To Buy Or Lease A Private Aircraft ?

by Greg Cirillo and Gary I. Horowitz

To answer the question in the headline, "It depends". That is an entirely unsatisfying answer, but one that unfortunately applies to the decision of whether to buy or lease a private aircraft.

For the most part, the legal/tax/practical factors that go into the 'own vs. lease' decision remain the same - however, periodically the landscape changes and the aircraft owner/purchaser needs to consider the "other" option. As discussed below, the landscape has shifted in the areas of public perception and tax audit exposure.

AIRCRAFT OWNERSHIP

Despite the epigram "if it flies or floats, rent it," aircraft ownership remains very popular. By owning your aircraft, you control it. There is no answering to anyone regarding its use and there is an intangible prestige-factor that does not come when you say "That's my leased aircraft."

Financially, the equity in an aircraft belongs to the owner, who will also benefit from any appreciation in the aircraft's value (which has happened on rare occasions in limited segments of the market). An aircraft owner has the sole authority to decide whether to charter or lease out the aircraft, and all revenue generated from such activity benefits only the owner. Aircraft purchasers can buy older, less expensive aircraft that are unlikely to be available for leasing.

From a tax perspective, the owner of a business aircraft is entitled to tax deductions on all aircraft depreciation and expenses relating to the business use of the aircraft. On the flip side, purchasing an aircraft can require large capital outlays, and cost more than leasing. An aircraft generally depreciates in value over time, so the future sale of the aircraft by the owner could be an economic loss.

Traditionally, aircraft ownership (versus leasing) is preferred for privately-held companies and high-net-worth individuals (having no qualms about showing an aircraft on financial statements), while leasing is employed by large companies to gain the benefits of business aircraft without carrying a multi-million dollar asset on the financial statements. Apart from the pure accounting distinction (impact on financial ratios) public companies or those subject to public scrutiny are under extraordinary pressure to avoid the appearance of extravagance; and unfortunately - and without justification - business jets have become the poster child for corporate extravagance.

Another part of the landscape that has changed (and affects the own-or-lease decision) is the increasing tax compliance burden and the increasing risk of a tax audit. Aggressive IRS and state tax auditors can make private aircraft ownership a tax headache. New IRS regulations on the personal, entertainment use of business aircraft subject owners to significant tax depreciation deduction disallowances that aircraft lessees do not directly suffer.

Aircraft owners may need to pay state sales tax based upon the purchase price of the aircraft, whereas aircraft lessees may only pay state sales tax on lease payments. Aircraft owners can overcome these tax challenges to put them in as good, or better, a tax position as an aircraft lessee, but that requires planning. Business jet owners often suffer even when they are in full, good faith compliance with state and federal tax laws › because the audit process itself can be arbitrary. In a sense, you are guilty until proven innocent, and you may not get to the "right" government official until you have moved from audit to appeal.

Given the foregoing, high-net-worth individuals and closely held companies are predisposed to purchase, rather than lease, a private aircraft. Essentially, they want the status of "owning" their aircraft - and these buyers do not share the same concerns as large companies, which prefer to lease, as explained below.

Also, companies and individuals buying aircraft that already own an aircraft do not want to pay federal income taxes on the tax depreciation recapture that happens when a depreciated aircraft is sold. To avoid this, a taxpayer will acquire a new aircraft, and dispose of the old one in a Section 1031 Exchange, which allows the taxpayer to defer the recognition of income on the disposition of the old aircraft. However, to do this the taxpayer must purchase - not lease - the new aircraft.

FINANCING AIRCRAFT OWNERSHIP

If any aircraft will be purchased, and not leased, it needs to be paid for. Cash is king, but many aircraft owners prefer to finance aircraft purchases to avoid tying up money in the aircraft and to take advantage of tax deductions on business aircraft loan interest payments.

There are financing companies that specialize in financing aircraft acquisitions, and there are banks that will finance aircraft on an occasional basis at the request of a high-net-worth client. Experienced aircraft financing companies will generally beat the local bank's loan terms, unless the bank relies on additional collateral (accounts and personal assets).

Most aircraft acquisition loans are secured by the aircraft itself as collateral. Mortgages on aircraft are specialized to deal with the details of aircraft maintenance, aircraft registration and aviation insurance. By Federal law, the mortgage on a U.S. registered aircraft will be filed with the FAA Civil Aircraft Registry in Oklahoma City, Oklahoma. Aircraft registered in other nations will benefit from similar national lien registries, and many aircraft mortgages must also be registered on the International Registry of Mobile Assets. Any "non-aircraft" assets associated with the aircraft (such as records, warranties and loose equipment) are taken as security for the loan by lenders with typical lien filings in local jurisdictions.

Aircraft buyers must also understand that lenders are concerned about the risks associated with aircraft as collateral. Aircraft move fast and frequently, lose value quickly if not properly maintained (with proper documentation), can be difficult to sell if repossessed, and aircraft values are volatile. Therefore, lenders will often seek credit enhancements through lower loan-to-value ratios, personal or corporate guaranties, and letters of credit, but these are negotiable matters.

AIRCRAFT OPERATING LEASES

The alternative to aircraft ownership is leasing. There are two primary types of leases; capital leases and operating leases. An operating lease, which is what we will focus on, is a contract that allows a lessee to use an aircraft, for a short term, such as five to ten years, at the end of which the lessee returns possession of the aircraft back over to the lessor (owner). By comparison, capital leases effectively transfer aircraft ownership to the lessee, as the capital lease contains a bargain purchase option, the lease term is 75% or more of the aircraft's economic life, or payments under the lease are at least 90% of the

aircraft's value. There are numerous benefits to an operating lease, particularly in the areas of risk management and cost containment. The lessee only pays rent for the aircraft, instead of paying the aircraft's purchase price. Rent payments are often priced down to include a pass-through of the tax depreciation benefits that the owner/lessor is entitled to take on the aircraft.

If the residual value of the aircraft at the end of the lease term is lower, the lessee is not affected, and this becomes the owner/lessor's problem. Because of the issue of residual values, aircraft available for operating leases are usually zero to ten years old. Lessors do not want to take back a twenty year old aircraft from a lessee as older aircraft are more expensive to maintain, repair, operate and dispose of.

For accounting purposes, operating leases are treated as a rental expense known as "off balance sheet financing." As such, the lessee's balance sheet does not record the assets or liabilities for the aircraft leasing activity, which can improve the lessee's financial ratios. The aircraft lessee will not generally have to pay state sales tax on the value of the aircraft, but at most only pay state sales tax on lease payments.

Who likes operating leases? Big companies that are first-time aircraft users looking for new aircraft (zero to ten years). Compared to buying, these companies like the lower cost, better cash flow, off-the-books treatment, and avoiding the risk of aircraft residual value going down and having an underwater loan on their books.

Of course, with leasing there are unavoidable obligations. The lessor of an aircraft will require that the lessee meet strict standards on maintenance, insurance and record keeping. In order to protect the lessor's asset, the lessee may be asked to maintain a reserve of funds (often held by the lessor) to fund ongoing maintenance costs. The purpose of these reserves is to ensure that a neglected or abandoned aircraft does not become a money pit with overdue maintenance and repairs.

For similar reasons, a lessor will strongly prefer that the lessee place engines and other components under a pre-paid or pay-as-you-go maintenance program.

THE END GAME

The decision of whether to buy or lease an aircraft will depend on all of the considerations discussed here plus the specific facts that are unique to each company or person looking to acquire an aircraft. Ultimately, the purchaser or lessor of an aircraft will need to decide how the issues balance out to determine the right path forward.

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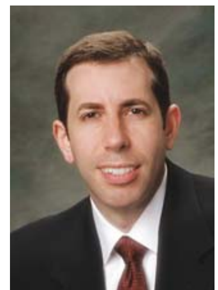
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