LILOs, SILOs and Business Purpose, Part II

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Customary Collateral?

Proponents of LILOs and SILOs see these as nothing more than customary collateral arrangements. In *Consolidated Edison Co. of New York, Inc.*, 90 FedCl 228, 2009-2 USTC ¶50,696 (2009), the Court of Federal Claims agreed that although the defeasance arrangement *minimized* the risk of default, it was not entirely eliminated. The defeasance accounts did not release the lessee from the legal obligation to pay rent and did not render the nonrecourse debt unworthy of respect.

However, other courts (and even juries, since some of these complicated tax cases have been jury trials!) have found that such a lender does not give up the use of its money in any real sense. The Fourth Circuit characterized it as withdrawing money from a bank and then immediately putting it back. Consequently, it denied the taxpayer's interest deduction. [*See BB&T Corp.*, CA-4, 2008-1 USTC ¶50,306, 523 F3d 461 (2008). *See also AWG Leasing Trust*, DC-OH, 2008-1 USTC ¶50,370, 592 FSupp2d 953 (2008); *Wells Fargo & Co.*, 91 FedCl 35 (2010).]

Options

Another source of controversy in LILOs and SILOs is the end-of-lease purchase option. At the end of the sublease, the lessee may terminate the transaction by exercising its

option to acquire the leasehold interest in the property. The exercise price is fixed at the inception of the transaction and generally equals (or exceeds) the property's projected fair market value at lease expiration.

If the lessee fails to exercise the option, what happens next varies. With a LILO, the taxpayer/lessor typically may:

(i) compel the lessee to renew the sublease (for rent set at 90 to 95 percent of the projected rental value) and require the lessee to obtain a letter of credit securing its rental obligations;
(ii) take possession of the leased property; or
(iii) enter into a replacement sublease with a third party.

If the lessee in a SILO elects not to exercise its option, the lessee must locate a third-party operator for the property and obtain nonrecourse refinancing of the lessor's outstanding debt. Payments under the third-party service contract must be sufficient to repay the nonrecourse financing and provide the lessor with the return on its equity it would receive if the lessee had elected to repurchase the property.

Of course, for a LILO or SILO to qualify as a true lease, the lessee must not be under any compulsion (economic or otherwise) to exercise the option. Accordingly, one answer is for the taxpayer to be able to demonstrate commercially viable alternatives to the option. A key supporting document for a LILO or SILO is an appraisal concluding that the tax-exempt lessee is likely *not* to exercise the purchase option.

Option in Name Only?

But despite what is usually voluminous documentation, the IRS has convinced several courts that the tax-exempt lessee is virtually certain to exercise its option. The IRS has emphasized the lessee's historical use of the essential property, the fully funded nature of the exercise price, and the arguably unfavorable alternatives. Advance funding means exercising the option requires no additional funds. Some participants admitted that everyone probably expects the option to be exercised.

Several courts have found the alternatives to be mere window dressing, with one court saying "no tax-exempt entity in its right mind would fail to exercise the purchase option." [*Wells Fargo*, 91 FedCl, at 74.] A typical SILO requires the lessee (rather than the owner of the property) to obtain nonrecourse refinancing if the purchase option is not exercised. The District Court in *AWG* believed that so obligating the lessee was inconsistent with the taxpayer's ownership.

Similarly, the *Wells Fargo* court quoted internal bank documents indicating that Wells Fargo fully expected the option to be exercised. Nevertheless, impressed with the thoroughness of the appraisal and expert reports, the *Con Ed* court found that exercise of the lessee's option was uncertain.

Business Purpose

Con Ed may have won largely because the court found substantial business reasons for engaging in the LILO. These business reasons included the expectation of making a pre-tax profit; the ability to pursue new opportunities in a deregulated market; entry into Western European energy markets; technical benefits to Con Ed of operating a state of the art plant in its field of expertise; the ability to further develop and share Con Ed's cutting edge technology; environmental benefits from being involved with an environmentally friendly plant; and improving its environmental public image.

Conclusion

Several battles are over, but the war over SILOs and LILOs is not. *Wells Fargo* and the jury verdict in *Altria Group* are on appeal. At least one other LILO case is on hold pending the Federal Circuit's decision in *Wells Fargo*. Furthermore, the government clearly intends to appeal its loss in *Con Ed.*

In the fact-intensive arena of leveraged leasing, the governing rules may not be as precise as either the IRS or taxpayers might hope. Indeed, the fate of LILOs and SILOs may turn more on subjective taxpayer motivations than on the form of the transaction. In some respects, that seems odd.

In any case, the taxpayer victory in *Con Ed* underscores the importance of having at least one credible nontax business purpose, and optimally having several. Perhaps that's true with any tax-advantaged transaction. Without it, the courts may not hesitate to wade through the paper and distill the transaction to its essence.