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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum, dated April 13, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Corp A	=
Corp B	=
X facilities	=
Year 1	=
Date c	=
Date d	=
Date e	=
Date f	=
$h	=
$i	=

ISSUES:

1. Whether Corp A may currently deduct attorneys' fees and accountants' fees incurred for the Initial Public Offering (IPO) of a Real Estate Investment Trust (REIT).

2. Whether section 482 could be applicable to the present case.

CONCLUSIONS:

1. Corp A must capitalize attorneys' fees and accountants' fees incurred for the IPO of a REIT.

2. Section 482 could be applicable to the present case if requisite control is shown.

FACTS:

The taxpayer, Corp A went through a substantial restructuring in Year 1. Part of the restructuring was a planned sale-leaseback of certain of its X facilities. As part of the sale leaseback, Corp A, as well of one of its subsidiaries, transferred the X facilities to Corp B on Date C in a purported section 351 transaction. Corp B had been formed several years earlier as a shell until the X facilities were transferred to it. Corp B was part of the Corp A consolidated group for purposes of the Year 1 income tax return.

Corp B sold the facilities to a REIT on Date d. The REIT had been formed on Date e, for the sale-leaseback transaction. Corp A's Chairman of the Board was also the Chairman of the REIT. The REIT was funded by an IPO held on Date f. The funds from the IPO were used to purchase the X facilities from Corp B. The Securities and Exchange Commission (SEC) required Corp A to be a co-registrant for the IPO. In the registration, Corp A represented that its relationship to the REIT was expected to provide access to additional capital to fund future growth. The SEC also required Corp A to be a co-registrant on the subsequent issuance of the REIT's preferred stock. The proceeds from the sale of stock were used to pay off indebtedness incurred to purchase additional X facilities from Corp A.

Corp A and the REIT agreed that the REIT would purchase and lease back nine X facilities. These facilities comprised the original leaseback transaction. The facilities were all leased back to Corp A. Corp A also granted the REIT the option to purchase five additional X facilities. By the end of Year 1, the REIT had purchased and leased back an additional four X facilities to Corp A. All the X facilities were leased back pursuant to 10- to 12- year leases with options for three additional 5-year periods.

Corp A currently deducted $h in attorneys' fees and $i in accountants' fees it incurred in connection with the REIT IPO.

LAW AND ANALYSIS:

Capitalization of Attorneys' Fees and Accountants' Fees

Section 162 allows a deduction for all ordinary and necessary expense incurred during the taxable year in carrying on a trade or business. However, capitalization under section 263 takes precedence over a current deduction under section 162. I.R.C. § 161. An expenditure is capital if it creates or enhances a separate or distinct asset or provides the taxpayer with a significant future benefit. INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992).

The present case is similar to FMR Corp. v. Commissioner, 110 T.C. 402 (1998), appeal docketed, No. 99-1073 (1st Cir. Mar. 3, 1999), where the Tax Court held that costs incurred in starting new Regulated Investment Companies (RIC) had to be capitalized. The taxpayer in FMR organized numerous RICs every year and argued the expenses incurred in starting them were "ordinary." The court did not decide the issue of whether the RICs were separate assets. Instead, the court found that each RIC provided the taxpayer significant future benefits beyond the tax year the organizational costs were incurred. The court quoted Fall River Gas Appliance Co. v. Commissioner, 349 F.2d 515, 515 (1st Cir. 1965), for the proposition that when "the totality of expenditure was made in anticipation of a continuing economic benefit over a period of years" it is "indicative of a capital expense." 110 T.C. at 421.

The court in FMR also found its facts analogous to other situations where capitalization was required. For example, it found the "[t]he right to market the investment concept, obtained through the process of executing the contract with the individual RIC...and filing with the SEC and individual states" similar to cases which required the capitalization of the costs of obtaining permission to operate or conduct a business. FMR, 110 T.C. at 421, citing P. Liedtka Trucking, Inc. v. Commissioner, 63 T.C. 547 (1975); Surety Insurance Co. v. Commissioner, T.C. Memo. 1980-70. The court also found the expenditures at issue in its case "similar to organizational costs, which are generally considered capital expenditures. Typically, expenditures incurred in connection with organizing recapitalizing, or merging a business are not currently deductible." FMR, 110 T.C. at 422, citing INDOPCO, 503 U.S. at 89-90; E.I. du Pont de Nemours & Co. v. United States, 432 F.2d 1052, 1058 (3d Cir. 1970); Skaggs Cos. v. Commissioner, 59 T.C. 201, 206 (1972).

The expenses in the present case should be subject to capitalization under the same rationale as found in FMR. There is no question that the REIT through the sale-leasebacks was intended to provide Corp A with significant benefits in future years. Corp A argues, alternatively, that the attorneys' fees and accountants' fees should be treated as costs of the sale of the X facilities to the REIT.

In Pope & Talbot, Inc. v. Commissioner, T.C. Memo. 1997-116, aff'd, 162 F.3d 1236 (9th Cir, 1999), legal and accounting expenses of forming a partnership were found to be attributable to the gain on taxable distribution for which the partnership was formed. That is, the partnership was created by a corporate taxpayer to accept the transfer of certain of its property. The interests in the partnership were then distributed to the shareholders of the corporation in proportion to their shares of stock, resulting in a section 311(d) gain.

However, the present case is distinguishable because the REIT was created not only for the sales but for the leasebacks, which extended into future years. Further, the sales and the corresponding leasebacks were integrated transactions, which should be considered together in determining whether the expenditures at issue should be capitalized.

In this sense, the present case is analogous to U.S. Bancorp v. Commissioner, 111 T.C. 231 (1998), where the court held that the charge incurred by a lessee for the termination of a lease on a mainframe computer must be capitalized where the lessee simultaneously entered into new lease on a more powerful mainframe computer with the same lessor. The taxpayer asserted and the court agreed that the law was well settled that the cost of terminating a lease is generally deductible in the year incurred. However, because of the integrated nature of the transactions by which the first lease was terminated and the second lease was entered into, neither could be viewed in isolation. Instead, the court found the charge was incurred not only to terminate the first lease but to obtain the larger capacity computer under the second lease. Thus, the charge had to be capitalized because the second lease extended into future years.

Application of Section 482

Generally, section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer as determined according to the standard of an uncontrolled taxpayer.
A District Director has the power to intervene in cases where a controlled taxpayer[1] does not conduct its affairs, transactions, and accounting records to truly reflect taxable income from the property and business of each of the controlled taxpayers. A District Director can make such necessary distributions, apportionments, or allocations of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group. The standard applied, in all cases, is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. See Treas. Reg. § 1.482-1 (T.D. 8552, 1994-2 C.B. 93).

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[1]Individuals and trusts, such as the REIT, as well as controlled corporations, such as CCA and CPI, are regarded as taxpayers under section 482. See Treas. Reg. §§ 1.482-1(i)(1),(3).

Section 482 and the regulations promulgated thereunder do not contain a precise, bright line ownership percentage test to determine control[2]. Furthermore, section 482 also does not depend exclusively on ownership to find control of the taxpayer [3]. See Hall v. Commissioner, 294 F.2d 82, 85 (5th Cir. 1961), acq., 1959-2 C.B. 4. (Despite the question of ownership, petitioner was still in "control" for purposes of 26 U.S.C.A. (I.R.C. 1939) section 45), (26 U.S.C.A. (I.R.C. 1939) section 45 was subsequently recodified in the Internal Revenue Code of 1954, Pub. L. No. 83-591, section 482, 68A Stat. 3, 162). See Ach v. Commissioner, 42 T.C. 114, 125, (1964), aff'd 358 F.2d 342, (6th Cir. 1966), cert. denied 385 U.S. 899, 17 L. Ed. 2d 131, 87 S. Ct. 205 (1966). (It is not record ownership, but actual control, which counts in the application of the statute). Control, as determined under section 482, depends on the facts and circumstances of each transaction.

We note that section 482 can also be used to allocate income under the section 351 transfers. According to Treas. Reg. § 1.482-1(f)(1)(iii), section 482 can be invoked in transactions providing for non recognition of gain or loss, including transactions under section 351, in order to prevent attempts by a taxpayer to avoid taxes or to clearly reflect income. See National Securities Corporation v. Commissioner, 137 F.2d 600 (3rd Cir. 1943), cert. denied, 320 U.S. 794 (1943). The purported section 351 transfer will be discussed in a separate Field Service Advice.

Should control exist for purposes of section 482, the District Director can reallocate the sales price, lease payments and IPO fees associated with the sale-leaseback arrangement between Corp A and the REIT, provided that such reallocation is necessary in order to prevent evasion of taxes or to clearly reflect income.

[redacted]

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[2]Treas. Reg. § 1.482-1(i)(4) defines control to include any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or 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.

[3]The language of section 482 includes "owned or controlled". Compare the broad definition of control and ownership under section 482 with other Internal Revenue Code sections providing for precise ownership and control tests, e.g., section 368(c).

[redacted]

DEBORAH A. BUTLER

By: _________________________
CLIFFORD M. HARBOURT
Senior Technician
Income Tax and Accounting Branch
Field Service Division