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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL
LMSB

FROM: WILLIAM C. SABIN, JR.
SENIOR TECHNICIAN REVIEWER
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SUBJECT: Lease Stripping Theory

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Hypothetical

A, a corporation, owns depreciable equipment subject to pre-existing user leases. A and B, a thinly capitalized partnership, engage in a sale-leaseback of the equipment. B issues a note to A for the equipment. The payments due under the terms of B's note approximate the rental payments due under the lease. A retains the option to buy the equipment back at the end of the lease term, and also retains all risks associated with the leased equipment. The residual value of the equipment at the end of the lease term is minimal.

B has a majority 98 percent partner, C, who is exempt from United States taxation. B subsequently sells the rent receivables from A to a bank for cash, thereby accelerating the income due under the lease. B allocates to C, the tax-exempt partner, C's respective share of the accelerated income. B uses the cash to pay off its note to A.

D, a corporation, is a subsidiary of E, also a corporation. E is the parent of a consolidated group which includes D. B contributes the equipment to D in exchange for preferred D stock in a purported I.R.C.§ 351 transaction. At the same time, E transfers property to D in exchange for additional D common stock. The amount of the property E transfers to D is sufficient for E to count as a transferor in the purported section 351 transaction. Since D is a member of the E consolidated group, the E consolidated group is entitled to utilize the depreciation deductions generated by the depreciable equipment. Such depreciation deductions will be limited to adjusted basis of the property interest acquired by D in the purported section 351 transaction. Section 167(b).

LAW AND ANALYSIS

In order to determine the tax consequences of the purported section 351 transaction, it is necessary to characterize the nature of the interest transferred to D by B, as well as the amount of basis properly allocable to such property. In the sale and leaseback transaction, prior to the income strip, the parties transferred the equipment as a whole. After the income strip, however, the equipment bifurcated into two distinct time-based property interests. By analogy to property law, these interests can be viewed as: 1) a term-of-years interest, followed by 2) a remainder interest. At the time of the lease strip, B realized the full benefit of the leasehold for the duration of the lease period, because B has accelerated and received all the income associated with the lease. Since the lease covers nearly the entire useful life of the property, the remainder interest is of minimal value. In terms of the leasehold period, B holds nothing of value that can be transferred, because the remainder value is negligible. Accordingly, B is transferring nothing greater than a remainder interest to D.

In determining the tax consequences of B's transfer of the remainder interest to D, it is necessary to allocate basis to both the term of years and the remainder interest. Initially, B's basis in the equipment is equal to its cost. Section 1012. At the point the equipment is bifurcated into a term-of-years interest and a remainder interest, the purchase price must be allocated between the two interests in order to determine the basis of each. Such allocation is generally based on the relative fair market value of the assets. Banc One Corporation v. Commissioner, 84 T.C. 476, 495 (1985). Although the burden would be on the taxpayer to prove the relative fair market value of each asset, it would appear that under the facts presented in this paper, since the residual value of the remainder interest is minimal, B's basis in it would be quite low. Furthermore, if D acquired the remainder interest in a valid section 351 transaction, D's basis in such property would be the same as B's basis in such property. Section 362 (a). As noted above, the E group's depreciation deduction for the remainder interest would be limited to this adjusted basis. Section 167(b).

This treatment is supported by analogous case law. For example, the Supreme Court has recognized that oil and gas reserves are a wasting asset and the corresponding depletion is akin to the depreciation of machinery. Anderson v. Helvering, 310 U.S. 404, 407-408. In Palmer v. Bender, 287 U.S. 551 (1933) the Supreme Court addressed the issue of the right of a transferor of a mineral lease to retain a depletion allowance associated with the lease after the purported sale. The transferor had retained a right to $1,000,000 to be paid out of the oil produced and saved from the field. Id. at 553. In addition to reporting income on its tax return from this contract, the transferor deducted a depletion allowance based on the value of the oil in place. Id. at 554. The Commissioner denied the deduction based upon the conclusion that the transfer of the lease was a sale and the transferor no longer had any ownership that would allow it to take a depletion allowance. Id. The Supreme Court disagreed and allowed the depletion allowance on the theory that despite the transfer of the legal interest in the minerals, the transferor had retained a right to share in the oil produced. Later the Supreme Court elaborated that in Palmer the "stipulation for royalty out of oil operated to save to them an economic interest in the oil sufficient to entitle them to deduct from their income derived from the oil an allowance for depletion. If Palmer had retained no interest in the oil he would have been entitled to no deduction on account of depletion. Ownership was essential." Thomas v. Perkins, 301 U.S. 655, 661 (1937).

With the lease strip, a future stream of income has been reserved to the transferor, B, who has accelerated it and allocated it to C, its tax-exempt partner. As with the transferor of the mineral lease, it is B's retained ownership that leads to the conclusion that B and not E through the consolidated group should receive the depreciation deductions.

Similarly, in Rev. Rul. 77-413, 1977-2 C.B. 298 the Service ruled that the amount realized from a sale of real property does not include the value of a 20-year possessory interest retained in the property and that the adjusted basis of the property should be allocated between the interests sold and the interest retained in the proportions that their respective market values bear to the fair market value of the entire property. The ruling states that whether the seller who has retained a term of years has done so as an owner depends on whether the seller has retained the benefits and burdens of ownership.

In Alstores Realty Corp. v. Commissioner, 46 T.C. 363 (1966), Acq. 1967-2 C.B. 1, the Tax Court addressed the question of whether a petitioner realized rental income when it purchased a building but allowed the seller to retain occupancy for 2 ½ years rent-free. Although the court ruled that the seller did not retain ownership, it did so based upon an analysis of the benefits and burdens of ownership. Id. at 372, see also, Ashlock v. Commissioner, 18 T.C. 405 (1952).

The term "sale" is given its ordinary meaning and is generally defined as a transfer of the ownership of property for money or for a promise to pay money. Commissioner v. Brown, 380 U.S. 563, 570-71 (1965). A transaction is a sale if the benefits and burdens of ownership have passed to the purported purchaser. Highland Farms, Inc. v. Commissioner, 106 T.C. 237, 253 (1996); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981). Courts have considered the following factors relevant in determining whether the benefits and burdens of ownership passed:

a. Whether the transaction was treated as a sale. United Surgical Steel Co., Inc. v. Commissioner, 54 T.C. 1215, 1229-30, 1231 (1970), acq., 1971-2 C.B. 3;
b. Whether the obligors on any notes were notified of the transfer of the notes. Id.;
c. Which party serviced the notes. Id.; Town & Country Food Co., Inc. v. Commissioner, 51 T.C. 1049, 1057 (1969), acq., 1969-2 C.B. xxv;
d. Whether payments to the transferee corresponded to collections on the notes. United Surgical, 54 T.C. at 1229-30; Town & Country, 51 T.C. at 1057;
e. Whether the transferee imposed restrictions on the operations of the transferor that are consistent with a lender-borrower relationship. United Surgical, 54 T.C. at 1230; Yancey Bros. Co. v. United States, 319 F. Supp. 441, 446 (N.D. Ga. 1970);
f. Which party had the power of disposition. American National Bank of Austin v. United States, 421 F.2d 442, 452 (5th Cir. 1970); cert. denied, 400 U.S. 827 (1970);
g. Which party bore the risk of loss. Union Planters Nat'l Bank of Memphis v. United States, 426 F.2d 115, 118 (6th Cir. 1970), cert. denied, 400 U.S. 827 (1970);
h. Which party had the potential for gain. United Surgical, 54 T.C. at 1229; Town & Country, 51 T.C. at 1057.

The last two factors are generally the most pivotal determiners, however, the overall concentration should focus on the economic substance of the transaction. Mapco, Inc. v. United States, 556 F.2d 1107, 1111 (Ct. Cl. 1977). In our hypothetical, all the gain has been stripped by B and then allocated to C. A, meanwhile, has retained all the risks associated with the equipment. See Torres v. Commissioner, 88 T.C. 702, 721 (1987) (discussing the benefits and burdens test applicable to a sale leaseback situation). D and E, through the consolidated return, have neither the benefits nor burdens of ownership.

We do not propose, moreover, that the lease be broken out as a separate amortizable asset that remains with the seller. The Tax Court has rejected attempts by buyers to separately amortize a favorable lease. Schubert v. Commissioner, 33 T.C. 1048 (1960), aff'd, 286 F.2d 573 (4th Cir. 1961), cert. denied, 366 U.S. 960 (1961); Friend v. Commissioner, 40 B.T.A. 768 (1939), aff'd, 119 F. 2nd 959 (7th Cir. 1941), cert. denied, 314 U.S. 673 (1941). Although it is analogous, we are not presented with a lease on real property. Rather, the sale should be seen as a sale of less than a full interest in equipment, with a remainder interest going to the buyer. Basis should be allocated accordingly.

Additionally, although, Apex Corp. v. Commissioner, 42 T.C. 1122 (1964), Acq. 1965-2 C.B. 4 appears to run counter to these arguments, the court did not have this issue squarely before it. In Apex, petitioner sold all of its rental rights to equipment to Murdock Acceptance Corp. (Murdock) and thereafter sold the equipment subject to Murdock's rights in the equipment to Equipment, Inc. (EI). Murdock had a right of recourse against petitioner in the event of default by the lessee and all three parties were interrelated. Id. at 1125. The issues presented to the court were 1) whether the basis should be allocated between the cost basis of the equipment and the rental or lease rights petitioner had sold; or 2) whether the petitioner could allocate its entire basis to the equipment and deduct a loss on its sale of the equipment. Id. at 1123.

The Commissioner primarily argued that the sale of the reversionary interest to EI was a sham and that EI never received the benefit and burdens of ownership. Id. at 1127. The Tax Court, however, found that there was no lack of substance to the dealings because all three corporations had business activity and purpose and profited independently from the deal. Id. at 1129. The court found that the petitioner was entitled to use his entire basis and deduct the loss from the sale of the machines. The court dismissed the cost basis allocation theory noting that Treas. Reg. § 1.61-6 which provides that when a part of a large property is sold, the cost is apportioned among the several parts, did not apply as the regulation related to the sale of a tract of land followed by a sale of a portion of it. The court did not address the issue of basis allocation to a reservation of a term of years in depreciable equipment. Because the Commissioner did not primarily argue basis allocation, and rather urged that EI received no ownership at all, we believe that Apex is not dispositive of this issue.

Please call if you have any further questions.

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