AVIATION & AIRCRAFT FINANCING

NEW RULES CONCERNING WITHHOLDING TAXES ON BRAZILIAN LEASE PAYMENTS

Revision 1, December 2020

In the end of 2019, the Brazilian Federal Government enacted Provisional Measure 907 ("MP 907"), which altered certain benefits over withholding of income taxes ("WHT") on aircraft and aircraft engine lease payments, which had been subject to a zero rate for more than 12 years. At the time, MP 907 created uncertainty in respect to its extension, in special when made reference to aircraft or aircraft engine "**mercantile**" leases, and in connection with the dates of execution of the underlying lease agreement and of effective payment of the applicable rates.

Below you will find a brief summary of the tax rules applicable to the leasing of aircraft and aircraft engines in the last two decades over to the present situation.

BACKGROUND

Back in 1997, Federal Law 9481/97 was enacted and became the key legal basis in respect to lease taxation, to the extent it brought two provisions applicable to aircraft leasing transactions: (i) "**Item I**" on the leasing of aircraft; and (ii) "**Item V**" that regulated leasing in general (now including other assets). At the time, both were eligible to zero rate of WHT. While **Item I** was meant to cover assets under operating lease only (in the context of rentals, letting and similar availability concepts) of aircraft, aircraft engines and vessels in general, **Item V** encompassed both operating and finance leasing, of any type of asset.

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As of 1999, payments made to tax haven jurisdictions would attract a 25% WHT, exception being made to the payments under for assets covered by **Item V** (leasing in general), which would still qualify for the zero WHT in cases of payments to beneficiaries domiciled in tax havens.

In the year of 2000, the WHT rate over lease payments for transactions under **Item V** (general leasing – any type of assets) was increased from zero to 15% (for both tax haven and non-tax-haven beneficiaries). Payments under **Item I** were still eligible for zero WHT rate, except for payments to tax havens countries (where the WHT rate was under the general rule, at 25%).

In 2006, a reduction of the rate of **Item V** to zero was introduced specifically for leasing of aircraft and aircraft engines payable by authorized **regular** air service operators (the "**Airlines**"). However, it was on a temporary basis: contracts executed by December 31, 2008, would benefit from the zero WHT rate for all payments made up to December 31, 2013.

Important to note that this ruling did not impact **non-regular** aircraft operators, such as Part 135 ("**Part 135**"), who remained subject to the aircraft lease rule under **Item I**, with zero WHT on operating lease payments, but 25% WHT to tax heaven countries.

This WHT rate reduction and the time limits (date of execution of contracts/triggering events) have been consistently extended from time to time: the first for the period 2008/2013, followed by 2011/2013, and 2013/2016 then 2016/2019. This last extension was brought about by Federal Law 13043/14 (back in 2014 – which also included aircraft engines in the definition of **Item I**) and confirmed the benefit for lease agreements signed up to 31 December 2019, under **Item V,** with the zero WHT, for payments made up to 31 December 2022.

In 2016, the inclusion of Ireland in the Brazilian blacklist brought controversy to the matter, and the tax authority indicated, by amending Normative Instruction 1,455, that **Item V** was not affected by such inclusion, only **Item I**. Since then, Airlines have been able to make lease payments, including to tax-heaven countries (such as Ireland) with zero WHT, while Part 135 operators, under **Item I**, benefit from the zero rate WHT, except when making lease payments to blacklisted countries (including Ireland).



2019 CHANGES ON WHT

As indicated, the zero rate for Airlines would in principle be applicable until 2022, following the legislative the same tax treatment that was in place for more than 13 years. However, late 2019 was then time for another extension, so as to safeguard to contracts signed in 2020 and beyond. MP 907 was supposed to do so, but not only has not extended the benefit, but introduced some new reduced WHT rates, as follows:

- for contracts executed until December 31, 2019, the zero rate was kept up to 31 December 2022;
- for contracts executed in 2020, a 1.5% WHT rate up to 31 December 2022;
- for contracts executed in 2021, 1 3% WHT rate up to 31 December 2022; and
- for contracts executed in 2022 a 4.5% WHT rate up to year end.

MP 907 partially renewed the benefit and assured that as of January 2020 the aircraft lease payments would not be subject to the general WHT rule at 15%. If a new rule extending the WHT benefit is not made for the period beyond 2022, as from January 1, 2023, the general 15% WHT rate will apply to both operating and finance leases carried out by Airlines, under **Item V**, irrespectively of whether an old or new contract, and whether to a tax haven beneficiary or not.

The 1.5% WHT for contracts signed in 2020 would be applicable on the gross payment (effective rate of 1.52% if grossed-up). In the specific case of finance leases, the amount of the amortization of the underlying good can be deducted from the calculation basis of WHT. In other words, for new finance lease contracts signed in 2020, the 1.5% WHT rate should have been applicable on the financial expenses portion of each instalment (after deduction of the amortization component of the underlying contract, as registered in the Central Bank documents), even if paid to tax havens. With respect to operating lease under **Item V**, the entire remittance relating to rent (fixed and or variable) would attract this new 1.5% WHT, even if paid to Irish lessors.

The assets covered under **Item I,** meaning the operating lease of aircraft and aircraft engines of Part 135 operators, were not impacted by MP 907.



2020 UPDATE AND REVISION

Upon conversion of MP 907 into Law 14.002 on May 22, there was a change in the language of the relevant provisions dealing with WHT on leasing of aircraft. The date of signature/execution of the contracts became no longer a parameter, and the applicable rate depends now solely on the date of payment/remittance abroad. In principle, taxation would be 1.5% in 2020 and back to zero in 2021 and 2022 on both aircraft and aircraft engines lease payments, irrespective of the date when the contract was executed.

However, the President vetoed the provision which would resume the zero rate for years 2021 and 2022, bringing uncertainty to the market in view of a "legal vacuum" for 2021 and 2022.

In view of this veto, the tax authorities have issued an Opinion (*Nota Cosit* 231 of June 30, 2020) affirming that:

(i) contracts executed up to 2019: the applicable WHT in 2020 would be zero and from 2021, 15% (or 25% if tax havens)
(ii) contracts executed in 2020 and beyond: WHT rate of 1.5% in 2020, and 15% (or 25%) in 2021 and beyond.

This position of the tax authority is accurate in relation to the legal vacuum that triggers the 15% rate in 2021 and beyond rather than the zero rate; however, it is wrong when it says that remittances to tax havens will attract 25%, in view of a specific rule that calls for the 15% even in case of Item V leasing payments to tax havens.



SUMMARY AND CONCLUSIONS

As it was portrayed above, after more than 10 years of stability, the taxation rules applicable to leasing of aircraft suffered severe changes in the last year.

The table below summarizes the applicable WHT rates:

	2006-2019	2020	2021	2022	2023 and beyond
Item I Leasing (Part 135)	0%	0%	0%	0%	0%
Item I Leasing (Part 135) tax haven	25%	25%	25%	25%	25%
Item V Leasing Contracts up to 2019 (both non and tax havens)	0%	0%	15%	15%	15%
Item V Leasing Contracts in 2020 and beyond (both non and tax havens)	N/A	1.5% (or 15% if Budget law is not observed)	15%	15%	15%

It is possible that amendments to Normative Instruction 1,455 or Income Tax Regulations (Decree 9580) be issued to conform their provisions to the new rules of Law 14,002/19. The controversy on Item V Leasing payments to tax havens may also be addressed in such legislative changes, if any. For now, resuming the 0% rate for 2021 and 2022 would only be possible by means of a new law or provisional measure to be published before year end, or specific litigation.

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