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# Client Alert

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## FINAL REGULATIONS ISSUED TO CLARIFY SAFE HARBOR FOR AIRCRAFT LEASING INCOME

On May 6, 2011, the IRS issued final regulations (the “Regulations”) addressing the leasing of aircraft or vessels in foreign commerce. The Regulations reflect changes to the Internal Revenue Code (the “Code”) made by the American Jobs Creation Act of 2004 (the “Act”), which adopted a “Subpart F” safe harbor for leasing income from aircraft or vessels engaged in international commerce in cases where the active leasing expenses are not less than 10 percent of the profit on the lease. The Regulations clarify that this so-called marketing safe harbor applies to all leases, without regard to their classification for financial accounting purposes as operating leases or finance leases. In addition, the Regulations clarify that an aircraft or vessel is considered to be leased in foreign commerce if it is used in foreign commerce and is used predominantly outside the United States.

### Background - Subpart F Regime and Changes Adopted by the Act

Subpart F of the Code requires “United States Shareholders” of “controlled foreign corporations” (or “CFCs”) to include in income their pro rata share of certain specified categories of passive or portable income, including rental income (“foreign personal holding company income” or “FPHCI”), whether or not the income is actually distributed to the shareholder by the foreign corporation.

A CFC is a foreign corporation of which more than 50% of the total combined voting power or value of all classes of stock is owned, directly or constructively, by United States Shareholders. In general, a United States Shareholder is any United States person, including a United States corporation, that owns at least 10% of the voting power of the foreign corporation’s stock.

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Although a CFC's rental income (including rental income from leasing aircraft and other vessels) is usually treated as Subpart F income, a significant exception applies to rents derived in the active conduct of a trade or business received from unrelated persons. Rental income is considered to be derived in the active conduct of a trade or business when it is derived as a result of the performance of marketing functions by the CFC (the "Marketing Exception"). For this purpose, marketing functions refers to the maintenance and operation by the lessor of its own office or staff of employees, located in a foreign country, who are regularly engaged in the business of marketing, or marketing and servicing the leased property. Moreover, the marketing function must be "substantial" in relation to the amount of rent derived from leasing the property.

The Act broadened the scope of the Marketing Exception to provide a cost-based safe harbor. Under the safe harbor, rents would be considered derived in the active conduct of a trade or business if the active leasing expenses constituted not less than 10% of the profit derived from the lease.

### **Regulations – The Marketing Exception**

The Regulations are intended to clarify the Marketing Exception to properly reflect changes adopted by the Act.

The Regulations provide that the marketing function with respect to leased property is substantial in relation to the rents derived when the active leasing expenses of the CFC's office or organization in the foreign country equal or exceed 10 percent of the CFC's adjusted leasing profit. Active leasing expenses, as was the case under previously issued Temporary Regulations, are all deductions incurred by the CFC's office or organization in the foreign country that are properly allocable to the rental income and that would be allowable as deductible trade or business expenses if the CFC were a domestic corporation (other than (a) compensation for services rendered by shareholders and related persons, (b) rents paid or accrued, (c) deductions specifically allowable under other sections of the Code (e.g., interest and taxes), and (d) deductions for payments made to agents and independent contractors with respect to the leased property other than for insurance, utilities, other similar expenses, and capitalized repairs). "Adjusted leasing profit" refers to the gross rental income of the CFC less (i) rents paid or accrued by the CFC, (ii) the amount of depreciation deductions that would have been allowable to the CFC if it had been a domestic corporation, and (iii) deductions for payments made to agents and independent contractors as discussed in (d) above.

The Regulations clarify that an aircraft or vessel is considered to be leased in foreign commerce if it is used in foreign commerce and used predominantly outside the United States. An aircraft or vessel is used in foreign commerce if it is used to transport property or passengers between the United States and a foreign country or between two foreign countries. An aircraft or vessel is considered to be used predominantly outside the United States if more than 50% of the miles traversed during the taxable year are traversed outside of the United States or if the aircraft or vessel is located outside of the United States more than 50% of the time during the year.

The Regulations also clarify that the Marketing Exception applies to "remarketing" activities (i.e., remarketing for the purposes of re-leasing or selling the property) in addition to marketing activities.

### **Regulations – Definition of United States Property**

The Subpart F regime also imposes a tax on United States Shareholders to the extent a CFC invests its current or accumulated earnings in "United States Property". United States Property generally includes tangible property that is located in the United States. The Regulations clarify that an aircraft or vessel is excluded from the definition of United States Property if the rents from the aircraft or vessel qualify for the active trade or business exception to FPHCI, as discussed above.

**Further Guidance**

The Treasury Department and Internal Revenue Service request comments on how to determine whether an aircraft or vessel is used predominantly outside of the United States during a particular month for purposes of the depreciation recapture rules under Section 367 of the Code. Until the further guidance is issued, taxpayers may continue to use any reasonable method to make this determination.

**Effective Date**

The Regulations are effective as of May 6, 2011.