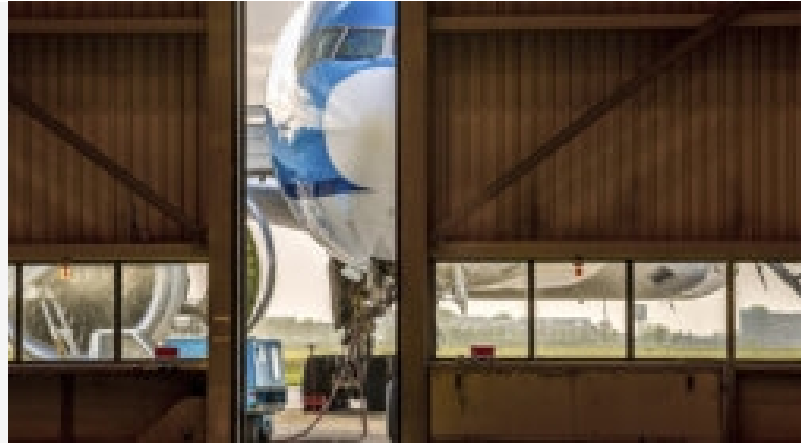


AVIATION IN INDIA TRANSFORMED: A GUIDE FOR INTERNATIONAL AIRCRAFT FINANCIERS ON INVESTING IN INDIA'S UNPRECEDENTED EXPANSION

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INDIA – A LAND OF PROMISE

India, with its large land mass and population, has long promised to be one of the world's largest aviation markets. Given recent developments and a changing legal and regulatory framework, indications are that it shall, and in many respects, has begun to, deliver on this promise.

To date, approximately 700 commercial aircraft are VT (Indian) registered. Clearly, India has much potential for growth considering China, which has a similar population size, has over 3000 registered commercial aircraft and continues to grow. Outstanding orders for aircraft by Indian airlines stood at 800 aircraft before the recent Air India group order which added 470 more to the total. India has a larger pipeline for aircraft than any other country. By 2040, it is predicted the number of VT registered aircraft will rise to approximately 2500. The most striking prediction is that 1500 to 1700 will be ordered in the next 12 to 24 months with Air India's order both being the first as well as the largest single aircraft order in aviation history.

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Of course, the metal is only part of the story. The development of India's aviation industry is a priority for its government. A thriving industry needs people and infrastructure, from airports and maintenance to training facilities and a reliable legal and regulatory framework. India's government has long-term plans for investment and change across the ecosystem including:

- US\$21bn for new airports. India has doubled its airports over the last nine years to over 140 to date. Its current plan is to eventually have 200 operating airports throughout the country;

- a total of nine new pilot training facilities were opened during FY 2021/22;
- the recent Maintenance, Repair & Overhaul ("MRO") directive issued by the government seeks to make India conducive to establishing more MRO facilities; and
- India has established GIFT City ("GIFT"), an ambitious international financial services centre ("IFSC"), based on the same principles as those in Dubai and Hong Kong. It will contribute enormously to the exponential increase in investment India will need to finance its aircraft, and also provides an opportunity for India to establish its own aircraft leasing hub and eventually become a global power in aircraft leasing and finance.

Funding originally earmarked for Air India can now be diverted into these projects following privatisation.

In this article, we consider the key issues for aircraft financiers when investing in Indian aircraft, whether that investor is an operating lessor or financier. We consider the tax and regulatory regimes and the legal framework for an enforcement. However, India's ambitions are driving fast paced positive change for investors. We consider this changing landscape and the opportunity it offers for Indian aviation and investors alike.

TAXES AND REGULATIONS

Financing aircraft in India

Domestic Indian aircraft finance is expected to expand to meet some of the growth required to meet the previously mentioned goals. However, most of the new financing is expected to come from foreign investors. Operating lessors already finance money to Indian registered aircraft and are expected to continue to do so. But, as Indian airlines look to build their balance sheets and take deliveries of more widebodies – notoriously more difficult to finance on an operating lease basis – the proportion of finance derived on a finance lease basis from international banks and financiers is expected to increase. The main tax and regulatory considerations in respect of operating and finance lease transactions for lessors/financiers are subject to change however in light of GIFT, which we discuss further below.

Taxes

An aircraft financing and leasing transaction will typically give rise to the following taxes in India:

- unless there is an available exemption, such as payments made to a lessor incorporated in a jurisdiction which has a double tax treaty with India (such as Ireland) and said lessor qualifies under such treaty, lease rental or the interest component on a finance lease will be subject to withholding tax at applicable rates. The standard rate for a deduction is 10% which is 'tax deducted at source' and is chargeable under the Indian Income Tax Act. Non-Indian lessors can apply under section 197 of the Income Tax Act for an exemption from this tax. In relation to the India-Ireland treaty, for example, this section grants a certificate for 'nil' rate of withholding tax on the premise that under Articles 8 and 12 of the treaty, the lessors will be liable to pay tax only in Ireland;
- a general sales tax ("GST") is also payable on lease rentals and will also be payable on lease rentals paid by a lessee. GST is India's consolidated indirect tax regime which came into force in 2017, effectively replacing a variety of previous indirect taxes including sales tax, VAT, service tax, purchase tax and excise duty amongst others; and
- stamp duty is also payable on sale/purchase, lease or financing agreements that are signed in India. The rate of stamp duty depends upon the nature of the agreement and differs in each state in which it is executed. All lease agreements should be stamped at the time of execution in case such document must be positioned in India for enforcement purposes.

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Reserve Bank of India approval

The transfer of foreign exchange from India is subject to controls and the approval of the Reserve Bank of India (the “RBI”) may be required. The RBI approval process is relatively streamlined and most transactions do not need direct approval from the RBI itself. Rather, payments are processed through banks acting as “authorised dealers” who have been appointed as such by the RBI. These do not need any direct involvement from the RBI. Broadly, rental and other amounts payable by an airline (including the provision of letters of credit) to the lessor pursuant to an operating lease do not require RBI approval as exemptions are available. Guarantees issued in connection with operating leases are also subject to a simplified approval process, as, if the guarantee is called, this would entail cross border payments from the guarantor to the lessor. Rental and other amounts payable by an airline to a lessor pursuant to a finance lease are, however, subject to RBI approval, though the process is not prohibitive.

REPOSSESSION AND EXPORT

When progressing credit approval for a transaction, a crucial part of the analysis for an investor is how quickly its aircraft can be recovered in the event an airline defaults. Often an enforcement occurs outside of an insolvency process and recent developments and experience in India have provided sufficient certainty and confidence for many investors. Some of this certainty derives from India’s ratification of the Convention on International and Interests and Mobile Equipment (CAPE TOWN, 2001) (the “Convention”), but only to an extent. India failed to pass primary legislation to implement the Convention and as such, investors do not have as much confidence in India’s status compared to jurisdictions that have implemented the Convention. There is, however, a bill at consultation stage of the Indian legislative process to correct this, together with the existing insolvency regime.

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The IDERA (Irrevocable deregistration and export request authorisation)

The Convention has had a significant impact on Indian aviation with respect to IDERAs which have proven to be an effective tool for deregistering Indian aircraft. Since the amendment of the Aircraft Rules in 2015, the Directorate General of Civil Aviation in India (the “DGCA”) has been obliged to deregister an aircraft by a registration holder (usually the operating lessor or security trustee acting on behalf of the financiers) pursuant to the exercise of its rights under an IDERA within five days of application. Anecdotal evidence suggests that an IDERA holder has been able to procure deregistration of an aircraft within seven to ten days of an application. Whilst we consider other methods of enforcement below, making use of the IDERA is the most effective method of enforcement in India for an investor to recover their

aircraft and is suitable for both operating lessors and lenders since it forms part of the security package in operating and finance leasing. The process for enforcement is as follows:

1. an IDERA holder begins the process by filing an application for deregistration with the DGCA using the prescribed form. The application should be made through the available online platform and will need to be notarised if it is not executed in India and the original delivered to the DGCA. An IDERA holder can also appoint Indian counsel to sign the application pursuant to a power of attorney;

2. together with the application, the registered holder must provide a notarised copy of the IDERA, the confirmation of recordation of the IDERA provided by the DGCA on or around delivery (recordation should be a condition precedent or subsequent to be fulfilled at delivery), a notarised priority search certificate from the International Registry providing all registered international interests made with respect to the aircraft and, if any priority interest holders have consented to the deregistration, such consents should also be provided;
3. the DGCA will post the application on its website to notify potential priority interest holders of the impending deregistration and export and shall also notify domestic airport operators. Airport operators can claim for unpaid dues in respect of the aircraft for a period of up to three months of the application being made (any unpaid dues prior to such date cannot be claimed). There is no fleet lien concept so the registered holder will not be required to discharge any unpaid dues incurred in respect of other aircraft. Other central government entities and private providers of public services can raise bills within the five day period for amounts due, and only with respect to, the aircraft. A common liability that lessors have been liable to discharge in addition to airport fees is that of GST on lease rentals which remain unpaid;
4. on the fifth day the registered holder must then pay the notified outstanding amounts. Upon receipt of payment the priority interest holders must issue a certificate to the registered holder that such liabilities have been discharged which the registered holder must then submit to the DGCA as evidence of payment. The DGCA will then proceed with the deregistration; and
5. the final step is for the registered holder to pay parking and take off fees incurred up to and in respect of the ferry flight and evidence payment to the DGCA.

Deregistration on lease termination

The DGCA is also required to deregister an aircraft on termination of a lease agreement. The original certificate of registration in respect of the aircraft is required in order to complete this process, which would usually be in the possession of the defaulting airline. Therefore, the IDERA route is preferable and should be available to all investors due to the standard requirement to provide an IDERA in all transactions.

Enforcement of mortgages

In finance lease transactions, the security trustee is also granted a mortgage over the aircraft. Indian courts recognise New York and English law governed mortgages which are enforceable in India, subject to standard exceptions applicable in most jurisdictions, such as where enforcement is contrary to public policy. Self-help remedies are available, but if the enforcement is challenged, then the mortgagee will need the assistance of the court. The action taken to recover the aircraft will depend on the circumstances, but it is possible to seek interim orders to ensure the aircraft is grounded and maintained in the short term. However, the security package in a finance lease transaction includes an assignment of the lease between the lessor/borrower and the airline in favour of the security trustee. Indian courts recognise lease assignments and the enforcement thereof. This method of enforcement is preferable to that of enforcing the mortgage because the security trustee can deal directly with the airline and the security trustee, as registered holder, can deregister and export the aircraft through an IDERA.

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ENFORCEMENT OF FOREIGN LAW JUDGEMENTS

The Indian courts do recognise and enforce English law monetary judgments as there are reciprocity arrangements between the two jurisdictions. There is no reciprocity with regards to New York law judgments. When enforcing a New York law judgment, the Indian court would need to consider a number of factors, including whether it would have followed the decision of the New York court. This would also be the case when enforcing a non-monetary judgment from a jurisdiction even where a reciprocity agreement exists.

INDIA, INSOLVENCY AND THE CAPE TOWN CONVENTION

Kingfisher v. Jet

The process of deregistration and export of an aircraft in an enforcement scenario described above is potentially subject to a less certain outcome if the airline is in insolvency proceedings. Unfortunately, the insolvency of Kingfisher Airlines (“Kingfisher”) is still remembered by many investors when discussing Indian insolvency risk, even though it occurred more than 10 years ago. It was a painful and expensive process for the concerned lessors and financiers and remains in the consciousness of many when considering financing Indian aircraft. This is perhaps unfair as the way the Kingfisher insolvency unfolded was impacted by the personality at the helm of the airline and it is unlikely it would ever be allowed to be repeated. The experience of many investors in the context of Jet Airways (“Jet”) insolvency, the only significant insolvency since Kingfisher, was markedly better.

The progress to a more sympathetic regulatory and legal framework for aircraft lessors and financiers in India began before the Kingfisher insolvency with India’s ratification of the Convention, but as Kingfisher had entered into its leases and finance agreements prior to ratification, this had very little impact on its insolvency. Notwithstanding India’s failure to pass primary legislation to implement the Convention, it did have an impact in the insolvency of Jet as lessors and financiers were able to deregister and export aircraft using their IDERAs and most aircraft were dealt with outside the insolvency. If such cooperation had not been forthcoming however, the lessors and financiers could have faced delays in recovering their aircraft. This is because India’s courts are likely apply the Bankruptcy and Insolvency Code (the “Insolvency Code”), and not the insolvency measures set forth in the Convention due to the failure to pass primary legislation.

The Insolvency code, Alternative A and s.1110 of the US Bankruptcy Code

Pursuant to the Insolvency Code, lessors and financiers are subject to a moratorium of 180 days (which may be extended by a further 90 days and beyond). Aircraft are depreciating assets and the ability to repossess, deregister and export promptly is crucial for a financier and lessor. Any lengthy moratorium period which does not have a definitive end date has a significant adverse impact on an investor as the asset may deteriorate in value due to lack of care and maintenance and is not generating any return (it is likely to recover only cents in the dollar from the insolvent airline even though the airline is required to continue to pay rent until redelivery). An insolvency officer under the Insolvency Code has no obligation to preserve the value of the aircraft during the moratorium.

The process in India can be contrasted with s.1110 of the US Bankruptcy Code which was introduced by US legislators to encourage investment in aircraft for US airlines, and on which Alternative A of the Convention is based. Under s.1110, an airline in bankruptcy has to make a choice within 60 days of the commencement of the bankruptcy proceedings to either hand back the aircraft to the financier or lessor, or cure all defaults and agree to perform the current terms of the lease or finance agreement thereafter. Alternative A of the Convention replicates a very similar approach to s.1110, although leaves it to the contracting state to determine the time period at the time of ratification. The Convention also provides for measures in the interim to ensure that the airline or insolvency officer is required to look after the aircraft and maintain its value.

The cost to India

As a result of India's failure to properly implement the Convention, it scores an average 69, in the medium category, on the Cape Town Convention Compliance Index maintained by the Aviation Working Group (the "Compliance Index"). The Compliance Index acknowledges the degree of compliance by the Indian legal system and courts with the terms and intent of the Convention, but overall scores India average as the outcomes remain mixed, inconsistent and perhaps unpredictable. This has, and continues to have, an adverse economic impact on Indian airlines. The cost of funds for financiers and lessors financing Indian registered aircraft is higher, for example, Indian airlines are not eligible for the "Cape Town discount" available in export credit agency backed finance transactions pursuant to the terms of the Aircraft Sector Understanding. The cost for Indian airlines could be billions in lost finance as well as cheaper finance over the last decade, even when mitigated by the era of low lease rate factors. The age of historically low interest rates is over and coupled with its plans to grow fourfold in the next decade, the failure to reform will cost the Indian aviation industry more billions and may have the tragic impact of slowing its ambitions.

The protection and enforcement of interests in Aircraft Objects Bill and the full implementation of the Convention

A pillar of India's ambition in aviation and its commitment to develop its ecosystem is its plan to finally pass primary legislation to implement the Convention and give it primacy over existing domestic law. The Cape Town Convention Bill 2018 was its first noble attempt, but which failed. The Protection and Enforcement of Interests in Aircraft Objects Bill/Act (the "CT Bill") is the second attempt and the path to its final assent remains only a matter of political will. If the CT Bill receives assent it will provide a landmark change for aviation in India with the adoption of the Convention's Alternative A approach in an insolvency of an airline and by adopting materially the same time period of two months for an insolvency procedure as s1110 of the US Bankruptcy Code. An airline (or insolvency officer as applicable) will be required to either hand back an aircraft to the lessor or confirm it wishes to keep the aircraft and cure all existing defaults (and agree to perform all future obligations) within such two month period. The CT Bill also provides the following:

"If the CT Bill receives assent, it will align India's laws with all material provisions of the Convention."

- the Convention's provisions with regards to non-consensual rights and interests will apply, and the categories of such provided in it are incorporated verbatim in the CT Bill. The airlines are tasked with keeping the DGCA informed of the liabilities incurred in connection with such non-consensual rights and interests, which provides some degree of certainty for a lessor or financier upon filing an application to deregister using an IDERA;

- the DGCA is required to deregister an aircraft upon request of the holder of an IDERA within five business days of application, subject to such holder confirming to the DGCA that the liabilities owed to non-consensual right holders have been discharged. This reflects the current law in as far as the DGCA is concerned, but will prevail over other laws, increasing certainty;
- an application to the court from a creditor for interim protection during the two months in the event of an insolvency must be heard by the court within 10 or 30 days of application (10 days for applications for more urgent measures). Lessors and financiers could obtain interim measures to protect the value of the asset swiftly and in line with the time periods set forth in the Convention;
- whilst certain procedures of the Insolvency Code still need to be followed notwithstanding the provisions of the CT Bill, the insolvency officer is expressly obliged to preserve the aircraft and maintain its value during the period of any insolvency proceedings, without the need for any application of the lessor or financier; and
- the CT Bill gives express primacy over existing domestic law.

Reductions in finance cost – more investors

If the CT Bill receives assent, it will align India's laws with all material provisions of the Convention. Many investors are happy to do business in India under the current circumstances and the ghost of Kingfisher should be laid to rest notwithstanding. There are many jurisdictions with large fleets which have not ratified the Convention. The UK, for example, attracted global investors prior to its ratification of the Convention on the basis that its insolvency regime was sympathetic to investors and provided certainty for creditors. However, many investors still needed persuasion and more expensive credit enhancements were bolted onto finance products which would not have been required if Alternative A of the Convention had applied. It required a depth of analysis to understand, as does India's current regime, but many international investors with large amounts of capital to deploy require a degree of uniformity when investing, which Alternative A provides. Where there are two competing opportunities to invest, investors will often select the option which features uniform protections. India's full implementation of the Convention will result in India receiving an upgrade in its rating on the Compliance Index. Its airlines will not only access reductions in finance cost, but a far more diverse range of products and become a bankable first choice for a much wider range of investors.

GIFT CITY – THE DEVELOPING EPICENTRE OF INDIA'S AVIATION INDUSTRY

GIFT City (India's special economic zone and IFSC) was established in 2015 in the State of Gujarat. GIFT is a city of 886 acres of land with 62m sq. ft. of office space and housing which already counts Indian and foreign financial institutions, insurance companies, manufacturers and an international bullion exchange amongst its occupants. Since 2020, GIFT has offered its potential as an aircraft financing and leasing hub.

Similar to IFSCs in Dubai, Singapore and Hong Kong, GIFT is a "deemed foreign territory" where transactions can be conducted in freely convertible foreign currency including US dollars. It is further radical reform of India's regulatory framework which will impact India's aviation industry and provide a more attractive ecosystem for financiers and investors. Initially, it is anticipated foreign investors will structure transactions through GIFT using special purposes companies to take advantage of the simplified tax regime and lighter regulatory requirements. In the long term however, the Indian authorities want foreign companies to establish their own entities in GIFT to do business with Indian companies, but also as base from which to enter into cross border transactions and for GIFT to become an aircraft finance and leasing hub in its own right.

Structuring a transaction through GIFT

Currently, the majority of cross border aircraft finance transactions for Indian aircraft are structured with Ireland. Part of Ireland's world leading aircraft finance ecosystem is, of course, its double taxation treaty network, including that with India, as a result of which payments on operating lease rentals and interest on finance leases are not subject to withholdings. However, due to the multilateral instrument entered into between India and Ireland in respect of the treaty, designed to implement the OECD's project concerning base erosion and profit shifting, the variety of transactions which can be structured based on utilising the benefits of double taxation treaties has decreased. A special purpose company established in GIFT can make payments outside of India without any requirement to withhold, including with respect to payments under an operating lease or a finance lease. Payments made to the GIFT SPC by an Indian airline are also made free of any such deductions. Therefore, a lessor and airline can structure a tax efficient transaction through GIFT. Under the double taxation treaty, only rentals and interest payments can be made free and clear of withholding taxes, whereas all payments under a transaction are made free of such if structured through GIFT. Investors can now structure tax efficient transactions through GIFT where they are not able to do so on the basis of a treaty. Those currently relying on the treaty may also choose to structure through GIFT as it avoids the risk and the increased scrutiny of a transaction which relies on the treaty. Other advantages of structuring a transaction through GIFT include:

- the financier or lessor need not take any jurisdictional risk on GIFT as the airline can establish the GIFT SPC. The foreign lessor would then be leasing to the GIFT SPC and the GIFT SPC will back-to-back lease the aircraft to the airline;
- payments made from a GIFT SPC to a foreign company do not need any RBI approval, although the financier would likely require a guarantee of the GIFT SPC's obligations from the airline as a condition to its credit approval. Whilst this adds a level of complexity to the transaction (as RBI approval might be needed in respect of the guarantee and withholding taxes may be incurred on payments under the guarantee), such complexities are unlikely to make the transaction materially less economical or unattractive; and
- the financier's rights on enforcement would not be compromised. The sublease between the GIFT SPC and airline can be assigned to the financier and the Indian courts recognise these assignments. The financier on an enforcement therefore would be able to deal directly with the airline as if it had not structured through GIFT and utilise an IDERA in the deregistration and export of the aircraft.

"As of today, approximately 15 GIFT entities are engaged in aircraft leasing in GIFT and by end of Q1 2023, approximately 60 aircraft are expected to be leased out of GIFT into India."

Transactions through GIFT still present challenges, such as the capitalisation requirements of the GIFT SPC required to demonstrate substance, which are manageable for an operating lease transaction, but are less economical for a finance lease transaction. Although this would be for the airline to fund, the transaction must be economical for the airline as well as the financier.

GIFT City as an aircraft financing and leasing hub

Structuring transactions through GIFT is only part of the story for its architects. To support the growing civil aviation sector and Indian airlines, the government has ambitions for GIFT to become an aircraft finance and leasing hub for India and the world. GIFT is designed as an attractive opportunity for foreign banks, aircraft lessors, investors, and other stakeholders to establish a base in India and deal in freely convertible foreign currency. It offers an 'off-shore' set up, free from India's sometimes onerous regulatory and tax regime, whilst also offering, in addition to the those described above the following advantages and incentives:

- 100% income tax holiday for any 10 consecutive years of the GIFT entity's first 15 years of operation; reduced minimum alternate tax; and exemption from capital gains tax on transfer of specified securities made within the tax holiday period;
- a waiver from stamp duty for aircraft leasing entities on all activities related to setting up the GIFT entity, including the acquisition of aircraft, for a period of 10 years;
- goods and services tax on lease rentals are reduced to 5% for GIFT entities, and such when leasing to an Indian airline is levied on a forward charge mechanism, instead of a reverse charge mechanism; and
- the unified International Financial Service Centre Authority provides regulatory clearance for GIFT entities for all purposes, whereas an entity establishing itself elsewhere in India would be required to approach separate regulators for approvals relating to banking, insurance, pension and foreign exchange regulations.

"India's growth will be driven by new technology aircraft, which is one of the pillars that will drive greater sustainability."

As of today, approximately 15 GIFT entities are engaged in aircraft leasing in GIFT and by end of Q1 2023, approximately 60 aircraft are expected to be leased out of GIFT into India. Although these aircraft shall be business jets and not commercial aircraft, it is a positive demonstration of GIFT's potential.

Initially, entities established in GIFT are likely to be used exclusively to lease aircraft into the domestic market. Foreign lessors will likely need clarity on whether establishing an entity in GIFT would cause them to have a permanent establishment in India. If GIFT's long-term ambition is to rival other global aircraft leasing hubs and enable GIFT entities to lease out of India to foreign airlines, a comprehensive

network of double tax treaties will need to be established with other jurisdictions to permit the payment of rentals from those jurisdictions to GIFT free of withholdings.

India transformed

GIFT as an aircraft leasing hub is likely a long-term project but is already underway as the first commercial aircraft lessor has announced its establishment in GIFT. In terms of structuring through GIFT, the first commercial aircraft transaction to close will open the floodgates for many more in quick succession and the race is on to be the first. The tax benefits, in particular the possibility of nil rate withholdings, will make those finance products economical (which currently are not) to investors and Indian airlines alike. GIFT combined with implementation of the Convention through primary legislation is a powerful compelling transformation.

SUSTAINABILITY

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India's plans for exponential growth coincide with a concerted and coordinated effort by the global aviation industry to make the industry more sustainable and eventually develop new technologies towards net zero by 2050. This has had an impact on finance, with new finance expected to come with strings attached, or targets, whereby the airline is incentivised to operate a more sustainable business. India's growth will be driven by new technology aircraft, which is one of the pillars that will drive greater sustainability. Within a decade the fleets of major Indian airlines will be packed with Neo, Max and the most efficient (Boeing 787 and Airbus A350) widebody aircraft. The Indian fleet is likely to be one of the most efficient operating globally. As a result, with the growing pressure on financiers to finance "best in class" aircraft, Indian airlines could enjoy discounts on their finance. However, it seems India could be missing an opportunity in sustainable aviation fuel ("SAF") production. There is no lack of planned investment for developing its aviation industry, a small proportion of which could be diverted into SAF. Sustainability targets are already having a significant impact on financiers and the notion of 'growth now, worry about sustainability later' is not viable as it could jeopardise India's access to finance. When developing industries, it is possible for an economy to leapfrog others and build to better, rather than to the same standard. India with its size and population has enormous domestic sources of feedstock for SAF is an opportunity that the country is uniquely placed to exploit as a world leader.

CONCLUSION

Undoubtedly, the Indian government making aviation a priority has already had an enormous impact on Indian aviation and the foundations have been established for decades to come. Through a combination of investment, plans and aircraft orders, India has made itself a jurisdiction where an investor in aviation cannot afford to *not* do business. Likewise, whilst the current legal framework together with more recent experience, provides enough certainty for many to support India's fleet ambitions, there are enormous savings available to India in continuing its journey, such as passing primary legislation to implement the Convention. This would generate significant savings through lower finance costs and will attract many investors who do not have previous experience of financing Indian aircraft and which place substantial value on processes which are standardised internationally such as the Convention. The benefits that structuring through GIFT offers, for example with regards to exemption of withholding taxes, will also open India to investors in markets that previously have not been able to structure economically into India.

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