DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR DISTRICT COUNSEL

FROM: ASSISTANT CHIEF COUNSEL
(FIELD SERVICE DIVISION)
CC:DOM:FS

SUBJECT: LEASE STRIPPING

This memorandum responds to your request dated May 12, 1999. This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the Field office with jurisdiction over the case.

Legend

A=
B=
C=
D=
E=
F=
G=
H=
J=
K=
L=
M=
N=
O=

Date 1=
Date 2=
Date 3=
Date 4=
Date 5=
#1=
#2=
#3=
#4=
#5=
$1=
$2=
$3=

Issue

Is this transaction a lease-stripping transaction as described in IRS Notice 95-53, 1995-2 C.B. 334, for which the claimed tax treatment may be disregarded?

Conclusion

We believe that the facts submitted indicate that this transaction is structured in a lease-strip form that does not produce the tax consequences desired by the parties and that is subject to challenge as contemplated by Notice 95-53.

Facts

B invested in a large number of leases between Date 1 and Date 2. The lease assets consisted mostly of C. In the early years of the leases, B recognized a significant amount of losses because of depreciation on the lease assets. When the lease assets were fully depreciated for tax purposes, the leases were expected to generate significant taxable income for B. In Date 3, D approached B with a plan to contribute certain lease assets to a partnership. Under the proposed plan, the lease income that would have been reported on B's returns for Date 3 and subsequent years would be allocated to a foreign tax exempt partner.

On Date 4, B and a subsidiary formed A, a limited liability company, treated for federal tax purposes as a partnership, with its principal office in E. B contributed to A its interest in #1 leases with fully-depreciated assets. E, the foreign partner, contributed $1 in cash.

Under the terms of A's operating agreement, #2 percent of lease income for a specific year was to be allocated to E until the total amount of income and gain allocated to E for the tax year and all prior tax years equaled a specified percentage of E's cash contribution plus any losses allocated to E in prior tax years. Any additional income was to be allocated #3 percent to B and its subsidiary, respectively.

Under the agreement, partnership cash could only be used for certain low risk, low return investments, which earned #4 percent. This is in contrast to the #5 percent the partnership was obligated to pay E. Thus, A was not generating a profit, nor could it, under the agreement.

The agreement provided that capital accounts will be respected on liquidation of the partnership or any partner's interest in the partnership. The agreement also provided for the mandatory redemption of E's partnership interest on Date 5.

If A's assets were sold, B would be allocated most of the appreciation in the assets under section 704(c). To the extent there was any gain above the section 704(c) built-in gain, the agreement provided that E may share in the gain only to the extent necessary to generate the specified return.

Discussion

IRS Notice 95-53 begins with the following discussion:

> The Internal Revenue Service understands that certain persons have entered into, or may be considering, multiple-party transactions intended to allow one party to realize rental or other income from property or service contracts and to allow another party to report deductions related to this income.

It then describes examples of lease-strips including: a) Transferred basis transactions; b) Transfers of an interest in a partnership; and c) Other variations such as licenses of tangible property; service contracts; leaseholds or other non-fee interests in property; or prepayment, front-loading or retention of rights to receive future payments.

Although the current transaction does not explicitly fall within these examples, these are examples only, and are not meant to limit the transactions which are considered lease-strips under the Notice. Specifically, this transaction falls under the following description included in the Notice:

> [T]he parties to stripping transactions generally claim that one party realizes the income from property or services and that another party is entitled to take related depreciation, rental expense, or other deductions. The Service believes, however, that the claimed tax treatment improperly separates income from related deductions and

> that stripping transactions generally do not produce the tax consequences desired by the parties.

In this transaction, B has claimed the depreciation, while E, a tax-exempt entity, is allocated most of the income. The facts reveal that there is no economic purpose behind this allocation. Absent the benefit of depreciation, B cannot make a profit on this transaction. Because of this, the separation of income from related deductions is improper, and the transaction falls squarely within IRS Notice 95-53.

Case Development, Hazards And Other Considerations

[redacted]

[redacted]

By: ______________________________
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