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

OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR
SENIOR ATTORNEY

FROM: Gerald B. Fleming
Acting Special Counsel (Corporate) CC:DOM:FS:CORP

SUBJECT: Lease Stripping

The facts are as laid out in the proposed RAR (the "report"). The analysis described below is stated in general terms. That is, it is generally applicable to lease stripping transactions. However, not all arguments are applicable to all lease stripping transactions. Because of the short deadline and informal nature of the request, the analysis is not applied to the specific facts of the case. Consequently, we are not stating conclusions or making recommendations. If you wish further assistance, please submit a formal request for Field Service Advice.

LEGEND:

X =

Step Transaction Issue

LAW AND ANALYSIS

The step transaction doctrine is a rule of substance over form that treats a series of formally separate but related steps as a single transaction if the steps are in substance integrated, interdependent and focused towards a particular result. Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987).

The step transaction doctrine, as described above, allows the Service to argue that certain economically meaningless steps of a transaction can be collapsed or ignored. Thus, the issue is whether the step transaction doctrine can be applied in this case to eliminate economically meaningless steps.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

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I.R.C. § 269 Issue

LAW AND ANALYSIS

Section 269(a) authorizes the Service to disallow any deduction or other allowance if: (1) any person or persons directly or indirectly acquire control of a corporation or (2) any corporation acquires property from an unrelated corporation in a transaction in which the basis of the property carries over, and, in either case, the principal purpose for the acquisition is to evade or avoid Federal income tax by securing the benefit of a deduction or other allowance that such person or corporation would not otherwise enjoy.

In this case, it does not appear that the parties acquired control of X in the Transaction because it appears that TP already controlled X. In that case, I.R.C. § 269(a)(1) would not apply. However, we do not have any information when TP first acquired X.

If TP formed X shortly before the Transaction and X conducted no business until this Transaction, the Service may be able to argue that the formation of, and the transfer of the property to, X should be integrated. In that case, TP and trust would be treated as having acquired X (by formation) as part of the Transaction. We note that the acquisition requirement of I.R.C. § 269(a)(1) may be met even if the target corporation was newly incorporated by the taxpayer in a tax-free exchange under I.R.C. § 351. See Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968).

In addition, X acquired property from a trust, not a corporation. Therefore, I.R.C. § 269(a)(2) does not apply to this case.

I.R.C. § 351 Issue

LAW AND ANALYSIS

Note: the following analysis applies only if X is claiming depreciation deductions.

Generally, I.R.C. § 351 provides that investors do not recognize gain or loss if they transfer property to a corporation solely in exchange for its stock and if the transferors, as a group, are in control of the transferee corporation immediately after the exchange. For purposes of I.R.C. § 351, control is defined as ownership of 80 percent of the total combined voting power of all classes entitled to vote and 80 percent of the total number of shares of all other classes of stock of the transferee corporation (I.R.C. §§ 351(a) and 368(c)). The ownership interests of all transferors participating in a single transaction are aggregated to determine whether the control test is met. Subject to certain limitations, to determine control, a group of transferors may include all of the transferee stock owned by each transferor participating in the transaction, not just the shares the transferors receive in the current transaction.

If I.R.C. § 351 applies to an exchange, under I.R.C. § 362(a)(1) the transferee corporation takes the same basis in the assets it received from the transferor as the transferor had in such assets increased by the amount of gain, if any, recognized to the transferor. The facts as stated indicate that trust's basis in the transferred assets exceeded the liabilities assumed (see I.R.C. § 357(c)). Thus, if I.R.C. § 351 applies to the transfer of the ownership and leasehold interests to X, it appears X will take the same basis in such interest as the transferors had. Consequently, I.R.C. § 351 will not prevent X from deducting the amounts claimed as depreciation.

On the other hand, if I.R.C. § 351 does not apply, the transfer of the ownership and leasehold interests to X is a taxable exchange under I.R.C. § 1001. X still recognizes no gain or loss on the Transaction under I.R.C. § 1032. However, X determines the basis of the property it receives under § 1012. Under Treas. Reg. § 1.1012-1(a), X takes a basis in the ownership and leasehold interests equal to the fair market value of the stock X distributes in the exchange.

The Service could argue that the transfer of the ownership and leasehold interests to X does not qualify under I.R.C. § 351 because such transfer lacks a business purpose. Courts have hinted at the concept of a business purpose requirement in I.R.C. § 351 repeatedly. Opinions discussing other I.R.C. § 351 issues often indicate that the taxpayer had a valid business purpose for the transaction in question. See Hempt Bros., Inc. v. United States, 490 F.2d 1172, 1178 (3d Cir. 1974), cert. denied, 419 U.S. 826 (1974); Stewart v. Commissioner, 714 F.2d 977, 992 (9th Cir. 1983). Perhaps the most thorough judicial exploration of the business purpose doctrine in I.R.C. § 351 is in Caruth v. United States, 688 F. Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989). In Caruth, the court explains that I.R.C. § 351 is tied very closely to the reorganization provisions and reasons that the doctrines applicable there are equally valid for capital contributions. Under Caruth, the business purpose requirement for I.R.C. § 351 transactions appears to be the same as the business purpose requirement for acquisitive reorganizations. Generally, I.R.C. § 351 will apply to a transaction if the taxpayer has a valid business purpose for the transaction other than tax savings. See Stewart v. Commissioner, 714 F.2d 977, 991 (9th Cir. 1983); Rev. Rul. 60-331, 1960-2 C.B. 189, 191.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

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I.R.C. § 482 Issue

LAW AND ANALYSIS

Generally, in order for I.R.C. § 482 to apply to a transaction, the transaction must be between two or more entities owned or controlled by the same interests. I.R.C. § 482. To the extent that it can be shown that a transaction was carried out pursuant to a common design intended to effect an arbitrary shifting of income and deductions, the participants in the common design may be treated for purposes of the transaction as "controlled by the same interests" for the purposes of I.R.C. § 482. Accordingly, in the lease stripping context, I.R.C. § 482 may be applied to prevent the arbitrary separation of deductions (steered to the entity subject to the

U.S.'s taxing jurisdiction) from the income associated with those deductions (steered to an entity exempt from the U.S.'s taxing jurisdiction).

A. Section 482 -- Generally

Section 482 provides the following:

> In any case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the Secretary may distribute apportion, or allocate gross income, deductions... between or among such organizations...if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations. [Emphasis added].

Thus, in order for I.R.C. § 482 to apply to a transaction, the transaction must be between two or more entities owned or controlled by the same interests. As there is no common ownership among the participants to the Transaction (other than TP's ownership of X), the primary question under I.R.C. § 482 becomes whether any of the participants, particularly trust, are controlled by the same interests.

B. Legal Standard for Control

The I.R.C. § 482 regulations define control "to include any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." Treas. Reg. § 1.482-1(a)(3), 1968-1 C.B. 218; Treas. Reg. § 1.482-1T(g)(4), 1993-1 C.B. 90; Treas. Reg. § 1.482-1(i)(4), 1994-2 C.B. 93. See also Appeal of Isse Koch & Company, Inc., 1 B.T.A. 624, 627 (1925), acq., 1925-1 C.B. 2 ("[C]ontrol not arising or flowing from legally enforceable means may be just as effective in evading taxation as if found on the most formal and readily enforceable legal instrument."). The regulations also state that "[i]t is the reality of control that is decisive," rather than a rigid focus on record ownership of the entities at issue. Id. Accord Ach v. Commissioner, 42 T.C. 114 (1964), aff'd, 358 F.2d 342 (6th Cir.), cert denied, 385 U.S. 899 (1966); Grenada Indus., Inc. v. Commissioner, 17 T.C. 231 (1951), aff'd, 202 F.2d 873 (5th Cir. 1953), cert. denied, 346 U.S. 819 (1953), acq. in part and nonacq. in part, 1952-2 C.B. 2, 5; Rev. Rul. 65-142, 1965-1 C.B. 223, 224; Charles Town, Inc. v. Commissioner, 372 F.2d 415 (4th Cir. 1967), aff'g, T.C. Memo. 1966-015, cert. denied, 389 U.S. 841 (1967).

Moreover, the 1968 regulations provide that a "presumption of control arises if income or deductions have been arbitrarily shifted." Treas. Reg. § 1.482-1(a)(3) (1968). See Dallas Ceramic Co. v. Commissioner, 598 F.2d 1382, 1389 (5th Cir. 1979), rev'g, 35 A.F.T.R.2d (RIA) ¶ 75-394 (N.D. Tex. 1974) (holding that based on Treas. Reg. § 1.482-1(a)(3) (1968), the Service properly argued that proof of income shifting between two corporations establishes a presumption of common control). Accord Hall v. Commissioner, 294 F.2d 82 (5th Cir. 1961), aff'g, 32 T.C. 390 (1959), acq., 1959-2 C.B. 4 (referring to Reg. 111 § 29.45-1). The 1993 and 1994 regulations also contain this presumption, and add that control may exist as a result of the actions of "two or more taxpayers acting in concert with a common goal or purpose." Treas. Reg. § 1.482-1T(g)(4) (1993); Treas. Reg. § 1.482-1(i)(4) (1994). Accord DHL Corp. v. Commissioner, T.C. Memo. 1998-461 ("[W]hen the interests controlling one entity and those controlling another have a common interest in shifting income from the former to the latter, entities may be considered commonly controlled [in determining whether the control requirement under the 1968 regulations is satisfied]."). Thus, under the regulations, joint, legal ownership, or overlapping ownership, is not required for unrelated corporations to come within the purview of I.R.C. § 482 if income or deduction shifting is present, or if there is common goal to shift income or deductions. But see Lake Erie & Pittsburgh Railway Co. v. Commissioner, 5 T.C. 558 (1945), acq., 1945 C.B. 5, acq. withdrawn and substituted for nonacq., Rev. Rul. 65-142, 1965-1 C.B. 223; B. Forman v. Commissioner, 54 T.C. 912 (1970), rev'd in relevant part, 453 F.2d 1144 (2d Cir. 1972), cert denied, 407 U.S. 934 (1972), reh'g denied, 409 U.S. 899 (1972), nonacq, 1975-2 C.B. 3 (nonacquiescence relates to the Tax Court opinion only, as the Second Circuit adopted an interpretation of control that is consistent with 1968, 1993, and 1994 I.R.C. § 482 regulations).

Where the Service seeks to establish common control due to the presence of an artificial shifting of income and deductions, it is the Service's burden to prove the applicability of I.R.C. § 482 by establishing a shifting of income and deductions. Dallas Ceramic Tile Co., at 1390. We believe that this burden is met by the "stripping" of income from the leases to trust, an entity that is exempt from U.S. tax, and the reporting of the deductions relating to that income by X. See Notice 95-53, 1995-2 C.B. 334 ("[T]he parties to a stripping transaction are controlled by the same interests, because, among other factors, they act in concert with a common goal of arbitrarily shifting income and deductions between a transferor and a transferee.").

C. Legal Standard for "Same Interests"

If control is found to exist, the Service may allocate income and deductions among members of the "controlled group." Treas. Reg. § 1.482-1(b)(1) (1968); Treas. Reg. § 1.482-1T(a)(2) (1993); Treas. Reg. § 1.482-1(a)(2) (1994). A controlled group or controlled taxpayer is defined to mean the entities owned or controlled by the "same interests," and includes the taxpayer that owns or controls other taxpayers. Treas. Reg. § 1.482-1(a)(5) (1968); Treas. Reg. §§ 1.482-1T(4), (5) (1993); Treas. Reg. §§ 1.482-1(i)(5), (6) (1994). Unlike the term "control," the phrase "same interests" is not defined in the I.R.C. § 482 regulations. Case law as well as the legislative history of I.R.C. § 482 provide guidance, however.

Section 482 was enacted to prevent the artificial shifting of income between controlled taxpayers to avoid Federal taxes, and thereby "milk" a taxable entity, i.e., placing deductions in one entity and income related to those deductions in another entity. Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5th Cir. 1979), citing, H. Rep. No.2, 70th Cong., 1st Sess. (1927), 1939-1 C.B. (Part 2) 384, 395; S. Rep. No. 960, 70th Cong., 1st Sess. (1928), 1939-1 C.B. (Part 2) 409, 426. See also H. Rep. No. 350 and S. Rep. No. 275, 67th Cong., 1st Sess. (1921). In using the term "same interests," Congress intended to include more than "the same persons" or "the same individuals." Brittingham, 598 F.2d at 1379; South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 894-95 (5th Cir. 1966), aff'g, 43 T.C. 540 (1965), cert. denied, 386 U.S. 1016 (1967); Appeal of Rishell Phonograph Co., 2 B.T.A. 229, 233 (1925). See also LXI-Part 6 Cong. Rec. 5827 (1921) (statement of Sen. King referring to the "same forces" controlling a number of corporations). Different persons with a common goal or purpose for artificially shifting income can constitute the "same interests" for the purposes of the statute. South Texas Rice Warehouse, 366 F.2d at 894-95. See also Brittingham, 598 F.2d at 1378-79, citing Ach, 42 T.C. at 125-26 (The phrase, "same interests," should not be narrowly construed to frustrate the intent of I.R.C. § 482); Rishell Phonograph, 2 B.T.A. at 233 ("If 'the same interests' was intended to mean only 'the same persons,' it would have been easy for Congress, by using the latter term, to have avoided all ambiguity."). Accord Grenada Indus., supra.

Thus, it is not necessary that the same person or persons own or control each controlled business before I.R.C. § 482 can be applied, but there must be a common design for the shifting of income in order for different entities to constitute the "same interests." Indeed, this definition of same interests is identical to the definition of control (and the presumption relating thereto) in the regulations and case law. Consequently, if there is a common design for shifting income or deductions, then the requirements for control and same interests will be met.

D. Control by the Same Interests in the Transaction

1. Common Plan Theory

Based on the facts as presented, we believe the parties to the Transaction likely acted pursuant to a common plan to shift income and deductions in a manner that was beneficial to each participant in the Transaction. The field should obtain more information on the manner in which each participant expected to be compensated for participating in the Transaction.

Further, based on: (1) the close proximity in time between the various steps and (2) the peculiarly circular cash flows between the parties to the Transaction, we believe it is likely that each of the parties to the Transaction acted pursuant to a common plan to effect the lease strip. Below, in the last section of this memorandum, we suggest types of information that should be developed in order to bolster the application of the common-plan theory.

2. Alternative Control Theory -- Ability to Direct the Actions

The District may wish to establish control among the participants under an alternative theory that does not rely on evidence of a common plan. Specifically, if it can be shown that certain participants had the ability to direct the actions of other participants, control may be found to exist. See Hall, supra, 32 T.C. at 409-10 (An arbitrary shifting of income coupled with the ability to direct the actions of an entity establishes control for the purposes of I.R.C. § 482, whether or not ownership exists). Various facts may aid the Service in establishing control under such a theory: the fact that (a) certain entities were "shell" entities; (b) certain individuals had no experience in the leasing business and relied on other participants to craft their role in the Transaction; and (c) other participants in the Transaction could direct the actions of other participants -- either by legally enforceable means, or by virtue of overlapping employees or officers. We ask that the District develop facts accordingly.

E. Section 482's Application to the Transaction -- In General

Generally, we have considered applying I.R.C. § 482 to lease stripping transactions under three alternative analyses. The application of these three analyses to a lease stripping transaction, however, does not preclude the application of other theories, such as the sham and step-transaction doctrines, to the Transaction. The I.R.C. § 482 analyses should be applied in conjunction with these other theories, because I.R.C. § 482 applies whether or not a transaction is a sham or otherwise colorable where a transaction is merely a device to shift income or deductions. Treas. Reg. § 1.482-1(c) (1968); Treas. Reg. § 1.482-1T(d)(1)(i) (1993); Treas. Reg. § 1.482-1(f)(1)(i) (1994); G.D. Searle & Co. v. Commissioner, 88 T.C. 252, 367 (1987).

1. Economic Substance

Section 482 overlaps with the case law relating to economic substance and sham doctrines by allowing the Service, in certain instances, to disregard contractual terms and agreements and to recharacterize a transaction. See Treas. Reg. §§ 1.482-2T(a)(1)(ii)(B), -2T(a)(3) (1993); Treas. Reg. §§ 1.482-1(d)(3)(ii)(B)(1), -1(d)(3)(ii)(C) ex. 3, -1(f)(2)(ii), -2(a)(1)(ii)(B), -2(a)(3), -4(f)(3)(ii)(A) (1994). See also B. Forman, supra, 453 F.2d at 1160-1, and Medieval Attractions N.V. v. Commissioner, T.C. Memo. 1996-455 (RIA) 3277, 3322 (applying the 1968 I.R.C. § 482 regulations to analyze the economic substance of intercompany contracts). However, the I.R.C. § 482 regulations expand upon case law principles and provide additional guidance in specific areas. Specifically, the regulations provide the following:

The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, great weight will be given to the actual conduct of the parties, and the respective legal rights of the parties.... If the contractual terms are inconsistent with economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

Treas. Reg. § 1.482-1(d)(3)(ii)(B) (1994); Treas. Reg. § 1.482-1T(d)(1) (1993). Thus, I.R.C. § 482 provides an alternative approach to challenging the Transaction by providing additional criteria under which to apply the economic substance and sham inquiries to the parties' conduct and not restricting the Service's allocation authority to instances of "colorable" or "sham" transactions. See G.D. Searle, 88 T.C. at 367. We note that in the context of the Transaction (and similar tax-shelter transactions), this allocation authority would exist only where there is a common tax avoidance scheme among the participants to arbitrarily shift income and/or deductions. [Note, the prior sentence does not apply to the alternative theory discussed above for establishing control (the ability to direct the actions of certain participants).]

Under the first I.R.C. § 482 analysis, the economic substance of a transaction subject to I.R.C. § 482 is analyzed by focusing on the parties' actual conduct; the economic risks purportedly transferred; and whether, from a business perspective, the transaction makes objective business sense, or under the language of some cases, would have been entered into by a "hard-headed business [person]." See Treas. Reg. § 1.482-1(d)(1) (1968); Treas. Reg. § 1.482-1T(d)(1) (1993); Treas. Reg. § 1.482-1(d)(3)(ii)(B) (1994). Where the economic substance of a transaction is inconsistent with the parties' purported characterization, the Service may disregard the contractual terms underlying the transaction and treat the transaction consistent with its economic substance. This treatment may result in a denial of deductions arising from the Transaction at issue. See, e.g., B. Forman, supra, 453 F.2d at 1160-1; Medieval Attractions, supra, at 3322 (royalty payments lacked economic substance under I.R.C. § 482, because the foreign payee was not the creator or developer of, nor in substance had the ability to, transfer intangibles.).

Considering whether the participants' conduct was consistent with the Transaction's putative substance, relevant factors include, inter alia, (1) whether for state law purposes, the registrations of the security interests of the third-party creditors were changed to reflect the sale-lease back transactions; (2) whether trust and other entities claimed deductions (e.g., for interest or depreciation expenses) for the period they held title to the equipment; (3) whether trust claimed rent deductions for the period it was a lessee of the equipment; (4) whether the third-party leases permitted the sale of the equipment without the prior consent of the lessees and whether such consent was obtained; and (6) whether dividends on preferred stock issued to trust by X were ever paid (assuming the subscription agreement provided for such dividends). We suggest other items of factual development in the last section of this Memorandum in comparing the consistency of the parties' conduct to their characterization of the Transaction.

2. Section 482's Role in Nonrecognition Transactions

The second I.R.C. § 482 analysis that may be applied to the Transaction relates to its role in nonrecognition transactions, such as I.R.C. § 351 transactions. Specifically, I.R.C. § 482 may apply in nonrecognition transactions to prevent the avoidance of taxes or clearly reflect income. For example, I.R.C. § 482 may allocate income and deductions attributable to an entity's disposition of built-in-loss (and gain) property, which it acquired in a nonrecognition transaction, to the contributing shareholder (or partner). See Treas. Reg. § 1.482-1(d)(5) (1968); Treas. Reg. § 1.482-1T(d)(1)(iii) (1993); Treas. Reg. § 1.482-1(f)(1)(iii) (1994); National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943), aff'g, 46 B.T.A. 562 (1942), cert. denied, 320 U.S. 794 (1943); Ruddick Corp. v. United States, 643 F.2d 747 (Cl. Ct. 1981), on remand, 3 Cl. Ct. 61, 65 (1983), aff'd without opinion, 732 F.2d 168 (Fed. Cir. 1984); Northwestern Nat. Bank of Minneapolis v. United States, 556 F.2d 889, 892 (8th Cir. 1977), aff'g, 37 A.F.T.R.2d ¶ 76-1400 (D. Minn. 1976); Dolese v. Commissioner, 811 F.2d 543 (10th Cir. 1987), aff'g, 82 T.C. 830 (1984); Foster v. Commissioner, 80 T.C. 34, 160, 172-77 (1983), aff'd in relevant part, 756 F.2d 1430, 1433-4 (9th Cir. 1985), cert. denied, 474 U.S. 1055 (1986). See also Eli Lily & Co. v. Commissioner, 84 T.C. 996, 1119 (1985), aff'd in part, rev'd in part, 856 F.2d 855 (7th Cir. 1988) (restricting I.R.C. § 482's application to nonrecognition transactions in cases of tax avoidance).

The above analysis, relating to the re-allocation to the contributing shareholder of the deduction attributable to an entity's disposition of built-in-loss property, may also be applied to re-allocate to the contributing shareholder the entity's depreciation deductions on built-in loss property, to the extent those deductions are attributable to the portion of the property's basis in excess of the property's fair market value at the time of the contribution. (By analogy, see the flush language of I.R.C. § 382(h)(2)(B), concerning the treatment of depreciation deductions attributable to built-in losses). Because there appears to have been a tax-avoidance purpose underlying the Transaction, including the I.R.C. § 351 Transaction between TP, trust, and X, the depreciation deductions, to the extent attributable to built-in losses, may be allocated to trust, a pass-through entity not subject to the U.S. tax.

Furthermore, in the lease stripping context, this analysis applies by likening the contribution (in a nonrecognition transaction) of the obligation to pay rent after the income has been stripped-off to a contribution of built-in-loss property. This is because the stripping off of income, combined with the continuing obligation to pay rent, creates continuing tax deductions (losses). This is in spite of the fact that the transferee (in the nonrecognition transaction) will pay little, if any, out-of-pocket cash. This is attributable to the fact that the cash inflows, consisting largely of (tax-free) principal, will offset the deductible outflows for rent. Accordingly, if a tax avoidance motive is present, which is often the case in lease stripping transactions, it is appropriate to allocate the built-in loss to the tax-exempt, contributing shareholder and prevent the evasion of taxes by the "investor."

Based on the facts provided, the net effect of trust's transfer to X of equipment that was subject to pre-existing debt and from which the right to future (taxable) streams of rental income had been sold is akin to a contribution of built-in loss property by trust to X. This is due to X's ability to take substantial tax deductions (e.g., for the deemed rental payments and possibly other expenses related to the equipment) without making actual cash disbursements. Because there appears to have been a tax-avoidance purpose underlying the Transaction, including the I.R.C. § 351 Transaction between TP, trust, and X, the deductions may be allocated to trust, a pass-through entity not subject to the U.S. tax.

3. Clear Reflection of Income & Prevention of the Evasion of Taxes

The third theory under which a lease stripping transaction may be analyzed under I.R.C. § 482 relates to the Service's ability to allocate income and deductions in order to clearly reflect income and/or prevent the evasion of taxes. I.R.C. § 482; Treas. Reg. § 1.482-1(d)(1) (1968); Treas. Reg. § 1.482-1T(a)(1) (1993); Treas. Reg. § 1.482-1(a)(1)(1994). This analysis, and the case law affirming the Service's exercise of this allocation authority, is not based upon an economic-substance analysis. Rather, it focuses on the distortions in taxable income caused by the separation of income from deductions. See Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir. 1951), rev'g, 16 T.C. 882, cert. denied, 344 U.S. 874 (1952); Rooney v. United States, 305 F.2d 681 (9th Cir. 1962).

As stated in Notice 95-53, the separation of income from deductions in lease stripping transactions does not clearly reflect income, particularly where they are achieved through a transaction structured to evade taxes. Lease stripping transactions are often effected by (a) creating an artificial separation of the rental income from the associated deductions by accelerating the rental income in the hands of an entity not subject to the U.S.'s taxing jurisdiction, and (b) by placing the deductions associated with the rental income in an entity subject to U.S. tax. See Notice 95-53. In such an instance, the Service may prevent this artificial shifting of income and deductions by (1) allocating the rental deductions from the U.S. taxpayer to the tax-exempt entity, or (2) allocating the rental income from tax-exempt entity to the U.S. taxpayer. See, e.g., Charles Town, Inc. v. Commissioner, 372 F.2d 415 (4th Cir. 1967), aff'g, T.C. Memo. 1966-015, cert. denied, 389 U.S. 841 (1967); J.R. Land Co. v. Commissioner, 361 F.2d 607, 609-10 (4th Cir. 1966), aff'g sub nom, Brentwood Homes, Inc. v. United States, 240 F. Supp. 378 (E.D.N.C.

1965); Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir.), rev'g, 16 T.C. 882 (1951), cert. denied, 344 U.S. 874 (1952); Rooney v. United States, 305 F.2d 681 (9th Cir. 1962); Advance Machinery Exchange, Inc. v. Commissioner, 196 F.2d 1006 (2d Cir. 1952), cert. denied, 344 U.S. 835 (1952).

Accordingly, it may be appropriate to either (1) allocate X's deductions to trust during the period trust owned stock of X, or (2) allocate income to X in proportion to the period X owned the interest in the equipment and leases, if such is the case. Such an allocation would match the income and the deductions associated with the income, and thereby constitute a clearer reflection of income than that which is represented by the Transaction. Concomitantly, the evasion of taxes would be prevented.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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