SILOs and LILOs Demystified

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SILOs and LILOs are large and complicated leveraged lease transactions, often involving domestic and foreign infrastructure, in which U.S. investors seek tax benefits from otherwise tax-exempt assets. In this report, Wood and Hollingworth demystify the mechanics of these complex structures and summarize the state of the administrative and case law, some of which has yet to be written.

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You may think you know what LILOs and SILOs[1] are and how they work. But to quote a recent movie title, it's complicated. Lilo was also the name of a complicated character in a 2002 Disney movie, paired with an alien called Stitch. But there's nothing alien about LILOs or SILOs.

In the tax world, LILOs and SILOs are acronyms for ''lease-in, lease-out'' and ''sale-in, lease-out.'' These cryptic names do nothing to tell you what's really going on; nor, we suppose, does the more traditional sale leaseback moniker. Yet these are enormous transactions in both size and importance, and their story is nearly Proustian in scope. And although much of the SILO and LILO story has already been written, some remains — perhaps at least an eighth volume to succeed the seven that serve as the remembrance of LILOs and SILOs past.

LILOs and SILOs are variations on good old-fashioned financing transactions born of the storied history of sale leasebacks. But as we shall see, they are embellished to a degree previously unknown to mere financings, and they have provoked a visceral response. LILO and SILO transactions have tripped up taxpayers in several large and high-profile cases.

Defenders of these transactions have argued that they are legitimate investments providing a vital source of funding to public transportation systems and many other worthy projects.[2] However, critics such as Senate Finance Committee ranking minority member Chuck Grassley, R-Iowa, have denounced them as nothing more than ''good, old-fashioned tax fraud.''[3] As one might expect from these big-ticket items, the tax amounts involved are

[1]Some have criticized the use of the term ''SILO'' as having been coined by the IRS in an attempt to carry over the tax shelter taint from the LILO transaction. *See* Kenneth J. Kies, '''Leave Us a Loan': A Rebuttal to Claims That Defeasance Invalidates Lease Transactions,'' *Tax Notes*, Feb. 9, 2004, p. 763, *Doc 2004-1546*, or *2004 TNT 27-31*; and William A. Macan IV, ''Good vs. Evil? Not This Time: SILO's Bad Rap,'' *Tax Notes*, Apr. 12, 2004, p. 241, *Doc 2004-6669*, or *2004 TNT 71-36*. Whatever the merits of this criticism, the term ''SILO'' has stuck, and so we will use it here.

[2]*See* Sheryl Stratton, ''SILOs: Abusive Tax Scams or Real Business Deals?'' *Tax Notes*, Jan. 19, 2004, p. 301, *Doc 2004-863*, or *2004 TNT 10-5*; and B. Cary Tolley III, ''Leasing to Tax-Exempt Entities: Setting the Record Straight,'' *Tax Notes*, Apr. 12, 2004, p. 244, *Doc 2004-6670*, or *2004 TNT 71-37*.

[3]Press Release, U.S. Senate Committee on Finance (Nov. 18, 2003), *Doc 2003-24836*, *2003 TNT 223-33*. Colorful denunciations of LILOs and SILOs have been a bipartisan phenomenon. According to current Finance Committee Chair Max Baucus,

(Footnote continued on next page.)

indeed significant. Before the congressional crackdown on most SILOs entered into after March 12, 2004,[4] U.S. taxpayers were involved in at least 400 SILO transactions, claiming tax deductions of more than $35 billion.[5]

But what about the many LILOs and SILOs that were entered into before the effective date of the 2004 act? These issues are still being sorted out. On August 6, 2008, IRS Commissioner Douglas Shulman announced a settlement initiative for taxpayers who participated in LILOs and SILOs. More than two-thirds of the participants accepted the IRS settlement proposal,[6] but some have chosen to take their cases to court. With one notable exception, the results to date have been big taxpayer losses.

First, a federal district court denied BB&T's $4.5 million tax refund claim, and the Fourth Circuit affirmed.[7] A federal district court in Ohio then rejected a similar refund claim for a SILO transaction and even upheld the IRS's imposition of penalties.[8] Juries have proven to be no more accommodating than judges, refusing to find merit in the refund claims of Fifth Third Bancorp[9] and Altria Group.[10] Nevertheless, some taxpayers may still prevail.

Indeed, *Con Ed*[11] finally broke the government's winning streak. Yet hopes that this case would permanently turn the tide were quickly dashed. Less than three months later, a separate case in the same court (albeit with a different judge) limited the *Con Ed* decision to its facts and denied Wells Fargo Bank a $115 million refund claim.[12]

Several battles are complete,[13] but the war over SILOs and LILOs is ongoing. *Altria* and *Wells Fargo* are now on appeal, and at least one other LILO case is on hold pending the Federal Circuit's decision in *Wells Fargo*.[14] Further, the government clearly intends to appeal its loss in *Con Ed*. The only impediment appears to be the court's delay in issuing a judgment order.[15] Whether a set of clear rules emerges or merely a facts-and-circumstances muddle, the LILO/SILO cases will eventually bring the SILO and LILO wars to an end. Moreover, they may have continuing significance in other leasing transactions. They may even help to determine the scope and application of the now codified economic substance doctrine.

I. LILO and SILO Transactions

LILOs and SILOs are specific types of leveraged lease transactions. Their distinguishing feature is what has come to be known as "defeasance," an arrangement securing the lessee's obligations under the lease.[16]

A debt is defeased when the borrower deposits enough cash into a pledged or restricted account to service the borrower's debt.[17] A deposit arrangement that completely extinguishes the borrower's legal obligation to pay the debt is referred to as "legal defeasance." A deposit arrangement that involves enough collateral to pay off the debt, but

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D-Mont., SILO transactions are "shell games" and "three-card-monty transactions" that "siphon cash" off taxpayers. *See* "Baucus Opposes Provision Helping Banks Avoid Taxes" (Dec. 10, 2008), *Doc 2008-25957*, *2008 TNT 239-28*.

[4]Congress acted to shut down SILOs in the American Jobs Creation Act of 2004, effective for transactions entered into after March 12, 2004. Section 470 now prevents a taxpayer, except as otherwise permitted in that section, from deducting losses attributable to a lease of property to a tax-exempt entity in excess of the taxpayer's income from that property. The tax benefits of LILOs were prospectively eliminated in 1999 when the final regulations under section 467 were promulgated.

[5]*See Mayer Brown LLP v. IRS*, 562 F.3d 1190, 1194 (D.C. Cir. 2009), *Doc 2009-8772*, *2009 TNT 73-47*.

[6]IR-2008-121 (Oct. 21, 2008), *Doc 2008-22385*, *2008 TNT 205-17*.

[7]*BB&T Corp. v. United States*, 523 F.3d 461, 469 (4th Cir. 2008), *Doc 2008-9547*, *2008 TNT 84-15*, *aff'g* 2007 U.S. Dist. LEXIS 321 (M.D.N.C. 2007), *Doc 2007-446*, *2007 TNT 4-19*.

[8]*AWG Leasing Trust v. United States*, 592 F. Supp.2d 953 (2008), *Doc 2008-11830*, *2008 TNT 105-10*.

[9]Special Interrogatories, *Fifth Third Bancorp v. United States*, No. 1.05-cv-350 (S.D. Ohio Apr. 18, 2008), *Doc 2008-9425*, *2008 TNT 83-17*.

[10]*Altria Group Inc. v. United States*, 694 F. Supp.2d 259 (S.D.N.Y. 2010), *Doc 2010-5869*, *2010 TNT 53-13*; "DOJ Announces Jury's Rejection of Altria Group's Tax Refund Claim" July 10, 2009), *Doc 2009-15744*, *2009 TNT 131-81*.

[11]*Consolidated Edison Co. of New York Inc. v. United States*, 90 Fed. Cl. 228 (2009), *Doc 2009-23332*, *2009 TNT 203-7*.

[12]*Wells Fargo & Co. v. United States*, 91 Fed. Cl. 35 (2010), *Doc 2010-540*, *2010 TNT 6-15*, appeal docketed, No. 2010-5108 (Fed. Cir. Apr. 16, 2010); Jeremiah Coder, "Wells Fargo Loses $115 Million SILO Refund Suit," *Tax Notes*, Jan. 18, 2010, p. 293, *Doc 2010-591*, *2010 TNT 7-4*.

[13]The taxpayers in *Fifth Third Bancorp* and *AWG* declined to appeal. *See* Conditional Order, *Fifth Third Bancorp v. United States*, 1:05-cv-00350-TSH (S.D. Ohio Dec. 16, 2008) and Order, *KSP Investments Inc. v. United States*, No: 1:07-cv-00857 (6th Cir. Oct. 9, 2008).

[14]Opinion and Order, *Unionbancal Corp. v. United States*, 93 Fed. Cl. 166 (2010), *Doc 2010-12778*, *2010 TNT 112-8*.

[15]With the court's permission, Con Ed has filed an amended complaint, adding a refund claim for at least $7.771 million in interest. *See* First Amended Complaint, *Consolidated Edison Co. of New York Inc. v. United States*, 1:06-cv-00305 (Fed. Cl. May 19, 2010). In opposition to Con Ed's motion to amend its complaint, the government protested that Con Ed's procedural actions compromised the government's right to appeal the LILO decision, because the government is unable to take an appeal without a judgment. Objection of the United States to Plaintiff's Motion for Leave to File an Amended or Supplemental Complaint, *Consolidated Edison Co. of New York Inc. v. United States*, 1:06-cv-00305 (Fed. Cl. Mar. 31, 2010).

[16]*See* Macan, *supra* note 1.

[17]*See BB&T*, 523 F.3d at 465; and LTR 8804020 (Oct. 29, 1987). *See also* Investopedia.com, *available at* http://dictionary.reference.com/browse/Defeasance.

maintains the borrower's liability if the assets in the account somehow fail, is sometimes referred to as ''economic defeasance.''[18] LILOs and SILOs involve the latter variety.

A. Tax-Driven Benefits of LILOs and SILOs

LILOs and SILOs are generally unattractive investments from a pretax perspective. Their primary financial benefit is derived by transferring unused or unusable tax benefits to an investor that is able to use them.[19] Thus, LILOs and SILOs depend on the cooperation of a tax-indifferent party. That usually means a government agency or foreign entity not subject to U.S. income tax.

After all, a tax-indifferent party receives no U.S. tax benefit from depreciation or interest deductions attributable to its assets. That seems a shame. In a SILO transaction, a taxable third party takes advantage of these unusable tax benefits by purchasing property from the tax-exempt entity and then immediately leasing the property back to the tax-exempt entity. The taxable party deducts depreciation on the asset it now claims to own. The investor also claims significant interest expense deductions because it acquires the asset primarily with borrowed funds.

A LILO is similar to a SILO. However, instead of *purchasing* the property, the taxable party first *leases* the property from the tax-exempt entity and then immediately leases the property back to the tax-exempt entity. The taxable party claims deductions for rent (and interest expense for any related financing).

In both SILOs and LILOs, the tax-exempt entity continues to use, operate, and maintain the property during the lease term in the same manner as before. As one would expect, the tax-exempt entity receives a fee for participating, generally ranging from 4 to 8 percent of the transaction's value.[20] This fee represents a portion of the investor's tax benefits that are shared with the tax-exempt entity.

In their heyday, these transactions found many willing tax-exempt participants. ''You were considered crazy if you didn't join in,'' a spokesperson for Berlin's public transportation company later recalled.[21]

B. Structure and Terminology

1. Lease/leaseback. In a typical LILO, the taxpayer, acting through a grantor trust, leases assets from a tax-exempt entity under a primary or ''head'' lease. A SILO transaction is similar, except that the head lease term is deliberately structured to extend beyond the remaining useful life of the asset, so that it is treated as a sale for tax purposes. The tax-exempt entity then subleases the property back for a term shorter than the head lease. The leases are all net leases, meaning that the lessee pays all insurance, taxes, and maintenance costs. The tax-exempt lessee thus retains substantially all rights and responsibilities to use and maintain the property during the sublease term.[22] To an outside observer, nothing appears to have changed.

2. Debt financing and rent. The financing and security arrangements for LILOs and SILOs are particularly controversial. The controversy arises, at least in part, from the circular pattern in which borrowed funds and rental payments flow.

The U.S. taxpayer typically prepays the entire rent due under the life of the head lease in a single upfront payment.[23] It finances most of that big payment with the proceeds of a nonrecourse loan (the debt portion). The taxpayer provides the remaining portion from its own funds or recourse borrowings (the equity portion). Rather than receiving these rent proceeds directly and having the free use of them, the tax-exempt entity places all but what the IRS refers to as its ''accommodation fee'' in payment undertaking accounts with the lender or an affiliate of the lender.

The payment undertaker then uses the debt portion to make the rental payments on behalf of the tax-exempt lessee. All rental payments match the taxpayer/lessor's debt service amounts and are paid directly to the lender to satisfy the lessor's debt obligations. Several courts have found it hard to

[18]*See* Kies, *supra* note 1.

[19]*See* Macan, *supra* note 1: ''The heart and soul of leasing is the transfer of tax benefits; leveraged net leasing is otherwise an inefficient way of providing capital to the lessee and without such benefits it makes no sense.'' *See also Wells Fargo*, 91 Fed. Cl. at 47, noting that Wells Fargo always ensured that it had sufficient taxable revenue against which to offset the expected tax deductions from the transaction.

[20]Maxim Shvedov, ''CRS Report for Congress: Tax Implications of SILOs, QTEs and Other Leasing Transactions with Tax-Exempt Entities'' (Nov. 30, 2004), *Doc 2005-4041*, *2005 TNT 40-57*, (CRS report) at 3.

[21]William Boston, ''German Cities Suffer in the U.S. Financial Crisis,'' *Time*, Apr. 9, 2009, *available at* http://www.time.com/time/business/article/0,8599,1890418,00.html.

[22]*See* William A. Macan IV, ''LILOs and Lease/Service Contract Transactions: A Response,'' *Tax Notes*, June 30, 2003, p. 1967, *Doc 2003-15585*, or *2003 TNT 126-26*: ''The Head Lease usually imposed typical net lease obligations on the U.S. lessor (*e.g.*, for insurance, maintenance, lawful use, etc.), but these obligations were often deemed satisfied for the term of the leaseback.''

[23]In a LILO, a portion of the head lease rent was often deferred until the end of the lease term.

view this flow of funds as anything but circular, particularly when the loan proceeds never actually leave the bank.[24]

After being reduced by the accommodation fee and transaction costs, the taxpayer's equity portion is also placed in a restricted account. The funds in the equity portion are typically invested in government bonds or other high-grade debt. They are expected to grow to precisely the amount necessary to pay the exercise price of the lessee's option to purchase the lessor's interest in the property.

3. Options at sublease termination. At the end of the sublease, the lessee may terminate the transaction by exercising an option to acquire the taxpayer/lessor's leasehold interest in the property. The exercise price is a fixed amount determined at the inception of the transaction. It is generally equal to or greater than the property's projected fair market value at the lease expiration date.

If the lessee does not exercise its option, what happens next varies from LILO to SILO. With a LILO, the taxpayer/lessor typically may:

1. compel the lessee to renew the sublease for an additional period (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;
2. take possession of the leased property; or
3. enter into a replacement sublease with a third party.

If the lessor/taxpayer takes option 1, it may compel the lessee to exercise the purchase option if the lessee does not obtain a letter of credit.

With a SILO, slightly different options are imposed if the lessee elects not to exercise the purchase option. The lessee must then 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 at least the same return on its equity contribution that it would have received if the lessee had elected to repurchase the property.[25]

SILOs involving qualified technological equipment (QTE) have somewhat different arrangements, but they tend to yield the same result. If the lessee does not exercise its option to buy back the property before the end of the lease term, the lessee incurs substantial responsibilities. These may include obtaining residual value insurance for the benefit of the lessor and reinstalling and upgrading the equipment for the lessor's benefit.

4. Double-dipping leases. The tax-exempt participant is often a foreign entity that is not subject to U.S. income tax. That can lead to even better tax results.

The long-term lease in a SILO is often structured so that it will be treated as a sale for U.S. tax purposes but not as a sale for foreign tax purposes. This is known as a "double-dipping" lease structure, because both parties can simultaneously claim ownership and depreciation on the asset.

The U.S. purchaser deducts depreciation on the asset for U.S. income tax purposes. The foreign lessor continues to claim depreciation for foreign income tax purposes.[26] Everyone wins, it would seem. However, some courts have counted the lack of transfer of title as a factor against SILO participants under substance-over-form principles.[27]

II. Development of Governing Law

LILOs and SILOs are a new generation of leveraged lease transaction, but they have a storied history.

A. The Beginning

The initial impetus for equipment leasing was an investment tax credit enacted in 1962. Around the same time, deductions for depreciation became available on an accelerated basis. Innovative planners soon figured out that leasing could make the benefit of these credits and deductions available to nontaxpaying entities. Yet there was little guidance on what constituted a lease for tax purposes.

After receiving multiple requests for private letter rulings, the IRS issued Rev. Proc. 75-21, which established guidelines the IRS would use in determining whether leveraged leases would be respected as leases for tax purposes. Rev. Proc. 75-21 expressly stated that its guidelines "do not define, as a matter of law, whether a transaction is or is not a lease for federal income tax purposes."[28] In spite of that disclaimer, planners have relied heavily on those guidelines for structuring leasing transactions, including LILOs and SILOs.

The tax benefits of leasing briefly got out of hand in the early '80s, at least from the government's

[24]*See, e.g.*, *BB&T*, 523 F.3d at 468. *See also Wells Fargo*, 91 Fed. Cl. at 39-40 (noting that payments of rent and interest were recorded as accounting entries).

[25]*See, e.g.*, *Wells Fargo*, 91 Fed.Cl. at 66-68; *AWG*, 592 F. Supp.2d at 971-972.

[26]*See, e.g.*, *Wells Fargo*, 91 Fed.Cl. at 53; *AWG*, 592 F. Supp.2d at 973-974.

[27]*See Wells Fargo*, 91 Fed.Cl. at 79; *AWG*, 592 F. Supp.2d at 982-983.

[28]Rev. Proc. 75-21, 1975-1 C.B. 715, section 3; Rev. Proc. 2001-28, 2001-1 C.B. 1156, section 3, *Doc 2001-12729*, *2001 TNT 88-8*.

perspective. In 1981 Congress enacted safe harbors for some sale and leaseback transactions that were little more than tax benefit transfers.[29] Under those rules, the form of the transaction was respected regardless of whether the lessor could obtain a pretax profit. It didn't even matter whether the lessor effectively acquired the benefits and burdens of property ownership. Congress shut down those leasing transactions after only one year, because of adverse public reaction and reduced tax revenues.

B. Pickle Rule

In 1984 Congress substantially reduced the tax benefits of leasing to tax-exempt entities by enacting what became known as the ''Pickle rule,'' after former Rep. J.J. Pickle of Texas. Under the Pickle rule, property leased to a tax-exempt entity is generally subject to unfavorable straight line (rather than accelerated) depreciation over the longer of the applicable asset class or 125 percent of the lease term.[30] The QTE, LILO, and service contract SILO are all attempts to circumvent the Pickle rule.

As previously mentioned, a QTE is a SILO involving qualified technological equipment. The code specifically provided that qualified technological equipment could be depreciated over a short-term of five years.[31] Accordingly, SILOs involving QTE typically claim depreciation over a five-year period, without regard to the length of the lease term.

A LILO attempts to circumvent the Pickle rule by having the taxable party lease, rather than purchase, the property from a tax-exempt entity, and then immediately sublease the property back to the tax-exempt entity. Because the Pickle rule limits depreciation deductions only, the rental deductions could arguably be claimed despite the Pickle rule.

A service contract SILO attempts to sidestep these rules by using a shorter lease term, followed by a service contract option. The payments on the service contract are economic substitutes for rental payments. Nevertheless, under previous law the service contract period was arguably not included in the lease term if the service contract complied with section 7701(e).

[29]Staff of the Joint Committee on Taxation, ''General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982,'' 97th Cong., 2d Sess. 53 (1982).

[30]Section 168(g)(3)(A).

[31]Section 168(g)(3)(C).

C. Judicial Doctrines

Leveraged leaseback transactions have long been controversial,[32] and the courts have struggled to enunciate clear rules for dealing with them. Because of the fact-intensive nature of the analysis and the permutations of fact patterns, the result has been justifiably referred to as a ''morass.''[33]

Still, the courts have succeeded in laying out some broad principles. A well-known principle of tax law is that the substance, not the form, of a transaction determines its tax treatment.[34] Thus, a taxpayer may claim ownership of property for income tax purposes only if he actually bears the current benefits and burdens of ownership.[35] Similarly, a taxpayer may claim a deduction for interest expense only if the indebtedness is genuine.[36]

Proponents and critics of LILOs and SILOs all claim support for their respective positions from the seminal case of *Frank Lyon*.[37] In that case, the Supreme Court said it would respect the form of a sale leaseback transaction ''which is compelled or encouraged by business or regulatory realities'' and in which ''the lessor retains significant and genuine attributes of the traditional lessor status.''[38]

Rice's Toyota World attempted to distill the holding of *Frank Lyon* into a two-prong test:

> To treat a transaction as a sham the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists.[39]

Before the recent codification of the economic substance doctrine,[40] this two-part test was applied by some courts in the conjunctive (an ''and'' test),

[32]*See* Michael H. Simonson, ''Determining Tax Ownership of Leased Property,'' 38 *Tax Lawyer* 1 (1984), summarizing numerous legal challenges to leveraged leases and concluding that ''a veritable pack of wolves exists to prey upon tax sensitive transactions.''

[33]*See* Lee A. Sheppard, ''Pondering the Fate of Lease-In, Lease-Out Deals,'' *Tax Notes*, Mar. 22, 1999, p. 1723, *Doc 1999-10884*, or *1999 TNT 54-6*. (''The law governing sale-leasebacks is a morass, and, as usual, we have the Supreme Court to thank for that.'')

[34]*Gregory v. Helvering*, 293 U.S. 465, 469-470 (1935).

[35]*Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

[36]*Goldstein v. Commissioner*, 364 F.2d 734, 740 (2d Cir. 1966).

[37]435 U.S. 561.

[38]*Id.* at 584.

[39]*Rice's Toyota World Inc. v. Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985).

[40]*See* section 7701(o), applicable for transactions entered into after March 30, 2010.

while others used a disjunctive test (an ''or'' test).[41] Still other courts considered the profit motive and business purpose prongs only as factors in assessing whether a transaction should be respected for tax purposes.[42] Apart from semantics,[43] a transaction was vulnerable to challenge if it lacked either a profit motive or a nontax business purpose.

D. Administrative Rulings

On March 12, 1999, the IRS and Treasury issued Rev. Rul. 99-14, which announced that deductions for rent and interest expense from a LILO would be disallowed. The stated reason was that LILOs lacked economic substance when viewed as a whole. The IRS declared that ''courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction.''[44]

The IRS contended that the obligations of the head lease were offset by the sublease. Further, the nonrecourse debt and defeasance arrangements offset each other, virtually eliminating the taxpayer's economic risk. Significantly, the IRS believed LILOs were structured with the intent that the lessee would exercise its purchase option and maintain possession of the property. That would vitiate the lessor's claim to ownership. As the IRS put it:

> The conclusion that [the taxpayer lessor] is insulated from any significant economic consequence of the Headlease residual is further supported by several factors indicating that the parties expect [the tax-exempt lessee] to exercise the fixed-payment option. First, [the tax-exempt lessee] has historically used the property. Second, because the fixed payment obligation is fully defeased, [the tax-exempt lessee] need not draw on other sources of capital to exercise the option. However, if [the tax-exempt lessee] does not exercise the fixed payment option and [the lessor] exercises the put renewal option, [the tax-exempt lessee] would be required to draw on other sources of capital to satisfy its put renewal rental obligations.[45]

The IRS concluded that the transaction lacked economic substance because the pretax economic return was insignificant compared to the tax benefits. Although Rev. Rul. 99-14 specifically addressed LILOs, its rationale attacked key aspects of both LILOs and SILOs. Indeed, both transactions involve debt financing, a defeasance arrangement, and a structure that the IRS believes ensures the lessee's exercise of the purchase option.

The IRS clearly believed that its ruling had broader application. Beginning in November 1999, the IRS applied the rationale of Rev. Rul. 99-14 to both LILOs and SILOs in a series of field service advice memorandums.[46] However, some commentators believed Rev. Rul. 99-14 was incorrect and unlikely to be upheld in court.[47] As it turned out, the courts have generally agreed with the IRS, although sometimes for different reasons.

III. Case Law

A. The Economic Substance Microscope

The application of the economic substance doctrine to LILOs and SILOs has had mixed results. For example, in *AWG*,[48] the court ruled that a taxpayer must only show a reasonably expected, minimal pretax profit to prove economic substance. The taxpayer need not demonstrate that its transaction would yield a higher pretax return than all other possible investment opportunities.[49]

The court found profit motive when a SILO investor reasonably expected to earn a 3.4 percent pretax return. This small but guaranteed profit was sufficient to show that the transaction had some ''practicable economic effects other than the creation of income tax losses.''[50] Moreover, even though the service contract option was extremely unlikely, the court found the slight chance of a

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[41]*See, e.g.*, *Klamath Strategic Investment Fund*, 568 F.3d 537, 544 (5th Cir. 2009), *Doc 2009-11265*, *2009 TNT 94-15*; *Gilman v. Commissioner*, 933 F.2d 143, 147 (2d Cir. 1991); *Boca Investerings Partnership v. United States*, 314 F.3d 625, 631 (D.C. Cir. 2003), *Doc 2003-1175*, *2003 TNT 8-7*; *Rice's Toyota World*, 752 F.2d at 91.

[42]*James v. Commissioner*, 899 F.2d 905, 908 (10th Cir. 1990); *Sacks v. Commissioner*, 69 F.3d 982, 988 (9th Cir. 1995), *Doc 95-978*, *95 TNT 13-15*.

[43]*See* Jeff Rector, ''A Review of the Economic Substance Doctrine,'' 10 *Stan. J. L. Bus. & Fin*. 173 (Autumn 2004) (arguing that semantic differences in doctrine have little practical significance).

[44]Rev. Rul. 99-14, 1999-1 C.B. 835, *Doc 1999-9587*, *1999 TNT 48-11*.

[45]Rev. Rul. 99-14, 1999-1 C.B. 835, *Doc 1999-9587*, *1999 TNT 48-11*.

[46]*See, e.g.*, FSA 200011004 (Nov. 8, 1999), *Doc 2000-8014*, *2000 TNT 54-77*; FSA 200045002 (June 30, 2000), *Doc 2000-28952*, *2000 TNT 219-44*; FSA 200105003 (Sept. 7, 2000), *Doc 2001-3223*, *2001 TNT 24-69*; FSA 200106019 (Nov. 3, 2000), *Doc 2001-3999*, *2001 TNT 29-48*; FSA 200112020 (Dec. 15, 2000), *Doc 2001-8470*, *2001 TNT 58-70*; FSA 200113016 (Mar. 30, 2001), *Doc 2001-9186*, *2001 TNT 63-32*; FSA 200120011 (Feb. 7, 2001), *Doc 2001-14271*, *2001 TNT 98-20*.

[47]*See, e.g.*, Toby Cozart, ''Disputing Rev. Rul. 99-14: Pre-Tax Profit, Defeasance, and Circular Losses,'' *Tax Notes*, Apr. 26, 1999, p. 557, *Doc 1999-15101*, or *1999 TNT 79-88*.

[48]592 F. Supp.2d 953.

[49]*Id.* at 980.

[50]*Id*.

higher 5 to 8 percent return under that option was enough to evidence a profit motive.[51] Accordingly, the SILO was not an economic sham.

In *Con Ed*, the Court of Federal Claims followed *AWG* to find that a pretax return of 4.44 percent was sufficient to demonstrate that a LILO had economic reality. Although the IRS had argued that the court should discount the expected return to present value because the transaction was designed to yield deferred, rather than immediate, profits, the court disagreed.[52]

The taxpayer argued that the opportunity to make a higher profit elsewhere is not evidence that the activity in question is not profitable. Claiming numerous business objectives, the taxpayer asserted that strict monetary profitability was an inappropriate measure of the transaction. The court agreed that the taxpayer was motivated by substantial nontax reasons, and it concluded that discounting was not required based on the "specific and unique characteristics" of the particular transaction.[53]

However, the Court of Federal Claims later distinguished *Con Ed* and *AWG*. In *Wells Fargo*, the court found that a SILO lacked a profit motive when the expected pretax return of 2.6 percent was less than the bank's cost of funds for its leasing business.[54] Although *Con Ed* had rejected discounting, the court in *Wells Fargo* concluded that each SILO was a money-losing proposition on a net present value basis.[55]

Wells Fargo would have been better off on a pretax basis, the court noted, simply by investing its funds directly, outside the SILO. Indeed, Wells Fargo's cost of entering one transaction was $17.7 million. The tax-exempt participant was paid $7.6 million as an incentive fee, and $3.2 million was paid in transaction costs. The court acknowledged that Wells Fargo would realize a return on the remaining $6.9 million.

However, the court was convinced that no rational business enterprise would pay $10.8 million for the right to invest $6.9 million, without taking the tax benefits into account.[56] Moreover, the court rejected the taxpayer's argument that its desire to benefit from favorable accounting rules (Financial Accounting Standard No. 13) qualified as a nontax business purpose. The court considered the financial benefits of improper tax deductions an insufficient basis for a nontax business purpose.[57]

B. Substance Over Form

Early on, the IRS apparently recognized the shortcomings of relying solely on the economic substance doctrine.[58] In Rev. Rul. 2002-69, the IRS reiterated the facts of Rev. Rul. 99-14 and announced that, in addition to lacking economic substance, LILOs will not be respected under substance-over-form principles. In this second ruling, the IRS argued that the overlapping periods of the head lease and sublease should be collapsed and disregarded.

After disregarding the offsetting portions (20 years in the example in the ruling), the IRS concluded that the remaining transaction was in substance a transfer of funds in return for repayment of those funds and the right to lease the property in 20 years. Critics of Rev. Rul. 2002-69 argued that the leases in a LILO do not fully offset one another. The lessor's rent is prepaid, so it cannot be ejected, they contended, while the lessee's right to continued possession is contingent on periodic rent payments.[59] Besides, they argued, the key difference between a lease and a financing is the investor's exposure to fluctuations in the value of the residual.[60]

After some initial success with its future interest theory at the district court level in *BB&T*, the government seems to have backed away from this argument in favor of a more traditional "benefits and burdens" analysis under *Frank Lyon* true lease

[51]*Id.* at 982.

[52]*Consolidated Edison*, 90 Fed. Cl. at 328-329. The IRS cited *ACM Partnership v. Commissioner*, 157 F.3d 231, 236 (3d Cir. 1998), *Doc 98-31128*, *98 TNT 202-7*, in support of its argument that discounting was appropriate.

[53]*Consolidated Edison*, 90 Fed. Cl. at 328-329. This taxpayer-friendly holding is of limited benefit to transactions entered into after March 30, 2010, since section 7701(o)(2)(A) now requires economic substance to be analyzed under time value of money principles.

[54]*Wells Fargo*, 91 Fed. Cl. at 48, 82. *See also Altria Group Inc. v. United States,* 694 F. Supp.2d at 282-283, in which the court rejected overturning the jury's verdict in favor of the government when the taxpayer had an expectation of pretax profits of between 2.5 and 3.8 percent.

[55]*Wells Fargo*, 91 Fed. Cl. at 82-83.

[56]*Id.* at 70.

[57]*Id.* at 84. *See also* section 7701(o)(4), applicable to transactions entered after March 30, 2010.

[58]*See* IR-2002-108 (Oct. 21, 2002), *Doc 2002-23194*, *2002 TNT 199-9*, quoting the observation of IRS Chief Counsel B. John Williams Jr. that the IRS position "does not rely on the lack of a pre-tax profit potential or business purpose." *See also* Sheryl Stratton and Jon Almeras, "ABA Tax Section Meeting: IRS to Litigate LILOs 'Full Bore,'" *Tax Notes*, May 19, 2003, p. 970, *Doc 2003-11791*, or *2003 TNT 91-2*: "The IRS will not be attacking LILO transactions on the basis of economic substance, Williams said, unless it otherwise applies because certain conditions exist."

[59]*See* Macan, "LILOs and Lease/Service Contract Transactions," *supra* note 22.

[60]*See* Macan, "Good vs. Evil?" *supra* note 1.

principles.[61] Even so, the presence of offsetting obligations, when taken together with the defeasance arrangements, has remained a significant factor in the courts' true lease analysis.

The courts generally have viewed the combined effect of the leaseback and defeasance arrangements as canceling out much of the putative lessor's benefits and burdens of ownership.[62] For example, in *BB&T*,[63] the court noted that BB&T was substantially insulated from any loss of its equity investment, even if the purchase option was not exercised. The lack of exposure to loss was an important part of the court's view that BB&T lacked the traditional attributes of a lessor.[64]

Similarly, the offsetting nature of the sale leaseback in *AWG* was evidence that the putative purchaser did not acquire the benefits and burdens of ownership.[65] The court found that the taxpayer did not bear any residual value risk, because it was almost certain that the lessee would exercise the purchase option at the end of the lease. Even if the purchase option were not exercised, the taxpayer was partially insulated from residual value risk because the service contract provided an almost guaranteed return on its equity investment.[66]

In *Wells Fargo*,[67] the court concurred with the decisions in *BB&T* and *AWG* that the critical factor was whether the taxpayer had any substantial risk of loss of its investment.[68] The court found that the defeasance arrangements, combined with the service contract option, effectively allowed Wells Fargo to recoup its entire investment if the property declined in value. Indeed, that was true regardless of whether the purchase option was exercised.[69] The court thus extended *AWG*, holding that the service contract option itself substantially eliminated the risk of loss.

Con Ed took a much more sympathetic view. The court held that the lessee's continued use of the leased facility did not automatically lead to the conclusion that the taxpayer-lessor lacked ownership for tax purposes. Unlike in *BB&T* and *AWG*, the court did not consider the exercise of the purchase option a virtual certainty. Because exercise of the purchase option was not certain, the court believed the taxpayer's investment in the residual value of the lease remained subject to market risk, including risk of loss.[70]

1. Controversy over option exercise. Clearly, the likelihood that a LILO or SILO will be collapsed depends heavily on whether exercise of the purchase option is considered certain. Understandably, participants often seek assurances that the tax-exempt entity will not jeopardize the transaction by disclosing prematurely whether it intends to exercise the purchase option. Accordingly, a typical requirement for a LILO or SILO is a tax indemnification agreement containing representations from the tax-exempt entity that it has not made any determination whether it will exercise the purchase option.[71]

Also, proponents of LILOs and SILOs have long recognized that for the transaction to qualify as a true lease, the taxpayer must be able to demonstrate that the lessee's alternatives to the purchase option are commercially viable.[72] A key supporting document for every LILO and SILO is an appraisal concluding that the tax-exempt lessee is more likely not to exercise the purchase option than it is to exercise the option.[73]

Of course, the persuasive power of the appraisal reports is presumably weakened by the fact that many lessees have exercised their purchase options despite an appraisal concluding that the exercise was unlikely.[74] Further, the IRS has convinced several courts that the tax-exempt lessee is virtually

[61]*See* Brief for the Appellee, *BB&T Corp. v. United States*, No. 07-1177 (4th Cir. Aug. 30, 2007).

[62]*AWG*, 592 F. Supp.2d at 982; *BB&T*, 523 F.3d at 470, affirming the district court's collapsing of offsetting obligations in the LILO; *see also Wells Fargo*, 91 Fed. Cl. at 78-79.

[63]*BB&T*, 523 F.3d at 469.

[64]*Id.* at 473. *See* 2007 U.S. Dist. LEXIS 321 at *24, noting that BB&T could recoup its equity investment in these circumstances by electing to extend the sublease term: "In the event Sodra does not exercise the purchase option and BB&T enforces the Sublease Renewal provision, the funds in the Equity PUA will be returned to BB&T through the Sublease Renewal rents."

[65]*AWG*, 592 F. Supp.2d at 983.

[66]*Id.* at 984.

[67]*Wells Fargo*, 91 Fed. Cl. 35.

[68]*Id.* at 76, citing *Coleman v. Commissioner*, 16 F.3d 821, 826 (7th Cir. 1994), *Doc 94-2598, 94 TNT 43-7*.

[69]*Wells Fargo*, 91 Fed. Cl. at 78. In the case of Wells Fargo's QTEs, the court found that the bank would recover its entire investment from the rental payments alone.

[70]*Consolidated Edison*, 90 Fed. Cl. 298-299.

[71]*See, e.g.*, *BB&T*, 523 F.3d at 469; *Consolidated Edison*, 90 Fed. Cl. at 238; and Brief for the Appellee at 20, *BB&T Corp. v. United States*, No. 07-1177 (4th Cir. Aug. 30, 2007). Political pressures have occasionally put some strain on these representations. *See* Mark Landler, "Latest German Fad: Leasing Out the Subway," *The New York Times* (July 10, 2003), quoting a German managing director assuring citizens of Frankfurt regarding the proposed lease of the German subway system: "There is always the fear that the foreign investor will take over our U-Bahn and turn it into the New York City subway, which would be terrible. *But of course, that's not the case*." (Emphasis added.) *See also AWG*, 592 F. Supp.2d at 989 (finding that declining to exercise the purchase option would be politically unpopular for the lessee).

[72]*See* Macan, "LILOs and Lease/Service Contract Transactions," *supra* note 22; Tolley, *supra* note 2.

[73]*See* Tolley, *supra* note 2.

[74]*See, e.g.*, *Wells Fargo*, 91 Fed. Cl. at 54, in which the court noted that in every prior leveraged lease transaction involving

(Footnote continued on next page.)

certain to exercise its purchase option and that (whatever the appraisal may say) these transactions are deliberately structured to ensure that result.

As support, the IRS has emphasized the lessee's historical use of the property as an essential part of its operations,[75] the fact that the option exercise price was fully funded through payment undertaking accounts, and that any alternatives to exercising the option were unfavorable. The IRS has persuaded some courts that the lessee will be more likely to preserve the status quo because it will not require any additional expenditure of its own funds.[76] Finally, statements by some participants in these transactions have suggested that the exercise of the option was both expected and understood.[77]

In fact, the purchase option has proven to be the weakest link in LILOs and SILOs. Several courts have found purported alternatives to be mere ''window dressing,''[78] declaring that the exercise of the purchase option was both the intended and the nearly certain result.[79] The court in *Wells Fargo* even went as far as to assert that ''no tax-exempt entity in its right mind would fail to exercise the purchase option.''[80]

2. Criticism of alternatives to purchase option. Proponents of LILOs and SILOs are, however, not without arguments. They counter that the exercise price of the option is set at an amount that exceeds the expected FMV of the leased property. Prefunding of the exercise price through payment undertaking accounts doesn't prove inevitability of the purchase option, defenders say, because the lessee receives those funds outright if it chooses not to exercise the option. They point to the appraisal, which examines the alternatives to the purchase option and concludes they are expected to be more attractive economically. The transaction cannot be set aside, they argue, unless the appraisal is demonstrably incorrect.

On the whole, however, the courts have generally been unimpressed by the appraisals. Some courts have expressed concern that the purchase price in a SILO is typically determined by an appraisal rather than by negotiation with the tax-exempt entity.[81] Although the valuation is required to reflect the price that would be reached by unrelated parties in an arm's-length negotiation, appraisers have an incentive to increase the value of the property.

After all, everyone benefits from a higher price. The purchaser obtains greater depreciation deductions, and the tax-exempt entity and promoters obtain higher fees based on a percentage of the transaction's size.[82] For example, in *Wells Fargo* the court found that the promoters and appraisers worked together to increase the valuation of the SILO property.[83] In one case, the court observed, the appraised value of rail cars significantly exceeded their original purchase price.[84]

The primary systemic weakness of the appraisals is the challenge of demonstrating that alternatives to the purchase option are not as onerous as they may appear. For example, a typical SILO requires the lessee (rather than the owner of the property) to

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the New Jersey Transit and Belgacom Mobile, the tax-exempt entities invariably exercised the purchase option.

[75]*See Altria*, 694 F. Supp.2d at 266, in which the taxpayer's internal credit memoranda generally described the leased assets as ''critical'' to the lessees' business operations.

[76]*See BB&T*, 523 F.3d at 473; *AWG*, F. Supp.2d at 987-990.

[77]*See, e.g.*, *Altria*, 694 F. Supp.2d at 266-267, in which the court noted that the taxpayer's internal staff ''uniformly expected the lessees to exercise their purchase options''; and *BB&T*, 523 F.3d at 469, in which BB&T conceded that ''it entered into the [LILO] transaction believing that 'the most likely thing is [the tax-exempt lessee] would not walk away from the property,' given that [the tax-exempt lessee] had been in business for years,'' and the tax-exempt lessee's tax advisers characterized the transaction as a financing arrangement that did not affect its interests in the equipment, apparently anticipating that it would not surrender control of the equipment to BB&T. *See also* admission by ABN AMRO in *BB&T*, indicating that the bank understood from inception that the transaction would not extend beyond the basic lease term: ''ABN AMRO Bank N. V. understands that the transaction will mature in maximum 17 years from the closing date.'' United States' Memorandum of Law in Opposition to Plaintiff's Motion for Summary Judgment at 10, *BB&T Corp. v. United States*, Civil No. 1:04-cv-00941 (M.D.N.C. June 30, 2006). *See also Wells Fargo*, 91 Fed. Cl. at 54, noting admissions by the parties to SILO transactions that ''probabilities were very high that we would exercise that'' and ''we fully anticipate that you will buy the buses back with the defeasance proceeds.''

[78]*See Altria*, 694 F. Supp.2d at 266-267, finding that a jury reasonably could have concluded that the appraisal reports were little more than ''window dressing designed to bolster Altria's tax position,'' based on the following evidence: (1) a transactional lawyer from a tax-exempt counterparty testified that the purpose of the appraisal was simply to support Altria's tax position; (2) Altria's counterparties generally did not receive a copy of the appraisals before the transactions closed; (3) although Altria's internal staff uniformly expected the lessees to exercise their purchase options, no one at Altria or the firms that performed the appraisals ever questioned the appraisals' conclusions to the contrary; and (4) one of Altria's appraisers testified that although the transactions involved assets worth hundreds of millions of dollars, he spent an average of only one week on each appraisal. *See also BB&T*, 523 F.3d at 473, noting

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that the appraisal report predicting that the tax-exempt lessee would be unlikely to exercise its purchase option ''plainly does not reflect the economic reality of the transaction.''

[79]*AWG*, 592 F. Supp.2d at 985.

[80]*Wells Fargo*, 91 Fed. Cl. at 74.

[81]*See, e.g.*, *AWG*, 592 F. Supp.2d at 963, in which the plaintiff investors acknowledged that they never engaged in any negotiations with the lessee about the price for the property and that such bargaining seldom occurred in those transactions.

[82]CRS report, *supra* note 20, at 10.

[83]*Wells Fargo*, 91 Fed. Cl. at 49.

[84]*Id.* at 83.

obtain nonrecourse refinancing if the purchase option is not exercised. The *AWG* court believed that placing this obligation on the lessee was inconsistent with the taxpayer's purported ownership.

Moreover, the court found no plausible explanation for this provision other than effectively forcing the lessee to exercise the purchase option.[85] Besides, the court found that refinancing would not be economically feasible, except in cases when it would be more advantageous to exercise the purchase option:

> We know that if the fair market value of the Facility in 2024 is less than anticipated, AWG will be more likely to enter into the Service Contract rather than pay the overpriced Fixed Purchase Option amount. But if the value of the Facility has declined significantly below the option price, AWG will almost certainly be unable to obtain the non-recourse refinancing that is a condition precedent to its ability to enter into the Service Contract. If, on the other hand, the fair market value of the Facility in 2024 is greater than anticipated, then AWG will have an economic incentive to repurchase the Facility for the fixed purchase price instead of absorbing all the financing costs created by the Service Contract and waiting until 2036 to reacquire the Facility at fair market value. In sum, AWG will therefore be unable to enter into the Service Contract option when it is desirable to exercise the Service Contact option, and will be unwilling to enter into the Service Contract option when it is feasible to exercise the Service Contract option.[86]

In *Wells Fargo*, the court reached the same conclusion. It quoted internal Wells Fargo documents indicating that Wells Fargo fully expected the purchase option to be exercised, since ''the original return provisions of the lease were written with the intention of being overly onerous to make the lease-end return of any equipment an unattractive option.''[87]

However, taxpayers in *Con Ed* convinced the court that exercise of the lessee's purchase option was uncertain. In contrast to the open skepticism exhibited by other courts, the judge in *Con Ed* seemed favorably impressed with the thoroughness of the appraisal and expert reports. Significantly, the court found that Con Ed had credibly demonstrated substantial business reasons for engaging in the LILO.

These business reasons bear repeating: the expectation of making a pretax 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 own field of expertise; the ability to further develop and share Con Ed's own cutting edge technology; environmental benefits from being involved with an environmentally friendly plant; and improving its own environmental public image.[88]

C. Controversy Over Interest Expense Deductions

The courts' analysis of financing arrangements in LILOs and SILOs is closely related to their analysis of the leaseback transaction. The IRS has argued that the nonrecourse debt in a LILO or SILO is not genuine debt, so investors should not be allowed to deduct the interest. Of course, interest is simply ''compensation for the use or forbearance of money.''[89] Deductible interest can accrue only on debt that is genuine in substance, not merely in form.[90]

LILOs and SILOs have been particularly vulnerable when little or no nonrecourse debt actually leaves the lender's control. In many cases, the loan proceeds must immediately be deposited with an affiliate of the bank under a payment undertaking agreement. These agreements typically provide that the account is the sole property of the bank. The bank repays itself from this account by making rental payments (on behalf of the lessee) to match the payments due on the loan.

The courts have often found that the bank in such an arrangement simply does not give up the use of its money in any real sense.[91] Even so, defenders of LILOs and SILOs contend that defeasance arrangements are nothing more than customary collateral arrangements. Although the deposit arrangements may economically defease the lessee's obligations, proponents argue, they do not release the lessee from the legal obligation to pay rent. The defeasance does not eliminate risk entirely, since the payment undertaker could go bankrupt or otherwise become unable to fulfill its obligations. Moreover, the payment undertaker is often a separate entity from the lender and should be respected as such.[92]

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[85] *AWG*, 592 F. Supp.2d at 971 and 987.

[86] *See* similar analysis in *Wells Fargo*, 91 Fed. Cl. at 70.

[87] *Wells Fargo*, 91 Fed. Cl. at 55.

[88] *Consolidated Edison*, 90 Fed. Cl. at 307.

[89] *Deputy v. du Pont*, 308 U.S. 488, 498 (1940).

[90] *Knetsch v. United States*, 364 U.S. 361, 365 (1960).

[91] *See BB&T*, 523 F.3d at 476; *AWG*, 592 F. Supp.2d at 992-994; *Wells Fargo*, 91 Fed. Cl. at 80 (holding that the loan did not constitute genuine indebtedness for income tax purposes).

[92] For a detailed defense of defeasance arrangements, see Kies, *supra* note 1.

Despite taxpayers' vigorous defenses, the courts have generally been hostile to defeasance in recent cases. The Fourth Circuit held that a deposit of loan proceeds with an affiliate of the lender was nothing more than "taking money out of a bank and then immediately returning it to the issuing bank."[93] That made it not genuine indebtedness.

Similarly, in *AWG* the court found that the true source for repayment of the loans was the loans themselves. The cash flows were circular and never truly left the hands of the lenders.[94] Since the court had previously found that the taxpayer did not become the owner of the asset, it followed that the taxpayer did not use the loans to acquire the asset. It merely used the proceeds to repay the loans.[95]

Wells Fargo followed the reasoning of *BB&T* and *AWG*. Wells Fargo did not have any real use of the funds, since they were immediately paid to the payment undertaker, which used the proceeds to repay the original loan. The court found the lenders' accounting treatment, which eliminated the loan through offsetting entries, reflected the economic reality of the nonrecourse loans.[96]

Some of these cases have been jury trials.[97] In *Fifth Third Bancorp*,[98] the jury found that the loan transaction should be entirely disregarded for tax purposes. Yet the jury also found there was a genuine lease that entitled Fifth Third Bank to deduct rent and transaction fees. The apparent inconsistency is an indication of the jury's struggle to analyze such a complex transaction.

In any case, *Con Ed* remains the exception. The taxpayer argued that the courts have considered it neutral if rental payments exactly match the lessor's debt service.[99] The taxpayer presented evidence that the use of nonrecourse debt is customary in leveraged lease transactions and is required to receive favorable accounting treatment under FAS 13.[100]

Moreover, the taxpayer argued that the amount of the loan was expected to be less than the value of the taxpayer's interest in the lease. That gave the taxpayer a financial incentive to pay off the loan to protect its equity interest.[101] Finally, the taxpayer argued that the payment undertaking accounts do not relieve the lessee of the legal obligation to pay rent, so the lessor is exposed to the lessee's credit if the payment undertaker becomes financially unable to pay.

The court agreed that although the defeasance arrangement *minimized* the risk of default, this risk was not entirely eliminated because of the volatility of worldwide economic conditions.[102] Given its finding that the purchase option was not certain to be exercised, the court reasoned that the taxpayer could have either profit or loss on its investment. Taking the transaction as a whole, the effect of the defeasance accounts was to *reduce* credit risk. It did not release the lessee from the legal obligation to pay rent and did not render the nonrecourse debt unworthy of respect.[103]

IV. Conclusion

SILOs and LILOs are enormously complicated, and the stakes are quite high. The recent LILO and SILO cases illustrate that in the fact-intensive arena of leveraged leasing, the governing rules are not as precise or as predictable as either the IRS or taxpayers may have hoped.

Indeed, the resolution of these cases may turn more on the subjective motivations of the taxpayer than the form of the transaction. The taxpayer victory in *Con Ed* underscores the importance of one or more credible nontax business purposes for any tax-advantaged transaction. Absent such a showing, the courts have shown little hesitation to cut through a thick stack of documentation and distil the transaction to its essence.

But the jury (so to speak) is still out on SILOs and LILOs. The results in *Con Ed*, *Wells Fargo*, and *Altria* could all be overturned on appeal. Until these cases become final, a comprehensive resolution of these complex transactions will remain elusive.

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[93] *BB&T*, 523 F.3d at 477.
[94] *AWG*, 592 F. Supp.2d at 992-993.
[95] *Id.* at 993.
[96] *Wells Fargo*, 91 Fed. Cl. at 80.
[97] Special Interrogatories, *Fifth Third Bancorp v. United States*, No. 1.05-cv-350 (S.D. Ohio Apr. 18, 2008); *Altria*, 694 F. Supp.2d 259.
[98] *See* Special Interrogatories, *Fifth Third Bancorp.*
[99] *Consolidated Edison*, 90 Fed. Cl. at 300.
[100] *Id.* at 302.
[101] *Id.* at 301.
[102] *Id.* at 306.
[103] *Id.* at 304.