LILOs, SILOs and Business Purpose, Part I

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M&A Tax Report readers are no strangers to complex structures, but there's complex, and then, well, *complex*. And sometimes the more complex something appears, the more plain old business purpose considerations can matter. You may think you know what LILOs and SILOs are and how they work. Yet 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 named Stitch. But there's nothing alien about LILOs or SILOs.

Acronyms for "lease in lease out" and "sale in lease out," these cryptic names do nothing to tell you really what's going on. LILOs and SILOs are sophisticated 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.

In fact, the Treasury shut down LILOs (prospectively, at least) back in 1999. Congress followed by cracking down on most SILOs entered into after March 12, 2004. But what about the many LILOs and SILOs that were entered into before the effective dates? And what about the huge dollars at stake?

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. Over two-thirds of the participants accepted the deal, but some have chosen to go to court. With one notable exception, the results so far have been big taxpayer losses.

Tax-Driven Benefits

LILOs and SILOs are specific types of leveraged lease transactions. Although they are generally unattractive investments viewed pre-tax, the tax benefits were substantial. Shorn of detail, they facilitate a transfer of unused or unusable tax benefits to an investor who is able to use them. 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.

It seems a shame when someone receives no tax benefit from depreciation or interest deductions attributable to its assets. In a SILO, a taxable third party gets the unused tax benefits by purchasing property from the tax-exempt entity (usually through a long-term "Head Lease" treated as a sale for tax purposes). The buyer then immediately subleases the property back to the tax-exempt entity. The taxable party deducts depreciation on its asset, as well as a significant amount of interest, since it acquires the asset primarily with borrowed funds.

With a LILO, instead of *purchasing* the property, the taxable party *leases* the property from the tax-exempt entity, then immediately subleases it back. The taxable party claims deductions for rent (and interest expense with respect to any related financing).

In both LILOs and SILOs, the tax-exempt entity continues to use, operate and maintain the property during the lease term in the same manner as before. The tax-exempt entity receives a fee, a portion of the investor's tax benefits.

Financing and Defeasance

Although similar to a traditional sale and leaseback, the distinguishing feature of LILOs and SILOs is "defeasance," an arrangement securing the lessee's obligations under the lease. A debt is "defeased" when the borrower deposits enough cash into a pledged or restricted account to service the borrower's debt.

A deposit arrangement that completely extinguishes the borrower's legal obligation to pay the debt is "legal defeasance." A deposit arrangement with enough collateral to pay off the debt, but that maintains the borrower's liability if the amount in the account somehow fails, is "economic defeasance." [*See* Kenneth J. Kies, *Leave Us a Loan: A Rebuttal to Claims That Defeasance Invalidates Lease Transactions,* 2004 TNT 27-31.] LILOs and SILOs involve this economic variety.

The controversy over defeasance arises, at least in part, from the circular pattern in which borrowed funds and rental payments flow in a SILO or LILO. The U.S. taxpayer typically prepays the entire rent due under the life of the Head Lease in a single up-front payment. It finances most of this big payment with the proceeds of a nonrecourse loan ("Debt Portion").

The taxpayer provides the remainder from its own funds or from recourse borrowings ("Equity Portion"). Rather than receiving these rent proceeds directly and having free use of them, the tax-exempt entity places all but what the IRS calls its "accommodation fee" in accounts with the lender or with an affiliate of the lender. "Payment undertaking" agreements typically provide that the account is the sole property of the bank.

The payment undertaker uses the Debt Portion to make rental payments on behalf of the tax-exempt lessee. The rental payments match the taxpayer/lessor's debt service amounts. They are paid directly to the lender to satisfy the lessor's debt obligations.

The taxpayer's Equity Portion is also put in a restricted account, typically invested in government bonds or other high-grade debt. They are expected to grow to precisely the amount needed to eventually pay the exercise price of the lessee's option to purchase the lessor's interest in the property.

[End of Part I. Part II will appear in the September 2010 issue.]