French Tax Leases- Ships and Trains

A fresh buzz has arisen among the French financial institutions, who are now eagerly awaiting regulations on the treatment of tax leases that will be emerging from Paris. Historically, from the inception of French tax leasing in the late 1990's, until December 2004 when the European Commission (EC) challenged French tax leasing, citing a potential incompatibility with Community rules. In the maritime markets, both cruise ships and container ships had been leased to French entities, while cross border deals had been done to Swedish tanker operators.

A recent memo by the Paris office of Watson, Farley & Williams (WFW) discussed provisions within the "Amended Financial Bill of 2006", adopted late last year, which will now pave the way, potentially, for more French tax lease transactions. According to WFW, no new transactions can be consummated until the French tax authorities provide "Official Comments" on exactly how the new rules will be applied, along with a Decree stipulating the conditions for apply the new rules. These are expected by end April.

Watson Farley's Paris based partner, Gilles Cervoni, in talking to JTF, said that going forward, new transactions will not require a pre approval from the French government, differing from the previous rules, and that "…banks and shipping companies would need to make their own judgments," on the correct application of their rules. He told JTF that the pace of French activity could likely quicken, with a liberalization of previous requirements that vessels be operated in France or built in French yards.

Jean-Marc Zampa, a Partner at Orrick Rambaud Martel, also situated in Paris, told JTF: "The new French tax regime (article 39C of the Code Général des Impôts) can allow shipowners to optimise their asset financing in a significant way" when he was asked about the likelihood of preferences being given to shipping under the pending French rules.

The WFW memo does outline what is known; the lease will allow a financial lessor to gain the tax benefits of ownership, through a front loading of depreciation benefits (capital allowances). Meantime, the lessee, often " a trading company that cannot use the capital allowances because of insufficient available profits", gains "nearly all the risks and rewards of ownership of that asset." Like other tax driven leases, the lessor sees a big tax shield in the early years of the lease, and benefits are shared with the charterer of maritime assets, in the form of lower hire payments on a bareboat charter. Likely changes concerning the treatment of depreciation by the owning entity- the " socie'te' en nom collectif (SNC)", as well as the mechanics of the timing of deductions, will be included in the clarifications.

The treatment of capital gains, when assets are sold, is also up for review. Under the old French rules, capital gains were exempt from taxation when assets were sold, but under

the new rules, a tax recapture is likely- at the level of individual members in an SNC. However, WFW points out that the recapture may be avoided through a transfer of SNC shares. Where ships are operated under the French tonnage tax regime, gains on the sale may be partially exempt from the capital gains tax.

The proposed treatment of capital gains shows just how closely the new rules are aligned with commercial dynamics, where many companies are not industrial shipping players and may wish to re-configure their equipment portfolios, and the desire to re-kindle a French shipping industry. An SNC's taxation will be apportioned according to the time that a vessel has been inside the Tonnage Tax regime (no tax) and outside the scheme (tax at the corporate rate). WFW points out that the old rules stipulated the use of accelerated depreciation and required a minimum of eight years in the French flag. Now "the new rules do not impose any conditions relating to the length or type (normal or accelerated) of depreciation used," according to the memo.

Law firm Orrick has acted in several big deals in the French market, in the container and the cruise sectors. The container transaction involved the large French containerline CMA-CGM In 4Q 2004, Calyon (advised by Orrick)- as mandated lead, put together a USD 750 Million French tax lease partially funded through an export credit by the Korean Export Import Bank (KEXIM, advised by Allen & Overy), to finance the construction of eight 6,800 teu vessels. The KEXIM senior debt was complemented by additional loans from a consortium of shipping banks that included BNP Paribas and Caisses d'Epargnes (CNCEP). Orrick's Zampa commented: "This was the first time a structure combined export finance and French tax lease under article 39 CA (now abolished)."

In the late 1990's, structured tax driven leasing transactions were also put in place for three smaller cruise ships built at Chantiers de Atlantique (acquired by Alstom and now in the hands of Aker), with Calyon also in the lead. In another 2005 deal that included an export credit, Orrick advised a bank syndicate that was funding a French tax lease on two cruise ships built for Mediterranean Shipping (MSC) at the same French yard.

Under the emerging rules, WFW points out that the nexus for qualifying assets (which might be ships, aircraft and even power generating equipment) will be widened to include countries that are members of the European Economic Area (EU members plus Norway and Iceland) and have entered into a double tax treaty with France. WFW's Cervoni said "…these new rules could benefit other transport areas beyond shipping. We have not yet explored how they could be applied to cross border transactions."

Another company operating vessels (built in Croatia and China) from an office in Paris, but financed through French tax leases, is Brostrom AB. The Swedish oil products and chemicals transporter has recently been in the financial news with a SEK 500 Million three year bond deal, at 5.25% coupon, done through SEB. The company points to this very recent bond issue (actually, its second instrument in two years) as part of its long term financing strategy. Brostroms has also been an innovator on the leasing front. In the mid 1990's, it was one of the few shipping companies to actually enter into lengthy

“Pickle Leases” with a U.S lessor- in a three ship deal financed under this arrangement, running until 2012.

In 2001 and 2002, the majority owned French subsidiary of Brostrom had entered into bareboat charters, under French tax leases, on five Far Eastern built 37,000 ton product tankers French tax leases, owned by the big institutions in France. The vessels, trading in European waters and operated under the French tonnage tax system, have been booked as financial leases on the Brostrom' accounts. Three of these chemical tankers, built in a Chinese yard, were booked into a French lease worth USD 102 Million in late 2004, spearheaded by mandated lead arranger BNP Paribas. Paribas also arranged two tranches of shipping debt, from the Scandinavian market (where Brostrom has close ties with SEB and others), to fund the transaction.

As the tax benefits have reduced after several years, Brostrom has exercised purchase options on at least one of the 2001 built vessels (bringing it onto the balance sheet), but under the “old” lease terms- the vessels must remain in the French flag for at least eight years in order for the favorable tax treatment to be released. The flexibility in the new French rules is in congruence with other industry forces. In a very cautious accounting treatment, the listed Swedish tanker operator presently maintains an accounting reserve for potential recapture on French tax benefits, which will fully amortize, declining to zero, after eight years. Brostrom has been a consolidator, buying out vessels from partners, for example- Iverships, as it brands itself as a logistics player. Yet, it could have gone the other way, under the new French rules, a lessee would not gripped by an eight year straight-jacket.

Tax leasing for shipping reached a zenith in 2004, according to the industry overview section of the recent First Ship Lease Singapore Trust (FSL) prospectus. The French case, in a market described, along with Korea and Holland, as: “comparatively small“ is nonetheless illustrative of the road back for tax driven leasing within the EU countries, after the EU challenged rules in individual jurisdictions. Orrick Partner Jean-Marc Zampa talked about the need for one set of rules, telling JTF: “We now need to mobilize for the harmonization of tax measures in the maritime and naval construction sector, in other words the harmonization of tax rules applicable to financing, to the taxation of the business of ship-owners, to naval construction yards and the rules applicable to international flags.” While certain leasing structures (such as the KGs) have suffered due to high asset prices, FSL's prospectus suggests that the capital conservation inherent in leasing would be an important driver of new business.

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While highly structured tax leasing is set to emerge from its hibernating status in France, leading French financier Societe Generale was recently involved in a €100 Million cross

border leveraged lease of double decker commuter railcars to New Jersey Transit (“NJT”, see JTF #   ). The carriages, to be delivered later this year from Bombardier, will serve crowded lines feeding riders into New York’s Penn Station. Robert Webb- NJT’s Manager, Project Finance, told JTF, that “…we have done a number of cross border leases in the French and the Swedish markets.” But, in describing this French lease, he cautioned that “…there’s not a lengthy process of comparison; if some money comes along, you grab it- these are really very much niche deals.”

More typically, NJT’s funding for equipment comes from its, from advances from the State of New Jersey (funded, in turn, by appropriations from the State, or from bond issuance), or from leases in from the Metropolitan Transit Authority (a tri-State agency, along with New York and Connecticut), or from the bi-state Port Authority of New York & New Jersey.

In fact, the French deal is something of an anomaly. An attorney involved in the NJT deal, Watson Farley Williams Partner Steve Millman, working on behalf of Soc Gen, the lessor in the leveraged transaction, provided a broader context. He emphasized that New Jersey Transit, as a tax exempt entity, does not generate the tax losses for a U.S. lessor. He commented: “Sometimes, you may see tax exempt entities like NJT engage in a pure financing, where they own the equipment at the end of the term, but there is no tax angle for U.S. equity lessors.” Millman said legislative changes have limited the leasing alternatives available to NJT, but that potential foreign deals could see terms of at least 15 years duration, and very often, the lessee can exercise an attractively priced call option at the end of the term.

Indeed, a NJT Press Release from the 2006 fiscal year highlighted the unusual role of the Cross Border leases, saying: “In addition <to fare increases>, the Corporation is optimistic that it will be able to generate $3.2 million in revenue by executing one more cross-border leveraged lease transaction, which is permitted under a grandfather provision in the new federal ban on such financial transactions.”