ConEd Gives IRS Last Laugh In SILOs and LILOs

By Robert W. Wood

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Sale-in, lease-outs and lease-in, lease-outs are complex and have not fared well in the courts. Most recently, in *Consolidated Edison Co. of New York*, the Federal Circuit reversed the Court of Federal Claims to disallow the benefits of a LILO. Wood examines the decision and its larger impact.

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The IRS continues to do well in litigation over a dying pair of tax shelters known as lease-in, lease-out and sale-in, lease-out transactions. They were complex and high-stakes leasing transactions, generally involving huge dollars and large pieces of equipment or infrastructure. Often, the party owning the property 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.

One key participant was a tax-exempt or tax-indifferent owner who had expensive and essential assets. Another key player was a U.S. moneybags that needed to invest big dollars. Watching a big bottom line, it could significantly increase its after-tax return by grabbing tax benefits the foreigners and tax-exempt owners could never use.

Why not put those two halves to good use? The LILOs and SILOs put those seemingly disparate parties together and were clearly win-win. The brokers did famously too. But that was then, in the heady days when those Byzantine but seemingly foolproof deals were being hawked vigorously and the cash flowed in.

Cool heads in major law and accounting firms went over not only the fine print but also the footnotes. The business the deals fostered was great for the tax advisers too. Tax lawyers and accountants were not just cogs in a machine. Since the transactions were tax-centric, the tax people and their roles in the mega-deals were important.

With near-religious zealotry, the deals were assembled, opined on, and closed. The money flowed in, and the deals were so foolproof that even bad economics seemed impossible. The flow of money was certain and almost always upfront, so that U.S. banks did not need to worry whether lease payments would be made.

And the tax benefits were rich. In some cases, tax opinions from major firms concluded that the tax benefits "will" be sustained. Will; not more likely than not, not should, but *will*. That may not sound astounding to a person in business or finance, but tax people know how hard it is to reach that standard. Some may wonder how it could possibly be reached in SILO and LILO cases.

IRS and Case Law

Predictably, the IRS took a sword to LILOs and SILOs. In March 1999 it issued Rev. Rul. 99-14,[1] which ruled that a taxpayer could not deduct rent and interest in connection with a LILO transaction lacking economic substance. The IRS reiterated its position in Rev. Rul. 2002-69.[2] Eventually, the IRS designated them as listed transactions.

Congress picked up its own sword. In 2004 it enacted section 470, which restricts the tax benefits of leasing transactions in which taxable U.S. persons acquire tax benefits for property of a tax-exempt organization or foreign person. Of course, as with other transactions in which the law develops, the tax aspect of transactions completed at various stages of that development had to be addressed case by case.

It often made sense for taxpayers to fight in court because the dollars involved were so large. Moreover, some had time on their side, because they

[1] 1999-1 C.B. 835.
[2] 2002-2 C.B. 760.

could logically say that the IRS should not be allowed to deny their deductions retroactively. Yet with the exception of *Consolidated Edison Co. of New York Inc. v. United States*,[3] taxpayers lost, and lost big.

In *ConEd*, the IRS 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, ConEd asserted that strict monetary profitability was an inappropriate measure of the transaction.

The Claims Court agreed with ConEd that it was a real business transaction and not a sham. The court even found that the taxpayer was motivated by substantial nontax reasons. It concluded that discounting was not required based on the ''specific and unique characteristics'' of the transaction.

The Federal Circuit reversed, disallowing the rent and interest deductions claimed by ConEd and its subsidiaries. It remanded the case to the lower court for the limited purpose of determining any refund of previously paid interest to which ConEd might be entitled.

ConEd involved a LILO transaction between ConEd and NV 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. EZH and ConEd 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 exercise the sublease purchase option in 2018. If EZH did not, ConEd could exercise one of two options. One was a 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, ConEd would operate the plant or find a new sublessee for the remaining term of the head lease.

Alternatively, ConEd could exercise the sublease retention option under which EZH would allow ConEd to take over the RoCa3 plant's operations for the remainder of the head lease term. The IRS's position was that the transaction was all pre-wired and devoid of risk. When the IRS denied the deductions, ConEd paid the deficiency and sued for a refund in the Court of Federal Claims.

The trial court concluded that ConEd'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 ConEd a full refund. The government appealed to the Federal Circuit, challenging the lower court's substance-over-form finding but not its economic substance holding.

Applying the substance-over-form doctrine from its decision in *Wells Fargo & Co. and Subsidiaries v. United States*,[4] the Federal Circuit disallowed ConEd's claimed rent deductions. *Wells Fargo* involved SILOs with leases and subleases of various public transit vehicles. The transactions contained purchase, renewal, and retention options similar to those in *ConEd*.

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 recharacterized 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 the claims court did not clearly err in finding that the tax-exempt entities were virtually certain to exercise their repurchase options.

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

ConEd argued that under *Wells Fargo*, the purchase option was significant only if it was certain to be exercised. The Federal Circuit held that the lower court's finding was incorrect and that the options at issue in *Wells Fargo* were virtually certain to be exercised. Nevertheless, it made clear that the relevant standard was reasonable likelihood, not certainty. Thus, ConEd's argument failed.

ConEd 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, ConEd argued that even if reasonable likelihood of exercise was

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[3] 90 Fed. Cl. 228 (Fed. Cl. 2009), *rev'd*, No. 2012-5040 (Fed. Cir. 2013).

[4] 641 F.3d 1319 (Fed. Cir. 2011), *aff'g* 91 Fed. Cl. 35 (Fed. Cl. 2010).

the correct standard, and even if it had been misapplied by the lower court, remand was needed for the lower court to decide the case under the correct standard.

However, the Federal Circuit rejected all of ConEd's arguments. It found that the record simply could not support a finding that EZH was not reasonably likely to exercise the option. The undisputed evidence established that EZH was reasonably likely to exercise the purchase option.

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

The Federal Circuit also considered whether ConEd was entitled to interest deductions associated with the Hollandsche Bank-Unce loan. To qualify, 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 ConEd'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 ConEd never obtained use of those funds. Thus, the Federal Circuit held that ConEd was not entitled to interest deductions.

Certainty of Option Exercise

As both *Wells Fargo* and *ConEd* make clear, the likelihood that a LILO or SILO will be collapsed depends heavily on whether the exercise of the purchase option is 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. That is plainly counterintuitive, but it is an important piece of every such deal.

Of course, any persuasive power of an appraisal report is weakened by the fact that many lessees have exercised their purchase options despite an appraisal concluding that the exercise was unlikely. The IRS has been able to show that the tax-exempt party was certain to exercise its purchase option. Indeed, whatever the appraisal may say, those 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 those transactions have suggested that the exercise of the option was expected and understood. 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 or worse.

To the IRS, and increasingly to the courts, the exercise of the purchase option was both the intended and 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. That is indeed a helpful fact.

Moreover, they claim, the pre-funding of the exercise price through payment undertaking accounts does not prove the inevitability of the purchase option. After all, they assert, 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, courts have been unimpressed with those arguments. 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.

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, it would seem that everyone (except the IRS) would benefit 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 *ConEd* in the lower court fueled some hope that having one or more credible nontax business purposes — a good idea for any tax-advantaged transaction — would make all the difference. For a time, a good nontax purpose seemed to carry the day.

In contrast, absent such a showing, the courts have shown little hesitation in cutting through a thick stack of documentation and distilling the transaction to its often not very appealing essence. With the *ConEd* appeal that is now consistent with *Wells Fargo*, the likelihood of any LILO or SILO passing muster grows dimmer still. Indeed, it does not seem premature to suggest that LILOs and SILOs may now be in the dustbin of history.

But if history is any indication, equipment leasing is not. It can clearly offer tax and financial benefits when the transactions are real and the defeasance and other aspects of the deal do 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 those massive transactions for the coming decades.

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