AIRCRAFT LEASING

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In the field of aircraft finance as in other fields of business activity in Canada and the United States today, there is a trend towards leasing items of capital equipment instead of purchasing such equipment.[1] Airlines have begun to use the lease as a means of acquiring aircraft, powerplants, spare parts and ground support equipment to expand their fleets and facilities, but at the same time to remain competitive under economic conditions which have made the outright purchase of such equipment undesirable or impossible.[2] There are circumstances which make leasing an attractive proposition to a carrier regardless of whether or not it has funds available to purchase the equipment.[3] In the aircraft industry in recent years, the manufacturers of airframes and engines have offered sufficiently attractive rental terms to make rental as an alternative to ownership worthy of careful consideration by many airlines.[4]

This study is intended to serve as an outline of some of the more important financial and legal considerations inherent in aircraft leasing which would normally be taken into account by the management of an airline in deciding whether or not to lease equipment.

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[1]As of October 31, 1962, the Boeing Airplane Company had on lease 9 B-720B's to Northwest, 2 B-707-120's to Pan-American and 5 B-707-320B's to TWA; Lockheed Aircraft Corporation had on lease 9 1049's to Capitol and 6 L-1049H's to TIA; Eastern had leased 10 B-720's, Northeast had leased 6 Convair 880's, Swissair had leased 4 Caravelles from S.A.S. and S.A.S. had leased Convair 990's from Swissair. In addition, a recent survey indicates that Pacific Northern, Slick, Interocean, British West Indian Airways, Air Afrique, Ansett, Air Ceylon and Thai Airways International are among the air carriers currently operating part of their flight equipment under lease arrangements.

[2]Steadman, "Chattel Leasing — A Vehicle for Capital Expansion" (1959) 14 *Bus. Law.*, 523; "It has become increasingly difficult for American businessmen to purchase new production and service equipment or to expand their facilities. Rising costs and the inadequate depreciation policies of the federal government's tax program have combined to shrink the corporate capital reservoir which in the past has supplied the funds for these purchases. To escape this capital squeeze, many corporations have begun to lease the equipment they formerly purchased outright. These companies now lease trucks, cars, buses, railroad cars, barges, airplanes, jet engines, machine tools and supermarket fixtures."

[3]White, "Equipment Leasing, Some Pros and Cons", *The Controller*, July 1957, p. 332.

[4]American Airlines has leased engines for its 25 Boeing 720's, 4 Convair 990's and 30 Electras (including the latter's propellers) from Allison, General Electric and Pratt & Whitney.

Financial Aspects

An important consideration for airlines whose earnings records have not been good and who as a consequence are short of capital, is that leasing avoids the investment of funds required in the case of purchase. Even when conditional sales provide credit over an extended period of time, the terms of sale normally require a down-payment, and other payments are scheduled at a rate faster than anticipated depreciation in value of the equipment. Through renting, the airline may obtain new equipment while avoiding the necessity of tying up its funds in the ownership of equipment. The airline may then release capital that would otherwise have been frozen. Presumably the released funds could be employed at higher rates of return in other uses than equipment ownership. Under present circumstances, in which marginal profits are general among the carriers, an airline management may prefer to lease and use its capital savings for conducting current operations. Leasing is particularly attractive to an airline desiring to expand its operations. It is recognized as a basic economic fact that capital which works, earns. Accelerated capital turnover, which results either from the use of more working capital or from turning the same capital over more quickly, increases profits in relation to the shareholders' investment. In addition, the financial position of the lessee airline is usually much stronger when it turns to its bankers for additional funds to bolster its operating capital.

Leasing may be attractive to an airline initiating a new route with previously undetermined load factors or desiring to gain experience on a new type of equipment. It also permits the interchange of equipment among carriers with seasonal peaks. A carrier with a North Atlantic route will need more equipment to take advantage of the summer traffic while an Eastern seaboard carrier with a Florida route will be busiest in winter. The lease will be used on a short term basis to supplement the carrier's normal fleet requirement. The carrier may thus achieve flexibility through leasing.

In periods preceding the introduction of new and more economical types of equipment by the aircraft manufacturers, the lease may be used as a hedge against obsolescence. The risk of obsolescence which is ever present in the aircraft industry is thus shifted to the lessor.

A number of engine manufacturers are prepared to offer a guaranteed maintenance charge fixed on an hourly basis in relation to their commitments as lessors. The manufacturer as lessor may carry out maintenance, overhaul and servicing of the powerplant for a fixed hourly charge negotiated with the lessee. In theory at least, the manufacturer should be able to perform this work more economically than the lessee since the manufacturer's personnel have no learning problems and are using fully equipped facilities which are already established. This service can reduce the lessee's own cost accounting problems, eliminate the administration of one entire operation and enable the

airline to analyze powerplant operation with a minimum of cost tracing. Definite forecasts of expenses can be made accurately and the risk of introducing a new type of engine into service reduced at least from the financial point of view.

In leasing its equipment, the airline does not become involved in the difficulties of disposing of the used aircraft. This sometimes troublesome problem is left with the manufacturer whose sales staff may be better organized to locate potential customers for the used aircraft than the airline, particularly if it be a local carrier without nation-wide contacts.

If the lessor is a manufacturer or manufacturer's subsidiary in the United States, the financing of the transaction may be handled through the manufacturer's bank. The bank will advance money to the manufacturer on its note, receiving the assignment of the lease and rental. The advance may or may not be secured by a chattel mortgage.[5] In aircraft leasing where new equipment is concerned, the manufacturer or its subsidiary created for the purpose will act as lessor. Usually the lessee is a prime lessee; otherwise the parent guarantees the credit of its subsidiary. In some cases financial organizations have acted as lessors, or trusts may be established by banks or finance companies to act as lessors.[6] Another means of financing the manufacture of new equipment under a lease arrangement, would be for the financial institution to enter into a lease with the airline and pay the full purchase price to the manufacturer with or without recourse against the manufacturer depending upon the credit rating of the airline.

In comparison with financing equipment through some form of borrowing, leasing has the advantage that the obligation to pay rent does not have to be shown on the balance sheet. The obligation to pay rent is, of course, definite

[5]Steadman, *op. cit.*, at p. 538; "Lenders also protect themselves in many instances by obtaining chattel mortgages on the equipment leased. The investor may require that the lease and mortgage contain default and acceleration clauses, in favor of the mortgagee. Such clauses require the lessee or lessor to pay the balance due in full if there is default on the payments, and allow the mortgagee or lessor to proceed immediately to foreclose the mortgage, repossess the chattels, or arrange for their resale. These clauses give the mortgagee investor his greatest protection, but their presence in a lease agreement, especially if there is no covering mortgage, will often reveal the security nature of the whole transaction. If this is a security transaction there is a danger that the lease itself may be considered a chattel mortgage or a conditional sales agreement . . .".

[6]"How Jets are Bought and Sold", *Flight International*, April 5, 1962, at p. 503. "Just published by Eastern Air Lines, in a notice to stockholders giving details of the proposed merger with American Airlines, is full information about how Eastern's new fleets are being financed.

Ten Boeing 720s, as well as 20 spare engines (to be used interchangeably on the entire fleet of 15 Boeing 720s operated by Eastern) are under lease from the Prudential Insurance Co. of America at an aggregate annual rental of approximately $6,420,000. The term of the lease for each aircraft (and its two accompanying spare engines) is for ten years from the delivery date of the aircraft from the manufacturer. Under the terms of the lease, Eastern may be required, at the lessor's option, to purchase the aircraft (with two spare engines each) on expiry of the lease for about $477,500 each. The first Boeing 720 under lease was delivered from the manufacturer on August 11, 1961, and the tenth and last was delivered on November 13, 1961."

and unconditional, but it is not necessarily reflected as a liability on the balance sheet:[7]

> When the use of chattel assets is acquired on leasing programs, the lease liability is not shown on the balance sheet as a liability. Of course there is no asset account for the leased equipment on the asset side; however, the asset to liability ratio and income to liability ratio will be higher. These ratios are important to creditors and to shareholders. Thus a lessee may, by leasing, save its regular credit sources for other purposes, and at the same time show a favorable balance sheet and current operating report when the time comes to utilize this credit. The advent of extensive balance sheet footnoting may result in the listing in footnotes of the leasing contracts, but accountants are by no means agreed as to the necessity for this practice. Even if the listing is necessary, the strength of this operating position will still be apparent.[8]

However, long term leases of aircraft usually involve such substantial commitments of funds by the lessee that footnoting is the practice.

Restrictive covenants in equipment trust agreements, mortgages, or indentures, which prohibit the airline from incurring additional indebtedness or which require certain consents before any further liens or creditors' interests may be attached to corporate assets, frequently do not restrict the airline in leasing. In some instances the governing security instrument may provide for leasing of aircraft equipment within certain specified limits in respect of term and rental commitment. Although the obligation to pay rental under a long-term lease must be regarded as a real liability, since it is not recorded as a debt on the balance sheet, liens are not created on the assets of the corporation as the corporation does not have title to the leased assets.[9] In addition, a number of the major flag carriers which purchased jet equipment under conditional sale, equipment trust, and chattel mortgage agreements during the period of 1956-1958 are today bound to maintain specified debt-equity ratios under restrictive covenants and, thus, it is a matter of importance whether lease commitments are recorded on the balance sheet as debts. Because of the substantial rental required in the lease of modern aircraft equipment, an operator

[7]A Committee on Accounting Procedures of the American Institute of Accountants has commented in *Accounting Research Bulletin*, No. 43, published in 1953, as follows: "The Committee believes that material amounts of fixed rental and other liabilities maturing in future years under long-term leases and possible related contingencies are material facts affecting judgment based on the financial statements of a corporation, and that those relying upon financial statements are entitled to know of the existence of such leases and the extent of the obligations thereunder, irrespective of whether the leases are considered to be advantageous or otherwise. Accordingly, where the rentals or other obligations under long-term leases are material in circumstance, the Committee is of the opinion that: a) disclosure should be made in financial statements or in notes thereto of: (1) the amounts of annual rentals to be paid under such leases with some indication of the periods for which they are payable and (2) any other important obligation assumed or guarantee made in connection therewith, b) the above information should be given not only in the year in which the transaction originates but also as long thereafter as the amounts involved are material, and c) in addition, in the year in which the transaction originates, there should appear disclosure of the principal details of any important sale and lease transaction."

[8]Steadman, *op. cit.*, p. 525.

[9]Hunt, Williams and Donaldson, *Basic Business Finance* (1958), p. 85.

in poor financial health desiring to obtain such equipment on lease may have the same problems in approaching a potential lessor as he may have in purchasing the equipment. Unless the lessee can demonstrate his sufficiency and capability of meeting his lease obligations, no manufacturer or other lessor would entrust to the lessee a $4-$6 million airplane.

Legal Aspects of Leasing

Registration

Section 204 of the Air Regulations, 1960,[10] sets forth the citizenship requirements which the owner of an aircraft must meet in order to register the aircraft in Canada. It is customary for an aircraft to be registered in the name of the actual operator even though the aircraft be operated under lease. Interesting registration problems may arise in circumstances in which a Canadian owner desires to lease an aircraft for operation in interstate commerce in the United States by a United States air carrier. A United States air carrier leasing Canadian-owned aircraft would be deemed to be the owner of such aircraft for registration purposes, provided that the lease agreement contains an option to purchase in favour of the United States carrier which is susceptible of being reasonably exercised.[11]

Although an aircraft be registered in the name of the operator, the problem of tort liability of the title owner of the aircraft may arise in certain jurisdictions in the circumstances of a lease. Until 1948 when Section 504 of the *Civil Aeronautics Act* was enacted, lease transactions in the United States relating to aircraft were unsatisfactory because the lessor was exposed to the risk that as owner, regardless of negligence, he could be held by a court to be absolutely liable under the laws of some states for damage to persons and property.[12]

Security

A lease is a security instrument which in practically all jurisdictions affords maximum protection to the creditor. In Canada under the *Bankruptcy Act*, 1949, Section 50 thereof allows the lessor to file with the trustee a proof of claim and the rights of the lessor will be respected. For Canadian corporations leasing aircraft to United States air carriers, it is of interest to note that the lessor of aircraft, aircraft engines, propellers, appliances and spare parts is granted an immediate right of repossession in reorganization proceedings under Section X of the U.S. *Bankruptcy Act*. This protection was introduced by a

[10]*Statutory Orders and Regulations Consolidation*, 1955, vol. 1, p. 7, as amended by P.C. 1960-1775 of 29 Dec. 1960, SOR/61-10, sec. 204, *Canada Gazette*, 11 Jan. 1961, Part II, vol. 95, No. 1, p. 43.

[11]Refer to *The Federal Aviation Act*, Act of Aug. 23, 1958, Sec. 501, 72 Stat. 731.

[12]Hines, "Legal Difficulties in Secured Airline Equipment Financing" (1948) 15 *J. Air L. and Com*, p. 11, at p. 15.

a 1957 amendment to the Act[13] to encourage aircraft financing and while it extends to include the conditional sales vendor, it does not include the chattel mortgagee. Prior to the introduction of this change in the law, a secured creditor of an air carrier could in the case of default be confronted with, at the minimum, a lengthy delay before he could exercise his right to repossess and sell the airline equipment subject to his claim, for the bankruptcy reorganization court had extensive powers to enjoin creditors from enforcing their rights against the bankrupt for such time as was required to permit the reorganization to be effected. Since the repossession of airline equipment would have a serious effect upon the public by disrupting passenger and mail services, it had been felt by financial institutions that the power of repossession was somewhat illusory.[14] The effect of the amendment has been to make the lease and conditional sale more popular as instruments of security in aircraft finance and to make the chattel mortgage less popular.

Under the laws of the Province of Quebec in circumstances in which the lease contains an option to purchase, the lessor repossessing moveable property does so subject to the provisions of Article 1561(h) of the Quebec Civil Code which permits the lessee and any creditor of the lessee to take back the moveable property repossessed within twenty days after the date of repossession upon paying to the lessor the rental instalments in arrears. A lease of moveable property cannot be registered under the laws of the Province of Quebec and since there is no central registry for recording title to and encumbrances against Canadian civil aircraft, the lessor of aircraft in Quebec is unable to effectively put third persons on notice of his rights.

Tax Consequences

Under some leasing arrangements tax advantages may be achieved by the lessee. These result from the fact that rental payments may be qualified as a business expense deductible before income taxes in greater amount and faster than the company as owner of the equipment could charge by way of deprecia-

[13]Subdivision (5) of Section 116 of the U.S. *Bankruptcy Act* (U.S. Code, Title 11): "Notwithstanding any other provisions of Chapter X, the title of any owner, whether as trustee or otherwise, to aircraft, aircraft engines, propellers, appliances, and spare parts (as any of such are defined in the Civil Aeronautics Act of 1938, as now in effect or hereafter amended) leased, subleased, or conditionally sold to any air carrier which is operating pursuant to a certificate of convenience and necessity issued by the Civil Aeronautics Board, and any right of such owner or of any other lessor to such air carrier to take possession of such property in compliance with the provisions of any such lease or conditional sale contract shall not be affected by the provisions of Chapter X if the terms of such lease or conditional sale so provide."

[14]Adkins and Billyou, "Developments in Aircraft Equipment Financing" (1958) 13 *The Business Lawyer* 199, point out that the reclamation of aircraft, engines and spare parts would be so serious that it would expose the carrier to the danger that the C.A.B. might exercise its power under Section 401 (h) of the *Civil Aeronautics Act* to revoke the carrier's certificate of public convenience. It is not likely that a bankruptcy court would have risked such a serious result affecting the public interest.

tion for tax purposes. Under certain forms of lease transactions, portions of rental payments may be used to apply against the later purchase of the equipment leased, or other purchase options which are offered to the user. In this area the laws of Canada and the United States differ considerably, but in both countries there is a real hazard that options to purchase may invalidate the tax deductibility of lease payments on the grounds that the transactions, nominally in lease form, in fact are purchases.

An attraction of leasing to the lessee may be the conservation of working capital in circumstances when rentals exceed allowable depreciation with respect to the leased equipment. In such circumstances, rental expense deductions can be larger and taxes can be decreased correspondingly. If such tax reduction is to be considered as a method of saving capital, it should be borne in mind that under the 47% (Canada) and 52% (U.S.) corporate tax rates, the capital saved as a result of the rental deduction will be approximately one-half of the amount paid as rent.

(i) *Income Tax Act of Canada*

Section 18 of the *Income Tax Act* sets out clearly the law respecting lease-option arrangements.[15] The Section provides that for tax purposes a lease-option agreement is to be considered (from the point of view of a lessee) as a contract for the purchase of property rather than as a lease arrangement under which rentals would be deductible as a business expense. The result is that the lessee is considered to be a purchaser who purchases for a deemed capital cost equal to the price fixed in the agreement subject to certain adjustments. Since he is considered to be purchasing the property, the lessee is allowed the same capital cost allowance to which the lessor-vendor is entitled.[16]

Section 18 of the Act is not applicable to lease-option arrangements entered into after 1957 in which the amount to be paid upon the exercise of the option is not less than 100% of the value of the leased equipment at the time the arrangement was entered into, provided, however, that the option must be exercised not more than five years after the date of the arrangement. If the option date is between five and ten years after the date of the arrangement the terminal payment must be not less than 75% (if in excess of ten years, not less than 60%) of the value at the date of the arrangement.[17] While the percentage figures in Section 18(4) are not realistic as related to aircraft equipment which has a high obsolescence incidence, nevertheless the legislation accomplishes its purpose which the *Canada Tax Service* states to be making ". . . certain that conditional sales of property by lease-option or hire-purchase (are) unattractive

[15]S.18(1) and (2) was formerly S.18(1) and (2) of *The* 1948 *Income Tax Act*, as amended, 14 Geo. VI, S.C. 1950, c.40, s.7. The present S.18 was substituted in 7 Eliz. II, S.C. 1958, c.32, s.8 (1).

[16]Refer to *Canada Tax Service*, p. 18-101.

[17]*Income Tax Act of Canada*, Section 18(4), *supra*.

to tax payers." The section is intended to be a counter-weight to the diminishing balance method of capital cost allowance and renders it unprofitable to the taxpayer to acquire equipment in this manner as compared to the taxpayer who purchases such equipment at the outset and claims capital cost allowance.[18]

(ii) *Internal Revenue Code of* 1954 *(U.S.)*

The lessor-owner who leases goods is entitled to a depreciation deduction from its income as an expense pursuant to Section 167 of the *Internal Revenue Code* of 1954. On the other hand, the lessee is allowed a deduction for rental paid under Section 162(a)(3) of the Code. Under U.S. tax legislation, the lessor who sells the equipment leased must pay a capital gains tax if a profit is realized on the transaction.[19]

The position of the lessee and the development of tax legislation in the United States with respect to lease-option agreements is described by Steadman as follows:[20]

> If the rental payments and corresponding rental deductions are greater than the depreciation deduction would be were the lessee to purchase the equipment, the lessee will have less tax liability than if it purchased the equipment. It will have less money tied up in equipment for which it cannot take a current deduction. If the lessee later purchases the equipment, its basis in these assets will be the paid option price. The rentals have already been deducted and can not be capitalized for deduction again as depreciation expense.
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> Prior to the passage of the 1954 Code this tax procedure permitted many tax saving arrangements. Before 1954 the only depreciation method which could be used was the straight-line method. If the lessee could rent for a figure higher than the permissible depreciation rate it would benefit by retaining capital and getting full depreciation for whatever capital it expended on its equipment. Of course the lessees did not want to pay high rent over the entire useful life of the equipment. They, therefore, negotiated for options to purchase the equipment after a certain number of years, or options to renew their leases for a period covering the useful life of the equipment at a nominal rental. The later options were granted because the lessee paid the lessor's purchase price for the equipment in the initial term rental payments. Many of these lessors and lessees were really arranging a financing transaction, hoping at the same time to avoid some taxes. Others were entering these leasing agreements to procure needed services and to protect their initial expenditures included these options permitting acquisition of the chattel.
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> The government, however, took a dim view of these leasing transactions. These options, which usually were exercised and resulted in the lessee's ownership of the leased equipment, appeared very much like a form of equity in the leased goods. I.R.C. S. 162 (a) (3), provides that acquisition of equity in property by payment of "rentals" will result in disallowance of the rental deductions. Therefore, the government disregarded the transaction's formal nature as a lease and redescribed this equity acquisition as a sale. On this basis the deductions for rental expense were disallowed and the lessee had to capitalize the rent it had paid, and take deductions on the basis of depreciation of this capitalized amount. The lessor then realized gain only on the excess it recovered over its own purchase price, under the installment payment provisions of the Code.

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[18]Section 18 applies to moveable and immoveable property except certain immoveable farm property.

[19]If the income of the lessor was not derived chiefly from rentals and a considerable proportion of its revenue resulted from the resale of leased equipment, then such equipment may not be treated as a capital asset but rather as part of inventoty and the profit from its sale would be subject to the usual income tax. Reference is made to Griesinger, "Pros and Cons of Leasing Equipment" (1955) 33 *Harv. Bus. Rev.*, p. 75.

[20]Steadman, *op. cit.* at p. 539.

The Internal Revenue Service with a view to placing further restrictions on the taxpayer in the case of a lease containing an option to purchase, had enacted Revenue Rule 55-504:[21]

> S.4.01. It would appear that in the absence of compelling persuasive factors of contrary implication an intent warranting treatment of a transaction for tax purposes as a purchase and sale rather than as a lease or rental agreement may in general be said to exist if, for example, one or more of the following conditions are present: . . .

The ruling has the effect of placing the burden of proof upon the taxpayer to show that his agreement is a lease if one or more of the following conditions exist:

(1) Part of the rental specifically is applied to the purchase price.

(2) After a stated amount is paid as rental, title to the property passes automatically to the lessee.

(3) Early rentals are very high, especially in comparison to the option price or the percentage specified in the contract.

(4) Rental payments materially exceed the fair rental value of the property.

(5) The indicated option price or the percentage is nominal in amount.

(6) The option price is relatively small compared to the total amount of rental which will be paid.

(7) Part of the rental is specifically designated as interest or is readily recognized as an interest charge.

(8) The total amount of rental paid during the lease, plus the option price, equals the fair market value of the property plus an interest and carrying charge factor.[22]

In conclusion, an airline desiring to enter into a lease with option to purchase for flight equipment should set the price at the market value of the flight equipment at the time of exercise of the option. Rentals should not be credited against the option price. If it is uncertain that the flight equipment will be purchased, the lease should be drafted to indicate clearly that the party had no intent to purchase at the time it entered into the lease. In the event that the party later decides to purchase the equipment, the price should be negotiated and when agreed upon should not be materially less than fair market values.

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[21](1955) 2 C.B. 39.

[22]Greenfield, "Corporate Benefits in Using the Sale—Leaseback Device", *The Tax Magazine*, November 1959, at p. 1017.