

## *Modifications to Treatment of Aircraft and Vessel Leasing Income*

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The Internal Revenue Service issued final regulations (the “Final Regulations”) addressing certain implications of leasing aircraft or vessels in foreign commerce. The Final Regulations apply to United States shareholders of controlled foreign corporations that derive income from the leasing of aircraft or vessels in foreign commerce, foreign corporations that are transferees of leased property, and also apply indirectly to foreign persons in connection with their qualification for benefits under an income tax treaty as a result of the active conduct of a trade or business.

*Background.* The American Jobs Creation Act of 2004 repealed the “subpart F” rules relating to foreign base company shipping income, and created a new marketing safe harbor for the exclusion from subpart F income of rents derived from leasing an aircraft or vessel in foreign commerce (the “Safe Harbor”). Generally, rents are excluded from subpart F income if the lessor maintains a substantial marketing operation. Under the new Safe Harbor, rents from leasing an aircraft or vessel in foreign commerce are excluded from subpart F income if the active leasing expenses comprise at least 10% of the leasing profit.

In July 2008, final, temporary and proposed regulations (the “Old Regulations”) were issued to provide guidance under Sections 954, 956, and 367 of the Internal Revenue Code of 1986, as amended (the “Code”).

The Old Regulations under Code Section 954 provided guidance for the application of the Safe Harbor. The Old Regulations under Code Section 956 provided that an aircraft or vessel is not U.S. property if either: (i) the aircraft or vessel is used in the transportation of persons or property in foreign commerce and used predominantly outside the United States or (ii) rents derived from leasing such aircraft or vessel qualify for the Safe Harbor. The Old Regulations under Code Section 367 provided that the principles of the Safe Harbor apply to determine whether a trade or business that produces rents or royalties is actively conducted.

### ***Final Regulations***

The Final Regulations adopt the Old Regulations with a few clarifications.

The Old regulations under Code Section 954 specifically provided that finance leases could qualify for the Safe Harbor. The omission of operating leases from this provision made it uncertain whether the

Safe Harbor also applied to operating leases. The Final Regulations clarify that the marketing exception can apply to both operating leases and finance leases.

The Old regulations under Code Section 954 also made it clear that the lessor's organization would be substantial if the lessor acquired an asset subject to a lease and performed substantial remarketing services. The scope of the term remarketing did not include remarketing for purposes of selling the leased property. The Final Regulations specifically include remarketing services in connection with a sale.

The Old Regulations under Code Section 956 provided that an aircraft or vessel is excluded from U.S. property if rents derived from leasing such aircraft or vessel are excluded from Subpart F income under the Safe Harbor but inadvertently omitted language that was part of interim guidance issued by the IRS and Treasury in 2006 that also required such property to be used in foreign commerce in order to be excluded from the definition of U.S. property. The Final Regulations modify the Old Regulations to clarify that an aircraft or vessel is excluded from the definition of U.S. property only if the aircraft or vessel is leased in foreign commerce and the rents qualify for the Safe Harbor.

The Final Regulations adopted the Old Regulations promulgated under Code Section 367 without change.

**Effective Date.** The Final Regulations are effective as of May 6, 2011.



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