



Financing and Aircraft Purchases – Critical Tax Considerations You Need to Know

-By Kara M. Kraman-

Let's consider the following scenario: You are thinking about acquiring a new aircraft, and your tax professional advises you that you can depreciate the aircraft and offset taxable income against the depreciation. The after tax cost of operating the aircraft appears to be very attractive due to the accelerated tax write-offs available. After you look at the numbers, you decide to go ahead with the transaction.

As the negotiations move forward, and after the tax planning is completed, your treasurer advises you that it would make sense to obtain a loan to pay for the aircraft, rather than using corporate funds. He also tells you he has found a lender who will lend the money at an attractive rate either on a non-recourse basis or without any type of personal guarantee.

You move forward with the loan and create a loan term sheet, identifying the aircraft owning entity as the borrower. You don't consider mentioning this to your tax advisors; why should you? Borrowing money isn't a tax issue... or, is it?

The at-risk rules under IRC § 465 limit the ability of individuals to deduct net losses from business investment activities involving borrowed money when the individual is not at-risk of repaying the money. In other words, in the context of funds borrowed by a limited liability company or partnership to purchase an aircraft, you are only considered at risk to the extent you are personally liable for the amounts borrowed. As a result, you may not have adequate basis to fully utilize the depreciation deductions flowing through on a K-1 if you take out a non-recourse loan to finance the aircraft.

The Internal Revenue Service does not consider a borrower to be at-risk for a non-recourse loan because unlike a recourse loan, a non-recourse loan does not allow the lender to recover the loan from the borrower in the event of a default. (On a related but separate topic, a shareholder in an S corporation who guarantees a corporate loan will not get additional basis in his stock and may also be precluded from fully utilizing his depreciation deductions.) If you cannot fully utilize the aircraft depreciation deductions, suddenly the transaction looks much less attractive. So you think to yourself, 'Okay, I will personally guarantee the loan and then I can take the deductions'. Not exactly.



The Internal Revenue Service (“IRS”) will not necessarily consider a person who personally guarantees a partnership or LLC loan to be at-risk for that loan. A proposed treasury regulation (which has never been finalized but is widely followed) provides:

If a taxpayer guarantees repayment of an amount borrowed by another person (primary obligor) for use in an activity, the guarantee shall not increase the taxpayer’s amount at risk (emphasis added). If the taxpayer repays to the creditor the amount borrowed by the primary obligor, the taxpayer’s amount at risk shall be increased at such time as the taxpayer has no remaining legal rights against the primary obligor.

In other words, if you have to pay the loan because of a personal guaranty but you have legal recourse against someone to recover the amount, you are not at-risk. The good news is that several courts have found that under certain circumstances, the individual guarantor of a loan is at-risk for purposes of § 465. The bad news is that the cases dealing with this issue can be confusing and sometimes contradictory because different courts may rely on different cases for guidance in determining whether you are at-risk for the amount of your guarantee. Thus, the matter can be more art than science.

In a frequently cited case, the Tax Court held that limited partners were not at-risk for the amount of the partnership loan they guaranteed because the applicable state law allowed them to recover against the primary obligor, in this case the general partner. In a subsequent case, a Federal District Court held that the right of the limited partners to be indemnified by the general partners prevented any amount guaranteed from being at-risk even though the right of indemnification against the general partners was waived by the limited partners at the outset. The general principle established by these cases is that if a guarantor has any right of contribution or reimbursement by contract, or even by state law, against another party or the partnership, he is not considered at-risk for the amount he has guaranteed.

Under certain select facts and circumstances the courts have found that a personal guarantee by an individual increases his amount at-risk under § 465. For example, where limited partners guaranteed a pro-rata portion of the partnership debt in order to avoid joint and several liability, the court found that each limited partner was at-risk for his pro-rata amount of the debt because each limited partner’s guaranty ran directly to the creditor so each was primarily liable and the creditor had no recourse against the partnership so each guarantor was ultimately liable.

Although sometimes the cases in which the courts find a guarantor is at risk versus the cases where the courts find that a guarantor is not at risk seem nearly indistinguishable, certain similarities run through these cases. The three main factors that may tip the scale toward an individual being at-risk are: (i) whether the guarantee is absolute, unconditional and not contingent; (ii) whether the guarantor has a right of subrogation, contribution or reimbursement from the entity or any other owner; and (iii) whether the guarantor bears ultimate responsibility for the debt or a stated portion of the debt.



Nevertheless, it is difficult for an individual who guarantees a debt to ascertain with any certainty whether or not he will be considered to be at-risk under § 465. With careful tax planning, however, it is possible for you to structure your loan to maximize your amount at-risk. In order to accomplish this, it is a good idea to consult with an aviation attorney who specializes in tax law and has experience working on aircraft finance transactions. The attorneys of GKG Law have worked on hundreds of aircraft finance transactions and can help you identify and capitalize on opportunities for effective tax planning.

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