Sale Leasebacks and Other Matters of Form

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The IRS continues to do well in litigation over a now moribund pair of tax shelters known as LILOs and SILOs. LILOs (lease-in, lease-out) and SILOs (sale-in, lease-out) were complex and high-stakes leasing transactions. They generally involved huge dollars and huge

pieces of equipment or infrastructure. Often, the party owning the property that would be leased under the deal was overseas.

It is not every day that a bank in the Midwest can buy a subway system in a major European city or a power plant in South America. These were tax-exempt or tax-indifferent owners of expensive and essential assets. There were also U.S. moneybags that needed to invest in something and that could amp up their after-tax return significantly by grabbing tax benefits the foreigners and tax-exempt owners could never use.

Why not put these two halves to good use? The LILO and SILO put these seemingly disparate parties together. LILOs and SILOs were clearly win-win. The brokers did famously too. But that was then.

Gone are the heady days when these byzantine but seemingly foolproof deals were being hawked vigorously. Cool heads in major law and accounting firms went over not only the fine print but also the footnotes. The business these deals fostered was great for the tax advisors too. Tax lawyers and accountants were not just cogs; they were important people in these megadeals.

With a kind of religious zealotry, the deals were assembled, opined upon and closed. Up to a point, the money flowed in. In some cases, tax opinions from major firms affirmed loftily that the tax benefits "will" be sustained. *Will*—not *more likely than not*, not *should*, but *will*. Think about that.

IRS and Case Law

The IRS took a predictable sword to LILOs and SILOs. In March 1999, the IRS issued Rev. Rul. 99-14, 1999-1 CB 835, which ruled that a taxpayer could not deduct rent and interest in connection with a LILO transaction lacking economic substance. The IRS reemphasized this position in Rev. Rul. 2002-69, IRB 2002-44, 760. Eventually, the IRS even designated them as "listed transactions."

Congress also got in on the act. In 2004, Congress enacted Code Sec. 470, which restricts the tax benefits of leasing transactions in which taxable U.S. persons acquire tax benefits with respect to property of a tax-exempt organization or foreign person.

Then came the case law. It would make sense for taxpayers to fight in court because the dollars involved are so large. Moreover, some had time on their side. After all, they could logically say that the IRS should not be allowed to deny their deductions retroactively.

Yet with one exception, taxpayers lost and lost big. The big exception was *Consolidated Edison Co. of New York, Inc.*, FedCl, 2009-2 USTC ¶50696, 90 FedCl 228 (2009), where in trial court, the taxpayer eked out a win. 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 taxpayer argued that the opportunity to make a higher profit elsewhere was not evidence that the activity was not profitable. Claiming numerous business objectives, Con Ed asserted that strict monetary profitability was an inappropriate measure of the transaction. The Claims Court agreed with Con Ed that this was a real deal not a sham and that the taxpayer was motivated by substantial nontax reasons.

The Claims Court even concluded that discounting was not required based on the "specific and unique characteristics" of the particular transaction. But that was then. Now, the Court of Appeals for the Federal Circuit has reversed the Court of Federal Clams.

The appellate court disallowed the rent and interest deductions claimed by Con Ed and its subsidiaries. The Appeals Court sent the case back to the lower court for the limited purpose of determining any refund of previously paid interest to which Con Ed might be entitled.

Not Going Dutch

The *Con Ed* case involved a LILO transaction between Con Ed and N.V. Electriciteitsbedrijf Zuid-Holland (EZH), a Dutch utility. The transaction centered on the lease and sublease of a gas-fired, combined cycle cogeneration plant (the RoCa3 plant) in the Netherlands. Con Ed's avowed purpose in entering into the LILO transaction was to achieve tax avoidance benefits associated with rent and interest deductions.

EZH and Con Ed formally completed the LILO transaction on December 15, 1997 by entering into several agreements. With a flow of cash that was circular and certain, the key question was whether EZH would or would not exercise the Sublease Purchase Option in 2018. If EZH did not, Con Ed had the

opportunity to exercise one of two options. Con Ed could exercise the Sublease Renewal Option, under which EZH would be required to renew the sublease for an additional renewal term of 16.5 years.

At the end of the sublease renewal term, Con Ed would operate the plant or find a new sublessee for the remaining term of the head lease. Alternatively, Con Ed could exercise the Sublease Retention Option, under which EZH would return the remaining interest in the Head Lease Term to Con Ed. This would allow Con Ed to take over the RoCa3 plant's operations for the remainder of the Head Lease Term.

The IRS took the position that this was all pre-wired and devoid of risk. That hardly seemed a stretch, as many aspects of the transaction itself tended to suggest it. When the IRS denied the deductions, Con Ed paid the deficiency.

It then sued for a refund in the Court of Federal Claims. That court concluded that Con Ed's transaction satisfied the substance-over-form doctrine and involved a true lease. It also found that the transaction had economic substance and so awarded Con Ed a full refund.

The government appealed to the Federal Circuit, challenging the lower court's ruling under the substance-over-form doctrine but not its holding under the economic-substance doctrine.

No Deductible Rent

Applying the substance-over-form doctrine under its decision in *Wells Fargo & Co. and Subsidiaries*, CA-FC, 2011-1 USTC ¶50,327 (2011), the Federal Circuit disallowed Con Ed's claimed rent deductions. The transactions at issue in *Wells Fargo* were SILOs involving leases and subleases of various public transit vehicles. The transactions contained purchase, renewal, and retention options similar to those present in *Con Ed*.

The Court of Federal Claims found that Wells Fargo expected the tax-exempt entities to exercise their options because the economic effects of the alternatives were so onerous and detrimental. The Court of Federal Claims re-characterized the transactions as a purchase of tax benefits for a fee from a tax-exempt entity and disregarded them under the substance-over-form doctrine. In affirming, the Federal Circuit said that the Court of Federal Claims did not clearly err in finding that the tax-exempt entities were virtually certain to exercise their repurchase options.

The Federal Circuit said its key inquiry, as in *Wells Fargo*, was whether EZH would exercise its purchase option at the end of the Sublease Basic Term. Con Ed argued that, unlike in *Wells Fargo*, the Court of Federal Claims had made factual findings in Con Ed's favor concerning the likelihood that the tax-indifferent entity would exercise the purchase option. Con Ed argued that these findings were not clearly erroneous, and that this distinguished its case from *Wells Fargo*.

Con Ed argued that, under *Wells Fargo*, the purchase option was significant only if it was "certain" to be exercised. While the Federal Circuit held that the lower court's finding that the options at issue in *Wells Fargo* were virtually certain to be exercised, it made it clear that the relevant standard was reasonable likelihood. Thus, Con Ed's argument failed.

Con Ed also argued that the lower court applied the correct standard. The Federal Circuit disagreed, stressing that the lower court erroneously assumed that the applicable standard was whether EZH was "certain" to exercise the option. Finally, Con Ed argued that even if "reasonable likelihood" of exercise was the correct standard, and even if it was misapplied by the lower court, a remand was needed for the lower court to decide the case under the correct standard.

However, rejecting all of Con Ed's arguments, the Federal Circuit found that the record simply could not support a finding that EZH was *not* reasonably likely to exercise the option. Indeed, the undisputed evidence established that EZH was reasonably likely to exercise the purchase option.

Thus, Con Ed failed to show that the substance of the transaction included a genuine leasehold interest in which Con Ed would bear the benefits and burdens of a lease transaction. Therefore, the LILO transaction did not constitute a true lease and Con Ed's rent deductions were properly disallowed.

No Deductible Interest

The Federal Circuit also considered whether Con Ed was entitled to its interest deductions

associated with the Hollandsche Bank-Unce (HBU) loan. To achieve the deductions, the taxpayer must have incurred genuine indebtedness associated with the LILO transaction. But here, the court said, the loan was not genuine.

The funds from Con Ed's HBU loan flowed from ABN AMRO Bank (ABN) (to fulfill the head lease obligation) and then back to ABN (to fulfill the sublease obligation) in a circle. The lender never forbore use of the purportedly loaned funds and Con Ed never obtained use of those funds. Thus, the Federal Circuit held that Con Ed was not entitled to interest deductions.

Option or Certainty?

As both the *Wells Fargo* and *Con Ed* cases make clear, the likelihood that a LILO or SILO will be collapsed depends heavily on whether the 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.

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. 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.

Of course, any persuasive power of the appraisal reports is weakened by the fact that many lessees have exercised their purchase options. Needless to say, they did so despite an appraisal concluding that such an exercise was unlikely. The IRS has generally been able to show that the tax-exempt party was certain to exercise its purchase option.

Indeed, the IRS has done well in showing 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, 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 also shown that the lessee will be more likely to preserve the status quo because it will not require any additional expenditure of its own funds. Statements by some participants in these transactions have suggested that the exercise of the option was both expected and understood. That too is hardly a surprise.

In fact, the purchase option has proven to be the weakest link in LILOs and SILOs. Some of the purported alternatives appear to be mere "window dressing." To the IRS, and increasingly to the courts, the exercise of the purchase option was both the intended and the nearly certain result. 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."

Proponents of LILOs and SILOs counter that the exercise price of the option is set at an amount that exceeds the expected fair market value of the leased property. Pre-funding of the exercise price through payment undertaking accounts doesn't prove inevitability of the purchase option, defenders say. After all, 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 been unimpressed.

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. That too seems less than market-driven. 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. Indeed, in *Wells Fargo*, the court found that the promoters and appraisers worked together to increase the valuation of the SILO property. In one case, the court observed, the appraised value of rail cars significantly exceeded their original purchase price.

Conclusion

LILOs and SILOs are enormously complicated and the stakes are high. The taxpayer victory in *Con Ed* in the lower court fueled some hope that having one or more credible nontax business purposes for a tax-advantaged transaction might carry the day. Indeed, a good nontax purpose seemed enough, while absent such a showing, the courts have had little hesitation to cut through a thick stack of documentation and distill the transaction to its essence: a tax shelter.

With the *Con Ed* appeal that is now consistent with *Wells Fargo*, the likelihood of any LILO or SILO passing muster grows dimmer still. LILOs and SILOs may now be on the dustbin of history. Nevertheless, if history is any indication, equipment leasing can still offer tax and financial benefits in some cases.

Yet the transactions must be real and the defeasance and other aspects of the deal must not eclipse all risk. As such, it is not mere conjecture to think that at least some aficionados of equipment leasing could be retooling some aspects of these massive transactions for the coming decades.