

## Part III - Administrative, Procedural, and Miscellaneous

### Announcement of Rules Implementing American Jobs Creation Act of 2004 Section 415 Modifications to the Subpart F Treatment of Aircraft and Vessel Leasing Income

Notice 2006-48

#### SECTION 1. OVERVIEW

This notice provides guidance relating to amendments made by section 415 of the American Jobs Creation Act of 2004 (Public Law 108-357) (October 24, 2004) (AJCA), which affect the treatment of certain income and assets related to the leasing of aircraft or vessels in foreign commerce. The Treasury Department (Treasury) and the Internal Revenue Service (IRS) intend to amend the regulations under sections 367(a), 954, and 956 of the Internal Revenue Code (Code) to address the amendments made by section 415 of the AJCA and this notice. Until regulations reflecting these changes are issued, taxpayers may rely upon this notice. This notice also solicits comments on whether any other changes to the regulations under sections 367, 954, and 956 are necessary to implement the purposes of section 415 of the AJCA.

#### SECTION 2. BACKGROUND

##### *.01 In General*

Section 415 of the AJCA repealed section 954(a)(4) and (f), the foreign base company shipping income provisions of subpart F. Following repeal of the foreign base company shipping income provisions, rents derived from leasing an aircraft or vessel may be included in subpart F income only if the rents are described in another category of subpart F income such as foreign personal holding company income as defined in section 954(c) (FPHCI). Rents are included in FPHCI under section 954(c)(1)(A).

Section 954(c)(2)(A) excludes from FPHCI rents received from unrelated persons and derived in the active conduct of a trade or business .

Rents derived by a controlled foreign corporation (CFC) (i.e., the lessor) are considered to be derived in the active conduct of a trade or business if the rents are derived under any one of four circumstances described in the Income Tax Regulations under section 954(c)(2)(A). One such relevant circumstance, provided in § 1.954-2(c)(1)(iv), is when rents are derived from leasing property that is leased as a result of the performance of marketing functions by the lessor. These rents are considered to be derived in the active conduct of a trade or business if the lessor, through its own officers or employees located in a foreign country, maintains and operates an organization in the foreign country that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from leasing the property. Section 1.954-2(c)(2)(ii) provides that the determination of whether the foreign organization is substantial in relation to the amount of rents derived is based on all the facts and circumstances. However, under § 1.954-2(c)(ii), the organization will be considered substantial in relation to the amount of rents if active leasing expenses equal or exceed 25 percent of the adjusted leasing profit, as those terms are defined under the regulations.

Section 415 of the AJCA amended section 954(c)(2)(A) to create a new safe harbor for rents derived from leasing an aircraft or vessel in foreign commerce. The amendment to section 954(c)(2)(A) provides that, for purposes of section 954(c)(2)(A):

[R]ents derived from leasing an aircraft or vessel in foreign commerce shall not fail to be treated as derived in the active conduct of a trade or business if, as

determined under regulations prescribed by the Secretary, the active leasing expenses are not less than 10 percent of the profit on the lease.

The legislative history of section 415 of the AJCA provides that the new safe harbor for rents derived from leasing an aircraft or vessel in foreign commerce “is to be applied in accordance with the existing regulations under section 954(c)(2)(A) by comparing the lessor’s ‘active leasing expenses’ for its pool of leased assets to its ‘adjusted leasing profit.’” H.R. Rep. No. 548, 108<sup>th</sup> Cong., 2d Sess. 210 (2004) (*hereinafter* 2004 House Report). The legislative history of section 415 of the AJCA<sup>1</sup> further indicates:

[T]he requirements of section 954(c)(2)(A) will be met if a lessor regularly and directly performs active and substantial marketing, remarketing, management and operational functions with respect to the leasing of an aircraft or vessel (or component engines). This will be the case regardless of whether the lessor engages in marketing of the lease as a form of financing (versus marketing the property as such) or whether the lease is classified as a finance lease or operating lease for financial accounting purposes. If a lessor acquires, from an unrelated or related party, a ship or aircraft subject to an existing FSC or ETI lease, the requirements of section 954(c)(2)(A) will be satisfied if, following the acquisition, the lessor performs active and substantial management, operational, and remarketing functions with respect to the leased property.

Id.

An aircraft or vessel will qualify for the new safe harbor under section 954(c)(2)(A) only if it is leased in “foreign commerce.” The legislative history provides that, for purposes of this safe harbor:

An aircraft or vessel will be considered to be leased in foreign commerce if it is used for the transportation of property or passengers between a port (or airport) in the United States and one in a foreign country or between foreign ports (or

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<sup>1</sup> While the legislative history indicates that the requirements of this provision may be met whether the lease is classified as a finance lease or an operating lease, under other provisions of the Code financing and operating leases are provided different treatment.

airports), provided the aircraft or vessel is used predominantly outside the United States. An aircraft or vessel will be considered used predominantly outside the United States if more than 50 percent of the miles during the taxable year are traversed outside the United States or the aircraft or vessel is located outside the United States more than 50 percent of the time during such taxable year.

2004 House Report at 210. This definition of “foreign commerce” is similar to the definition of foreign commerce contained in § 1.954-6(b)(3), the regulations under the now repealed foreign base company shipping income provisions, except that this regulation does not include a predominant use standard.

The legislative history directs the Secretary of the Treasury to make conforming changes to current regulations “including guidance that aircraft or vessel leasing activity that satisfies the requirements of section 954(c)(2)(A) shall also satisfy the requirements for avoiding income inclusion under section 956 and section 367(a).” *Id.* This legislative history indicates that Congress anticipated that taxpayers might restructure their operations to take advantage of the new benefits under subpart F provided by section 415 of the AJCA, namely the repeal of the foreign base company shipping income provisions and a liberalized safe harbor for excluding active leasing income from aircraft or vessels from foreign personal holding income.

## *.02 Section 956*

Section 956(c)(1)(A) provides that the term “United States property” (“U.S. property”) generally includes tangible property located in the United States. Section 956(c)(2) provides exceptions to the general definition of U.S. property. Section 956(c)(2)(D) excludes from the term U.S. property any aircraft, railroad rolling stock, vessel, motor vehicle, or container used in the transportation of persons or property in

foreign commerce and used predominantly outside the United States.

Section 1.956-2(b)(1)(vi) provides that whether an aircraft, railroad rolling stock, vessel, motor vehicle, or container is used predominantly outside the United States depends on the facts and circumstances in each case. This regulation also provides that as a general rule, such transportation property will be considered used predominantly outside the United States if 70 percent or more of the miles traversed in the use of such property are traversed outside the United States or if such property is located outside the United States 70 percent of the time during such taxable year.

As noted above, the legislative history of section 415 of the AJCA provides, for purposes of the newly-created section 954(c)(2)(A) safe harbor, an aircraft or vessel will be considered used predominantly outside the United States if more than 50 percent of the miles during the taxable year are traversed outside the United States or the aircraft or vessel is used predominantly outside the United States more than 50 percent of the time during such taxable year. 2004 House Report at 210. In addition, the legislative history indicates that Congress intended to exclude aircraft or vessels from the definition of U.S. property under section 956 if the rents derived from leasing the aircraft or vessels are excluded from foreign personal holding company income under section 954(c)(2)(A). To implement congressional intent with regard to aircraft or vessels leased in foreign commerce, conforming changes must be made to the regulations under section 956.

### *.03 Section 367(a)*

Section 367(a)(1) provides that if, in connection with any exchange described in

section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, the foreign corporation will not, for purposes of determining the extent to which gain will be recognized on such transfer, be considered to be a corporation. The effect of this general rule is that the transfer will not qualify for nonrecognition treatment, and thus, the transferor must recognize gain on the transferred assets. However, under section 367(a)(3)(A), except as provided in regulations, this general rule does not apply to any property transferred to a foreign corporation for use by the foreign corporation in the active conduct of a trade or business outside of the United States. Except as provided in regulations, however, section 367(a)(3)(A) does not apply to property with respect to which the transferor is a lessor at the time of the transfer (unless the transferee is the lessee). I.R.C § 367(a)(3)(B)(v).

Section 1.367(a)-2T(a) provides, in part, that section 367(a)(1) does not apply to property transferred to a foreign corporation if the property is transferred for use by that corporation in the active conduct of a trade or business outside of the United States and certain reporting requirements are met. Section 1.367(a)-2T(b)(3), in turn, provides that “[w]hether a trade or business that produces rents or royalties is actively conducted shall be determined under the principles of § 1.954-2(d)(1) (but without regard to whether the rents or royalties are received from an unrelated person).” Section 1.367(a)-2T(b)(4) provides generally that a foreign corporation conducts a trade or business outside of the United States if the primary managerial and operational activities of the trade or business are located outside of the United States and if

immediately after the transfer the transferred assets are located outside of the United States.

Section 1.367(a)-5T(f) then provides that, regardless of use in an active trade or business, section 367(a)(1) applies to a transfer of tangible property with respect to which the transferor is a lessor at the time of the transfer unless: (1) the transferee was the lessee and the transferee will not lease to third persons, or (2) the transferee will lease to third persons and the transferee satisfies the conditions of § 1.367(a)-4T(c)(1) or (2).

Finally, § 1.367(a)-4T(c)(1) provides that if the transferred property will be leased by the transferee foreign corporation, the property generally is considered to be transferred for use in the active conduct of a trade or business outside of the United States only if all three of the following conditions are met: (i) the transferee's leasing constitutes the active conduct of a leasing business; (ii) the lessee does not use the property in the United States; and (iii) the transferee has need for substantial investment in assets of the type transferred.

Even if property qualifies for the active trade or business exception, when a U.S. person transfers U.S. depreciated property to a foreign corporation, that person must include as ordinary income in the year of the transfer the gain realized that would have been included as ordinary income under sections 617(d)(1), 1245(a), 1250(a), 1252(a), or 1254(a) if the taxpayer had sold the property at its fair market value on the date of the transfer. Treas. Reg. § 1.367(a)-4T(b)(1) ("section 367 recapture"). For this purpose, U.S. depreciated property includes property that has been used in the United States or

has qualified as section 38 property by virtue of section 48(a)(2)(B). Treas. Reg. § 1.367(a)-4T(b)(2)(ii). Some transferors that qualify for the section 367 trade or business exception under the provisions of this notice may have used depreciated property in the United States prior to the transfer to the foreign corporation and therefore may be subject to section 367 recapture.

The section 367 recapture amount is reduced if the property has been used partly outside the United States. Treas. Reg. § 1.367(a)-4T(b)(3). In this circumstance, the amount of the section 367 depreciation recapture is determined by multiplying the full section 367 recapture amount by a fraction, the numerator of which is the U.S. use of the property and denominator of which is the total use of the property. U.S. use is the number of months that the property either was used within the United States or qualified as section 38 property by virtue of section 48(a)(2)(B) and was subject to depreciation by the transferor or a related person. Total use is the total number of months that the property was used (or was available for use), and subject to depreciation, by the transferor or a related person. Property is not considered to be used outside the United States during any period in which the property was, for purposes of section 38 or 168, treated as property not used predominately outside the United States pursuant to the provisions of section 48(a)(2)(B).

Therefore, to apply the section 367 recapture provisions, transferors must determine the number of months that the property was used in the United States or qualified as section 38 property. Mobile assets such as airplanes and vessels may enter and leave the United States a number of times during a month, thus raising the



issue of how to determine whether such an asset was used predominately outside the United States during that month. Rev. Rul. 71-178, 1971-1 C.B. 6., provides generally that each day an aircraft under foreign registry is physically located in the United States for more than 12 hours is considered a day within the United States for purposes of § 1.48-1(g). There is no guidance under either section 48 or section 367, however, that specifies how to determine whether the aircraft was used predominately outside the United States for a particular month.

### SECTION 3. SECTION 954 GUIDANCE

Future guidance will amend the regulations under section 954 to address the determination of whether rents derived from leasing an aircraft or vessel in foreign commerce will be treated as derived in the active conduct of a trade or business under section 954(c)(2)(A), as amended by section 415 of the AJCA. Comments are requested on whether there are issues with regard to this determination that require clarification.

In addition, future guidance will clarify that an aircraft or vessel will be considered to be leased in foreign commerce, for purposes of section 954(c)(2)(A), only if the aircraft or vessel is used in foreign commerce, within the meaning of § 1.954-6(b)(3), and is used predominately outside the United States. For this purpose, an aircraft or vessel will be treated as used predominately outside the United States if it would be so treated under § 1.956-2(b)(1)(vi) with the phrase “more than 50 percent” substituted for the phrases “70 percent or more” or “70 percent.”

### SECTION 4. SECTION 956 GUIDANCE

Future guidance will provide that, for purposes of applying § 1.956-2(b)(1)(vi), an aircraft or vessel used in the transportation of persons or property in foreign commerce is excluded from U.S. property under § 1.956-2(b)(1)(vi) if rents derived from leasing such aircraft or vessel are excluded from foreign personal holding company income under section 954(c)(2)(A) and such property is considered to be used predominately outside the United States under § 1.956-2(b)(1)(vi), determined by substituting the phrase “more than 50 percent” for the phrases “70 percent or more” or “70 percent.” For purposes of determining whether an aircraft or vessel is used in foreign commerce, the definition of “foreign commerce” contained in § 1.954-6(b)(3) shall continue to apply.

## SECTION 5. SECTION 367(a) GUIDANCE

### *.01 Active Conduct of a Trade or Business that Produces Rents or Royalties*

In light of section 415 of the AJCA and its legislative history, the regulations under section 367(a) will provide that the principles of section 954(c)(2)(A) (as amended by the AJCA), and the regulations thereunder (as they will be amended pursuant to section 3 of this notice), shall apply to determine whether a trade or business that produces rents or royalties is actively conducted under § 1.367(a)-2T(b)(3). Until those regulations under section 367(a) are issued, taxpayers relying upon this notice must state that they are applying the provisions of this notice to meet the requirement of § 1.6038B-1T(c)(4)(i) and (iv) to specify the reason the transfer qualifies for the active trade or business exception.

### *.02 Conduct of Trade or Business Outside of the United States*

For purposes of applying § 1.367(a)-2T(b)(4) or a similar provision of future

regulations, the regulations under section 367(a) will provide that generally the primary managerial and operational activities of the trade or business of leasing an aircraft or vessel must be conducted outside of the United States, and the aircraft or vessel must be used predominantly outside of the United States, as defined above in section 3. A lessee that uses an aircraft or vessel predominantly outside of the United States will satisfy the requirement in § 1.367(a)-4T(c)(1)(ii).

#### *.03 Depreciation Recapture for Certain Section 367 Transfers*

Treasury and the IRS are considering future guidance regarding how to determine whether an aircraft or vessel was used predominantly outside the United States for a particular month for purposes of calculating section 367 recapture. Until further guidance is issued, taxpayers are permitted to use any reasonable method to make this determination.

#### SECTION 6. EFFECTIVE DATE

The future regulations described in this notice will be effective beginning on or after May 2, 2006. Until those regulations are issued, taxpayers may rely upon the provisions of this notice as of May 2, 2006. In addition, taxpayers may elect to apply sections 3 and 4 of this notice retroactively to tax years of foreign corporations beginning after December 31, 2004 and for tax years of United States shareholders with or within which such tax years of foreign corporations end. Taxpayers may elect to apply section 5 of this notice retroactively to transfers of aircraft or vessels occurring on or after October 22, 2004. This election is made by providing the description of the transfer under § 1.6038B-1T(c) as specified in section 5.01 of this notice. No relief

under § 301.9100-1 is necessary for this election. Taxpayers electing to apply sections 3 through 5 of this notice retroactively must do so consistently for all transactions.

## SECTION 7. COMMENTS

Comments are requested on whether any other changes to the regulations under sections 367, 954, and 956 are necessary to implement the purposes of section 415 of the AJCA. Specifically, Treasury and the IRS are considering clarifying how the depreciation recapture rules apply to aircraft and vessels that were used both in and outside the United States. Treasury and the IRS request comments on how the depreciation recapture rules under section 367(a) should apply to leased aircraft and vessels.

Written comments on the issues addressed in this notice may be submitted to the Office of Associate Chief Counsel International, Attention: Jason Kleinman (Notice 2006-48), room 4710, CC:INTL:B2, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, D.C., 20224. Alternatively, taxpayers may submit comments electronically to [Notice.comments@ml.irs.counsel.treas.gov](mailto:Notice.comments@ml.irs.counsel.treas.gov). Comments will be available for public inspection and copying.

## SECTION 8. DRAFTING INFORMATION

The principal authors of this notice are Jason Kleinman and Daniel McCall of the Office of Associate Chief Counsel (International). For comments or questions regarding sections 954 or 956, contact Mr. Kleinman at (202) 622-3840. For comments or questions regarding section 367, contact Mr. McCall at (202) 622-3860.

