisions are automatic. This may result in the aggregation of activities that are for operational purposes separate. This would be administratively burdensome as taxpayers would need to aggregate results from these divisions.

2) Being able to keep certain group companies separate from the wider group is important from an aviation finance perspective, where there are often financing covenants that require the separateness of borrower entities to be maintained. In particular, due to financing restrictions, companies in aircraft leasing groups can be legally restricted from 'sharing tax attributes' (which could include interest spare capacity for example) with companies outside of the 'financing group'.

Question 2 – Definition of Interest Group cont’d

- In the absence of being able to form such ‘subgroups’ as a separate ILR group, each individual company that is subject to financing restrictions would need to make a company by company election to keep it out of the wider interest group. This would result in taxpayer groups preparing a number of single entity ILR calculations in parallel to the interest group calculation. This would cause significant practical issues and compliance costs for taxpayers. This outcome could also result in a disadvantageous result for the companies that are subject to financing covenants, which in our view would be a disproportionate burden for such entities that is not warranted by the Directive.

- We do not believe that Article 4(1) imposes a requirement on Member States to have only a single interest group. We note a number of other EU countries, including Germany and Belgium allow for more than one interest group.

Ask No 2 : We request that the definition of relevant group be widened to include any company that is both: (i) included in the ultimate consolidated financial statements of the group; and (ii) liable to corporation tax in Ireland.

The reason for this is as follows:

- This approach would align the interest group concept with the wider provisions of ATAD which apply with reference to the consolidated accounting group. We believe that this approach is justified by the 'accounting group' focus of many of the ILR provisions (e.g. it would seem an unusual strange result if two separate Irish Section 411 tax groups with the same ultimate parent were to compare their results to those of the worldwide accounting group (inclusive of the other Irish Section 411 tax group) under the Equity Rule and Group Ratio Rule without the opportunity to combine the Irish operations into a single interest group).

Question 2 – Definition of Interest Group cont'd

- In terms of a practical example, many leasing groups are required for financing purposes to establish orphan entities (e.g. in an asset backed securitisation structure or an Export Credit Agency debt facility). These entities/structures are established as orphans solely at the request of the financiers and the entities may be included in the group consolidated accounts but would be excluded from a Section 411 tax losses group. It would seem unfair for such entities that are leveraging common and market standard sources of funding to be prejudiced under the ILR rules.

- By including all Irish taxpayers within the wider consolidated group (where permitted under financing facilities, etc.), it should also help alleviate the compliance burden on taxpayers (e.g. reduces the number of ILR groups, avoid preparing carve out accounts for the Section 411 group, etc.). It should also help ensure that intra-group balances between Irish tax resident group companies which are not part of the same Section 411 group do not inadvertently result in an ILR restriction applying (where the balances are solely within the Irish tax net).

- In order to protect from the risk that the above approach could change the operation of the Irish tax losses rules, a protective provision could also be included in the ILR to ensure that any disallowable amount which is to be carried forward as a tax loss under the ILR rules, may only be shared intragroup between companies that would otherwise form a Section 411 tax losses group. For example, if there was only one company in the ILR group which was not also a member of the Section 411 group, it would have to receive its proportionate share of the disallowed amount first. The remaining disallowed amount could then be allocated amongst the members of the Section 411 group (up to the level of each entities' deductible amount).

- It would remain paramount that taxpayers retain the flexibility to be able to form two or more interest groups so as to also ensure that the activities of different operating divisions or bankruptcy remote entities are not included in the interest group (i.e. our Ask no. 1 would also be required).

Question 5 – Legacy Debt

- We welcome the revised definition of legacy debt and the updated approach to the calculation of the 'amount in respect of legacy debt' which may be excluded from the calculation of exceeding borrowing costs. We also understand that where facilities were in place on 17 June 2016, but undrawn, that future drawdowns will be grandfathered – this is also welcome.

- In the aviation sector, it is common for facilities to have a combination of some of the terms of a RCF (i.e. a Revolving Credit Facility – See Appendix 1 for further comments on the key features of such facilities), namely the ability to make successive drawdowns and repayments within a set agreed principal level, and those in a standard existing debt agreement with phased drawdowns. Such facilities are used in a wide range of circumstances in the industry, with both third-party and group lenders, for extended periods of time. Within Appendix 1 we set out a practical example of such a scenario to demonstrate the commercial drivers for facilities with a revolving feature.

Ask No 3 : We would ask that for such facilities, no reduction in grandfathered principal should arise as a result of amounts repaid which are subsequently drawn down again. We would suggest a ‘sunset clause’ of 12 years from 17 June 2016 could be introduced to alleviate concerns that a wide array of debt could remain in place for an extended period of time while providing taxpayers with certainty on the application of the legacy debt exemption for a set period of time.

- We have also included some commentary in Appendix I around the common commercial terms of select forms of facilities seen in the aircraft leasing industry.

Question 5 – Legacy Debt cont'd

Ask No 4 : We would request that guidance be provided on the types of modifications to legacy debt that may be permitted without losing the grandfathered status of interest payable on such debt. We have set out our suggestions for such modifications in Appendix 2.

- We understand that the approach to the application of the exemption included in the July Feedback Statement works such that any amendments to the terms of legacy debt will only result in a limitation to the exemption to the extent that they increase the interest equivalent payable on such legacy debt and, in such circumstances, only to the extent of such increase. We welcome this approach.

- However, there are certain instances in which amendments to loan terms provided for and anticipated within loan agreements as at 17 June 2016 may result in an increase in interest payable on that debt. Where such terms were envisaged in the original agreement, we believe that any increased interest charge arising should also be grandfathered. Such approach should be in compliance with ATAD and in line with the approach adopted by many other Member States. Clarity that certain other amendments which alter the terms of a loan agreement without increasing interest arising would also be welcome. See Appendix 2 for our specific requests in this regard.

Question 8 – Definition of Interest Equivalent

- Further to our previous submissions and discussions, we have summarized below why operating lease rentals for big ticket assets (such as aircraft) include a readily identifiable portion that is 'economically equivalent' to interest.

- ATAD refers to 'taxable interest revenues and other economically equivalent taxable revenues that the taxpayer receives'. This concept has been enumerated in Section 3.4.1 of the current ILR consultation by the wording 'any amount arising from an arrangement, or part of an arrangement, which could reasonably be considered, when the arrangement is considered in the whole, to be economically equivalent to interest.'

- There is no clear definition in ATAD or the BEPS papers of what is considered 'economically equivalent' to interest income. However, it would seem reasonable to assume that a revenue stream that is calculated in a similar manner to 'interest' income should qualify.

- The pricing methodology adopted by aircraft lessors is very similar to any provider of finance. It comprises 3 key elements:

    i. Recovery of the principal amount expended (in this case, on the aircraft);
    ii. The cost of funds of the lessor (i.e. the lessor's interest expense); and
    iii. A financing return for the lessors reflecting the credit risk of the lessee.

- Taking the above, (ii) and (iii) are 'economically equivalent' to interest in our view. The above methodology is very similar (or indeed identical in many cases) to how a lender would price the interest component of a loan after taking into account the identity and creditworthiness of the borrower. The operating lease therefore includes a predictable interest-like return for a lessor (which is economically equivalent to interest income for a lender).

Question 8 – Definition of Interest Equivalent cont’d

Ask No 5 : Given this reality, we would ask that this is specifically legislated for in the new ILR in order to give clarity to companies that are engaged in a trade of leasing. If a legislative solution is not feasible, we request that supporting guidance is clear that a portion of operating lease rentals should fall within 'interest equivalent' where the commercial facts support that position.

- In our view, the sample guidance should apply the following principles:

  i. Recognise that each circumstance should be reviewed on a case-by-case basis as not all operating lessors are the same.
  ii. The position of a lessor and a lessee can be different depending on their circumstances. As noted above, a lessor would be expected to fall within Section 403 for its rentals to contain an amount which is economically equivalent to interest.
  iii. The Lessor should commercially evaluate its operating lease transactions with reference to earning a financing return and should be able to evidence this as required.
  iv. The nature of the underlying asset is such that the lessor is effectively providing long-term finance to fund the lessee’s use of the asset.

- It would also be preferable to provide guidance around how the amount of operating lease rentals that is 'economically equivalent to interest' should be calculated. This should help ensure consistency across taxpayers. We would be happy to work with you to agree an appropriate methodology.

Question 11 – Equity ratio rule

- We welcome the inclusion of both the equity ratio rule and the group ratio rule in the July Feedback Statement. As noted in past submissions, due to different group profiles and wider global group structures, it is impossible to choose a preferred group exception and ATAD clearly permits the selection of both.

- We understand that the ILR group will be required to prepare consolidated accounts in the same GAAP as their ultimate parent in order to qualify for this exemption.

- On this basis, it will be administratively challenging for ALI members to apply the equity ratio rule in practice as most Irish leasing groups do not prepare consolidated accounts consisting solely of the Irish group members and, even in the limited scenarios where consolidated accounts are prepared for the Irish group members, they will likely not be prepared under the same GAAP as the ultimate parent.

Ask No 6 : As audited accounts prepared under the same GAAP as the ultimate parent will not be available in the vast majority of cases, we request clarity in Revenue guidance that management accounts prepared in accordance with the GAAP of the group accounts will be sufficient.

Question 14 – €3 million de minimis amount

Ask No 7 : We would ask that the approach to the application of the 'de minimis' amount in the July Feedback Statement revert to the approach proposed in the December 2020 Feedback Statement. Specifically, we ask that the 'de minimis' amount apply such that the first €3,000,000 of exceeding borrowing costs should be deductible, even where interest exceeds €3,000,000.

- The impact of the change in approach (when compared to that in the December 2020 Feedback Statement) may have a material impact on smaller and newer aircraft lessors establishing platforms in Ireland. This may decrease Ireland's attractiveness as a location in which to set up new leasing businesses.

- The approach adopted in the December 2020 Feedback Statement is in line with that set out in ATAD and we see no reason for the restriction of its application as set out in the July Feedback Statement.

Question 19 – ILR Group calculation

The Feedback Statement proposes that the ILR calculations for a group should be based on 'the results of all the members of the interest group disregarding the results of transactions between members of the interest group'. We understand that this would essentially require some form of consolidated accounts for the ILR group which would then be 'tax adjusted'.

This requirement will be extremely onerous for Irish leasing groups who typically have a significant number of subsidiaries (upwards of 400 companies would not be uncommon) and who will have a combination of intra-group lending, servicing and sale transactions. In such groups where the intra-group transactions are typically all 12.5% trading transactions, the requirement to identify and disregard intragroup transactions will be hugely cumbersome and yet have no impact on the group's ILR calculations.

Ask No 8 : We propose that the calculations for the ILR group should be capable of being done using an 'aggregation approach' based on all the single entity financial statements in the Irish interest group.

An 'aggregation' approach would be favoured for the following reasons:

- The Irish corporation tax regime does not currently provide for tax liabilities to be calculated on a consolidated basis. Each company in a corporate tax loss group is required to firstly determine its own taxable profits and subsequently, can surrender loss relief to other members of the group. Consequently, preparing group tax adjusted consolidated amounts for this single purpose (i.e. the ILR) would be a fundamental divergence from how the Irish tax system works.

- Apart from imposing a significant burden on taxpayers to identify each and every intra-group transaction within the Irish group and adjusting for these transactions (solely for the purposes of this ILR tax consolidation), the companies themselves will continue to be taxed on a non-consolidated basis for all other purposes.

Question 19 – ILR Group calculation cont’d

- It is unlikely that existing Irish group financial statements could be used for this purpose either because (i) they simply do not exist (see previous comments above) or (ii) the Irish group financial statements include entities which are not part of the ILR group (i.e. companies outside a Section 411 loss group or alternatively non-Irish tax resident companies). Therefore, a new standalone set of tax consolidated accounts would need to be prepared for the purposes of the ILR. This would be a significant undertaking for Irish groups.

- Taking this ‘aggregation approach’ would align with how most groups already calculate their group tax provisions and would be administratively much more straightforward and efficient to administer for taxpayers.

- We understand that there is a concern that asymmetry of treatment for intragroup transactions between group members may result in an 'aggregation approach' giving rise to anomalies (e.g. a deductible expense in one company and capital/non-taxable treatment in another). In practice, such asymmetry is very unlikely to give rise to a favourable result for a taxpayer. For example, it would be unlikely that an expense would be deductible as a trading expense in one group company and not taxed as capital in another – in the absence of 'trading' treatment for the receipt, it is more likely that the receipt could be taxed as passive income at a higher rate.

- While we do not believe this is necessary in order to protect the Irish tax base, if the concern on asymmetry needs to be addressed, we believe that it should be possible to include a provision in legislation that requires that 'taxpayer favourable' asymmetric transactions should be stripped out of the 'aggregation approach'. This would address any concern while not burdening taxpayers with the obligation to prepare a bespoke set of consolidated Irish group accounts.

Question 21 – PT calculation

We would agree with the acknowledgement in the Feedback Statement that it is likely to be difficult for taxpayers to accurately estimate the effect of the ILR on their preliminary tax obligations.

Ask No 9 : In acknowledgement of the complexity of the ILR and time it will take to amend systems and processed to implement the ILR, we recommend that Revenue provide a waiver for interest arising on underpayment of preliminary tax arising from the ILR for 2022 and 2023.

This could be implemented by way of legislation or by way of guidance in line with Revenue's practice of waiving interest charges where a company fails to comply with preliminary tax obligations due solely to a fluctuation in currency exchange rates (per: Part 41A-07-01 - Underpayment of Preliminary Corporation Tax). We note that similar reliefs have been provided for FX fluctuations in the past.

Appendix 1

Appendix 1 – Legacy Debt

General Phased Drawdowns of Loans under Existing Debt Agreements

- As noted in our 8 March 2021 response to the December Feedback Statement, it is common in the aircraft leasing industry (as in many other industries) for general loan facilities to be in place, with both group and third-party lenders, for extended periods of time. The terms of such loan facilities can be agreed in advance, with the actual drawdown delayed until such time as is commercially appropriate. The terms of the facility can often remain unaltered in that time, with the only variable being the amount drawn down on the facility (up to the pre-agreed facility amount).

- In light of the definition of 'the amount in respect of legacy debt' included in the July Feedback Statement, we would expect that any taxpayer who has a loan facility in place prior to 17 June 2016 where the agreed facility limit had not been fully drawn down as at that date, should be entitled to drawdown the remaining agreed facility limit, with interest (at the rate set out in the terms of the facility on 17 June 2016) on the drawn down principal up to that facility limit constituting an 'amount in respect of legacy debt'.

- The terms of loan facilities can differ significantly in the industry depending on the source and type of aircraft being financed, however, facilities commonly have the following key terms:
  - a set time period within which funds can be drawn down under the facility;
  - a set term, commonly for 4 to 12 years, though this is very much borrower and transaction dependent;
  - an agreed facility limit;
  - a specified fixed or variable interest rate;
  - pre-defined circumstances under which the borrower can draw down funds, e.g. for the acquisition of specified aircraft on order or in a target portfolio, or select replacement aircraft for such; and
  - event of default provisions under which a borrower may be prevented from drawing down additional funds.

Appendix 1 – Legacy Debt

General Phased Drawdowns of Loans under Existing Debt Agreements (cont.)

- In most cases in the aircraft leasing industry, there will be no set schedule for the specific timeline for drawdowns on the facility as the timing of such will generally be driven by an array of commercial factors which are outside the control of the borrower and lender e.g. the delivery of aircraft, the commencement of a lease etc.

Appendix 1 – Legacy Debt

RCFs

- A RCF, as we see such used and referred to in the aircraft leasing industry, is a form of credit that enables the borrower to draw down money, use it to fund day-to-day business needs, repay it and then withdraw again as required and so on, for the agreed duration of the RCF's term. Borrowings under a RCF are typically of a short-term nature (commonly less than one year and often involving borrowings which are repaid within a few days), with a RCF effectively working as a working capital liquidity source for many RCF borrowers.

- Having reviewed the terms in place across a range of aircraft lessors, RCFs of such lessors generally have the following common terms:
  - a set expiry date, terms of 3 to 5 years are most common;
  - any change to the expiry date typically requires agreement to amend the RCF;
  - a capped facility amount, which may only be increased through an amendment to the facility;
  - pre-defined terms in the agreement under which an entity can draw down and repay repeatedly e.g. drawdowns may be for periods of one, three or six months but need to be repaid within the specified period and rolled again if needed;
  - a specified fixed or variable interest rate, though there are commonly provisions in the facility which mean that the rate will automatically change based on certain external factors, e.g. based on the credit rating of the lessor; and
  - event of default provisions under which a borrower may be prevented from drawing down additional funds.

Appendix 1 – Legacy Debt

Other facilities

- There are other common forms of facility which have a combination of some of the terms described for a RCF and those in a standard existing debt agreement with phased drawdowns.

- While it would be impossible to illustrate the full range of terms for such facilities which exist in the market, in our experience many commonly have the following key terms:
  - a set expiry date (typically not exceeding 10-12 years);
  - a capped facility amount;
  - a specified fixed or variable interest rate, commonly with provisions in the facility which mean that the rate will automatically change based on certain external factors, e.g. based on the credit rating of the lessor;
  - set and pre-defined circumstances under which the borrower can draw down and repay funds, e.g. for the acquisition of specified aircraft on order or in a target portfolio, or select replacement aircraft for such; and
  - event of default provisions under which a borrower may be prevented from drawing down additional funds.

- Such facilities are used in a wide range of circumstances in the industry, with both third-party and group lenders, for extended periods of time. One such circumstance is where a facility with an ability to drawdown and repay is established for short to medium term funding purposes, with an intention to subsequently refinance at better interest rates from alternative sources post acquisition and lease (or re-lease) of targeted aircraft. Such a facility may be established with a capped principal that will only enable an aircraft lessor to borrow funds to finance a limited number of planned aircraft acquisitions at any one time, albeit that the facility has been agreed with an expectation that over its life time it will involve repayments and subsequent draw downs to finance additional aircraft.

Appendix 1 – Legacy Debt

Other facilities (cont.)

- While this type of facility may be in place for various commercial purposes in an aircraft leasing context, one example which may be easiest to set out involves cargo aircraft lessors. Such lessors may acquire later life passenger aircraft, either off lease or with a short-term lease remaining, which are funded by such a facility. The relevant cargo aircraft lessor will then engage a company to convert the aircraft from a passenger aircraft to a cargo aircraft. This process could take anywhere from 6 months to a year, and, if the aircraft is first acquired with a short-term (1-2 years) lease remaining while it is a passenger aircraft, the aircraft could be owned for 2-3 years before it has been converted and is re-leased as a cargo aircraft.

- Financing for such an aircraft with a short-term passenger lease remaining and during the conversion process is relatively more expensive than financing post-conversion and lease out as a cargo aircraft as banks or other lenders may view the initial period pre and during conversion as relatively riskier than the post-conversion lease period, at which stage a longer term sustainable lease income flow may be established. As a result, there are generally specific lenders willing to provide finance to cargo lessors for aircraft during this initial acquisition and conversion phase who charge higher rates of interest during such period to account for the perceived higher risk. While such lenders will cap the amount of finance under a facility which can be provided at any one time, they may provide an ability to drawdown and repay for multiple aircraft financings. Post completion of any one conversion and arrangement of a cargo lease, the lessor will then typically look to refinance at better rates for that aircraft while potentially drawing down on the facility for another aircraft acquisition.

- Similar financing arrangements may equally be in place for standard operating lessors which look to acquire passenger aircraft nearing the end of a lease term, even where the subsequent lease is expected to be to a passenger airline. The short existing lease term may lead to a higher interest rate on initial financing available until such time as the aircraft is re-leased for a longer period of time.

Appendix 1 – Legacy Debt

Other facilities (cont.)

- Such facilities therefore represent a significant and ongoing (though generally with a set expiry date) source of short to medium term rolling funding for many cargo and other aircraft lessors, with consequential levels of interest arising on such in light of the higher rates on such loans. Given the nature of these arrangements, involving a regular flow of short to medium-term drawdowns and repayments on such facilities for many lessors, the agreed principal on such funding as at 17 June 2016 may in many instances be exhausted at this stage already if repayments were set against the drawdowns in determining the grandfathered principal (as we understand may have been contemplated as an option in applying the legacy debt exemption).

- In our view, it would be unfair to discriminate between credit facilities provided for under a phased draw down loan and a facility with an ability for repeat draw downs and repayments, such existing for clear commercial purposes as illustrated above.

Appendix 2 – Legacy Debt : Modifications

Modifications

- We set out below some common amendments which, even if such were to result in an increase in the interest payable on legacy debt, we would view as not constituting a modification:

    1. The mere drawdown of debt pursuant to a loan facility or commitment entered into before 17 June 2016,

    2. An interest rate change applied to an existing loan within the existing terms of the loan such as swapping from floating to fixed interest rates, or an increase due to the decline in credit rating of a borrower due to the current crisis,

    3. Loan amendments where banks have specific collateral against particular aircraft for:
        - replacement aircraft if a delivery is delayed,
        - changes to the underlying leases that also need to be reflected in the loan documents, or
        - if substituting an aircraft out of the facility if the airline goes bankrupt before or during the period of the loan.

    4. Exercising permitted flexibility within the loan facility e.g. banks often have the right to syndicate their share of the loan. This requires borrower consent and a loan amendment to facilitate syndication between the banks or the introduction of a new lender,

    5. Updating loan agreements for changes in law,

    6. Dealing with specific issues relating to Covid-19, such as technical covenant amendments etc.

Appendix 2 – Legacy Debt : Modifications

Modifications (cont.)

- It is unlikely that the technical amendments referenced in items 3 to 6 above would result in an increase in the interest payable on legacy debt in any case. However, items 1 and 2 may well result in interest in excess of that which would have arisen if the changes had not been made, hence, if such amendments are regarded as a modification, a limitation may apply to the application of the legacy debt exemption.

- Guidance on this area will be important to ensure that there is clarity for taxpayers in the application of the legacy debt provisions and we ask that the scenarios above be included as examples of modifications which will not result in a restriction.