

COELUM.

Monthly Digital Publication by
ABOGADOS SIERRA

Navigating through finance leasing.

- By María Paula Pardo




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L A T A M

January 15, 2024
Year 18 No. 8

PRONUNCIATION:

'che-l&m' is Latin for airspace or sky. The Romans began questioning the rights they had in the space above the land they owned and how high above them those rights would extend. They decided on, Ad coelum et ad inferos, meaning that their property rights would extend as high up as the heavens and all the way down to hell.

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There is no doubt that the acquisition of aircraft and engines is a complex process marked by various intricacies; for instance, one key factor is the high value associated with these assets and the fact that manufacturers do not maintain inventories for their immediate purchase. Given the significant financial investment required, acquiring these assets typically requires engaging in aircraft finance transactions, which often involve concepts such as (i) a secured loan arrangement, (ii) an ownership and lease arrangement (operating or finance lease), (iii) a capital markets transaction, or (iv) a combination thereof¹.

Whilst the structures mentioned above hold significant relevance and are the object of further analysis, this first edition of Coelum in 2024 will concentrate on finance leasing as a widely recognized financing mechanism within legal frameworks across various jurisdictions. A special emphasis will be dedicated to its regional treatment in Latin America, with an analysis of this concept in Mexico and a brief description of its treatment in Colombia.

The undeniable evolution and significance of aircraft leasing in the aviation industry make it the preferred structure for airlines globally when acquiring fleets. As stated by Mendes de León, “under a leasing model, airlines can rapidly increase or decrease the size of their fleet without expensive assets sitting on the ground”². In the aviation industry, it is common to find two categories of leasing, i.e., operating lease and finance lease.

An operating lease is an agreement between an aircraft owner and an operator, where the operator rents the aircraft from the owner for a defined lease term and returns the aircraft to the owner at the end of the lease term³. On the other hand, although a finance lease is a variation of an operating lease⁴, in this event, the transaction is structured where the risks and rewards of aircraft ownership are meant to pass to the lessee at the end of the lease term⁵. Whilst these categories of leasing have similarities, the main difference is the transfer of ownership at the end of the term of the lease. In the operating lease following the expiry of the agreed lease term, the lessor will take the aircraft back and try to either sell, trade or re-lease the aircraft to another operator⁶. In contrast, the financial lease seeks to transfer the property of the asset to the lessee at the end of its term.

According to Mendes de Leon, in the aviation sector, finance leasing has become one of the prime instruments to finance the acquisition of aircraft. Under a finance lease, substantially all the risks and rewards of ownership are transferred to the lessee⁷. Given the significance of this structure in the aviation industry, it is essential to recognize that the concept has gained widespread acknowledgment in the Latin American region, establishing itself as a valid financing mechanism for acquiring various assets, including aviation assets.

From a regional standpoint, the finance leasing structure has served as a financing mechanism that significantly contributed to the development and growth of the region since its introduction back in 1970. This evolution is attributed to the liberalization process that unfolded during that period.

Having the foregoing in mind and recalling Coelum’s edition of August 2021, under Mexican law, finance leasing is regulated in the General Law of Operations and Credit Titles (*“Ley General de Títulos y Operaciones de Crédito”* or

1.- *Structuring Aircraft Financing Transactions*, Practical Law, Holland & Knight, <https://www.hklaw.com/-/media/files/insights/publications/2019/02/structuring-aircraft-financing-transactions-w0016292.pdf?la=es>, page 1, (last visited on December, 2023).

2.- P. Mendes de Leon, *Introduction to Air Law*, Chapter 11, page 423.

3.- *A comparison of ACMI leasing, operating leasing and aircraft ownership – to lease or to own*, ACC Aviation,

4.- *Ibidem*.

5.- *Ibidem*.

6.- P. Mendes de Leon, *Introduction to Air Law*, Chapter 11, page 423.

7.- *Ibidem*.

“LGTOC”) and, according to Article 408 of the LGTOC is defined as “the agreement by which a person is obliged to acquire certain goods or assets and grant temporary use or enjoyment of such assets, on a forced term, to another person who is obliged to pay in installment, a determined or determinable amount of money that covers the acquisition value of such goods, financial charges and other accessories”⁸. Furthermore, according to this provision one of the following options must be adopted at the termination of the term of the agreement:

- i. Purchase the asset at a price lower than its acquisition value.
- ii. Hold the asset on lease for a further period, or
- iii. Participate with the lessor in the sale of the asset to a third party.

As for specific requirements of a financial lease under Mexican law, Article 408 of LGTOC provides that it must be executed in writing and registered at the Single Registry of Guarantees (“RUG”)⁹ to be effective against third parties, without prejudice to the registration in other special registries determined by law, for instance, before the Mexican Aeronautical Registry (“RAM”).

Registration at the RUG of a financial lease might give the indication that the financial lease constitutes a guarantee, and therefore registrable at the registry intended for guarantees, however, this is not the case, as the financial lease does not constitute a guarantee whatsoever. The legislator’s rationale behind the requirement of registration at the RUG was intended towards:

- i. Giving publicity to potential right to purchase, which may impact third parties acting in good faith. Publicity helps to prevent hidden encumbrances.
- ii. Confirming the unequivocal ownership by the lessor of the aircraft, in order to prevent future creditors from mistakenly assuming that the possessor is the owner.

In case of aircraft, as explained above, registration can also be accomplished at the RAM as a special registry for aircraft, but not all assets have specific registries, and therefore, the legislator expanded the scope of RUG to give publicity to all financial leases, and specifically to those relating to assets that do not have a special registry.

In addition to the definition set out in Article 408 of the LGTOC, Article 14 of the Federal Tax Code provides that, under a Mexican tax law perspective, financial leasing is a transfer of assets¹⁰ and Article 15 of the Federal Tax Code also imposes additional requirements. These include stipulating in the financial lease agreement:

- i. The precise value of the asset or the method to determine it.
- ii. The agreed-upon interest rate.
- iii. The mandatory registration in the Single Section of the Single Registry of Secured Transactions of the Public Registry of Commerce to ensure effectiveness against third parties.

Concerning the tax treatment of finance leases in Mexico, according to the Value Added Tax Law and the Income Tax Law, the lessee is entitled to deduct the VAT paid on the interests. Recalling Coelum’s publication of August 2021 as provided in Article 25 of the Income Tax Law, the “lessor is entitled to deduct the cost of the asset when the payment is received and on the other hand, lessee is entitled to deduct the investment of the original amount of the asset according to the maximum percentage authorized by law, under Article 34 fraction V subsection b of the Income Tax Law, in case of aircraft 10%; and at the maximum original amount of investment permitted by law, pursuant to article 36 fraction III of the Income Tax Law, in case of aircraft, an

8.- Article 408, General Law of Operations and Credit Titles

9.- The RUG is a section of the Public Registry of Commerce in which creditors and financial institutions can register guaranties on movable assets from their debtors, with declarative effects.

10.- Article 14, Federal Tax Code.

amount equivalent to \$8,600,000.00 Mexican Pesos (approximately US \$506,772)¹¹. Furthermore, “if, at the termination of the financial lease, lessee acquires the option to buy the equipment, it will have an additional right of deduction and the lessee is entitled to deduct the accrued interest derived from the acquisition of the asset through financing¹².”

Provided that the finance lease is recognized as a transfer of assets for tax purposes in Mexico, it creates confusion, as some believe that in fact is a transfer of asset from a legal perspective, and that lessee becomes the owner of the asset with each and every payment. It is essential to emphasize that a financial lease, a loan, a pure lease, and a purchase in installments constitute distinct legal concepts under Mexican law.

Like Mexico and other regional jurisdictions¹³, finance leasing is widely utilized and acknowledged as a financing mechanism in Colombia. According to Article 2 of Decree 913 of 1993, a financial leasing operation is “understood as the delivery, by way of lease, of assets acquired for such purpose, financing their use and enjoyment in exchange for the payment of rents to be received during a determined term, with the lessee having the right to exercise a purchase option at the end of the term. Consequently, the asset shall be the property of the leasing company, a right of ownership that shall be retained until the lessee exercises the purchase option. Likewise, it should be understood that the cost of the leased asset will be amortized during the term of the contract, generating the respective profit”. In line with Mexico, finance leasing in Colombia presents enticing tax advantages, further boosting its appeal.

As outlined by the Financial Superintendence of Colombia in the concept 2010027830-002, a financial lease agreement involves two key parties: the lessor and the lessee. It's crucial to note that the lessor must meet specific qualifications, being limited to banks or financing companies, and is tasked with delivering the acquired asset to the lessee for the purpose of financing its use and enjoyment. Additionally, the Financial Superintendence specifies essential elements of the contract, including:

- i. The delivery of any type of asset (movable or immovable) for its use and enjoyment,
- ii. The establishment of a periodic fee covering factors such as the amortization of the asset's cost, and
- iii. The inclusion of a purchase option in favor of the lessee at the conclusion of the agreement.

Although the concept of financial leasing is essentially the same in the jurisdictions previously analyzed, it is crucial to recognize the distinctions between substantive rules and procedural rules applicable to the finance lease. The substantive law of the agreement, which delineates the rights and obligations of the parties, will be the one set out in the contract. However, the procedural rules governing the agreement's enforcement will align with the jurisdiction's local laws where the contract will be enforced.

Taking into account the preceding analysis, it becomes evident that finance leasing is widely employed and acknowledged in regional jurisdictions. Conceptually, these jurisdictions feature similar legal structures serving identical purposes. Nevertheless, a more in-depth analysis is required to discern the specific benefits and risks associated with each jurisdiction. Consistent with the above, it is crucial to clarify that a foreign company is precluded from acting as the finance lessor in a finance lease governed by the laws of Colombia and Mexico. Furthermore, it is important to bear in mind that these jurisdictions explicitly stipulate that the finance lessor in a finance lease governed by local law must be a qualified party.

11.- *García, V. Aircraft Leasing, Coelum, August 2021. Available at: https://asyv.s3.us-east-2.amazonaws.com/COELUM_AUGUST_2021_ee31fb691a.pdf*

12.- *Ibidem.*

13.- *For instance, Brazil, Ecuador, Argentina and Chile.*

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