Judicial Surprise

Appeals Court Decision Has Tax Credit Industry on Edge About Puts

A January 9 ruling by the U.S. Court of Appeals for the Federal Circuit has some tax credit industry participants worried about the use of put options in transactions utilizing federal historic rehabilitation and new markets tax credits. The ruling held that a tax shelter transaction did not have substance due to the "reasonable likelihood" that a purchase option would be exercised. The concern is that the presence of put options could spark audits of transactions by the Internal Revenue Service and that it may be prudent to drop or modify puts in historic and new markets transactions going forward.

The appeals court ruled in favor of the IRS – in its appeal of a U.S. Claims Court decision for the plaintiff – in an case involving a complex "lease in/lease out" (LILO) transaction between two utility companies that closed in December 1997. *(Consolidated Edison Company of New York, Inc. & Subsidiaries vs. U.S., No. 06-CV-305).* In such a transaction, a U.S. taxpayer enters into a long-term "head lease" (master lease) to acquire depreciable property from a non-U.S. taxpaying entity, and then subleases the same property back to the original owner.

The court said that the proper standard to apply in the current case to determine whether the transaction had substance for federal tax law purposes was the 'substance-over-form doctrine.'

Details of Transaction

In the transaction in question, Consolidated Edison Company of New York, Inc. and its subsidiaries (ConEd) entered into a set of agreements with a Dutch utility company (EZH) that owned and operated a gas-fired cogeneration plan (RoCa3 plant) in the Netherlands. ConEd leased an interest in the plant for 43.2 years from EZH and then subleased its interest back to EZH for 20.1 years. EZH entered into an agreement with ConEd to continue operating and maintaining the plant.

ConEd made an initial payment to EZH with equity and the proceeds of an interest-bearing bank loan that were deposited into two separate defeasance accounts. Monies in these accounts were to be simultaneously used for ConEd's payments to EZH under the head lease, for EZH's payments to ConEd under the sublease, and for repayments on the bank loan, such that no out-of-pocket payments were made by either party. At the end of the sublease term, EZH had an option to repurchase its original interest in the plant back from ConEd, using remaining funds in the defeasance accounts.

ConEd claimed tax deductions in 1997 for rent payments and loan interest. The IRS later disallowed the deductions and assessed deficiency payments. ConEd paid but filed an appeal with the federal Claims Court for a refund, and won. The U.S. Justice Department, representing the IRS, subsequently appealed to the Court of Appeals for the Federal Court.

In its appeal, the federal government's primary contention was that because EZH was reasonably likely to exercise the sublease purchase option, the purported head lease should not be treated as a true lease for federal tax purposes and that, as a result, the tax deductions that would flow from a true lease were not available to ConEd.

View by Court

The appeals court agreed, applying the same standard of reasonable likelihood that it had laid out in a previous decision *(Wells Fargo v. U.S., 641 F.3d 1319; Fed. Cir. 2011).* The court said that the proper standard to apply in the current case to determine whether the transaction had substance for federal tax law purposes was the "substance-over-form doctrine." Under this, courts determine the tax consequences of a transaction based on the underlying substance of the transaction rather than its legal form.

The court pointed out that "if the sublease purchase option were exercised, the transaction would merely become a transaction in which ConEd leased the RoCa3 Plant from EZH and leased it back for the same identical period. Such a transaction lacks substance. This would particularly be so here because EZH would maintain

Decision, continued on page 36

Decision, continued from page 34

uninterrupted use of the RoCa3 Plan without any involvement on ConEd's part and ConEd would not experience any benefits or burdens associated with its leasehold interest."

The lower court ruled that the transaction was valid because there was no certainty that the purchase option would be exercised, and that it satisfied the economic substance doctrine. The appeals court held that the former view was a mistaken interpretation of its position in the *Wells Fargo* decision. The appeals court didn't discuss, and the federal government appeal didn't challenge, the Claims Court ruling under the economic substance doctrine.

The court held that ConEd was not entitled to deductions for interest on the bank loan, concluding that "it is clear that the loan is not genuine."

Reaction to Ruling

Washington, D.C. tax attorney Jerry Breed, a partner at Bryan Cave LLP, said there are divergent opinions within the legal community as to how – and indeed whether – the ConEd decision should be applied to tax credit transactions. Breed believed that the ruling has implications for historic rehabilitation and new markets tax credit transactions with put options as they have typically been structured, and felt that puts in these transactions going forward may need to be dropped or modified.

In the typical historic or new markets tax credit transaction, there is a "put" option that gives the limited partner investor the right – but not the obligation – to sell its interest in the partnership (and underlying asset, such as a real estate project) to the general partner after the end of the tax credit compliance period for a predetermined price set at closing. If the investor fails to exercise the put, the general partner can exercise a "call" option to purchase the investor's interest for a price generally equal to current fair market value. The compliance period is five years for historic tax credits and seven years for new markets tax credits.

Breed said the "reasonable likelihood" standard applied by the court in *Consolidated Edison* is stiffer than the old standard in *Penn Dixie Steel Corp. v. Commissioner (69, T.C. 837, 1978)* that was "whether or not you were economically compelled to exercise the put."

Breed pointed out that there are significant differences in the facts and circumstances of the ConEd transaction and of typical historic tax credit transactions, such as financial risk, the construction of significant assets with equity from the transaction, and real cash changing hands between the two parties during the transaction.

At the same time, he felt that the ConEd decision – underscoring the impact from the previous *Historic Boardwalk Hall* opinion – is "certainly the nail in the coffin" to any further historic tax credit transactions that are structured upfront with reserves or other resources to secure the exercise of a put at the end of the transaction.

Breed suggested that legal practitioners and other parties in planning and structuring historic and new markets transactions be careful in how they document put options and communicate about them (by email, letter, etc.). He indicated that it would be unwise to use language that explicitly states or suggests an assumption that a put option will be exercised. Instead, he suggested language along the lines of what will happen "if" the option is exercised, and he recommended against including in the file for a deal a detailed analysis that specifies the circumstance under which the put will be exercised and the steps to be implemented to unwind the transaction unless such analysis was part of a general discussion of the entire universe of possible disposition scenarios, including exercise of the call option and retention of the interest until termination of the master lease or other concluding event.

For a variety of reasons, Breed felt the appeals court decision doesn't have applicability to low-income housing tax credit transactions.

John Leith-Tetrault, President of the National Trust Community Investment Corporation (NTCIC), an arm of the National Trust for Historic Preservation that syndicates historic and new markets tax credits, said NTCIC had made a change to one pending historic tax credit transaction so far as a result of the ConEd decision. In this transaction the put option was dropped after consultation with the investor and the concurrence of the developer. Leith-Tetrault noted, "We're looking at our exits for our different lines of business, and from investor to investor, to see what we want to do."

(Decision: http://tinyurl.com/ayv85lf) TCA