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FROM THE EDITORS

Welcome to our latest edition of K&L Gates' *Cleared for Landing*, published jointly by our Aviation and Banking & Asset Finance practice groups. *Cleared for Landing* highlights significant developments and issues relating to aviation law and asset finance globally.

This issue focuses on Hong Kong as a center for aircraft leasing, drone operations near U.S. airports and commercial aircraft, and legal and documentation changes arising in India as a result of the collapse of a major Indian airliner. We have also included an article on the new EU Transparency Rules for Intermediaries and how they might affect aircraft finance transactions. These articles have all been drafted by a number of K&L Gates lawyers who focus on these matters on a daily basis.

We hope you find this edition of the *Cleared for Landing* interesting and welcome your feedback.

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DRONE OPERATIONS NEAR U.S. AIRPORTS AND COMMERCIAL AIRCRAFT

Amanda L. Darling

NUMBERS ON THE RISE

In January 2018, the U.S. Department of Transportation Secretary Elaine L. Chao announced that over one million drones (also known as unmanned aerial vehicles ("UAVs") and unmanned aircraft systems ("UAS") had been registered with the Federal Aviation Administration ("FAA"), marking a new milestone for the registration program. This number is made up of approximately 878,000 hobbyist registrations and approximately 122,000 drones to be operated for commercial purposes. According to an aerospace forecast published by the FAA, drone operations are expected to increase and the sales of small drones requiring registration are projected to rise to around seven million by 2020.

PART 107—FAA REGULATIONS

Currently, drones operated for commercial purposes must comply with the FAA's rule on the Operation and Certification of Small Unmanned Aircraft Systems (14 C.F.R. Part 107, known as "Part 107"). Although Part 107 generally authorizes the commercial use of drones that weigh less than 55 pounds (including the entire payload), the authorization is subject to significant conditions. For example, drones must:

- not be flown over people;
- not exceed a flying speed of 100 miles per hour (87 knots);
- remain in Class G airspace (i.e., the only form of "uncontrolled" airspace in the U.S.);

- only operate within Class B, C, D, and E airspace if granted permission from Air Traffic Control ("ATC"); and
- be operated by a FAA certified Remote Pilot in Command.

If the commercial drone operation is not compliant with Part 107, a waiver or special exemption from the FAA must be issued, which requires the operator be able to demonstrate to the FAA that the intended operations can be done in a safe manner.

Most of the airspace surrounding the busiest airports in the U.S. is Class B from the surface to 10,000 feet Mean Sea Level ("MSL"). Under Part 107, a commercial drone operator must obtain specific permission from ATC before operating in this airspace. A recreational drone operator may either (1) operate under Part 107, requiring the same ATC authorization as commercial operations, or (2) operate in compliance with the Special Rule for Model Aircraft (Public Law 112-95 Section 336). Under the second option, the operator must provide proper notification to any airport and ATC tower (if available) when the operation is within five miles of an airport. These provisions are intended to make airports and ATC aware of any drones operating near airport facilities in order to adequately be able to protect manned aircraft operations and sensitive information regarding airport infrastructure.

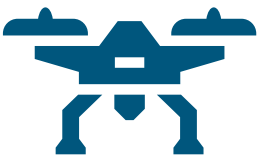
The FAA's June 2017 "Law Enforcement Guidance for Suspected Unauthorized UAS Operations" publication recognized the significant benefits offered by drones and emphasized its priority of integrating drones into the National Airspace System. However, this guidance also cited the increasing number of unauthorized drone operations as a primary concern for the FAA. The FAA has emphasized that operating drones near manned aircraft and helicopters is not only dangerous, but also illegal, and former FAA Administrator Michael Huerta has reiterated that persons conducting unauthorized or irresponsible drone operations will be prosecuted to the fullest extent of the law.

INCIDENTS

Unauthorized drone operations near airports can pose serious safety risks for aircraft taking-off and landing and for other airport operations. In some instances, the security threat can be severe enough to cause the shutdown of an entire airport. An airport shut down is not only inconvenient for passengers, staff, and airline crew, it is extremely costly to the airport and the airlines. For example, flights scheduled to land at the airport may be rerouted and take-offs may be delayed, which can cause high costs to accrue on a minute-to-minute basis. In September 2016, unauthorized drone operations forced Dubai International Airport ("DXB") to shut down for approximately 27 minutes totaling a cost of around US$28 million.

On September 21, 2017, a U.S. Army UH-60M Black Hawk Helicopter was struck by a drone being operated by a hobbyist. The drone caused minor damage to one of the helicopter's four main rotor blades and parts of the drone got lodged into the helicopter's engine oil cooler fan. In October 2017, a drone collided with a Beechcraft King Air A100 C-GJBV commercial aircraft that was in the process of landing at Québec City Jean-Lesage International Airport ("CYQB"). This incident was the first reported collision between a commercial aircraft and a drone in Canada and the Transportation Safety Board of Canada was unable to identify the drone operator responsible. Fortunately, the airworthiness of the aircraft was not compromised by the incident.

In late 2017, the Alliance for System Safety of UAS through Research Excellence ("ASSURE"), led by Mississippi State University, released a research report regarding airborne collision severity. The FAA is using these research results in the development of tools to mitigate the risks of potential collisions between manned aircraft and drones.



AIRPORT STRATEGIES TO COMBAT UNAUTHORIZED DRONE OPERATIONS

Airports across the U.S. are testing different strategies to prevent unauthorized drone operations. One approach being tested is the use of anti-drone technology, also known as counter drone technology, to identify and/or combat unauthorized drone use. Another approach various airports are testing is the FAA UAS Data Exchange, which facilitates the sharing of airspace data between the government and the private sector. The first partnership under the UAS Data Exchange is the Low Altitude Authorization and Notification Capability ("LAANC"), which allows LAANC service providers to work with the FAA to develop a UAS traffic management system. The UAS traffic management system will help allow drones and manned aircraft to operate safely in the same air space, such as around an airport. During Fall 2017, there were 45 airports/facilities who participated in LAANC's initial prototype evaluation. Although LAANC is still only in the testing phase, ultimately it is meant to allow a drone operator to apply for the authorization or notify the ATC tower of the intended flight plan with nearly real-time FAA approval for commercial drone operations in controlled airspace.

CONCLUSION

It is critical that both commercial and recreational drone operators abide by the current regulations and obtain the proper authorization before flying near an airport or anywhere near the flight path of a manned aircraft. As the FAA continues to develop a UAS traffic management system, anyone interested in operating a drone near an airport should remain up-to-date on the evolving regulations, requirements, and technologies to ensure that proper authorization is received and the operations are conducted in a safe manner.

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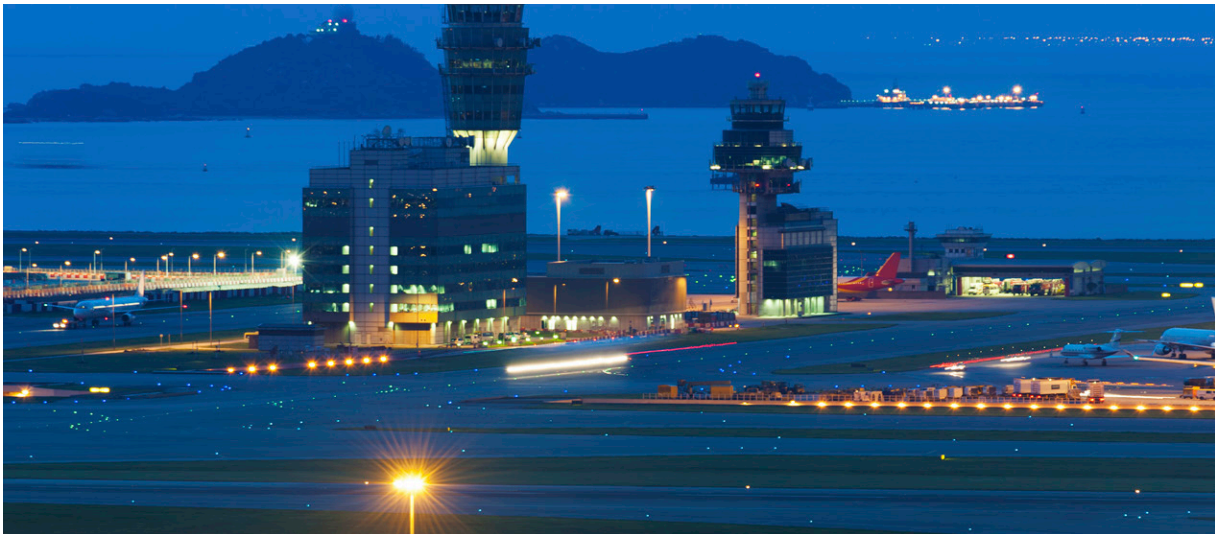
HONG KONG AS A CENTER FOR AIRCRAFT LEASING

Neil Campbell

There have been several statements by the Government of the Hong Kong Special Administrative Region ("HKSAR") over the last few years suggesting it was considering how Hong Kong might position itself to become a center for aircraft leasing, especially given the large number of aircraft deliveries scheduled to be made to Asian airlines (and, in particular, Chinese airlines) over the next decade and beyond. Hong Kong is not looking necessarily to lure existing business away from Dublin and Singapore—rather it is looking to take a slice of an enlarged pie, given the level of anticipated Asian deliveries referred to above. In his budget for 2016/2017, the HKSAR Financial Secretary announced that the government was looking to achieve its objective primarily by the use of tax concessions to encourage the establishment of aircraft leasing businesses in Hong Kong.

In July 2017, a number of amendments to the Inland Revenue Ordinance (Cap. 112), through the Inland Revenue (Amendment) Ordinance No. 2, provided for new tax concessions for aircraft leasing businesses established in Hong Kong. The changes are based on the SPV business model for aircraft leasing and, in summary, the tax rate on profits generated by qualifying aircraft lessors and qualifying aircraft lease managers was reduced to 8.25 percent, half the current rate at the time of the announcement of the proposed changes. Lessors will also be taxed only on 20 percent of their gross rentals less deductible expenses. This could bring the headline tax rate down to 3 to 4 percent although direct comparison of the headline rate with other jurisdictions could be misleading as there are other tax issues to consider such as the differential treatment of depreciation. The tax concession only applies if several conditions are satisfied including that the central management and control of the lessor are carried out in Hong Kong and that the business that generates the profits is carried out in Hong Kong or arranged to be carried out in Hong Kong. Both "qualifying aircraft lessor" and "qualifying aircraft leasing manager" are subject to the satisfaction of certain



conditions. In addition, the lease itself must be a "dry lease"—the conditions for which include that the lessor is not responsible for ensuring that the aircraft is airworthy and that no crew member is employed by the lessor. The dry lease must also not be a funding lease which means that generally finance leases are excluded from the tax concessions.

The devil, as they say, is in the detail and we shall have to wait and see how these various defined terms are interpreted by Hong Kong's Inland Revenue Department. However, a number of well known lessors have already established a presence in Hong Kong and we have already seen the first transactions closed.

By encouraging aircraft lessors to set up business in Hong Kong, the HKSAR government is looking not only to see the employment of over 15,000 people but also a profits tax revenue of about HK$10 billion over the next 20 years. Hong Kong has already seen the establishment of the Hong Kong Aircraft Leasing & Aviation Finance Association. The HKSAR government's commitment to this initiative was underscored by Carrie Lam, the Chief Executive of the HKSAR, who gave the keynote address at the Association's launch reception.

There are still a few hurdles to be overcome that currently put Hong Kong at some disadvantage to competitor jurisdictions, including the small number of countries with which Hong Kong has signed double taxation treaties compared to Ireland and Singapore. However, there is no doubt that Hong Kong has positioned itself well to take advantage of the increased Asian deliveries mentioned above and establish itself as a visible alternative jurisdiction for aircraft leasing especially to Asian airlines.

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LEGAL AND DOCUMENTATION CHANGES ARISING AS A RESULT OF THE COLLAPSE OF KINGFISHER

Sebastian Smith

In February 2018, the Financial Times reported that India had regained its title as the world's fastest-growing major economy, overtaking China in the process. Given India's burgeoning middle class with a taste for sophisticated air travel, this makes it a potentially very attractive jurisdiction for investment opportunities in the aviation sector.

However, for some, the concept of aircraft investment in India reignites memories of the insolvency of the airline Kingfisher and the pains endured by aircraft lessors in order to repossess their aircraft from the defunct airline. Moreover, some commentators felt that the ensuing debacle in the Indian courts effectively undermined the implementation of the Cape Town Convention ("CTC") in India, legislation which is supposed to enhance the aircraft enforcement regime.

In the resulting Kingfisher aftermath, many aircraft lessors/financiers simply stopped doing business with Indian airlines or imposed additional prohibitive conditions onto said airlines. Whilst it may seem unfair that reputable, creditworthy Indian airlines were taking the brunt for another's wrongs, it did

galvanise a lobbying movement and the government realised that in order to safeguard its aviation industry, it would have to take action. In short, the irrevocable de-registration and export request authorisation ("IDERA") under the CTC was given legal bite by new legislation in 2015. Subsequent case law in India seems to have given credence to said legislation, requiring the Directorate General of Civil Aviation ("DGAC") in India to deregister the aircraft, provided of course that certain conditions are met.

Following Kingfisher and other repossessions in India such as those relating to a domestic Indian airline, a much better understanding of the legal pitfalls exists for aircraft repossession in India and reputable, independent counsel should be sought as to the deregistration documentation required before leasing to an Indian airline. Whilst the most obvious documents to have in place are the IDERA and deregistration letters for the DGAC, it must also be appreciated that various government agencies may be involved when deregistering an aircraft. The role of the Customs authorities in India is often underestimated in aircraft repossession and can be the stumbling block in enforcement scenarios, so it is crucial to have documentation in the requisite form when dealing with said authorities.

India's national motto is "Satyameva Jayate", literally translated as the "Truth Alone Triumphs". Given the changes in the legal landscape and the increasing importance of India's economy, it seems the law in India in relation to aircraft repossession is looking to follow suit.

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NEW EU TRANSPARENCY RULES FOR INTERMEDIARIES MIGHT AFFECT AIRCRAFT FINANCE TRANSACTIONS

Frank Thomas and Manuel Rustler

On March 13, 2018, the EU Economic and Financial Affairs ministers ("ECOFIN Council") adopted the European Commission's proposal from June 21, 2017 on new transparency rules for intermediaries and for an automatic exchange of information in respect to cross-border arrangement and potentially harmful tax schemes. Among other things, the proposal was crafted in response to the so-called "*Panama and Paradise Papers*" and "*LuxLeaks*" to give Member States more information on tax planning schemes that intermediaries design or sell to the market.

Intermediaries are, for example, tax advisors, accountants, financial institutions, arrangers, or law firms based in the EU. However, if the intermediary is not resident in the EU or is bound by legal professional privilege or banking secrecy rules or an intermediary does not exist, the reporting obligation would automatically pass on to the respective taxpayer.

Although the EU Commission explicitly states that most services provided by intermediaries are legitimate, the EU Commission takes the view that certain transactions and structures have been or will be set up to avoid or escape taxation. Hence, the hallmarks for a potential cross-border arrangement which needs to be reported shall be as wide-ranging as possible to avoid any gaps. The first and foremost goal of the directive is to implement a mechanism that creates a deterrent effect regarding said structures. The proposal aims to keep intermediaries from proposing such structures in the first place. Thus, the directive ascertains that the obligation to report shall arise before final implementation of a structure. In case of an obligation to

report an arrangement, the intermediary or the respective taxpayer (due to a transfer of the obligation) has to file a report with their EU tax authorities within 30 days after the day the reportable cross-border arrangement is (i) made available for implementation or (ii) the arrangement is ready for implementation or (iii) after the first step in the implementation has been made, whichever occurs first. Subsequently, the intermediary or the respective tax payer is obligated to draft a quarterly periodic report providing updated reportable information.

Due to the envisaged wide formulation of the list of generic hallmarks attached to the proposal and their characteristics, the new rules might also be relevant to cross-border aircraft finance and lease transactions. For example, this could be the case if standard documents or forms are used for a cross-border aircraft finance transaction or an aircraft lease transaction involves a cross-border payment by a lessee which is deductible at source to a lessor who is related to the lessee and either (i) not resident in any tax jurisdiction or (ii) resident in a low tax jurisdiction (a tax jurisdiction that does not impose any or almost no corporate tax or is listed on the official list of non-cooperative tax shelter countries or said payments benefit from full tax exemptions in a preferential tax regime). It might also affect an aircraft transaction where depreciation on the airframe and engines is possible in more than one jurisdiction or both the lessee and the lessor can claim tax relief even if the parties are not related.

The EU member states shall adopt and publish their respective laws, regulations and administrative provisions necessary by December 31, 2019 at the latest. The new reporting requirements shall apply as of October 31, 2020. Additionally, the directive aims to require intermediaries or the respective taxpayers to file information on reportable cross-border arrangements the first of which was implemented between the date of entry into force and the date of application of this directive by August 31, 2020.

The proposal of the European Commission has been submitted to the ECOFIN Council and on June 5, 2018, the proposal has been published as EU directive 2018/22 in the Official Journal of the EU.

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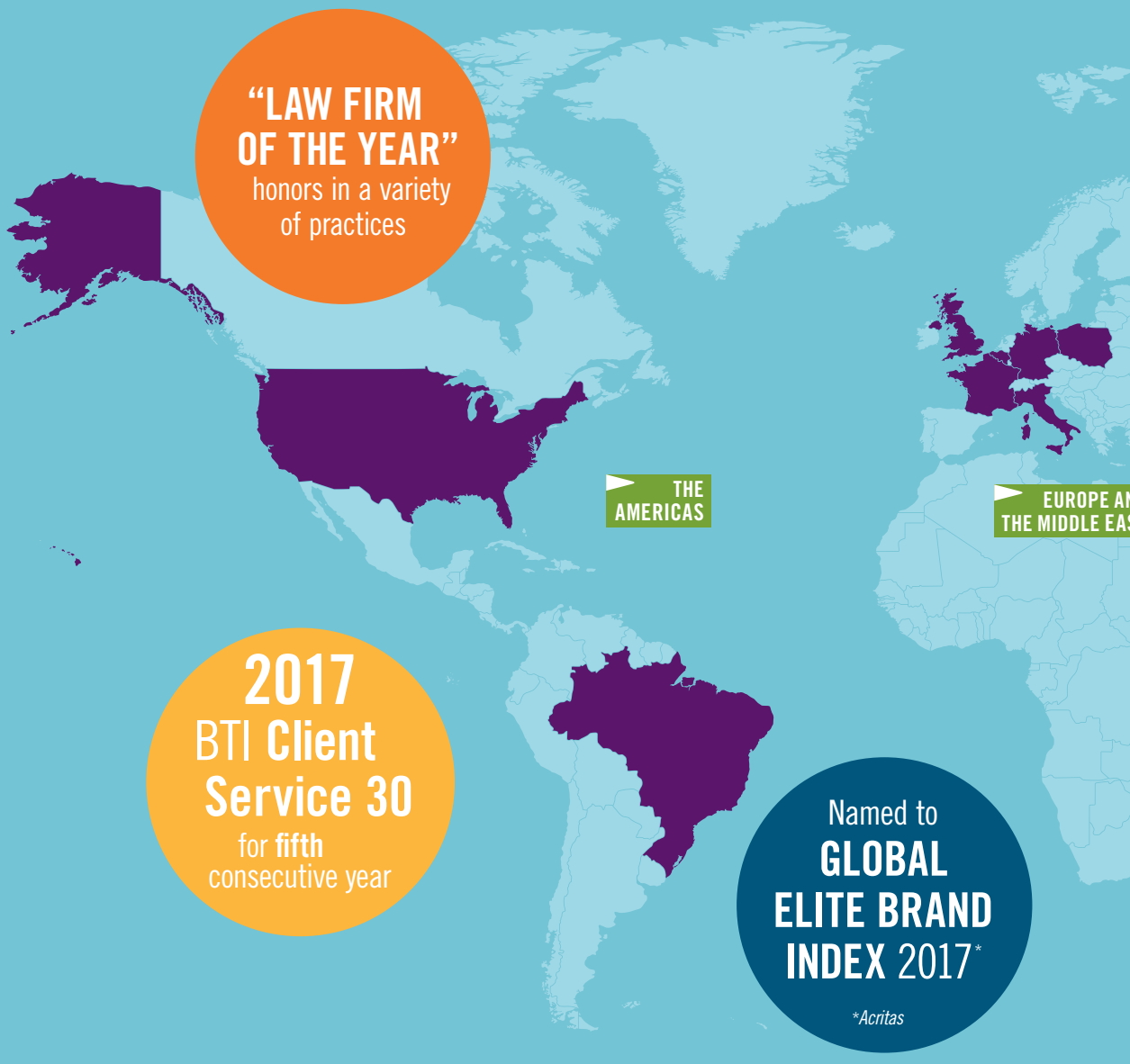

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