

COELUM

COELUM Pronunciation: 'che-läm, is Latin for air space or sky. The Romans began questioning the rights they had in the space above the land they owned and to how high above did that right extended to. Ad coelum et ad inferos, they discussed, meaning that their right of property would extend as high up to the heavens and down to hell.

newsletter |

monthly digital publication by

ABOGADOS SIERRA Y VAZQUEZ

www.asyv.com

june 15, 2008

year 03 | No. 02

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TAX SERIES II:¹

Tax liabilities resultant from the granting of rights of use and enjoyment of aircraft. | Carlos Sierra *

In this second article of Coelum related to tax issues, we intend to review the tax obligations involved in the transfer of the use and enjoyment of an Aircraft to a lessee. We will start by saying that the taxes that could become applicable when the transfer of the use and enjoyment of an asset is conducted are of two kinds, first we will discuss the Value Added Tax '*Impuesto al Valor Agregado*' (VAT), which is a tax payable on the consumption of goods and services; and second, we shall forthwith discuss the tax obligation that would result from the profit resultant from the income generated by lessor from the leasing of the aircraft itself which would be taxed as Income Tax '*Impuesto Sobre la Renta*' (ISR).

Applicability of VAT:

To determine the obligations involved we must consider that the transfer of the use and enjoyment of aircraft, when occurring between two tax residents of Mexico would be taxed with VAT in accordance with Article 1 of the VAT law, which states that the persons that conduct the activities listed therein within Mexican territory shall be subject to this tax. In such context, paragraph III of this article refers to the granting of use and enjoyment of assets, as it would result from a lease agreement.

The above is the general rule -i.e. that the activities listed in Article 1 be conducted within the territory of Mexico-- for which the exception would result when such activities are not conducted in Mexican territory.

In a lease agreement, we could initially consider that the leasing of the aircraft occurs within Mexican territory clearly when both parties are tax residents of Mexico. How do we explain then what happens when the lessor is a foreign entity? To resolve this question we must bear in mind what the law considers to be the taxable activity in order to determine if such really takes place within the territory of Mexico or not. Once again looking at Article 1 paragraph III, we must read carefully that the leasing of the aircraft as a continuing activity is not what the VAT law intends to consider to be the taxable act, but actually the act through which such transfer of the rights of use and enjoyment of the lessor in respect to the aircraft are transferred by lessor to lessee for the purpose of the leasing thereof, which is the act that would trigger the tax in question.

In confirmation of this argument, we must refer to what is written in Articles 20, 21 and 24 of the VAT law. Article 20 states the cases in which payment of VAT for the transmission of use and enjoyment of tangible assets is exempted from this tax, referring to the transmission of use and enjoyment of such tangible assets by foreign residents without a permanent establishment in Mexican territory as one of the exempted activities, provided that the importation taxes referred to in Article 24 shall have been paid², when applicable, in respect to such assets. This would be sufficient to conclude that when the lessor is not a tax resident of Mexico VAT would not apply, however, we need to make sure that the general rule that

* IN COLABORATION WITH SVEIN AZCUE.

1.- The first article of this series referring to tax issues appeared on March 15, 2008 year 02 no. 12 of COELUM.

2.- The importation of aircraft by companies that provide public air transportation services is exempted from the payment of import taxes for a period of ten years in accordance with Article 106(v)(b) of the Customs Law.

we described above, related to the applicability of this tax when the use and enjoyment is granted within Mexican territory, is not met in order not to run into trouble with what we described to be stated in Article 1. To this effect Article 21 clarifies the issue by stating that the transmission of the use and enjoyment of an asset is considered to have been granted in Mexican territory when the asset is located in Mexico at the time when '*material delivery*' of the asset takes place.

Some debate has taken place as to what should be considered to be the '*material delivery*' of the asset, which certain interpretations consider to include the transfer of the asset to the lessee whether physically or legally. This interpretation however has been generally accepted to be in respect only to the physical delivery of the asset, which would need to take place in order to trigger the VAT obligation.

In summary two tests must be met to consider that VAT is not applicable to the leasing of aircraft conducted between a foreign resident lessor and a Mexican resident lessee, where (a) the lessor must be a foreign resident without permanent establishment in Mexico and (b) the act of physical (*material*) delivery of the aircraft must be conducted outside of the territory of Mexico. Under such structure, the payment of VAT on rental payments derived from the leasing of aircraft does not apply.

Applicability of ISR,

The ISR, as said, would be applicable not on the rentals paid by lessee in consideration of the received service -i.e. the leasing of the aircraft- as VAT would apply, but on the profit generated by the income that such rentals produce on the lessor. This tax as a general rule would be a lessor's tax that, if lessor were a Mexican tax resident, would be payable by

lessor directly to the Mexican tax authorities as part of the general tax obligations of any other person.

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... (a) the lessor must be a foreign resident without permanent establishment in Mexico and
(b) the act of physical (*material*) delivery of the aircraft must be conducted outside of the territory of Mexico.”

Being lessor a foreign tax resident and being the income construed by the rental payments that are made by the lessee consistent of funds that are transferred for payment outside of the country --without implying that ISR should be considered in any form as a tax on remittances which is a different concept-- these payments are subject to a withholding that lessee becomes obliged to conduct on behalf of the lessor from the amount to be paid as rent for the leasing of the aircraft.

The percentage in which this tax is applicable is established in Article 188 of the ISR Law, where the income generated from the granting of the use and enjoyment of mobile assets destined to certain activities is considered to be originating from a source within Mexican territory when such goods shall be used within the country, presuming that such goods shall be used within the country when the user shall be either a Mexican tax resident or a foreign

resident with a permanent establishment in Mexico. In such cases, which refer to commercial, industrial, agricultural, livestock and fishing, such withholding tax is set at a rate of 25% on gross income without any deductions. In respect to aircraft, containers and vessels which hold a concession or permit to be operated commercially the withholding rate set by this Article is 5% of the amount of the monthly rental. A separate withholding obligation exists in respect to payments made to tax residents of countries located within the list of 'low tax imposition jurisdictions' that the Mexican tax authorities publish every year. In these cases the withholding rate applicable is equivalent to 40%.

In respect to aircraft operated by air carriers in provision of public air transportation services a decree has been issued by the federal government dated November 29, 2006, whereby a discount has been granted of the equivalent of 80% from the already applicable 5% rate. This discount which effectively reduces the applicable withholding rate in relation to aircraft to nearly 1% is an incentive in order to procure the payment of this withholding by Mexican airline operators, which, notwithstanding that this withholding obligation is clearly stated in the ISR Law and applicable, have been refusing to conduct the withholding pursuant to an interpretation of the terms of the effective Convention between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income "(US-Mexico Tax Treaty)", which in Article 8 states that:

"Article 8 Shipping and Air Transport

1. Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.

2. For the purposes of this Article, profits from the operation of ships or aircraft in international traffic include profits derived from the rental of ships or aircraft on a full (time or voyage) basis. They also include profits from the rental of ships or aircraft on a bareboat basis if such ships or aircraft are operated in international traffic by the lessee and such rental profits are accessory to other profits described in paragraph 1. ..."

In accordance to this provision, the income generated by the operation in international traffic of full time leased aircraft can be taxed only in the state of residence of the party that generates such profits.

This interpretation appears to be reasonable at first, but is debated considering two important factors: (i) that the Mexican tax authorities have refused to sustain the same in writing, at least commencing from the 2007 tax period, and (ii) that it causes an unequal application of the tax that could be considered unconstitutional as it could be construed to be against the principle of equity that must prevail in all tax obligations. The inequality in question is that being this withholding based on the profits generated on the rentals payable to lessor for the leasing of aircraft objects, the condition contained in the cited portion of Article 8, which requires such aircraft to be operated in "international traffic", makes the claimed exemption from this payment obligation not applicable to all air carriers that dry lease aircraft under similar circumstances and

often even from the same lessors, considering that some of these air carriers only operate domestic services and consequently fail to meet the test imposed by Article 8 of the US-Mexico Tax Treaty.

By some interpretations, instead of referring to the profits of the lessor resultant from the rental of aircraft under a traditional dry lease, in respect to which the international or domestic operation of the aircraft by a Mexican tax resident could be said to be irrelevant, Article 8 pretends to refer to the profit that is generated from the rental of aircraft by the air carriers to their users or clients, which supports for instance why the profits generated by a non-scheduled US carrier that enters into a charter agreement with a tour operator in the US to operate international flights between points in the US and points in Mexico, and consequently rents to such operator one aircraft on a full time or voyage basis for such purpose, can be taxed only in the US based on the fact that such air carrier has no source of income in Mexico.

It is no secret that after the commencement of operations of many new domestic low cost carriers in Mexico in early 2006, efforts were made to resolve the controversy related to the interpretation of Article 8 of the US-Mexico Tax Treaty, which clearly was beneficial only to the operators of international services. This resulted in the decree that granted the 80% discount applicable to the 5% withholding rate, which was envisioned to reduce the rate substantially, but also intended to cause all international carriers to avoid relying in the questionable interpretation of Article 8 of the treaty and to start making such withholding as required by Article 188 of the law.

For a few years up to and ending on the 2006 tax year period, the Mexican tax authorities had been permitting the interpretation of

Article 8 that favored the carriers' interests. From 2007 onwards however it has refused to confirm such criteria any longer, notwithstanding which, many –and possibly all- of the Mexican air carriers that operate international services continue to rely in such interpretation, even after the 80% discount granted by the decree, and continue to avoid making such withholding as required by law.

In conclusion, it is important to state in respect to the referred withholding tax on rental payments that the payment is clearly applicable at a 5% rate pursuant to the referred Article 188 (as discounted down to 1%), and that any interpretations to the contrary are still subject to debate and are potentially not applicable. The cautious lessor should be aware of this fact in order to make sure that the Mexican lessee always remains liable for any risks associated with making such interpretation.

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Convenience of entering into mortgages regulated by the law of the place where the asset is located. | Viridiana Barquín *

This article will explain the advantages of entering into a Mortgage Agreement regulated by the laws of Mexico where the Aircraft is operated under Mexican registration.

A mortgage subject to the law and jurisdiction of any other country would certainly be recognized and enforceable in Mexico, although it would only be required to be registered in Mexico if the aircraft is bearing Mexican registration. If the aircraft is registered abroad, the interest created under a mortgage subject to any law (other than Mexican law) would be fully enforceable and recognized against third parties however it must be registered in the jurisdiction where the aircraft is registered and/or at the International Registry. If the aircraft is registered in Mexico and the mortgage is governed by the law of any other country, it would be able to be registered at the Mexican Aeronautic Registry¹ provided that it is duly notarized, apostilled and translated into Spanish for registration purposes. In such case, the filing for registration of the mortgage at the Mexican Registry is necessary regardless of the law that governs the same if such is intended to be enforceable in Mexico in respect to a Mexican registered aircraft. The interest that the mortgage creates should also be registered in the International Registry; this would assist in terms of enforceability as such registration must also be now recognized by Mexican courts.

To determine the law that governs the mortgage, it is important to consider that if the mortgage has to be enforced in Mexico:

- (i) the aircraft must likely be located in Mexico at the time of such enforcement;
- (ii) the rights resulting from a Mortgage are totally real property rights² (*rights in rem*) (**In Rem**: Latin, all legal rights are either in personam or in rem. In rem rights are proprietary in nature; related to the ownership of property and not based on any personal relationship, as is the case with in personam rights);³
- (iii) pursuant to Mexican law, the constitution, regime and extinction of such rights are governed by the law of place where the asset is located. Therefore for enforcement purposes, a Mexican court will apply without exception Mexican Law notwithstanding the mortgage is written to be subject to any other law;
- (iv) moreover, the enforcement of the mortgage against an aircraft located in Mexico would not be possible by means of a judgment issued by a foreign court because it would fail to meet the requirements of Mexican law for the validation of foreign judgments. The rights created under a mortgage subject to the law of any other country would be recognized in Mexico, but it could present practical problems

* IN COLABORATION WITH ENRIQUE BOUCHOT.

1.- Article 11 of the Regulation of the Mexican Aeronautic Registry.

2.- As seen in: <http://taloco.com/wp-content/uploads/2007/03/CUADERNOREALES%20I.doc>, consulted on March 25, 2008.

3.- As seen in: <http://www.duhaime.org/LegalDictionary/I/Inrem.aspx>, consulted on March 25, 2008.

to be enforced, so the task of enforcing would certainly be more complex than enforcing a Mexican law mortgage against an asset which is located in Mexico.

The enforcement by a Mexican court is possible considering however that pursuant to Article 13 paragraph II of the Federal Civil Code the mortgage would be enforced by a Mexican court in application of Mexican law, regardless of the law of any other country:⁴

“ARTICLE 13. The Determination of Applicable Law shall be made pursuant the following rules:

II. the constitution, regime and extinction of rights in rem over real estate, as well as the contracts for the lease and the temporary use of such goods, and the movable assets, shall be governed by the law of the place of their location, even if their beneficiaries are foreign...”;

The enforcement thereof by virtue of a judgment issued by a foreign court is not possible considering that pursuant to Article 1347A of the Commercial Code, one of the conditions for enforcement of a foreign judgment must be that it shall not be dictated as a consequence of an action in rem:

“ARTICLE 1347-A. The Judgments and Resolutions dictated abroad may have force of execution if such shall meet the following conditions:

*II. that such not have been dictated as a consequence of the exercise of an action in rem...”;*⁵

In conclusion, it is much more practical to have a mortgage under Mexican law in order to avoid the task of trying to make a Mexican court apply foreign law when it is likely to refuse to do so, and to avoid the task of obtaining a decision from a foreign court when a Mexican court would ultimately refuse to enforce it.

“The rights created under a mortgage subject to the law of any other country would be recognized in Mexico, but it could present practical problems to be enforced, so the task of enforcing would certainly be more complex than enforcing a Mexican law mortgage against an asset which is located in Mexico.”

4.- As seen in: <http://info4.juridicas.unam.mx/ijure/tcfed/1.htm?s=>, consulted on March 25, 2008.

5.- As seen in: <http://www.diputados.gob.mx/LeyesBiblio/pdf/3.pdf>, consulted on March 25, 2008.

News | May

Extract of Mexican Aviation News

Cost of fuel drowns the airlines.

The aviation industry is having a most difficult time because of the cost of fuel and the competition between airlines. Dennis Lazarus, general secretary of the syndical association of pilots of Mexico (ASPA), said that every dollar that a barrel of oil increases, the impact on the airlines is an increase operational cost of 250 million dollars a year. He also said that Mexicana and Aeroméxico need to join together and make an alliance instead of fighting for market share.

El Universal. 02/May/2008

Possible charges for a second suitcase.

As consequence of the increase in the cost of fuel, Mexican airlines are looking at the possibility of copying the recent actions of US carriers in adding fees for checked baggage. The crisis within the aviation sector is due to multiple reasons, among them, the high cost of the fuel and too many airlines chasing too few customers. That is why an integrated strategy is needed between the aviation sector and the Government that includes a charge to the passenger with more than one suitcase, increase in the ticket price and a decrease in taxes. Javier Christlieb, President of the National Air-transport Chamber (CANAERO) explains that the concept of low cost refers to the security and the efficiency of air transport, and that other services should carry an additional charge.

El Excelsior. 05/May/2008

Price of Aviation fuel affects travel agents.

Faced with increasing cost of aviation fuel, traditional airlines are adjusting their compensation scheme and will offer reduced commission to travel agents. Four years ago airlines developed a system that included a commission of one percent for every plane ticket sold, plus another three or four percentage points of compensation. However, the new scheme, which airlines have started to implement, is based on the sales. Base commission remains at one per cent but for three or four additional percentage points, it will be require that agents increase sales as much as 20 percent. It will be difficult to increase sales to the same levels as last year, as prices of airline tickets have increased up to 30 percent, and the market has contracted. Due to this adjustment, between 400 and 500 travel agents are at risk of disappearing, due to low revenue. The biggest agencies, which have a higher operational expenditure, are also at risk because their earnings will be insufficient to pay for operating expenses.

Reforma. 06/May/2008

Canaero negotiates support because of the rise in aviation fuel.

Today the cost of aviation fuel represents 40% of ticket price, 5 years ago this percentage did not exceed of 15%, and the fuel costs had been going down. These costs are also affecting the costs of airport services, and while all the airlines are having problems, the airport groups report excellent results with a rise of the revenue and use of facilities. The new low-cost airlines have caused a traffic increase of the 80% with the use of low rates, with which the new airlines started to compete. All airlines, not only from Mexico, but around the world are now in a crisis mode.

El Economista. 08/May/2008

Monterrey Airport's Terminal "B" will be completed this year.

With an investment of 60 million dollars, the Center North Airport Group (OMA) expect to complete Terminal "B" of the Monterrey International Airport before the end of this year. The new terminal would have a capacity of between 1.5 and 2 million passengers per year. Juan Manuel Jaureguí, OMA's Chief of Projects and New Terminals, explained that the demand for airport services in 2007 increased by 12% and that they closed the year with 6.6 million passengers. He also noted that the development contemplated in OMA's Master Development Plan, would allow for the construction by 2010 of two more buildings to integrated terminals A and B and also a new runway.

La Crónica. 09/May/2008

News | May

Extract of Mexican Aviation News

With massive aviation losses in 2008, and the urgent need of liquidity, Mexicana's Azcarraga goes for a merger with AeroMéxico and the SCT approves.

The crisis originated with the rise in fuel price and arrived at the worst possible moment for Mexican aviation with the start up of many low-cost airlines. There is overcapacity coupled with a reduction in price and that's why all companies are registering losses. In 2007 the losses were 600 million dollars, and for this year losses of 1,200 million dollar are expected. Mexicana, headed by Gaston Azcarraga is trying to consolidate an alliance between Mexicana and AeroMéxico to get a handle on constant rise in fuel prices. These two airlines, between them control more than the 50% of the national market. The SCT approves the efforts of Azcarraga, as it is likely that without an alliance, one of these companies will go into bankruptcy.

El Universal. 09/May/2008

The air cargo market is expected to consolidate.

To encourage an increase in air cargo the federal authorities and our airports need to work together to attract importers and exporters in order to jump start this sector's development. They are now investing in the loading areas because it will be very important to have infrastructure ready for international flights. Rubén López Barrera, General Director of "Grupo Aeroportuario del Centro y Norte (OMA)" said: "We anticipate investing in cargo infrastructure, not only in Terminal B of Monterrey airport, also on the repair of roads and in loading and unloading areas." He also commented that the central and northern airport group has invested a significant amount in infrastructure in the construction of warehouses and facilities for Customs.

Milenio. 13/May/2008

An End to Low Cost Fares.

The low-cost airlines have reached an end to their low fare prices as the cost of aviation fuel rises. These low fares were able to be maintained, thanks to the credits and facilities granted to these low-cost airlines in order for them to operate into airports such as Toluca, Puebla, Cuernavaca and Queretaro and in exchange for the waiver of payment of taxes such as TUA (Tarifa de Uso Aeroportuario) and Airport Operation Services during the first year of operations. The price increase is due to the high traffic routes such as Cancun, Mexico City and Monterrey where the prices were just not sustainable in the long run.

El Universal. 21/May/2008

EADS wants to transfer part of AIRBUS production to India or Mexico..

The European Aeronautic Defense and Space Company wants to transfer part of Airbus's production to a country with lower labor costs such as India or Mexico in order to reduce costs and insure their access to new markets and resources. This could help them to become more independent from the Dollar and expand EADS to a world presence instead of just Europe. India is quite interested and will be a guest at Berlin's Aeronautical fair to show their new technology. This idea could bring great technological advances and new potential customers for Airbus. Airbus noted that while the new model, the A380 is still behind schedule, it will certainly meet its expectations by consuming only 3 liters of fuel per passenger for every 100 km. This is 2 liters under the average consumed by aircraft today.

www.soitu.es 24/May/2008

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