

## Taxpayer Wins LILO Case in the Court of Federal Claims

October 23, 2009

On October 21, 2009, the Court of Federal Claims found in favor of the taxpayer, Consolidated Edison Company of New York (Con Ed), holding that Con Ed was entitled to a refund for taxes with respect to previously disallowed deductions incurred in connection with a lease-in, lease-out (LILO) transaction.<sup>1</sup> This taxpayer victory comes on the heels of the very successful IRS settlement initiative that the IRS announced on August 6, 2008, for LILO and sale-in, lease-out (SILO) transactions. The IRS offered the settlement initiative after the IRS victories in three LILO/SILO cases: *BB&T Corp v. United States*<sup>2</sup>; *AWG Leasing Trust v. United States*<sup>3</sup>; and *Fifth Third Bancorp v. United States*.<sup>4</sup>

The LILO transaction at issue in the present case was entered into between Consolidated Edison Leasing, Inc. (CEL), a wholly-owned domestic subsidiary of Consolidated Edison Development, Inc. (CED), and Electriciteitsbedrijf Zuid-Holland, NV (EZH), a Dutch utility, and involved the RoCa3 Facility located in the Netherlands. The disallowed deductions related to rental, interest, and transaction costs with respect to the RoCa3 Facility.

In the LILO transaction, CEL leased an undivided 47.47 percent interest in the RoCa3 Facility from EZH for a 43.2-year term (approximately 80 percent of the facility's estimated remaining useful life of 54 years) under a Lease Agreement and, pursuant to a Sublease Agreement, subleased the undivided 47.47 percent interest back to EZH for 20.1 years of the 43.2-year term. The transaction was effectuated through a series of agreements entered into between EZH, CEL (directly and indirectly through CEL Trust) and third parties, including the Participation Agreement, the Lease Agreement, and the Sublease Agreement; defeasance accounts; and three options: the Sublease Purchase Option, the Sublease Renewal Option, and the Retention Option.

### Agreements

The Participation Agreement set out various general agreements entered into by the parties, such as conditions precedent to closing the transaction, documents to be provided, and warranties to be made,

<sup>1</sup> *Consolidated Edison Co. of New York, Inc. v. United States*, No. 06-305T (Oct. 21, 2009).

<sup>2</sup> 523 F.3d 461 (4th Cir. 2008).

<sup>3</sup> 592 F. Supp. 2d 953 (N.D. Ohio 2008).

<sup>4</sup> No. 1:05-cv-350 (S.D. Ohio Apr. 17, 2008). The government was also successful in the *Altria* case involving a SILO transaction. *Altria Group, Inc. v. United States*, No. 06-9430 (S.D.N.Y. July 9, 2009).

and addressed items such as jurisdiction, currency, transfers of interest, and indemnities, amongst other items.

As discussed above, the Lease Agreement created a 43.2-year lease term, which commenced on December 15, 1997, and was to end on February 24, 2041. The rent payments consisted of only two payments: a payment of \$120,112,270 due on closing and a second payment of approximately \$831,525,734 due on the lease termination date. The Lease Agreement also set out the maintenance, repair, and preservation requirements of each party, as well as events that constituted a default. Similarly, the Sublease Agreement established the 20.1-year sublease term and described the maintenance, servicing, and repair requirements of EZH. Additionally, the Sublease Agreement established annual rent payments to be made by EZH to CEL Trust starting on January 2, 1998, and ending on January 2, 2018 and events that would constitute a default.

Additional agreements entered into included the Sublessee Loan Agreement, which provided that CEL Trust was to lend the sublease payments due to EZH from 1997 through part of 2004, although EZH was permitted to defer the payments due during that time; the Facility Operating Agreement, which established the parties' rights and obligations with respect to the facility's operations; the Facility Support Agreement, which granted the parties the right to use the facility's equipment, parts, supplies, and the like; and the Tax Indemnity Agreement, which states that the parties intended to treat the lease and sublease as "true leases" for US federal income tax purposes and that the parties did not have a separate written or oral agreement whereby the exercise of the options (to be discussed) was legally or economically required.

### **Defeasance Accounts**

To finance the transaction, EZH created two defeasance accounts (the "Sublease Deposit" and the "IJssel Deposit") and the Rotte Foundation. In order to make its sublease payments, EZH would transfer and assign its rights in a bank account to the Rotte Foundation. CEL Trust was granted a first priority right of pledge in the Sublease Deposit by the Rotte Foundation. This first priority right of pledge was then repledged to HBU (the bank from which CEL Trust obtained a nonrecourse loan in the amount of \$80,792,270 in order to make the first rental payment under the Lease Agreement) as security for CEL Trust's obligation to repay secured loan amounts. Notwithstanding the Sublease Deposit, EZH remained liable for all of its obligations under the Sublease Agreement; events such as bankruptcy or another sublease did not terminate EZH's liability.

EZH also formed the IJssel Foundation to purchase debt instruments, make deposits, and grant security interests in its assets to third parties to secure certain EZH payment obligations under the Sublease Agreement. EZH formed the IJssel Deposit the day after the LILO transaction closed by entering into the IJssel Agreement and transferring \$31,252,643.73 to the IJssel Foundation to be used to purchase certain US government securities known as “Treasury STRIPS.” CEL Trust was granted a first priority right in the IJssel Deposit as security for its payment obligations. The Treasury STRIPS in the IJssel Deposit were to cover the sublease rent payments, if made, and the equity portion of the Purchase Price Option (as discussed below), if paid. EZH remained liable for all payment obligations and was permitted to terminate the IJssel Agreement anytime after the sublease and other payment obligations were terminated.

EZH obtained Letters of Credit in favor and for the benefit of CEL and CEL Trust, as required under the Participation Agreement.

### **Options**

There are also three options that can be exercised as of January 2, 2018, the time at which the sublease term is to end: (1) the Sublease Purchase Option, exercisable by EZH; (2) the Sublease Renewal Option, exercisable by CEL Trust if the Sublease Purchase Option is not exercised by EZH; or (3) the Retention Option, also exercisable by CEL Trust if the Sublease Purchase Option is not exercised by EZH.

The Sublease Purchase Option, if exercised by EZH, allows EZH to purchase CEL Trust’s remaining lease interest in the facility for \$215,450,949.20, payment of which can be accomplished by a transfer of the entire amount, in cash, from EZH to CEL Trust, or by transferring \$123,615,472 in cash plus the Treasury STRIPS from the IJssel Deposit. If EZH does not exercise this option, CEL Trust can exercise either the Sublease Renewal Option or the Retention Option.

The Sublease Renewal Option allows CEL Trust to renew the sublease for 16½ years (i.e., from January 2, 2018, until June 15, 2034). Annual rents would be due through January 2, 2027, at which point the Sublease Deposit would be exhausted. The undivided 47.47 percent interest in the facility would return to the CEL Trust following the renewal period, and CEL Trust would be required to make the final payment under the Lease Agreement at the time the lease terminates on February 24, 2041. If this option is elected, CEL, on behalf of CEL Trust, is required to fund two deposits — the Lease Collateral Deposit and the Trustee Treasury Collateral — to provide collateral for the final payment under the Lease Agreement. In the alternative, CEL or CEL Trust can elect to use Acceptable Substitute Collateral in the form of

(1) a letter of credit and (2) a first priority security interest in either cash or US-backed securities, or (3) any other collateral that is acceptable to EZH in its sole discretion, subject to certain limitations.

The Retention Option, if exercised by CEL Trust, requires EZH to return CEL Trust's undivided interest in the lease to CEL Trust on January 2, 2018. At that time, the Sublease Deposit, Pledge, and Repledge Agreement will terminate, and EZH will be required to maintain an acceptable letter of credit in favor of CEL Trust securing its obligations under the Sublessee Loan (described above). Additionally, CEL Trust will be required to prepay the nonrecourse loan and, in the event that it can not make arrangements for such prepayment and CEL Trust and EZH are notified of this failure on or before the 45th day prior to the termination of the sublease, the Sublease Renewal Option will be deemed to have been exercised. CEL Trust's exercise of the option also allows EZH to withdraw the Sublease Deposit balance and requires CEL Trust to fund the Lease Collateral Deposit and the Trustee Treasury Collateral or provide Acceptable Substitute Collateral.

### **Reporting of the Transaction**

In 1997, Con Ed reported rental income of \$399,693 and claimed the following deductions related to the LILO transaction: (1) \$1,072,652 for rent paid to EZH, (2) interest expense from the nonrecourse debt of \$254,944, and (3) \$9,698 for amortization fees. Following an audit by the IRS, Con Ed's taxable income was increased by \$937,331, resulting in a tax deficiency of \$328,066. Con Ed paid this amount and timely filed a claim for refund with the IRS, which was subsequently denied.

### **Opinion**

Relying primarily on *Frank Lyon Co. v. United States*<sup>5</sup> and *Coltec Industries, Inc. v. United States*,<sup>6</sup> U.S. Court of Federal Claims Judge Marian Horn found that the transaction at issue "was a unique LILO transaction, which provided tax and bookkeeping advantages to the plaintiff; was, in form, a true lease; possessed economic substance; and, therefore, should be respected as qualifying for the tax deductions claimed." Specifically, the court stated that, in determining whether a transaction has or lacks economic substance, the facts and circumstances of each transaction must be analyzed. Here, the court found that Con Ed exhibited multiple non-tax purposes for entering into the transaction, including (1) the opportunity for profit, (2) the encouragement of technology transfer, (3) the improvement of Con

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<sup>5</sup> 435 U.S. 561 (1978).

<sup>6</sup> 454 F.3d 1340 (Fed. Cir. 2006).

Ed's industry competence, (4) expansion and improvement of Con Ed's position in new markets domestically and abroad, (5) the potential improvement of Con Ed's environmental image, and (6) a better understanding of deregulation at home and abroad. The court noted that, without the LILLO transaction, Con Ed would have incurred significant costs in achieving these goals; thus, the court found, the LILLO transaction actually created an increase in cash flow. Accordingly, the court concluded that, although Con Ed could derive tax benefits from the transaction, the business motives, risks, and benefits of the transaction; Con Ed's expectation of a pretax profit; and the transaction's environmental benefits supported the conclusion that the transaction possessed economic substance.

The court also found that Con Ed was the true owner of the leasehold interest in the facility and possessed the benefits and burdens of ownership, thereby satisfying the substance-over-form test. First, the court determined that the three options were "viable" and presented potential economic profit, and that none of the options were guaranteed or inevitable at the time the transaction was consummated. Specifically, based on fluctuations in discount rates, inflation, market changes, and technological evolution, there was no way to predict the future value of the lease interest or whether or not the exercise of the options, especially the Sublease Purchase Option, would be virtually certain. Second, the court determined that the lease was a "true lease" because Con Ed's equity investment, in addition to the nonrecourse debt, was above average; Con Ed had a projected potential for profit in the transaction, exclusive of tax benefits, due in part to its ability to use the loan funds to finance its lease of the facility; and because the record supported Con Ed's assertion that, if EZH does not exercise the Sublease Purchase Option, there is "the potential for a realistic residual value remaining" after the sublease term. Also, the court noted that the IJssel and Sublease Deposits will not necessarily be sufficient to meet EZH's obligations after 2018, and that such deposits reduce the credit risk but do not defeat true lease status.

Finally, the court found that the transaction was not without risk to Con Ed, which supported the court's determination that the transaction possessed economic substance and that the form of the transaction should be respected as a true lease. In so finding, the court looked to reports prepared for Con Ed by Deloitte and Shearman & Sterling, expert testimony presented by both Con Ed and the United States, and the transaction documents and determined that the transaction "as a whole contains various uncertainties and speculations" and that "[b]oth internal and external forces can operate to change results."

The judge ultimately found Con Ed's witnesses and exhibits more convincing. According to the court, Con Ed's "management team was

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careful in its considerations of, planning for, and execution of the [LILO] [t]ransaction, and created a true lease transaction that possessed economic substance.” Therefore, the court held that the deductions claimed in connection with the LILO transaction were proper.

### **Conclusion**

As discussed, this is the first case the government has lost following its successful LILO/SILO transaction settlement initiative. Given the number of decisions in its favor, the IRS will likely appeal the *Con Ed* case to the U.S. Court of Appeals for the Federal Circuit.

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