

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-209817-96

RIN 1545-AU19

Treatment of Obligation-Shifting Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking.

SUMMARY: This document withdraws a proposed regulation relating to the treatment of certain multiple-party financing transactions in which one party realizes income from leases or other similar agreements and another party claims deductions related to that income.

FOR FURTHER INFORMATION CONTACT: Pamela Lew, (202) 622-3950, (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

In Notice 95-53 (1995-2 C.B. 334) (modified and superseded by Notice 2003-55) (2003-34 I.R.B. 395), the IRS and Treasury Department stated that regulations under section 7701(l) would be issued to recharacterize lease strips to prevent tax avoidance. On December 27, 1996, a notice of proposed rulemaking (REG-209817-96) relating to the treatment of certain obligation-shifting transactions was published in the Federal Register (61 FR 68175). An obligation-shifting transaction is a transaction in which the transferee (the assuming party) assumes obligations or acquires property subject

to obligations under an existing lease or similar agreement and the transferor (the property provider) or any other party has already received or retains the right to receive amounts that are allocable to periods after the transfer.

The proposed regulations recharacterize obligation-shifting transactions in a manner intended to reflect the economic substance of the transactions and to clearly reflect the income of the parties to the transaction. Under the recharacterization, the property provider and the assuming party must report the income from the underlying property allocable to their respective periods of ownership. This result is achieved by imputing a series of transactions to both the assuming party and the property provider that results in a rent-leveling process based on the constant rental accrual method described in ' 1.467-3(d).

The assuming party is required to recognize rental income for the period in which it owns the property or leasehold interest. The property provider must adjust its income for any differences between amounts it recognized and amounts it would have recognized if it had reported income on a level-rent basis for the periods that it owned the property or leasehold interest. To account for the difference between rental income the assuming party is required to recognize and rental income the assuming party actually receives, the proposed regulations treat the assuming party as issuing an interest-bearing note to the property provider as additional consideration for the obligation-shifting transaction. Both parties must account for the resulting interest income and expense appropriately. To account for any differences in timing or amount between payments the property provider actually receives after the transaction and payments treated as being made to the property provider under the note from the assuming party, the property provider is treated as an obligor or obligee under a second loan, for which the property provider must account accordingly.

After careful consideration, the IRS and Treasury Department have concluded that the

complexity presented by these proposed regulations is not necessary to prevent tax avoidance in these transactions. Since the publication of the proposed regulations, the Court of Appeals for the District of Columbia Circuit has 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.

In the opinion of the IRS and Treasury Department, the claimed tax treatment for lease strips improperly separates income from related deductions, and lease strips do not produce the tax consequences desired by the participants. See Notice 2003-55 (2003-34 I.R.B. 395).

List of Subjects in 26 CFR Part 1

Income taxes, reporting and recordkeeping requirements.

Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG-209817-96) that was published in the Federal Register on December 27, 1996 (61 FR 68175) is withdrawn.

Dale F. Hart

Acting Deputy Commissioner for Services and Enforcement.