

Airfinance Annual

2018/2019

www.airfinancejournal.com



AIRFINANCE
JOURNAL

Jolco rides the wave

The Japanese operating lease with call option goes where banks fear to tread. By Caroline Devlin, partner, co-head of tax and leasing, and Laura Cawley, associate, aviation group, of Irish law firm Arthur Cox.

After a dip in popularity during the economic downturn, the Japanese operating lease (Jol) and Japanese operating lease with call option (Jolco) structures continue their rise. It is perhaps obvious because they offer up to 100% financing to airlines, and produce an attractive internal rate of return to investors with interesting tax allowances, a level of finance which is beyond the appetite of banks.

Both new and traditional airlines are using this financing arrangement, and it is becoming increasingly popular in Asia, including with airlines with no Japanese routes.

Jolco structure – tax considerations

From the Irish perspective, the fact that the Irish lessor does not own the aircraft does not present any particular Irish difficulties, and Irish lessors are frequent users of Jol/Jolco structures. Looking at the Irish tax position, it is not necessary that an Irish entity owns an asset in order to obtain tax depreciation (or capital allowances). Rather, the allowances are given to the entity that bears the burden of wear and tear.

Also, there is no Irish withholding tax on rent (or interest) paid from Ireland to Japan. While there is a double-tax treaty between Ireland and Japan, it is not required here, because there is no Irish withholding on aircraft lease payments in any event.

Interestingly, the treaty between Ireland and Japan permits a withholding of up to 10% on interest payments between the two territories; however, as a matter of domestic Irish law, Ireland does not levy withholding tax to recipients in double-tax territories. The same is not the case for payments of interest from Japan to Ireland.

Irish leasing companies are traditionally either trading companies – subject to tax at 12.5% on their net profits, after all expenses and allowances, including capital allowances – or “Section 110 companies” which are technically taxed at 25% but, in practice, would have a negligible profit.

Irish companies will typically satisfy the substance requirements set down in BEPS (base erosion and profit shifting), and will have their centre of control and management in Ireland. It is increasingly common that airlines will be concerned to ensure that their lessor has the required level of substance, and is the beneficial owner of the rental income stream, in order to ensure that the airline can safely pay rent free from withholding tax in its own jurisdiction.

The Jol/Jolco structures do not impact on this analysis, because the Irish lessor will typically maintain the same level of substance and overview of its portfolio, whether financed through a Jolco or otherwise.

It is not necessary that an Irish entity own an asset in order to obtain tax depreciation or capital allowances.

Part of the attractiveness of the Jolco is the tax allowances available under Japanese tax laws. As with any product that derives value from tax breaks, the sustainability of the Jolco is, to some extent, dependent on Japanese tax rules, and rules can change. This is relevant when considering how the risk of tax changes is to be shared between the parties, whether funding might terminate early, and what inventive solutions might be found should a change occur. However, it is clear that the structure is well known to legislators and, for the time being, enjoys popularity. In any market, this can seem like a lifetime.

Aircraft mortgage registrations

The aircraft mortgage will generally be considered to be the primary protection available to a creditor in the senior secured portion of the Jolco financing transaction.

In taking an aircraft mortgage, the creditor will be mindful to ensure that it procures the most robust protection in each jurisdiction that the aircraft, the owner and the lessee are operating in, subject always to the commercial realities of each particular transaction.

As in a Jolco, the owner of the aircraft is generally located in Japan, so in the interests of certainty, familiarity and speedy accessibility to remedies and enforcement mechanisms, it would generally follow that the aircraft would be registered in that jurisdiction.

An aircraft mortgage in Japan will be registered with the Japanese Civil Aviation Bureau (JCAB), which is a department of the Ministry of Land, Infrastructure, Transport and Tourism in Japan. The JCAB aircraft registry is open to the public. (In the case of an equivalent Irish company granting a mortgage over an aircraft, details of the aircraft mortgage would also be filed in the Irish Companies Registration Office, which is also open to review by the public.)

There is a two-step optional process to registration of the aircraft mortgage in Japan:

1. A provisional registration of the aircraft mortgage, which will secure priority; and
2. A full registration, which is required to enforce against the debtor which is more costly.

In most cases, the provisional registration will be made as a matter of course, and if and when there is a real risk of default, the full registration will be made in order to support enforcement. The mortgage registration must disclose information on the secured obligations amount, the interest amount and conditions to the secured obligations which, given the increasingly competitive marketplace, is not ideal if this creates a scenario whereby other industry players can deduce the terms of lending from the publicly available registration document.

If the aircraft was owned by an Irish entity, the registration of the charge in the Irish Companies Registration Office will be made for a fee of €40 (¥5,210) and the particulars described can be limited to what is needed for a third party to identify the asset being mortgaged and the parties involved.

Significantly, Japan is not a contracting state to the Cape Town Convention (Ireland is), so a route to registration, other than the location of the debtor, would be required.

Priority of security

In Japan, whereas the full mortgage registration protects against third parties and gives priority over subsequent registered security interests, the typical provisional registration will give priority over subsequently registered security interests only, but full registration is needed for the mortgage to be enforced.

The registration in the Irish Companies Registration Office will give priority over a liquidator and any creditor of the company which will run from the date of registration. Any mortgage registered ranks ahead of any mortgage or charge subsequently registered; however, a registered mortgage will not take priority over a possessory lien for work done on the aircraft, whether before or after the creation or registration of the mortgage and also any rights of detention (for instance, unpaid airport charges, air traffic control charges and Eurocontrol charges).

The international registry filings of course rank priority on a first-to-file basis, unless this is amended by subordination, which can only be achieved with the consent and knowledge of all parties which have a previously registered interest in the aircraft. This is the case, even if the first registered interest holder has knowledge of an existing unregistered interest. The international interest in the aircraft mortgage will be effective even if it is registered prior to the debtor's insolvency, although the timing of insolvency will be determined by the relevant jurisdiction.

Enforcement of security

Enforcement in Ireland is, on the face of it, more straightforward and appealing to the creditor. In the first instance, the legal aircraft mortgage in Ireland can be enforced without intervention from the court. The concept of "self-help" prevails under domestic Irish law, whereby, in essence, on an event of default under a mortgage, the creditor can take possession of the aircraft (or appoint a receiver to do so) without judicial intervention and subsequently sell the aircraft, provided this has been specified in the mortgage document or elsewhere in writing.

In practical terms, the creditor can go to court where the debtor resists repossession or where there is a dispute about whether there has been an event of default.

In reality, however, a court order will be sought for the purposes of certainty of title on resale of the aircraft. The Commercial Court in Ireland offers speedy court remedies.

In Japan, the creditor will need to perfect the registration of the aircraft mortgage in the JCAB, and pay the debt-gear fees as a prelude to enforcement.

Also, in Japan there is no concept of self-help. Unless there is cooperation between the lessee and the owner, the creditor will need to commence a court procedure to enforce the aircraft mortgage by way of public sale supervised by a court (a court sale).

Where there has been a filing of the international interest constituted by the aircraft mortgage in the International Registry, there are significant pro-creditor remedies that can be utilised – such as taking possession of the aircraft without obtaining a court order, deregistering and exporting an aircraft by exercising rights under an irrevocable deregistration and export request authorisation, selling or granting a lease of an aircraft object, collecting or receiving any income or profits in connection with the management or use of the aircraft and obtaining interim relief pending final determination of any claim.

In addition to these, the election of Alternative A under Cape Town in Ireland now allows, where there is insolvency, the creditor to take possession of the aircraft, if the debtor defaults and fails to perform its obligations under the aircraft mortgage for 60 days.

The limitations to the legal aspect of enforcement of an aircraft mortgage in a Jolco transaction may never come into play because once the aircraft is located outside of Japan, this jurisdiction can be relied on for enforcement and if this jurisdiction is a Cape Town Contracting State, the protections under the convention will become available.

More Japanese investment to come

Despite some of the potential hurdles described above, which can generally be structured around, it is clear that the Jolco is only increasing in popularity. High tides carry all boats, or perhaps aircraft even, and the strong steady flow of funding through Jolcos facilitates the growth of both airlines and lessors, while giving a Japanese investor tax advantages and access to the attractive aviation industry.

Although there was a reported slowdown in the Japanese market in the first quarter of 2018, GDP rose in the second quarter. The economy is projected to reach growth of 1.25% in 2018 and growth is projected to remain above 1% through 2019, according to the OECD Economic Outlook, Volume 2018 Issue 1.

These figures suggest there will be increasing Japanese equity investment available in the market. Any uncertainties over global trade tensions or the outcome of the Brexit negotiations are not obvious here. ▲