What Wells Fargo Brings to the SILO/LILO Debate

By Robert W. Wood


Sale-in, lease-out and lease-in, lease-out transactions are enormously complex deals that the IRS has attacked as tax-motivated arrangements lacking economic substance. A steady stream of these big-dollar cases has been litigated. Wood evaluates the latest decision involving Wells Fargo.

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The setting for Meredith Willson’s 1950s musical The Music Man is an idyllic small town in turn-of-the-century Iowa. The simultaneously wholesome and stubborn Iowa townsfolk are not too stoic or flinty to be bamboozled by a polished flimflam man posing as a music professor. A Broadway hit winning five Tony Awards, the production morphed into an Academy Award winning film in 1962 and successful Broadway revivals in 1980 and 2000.

In one of the musical’s signature songs, the entire town lines the streets singing with breathless anticipation as the Wells Fargo wagon — their equivalent to a UPS or FedEx truck — brings something into town. It could hold something special for any one of them, they intone achingly. It turns out to hold instruments for a boys’ band, something the flimflam professor claims is necessary to counter the corrupting influence of a new pool table at the billiard hall.

Today, Wells Fargo might still signal the anticipation of something special, with stagecoach imagery and a lustrous, adventure-filled past. Yet these days Wells Fargo may be known in tax circles for aggressive leveraged leasing deals designed to artificially boost the bottom line. To be fair, Wells Fargo was not the only bank involved in these pariah deals. It was not the only bank looking tarnished, regretting ending up in the unfortunate sale-in, lease-out and lease-in, lease-out alphabet soup.

State of Play

The latest delivery in the SILO/LILO hit parade involves the Federal Circuit. In Wells Fargo & Co. v. United States, the Federal Circuit upheld the Court of Federal Claims’ denial of tax benefits from SILO transactions. This slap-down involved a whopping 26 transactions, with the court finding they lacked economic substance.

Wells Fargo claimed $115,174,203 in deductions for depreciation, interest, and transaction costs from these SILOS for its 2002 tax year. They blossomed from Wells Fargo’s participation in 26 leveraged lease transactions, 17 with domestic transit agencies, and 9 involving qualified technological equipment (QTE). The tax treatment of all 26 transactions was at issue in the case, but the parties limited their trial presentation to five agreed-on transactions. That allowed the court’s holding on those five specimens to inform the resolution of the remainder. Of the five, four involved public transit agencies, and one was a QTE lease involving cellular telecommunications equipment.

A Lease by Any Other Name

SILOS and LILOS are financing transactions. Their defenders argue they are legitimate investments that provide vital funding to public transportation and other worthy projects. Critics such as...
Senate Finance Committee member Chuck Grassley, R-Iowa, denounced them as “good, old-fashioned tax fraud.” Before Congress cracked down on most SILOs entered into after March 12, 2004,6 U.S. taxpayers were involved in at least 400 SILO transactions, claiming tax deductions exceeding $35 billion.7

One cannot discuss LILOs and SILOs without discussing taxes. Plainly, these transactions are unattractive investments from a pretax perspective. Their primary financial benefit is derived from transferring unused or unusable tax benefits to an investor who can use them.8 They depend on the cooperation of a tax-indifferent party, usually a government agency or foreign entity not subject to U.S. income tax.

Just as there is no question that Marley is dead in Dickens’s A Christmas Carol, there is no question that SILOs and LILOs are dead. Both the IRS and Congress put an end to them and no one would try one today. Nonetheless, they remain big issues in high-stakes litigation over deals done in the past.

Attempting to reach the many LILOs and SILOs that had been entered into before the effective date of the American Jobs Creation Act of 2004, IRS Commissioner Douglas Shulman announced a settlement initiative in August 2008 for taxpayers who participated in LILOs and SILOs. More than two-thirds of participants accepted the IRS settlement proposal,9 but some chose to take their cases to court.

With one notable exception, the court cases have resulted in big taxpayer losses. First, a district court denied BB&T’s $4.5 million tax refund claim, which the Fourth Circuit affirmed in BB&T Corp. v. United States.10 A district court, in AWG Leasing Trust v. United States,11 then rejected a similar refund claim for a SILO transaction, upholding penalties.12 The IRS also prevailed in two other district courts in tax refund claims brought by Fifth Third Bancorp13 and Altria Group.14

Taxpayers broke the government’s winning streak in Consolidated Edison Co. of New York Inc. v. United States,15 decided by the Court of Federal Claims. But soon afterward a different judge in the same court limited the Con Ed decision to its facts and denied Wells Fargo a $115 million refund.16 Wells Fargo has since lost on appeal.

**Defeasance and Risk**

LILOs and SILOs are leveraged lease transactions, distinguished by “defeasance,” an arrangement securing the lessee’s obligations under the lease.17 A deposit arrangement that completely extinguishes the borrower’s legal obligation to pay the debt is referred to as “legal defeasance.”18 A deposit arrangement that involves enough collateral to pay off the debt, but maintains the borrower’s liability if the assets in the account somehow fail, is sometimes referred to as “economic defeasance.” LILOs and SILOs fall into the latter category.

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. Yet the tax-exempt entity receives a fee for

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6Senate Finance Committee release (Nov. 18, 2003), Doc 2003-24836, 2003 TNT 223-33. Colorful denunciations of LILOs and SILOs have been a bipartisan phenomenon. According to Finance Committee Chair Max Baucus, D-Mont., SILO transactions are “shell games” and “three-card-monte transactions” that “siphon cash” off taxpayers. See Baucus release (Dec. 10, 2008), Doc 2008-25957, 2008 TNT 239-28.

7Congress 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.

8See Macan, supra note 2 (“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).

participating, generally 4 to 8 percent of the transaction’s value. This fee represents a portion of the investor’s tax benefits that are shared with the tax-exempt entity.

IRS Tourniquet

On March 12, 1999, the IRS and Treasury issued Rev. Rul. 99-14, announcing that deductions for rent and interest from a LILO would be disallowed. The reason: LILOs lack economic substance. 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.” To the IRS, the transaction lacked economic substance because the pretax return was insignificant compared with the tax benefits.

Although Rev. Rul. 99-14 addressed LILOs, its rationale attacked key aspects of SILOs, too. Thereafter the IRS applied Rev. Rul. 99-14 to both LILOs and SILOs in a series of field service advice memorandums. Some commentators believed Rev. Rul. 99-14 was incorrect and unlikely to be upheld in court. As it turned out, the courts have generally agreed with the IRS, although sometimes for different reasons.

Economic Substance?

You might think the economic substance doctrine would be like kryptonite to LILOs and SILOs. Yet in AWG, a district court held 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.

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 sufficiently to show the transaction had some “practicable economic effects other than the creation of income tax losses.” Moreover, the court concluded that even the slight chance of a higher 5 to 8 percent return was enough to evidence a profit motive. Accordingly, the SILO was not an economic sham.

In Con Ed, the Court of Federal Claims followed AWG to find a pretax return of 4.44 percent sufficient to demonstrate economic reality. The IRS unsuccessfully argued that the court should discount the expected return to present value. Claiming numerous business objectives, Con Ed successfully asserted that strict monetary profitability was an inappropriate measure. The court even agreed that discounting was not required based on the “specific and unique characteristics” of the particular transaction.

However, in Wells Fargo, the Court of Federal Claims distinguished Con Ed and AWG to find that a SILO lacked a profit motive. The expected pretax return of 2.6 percent was less than the bank’s cost of funds for its leasing business. Concluding that each SILO was a money-losing proposition, the court noted that Wells Fargo would have been better off investing its funds directly outside the SILO.

Indeed, Wells Fargo’s cost of entering into one transaction was $17.7 million; $7.6 million paid to the tax-exempt participant as an incentive fee and $3.2 million consumed in transaction costs. Wells Fargo would realize a return on the remaining $6.9 million, but the court reasoned 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.

Moreover, the court held that a desire to benefit from favorable accounting rules (Financial Accounting Standard No. 13) was not a nontax business purpose.

And that brings us to risk of loss. The court in Wells Fargo concurred with BB&T and AWG that the critical factor was whether the taxpayer had any
substantial risk of loss on its investment. The defeasance arrangements, combined with a service contract option, effectively allowed Wells Fargo to recoup its entire investment if the property’s value declined, whether or not the purchase option was exercised.35

On the whole, however, the tax-exempt entity’s option to repurchase the leased property may be the weakest feature of all for LILOs and SILOs. Several courts have found the supposed alternatives to be mere window dressing,36 declaring that the exercise of the purchase option was intended and nearly certain.37 The court in Wells Fargo even went so far as to assert flatly that “no tax-exempt entity in its right mind would fail to exercise the purchase option.”38

Proponents of LILOs and SILOs argue that the exercise price of the option is set so it will exceed the expected fair market value of the leased property. Prefunding of the exercise price through payment undertaking accounts does not prove the inevitability of the purchase option, defenders say. After all, the lessee receives those funds outright if it chooses not to exercise the option.

Proponents point to appraisals that examine the alternatives to the purchase option and glowment conclude they are expected to be more attractive economically. The transaction cannot be set aside, they argue, unless the appraisals are demonstrably incorrect. Yet the courts have generally discounted those appraisals.

The purchase price in a SILO is typically determined by an appraisal rather than through negotiation with the tax-exempt entity.39 Although the valuation is required to reflect the price that would be reached by unrelated parties in arm’s-length negotiations, appraisers have an incentive to increase the value of the property. Besides, a higher price means the purchaser obtains larger depreciation deductions and the tax-exempt entity and promoters earn higher fees.40 Everyone seems better off.

In Wells Fargo, the Court of Federal Claims found that promoters and appraisers worked together to boost the valuation of the SILO property.41 In one deal, the appraised value of rail cars significantly exceeded their original purchase price.42 The court even quoted internal Wells Fargo documents proving that the bank fully expected the purchase option to be exercised.43

Stagecoach Justice

Like most SILO/LILO participants, Wells Fargo failed at the trial court level. The Court of Federal Claims determined that Wells Fargo was not entitled to its deductions on any of the five trial transactions. Wells Fargo did not have the benefits and burdens of property ownership. Plus, the deals lacked economic substance and were intended primarily to reduce the bank’s taxes.

Stripped bare, Wells Fargo purchased tax benefits for a fee from a tax-exempt entity that couldn’t use the deductions. The transactions were designed to minimize risk and to assure the outcome to Wells Fargo regardless of value fluctuations during the term of the transactions. Nothing of any substance changed in the tax-exempt entity’s operation and ownership of the assets, said the court. The only money changing hands was Wells Fargo’s upfront fee to the tax-exempt entity, and Wells Fargo’s payments to those participants in or structured the deal.

Appealing Appeal?

The most recent iteration of the SILO/LILO tale of woe comes in Wells Fargo’s appeal to the Federal Circuit. There, the bank argued that the lower court:

- employed an inappropriate method to determine that Wells Fargo lacked the benefits and burdens of ownership in the assets that were the subject of the SILO transactions;

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34Wells Fargo, 91 Fed. Cl. at 76 (citing Coleman v. Commissioner, 16 F.3d 821, 826 (7th Cir. 1994), Doc 94-2598, 94 TNT 43-7).
35Id. 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.
36See Altria Group, 694 F. Supp.2d at 266 (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 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.”).
37AWG, 592 F. Supp.2d at 985.
38Wells Fargo, 91 Fed. Cl. at 74.
39See, 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 over the price for the property and that such bargaining seldom occurred in those transactions).
40CRS report, supra note 19, at 10.
41Wells Fargo, 91 Fed. Cl. at 49.
42Id. at 83.
43Id. at 55.
• used the wrong test to measure its pretax profit; and
• misapplied the “nontax business purpose” test.

Each of those arguments failed, making little impression on the appellate panel.

The Federal Circuit stressed that Wells Fargo had to show that it owned the SILO equipment to be entitled to deductions for depreciation and interest. Rather than being determined solely by legal title, the taxpayer must bear the benefits and burdens of ownership. Here, that meant the allocation of risk associated with the value of the leased assets.

Wells Fargo argued it had the benefits and burdens of ownership in the leased assets, in part because it could regain possession of the assets while they still retained some economically useful life. The Court of Federal Claims observed that Wells Fargo actually required the tax-exempt entities to represent at the time of closing that they had not made any determination whether they would exercise their repurchase options. Nonetheless, the lower court found the repurchase options would almost certainly be exercised to terminate the transactions. The Federal Circuit affirmed, citing witness testimony and documentation as compelling evidence supporting the trial court’s conclusions. Based on that evidence, the economic effects of the alternatives were so onerous and detrimental that no rational tax-exempt entity would fail to exercise the options.

The Federal Circuit stressed that absolute certainty was not a requirement in determining whether the transaction was abusive. Instead, the critical inquiry was whether Wells Fargo could reasonably have expected that the repurchase options would be exercised. The evidence before the court clearly indicated that such an expectation existed. After all, the transactions were marketed as part of a prepackaged tax shelter, with the understanding that the tax-exempt participants would exercise their purchase options.

In the end, the transactions were purely circular, elevating form over substance, said the courts. The only flow of funds between the parties was the initial lump sum given to the tax-exempt entity as compensation for its participation in the transaction. That seemed to be a fee for selling tax benefits. To the tax-exempt entity, the transaction did not affect any real change to the status quo ante.

Of course, Wells Fargo continued to benefit throughout the term of the sublease, receiving deferred tax payments. The third-party lender and its affiliate were compensated for their participation, as were the creators and promoters of the transactions. This was a win-win deal for all of the private parties. Free money in the form of previously unavailable tax benefits used by Wells Fargo was divvied up.

Marley Is Dead

It is hard to read the Federal Circuit opinion in Wells Fargo and maintain hope that there is much life left in historical SILOs or LILOs, notwithstanding the fact-specific Con Ed exception. The Federal Circuit agreed that Wells Fargo’s SILO transactions ran afoul of the substance-over-form doctrine and were abusive tax shelters. The Federal Circuit found the claimed deductions to be for:
• depreciation on property Wells Fargo never expected to own or operate;
• interest on debt that existed only on a balance sheet; and
• write-offs of transaction costs that amounted to nothing more than tax deduction arbitrage.

No one can or will do a SILO or LILO today. In that sense, reading these cases seems akin to a visit from the Ghost of Christmas Past. Yet when the next wave of leveraged lease transactions is planned by the tax lawyers of tomorrow, there are lessons here as stark as those from Scrooge and Marley’s countinghouse.