

Recent PRC legal developments relevant to the aviation sector: IDERA and others

This client briefing discusses certain recent regulatory developments in the People's Republic of China (PRC) that are highly relevant to the aviation sector.

Irrevocable De-Registration and Export Request Authorisation (IDERA)

Background: Shortly after China ratified the 2001 Convention on International Interests in Mobile Equipment and the corresponding 2001 Protocol thereto on Matters Specific to Aircraft Equipment (the Convention and the Protocol respectively), the Civil Aviation Administration of China (CAAC) issued administrative procedures regarding IDERA in July 2009.

Development: In order to improve local regulations so as to implement the provisions of the Convention and the Protocol, CAAC has updated the existing administrative procedures regarding IDERA.¹ According to sources, the proposed revised procedures will require the PRC court to issue a document "confirming that the Authorized Party is entitled to possession of the aircraft under the Convention", in contrast to the 2009 version which required a PRC court to issue a document that "approves the Authorized Party to deregister and export the aircraft from China".²

The change signals China's clarification of the use of IDERA and its continuing efforts to regulate the implementation of the Convention. This position is echoed in recent experiences where CAAC has accepted the filing of IDERA by various Chinese airlines.

Key Issues

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¹ The formally updated administrative procedures regarding IDERA have not as yet been published on CAAC's website.

² The PRC has declared that it will apply the provisions of Article X(1), (2), (3), (4), (6) and (7) of the Protocol. Accordingly, after receipt of an application, a court of the PRC will, in respect of the remedies specified in Articles 13(1)(a), (b) and (c) of the Convention, make an order within 10 calendar days to be enforced immediately and, in respect of the remedies specified in Articles 13(1)(d) and (e) of the Convention, make an order within 30 calendar days to be enforced immediately.

Continuation of Business Tax Exemption for Cross-Border Leases

Background: Pursuant to the Interim Regulations on Business Tax as amended and effective as of 1 January 2009 (2009 Interim Regulations), the provision of certain services (including leasing), transfer of intangible assets and sale of immovable properties in China will be subject to business tax. Under the 2009 Interim Regulations, rental payment made by a PRC lessee to an offshore lessor is subject to PRC business tax even if the offshore lessor has no permanent establishment in China. However, according to a notice promulgated by the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) in August 2009, existing contracts signed before 31 December 2008 and satisfying certain conditions were grandfathered until the earlier of the termination date of the contract or 31 December 2009 and would continue to enjoy the business tax exemption.

Development: The MOF and the SAT jointly promulgated a circular (Circular No. 48) on 10 June 2010 to continue the grandfathering of business tax exemption treatment for cross-border equipment leasing contracts. This extends the business tax grace period for cross-border equipment leasing contracts entered into before 2009. The extension is for the remaining length of a grandfathered lease contract (as defined in Circular No. 48), but the terms of the contract cannot be modified. As a result of Circular No. 48, grandfathering treatment for the period starting from 2010 for qualified leasing contracts became available.

The Circular extends the period for business tax exemption on existing cross-border equipment leases (regardless of whether it is a finance lease or operating lease) to the expiration of these contracts. The detailed eligibility requirements for such leasing contracts are as follows:

- the contracts must be in writing and entered into on or before 31 December 2008, with a lease period of more than 365 days;
- the objects under the lease must be aircraft, vessels, aircraft engines or other big-ticket equipment and the agreed average annual rental must not be less than RMB500,000;
- the objects under lease, lease period and rental terms have not been changed (for the avoidance of doubt, a change of lessor under the lease would not disqualify the contract from the exemption); and
- the amount due on and before 31 December 2009 as stipulated in the lease contract (including security deposit) has been paid by the PRC lessee (or through its overseas subsidiary) in foreign currency through a financial institution.

In addition, the PRC lessee is required to file the original and copies of the existing lease contract, proof of rental payment, receipts or invoices from the lessor and other documents as required with the tax authorities, i.e. local branches of the SAT, before 30 September 2011, so as to effect the exemption of business tax on the lease.

Tianjin Free Trade Zone

Background: Since the promulgation of a circular by the China Banking Regulatory Commission (CBRC) in January 2010 which permits financial leasing companies regulated by CBRC to set up project companies (PCs) in free trade zones in China, many PCs have been set up and leases entered into with such PCs as lessors, mainly for tax reasons³.

Development: The State Council recently approved the Development Plan of the Core Area of the Northern International Transportation Center in Tianjin (Plan). The Plan was released by the National Development and Reform Commission on 19 May 2011 and is applicable to the area of Dongjiang Free Trade Port Zone in Tianjin (Dongjiang FTPZ).

Although the Plan is only a statement of high-level policies, it signals the central government's formal support in encouraging the setting up of leasing PCs in Dongjiang FTPZ. According to the Plan, Dongjiang FTPZ is encouraged to carry out innovative leasing business on a trial basis. In particular, the Plan encourages aircraft leasing business by providing the following preferential treatment:

³ For more background information on the PCs in free trade zones, please see Clifford Chance's client briefing on this topic: *The Introduction of Onshore Project Companies to China's Leasing Industry*, May 2010. [\[English\]](#) [\[Chinese\]](#)

- aircraft imported by PCs in the Dongjiang FTPZ will be counted as part of the state aircraft purchase plan;
- where the lessor, i.e. a PC in the Dongjiang FTPZ, borrows money from a foreign lender, and hence triggers foreign debt control under PRC law, the approval for such foreign debt will be arranged in priority;
- the leasing companies and the PCs set up in the Dongjiang FTPZ may enjoy a 4% aircraft import VAT rate, provided that the unladen weight of the aircraft imported by the PCs and leased to PRC airlines is 25 tonnes or above; and
- upon satisfaction of certain conditions (which the Plan did not specify), when the aircraft is exported to a foreign buyer at the end of the relevant finance lease, the lessor in the Dongjiang FTPZ is entitled to a "tax rebate" under the Plan for such export. However, what the rebate comprises is unclear.

As the Plan is only a high-level policy statement, the details for implementing the preferential treatment stated therein are yet to be disclosed. For example, while the Plan appears to say that government support will be given in respect of the approval of foreign debt and import quota procedures, how such favorable treatment would be implemented remains unclear.

Given the uncertainties, the actual impact of the Plan may not be imminent until further detailed regulations are issued by relevant regulators, such as the State Administration of Foreign Exchange, SAT and the Customs Office.

Imported Aircraft as Loan Collateral: Exemption Permitted but Customs Guarantee Required

Background: Chinese airlines have been able to enjoy reduced import duty and VAT when importing aircraft into China. However, the relevant import tax implication arising from creating a security interest over an imported aircraft has not been specifically addressed in Chinese laws and regulations.

Development: The General Administration of Customs of the PRC issued a Circular (Circular No. 88) on 2 March 2011 with respect to customs guarantees for aircraft used as loan collateral after importation. Circular No. 88 took effect as of 1 April 2011 and addresses the situation where an aircraft is used as collateral to raise financing.

Circular No. 88 applies to passenger or cargo aircraft with an unladen weight of more than 25 tonnes. This type of aircraft has been enjoying relevant import duty and VAT exemption under existing laws and regulations.

Pursuant to Circular No. 88, Chinese airlines may create a security interest over an aircraft in order to obtain financing from financial institutions (foreign or domestic) or to enter into a finance lease with domestic or foreign financial institutions (including sales and lease back arrangement), and

- if the aircraft has been imported and is still within the customs supervision period⁴, the Chinese airline must obtain prior approval from the customs authority and submit the relevant security deposit to the customs authority; or
- if a security interest is created over the aircraft before the aircraft is imported into China, the Chinese airline must report to the relevant customs authority in writing in respect of the security interest when applying for the reduction/exemption of import duties. It must also submit the relevant security deposit to the customs authority.

The security deposit may take any of the following forms: (1) a deposit from the Chinese airline in an amount equivalent to the tax/duties payable; (2) a guarantee from a domestic Chinese financial institution in an amount equivalent to the tax/duties payable; or (3) a letter of undertaking provided by the Chinese airline alone or jointly with a PRC financial institution, such that if the aircraft is disposed of upon the failure to repay the loan or discharge the rental payment obligations, the tax payable to the customs authority will be paid before the aircraft is disposed of or will be paid in priority from the disposition proceeds. The following chart illustrates the available forms of security deposit under different scenarios.

⁴ The customs supervision period for an imported aircraft is 8 years, calculated from the date on which the imported aircraft was released by the Customs authority. For aircraft imported under a lease with a term not exceeding 8 years, the customs supervision period is 8 years; where the lease term is over 8 years, the customs supervision period will continue until the lease expires and the customs procedures are completed pursuant to the *PRC Customs Administrative Measures on Tax Collection for Imported and Exported Goods*.

	Security interest created after the aircraft is imported	Security interest created before the aircraft is imported
foreign financial institution as beneficiary	(1) or (2)	(1), (2) or (3) (in the case of (3), the letter of undertaking as provided by the Chinese airline only)
a PRC domestic financial institution as beneficiary	(1), (2) or (3) (in the case of (3), the letter of undertaking jointly provided by the Chinese airline and a PRC financial institution)	

Circular No. 88 does not address operating leases, and it is generally perceived that it does not apply to operating leases.

Circular No. 88 also states that Chinese airlines cannot arrange for an aircraft to be used by its subsidiary or another Chinese airline, or otherwise sublease the aircraft without the prior approval of the customs authority during the customs supervision period.

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