REPORT #877

TAX SECTION

New York State Bar Association

Report on Announcement Regarding "Lease Stripping"
Set Forth in IRS Notice 95-53

Table of Contents

Cover Letter: i

INTRODUCTION 1

SUMMARY OF COMMENTS 4

SPECIFIC COMMENTS 5

1. New regulations regarding lease strips will need to identify clearly the types of transactions covered by such rules. 5

2. In promulgating regulations addressing lease strips it is necessary to develop the analytical framework that will be applied to recharacterize the transaction. 10

3 The recharacterization of transactions involving partnerships raises special considerations. 19

4. It is not clear from the Notice how Treasury intends to apply section 482 to lease strip transactions. 21

CONCLUSION 22

TAX SECTION
New York State Bar Association

May 14, 1996

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson Commissioner
Internal Revenue Service 1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Report on Announcement Regarding Stripping Transactions

Dear Secretary Samuels and Commissioner Richardson:

I am pleased to enclose a report of our Committee on Cost Recovery on Internal Revenue Service Notice 95-53, relating to "Lease Stripping." As stated in the report, we support the efforts of Treasury and the Internal Revenue Service to close down noneconomic transactions like abusive lease strips, and we look forward to the promulgation of regulations regarding the treatment of such transactions.

We do believe that in many cases abusive stripping transactions can be defeated under existing Code provisions and principles of common law. Nevertheless, the promulgation of regulations specifically addressing stripping transactions clearly will strengthen the integrity of the tax law.

The tax benefits sought in stripping transactions stem from the longstanding tax accounting anomaly that treats accelerated income as fully includible in income in the year of receipt. As discussed in the report, we believe that the theoretically proper response to stripping transactions is for the Secretary to exercise the authority under Code sections 467(f) and 7701(1) to promulgate regulations that would, in general, recharacterize the prepaid income as a loan, with the loan deemed paid through deemed payments of rent over the term of the lease (subject to exceptions for commercially reasonable prepayments). Failing that, the report recommends that consideration be given to two alternate methods of recharacterizing stripping transactions and, as between these alternatives, the report recommends a recharacterization approach based on the Alstores line of cases.

The report also illustrates the need for a clear definition of the types of transactions subject to recharacterization, and discusses the special issues raised by partnerships. Finally, the report questions what is meant by the Notice's discussion of section 482, and reflects our view that section 482 cannot be applied to otherwise unrelated persons based solely upon their having engaged in an otherwise arm's length transaction that is defined as a stripping transaction.

Please let me know if we can be of assistance in the development of further guidance in this area.

Respectfully submitted,

Richard L. Reinhold
Chair

RLR/mg
Enclosure

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON COST RECOVERY*

Report on Announcement Regarding "Lease Stripping" Set Forth in IRS Notice 95-53

INTRODUCTION

In Notice 95-53, I.R.B. 1995-44, the Internal Revenue Service announced its awareness and proposed treatment of "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 that income (for example, depreciation or rental expenses) ['lease strips' or 'stripping transactions']."

The Notice provides as examples three types of stripping transactions:

a. A transferred basis transaction: a sale, assignment or other transfer by one party of the right to receive future payments under a lease of tangible property, with the amount realized from the assignment treated as its current income, followed by a transfer of the property- subject to the lease and

* This report was prepared by members of the Cost Recovery Committee. The principal author of this report was Carolyn Joy Lee, with assistance from Robert D. Schachat and Elliot Pisem. Significant contributions were made by David H. Bamberger and John A. Corry. Helpful comments were made by Kimberly S. Blanchard, Peter C. Canellos, Naftali Dembitzer, Samuel Dimon, Steven Millman, Richard L. Reinhold, Richard O. Loengard, Jr., Steven C. Todrys, Michael L. Schler and Ralph O. Winger.

assignment in a transfer intended to qualify as a transferred basis transaction, e.g., under §351. "Typically, the transferor (or partner in a partnership that is a transferor) is generally not subject to 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 transfer of an interest in a partnership or other pass-through entity: "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. "Other variations of stripping transactions might involve, among other things, licenses of intangible property; service contracts; leaseholds or other non-fee interests in property; or prepayment, front-loading, or retention (rather than assignment) of rights to receive future payments."

The Service stated that "the 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."

The approach taken by the Notice is to redress the stripping problem by reallocating income and deductions among the parties to the transaction. Thus, the Notice states that "in the case of stripping transactions structured in a manner similar to that described in paragraph (a) above (including transactions with variations like those described in paragraph (c) above), the Service intends to exercise its authority under §482 to reallocate gross income, deductions, credits, or allowances between the parties as appropriate ... For purposes of §482, the parties in these stripping transactions generally are 'controlled ... by the same interests' because, among other factors, they act in concert with the common goal of arbitrarily shifting income or deductions between the transferor and the transferee. See, e.g., §1.482-1(i)(4) of the Income Tax Regulations. The Service will not apply §4 82 to other transactions where not necessary to clearly reflect income or to prevent the evasion of taxes. See Rev. Rul. 80-198, 1980-2 C.B. 113 (subject to the limitations described therein)."

The Service further announced that regulations also will be issued under section 7701(1) and other sections of the Code to recharacterize stripping transactions.[1] As stated in the Notice, under section 7701(1) Treasury "has the authority to prescribe regulations recharacterizing any multiple-party financing arrangement as a transaction directly among two or more of the parties in order to prevent the avoidance of tax." The Notice announces that regulations under section 7701(1) and other

[1] Treasury's list of 1996 Guidance Priorities, issued in February, 1996, also includes, under the heading "Financial Institutions and Products" the issuance of proposed regulations under section 7701(1) regarding lease stripping.

sections will apply to a stripping transaction if any significant element of the transaction is entered into or undertaken on or after October 13, 1995 (the date on which the Notice was issued).

SUMMARY OF COMMENTS

We support the efforts of the Treasury and the Internal Revenue Service (hereinafter collectively the "Treasury") to close down noneconomic, tax-driven transactions like the abusive "lease strip" transactions described in the Notice. The integrity of the tax law is compromised by the persistent marketing of structures that have no purpose other than the manipulation of selected tax rules. The issuance of the Notice has served a useful function in alerting taxpayers to Treasury's position with regard to abusive lease strips; we support the prompt promulgation of more complete guidance respecting the treatment of such transactions.

In many cases we believe that existing Code provisions and common law principles are sufficient to defeat abusive lease strips. Existing law can and should be applied on audit and in litigation to deny the tax advantages sought in such transactions. Specifically, we believe that cases such as Hydrometals Inc. v. Commissioner, 41 T.C.M. (PH) 1317 (1972), aff'd per curiam, 485 F.2d 1236, 32 A.F.T.R. 2d 6090 (5th Cir. 1973), cert. den., 416 U.S. 938 (1974) and Mapco. Inc. v. U.S., 556 F.2d 1107, 40 A.F.T.R. 2d 5144 (Ct. Cl. 1977) are particularly relevant to lease strips, for in many cases income purportedly accelerated by way of an assignment may be vulnerable to recharacterization as a loan under this authority.

We recognize that promulgating specific regulations under section 7701(1) and other sections will buttress Treasury's attack on abusive lease strips, albeit prospectively. We support the promulgation of such regulations. Fuller development of the types of transactions that will be covered by such regulations is needed, however, as is a system for recharacterizing stripping transactions. As discussed more fully below, we believe that the problem of separating income from expense is broader in scope than the types of transactions described in the Notice, and that the recharacterization required to address this problem effectively is likewise broader in scope than the Notice might suggest. The report discusses three alternative approaches for recharacterizing lease strips, and possible definitions of lease strips.[2]

It is not clear from the Notice what is the intended application of section 482. In general, we do not support the application of section 482 to persons who are not related, except in their status as parties to a transaction. We recommend that Treasury clarify the intended application of section 482.

SPECIFIC COMMENTS

1. New regulations regarding lease strips will need to identify clearly the types of transactions covered by such rules.

The Notice sets forth a description of two different types of transactions that are characterized as abusive "lease strips," and thus are subject to recharacterization as proposed

[2] This report primarily speaks to the issue of accelerated rent. Other kinds of accelerated payments, such as royalties on intangible property, present similar analytical issues. In concept, we believe it would be correct to apply to other kinds of accelerated income the same general recharacterization approach as is applied to rents. We note, however, that the determination of the appropriate amounts subject to recharacterization will be more complex in cases where the allocation of income to particular time periods is not as clear as it is in the usual lease transaction.

in the Notice. The Notice further states that the claimed tax treatment of stripping transactions -- that one party realizes the income from property or services and other party deducts the "related" expenses -- "improperly separates income from related deductions."

As a theoretical matter, lease strips are a subset of a broader class of cases, all of which involve a temporal mismatch of income and deductions caused by the essentially artificial accounting rules that treat advance receipt and assignments of future income as producing current income. In the Notice, Treasury did not announce that it would address lease strips by exercising its authority under section 467(f) to level advance rents. This raises a question, addressed more fully in Section 2, below, as to whether the simple case of accelerating rental income by receiving advance rents or assigning rights to receive rent should be considered a lease strip and should be recharacterized.

Because the recharacterization regulations presaged by the Notice will affect at least two different taxpayers and potentially apply for a number of taxable years, it is important that future guidance clearly address the nature of the transactions that Treasury seeks to recharacterize. This in turn, may be a function of the perceived abuse, which could include any or all of (i) temporal mismatches occasioned by accelerating income, (ii) the shifting that stems from a subsequent transfer,

(iii) the overstating of tax basis,[3] or (iv) possibly, the presence of a tax avoidance motive.[4]

The nature of these questions can perhaps be better appreciated by considering a very common kind of transaction that is theoretically similar to, but differently motivated than, the lease strips described in the Notice. Assume that Taxpayer A owns rental property, and collects rent on the property from B, its lessee, semiannually, in advance. In the middle of a rent period A sells the leased property to C. How are A and C supposed to report the rental income and expenses for the rent period in which the transfer occurred? Does A treat the entire advance rent payment as income? Should C report the portion of the rent allocable to the post-transfer period as its income? Should A be claiming depreciation deductions post transfer? What ensures that A and C report consistently, so that someone actually reports the post-transfer rents as income, and only one party claims the related deduction?

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[3] There can be situations in which, even without the preservation of the first owner's high property basis, the acceleration of rents followed by a transfer of the property achieve an income tax benefit. Compare, for example, a buyer who acquires rental real property for a $100, 10-year purchase money mortgage, with a buyer who permits the seller to accelerate and retain 10 years of rental income (which has a $100 present value). In the first example the buyer will have a 39-year asset with a $100 basis, and in the first 10 years will have to use taxable rental income to pay nondeductible principal on the 10-year note. In the second example the buyer would (absent recharacterization) have no depreciable basis in the property, but also would have no income at all for the first 10 years. Depending upon the seller's sensitivity to capital gains vs. ordinary income this kind of lease strip (or less extreme versions) may provide federal income tax benefits even without the fillip of a transferred basis.

[4] For example, a test of whether both parties to the transaction are subject to the same effective rate of tax is employed in the partnership allocation regulations in determining whether an allocation has substantial economic effect. See Reg. §1.704-l(b)(2)(iii)(a), and §1.704-1(b)(5), Example 5.

More broadly, new regulations will need to address a range of transactions that may be similar or may differ somewhat, and that can take different legal forms. For example:

1. A owns property, leases it to B, and B pays advance rent.

2. A owns property, leases it to B, and assigns B's rent to C.

3. A owns property, leases it to B, B pays advance rent, and A transfers the property to D (a) contemporaneously; or (b) five years later.

4. A owns property, leases it to B, assigns B's rent to C, and transfers the property to D (a) contemporaneously; or (b) five years later.

The Notice indicates that transaction 4(a) will be subject to recharacterization. Should the same reconstruction also obtain in situation 4(b), where five years pass between A's assignment of B's rent and D's use of that assignment to finance its property acquisition? Should there be different tax accounting for accelerated rents on transferred property based solely on the passage of time? Should the definition of a lease strip be based on an analysis of the relationship between the first owner's assignment and the second owner's acquisition, or on some test of an actual or deemed motivation underlying the transaction? Looking to situation 3, should the tax treatment change if it is the tenant who provides the “financing,” rather than a third party (whose only role in the transaction is as financier)?

As discussed below, there are different theoretical approaches to answering these questions. Whether various transactions are covered by or carved out of the proposed recharacterization of lease strips will depend on the scope of the guidance Treasury chooses to promulgate in this area, and on the type of recharacterization approach employed. As these examples illustrate, however, a clear definition of the parameters of the proposed lease strip rules is essential.

As discussed in section 2, below, we believe that the most theoretically sound solution to the problem evidenced by stripping transactions would be a reversal of the artificial accounting rules that currently result in the inclusion of prepaid income in full in the year of receipt. Instead, the prepaid amount should be characterized as a loan from the lessee to the lessor which is then deemed repaid (with interest) as the parties amortize the advance payment over the term of the lease through deemed payments of rent, presumably on a level basis. Adopting such a recharacterization approach means that a “stripping transaction” will be defined very simply as any case in which a taxpayer accelerates income by an assignment or by receiving a prepayment, subject to exceptions for commercially reasonable prepayments.

If this “leveling” approach is not adopted, then we would recommend defining a lease strip as any transaction involving (i) the acceleration of rent followed by (ii) a transfer (direct or indirect) of the leased property. Because stripping transactions can inappropriately affect the tax treatment of the first and second owners even without a carryover of the first owner's basis (see footnote 3), we suggest that all such situations be subject to recharacterization. Treasury might, however, prefer to limit recharacterization only to transferred basis situations; in that case we suggest that the negative implications of limited recharacterization for those transfers not covered by the new regulations be carefully considered.

We do not believe that Treasury should attempt to draw a line between "good" lease strips and "bad" lease strips based on factors such as tax motivation. Instead, we recommend that Treasury promulgate comprehensive guidance to provide administrable rules that reach sensible results in all cases.

And whatever the ultimate definition of a "lease strip," and the ultimate choice of the recharacterization approach, is very important that the new guidance insure that all the parties to such transactions clearly understand and be consistent in their treatment of the rental income and the related expense. If recharacterization applies to a transferred asset, for example, the section 7701(1) reallocation of income or deductions will affect at least two property owners over an extended period of time. It is therefore essential that guidance regarding the recharacterization of "lease strips" achieve consistency among taxpayers and over tax years, and not be subject to whipsaw resulting from conflicting interpretations by different taxpayers or different auditors.[5]

2. <u>In promulgating regulations addressing lease strips it is necessary to develop the analytical framework that will be applied to recharacterize the transaction.</u>

The root of the stripping problem is the temporal mismatch between income and deduction that stems from the

[5] This type of consistency rule is not granted in the existing conduit regulations, which also provide that they can be invoked only by the government. Reg. §1.881- 3(a)(3)(ii); compare Reg. §1.482-1(a)(3).

artificial, and in many respects outmoded, advance rent and assignment of income rules, which override traditional accrual principles and treat prepaid income as includible entirely in the year of receipt. Since 1986 Treasury has had authority under section 467 (f) to reverse this anomaly by leveling advance rental income. And in the contexts of original issue discount[6] and swaps,[7] Treasury has leveled prepayments, providing that they are to be included in income over the term of the agreement, rather than upon receipt.

We believe that the most sound theoretical approach to recharacterizing lease strips is to address the temporal mismatching utilized in stripping transactions by issuing regulations (comparable to the statutory rules of section 3 67 currently applicable to backloaded rents) to require the leveling of accelerated rentals over the term of the lease.[8] This “leveling” approach would eliminate the advance rent/assignment of income rules that are the basis of current lease strip

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[6] See Treas. Reg. §1.1273-2(g)(2)(i), which treats a payment made by a borrower to a lender other than for property or services provided by the lender, such as commitment fees or loan processing costs, as reducing the issue price of the debt instrument, rather than constituting immediate income to the lender.

[7] See Treas. Reg. §1.446-3(f)(2), allocating up-front payments on swaps over the term of the swap. See also Notice 89-21, 1989-1 C.B. 651.

[8] We note that the issuance of proposed regulations under section 467 is included among Treasury's 1996 Guidance Priorities. Although changing the treatment of advance rent under section 467(f) would not deal with the question of assignments of rental income, we think the Treasury has adequate authority under section 467(h) or section 7701(1)

transactions.[9] By treating prepaid or assigned rent as a loan to the lessor, and spreading the rents (adjusted for an interest factor) over the term of the lease, the recognition of rental income would necessarily follow the ownership of the property, and in general would be appropriately matched with the expenses relating to the property. This recharacterization approach would conform to the economics of the transaction, by recognizing that the advance rental paid by a tenant, or the amount paid for an assignment of future rents, is the discounted amount of the future rental payment or income. Exceptions to the rent levelling approach would need to be provided for commercially reasonable prepayments such as prepayments not exceeding one-year's rent.

If a leveling approach is applied only to identified stripping transactions, and not to all cases involving accelerated rents, then a number of difficult issues arise. First, it obviously is necessary to define such transactions. Moreover, it will be necessary to ascertain in the taxable year of the acceleration (or at least by the time the returns for such year are due), whether the acceleration produced income or was a loan.

If all of the components of a lease strip occur within the same year the latter inquiry will be fairly straightforward. If that is not the fact, however, a choice must be made between

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[9] On a transfer of the property the transferee would be treated as having taken subject to the transferor's obligation to repay the constructive loan, resulting in additional amount realized to the transferor, additional basis to the transferee, and rental income to the transferee over time, as the property owner is deemed to receive rental income and repay the loan. Assuring the transferee's compliance with these requirements presents a compliance issue that would need to be addressed. We note, however, that the transferee would have knowledge of the prepayment (or assignment) since the transferee would not be entitled to receive rent payments from the lessee during the period covered by the prepayment or assignment.

rules that apply rent leveling to “incomplete” lease strips, or rules that limit rent leveling to strips completed within a time certain. Both approaches have merits and problems.

If rent leveling applies only to strips (as defined) that are completed by a certain date, then the appropriate treatment of the stripped rents will be clear to all the parties and to the government. Taxpayers who are able to plan far enough in advance will, however, be able to avoid the application of the rent leveling rules, and can continue to effect lease strips.

If on the other hand the rent-leveling rules are applied to potential but as yet incomplete stripping transactions, taxpayers will not be able to avoid the anti-abuse rules by waiting to effect a strip. This kind of rule will, however, place considerable stress on the definition of lease strips, may be open to manipulation by taxpayers, and can lead to whipsaw if the first and second owners take differing views as to the applicability of rent leveling in the year of the acceleration.[10]

Because of the foregoing uncertainties that result from applying leveling only to identified strips, we believe that leveling should apply to all cases in which a lessor assigns rental income or receives advance rents (other than commercially reasonable arrangements involving minor acceleration of

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[10] Consideration must also be given to the effects of income leveling on the prepaying tenant or assignee. The deemed loan analysis presumably would apply both to the property owner and to the tenant (in the case of prepaid rent), or the assignee (in the case of an assignment of rental income). Thus, the tenant would be considered to earn interest (which is then paid over as rent); similarly a portion of the amounts received by the assignee would be treated as interest.

income).[11] This approach is simple, is fairly easy to apply, and purely as a policy matter is better reflective of income than the current assignment of income rule of Regulation section 1.61-8(b). Adopting such a rule would also rectify a number of other anomalies caused by the current accelerated rent rules, such as the mismatches that arise as a result of the carryback limitations of section 172 and section 469, which can limit taxpayers' abilities to apply against accelerated income the related losses arising in later years.

We recognize that an across-the-board income leveling approach would have implications considerably beyond the lease strip context. A system that permits the receipt of advance payments of income while deferring the tax thereon might lead to new forms of tax planning; although the economically correct result of a loan plus level rent payments generally can be achieved without difficulty today. And if the problem that is perceived with respect to stripping transactions is not the temporal mismatching of income and deduction that results under current law but instead the shifting of income and deductions between taxpayers, then promulgating regulations that level all accelerated income would have a much broader effect, on both taxpayers and the fisc, than may be warranted by the current problem of abusive stripping transactions. Nevertheless, we believe that leveling is the better answer, and should be adopted as the most economically principled recharacterization approach.

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[11] As indicated in footnote 2, we think it would be conceptually correct to apply a leveling regime to other types of accelerated income, such as income from royalties, service contracts, etc.However, a significant constraint in taking such an approach is that, unlike income under a net lease at a constant rent, the allocation of prepaid income to future periods in these other contexts may not be achieved with the same degree of accuracy.

If, however, Treasury is not at this time prepared to adopt the leveling approach to recharacterize strips, then we urge consideration of two additional analytical approaches that were not described in the Notice, but that could be particularly useful in recharacterizing strips, both prospectively, under new regulations, and perhaps for existing strips as well. As noted above, the theoretical problem presented by lease strips is a subset of a larger group of issues that bedeviled the tax system long before "lease strips" were coined. The basic problem is easy to state -- it is identifying which party is taxable on rental income and which owns the depreciable interest in leased property where, as an economic matter, the timing of the transferor's and transferee's receipt of income from property does not correspond to their periods of ownership of the property. This problem has existed under the tax law for many years. As is often true when issues are developed through litigation, the analysis of this basic question, and its various particular resolutions, have not always been clearly or consistently articulated by the decided cases, and have often been fact-sensitive.

Nonetheless, decided cases involving this same conceptual problem provide analytical frameworks that can serve as a basis for formulating a comprehensive response to this area that matches income and deductions in the same taxpayer, that deals with all parties in a known and predictable manner, and that does not vary the basic accounting treatment depending on indicia of tax avoidance.

One approach suggested by the case law is distilled in the Tax Court's opinion in I. J. Wagner.[12] While that decision was reversed on appeal by the 10th Circuit, we nevertheless

[12] I.J. Wagner. 33 T.C.M. 201 (1974), rev'd 518 F.2d 655, 36 A.F.T.R. 2d 75-5233 (10th Cir. 1975).

believe that the Tax Court's analysis has merit, and should be considered as one approach to resolving these issues. The system suggested by Wagner would treat all of the advance or assigned rents as income to the first owner upon receipt, and would essentially allocate to the first owner the basis recovery attributable to the period to which the accelerated rent relates.[13] The second owner would not be treated as having received any accelerated rental income, but also would be precluded from claiming depreciation deductions for the period to which the accelerated rents relate. Thus, the second owner would not be treated as having a depreciable interest in the property during the period covered by the first owner's acceleration and retention of the rental income.

An alternative approach is illustrated by the result in Hyde Park.[14] and essentially stems from the analytic framework underlying cases like Alstores[15] and Steinway.[16] Under this approach, the first owner would initially report the full amount of advance or assigned rents in income when received, but at the time of transfer would be treated as having a deduction for the

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13 The first owner could recover its basis either upon disposition of the property or over time thereafter. If the first owner is considered to have retained a term interest in the property it would continue to recover the basis allocated to that interest over time, even after the transfer to the second owner (and thus would have less basis attributable to the interest deemed transferred to the second owner). Alternatively, inasmuch as the first owner will already have included all of the accelerated rent in income, it may be more appropriate to treat the transfer, which is the event that severs the first owner's relationship to the property, as permitting the first owner to offset or write off the entire amount of its unrecovered basis at that time.

14 Hyde Park Realty, Inc., 20 T.C. 43 (1953), aff'd 211 F.2d 462, 45 A.F.T.R. 812 (2d Cir. 1954). See also Wm. R. Pokusa. 47 T.C.M.(PH) 433 (1978) and International Life Insurance Co., 51 T.C. 765 (1969).

15 Alstores Realty Corporation, 46 T.C. 363 (1955).

16 46 T.C. 375 (1955), Acq., 1967-2 C.B. 3. This approach also is similar to the tax treatment of property taxes on a transfer of property. See §164(d).

amount of previously reported income that is attributable to the period following the transfer. The second owner would report such advance rental income at the time of the acquisition, and would be treated as having paid for the property in part by allowing the first owner to retain the rents attributable to post-transfer periods. The first owner would therefore have an additional amount realized on the transfer, and the second owner would have advance rental income, would have a higher basis in property, and would take all depreciation deductions following the transfer. Thus, the amount of prepaid rent would become, at the time of transfer, an ordinary deduction and amount realized to the first owner, and ordinary income and basis to the second owner.

The Wagner approach has the benefit of not resulting in advance rental income to a transferee upon the acquisition of property -- a result that can be harsh and is in some respects surprising to a buyer. It would, however, require a fairly sophisticated system for allocating tax ownership and depreciation deductions between the first and second owners.[17] It also may be more difficult to reach this result under existing law.

The Alstores approach has appeal as being based on the economic practice commonly followed in nonabusive cases where there is a transfer of property after rent is received in advance. In most commercial transactions (like the simple example of A and C at page 10, above), transferors and transferees make economic adjustments at closing to allocate items of prepaid and deferred income and expenses between the transferor's ownership period and the transferee's. Under these adjustments the

[17] See also Morris, Sale-Leaseback Transactions of Real Property -- A Proposal. Tax Lawyer Vol. 30, No. 3, p. 701 (1977).

transferee is given credit against its purchase price for prepaid rents retained by the transferor.[18] By imposing an income tax analysis that likewise allocates prepaid or assigned rent between a transferor and a transferee based on the period to which it relates, the Treasury could address both the common cases and abusive lease strips in the same fashion, and with a rule that is easy to understand on an economic level. Adopting this approach also has theoretical appeal, for it augments the existing advance rent/assignment of income rules applicable to a single owner by applying an additional accounting rule that reflects the fact that the transferee is, in a sense, financing its acquisition of the property by permitting the transferor to retain income that relates to the transferee's period of ownership.[19]

As between Alstores and Wagner, we recommend recharacterizing lease strips (i.e., transactions involving an acceleration of income followed by a transfer) under the Alstores approach. This approach reaches reasonable results in both the simple case and the "abusive" case, is consistent with the

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[18] Similarly, the transferee is given credit for deferred expenses that will be paid by the transferee, and is required to increase its payment to the transferor to reflect rents accrued prior to closing but not yet received by the transferor, and prepaid expenses.

[19] In a similar vein, see James M. Pierce Corporation v. Commissioner, 326 F.2d 67, 13 A.F.T.R. 2d 358 (8th Cir. 1964). In Pierce, the transfer of a newspaper business as to which a reserve had been established for prepaid subscriptions was held to trigger both income and an offsetting deduction (or its equivalent) to the seller. The previously deferred subscription income was triggered because the transfer caused the "reasons for the establishment of the reserves and their tax deferral [to] cease to exist." 826 F.2d at 69. The deduction was allowed to the seller at the time of transfer on the theory that the seller had, by reason of the purchaser's assumption of the liability relating to the prepaid subscriptions, effectively received a smaller cash price from the purchaser, and the seller had essentially paid that difference to the purchaser to take over the reserve-related liabilities. Although the purchaser was not before the court, the Eighth Circuit's opinion plainly suggests that the purchaser would realize income by reason of the assumption/deemed payment to it (unless it was entitled to the same special deferral as Pierce had been). 326 F.2d at 72.

economics of such transactions, is relatively easy to apply, and is readily integrated with the Code and with existing tax law principles. And because it is more narrowly targeted, the Alstores approach may have utility as an interim solution to the problem of stripping transactions that can be readily implemented while the broader leveling approach is developed.

To achieve an Alstores recharacterization under section 7701(1) the regulations would treat the second owner as having financed its acquisition of the property by permitting the first owner to retain the "unamortized" portion of the accelerated income.[20] The transaction could. thus be recast as an assignment or prepayment of rents directly between the second owner and the assignee or tenant.[21]

3 The recharacterization of transactions involving partnerships raises special considerations.

As the Notice points out, one variety of lease strips employs a partnership. The partnership owns the property, accelerates income while the first owner is a partner, and then the first owner transfers its partnership interest to the second owner. As set forth in the Notice, general anti-abuse principles

[20] In general, it would not be necessary to implicate the tenant or assignee in such a recharacterization, for this recharacterization simply assumes a different recipient of the prepaid rent or assignment proceeds, rather than a different character of payment.

[21] By contrast, a Wagner-type of recharacterization under which the first owner is deemed to retain a depreciable interest in the property, may be harder to implement under section 7701 (1), as it is less apparent how recharacterization of the transaction as "directly among any two or more parties" leaves part of the depreciable basis of transferred property with the transferor. Nevertheless, authority to write such a regulation (or other regulation reflecting a similar or different approach) could be found in sections 467 (f), 467(h), 446, or 7701 (1).

and the partnership anti-abuse regulations can be brought to bear on partnership transactions.[22]

The promulgation of regulations under section 7701(1) will provide considerable opportunity for flexibility in treating partnership lease strips. We urge, however, that in drafting regulations under section 7701(1) every effort be made to avoid designing a special system particularly for the partnership treatment of lease strips. Subchapter K and the regulations thereunder, including the anti-abuse regulations, already provide a host of rules for allocating, reallocating and recharacterizing partnership transactions. We would expect that these rules, when paired with the general rules under section 7701(1) for recharacterizing direct, property-level lease strips, should provide sufficient protection against abusive partnership lease strips. What is needed therefore should be an explanation of how the basic set of recharacterization rules apply to partnership strips, rather than a different set of rules for partnership lease strips.

In terms of the specific recharacterization approach applied, rent leveling would simply change the timing of the recognition of partnership rental income, and result in the recognition of income over the term of the lease by the persons who are, from time to time, partners. Under a Wagner approach the future year's depreciation could be deducted by the first owner, either at the time of transfer or subsequently (see footnote 13), and the second owner would be treated as having acquired an interest in a partnership that owns a future interest in real

[22] See, in particular, Reg. §1.701-2(d), Example 7. A transaction falling within the existing anti-abuse regulations can be recharacterized under such authority. We assume that the proposed treatment of partnership lease strips applies to transactions not otherwise covered by such existing regulations.

property. Under the Alstores approach, an aggregate analysis probably would be necessary, under which the transferor and transferee partners would be treated as having adjusted the consideration paid for the partnership interest by crediting the transferor partner's share of the rents attributable to the post-transfer period to the transferee, and then applying those rents to the “purchase price” of the partnership interest.

4. It is not clear from the Notice how Treasury intends to apply section 482 to lease strip transactions.

Section 482 applies to “two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests.”

Regulations adopted under section 482 in 1994 define “[c]ontrolled” to include “any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable and exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.” Reg. §1.482-1 (i)(4) (underscored language added in 1994 regulations).

The Notice states that the underscored language of the 1994 Regulation means that “the parties in these stripping transactions generally are 'controlled ... by the same interests' because, among other factors, they act in concert with the common goal of arbitrarily shifting income or deductions between the transferor and the transferee.” It is not clear from the Notice's discussion of section 482 exactly what Treasury's position is.

If the Notice means that section 482 can apply to two otherwise unrelated persons who act in concert with respect to their ownership of an entity to shift income or deductions between such entity and themselves, we have no quarrel with that result. Such a definition of “control” would be grounded in findings of actual, ongoing cooperation among unrelated persons that achieve effective economic control of another entity, and essentially reflects the result in B. Forman Company. Inc., 453 F.2d 1144, 29 A.F.T.R. 2d 72-403 (2d Cir. 1972) and in Rev. Rul. 65-142, 1965-1 C.B. 223.

We do not believe, however, that persons can be considered to be commonly controlled based solely upon their having engaged in an otherwise arm's length transaction that, because of a particular income tax rule, confers a tax benefit. Moreover, such an interpretation of section 482 would have implications for a much broader class of transactions than the targeted lease strips.

We recommend that Treasury clarify that it does not propose to apply section 482 to unrelated parties dealing at arm's length, based solely on their having engaged in a transaction defined as a lease strip.

CONCLUSION

We believe that the fundamental problem in stripping transactions stems from the artificial accounting rule that treats prepaid income as currently taxable, and that the correct recharacterization of stripping transactions would be achieved by generally leveling prepaid rental income and taking it into account over the term of the lease (subject to exceptions for commercially reasonable prepayments). Failing that, we believe Treasury should define stripping transactions as any transaction in which rent is accelerated and the leased property is thereafter transferred, and should recharacterize stripping transactions by allocating to the transferee the accelerated income attributable to its period of ownership, and treating the transferee as paying such income over to the transferor as additional consideration for the transferred asset. We recommend that the same recharacterization construct apply both in the direct ownership context and in the partnership context. In drafting these regulations it will be important to clearly identify the types of transactions that are subject to recharacterization, and the type of recharacterization to which such transactions are subject.

We also think that it is not appropriate to apply section 482 to unrelated parties dealing at arm's length based solely on their having effected a shifting of income and expense, and suggest clarification on this point.