

Part III - Administrative, Procedural, and Miscellaneous

Accounting for Lease Strips and Other Stripping Transactions

Notice 2003-55

Notice 95-53, 1995-2 C.B. 334, addresses certain tax consequences of lease strips or stripping transactions. Lease strips are transactions in which one participant claims to realize rental or other income from property and another participant claims the deductions related to that income (for example, depreciation or rental expenses). Lease strips may take a variety of forms, including, but not limited to, those in the following examples.

(a) A lease strip effected through a transferred basis transaction. In exchange for consideration, one participant sells, assigns, or otherwise transfers ("assigns") the right to receive future payments under a lease of tangible property, and treats the amount realized from the assignment as its current income. The participant later transfers the property (subject to the lease) in a transaction intended to qualify as a transferred basis transaction, such as a transaction described in ' 351 of the Internal Revenue Code. The transferee often is not identified until after the transferor has assigned the future payments. Typically, the transferor (or a partner in a partnership that is a transferor) is generally not subject to U.S. federal income tax or has available net operating losses, and the equity of the transferee is owned predominantly by persons other than the transferor.

(b) A lease strip effected through a transfer of an interest in a partnership (or other pass-through entity). In exchange for consideration, the partnership assigns its right to receive future payments under a lease of tangible property and allocates the amount realized from the assignment to its current partners (many of whom are generally not subject to federal income tax or have available net operating losses). The partnership retains the underlying property, and thereafter, there is a transfer or redemption of a partnership interest by one or more partners to whom the partnership allocated the income that it reported from the assignment. The transfer or redemption is structured to avoid a reduction in the basis of partnership property.

(c) A lease strip effected by a single participant. A participant assigns its right to receive future payments under a lease of tangible property at a time when that participant is not subject to U.S. federal income tax or in a manner in which the realized amount is not includible in computing the participant's U.S. federal income tax and that same participant or a successor claims deductions related to that income for purposes of U.S. federal income tax.

In addition to transactions described above, this notice applies to lease strips involving licenses of intangible property, service contracts, leaseholds or other non-fee interests in property, and the prepayment, front-loading, or retention (rather than assignment) of rights to receive future payments.

DISCUSSION

The Internal Revenue Service has concluded that lease strips improperly separate income from related deductions and generally do not produce the tax consequences desired by the participants. Depending on the facts of a particular case, the Service may apply one or more Code sections or theories to challenge a lease strip. For example, the Service may apply §§ 165, 269, 382, 446(b), 701, or 704. The Service also may challenge certain assignments or accelerations of future payments as financings. Finally, the Service, as appropriate, may assert that there is no valid partnership or may apply various judicial doctrines, such as the doctrines of assignment-of-income, business purpose, substance-over-form, step transaction, or sham.

Recently, the Court of Appeals for the District of Columbia Circuit held that the partnership used in a lease strip was not a valid partnership because the participants did not join together for a non-tax business purpose. *Andantech L.L.C. v. Commissioner*, Nos. 02-1213; 02-1215, (D.C. Cir. June 17, 2003), 2003 U.S. App. LEXIS 11908, aff'g in part and remanding for reconsideration of other issues T.C. Memo 2002-97 (2002). Also, in *Nicole Rose v. Commissioner*, 320 F.3d 282 (2d Cir. 2002), aff'g per curiam 117 T.C. 328 (2001), the United States Court of Appeals for the Second Circuit upheld the Tax Court's determination that a lease transfer did not have economic substance.

Transactions that are the same as, or substantially similar to, the lease strips described in this notice are identified as "listed transactions" for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations. Independent of their classification as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2), transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the disclosure requirements of § 6011, the tax shelter registration requirements of § 6111, or the list maintenance requirements of § 6112 (§§ 1.6011-4, 301.6111-1T, 301.6111-2, and 301.6112-1). Persons required to register these tax shelters who have failed to register the shelters may be subject to the penalty under § 6707(a). Persons required to maintain a list of investors under § 6112 may be subject to the penalty under § 6708(a) if the requirements of § 6112 are not satisfied.

Finally, the Service may impose penalties on participants in lease strip transactions or, as applicable, on persons who participate in the promotion or reporting of lease strips, including the accuracy-related penalty under § 6662 and the return preparer penalty under § 6694.

In addition, the Service is currently evaluating other situations in which tax benefits are claimed as a result of transactions in which the ownership of property has been separated from the right to income from the property. For example, the Service is evaluating situations in which, in exchange for consideration, one participant assigns its interest in property but retains the right to income from the property, and, by allocating all of its

basis to the transferred property and none to the retained future payments, the transferor claims a loss on the transfer.

This Notice 2003-55 modifies and supersedes Notice 95-53.

DRAFTING INFORMATION

The principal author of this notice is Pamela Lew of the Office of Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this notice, contact Ms. Lew at (202) 622-3950 (not a toll-free call).