

# Analysis: Tax ambiguity holds up US airlines' Jolco plans

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US carriers have done a 180-degree turn in terms of market perception. Previously viewed as financially weak, in need of fleet trimming and frequenters of Chapter 11 restructuring, US carriers are now viewed as some of the best financially performing airlines in the sky.

It is no wonder they want to enter the Japanese operating lease with call option (Jolco) market to fund their aircraft, following in the footsteps of the likes of British Airways, Air France and Lufthansa.

Although they are generally spoiled for choice with domestic financing options in the USA, the Jolco offers cheap, 100% off-balance-sheet financing, with plenty of equity investor demand.

Amelia Anderson, American Airlines' managing director and assistant treasurer, said earlier this year that the carrier was exploring Jolco financing.

At the same time, Ted North, senior vice-president and treasurer at Chicago-based United Airlines, said his airline also was eyeing the structure.

"The economics are very attractive, so we are exploring that as well [as other structures, including the enhanced equipment trust certificate]," he said. Atlanta-based Delta Air Lines, sources say, may be less inclined to use a Jolco structure because it is cash-rich and may not be as reliant on financing as United or American.

Sources say that other potential candidates outside of the "big three" could be Alaska Airlines, Hawaiian Airlines and Southwest Airlines.

## Silent partnership

But the viability of US-Japan Jolcos rests on an ambiguous clause in the Protocol to the US-Japan Income Tax Treaty signed more than a decade ago, in November 2003. The Jolco structure relies on two types of bilateral contract, called tokumei kumiai (TK) and nin-i-kumiai (NK), which are similar to partnerships in the US.

The NK structure differs from the TK in that it is more suited to a single larger-ticket investor, while the TK structure can accommodate multiple small-ticket investors.

TKs are more popular and common than NKs, but there have still been a significant amount of deals done using the NK structure.

Both contracts form a so-called silent partnership in which the assets are the property of a manager (in the case of Jolcos, this is a Japanese equity arranger) and the anonymous partners have a right to a share of profits from the venture.

The TK structure, which holds the equity in a Jolco deal, is not the object of Japanese tax because it is regarded as a pass-through entity.

"The Jolco investor only has to pay the tax for their income or their core business generated from their core business plus profit from TK structure," explains one Japanese equity arranger source.

"The equity provider of a Jolco is a special purpose company [SPC], which contracts a TK agreement. By contracting a TK agreement, Jolco

investors get the benefit of obtaining tax loss and profit. So by obtaining a tax loss from the SPC, that Japanese investor could reduce their tax payment by combining tax loss distributed from the SPC, which itself doesn't have to pay tax to Japanese tax authorities, notwithstanding they get profit or loss."

But Paragraph 13A of the 2003 protocol removes the tax benefits available from using the TK structure. It is not clear, however, what the impact on the NK structure from this clause is.

"The United States may treat an arrangement created by a sleeping partnership (tokumei kumiai) contract or similar contract as not a resident of Japan, and may treat income derived subject to the arrangement as not derived by any participant in the arrangement," according to the protocol.

It adds: "In that event, neither the arrangement nor any of the participants in the arrangement will be entitled to benefits of the Convention with respect to income derived subject to the arrangement."

Simon Collins, a partner at White & Case Tokyo, explains that the interpretation of the words "or similar contract" in the protocol is the source of differences in opinion in the legal market about whether the NK structure can be used in this context.

"We believe an NK will clearly be outside the scope of the protocol. We have to assume for this purpose that NKs elect the flow-through method in their accounting, which is, we understand, generally the case – and, hence, can benefit from the exemption for withholding tax under the double tax treaty," says Collins.

However, a source at an international bank in Japan, which is active on the debt side of Jolcos, thinks that both the TK and NK structure will be caught in the net, although the ultimate interpretation can only be decided by the US taxman.

"This is [about] how the tax authority in the US will interpret the language, so all that we can do from Japan is just guess from the language of the treaty," says the source.

"Our understanding in our communications with local tax advisers and other guys is the current language will catch both the TK and NK structure. I think in that sense we have to think about the other routes to pave the way [for US airlines to enter the market]."

## **Finding a solution**

*Airfinance Journal* understands that Skyworks Capital is working to create a structure – likely to be an NK – that that would allow US carriers to execute Jolco transactions.

The company has previous experience as advisers in the Jolco market, most recently with Air Canada and Aeromexico.

However, an NK has different structuring requirements to a TK and, while it may allow US airlines to close some Jolco financings, the investor base may not allow for as many deals as if the use of a TK structure were possible.

"Part of the challenge that the US carriers face is they are looking to do a series of deals but there is reportedly a smaller investor base for NK than TK structures," says White & Case's Collins.

*Airfinance Journal* understands that some investors which have historically invested in TK structures may not be willing to switch to NK, though some of those which have invested in NKs are comfortable doing TKs.

Some sources suggest that the NK structure provides less anonymity to investors and means their identities are visible to an airline.

"To receive the benefit of the US-Japan tax treaty, the NK investors need to provide an IRS Form W-8BEN and obtain a US taxpayer ID number. They will not be anonymous, as the US withholding agent, which includes the airline and the trustee of the aircraft owning trust, will receive and review those forms," says Collins.

He adds: "This requirement for the tax form does discourage some Japanese investors from investing through NK."

## Japan-US relations

Even if the tax issues do get resolved by Skyworks or another party, the issue of Japanese investors' historically negative view of US carriers remains. Although they have noted the improved financial performance of several US carriers in recent years, the memory of Jolco investors is long, and the ghost of Chapter 11 bankruptcy haunts their investment decisions.

"Probably the Japanese investors' view of the other airlines [outside of the big three] is not so good, as they have had bankruptcies," says one equity arranger source.

However, the memory of what happened does seem to be gradually fading, although one Japanese banker suggests a younger generation of financiers might be more open to pursue financings with US carriers.

Collins says: "I think there's a recognition that the US market has changed and the US airlines have had a good stretch of profitable years. There was historically a concern about Chapter 11 but Japanese equity investors now seem to be much more comfortable with the US airlines as potential lessees for Jolcos."

If US carriers do manage to pull off a Jolco, one equity arranger source assumes that, although their ultimate goal must be to finance widebodies using Jolcos, they will likely start with narrowbody aircraft.

The source says: "Obviously, the aircraft cost is lower and therefore the equity amount will be smaller and will be probably swallowed by one leasing company or arranger who is interested in pursuing this structure."

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