Federal Circuit Reverses in ConEd and Disallows Leasing Deductions

by Jeremiah Coder

The Federal Circuit on January 9 reversed a lower court's favorable decision regarding expense deductions that Consolidated Edison Co. took in connection with a leasing transaction, holding that the deductions must be disallowed based on a substance-over-form analysis.

The Federal Circuit had already expressed skepticism about the claimed nature of the transaction as a genuine lease for tax purposes. In its opinion, the circuit held that the deductions had to be disallowed because the master lease was illusory (*Consolidated Edison Co. of New York Inc. v. United States*, No. 2012-5040 (Fed. Cir. 2013), *rev'g* 90 Fed. Cl. 228 (2009)). (Prior coverage.)

Background

ConEd in 1997 used a subsidiary to enter into a lease-in, lease-out arrangement with Dutch utility Electriciteitsbedrijf Zuid-Holland NV (EZH) that involved a gas-fired, combined-cycle cogeneration plant (RoCa3). The transaction was structured as a 43-year lease from EZH to ConEd with a 20-year sublease back to EZH, with purchase and retention options available to EZH at the end of the sublease. ConEd deducted interest, rent, and transaction costs associated with the RoCa3 leasing transaction.

The IRS disallowed ConEd's deductions and assessed a deficiency of $328,066 for the 1997 tax year. ConEd sued for a refund in the Court of Federal Claims. The three chief issues before the court were whether ConEd was leasing from EZH in form rather than in substance, whether the economic substance doctrine negated the lease, and whether ConEd's indebtedness on its loan was bona fide. The IRS argued that ConEd never in substance acquired a present leasehold interest in the Dutch utility.

After a five-week trial, the Court of Federal Claims concluded that the company had entered into a true lease with economic substance. Perhaps central to the court's analysis of the case was its statement that "although LILO transactions often include certain general, common characteristics, each LILO transaction is developed and formed differently."

The claims court was satisfied that ConEd had acquired the benefits and burdens of a leasehold interest in the RoCa3 facility. Because ConEd's experts showed credible evidence that forgoing exercise of the sublease purchase option would cause the taxpayer to bear the burdens and benefits of ownership -- and because "no such decision is pre-ordained" -- the transaction had substance, the court held. Also, the trial record illustrated RoCa3's potential residual value after the lease term, indicating a "true possibility of obtaining a significant profit," said the court.

Circuit Reversal

The Federal Circuit disagreed, finding that ConEd's deductions must be disallowed because there was "a reasonable likelihood" that EZH would exercise its purchase option at the end of the sublease, "rendering the master lease illusory." In applying a substance-over-form analysis, the circuit panel said that the reasonable expectation of exercising the sublease purchase option recharacterized the transaction as "one without any meaningful substance."

Drawing on its prior opinion in *Wells Fargo & Co. v. United States*, 641 F.3d 1319 (Fed. Cir. 2011), the circuit court reiterated that the proper standard for evaluating the effect of the purchase option on the transaction's genuineness is that of reasonable likelihood. A "reasonable expectation standard, rather than a certainty standard, governs the recharacterization of transactions under the substance-over-form doctrine," the court wrote. The court held that the claims court made no factual findings based on that standard because the *Wells Fargo* opinion had not yet been rendered.

Finding it unnecessary to remand the case, the court stated that the record reflected a clear intention of the parties for EZH to exercise the purchase option, with ConEd presenting insufficient evidence that that exercise was not reasonably likely by a prudent investor. Consequently, 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 court wrote.

The initially favorable decision that ConEd received in the lower court was an exception, because most of the leasing shelter cases resulted in wins for the government. The Federal Circuit's reversal gives the Justice Department a string of victories in the courts on the issue of deductible expenses incurred in LILO and sale-in, lease-out transactions (*BB&T Corp. v. United States*, 523 F.3d 461 (4th Cir. 2008); *Altria Group Inc. v. United States*, 694 F. Supp.2d 259 (S.D.N.Y. 2010); and *AWG Leasing Trust v. United States*, 592 F. Supp.2d 953 (N.D. Ohio 2008)).

"While the Federal Circuit decision is disappointing for LILO participants, it is hardly surprising given the trend of the courts generally on these types of transactions and specifically in light of the circuit's *Wells Fargo* decision," said Mark D. Allison of Caplin & Drysdale. That the foreign lessee holds and operates the asset during the term of the transaction and the purchase option funding is fully defeased "appears to serve as a virtual mental roadblock to any view that the purchase option would not be exercised," he said.

Monte A. Jackel of Monte A. Jackel Federal Tax Advisory Services LLC said, "I think that this case restored order to the universe." In applying a "reasonably likely" standard and rejecting an absolute certainty test in determining whether the purchase option would be exercised, "the Federal Circuit exercised common-sense judgment," he said.

"The result is what I would have expected to see in a sane world where a transaction is entered into predominantly for the tax benefits and would not have been entered into if those tax benefits did not exist," said Jackel.