# AIRCRAFT FINANCING OPTIONS: COMMUNICATING WITH THE CFO ON AN AIRCRAFT PURCHASE

A new or used aircraft purchase is an exciting event for a flight department and for the company as a whole. The challenge comes in planning and executing the purchase. The planning process becomes easier when the flight department and the company finance department can communicate effectively. This article addresses several goals of each department and examines various aircraft financing options in light of these concerns.

## Competing Goals?

The company finance department is primarily concerned with the cost of the aircraft, but there are many facets to cost. What is the company's cash outlay for the aircraft? Should the company incur additional debt for the aircraft purchase? What tax benefits are most valuable to the company? Does the company desire its new aircraft to have a "low profile" with the public? How will shareholders perceive the aircraft acquisition?

On the other hand, once the type of aircraft is determined, the flight department is primarily concerned with maximizing operational flexibility. Can the company lease, interchange or charter the aircraft? Are there any limits on the amount or geographic location of aircraft use? Does the type of aircraft ownership impose additional costs on the department?

Any aircraft ownership structure involves some compromise between the finance department and the flight department. The trick is to choose the financing structure which best fits the company.

## Financing Options

The market offers three basic options for a company acquiring an aircraft: outright ownership, borrowing and leasing.

## **Outright Ownership**

Some companies pay cash for their aircraft. The lucky flight department which is part of such a company may generally lease, interchange and charter the aircraft to the full extent of the law, use the aircraft as much as necessary or desirable, fly when and where it wants (subject only to legal and insurance limitations), maintain the aircraft in any manner compliant with the law, and when the time comes to sell the aircraft, arrange the sale directly with the buyer without coordinating with a lender or leasing company.

Outright ownership is not the best option for all companies, however. The initial cash outlay is the greatest of all financing options. Some companies cannot fully utilize the income tax deductions for aircraft depreciation. The aircraft owner company may dislike that its ownership of the aircraft is public information and that the information is easily and immediately accessible on the Internet. Furthermore, the aircraft is an asset on the company's balance sheet, which may be a sensitive shareholder issue.

## **Aircraft Loan**

Other companies borrow funds from banks and other third party sources in order to finance the aircraft purchase. A typical aircraft loan consists primarily of a loan agreement, a promissory note and a security agreement. The loan agreement outlines the terms of the loan, including the maximum loan amount, borrowing procedures, maturity date, and interest rate calculation. The promissory note evidences the borrower's promise to repay the amount borrowed with interest. The security agreement grants the lender a security interest in the aircraft and generally sets forth aircraft-related conditions which if not met constitute a default and enable the lender to exercise remedies, including repossession of the aircraft. The security agreement is filed and recorded with the FAA Aircraft Registry in order for the lender to perfect this interest. State and local Uniform Commercial Code filings may also be made to supplement the FAA filing. The loan may also include a guarantee by a parent company, related company, or individual shareholders. A guarantor is liable for payments due under the loan.

An aircraft loan has several financial advantages. It reduces the company's initial cash outlay for the aircraft. The borrower company remains the owner of the aircraft for FAA aircraft registration purposes. The borrower company also remains the owner of the aircraft for tax purposes and can deduct aircraft depreciation to the extent the aircraft is used in the company's trade or business. Interest paid on the loan is similarly a deductible expense.

A financial disadvantage is that the borrower company is the owner of the aircraft for financial accounting purposes. The ownership and the loan are shown on the company's balance sheet.

An aircraft loan has operational implications as well. Many loan documents require the lender's prior written approval for leasing and charter arrangements involving the aircraft, and for moving the aircraft base of operations. Most loan documents contain specific insurance requirements which, if not met, place the borrower in default of the loan. Loan documents may also contain restrictions on geographic flight of the aircraft. (For example, the aircraft will not be operated in countries for which the U.S. State Department has issued travel restrictions.) The documents may contain maintenance requirements which differ from the normal procedures of the flight department. Finally, the aircraft is subject to a recorded lien and ownership may not be transferred without the lender's written agreement.

## **Aircraft Leasing**

Aircraft leasing is an increasingly popular form of financing the purchase of an aircraft (or refinancing an aircraft already owned by the company). There are several different types of leases, but they generally fall into three categories: true lease, financing lease and synthetic lease.

An aircraft lease generally consists of one main document -- the lease itself. This document is examined and interpreted independently by the FAA, IRS and financial accountants using Financial Accounting Standards Board Statement 13. A detailed discussion of aircraft leasing is beyond the scope of this article, but the following section briefly describes each type of lease and some of its advantages and disadvantages.

## **True Lease**

A true lease is a lease of the aircraft from a third party to the operator company where the lessor is considered the aircraft owner for FAA, IRS and accounting purposes. Accordingly, the aircraft is registered in the name of the lessor, the lessor obtains the tax benefits of the aircraft depreciation deductions and the asset appears on the lessor's balance sheet. The lessee leases and has operational control of the aircraft, may deduct the lease payments as a business expense for federal income tax purposes. The aircraft does not appear on the lessee's balance sheet. (This type of lease is also called an "operating lease" in accounting.)

Advantages of a true lease include low initial cash outlay for the operating company, generally favorable lease rates (primarily because the lessor receives the tax benefits of ownership), some degree of anonymity because the lessor is the registered owner of the aircraft (but the lessee's name appears in the lease, usually filed and recorded with the FAA, which filing constitutes public information), and lack of visibility to shareholders because of off-balance-sheet accounting treatment. Also, if the lessee is not a "Citizen of the United States" for FAA registration purposes, a true lease with a lessor eligible for U.S. citizen registration enables the aircraft to be registered in the United States.

Disadvantages include lack of equity in a valuable asset, decreased tax benefits for the lessee, and some potential loss of operational flexibility.

From an operations standpoint, a true lease contains many of the same restrictions discussed above with respect to loan documents. In addition, a true lease often contains the requirement that the aircraft be used solely for business purposes (so that the lessor may depreciate the entire value of the aircraft) and solely or primarily in the United States (so that the lessor may use the most favorable depreciation method -- However, consult with an aviation tax advisor on this subject while negotiating the document, as the tax rules contain some leeway which may loosen these restrictions for the operator). Also, because under a true lease the documents contemplate that the aircraft will eventually be returned to the lessor, the agreement may contain significant restrictions on the amount of aircraft usage and specific maintenance requirements. For example, the lease may contain a penalty upon return if the aircraft is used more than an average of 400 hours per year, or if the airframe or engines have less than 50% remaining of time between overhauls.

Additionally, the lessee under a true lease must comply with the "Truth-in-Leasing" requirements of Federal Aviation Regulation 91.23. Finally, under a true lease, the company may find it difficult to eliminate the aircraft from its operations or to change to a different type of aircraft during the lease term.

## Financing Lease

A financing lease (sometimes called a "lease intended for security") is a long-term lease of the aircraft from a third party to the operator company where the lessee is considered the aircraft owner for FAA, IRS and accounting purposes. A financing lease generally differs from a true lease in that it contains significant incentives for the lessee to purchase the aircraft during or at the end of the lease term, generally in the form of "bargain" purchase options. (The FAA considers a financing lease a "contract for conditional sale.")

Accordingly, the aircraft is registered with the FAA in the name of the lessee with the lease document filed and recorded in the same way as the security agreement associated with a loan. From an income tax standpoint, the lessee receives the depreciation deductions and may generally deduct the interest portion of the lease payments. The aircraft appears on the lessee's balance sheet, and future lease payments appear as a liability on the balance sheet.

The advantages and disadvantages of a financing lease are similar to those of an aircraft loan, as discussed above.

## Synthetic Leasing

"Synthetic lease" is a term for a lease under which the aircraft ownership differs for FAA, IRS and accounting purposes. This synthesis is accomplished with close attention to the differences between FAA, IRS and financial accounting rules for leases.

One of the most popular kinds of synthetic lease is a financing lease (or "contract for conditional sale") for FAA registration and IRS tax purposes, but a true lease (or "operating lease") for financial accounting purposes. For many lessees, this type of lease combines the best of all worlds. The lessee is the registered owner of the aircraft. The lessee obtains the tax benefits of aircraft depreciation and may generally deduct the interest portion of the lease payments. The aircraft is off-balance-sheet for financial accounting purposes.

Some synthetic leases involve not only a lessor and a lessee but also, as an integral part of the arrangement, a lender who finances the lessor's purchase of the aircraft.

The big advantage of synthetic leasing over other types of aircraft financing is flexibility. The parties can tailor the FAA registration, IRS tax and accounting aspects to meet their particular needs. Perhaps the biggest disadvantages are the additional time and expense associated with such a sophisticated instrument. The lessor may charge an additional fee. Many synthetic leases require FAA Aeronautical Center counsel examination to aid in proper registration. Tax and accounting professionals may be called in to examine and comment on documents which are non-standard.

## Conclusion

A prospective purchaser faces several aircraft financing options. It is important for the company's finance department and flight department to cooperate in choosing the type of financing that is best for the company. Both departments should work together to avoid unintended financial and operating consequences. We would recommend that the CFO review with the flight department any operating limitations and insurance and maintenance requirements, so that the company may avoid an unintended default under the financing documents.

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