Issues and Opportunities for Business Aviation in Russia in 2013

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The issues and opportunities for business aviation in Russia in 2013 arise out of the key characteristics of the Russian market.

What are the key characteristics?

What are the key issues?

What are the key opportunities?
1. Key Characteristics of the Russian Business Aviation Market

1. Russian-owned business aircraft are approximately 90% registered outside of Russia.
   
   - According to information provided by the Russian Ministry of Transportation, as of November 1, 2012, only 43 business jets were registered in Russia.
   
   - According to general understanding, approximately 450 business jets are owned by Russian individuals and corporations.
   
   - Thus, approximately 90% of Russian owned business jets are registered outside of Russia, and 10% are registered in Russia.
2. Russian-owned aircraft are frequently registered for private use, but are used commercially, both in Europe and in Russia.

- This issue is widely discussed at professional conferences, but is hard to quantify and document because it involves the intentional cover-up of illegal activity.

- The EBAA website has a lengthy discussion of illegal flights, setting out arguments why:

  Illegal operations discredit the sector and impact the bottom lines of BizAv operators.

  They are essentially of a two-pronged nature:

  a. commercial transactions operated without the necessary Aircraft Operating Certificate (AOC), and/or

  b. commercial flights between countries without the necessary traffic rights (or permits).
3. There remain substantial risks to the use of foreign registered aircraft on cabotage flights in Russia, including:

- Potential criminal and administrative risks, including for bribery and corruption of government officials,

- Potential denial of insurance in the event of a crash or other event thought to be insured if a flight was an illegal flight,

- Potential loss of collateral (the aircraft) used as security for a loan, or as the subject of a lease,

- Potential customs risks, including impoundment of an aircraft, and large fines, and

- Violation of the FCPA and Bribery Act, and reputational risks.
4. In Russia, selective enforcement or non-enforcement of the law is a recognized problem.

- Selective enforcement or non-enforcement of the law is ingrained and widespread and is seen as an essential part of the system and "business as usual". Industry leaders advocate the making of false flight plans for domestic commercial flights, declaring them to be private when they are in fact commercial, since there is a low probability of adverse consequences if regulators are motivated not to inspect a flight.

- The Customs Service and Rosaviatsia challenge flights that are declared to be private on only a selective and rare basis. When a flight is challenged, an aircraft may be impounded and this may become a very expensive and protracted problem.

- Competition from illegal cabotage flights makes it difficult for law compliant operators to offer cost competitive services, as compared to flights offered on aircraft that have not been customs-cleared which are offered at lower cost.
2. The Key Issues in the Russian Market

The "key issues" depend on your point of view.

As a creditor, the key issues are likely to include:

- Choice of jurisdiction and governing law for a credit agreement, and willingness to use an 83-bis arrangement, as discussed below, including a lease or sublease of an aircraft to a Russian operator, not to the Russian client, with the operator contractually obligated to return the aircraft in the event of a default by the Russian client, and termination of the lease,

- Choice of additional forms of security including corporate guarantees from Russian corporations and personal guarantees from Russian individuals, both governed by and enforceable under Russian law, in addition to off-shore guarantees from companies outside of Russia controlled by the Russian client, and

- Prevention of illegal use of an aircraft, while permitting domestic, private flights within Russia that would not be prohibited "carriage", i.e. are not cabotage flights.
As a creditor, the key issues are likely to include:

- Observation of customs requirements for importation of an aircraft as a "means of international transport" within the meaning of Section 340(1) of Chapter 48 of the Customs Code, if the aircraft is to be used privately and there are to be no passengers paying for transportation inside Russia, and

- Observation of Rosaviatsia permitting requirements for domestic flights that are part of an international round trip flight along international flight routes, and domestic flights that are not part of an international flight along international flight routes if a permit is obtained from Rosaviatsia in accordance with GEN 1.2. AIP of Russia.
As an owner, the key issues are likely to include:

- Do you need financing, and do you need to satisfy operational restrictions that a creditor would impose?

- Do you desire to have your aircraft in Russia for more than 180 days a year for private use? If yes, customs clearance will be required. If the aircraft will be in Russia for no more than 180 days, and used only privately, customs clearance is not required.

- Do you intend any commercial use of your aircraft within Russia? If yes, customs clearance will be required.
As an owner, the key issues are likely to include:

- If some commercial usage is planned, is it to be exclusively on international routes, and to involve no illegal cabotage flights within Russia? If yes, the aircraft does not need to be customs-cleared in Russia, but may need to be customs cleared in Europe.

- If domestic commercial usage is planned, is the aircraft to be Russian-registered and placed on a Russian AOC, or foreign-registered and placed on a Russian AOC pursuant to an 83-bis agreement?

- If an aircraft is to be imported and customs cleared in Russia, what is a viable plan for recovering the import VAT to be paid?
As a foreign (non-Russian) operator, the key issues are likely to include:

- What domestic legs may be included as part of a permitted international roundtrip flight?
- How are you going to meet the illegal low cost competition from cabotage operators?
- Can you get a sufficient premium price for legal commercial flights within Russia that will allow you to recover the cost of customs clearance? In this connection, there appears to be pent-up un-met demand for fully legal commercial flights within Russia. Certain operators are reporting high demand, and the ability to charge high fees, for fully legal domestic commercial flights.
3. Tax Planning Issues in Use of a Foreign Registered Aircraft in Russia

- Russian customs duties - 20% of value
  - For aircraft under 20,000 kg
  - Consequently, heavy business jets are typically not imported

- Russian import VAT - 18% of value
  - At time of import, or over 34 months, plus interest

- Russian property tax - 2% of value
  - Annually
4. Potential Creation of an Exemption from Import VAT

Import VAT is single largest reason that Russian owned business jets are not registered in Russia.

The Russian Ministry of Transportation supports 0% VAT on all aircraft. However, no specific Ministry proposals have been published.

An ad-hoc working group has been promoting an exemption from Russian Import VAT and customs duties for aircraft imported into Russia. The group includes representatives of OEM's, and trade representatives from four countries, and has been working with members of a Presidential Commission studying proposals to promote civilian aviation in Russia.
5. What to do while the 18% Import VAT is Still in Effect?

For large Russian corporations, the import VAT may be rapidly recovered and offset against other VAT inputs. Severstal has given a presentation about this and recovered VAT on two Challenger 604's over 5 months.

Alternatively, Russian corporations may set up an arrangement providing for extensive "private" use of a foreign registered aircraft in Russia.

For wealthy Russian individuals, import VAT becomes a sunk cost, so they will register their aircraft outside of Russia.
6. **Use of 83-bis and a Cross Border Lease**

In order for a foreign registered aircraft to be flown, legally, on commercial charter flights within Russia, that aircraft must be registered in Russia or registered in a country that has entered into an Article 83bis Agreement with Russia according to the Chicago Convention.

Then, this foreign-registered aircraft must be placed on to the certificate of a Russian operator.

Seven countries outside of the former Soviet Union have 83-bis Agreements with Russia. These are: (1) Ireland, (2) Turkey, (3) Switzerland, (4) Bermuda, (5) Austria, (6) Bulgaria, and (7) Malawi. Most Russian commercial airliners are registered in Ireland and Bermuda.
6. cont'd. What does 83-bis require?

Aircraft registered in a contracting state.

Leased to an operator in another contracting state.

Certain functions and duties of country of registration may be transferred to country of lessee, including Articles:

12 Rules of the Air for flight and maneuver,
30 Requirements for aircraft radio equipment,
31 Issuance of certificates of airworthiness, and
32 Pilot licensing.
7. Calculation of Import VAT for a Leased Aircraft

In the case of an aircraft leased into Russia, the Russian lessee must file a customs declaration with the Russian Customs Service.

The key issue is the proper calculation of the declared customs value.

There are good arguments that the declared customs value may be the sum of the lease payments due over the term of the cross border lease. We submitted a ruling request to the Russian Customs Service to obtain guidance on this issue and expect a favorable reply soon.

18% of the total cross border lease payments for a lease of a year or two years, is, to state the obvious, much less than 18% of the full value of an aircraft.
8. Likely Customs Service Position

The Customs Service will likely contest a declared value based on lease payments due. We think the lessor and lessee should win on appeal.

The Customs Service will argue the declared value ought to be:

- the full fair market value of the aircraft,
- the insured value of the aircraft, or
- the total amount of lease payments that would be due under a lease for the aircraft's entire useful life, not just this lease term.
9. Issues in Determining Customs Value

It is problematic if a cross border lease provides for a lease fee calculated with regard to the number of hours flown. This does not result in a definite value to show on a customs declaration.

It is better to refer to an exact amount due under a senior lease if the aircraft is subleased into Russia.
10. Time Period for Payment of Agreed Customs Value

A Russian industrial company will typically choose to pay the full amount of import VAT, 18% of the declared value, in a lump sum at the time of importation.

An operator will typically choose to use the "temporary import regime" and pay import duties over the lesser of the term of the lease, or a maximum of 34 months.
11. Use of a Cross Border Lease Without 83-bis

It is possible to lease or sublease an aircraft registered in a non 83 bis country to the Russian subsidiary ("Subsidiary") of the aircraft owner for private use.

The Subsidiary may hire a foreign operator to operate the aircraft within Russia.

It would be best to register the aircraft in a jurisdiction, such as the Isle of Man, that allows only private use of aircraft registered in that jurisdiction.

The may be customs-cleared and based at a Moscow airport and operated by a foreign flight crew on private flights within Russia.
12. Private Use in Russia of a Foreign Registered Aircraft

This is the dominant arrangement for Russian-owned, foreign-registered aircraft. These aircraft are typically not customs cleared in Russia and no import VAT is due.

The aircraft is registered in any jurisdiction, not limited to 83-bis countries, and not limited to countries that register aircraft for commercial use.

A permit is received from Rosaviatsia providing for operation of the foreign-registered aircraft within Russia "in the interests of" the Russian lessee pursuant to a series of one-time permits.

The Rosaviatsia permit will list a large number of persons (20 or 30 or more) who may be passengers who are affiliated with the Russian lessee.
13. **Picking up passengers on Private Flights / The Rosaviatsia Position**

Russia does allow foreign-registered aircraft to be flown into Russia, and to make stops in multiple Russian cities, and to take onboard passengers for flights within Russia, provided that all such flights are "in the interests of the possessor of the aircraft."

Such flights are made pursuant to a "one-time permit" that may be issued by the Rosaviatsia. The authority for such one-time permits is found in Decree No. 69 of the Federal Air Navigation Service.

If the passengers are restricted to the persons named in the permit received from Rosaviatsia, the transportation of such persons is typically not challenged as prohibited commercial flights.
14. Picking up passengers on Private Flights/The Customs Service Position

Russia is now a party to the Customs Code of the Customs Union (the “CCCU”).

According to the Customs Code, foreign-registered business aircraft are exempted from Russian import duties and import VAT if the aircraft are owned by a foreign individual or entity and are used on non-commercial flights within the Customs Union (including within Russia).

This exemption is set out in Customs Union Commission Decision No.662.

This exemption from import duties and import VAT does not apply to aircraft to be used on charter flights within Russia, and flights "aimed at deriving income".
15. Picking up passengers on Private Flights / The Customs Service Position

The exemption applies to aircraft if:

1. the maximum seating capacity of the aircraft does not exceed 19 passengers;
2. the aircraft is owned by foreign legal entities or individuals;
3. the aircraft is used in the customs territory of the Customs Union for occasional flights (i.e. for the flights not included in a schedule of commercial flights);
4. the use of the aircraft is not aimed at deriving income.

Aircraft satisfying these criteria may be cleared for use in Russia under the temporary import customs procedure for a period not exceeding 30 days, provided the total period of time the aircraft may be in the customs territory of the Customs Union may not exceed 180 calendar days within a calendar year.

It is not allowed to pick up passengers in Russia and drop them off within the territory of the Customs Union if the aircraft is not customs cleared. See Clause 2 Article 344 of the CCCU.
16. What Would Be A Better Idea?

The current practices in Russia of allowing extensive use in Russia of foreign-registered aircraft strongly incentivizes Russian owners to register their aircraft outside of Russia.

A better alternative would be for Russia to create an exemption from import VAT for business aircraft that are imported to Russia and will be used privately or commercially.

This would be consistent with the EU Directive that exempts aircraft imported to European countries from import VAT if the aircraft are to be used commercially.

Progress may currently be being made toward Russia allowing an exemption from import VAT for business aircraft imported to Russia to be used privately, and not commercially.
16 cont'd. **What Would Be A Better Idea?**

Such an approach would help to limit "gray aviation" in Russia, the extensive use on domestic commercial flights of aircraft that are registered for private use, and imported for private use.

Such an approach would facilitate:

- investment in the Russian aviation infrastructure for business aviation,
- employment of Russian pilots and mechanics,
- creation of more FBO's,
- expansion of the number of airports that would have sufficient demand to be viable.
17. Recent Transactions in Commercial Aviation in Russia that may have applications for business aviation:

1. February 12, 2013  Washington, D.C. – The board of the Export-Import Bank of the United States (Ex-Im Bank) voted to guarantee a loan of more than $500 million provided by Apple Bank for Savings to OJSC VEB Leasing (VEBL) of Moscow for the export of a fleet of Boeing 777 aircraft to Russia to be operated by Aeroflot Russian Airlines (Aeroflot).

2. February 20, 2013  Toronto – Bombardier Aerospace announced today that Moscow-based, national leasing company, Ilyushin Finance Co. (IFC), has signed a purchase agreement to acquire 32 CS300 aircraft and options for an additional 10 CS300 aircraft. The transaction, which follows a letter of intent signed by IFC in 2011, is subject to approval by the company’s shareholders.
18. Opportunities for Financiers

1. Serve an unmet demand by providing financing for business aircraft that are to be customs cleared and operated in Russia for more than 180 days a year. Certain OEM finance companies allow this.

2. For aircraft to be operated at least partially commercially inside Russia, consider allowing use of 83-bis transactions to register aircraft in one of the European countries that has such an agreement with Russia, and then lease or sublease the aircraft to a Russian operator. For aircraft to be operated exclusively privately within Russia for more than 180 days, the aircraft may be registered in any country, not limited to 83-bis countries, but would have to be customs-cleared in Russia.

3. Use corporate guarantees and individual guarantees that are enforceable in Russia under Russian law as additional security for a loan or lease.

4. Create a leasing company in Russia, possibly with participation by OEMs, that can receive government guaranteed financing, such as an Exim-Bank guarantee, to import aircraft to Russia. Or, partner with VEB Leasing or Ilyushin Finance Co.
19. Opportunities for Operators

1. Create a wholly-owned Russian operator that holds a Russian AOC, and become the trusted partner for Western creditors that desire to lease aircraft into Russia to a trusted operator.

2. Joint venture with a Russian operator that holds a Russian AOC, and, together, become the trusted partner for Western creditors that desire to lease aircraft into Russia to a trusted operator.

3. Earn premium fees for offering domestic charter flights within Russia that are fully legal and conducted on customs-cleared aircraft.

4. Apply for a quota and the right to hire Western pilots in command to fly within Russia.
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