

Recent developments in the PRC aircraft leasing market – calculation of customs duties and relaxation of foreign security rules

Overview

There have been two recent developments in the PRC which have drawn the attention of both domestic and foreign leasing companies. The first concerns the calculation of dutiable value for aircraft leasing contracts in the context of customs duties and other taxes collected by the PRC customs authorities. The second concerns the rules governing foreign security which, although not specifically related to leasing, eases restrictions on foreign security that may be provided by Chinese leasing (and other) companies in cross-border transactions. This client briefing provides a summary of these two developments, focusing in particular on the aircraft leasing industry.

Foreign Security – Easing Restrictions

On 30 July 2010, the State Administration of Foreign Exchange (SAFE) issued the long-awaited *Notice regarding the Administration of Foreign Security Provided by Domestic Institutions (Hui Fa No. [2010] 39)* (SAFE Notice). The SAFE Notice, effective from the same date, substantially amended the previous regulations governing the grant of foreign security, namely *the Administrative Measures on Foreign Security Provided by Domestic Institutions* and its implementing rules, promulgated in 1996 and 1997 respectively (Foreign Security Regulations).¹

China is a jurisdiction that maintains foreign exchange controls. The Foreign Security Regulations were implemented as part of a wider regime regulating cross-border cash flow. Foreign security, in the context of the PRC's foreign exchange regime, means security or a guarantee provided by a PRC resident to a foreign resident. Foreign security comprehends security provided by domestic entities (security providers) in favour of foreign entities (beneficiaries) to secure the obligations of either domestic entities or foreign entities (secured parties) (if the beneficiary is a domestic entity but the secured party is a foreign entity, such security is also deemed to be foreign security). Under the Foreign Security Regulations, the basic principle is that foreign security is subject to approval from and/or registration with SAFE. In the context of aircraft leasing, the lessor is typically an offshore or onshore special purpose vehicle (SPV), and it is not uncommon to see corporate guarantees provided by the lessor's parent company (in most cases, the PRC operating lessor itself). No matter whether the SPV is an onshore or offshore company, if the beneficiary of such guarantee is an offshore entity, then such corporate guarantee would fall within the scope of foreign security and will require SAFE approval.

Key Issues

Overview	1
Foreign Security – Easing Restrictions	1
Import Duties and VAT – Calculation of Dutiable Value for Aircraft Lease Contracts	3

If you would like to know more about the subjects covered in this publication, please contact:

Beijing
[Tiecheng Yang](#) +86 10 6535 2265

Shanghai
[Katherine Ke](#) +86 21 2320 7248

Hong Kong
[Paul Greenwell](#) + 852 2825 8857
[Christie Fang](#) + 852 2826 3522

If you would like to know more about our China publications, please contact:

[Chlorophyll Yip](#) (852) 2826 3426

Clifford Chance, 28th Floor, Jardine House,
One Connaught Place, Hong Kong SAR
www.cliffordchance.com

¹ Please refer to an earlier briefing titled "China eases restrictions on foreign security" which we have circulated via China Focus in September 2010.

This newly issued SAFE Notice generally relaxes the restrictions and procedural requirements for obtaining such SAFE approval. Different procedural regimes have been introduced to govern foreign security depending on the organizational type of the security provider (i.e. whether the security provider is a bank, non-banking financial institution or enterprise) and the nature of foreign security itself (i.e. whether the secured obligations are in the nature of financing or not). The table below summarizes the new regulatory regime:

Types of Security Providers	Banks		Non-banking Financial Institutions and Enterprises	
	Financing foreign security	Non-financing foreign security	Financing foreign security	Non-financing foreign security
Qualification requirements of secured party and beneficiary	No	At least one party should be a domestic institution or offshore institution directly or indirectly held by domestic institutions	For non-banking financial institutions, the secured party must be a domestic institution or a foreign institution held directly or indirectly by a domestic institution; For domestic enterprises, the security party must be an affiliate that the security provider holds directly or indirectly in or outside China.	
SAFE approval	Annual quota	No SAFE verification requirement or quota requirement	Case-by-case SAFE verification required if not subject to quota	
Performance of security	No SAFE verification required		Case-by-case SAFE verification required	
Registration	Monthly filing		Case-by-case registration within 15 days upon the execution of the foreign security agreement	

One notable change is that non-banking financial institutions or enterprises that satisfy certain requirements may apply to SAFE for an annual quota within which they can provide foreign security without going through a case-by-case approval process (except for certain kinds of foreign security, e.g. the secured party is financing for the purpose of an acquisition). Such requirements include:

- the applicant provides foreign security with a relatively high frequency;
- the applicant has a sound and standard internal management system;
- for a non-banking financial institution, SAFE will also review its paid-in capital, working capital, net assets in foreign exchange, the foreign security business in the preceding year, compliance with foreign exchange regulations in its general and business plan etc.; and
- for an enterprise, the ratio of net assets against total assets shall not be lower than 15%.

This change makes it possible for PRC leasing companies to obtain an annual foreign security quota from SAFE, so that they can more easily provide foreign security for the obligations of their SPVs under loans or leases, etc.

It is still unclear whether such a quota will be used with any frequency by PRC leasing companies. Some factors giving rise to this uncertainty are set out below:

- it is unclear whether the quota approval can be easily obtained;
- it is unclear whether the verification for performance of the foreign security can be easily obtained;
- if the secured party is an offshore SPV, it is required to be an entity directly or indirectly held by the leasing company. However, leasing companies regulated by the China Banking Regulatory Commission (CBRC) are subject to restrictions governing the ownership of offshore SPVs; and
- existing security or other credit support arrangements which do not require the provision of foreign security may be accepted by foreign lenders, in which case, PRC leasing companies may lack the commercial motivation to apply for such a quota.

Import Duties and VAT – Calculation of Dutiable Value for Aircraft Lease Contracts

The General Administration of Customs (GAC) of China issued Announcement 47 in respect of the duties related to certain expenses under aircraft lease contracts (Announcement 47). Announcement 47 is to be read as a supplement to the *Measures for Determining Dutiable Value of Imported and Exported Goods* issued by GAC on 28 March 2006 (Dutiable Value Measures) and basically clarifies that certain expenses under aircraft lease contracts shall be calculated as part of rentals which means they are dutiable in respect of import duty and other taxes collected by the customs authorities (e.g. import value added tax (VAT)). A summary of the most relevant provisions affecting aircraft leasing contracts is set out below.

Maintenance Expenses

- The overhaul expenses for which the lessee is responsible under the lease (whether incurred in or outside PRC) shall be included in the dutiable value as rentals.
- The expenses for maintenance carried out by the lessee outside the scope provided in the lease shall be included in the dutiable value in accordance with Article 31 of the Dutiable Value Measures, if such expenses are incurred outside PRC.
- The maintenance reserves which will be retained by the lessor at the end of the lease shall be included in the dutiable value as rentals.
- The compensation paid by the lessee to the lessor at the end of the lease if the aircraft does not meet the redelivery conditions shall be included in the dutiable value as rentals.

Domestic Taxes

- If the lessee, in accordance with the lease, pays for certain PRC taxes imposed on the lessor (e.g. income tax and business tax etc.), such payment shall be included in the dutiable value as indirect rentals.

Insurance Premium

- The insurance premium paid by the lessee for hull and machinery all risks insurance (whether incurred in or outside PRC) shall be included in the dutiable value as indirect rentals. If the premium for different types of insurance cannot be identified on the insurance policy, the relevant premium shall not be included in the dutiable value.

Retrospective Effects

- Announcement 47 shall be effective from the date of its issuance, i.e. 19 July 2010. If the lease had not been fully performed by 19 July 2010, the duties under such a lease shall be adjusted in accordance with Announcement 47.

Announcement 47 was issued by GAC. Because withholding tax and business tax are not within GAC's jurisdiction, it is unclear whether the above mentioned maintenance expenses, domestic taxes and insurance premium calculations shall also be regarded as part of rentals in the context of calculating withholding tax and business tax payable by foreign lessors. In any event, Announcement 47 may not be welcome news to PRC airlines and their foreign lessors, as it will

likely increase the burden of customs duties and import VAT applicable under cross-border aircraft leases (and in turn make leasing from domestic lessors commercially more attractive).

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