

The potential impact of the American Jobs Creation Act on the ownership of aircraft held for lease

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When George W. Bush signed the American Jobs Creation Act of 2004 in October of that year, he created several significant amendments to the Internal Revenue Code. One change, in particular, has potentially far reaching consequences for US aircraft lessors. In this article I provide an overview of the American Jobs Creation Act and the impact that it might have on the ownership of aircraft held for lease.

How often does an opportunity arise to create a permanent deferral of US taxes? How would you feel about reducing taxes on ongoing income by about two thirds? Add the possibility of writing back deferred tax provisions and you can see how powerful the application of the American Jobs Creation Act of 2004 can be for US lessors.

What is the American Jobs Creation Act of 2004?

The World Trade Organisation ruled in 2000 that the US Extra Territorial Income regime (remember the FSC?) represented an illegal subsidy to US exporters. There was little impetus for change until the EU began to impose duties on imports from the US. Initially, the American Jobs Creation Act of 2004 (JCA) was designed as a response to this ruling (and the EU levies), creating a new deduction for manufacturers. However, what began as a bill to compensate exporters morphed into a 900-plus section, 450-plus amendment Act catering to various other special interest groups.

Running to 270-plus provisions, the JCA, not surprisingly, adds more complexity to the tax code. I hope that this article will not add a further layer of complexity to people's understanding.

Let us get some definitions and background out of the way. A foreign company is regarded as a Controlled Foreign Corporation (CFC) if more than 50% of its voting stock is owned by US shareholders, each of which owns at least 10%.

Subpart F of the Internal Revenue Code (Subpart F) describes certain types of income of a CFC that must be taxed on a current basis in the US. There are carve-outs where such income is generated in the active conduct of a trade or business. The determination of whether rent is derived in the active conduct of a trade is made based on an assessment of all the facts and circumstances, but normally this means that the company will have the resources and in-house personnel required to run the business independently and on an ongoing basis.

Have you ever wondered why, with the exception of GECAS, the major US lessors have not – until recently – had any significant operating presence in Ireland and, without exception, had not located any of their portfolios in Ireland?

The answer is that Subpart F income separately and additionally included "foreign base company shipping income" without carve-outs for active trade. This income source covers income derived from a vessel or aircraft used in foreign commerce. The "active trade" test was rendered meaningless for aircraft leasing companies and the location of ownership, therefore, pretty irrelevant. The US shareholders of CFCs were required to include the aircraft leasing income of the CFCs in their currently taxable US income – regardless of whether the income was distributed to them. In the case of a CFC that was wholly owned by a single US shareholder, the result was to tax the CFC's profits in the US in the same way as they would have been taxed had they been earned by a US person.

The JCA eliminates income from the leasing of a vessel or aircraft in foreign commerce from the definition of Subpart F income. The rules apply only to aircraft operated outside the US. There are still accelerated depreciation benefits to a US lessor owning US-operated aircraft in the US.

The consequence of the change is to, more or less, standardise the US tax treatment of the income derived by active

aircraft and ship leasing CFCs with the treatment of other active businesses.

So, what happens next?

US lessors should (and will) centralise all of their non-US leasing business in foreign subsidiaries. Not only that, but – in a dream scenario – they will look for the jurisdiction with a zero tax rate to be the booking office, since there is little point in moving from one high tax regime to another. The reverie will soon be interrupted by the real world requirements for an "active trade", for skilled personnel capable of devising and executing transactions and for withholding tax exemptions.

The best base for operations is one with a low tax rate, a wide network of lease-friendly tax treaties and an availability of skilled people to make the whole thing happen – the marketing of the aircraft, the documenting of the lease, the management of the resulting leases.

Such a place is closer than you think.

A brief time in history

As an island nation, Ireland, since early times, has been compelled to look across her borders for trade and development opportunities. Because of this dependence on cross-border trade, it is little surprise that her tax treaty network is extensive – there are 45 in all with nine more in the process of ratification. The treaties are also quite lessor-friendly and sympathetic toward the recipient of payments out of Ireland.

In 1954, the Irish Government instituted a tax system aimed at encouraging inward investment. A zero percent corporate tax rate was aimed at stimulating manufacturing and exports. A special tax free zone was established at Shannon Airport to assist in the creation of employment in the surrounding region (the Shannon Zone tax rate increased to 10% in 1990). The licensing system for Shannon's low rate was designed to also encourage non-manufacturing companies. A second incentive zone was established in Dublin's International Financial Services Centre (taxed at 10%) in 1987.

These incentive rates evolved into the current corporate tax rate of 12.5%. This is a non-incentive rate applicable nationally to all active income sources.

In 1975, Tony Ryan established Guinness Peat Aviation Limited (GPA) in Shannon. Its phenomenal growth, sparked by talent, ability, a favourable tax regime and dogged determination to succeed was to create a major aircraft leasing infrastructure of experienced marketing, technical, legal, financial structuring, tax advisory and support services personnel. Notwithstanding GPA's subsequent setbacks, the infrastructure that it created has thrived and grown, and the knowledge and experience has spread widely in Shannon and Dublin.

Arising from these 30 years of leasing experience, Ireland is an operating lessor's

dream come true – low tax rate, lots of tax treaties, a helpful legal and regulatory framework, highly skilled, experienced and effective professionals. And let us not forget that with the onset of global warming all of the prerequisites for a “paradise island” are in development.

Back to the Future

The criteria whereby the income from foreign based aircraft leasing will fall outside the US tax net are quite stringent. There is no free for all for brass plate operations. The “active trade” requirement will be judged on a facts and circumstances basis. An alternative means of qualifying is to pass a pretty onerous safe harbour test. CFCs that pass the safe harbour test are automatically assumed to be engaged in an active trade.

The safe harbour test measures whether the active leasing expenses exceed 10% of the leasing profit (each as determined in the regulations).

The Treasury Regulations give guidance on the assessment of facts and circumstances. Rent is considered to be derived from an active trade of leasing where it is generated as a result of the performance of the marketing functions of a company through its own employees located in a foreign country and where the company maintains and operates an organisation that regularly engages in the business of marketing or marketing and servicing of the leased property.

A number of Irish subsidiaries of US leasing companies already have substantial operations in Ireland – GECAS and, more recently, CIT come to mind. These operations consist of the marketing, asset management, technical and other resources needed to run an aircraft operating leasing company.

As we know, some US venture capital firms and hedge funds are assembling large portfolios of non-US operated aircraft. It seems sub-optimal to subject the profits of these portfolios to US taxation. These owners (and the other US lessors) may not find it as easy to assemble internally the requisite skill sets needed to comply with the regulations to be a qualifying CFC. GECAS already had over 100 people of varying skills including the all-important marketing group based in Shannon. CIT also had a presence – but to a lesser extent. However, CIT has relocated a significant number of its senior team to Dublin in order to copper-fasten the active nature of the business generated out of Ireland.

For those that find it difficult to assemble or relocate the required blend of people and skills, there are some smaller Irish-based leasing companies that have substantial portfolios and active businesses already in place. It will not be beyond the imagination and ability of some of the non-aligned Irish operations to form alliances with various US leasing companies, establishing further major operation bases in Ireland. However, the relocation of senior people can be an expensive and complex arrangement.

An increase in joint venture activity may be on the horizon for unaligned lessors that can transfer personnel and assets to a joint venture, to match assets contributed by US aircraft owners. A pre-existing track record involving significant activity will always be an advantage.

Regardless of taxation considerations, the volume of operating leased assets will require the new entrants to create adequate operating platforms. With the additional tax-generated benefits to be gained from holding aircraft overseas it seems to me that ultimately, some of the smaller players may be acquired by US lessors primarily for their skilled teams of marketing and other transaction staff.

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ENDNOTE

1. Pembroke Capital Limited, established in 1993, with offices in Shannon and Dublin, Ireland, manages the leases of approximately 100 aircraft to 39 airlines in 25 countries around the world. The portfolio consists of a mix of single-aisle and twin-aisle Stage 3 jet aircraft. Although it acts as a principal for its own account, a significant proportion of Pembroke's current portfolio is managed on behalf of third party banks, financial institutions and airlines.



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