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Non-Recourse Financing Can Imperil Tax Deductions: The Application of the Internal Revenue Code 'At-Risk' Rules to Aircraft Purchases

Taxpayers who lease or purchase aircraft face a myriad of tax issues, and aircraft can be a favorite target of both federal and state tax auditors. While the restrictions imposed by the "hobby loss" and "passive activity" limitations are more widely known, taxpayers can suffer just as much from a lesser-known scourge: the "at risk" rules imposed by Section 465 of the Internal Revenue Code (the Code).

The 'At Risk' Labyrinth

With respect to any business activity, the Code generally does not allow the total tax deductions for that activity to exceed the amount that the taxpayer has "at risk." For financed aircraft, a taxpayer is considered to have "at risk" the amount of cash contributed as a down payment. The taxpayer also has "at risk" money borrowed to finance the aircraft, but only to the extent of (i) the amount borrowed for which the taxpayer is personally liable or (ii) the value of property (other than the aircraft) that the taxpayer has pledged to secure the borrowed amounts.[1]

[1] Section 465(b) of the Code; Treas. Reg., §1.465-1(a). Only pledged property which is not used in the activity is considered; hence the value of the aircraft itself will not increase the at-risk amount. Pledging other property used in the same activity also will not increase

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Individuals often finance an aircraft purchase using a limited liability company or other legal entity. Where the individual taxpayer is not the primary borrower, providing a personal guarantee usually will not increase the taxpayer's at-risk amount.[2] The IRS consistently regards a guarantor as not "at risk" because, generally, a guarantor has a common-law right to seek reimbursement ("subrogation") from the primary borrower in the event that the guarantor is called upon to honor the guarantee. However, in certain cases, a guarantor can be "at risk" for part or all of the loan he guarantees. For example, if a member of an LLC personally guarantees debt incurred by the LLC to finance aircraft, the IRS will consider that member "at risk" for the member's pro-rata share of the obligation, to the extent that the member does not have a subrogation right against the LLC or the other members.[3]

Moreover, although the IRS may not agree, the Tax Court has held in some cases that a guarantor can be "at risk" if the "economic reality" is that the taxpayer will ultimately be responsible for the borrowed amount in the event of default.[4] Despite these Tax Court rulings, purchasers of aircraft may nevertheless feel uncomfortable in providing a mere guarantee, since, in practice, the application of the Tax Court's "economic reality" test can be fuzzy. The test involves an analysis of *all* facts and circumstances that influence the probability that the taxpayer will ultimately end up paying the debt. These factors include: the financial condition and liquidity of every party responsible for payment; the value of the aircraft and of any other collateral; whether the guarantee is contingent or in some way conditioned; and whether the guarantor has a right of stated subrogation against one or more primary borrowers. It can be difficult to predict how the IRS or the courts will view any particular combination of factors. More importantly, the IRS has not acquiesced in the Tax Court's test.

Even if the individual taxpayer is the primary borrower, the taxpayer is *still* not considered "at risk" if the taxpayer is protected against loss as a practical matter.[5] Certainly, a legally binding agreement between the taxpayer and another person, requiring that other person to reimburse the taxpayer for any loss, will cause the taxpayer to be not "at risk." But the IRS may see much less obvious arrangements as limiting loss. For example, a lender might document in its file that it is largely relying on the credit of a guarantor, rather than on the credit of the primary borrower; or the primary borrower might not in fact have *liquid* assets, which would, as a practical matter, cause the lender (in the event of default) to seek repayment from co-borrowers or from guarantors.[6] The IRS may take the position, in such cases, that the individual taxpayer is very unlikely to end up paying the loan, and therefore is not "at risk" for the borrowed amount.

The Impact of Non-Recourse Financing

When a taxpayer purchases or leases an aircraft on a non-recourse basis, by definition, the taxpayer is not primarily liable for the loan. In the event of default, the non-recourse lender can look only to the collateral itself for repayment. Therefore, the non-recourse borrower will be "at risk" only to the extent that he has pledged valuable collateral (other than the aircraft itself, and other than property used in the same activity) to secure the loan. As a practical matter, it is very rare that non-recourse borrowers make such a pledge. Even where a non-recourse borrower does pledge additional collateral, the IRS may still not

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the at-risk amount. Note that the taxpayer will also not be considered at risk if the lender has an interest in the activity (beyond merely being a creditor), such as an interest in net profits. See Prop. Treas. Reg., §1.465-4.

[2] Wag-a-Bag, Inc., Tax Court Memorandum 1992-581 (1992); Brand, Hugh M. (1983) 81 T.C. 821 (1983). See Prop. Treas. Reg., §1.465-6(d). In contrast, a taxpayer who is a *co-borrower* with others will be "at risk" to the extent he has a direct obligation to repay; Edwin D. Abramson, 86 T.C. 360 (1986).

[3] IRS Field Service Advice 2000-25018.

[4] *See for example, Moreno, Michael B., et al. v. United States* (U.S. District Court, W.D. La.), 113 AFTR 2014-2149 (2014). Note that some courts, in particular the Sixth Circuit Court of Appeals, use a slightly different test, determining whether the taxpayer is the "payor of last resort" in a worst-case scenario. See Pledger v. United States, 949 F.2d 841 (1991).

[5] Treas. Reg., §1.465-20.

[6] See discussion of these issues at *Moreno*, above.

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regard the individual taxpayer as "at risk" unless the "economic reality" is that he will bear the responsibility of repayment in the event of default.

Pursuant to the Code, taxpayers who purchase certain goods used in business operations, including aircraft, are able to deduct up to 100% of the acquisition cost of the asset.[7] The decision to use non-recourse financing can therefore deprive the taxpayer of Bonus Depreciation and other important tax benefits, which would otherwise be available in purchasing an aircraft. Consider the following examples:

> *Example A*. Jordan, a high-income taxpayer, purchases an aircraft for $3 million, providing a $500,000 cash down payment, and borrowing $2.5 million on a full recourse basis. He will use the aircraft solely for business purposes, and he actively participates in this business.[8] Although the aircraft has a useful life of five years (for purposes of tax depreciation), recent legislation will allow Jordan to realize a Bonus Depreciation deduction for the full purchase price of the aircraft in the current year. Because Jordan is fully "at risk," this deduction will not be limited, and he will be able to deduct the entire $3 million immediately.
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> *Example B*. The facts are the same as above, except that Jordan borrows the $2.5 million on a nonrecourse basis. As a result, Jordan is "at risk" only for the $500,000 cash down payment. The deduction for the remaining $2,500,000 will be disallowed, because Jordan is not personally liable for this loan. This will likely cost Jordan $1 million or more in federal and state income tax in the current year.[9]
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> *Example C*. Leah, a high-income taxpayer, is the sole member of Widgets LLC. Widgets LLC purchases an aircraft for $3 million, providing a $500,000 cash down payment utilizing funds contributed from Leah, and borrowing $2.5 million on a full recourse basis. Leah will personally guarantee the loan. The aircraft is used solely for the business purposes of Widgets LLC. Leah actively participates in this business. Although recent legislation will allow some purchasers to realize a Bonus Depreciation deduction for the full purchase price of the Aircraft in the current year, the IRS may take the position that Leah is "at risk" only to the extent of her $500,000 cash down payment and that Leah's Bonus Depreciation benefits will be limited to this amount.
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> *Example D*. Sam, a high-income taxpayer, is the sole member of HighTech LLC and materially participates in the business. Sam wishes to acquire a business jet for use by HighTech LLC. Sam borrows $2.5 million from the bank on a full recourse basis. Sam lends $3 million ($2.5 million of loan proceeds and $500,000 of personal funds) to HighTech LLC. HighTech LLC uses the $3 million loan proceeds from Sam to purchase an aircraft. The aircraft is used solely for the business purposes of HighTech LLC. HighTech LLC grants a security interest in the aircraft to Sam as collateral for the loan. Because Sam is fully "at risk," his deductions will not be limited, and he will be able to recognize a 100% Bonus Depreciation deduction for the entire $3 million purchase price in the year of acquisition.

In summary, except in the straightforward case where an individual directly borrows money on a full-recourse basis to finance the aircraft, the at-risk rules can threaten the tax advantages of aircraft

[7] The Tax Cuts and Jobs Act amended the "bonus depreciation" provisions of the Code such that, for aircraft used exclusively for business purposes and acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023, the taxpayer may deduct 100% of the cost of the aircraft in the year placed in service. This benefit is commonly referred to as "Bonus Depreciation"

[8] These facts are critical to avoid the limitations imposed on passive activity losses by Section 469 of the Code, and by the "hobby loss" limitations of Section 183 of the Code.

[9] At the highest marginal rate of 37%, the tax on income that otherwise would be avoided is $2,500,000 x 37% = $925,000. In addition, Jordan's federal income will almost certainly carry over to his state income tax return; even assuming a low state rate of only 4%, this results in an additional $100,000 in tax.

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ownership and must be navigated carefully. Despite careful planning, employing non-recourse financing may dramatically reduce the taxpayer's "at risk" amount and may result in immediate adverse tax consequences, including the loss of Bonus Depreciation benefits. With careful structuring of a full recourse loan transaction, a taxpayer may be able to take advantage of the enhanced tax benefits available under the Tax Cuts and Jobs Act enacted in late 2017, including 100% Bonus Depreciation, to a greater extent than would be available with non- or limited-recourse financing.

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