

## **CURRENT HOT TOPICS IN LEASE VERSUS PURCHASE ANALYSIS**

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Over the last couple of years, the IRS has been busy revising and refining rules that bear on deductibility of tax depreciation from aircraft ownership. Despite the new landscape of IRS restrictions on depreciation deductions, it is still common to see aircraft proposals presented on the basis of an assumption that depreciation is fully deductible by the aircraft owner. Although it is understandable why sales presentations include the most ideal tax assumptions, purchasers of corporate aircraft must undertake their own tax analysis to validate those assumptions. This article will briefly address three (3) of the most common stumbling blocks preventing aircraft owners from fully realizing all the benefits of tax depreciation.

**In the event that the aircraft owner will not realize all of the tax benefits from depreciation, then the owner will likely realize the lowest overall ownership costs by structuring the acquisition as an operating lease which shifts depreciation to a commercial lender, thereby leveraging the tax benefits to produce a lower effective cost of funds.**

### **RECREATIONAL USE OF CORPORATE AIRCRAFT:**

In October 2004, President Bush signed the American Jobs Creation Act amending Internal Revenue Code Section 274 (hereinafter "AJCA"). The IRS subsequently issued IRS Notice 2005-45 which provides interim guidance for implementing AJCA pending issuance of final regulations. Proposed Regulations which were issued in June 2007. Most notably for aircraft owners, these new rules limit deductibility of depreciation and all operating expenses in the event that the aircraft is used for recreation. Under old law, a determination of whether a trip was for business or recreation was based on the "primary purpose" of the trip. If the primary purpose was business, additional passengers traveling for recreation would not affect corporate tax deductions. The AJCA has changed the analysis significantly.

Under the AJCA, the primary purpose test has been withdrawn, the new rules require an examination of the purpose for which each passenger was traveling onboard the aircraft. If even a single passenger is traveling for recreation, then some disallowance of depreciation and operating expenses will occur. The calculation of how much of otherwise available deductions is disallowed is beyond the scope of this brief discussion and will be provided upon request.

### **PASSIVE LOSSES:**

Many sales proposals project charter revenue off-setting operating expenses, resulting in a lower operating cost per hour. Charter companies have been very successful in generating significant charter revenue for owners of managed aircraft. However, charter use of an aircraft is considered to be a "passive activity" of the aircraft owner.

IRC Section 469 provides rules for classifying income and deductions (including tax depreciation) as “passive”. Tax deductions characterized as “passive” are only deductible against passive income, and most people have very little passive income. Passive income is commonly generated from ownership of pass-through entities such as S Corps, LLC’s, or Limited Partnerships which generate income, where the owner does not “materially” participate in the business activities (IRS regulations provide several tests to aid in determining whether a taxpayer “materially” participates in a business activity. These tests are beyond the scope of this discussion). Additionally, income generated from many rental activities is considered passive income regardless of whether the owner materially participates in the business activities. However, the most common type of income generated by high net worth individuals is dividend and capital gain income, neither of which is passive for tax purposes.

In the ordinary situation, when an aircraft owner places his or her aircraft in charter operations, IRC Section 469 will classify that activity as a passive rental activity. As an example, in the event an aircraft is used 600 hours for the year, 400 of which are in charter, then two-thirds of the use of the aircraft would have been in a passive rental activity resulting in two-thirds of the tax depreciation and operating expense deductions being characterized as passive. Consequently, two-thirds of the tax depreciation and operating expense deductions may only be used to offset the income generated by the charter activity, as well as any other passive income the aircraft owner may have.

Any net passive losses (i.e., net passive depreciation and operating expense deductions in excess of net passive income) may not be used to offset other types of income, and may not be currently deducted. Such net passive income must instead be carried forward to future tax years, hopefully, to be netted against future passive income. Net passive losses may be deducted in the year of a taxable sale of the aircraft. However, if the aircraft has retained significant value, or a tax free exchange is conducted, then the net passive losses produce no benefit to the aircraft owner.

#### **[OPTIONAL] NON-RECOURSE FINANCING:**

Many lenders offer non-recourse financing, which at first glance seems compelling. In today’s competitive financing environment, non-recourse financing may only carry a one percent (1%) premium over recourse financing, with less financial disclosure; many aircraft purchasers are intrigued by the prospect of non-recourse financing. However, non-recourse financing will generally limit the owner’s ability to realize the tax benefits of depreciation.

IRC Section 465 provides rules governing when a borrower is “at risk” with respect to debt financing. In connection with the use of an LLC to own an aircraft, the “at risk” rules may be satisfied by the LLC member(s) guaranteeing the entire debt. In connection with an S Corporation owning an aircraft, the S Corporation shareholder(s) **must** be the borrower(s), and not the guarantor(s). Non-recourse financing or improper structuring, may result in tax depreciation and operating expense deductions that may not be used by the shareholder(s) or

member(s) due to limited basis and at risk problems. Again, these rules are complex and the details are beyond the scope of this brief discussion.

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