INDOPCO APPLIES TO REIT IPO

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It may come as no surprise to *M&A Tax Report* readers that the IRS National Office, ruled that a taxpayer must capitalize attorneys' and accountants' fees incurred in an initial public offering of a real estate investment trust. The news came as a field service advice (Letter Ruling 9945004) in which the taxpayer went through a substantial restructuring involving a leaseback of its facilities, a transfer of some of its facilities to a corporation under Section 351, the sale of the facilities to a REIT, etc. Ultimately, the REIT was funded by an IPO. The funds from the IPO were used to purchase the facilities that followed this circuitous path.

Interestingly, the field service advice considers in some detail the relationship between the corporation and the REIT and the company to which the assets were transferred. The SEC required the company to be a co-registrant for the IPO, and on the later issuance of preferred stock by the REIT. (The latter proceeds were used to pay off indebtedness incurred to purchase additional facilities from the company.)

The transaction was enormously complex and convoluted. The company deducted all attorneys' and accountants' fees it incurred in connection with the IPO and the REIT. The IRS ruled that the expenditures had to be capitalized. The Service's theory was that there was no question that the REIT (through the sale-leasebacks) was intended to provide the company with significant benefits.

As benefits would be expected to extend to future years, the IRS stated that the expenditures were capital in nature. The IRS was able to cite a case even better than *INDOPCO*, holding that costs incurred in starting new regulated investment companies had to be capitalized. (*See FMR Corp. v. Commissioner*, 110 T.C. 402 (1998), *appeal docketed*, No. 991073 (1st Cir. 1999).

Taxpayer Arguments

The field service advice goes through the taxpayer arguments. They centered on the fact that the fees should be considered only as connected with the sales — all of which took place during a single year. They should not, said the taxpayer, be connected to the leasebacks, which went on into future years. Despite such arguments, the Service found that the sale and the leasebacks were integrated transactions, and had to be considered together. As support, the Service cited a case holding that a charge incurred by the lessee for the termination of a computer lease had to be capitalized where the lessee simultaneously entered into a new lease (on a more powerful mainframe computer) with the same lessor. See *U.S. Bancorp v. Commissioner*, 111 T.C. 231 (1998).

In light of this field service advice, it is worth considering other recent authority that looks more rosy (and a little less colored by *INDOPCO*). In *PNC Bancorp, Inc. v. Commissioner*, 85 A.F.T.R.2d 2000-1854 (3d Cir., May 19, 2000), the issue was whether certain costs incurred by banks for marketing, researching and originating loans were deductible as ordinary and necessary business expenses. The IRS, obviously, was touting *INDOPCO* to try to capitalize all of these items.

"With the increasing prevalence of multi-county and even global mergers, corporate and tax advisors will be better prepared to render tax advice if they have some idea of the various corporate laws. Many U.S. tax advisors are acquainted with U.K. taxation (and vice versa). However, few who know the rudiments of U.S. corporate practice also understand the corporate that apply in the U.K."

When the matter went to Tax Court, the Court sided with the government, determining that the costs had to be amortized over the life of the various loans. The taxpayer appealed to the Third Circuit, and the Third Circuit was more sympathetic. It reversed, holding the costs to be ordinary and necessary business expenses of the banking business. See Muntean, "Third Circuit Puts Brakes on Service's Wild *INDOPCO* Driving," Vol. 8, No. 12, *M&A Tax Report* (July 2000), p. 6).

Conclusion

Reading Letter Ruling 9945004 in which REIT IPO expenses had to be capitalized, one wonders how such a case would be litigated. Most of the recent litigated cases involving *INDOPCO* have not come out all that well. *PNC Bancorp* represents an important taxpayer victory, as noted in the July issue. Still, the "future benefit" analysis that plagues us has not disappeared.

In *PNC Bancorp*, we saw the future benefit analysis turned toward the taxpayer's favor. In other banking-related cases, courts have focused on the typically short useful life of credit information, thus generally allowing deductibility. See *Iowa-Des Moines National Bank v. Commissioner*, 592 F.2d 433 (8th Cir. 1979), and *Colorado Springs National Bank v. U.S.*, 505 F.2d 1185 (10th Cir. 1974). These were pre-*INDOPCO* cases, and it is unclear how financial institutions will be viewed after *INDOPCO*.

But at least *PNC Bancorp* suggests that financial institutions may not be held to the strict "some future benefit sometime..." standard that *INDOPCO* seems to impose on all of the rest of us.