

2010-5108

UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

WELLS FARGO & COMPANY AND SUBSIDIARIES,

Plaintiff-Appellant,

v.

UNITED STATES,

Defendant-Appellee.

APPEAL FROM THE UNITED STATES COURT OF FEDERAL CLAIMS IN
CASE NO. 06-CV-628, JUDGE THOMAS WHEELER

BRIEF FOR PLAINTIFF-APPELLANT WELLS FARGO & COMPANY AND
SUBSIDIARIES

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UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

WELLS FARGO v. US

No. 2010-5108

CERTIFICATE OF INTEREST

Counsel for the Plaintiff-Appellant certifies the following (use "None" if applicable; use extra sheets if necessary):

1. The full name of every party or amicus represented by me is:

Wells Fargo & Company and Subsidiaries

2. The name of the real party in interest (if the party named in the caption is not the real party in interest) represented by me is:

None

3. All parent corporations and any publicly held companies that own 10 percent or more of the stock of the party or amicus curiae represented by me are:

None

4. The names of all law firms and the partners or associates that appeared for the party or amicus now represented by me in the trial court or agency or are expected to appear in this court are:

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Please Note: All questions must be answered

cc: Judith Hagley, DOJ

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BRIEF FOR APPELLANT WELLS FARGO & COMPANY

STATEMENT OF RELATED CASES

No appeal in this case was previously before any court. No case is pending in this Court or any other that will directly affect or be directly affected by this Court's decision in the pending appeal. Although not directly related, the following cases involving leasing transactions are pending in other courts: *Consolidated Edison Co. of N.Y. & Subsidiaries, Inc. v. U.S.*, 90 Fed. Cl. 228 (2009) (upholding lease-leaseback transaction); *Altria Group, Inc. v. U.S.*, No. 06-9430 (S.D.N.Y.) (jury verdict against taxpayer); *UnionBanCal Corp. & Subsidiaries v. U.S.*, No. 06-587 (Fed. Cl.) (pending lease-leaseback case); *John Hancock Life Insurance Co. and Subsidiaries v. Commissioner*, Nos. 6404-09 and 7084-10 (pending leveraged leasing case in the United States Tax Court).

JURISDICTIONAL STATEMENT

Wells Fargo ("Wells") timely filed a Federal income tax refund claim with the Internal Revenue Service ("IRS"). The IRS did not act on this claim within six months. *See* 26 U.S.C. §6532(a)(1).¹ Wells then filed a complaint in the United States Court of Federal Claims ("CFC"), which had jurisdiction under 28 U.S.C. §1491(a).

¹/Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as in effect in 1997-2002.

The CFC entered final judgment on February 19, 2010. JA1.² Wells timely filed a notice of appeal on April 15, 2010. JA50000. This Court has jurisdiction under 28 U.S.C. §1295(a)(3).

STATEMENT OF THE ISSUES

This appeal concerns sale-leaseback transactions in which Wells purchased and leased equipment as part of its leasing business. The following issues of law are presented:

(1) Longstanding case law and IRS rulings hold that a lease has objective economic substance if the lessor expects to make a pretax profit from its investment. These authorities use a “cash-in, cash-out” standard to measure pretax profit. *See, e.g., Consol. Edison*, 90 Fed. Cl. at 326. Under this standard, undisputed evidence shows that Wells expects to earn at least \$61 million in pretax profits from the transactions. In holding that the leases lack economic substance, did the CFC err by adopting a net present value pretax profit test instead of the established “cash-in, cash-out” standard? Argument, Part I.

(2) Transactions should be disregarded for tax purposes only when they are motivated “solely” by tax benefits, since tax considerations play a legitimate role in “nearly every business transaction.” *Frank Lyon Co. v. U.S.*, 435 U.S. 561, 580, 583-84 (1978). Wells entered into the disputed leases to earn a profit, generate earnings,

² /“JA” references are to record items in the joint appendix, and adjacent parentheses reference specific transcript pages.

receive tax benefits, and diversify its lease portfolio. In holding that Wells lacked a nontax business purpose for entering into the leases, did the CFC err in applying a standard that would invalidate all transactions in which tax benefits were an important, but not sole, consideration? Argument, Part II.

(3) Under established precedent, a lessor lacks the benefits and burdens of ownership in a lease if the lessee has a future option to purchase the equipment for a fixed amount that is nominal compared to the equipment's expected fair market value ("FMV") on the option's exercise date. *See, e.g., Lockhart Leasing Co. v. Comm'r*, 446 F.2d 269, 271-72 (10th Cir. 1971). In each disputed transaction, the purchase option price was set at an amount significantly exceeding the equipment's expected FMV on the option date. In holding that the lessees are certain to exercise their purchase options, did the CFC err in adopting a novel and unsupported methodology, which determines a unique equipment value for a particular lessee instead of the equipment's FMV? Argument, Part III.

STATEMENT OF THE CASE

The 26 transactions at issue fall into two categories. Seventeen involve sale-leasebacks initiated under a Federal policy, sponsored by the Federal Transit Administration ("FTA"), to provide funding to public transit agencies. *See* Facts, §E. Nine others are sale-leasebacks of "qualified technological equipment" ("QTE"), as defined by §168(i)(2).

Wells claims tax deductions for depreciation, §§167(a), 168, interest on acquisition indebtedness, §163(a), and amortization of transaction expenses, §167, with respect to its leveraged leasing transactions. The IRS examined Wells's 2002 tax year and disallowed deductions related to the disputed transactions. Wells filed suit in the CFC seeking refunds for the disallowed deductions.

To simplify the trial, the parties presented evidence on six "Trial Transactions." Four of these (the "Transit Transactions") are sale-leasebacks of transit equipment, specifically:

- Washington Metropolitan Area Transit Authority ("WMATA") (2002) (railcars)
- Metropolitan Transit Authority of Harris County, Texas ("Houston Metro") (2002) (buses)
- California Department of Transportation ("Caltrans") (2001) (railcars and locomotives)
- New Jersey Transit ("NJT") (2001) (railcars)

The remaining two Trial Transactions involved 1997 sale-leasebacks of QTE with Belgacom, a Belgian telecommunications company.

The CFC issued its opinion on January 8, 2010, denying Wells's refund claim. 91 Fed. Cl. 35 (2010). JA4-74. Without waiving the right to appeal, the parties agreed that the CFC's opinion controlled the remaining 20 transactions. JA2.

The U.S. will refer to the Trial Transactions as "sale-in, lease-out" transactions, or "SILOs," a label the IRS invented. JA4003(1271). A "SILO" is just another name for a sale-leaseback, a structure the Supreme Court has specifically approved. *Frank Lyon*, 435 U.S. 561.

STATEMENT OF FACTS

A. Overview of the Leasing Business

Wells engages in the business of leasing equipment to earn a profit. Wells earns a profit when its revenues from rental income and the residual value of the property at the end of the lease exceed its costs, which include its cash investment, debt service, and transaction costs. Generally Accepted Accounting Principles (“GAAP”) provide a favorable method for reporting the profit from leveraged leases by “front-loading” the expected minimum profits into the early years of the lease, providing Wells with an 11-13% pretax accounting return on the disputed leases. JA21185(n.3).

Leveraged leases also produce tax deductions from equipment depreciation and interest deductions on the debt incurred to buy the equipment. These tax benefits are temporary and reverse during the later years of the lease as depreciation benefits expire, the loan is paid off, and the lessor pays taxes on rent and income from the property after the lease ends. Thus, the lessor’s cumulative profit for tax purposes matches its cash profit. These temporary tax benefits are “normal and expected,” *Consol. Edison*, 90 Fed. Cl. at 234, and are an important part of the economics of leveraged leasing. JA7638(3811-13).

The tax benefits associated with leveraged leasing have engendered decades of litigation concerning whether a transaction should be treated as a “true lease” that allows the lessor to claim tax benefits. *See Consol. Edison*, 90 Fed. Cl. at 268-70 (collecting cases). The IRS has also promulgated “safe haven” rules that define a “true

lease.” *See* Facts, §E; Argument Part I.A.2. There is thus a substantial body of law defining a “true lease.”

Three principles from this body of law are at issue here. First, leasing transactions must have objective “economic substance,” defined as a “change in the flow of economic benefits” that appreciably affects the taxpayer’s beneficial interests. *Coltec Indus., Inc. v. U.S.*, 454 F.3d 1340, 1360 (Fed. Cir. 2006). A lease has “economic substance” when the lessor can reasonably expect to earn a pretax profit from the lease. *Consol. Edison*, 90 Fed. Cl. at 268-69 (collecting cases).

Second, a leasing transaction must have a subjective “business purpose” aside from reducing taxes. *Coltec*, 454 F.3d at 1355. In a lease that is reasonably expected to produce a pretax profit, the lessor necessarily has a “business purpose” other than claiming tax deductions. *Estate of Thomas v. Comm’r*, 84 T.C. 412, 437, 440 n.52 (1985).

Finally, a lessor must have the “benefits and burdens of ownership” with respect to the leased property. This requirement is satisfied when the term of the lease is significantly shorter than the useful life of the property, so that the lessor will be directly exposed to the possibility of gain or loss from the property after the lease ends. The IRS generally requires a 20% residual life after the lease ends, but case law has allowed shorter periods. *Consol. Edison*, 90 Fed. Cl. at 297-98.

Leases often include fixed price purchase options, which allow a lessee to purchase the equipment at the end of the lease. These options are consistent with the

lessor's ownership interest in the property, unless the fixed price is nominal compared to the property's FMV. *See, e.g., Lockhart*, 446 F.2d at 271-72.

Wells carefully structured all of its leases to comply with this body of law. *See* JA4468(1806-07). Wells entered into its leveraged leases, including the transactions at issue, by purchasing equipment from lessees using its own equity and the proceeds of a nonrecourse loan from an independent lender. Wells paid each lessee an amount equal to the equipment's FMV in exchange for a property interest in the equipment exceeding its useful life.

Wells then leased the equipment back to the lessees for terms significantly shorter than the equipment's useful life, during which the lessees must comply with standard leasing terms, including paying rent. A lessee's failure to comply with these obligations may result in Wells repossessing the equipment and/or demanding a termination payment, which are standard leasing remedies. If no premature termination occurs, a lessee will return the equipment to Wells at the end of the leaseback (unless the lessee has elected to exercise its purchase option), at which point Wells may derive additional profit, or may incur a loss, from the equipment.

B. Wells's Leasing Business

Wells provides banking and financial services, and has engaged in the leasing business since the early 1970s.³ Through Wells Fargo Equipment Finance, Inc.

³/Before 1998, Wells's predecessor, Norwest Corporation, conducted the leasing business.

(“WFEFI”), Wells provides equipment financing to customers via loans and leases. JA2019(80). As of December 31, 2001, WFEFI’s equipment finance portfolio (excluding affordable housing) exceeded \$5.5 billion, and its leveraged leasing portfolio included \$878 million in assets. JA10917.

WFEFI entered into leveraged leases, including the Trial Transactions, in its normal course of business. A “leveraged lease” has three principal parties: a lessor that purchases the leased asset by combining its own equity with the proceeds from a nonrecourse loan; a long-term creditor that makes the nonrecourse loan to the lessor; and a lessee. Comptroller of the Currency, Lease Financing at 11 (1998) (“OCC Handbook”).⁴

A sale-leaseback is a lease in which the lessor purchases the asset from the lessee, then leases it back to the lessee through “complementary and interlocking agreements.” *Frank Lyon*, 435 U.S. at 565. Sale-leasebacks allow lessees to raise funds while retaining use of the equipment at a lower cost than owning it. OCC Handbook 1; JA20688. Sale-leasebacks are cheaper than owning equipment when the sales price received by the lessee exceeds the costs it incurs under the leaseback. JA4063(1510-11), JA6007-08(2623-27), JA20688-89; see Shrank & Gough, *Equipment Leasing-*

⁴/The OCC Handbook provides bank examiners with guidelines for reviewing the leasing activities of national banks.

Leveraged Leasing, 6-4 (“*Equipment Leasing*”).⁵ The FTA described this excess as the lessee’s “net benefit” from the lease. JA10710.

Leasing is often cheaper than owning because the lessor shares its tax benefits of ownership with the lessee by charging rents lower than the lessee’s cost of borrowing. OCC Handbook 1, 11; *Equipment Leasing*, 4-7, 6-4; JA20688-89, JA6007-08(2624-25), JA7659(3898). Therefore, as the U.S.’s leasing expert confirmed, lessors must be able to utilize the tax benefits of ownership, i.e., have “tax capacity,” to pass part of these benefits to lessees through lower rentals. JA7638(3811-13).

Leasing property to *tax-exempt* entities is allowed by the tax code, but with reduced annual depreciation deductions for the lessor. §168(g), (h). WFEFI must therefore use longer depreciable lives and straight-line cost recovery for the Transit Transactions, reducing its net deductions. JA7660(3899-3900). For example, in the first full year of the Caltrans transaction, WFEFI’s depreciation deductions were limited to only 3% of its equipment cost. JA15173, JA15184, JA15200, JA15209. By comparison, WFEFI entered into a lease with Union Pacific (a taxable entity) the same year, and was entitled to depreciation deductions of over 24% of equipment cost in the first full year. JA10861, JA10892, JA6047(2782-83). The QTE leases also provide reduced depreciation deductions because WFEFI must use straight-line depreciation since Belgacom is exempt from U.S. tax. §168(g),(h).

⁵/*Equipment Leasing* was recognized as a learned treatise at trial. JA6019(2669-70).

C. Leasing Is Integral to the Banking Business

Leasing is a natural extension of Wells's financing business. JA7641. Banks have engaged in leasing since 1963, when the Office of the Comptroller of the Currency ("OCC") ruled that leasing is "necessary to the business of banking." Fed. Banking L. Rep. ¶93,770 (March 18, 1963). Banks have leased a wide variety of assets. JA7613(3712-13). In 2003, banks were responsible for about 44% of all equipment placed in service via leasing. JA20681.

Federal banking authorities regulate banks engaged in leasing. For example, the OCC prohibits banks from engaging in leases unless they are "net leases," i.e., leases in which the lessee is responsible for maintaining and insuring the equipment. 12 C.F.R. §§23.2(f), 23.3(a).

From a bank's standpoint, the principal difference between a lease and a loan is that in a lease, the bank continues to own the asset after the lease ends and is exposed to changes in the asset's value during this period ("residual value period"). JA2019-20(80-81). No ownership of residual value occurs in a loan. Residual value risk is thus the defining characteristic of a "true lease" for tax purposes. *Equipment Leasing*, 2-15; Argument, Part III.

WFEFI enters into leases to earn a profit, or "earnings," for financial reporting purposes. It would not "do deals unless there's earnings." JA4842(1989), JA4405(1554). Each Trial Transactions is expected to produce millions of dollars in pretax profit, which Wells must report under the favorable GAAP accounting rules

promulgated by the Financial Accounting Standards Board (“FASB”). FAS 13, adopted in 1976, mandates the method of reporting earnings from leveraged leases. JA6453(3085-86). A lessor’s cumulative FAS 13 earnings are attributable solely to pretax cash profits, and do not include any net tax benefits. JA6464(3131), JA8006(3948-49). After taxes are imposed on these earnings, the remaining net income is equal to the after-tax book earnings from the lease. A lease that produces only tax deductions and no expectation of pretax profit would neither provide any FAS 13 earnings nor constitute a leveraged lease under FAS 13. JA4418(1606).

FAS 13 requires that the cumulative pretax and after-tax profits of a leveraged lease be accelerated, or “front-loaded,” into the early years of the lease. JA6802(3143). FASB determined that this method best reflected the profits of a leveraged lease. JA6460(3115-16). “Front-loading” profits provides a favorable pattern of earnings, which the U.S.’s leasing expert acknowledged is “one of the reasons” banks find leveraged leasing attractive. JA8006(3947-48). The U.S.’s leasing expert agreed that the Trial Transactions qualify for this “front-loading” of earnings. JA8006(3948).

D. Diversifying Wells’s Leasing Business

Before 1990, WFEF’s leveraged leasing focused on Class I rail (major freight railroads like Union Pacific and Burlington Northern), aircraft, and manufacturing equipment. In 1990, WFEFI added new personnel to expand and diversify its leveraged leasing business to avoid the risks associated with overconcentration in a particular asset. JA8005(3944-45). The new management had computer leasing

experience to facilitate expansion into that field. They established parameters for expanding WFEFI's leveraged leasing business, including standards for credit quality, equipment, yield/return, and concentration limits. JA10834-35, JA10905-09. The 1997 Trial Transactions with Belgacom were a direct result of WFEFI's plan to diversify its portfolio by investing in high-tech equipment. JA4840-41(1981-82).

From 1998-2000, however, WFEFI's lease portfolio was still concentrated in Class I railcars and aircraft. JA4058. To monitor its portfolio, WFEFI developed "pipeline reports" containing information on every proposed transaction. JA4403-4404(1547-50), JA10847-57. WFEFI rejected proposed leases—including leases the IRS would label "SILOs"—that did not fit its investment objectives because of concentration concerns, the asset involved, or the lessee's location. JA4057(1487-88), JA4064(1514), JA4066-67(1523-26), JA10848, JA10851, JA11009-11. Had tax benefits been WFEFI's "sole" consideration, it would not have taken such considerations into account. *See* JA4063-64(1519-22).

Concentration concerns led WFEFI to pursue leases involving passenger rail equipment, which used WFEFI's rail experience while providing diversification. JA4057-58(1486-90). WFEFI's first passenger rail leveraged lease was with Amtrak in 1999, which the IRS never challenged even though it is a "SILO" under the IRS definition. JA4058(1489).

E. The Federal Government Promoted Leveraged Leasing of U.S. Transit Assets

WFEFI's desire to diversify its leasing portfolio coincided with the FTA's policy of encouraging state and local transit agencies to engage in leasing to stretch scarce federal funding. Transit agencies depend on federal grants because farebox revenues are insufficient to fund their operations. JA3253(955). The FTA supported leveraged leasing to supplement these grants.

From 1995-2003, the FTA promoted leveraged leasing through presentations at conferences attended by banks and transit agencies and in other ways. JA2860. In 1998, it distributed a handbook that highlighted sale-leasebacks as a financing technique for transit systems. JA10681, JA10683, JA10712. WFEFI and its lessees were familiar with the FTA's policy. JA3253-54(956-59), JA3639-40(1170-72), JA4420-22(1615-21), JA4427-28(1641-44).

A transit agency needed FTA approval before entering into a sale-leaseback of assets purchased with FTA funds. JA2862(706), JA11295. The FTA sought to ensure that a transaction would create a sufficient "net benefit" for the transit agency. JA10710, JA10716, JA11298.

The FTA recognized that a leveraged lease would present risks to a transit agency. A default under the lease could result in the lessor either repossessing the assets, JA2866-67(725-26), or requiring the agency to pay a termination value that significantly exceeded its benefit from the transaction. JA2866(724). *See Hoosier Energy*

Rural Elec. Coop., Inc. v. John Hancock Life Ins. Co., 582 F.3d 721, 726 (7th Cir. 2009) (“SILO” termination resulting in potential bankruptcy of lessee). This payment could be three to six times a lessee’s net benefit, causing a catastrophic loss. JA2869(736), JA18239-40.

The FTA sought to mitigate these risks by requiring that each transit agency have the financial stability to survive a default, and defease its lease obligations. JA10715. A defeasance is a deposit of funds by the lessee as collateral that, with interest, will be sufficient to meet the lessee’s future obligations, including rent. The head of the FTA’s leasing program testified that defeasance was a “de facto” requirement for all leasing transactions. JA2867(728), JA19800 (“FTA *always* requires economic defeasance”) (original emphasis), JA3616(1079). The lessees in the Transit Transactions complied with the FTA’s mandate, which they perceived as beneficial because the defeasance mitigated their risks. JA3230(861), JA3233(874-75), JA3256(966-68); *see* JA3623(1105-06) (defeasance required by California law).⁶ Defeasance funds are treated as the transit agencies’ funds because they are used as collateral for, but do not reduce, the transit agencies’ obligations. *Consol. Edison*, 90 Fed. Cl. at 305. In fact, a default by a WFEFI lessee would result in catastrophic loss. This occurred in *Hoosier*, where the lessee hoped to receive a net benefit of \$21 million but was required to pay back \$120 million. 582 F.3d at 724.

⁶/In the Belgacom transaction, Belgacom’s defeasance funds protected it against currency risk. JA6040(2755-56), JA20730-33. *See Consol. Edison*, 90 Fed. Cl. at 243 (defeasance funds mitigate currency risk).

Moreover, the defeasance funds are returned to the lessees once their obligations under the lease are satisfied, including if they forgo their purchase options. This would increase the lessees' financial benefit from entering into the leases, JA3235(862), JA3251(945), because they keep these funds and use them for any purpose they desire. For example, a lessee could use these funds to buy replacement equipment. JA8018(3995), JA8012-13(3973-76).

The FTA understood that a transit agency's sale of equipment to a taxable U.S. lessor entitled the lessor to take tax deductions. In 1993, when an Indiana transit agency proposed a sale-leaseback, the FTA met with the Department of the Treasury to obtain "guidance with respect to the IRS' view of the transaction." JA11907, JA3205-06(764-67). In July 1993, the IRS sent a letter to the FTA, JA26477-81, highlighting a series of IRS rulings commonly referred to as the "Leasing Guidelines." *Equipment Leasing*, 4-18-4-19. The IRS "Leasing Guidelines," contained in Revenue Procedure 75-21 and Revenue Procedure 75-28, are a safe haven for determining whether a leasing transaction should be respected as a "true lease" for tax purposes.

The IRS's letter to the FTA described the requirements that a lease must meet to pass IRS muster, including that the lease produce an "economic profit," defined as an "excess of the rent plus the anticipated residual value...over the debt service." JA26479. The IRS did not apply a "present value" test to measure this economic profit. Following this advice, the FTA imposed a "tax positive" requirement, requiring proof that the transaction would create a pretax profit on a "cash-in, cash-out basis,"

JA2865(719-21), JA11373, and analyzed proposed transactions to ensure they qualified as “true leases.” JA11383. The IRS also highlighted rulings requiring that any purchase option must be set at a price that would not compel the transit agency to exercise the option. JA26480. The FTA followed this advice by reviewing transactions to confirm that lessees would not be compelled to exercise their purchase options. JA11390-92.

The FTA’s leasing program was a successful Federal government initiative, raising \$1.05 billion for transit agencies. JA11291-92.

F. WFEFI’s Transit Sale-Leasebacks

In 2000, WFEFI began making additional passenger rail investments in California. Wells was headquartered in California and initially desired to stay within this business “footprint.” JA2025(103-04), JA4058(1490-91), JA10848 (rejecting lease “[o]ut of WF footprint” and approving lease in California). In 2001, Wells began reviewing passenger rail investments outside of California to diversify geographically. JA4061(1502-03). During 2001 and 2002, WFEFI entered into three Trial Transactions of passenger rail equipment, the Washington Metropolitan Area Transit Authority, Caltrans, and NJT transactions. JA4048-49(1451-53). WFEFI also began considering sale-leasebacks of buses with transit agencies. JA4061-62(1504-05), JA10852. WFEFI already owned a lease portfolio of buses, so leasing buses would build on its existing leasing experience. *Id.*

In 2002, WFEFI entered the final Trial Transaction, a sale-leaseback of buses with Houston Metro. Three of the four Transit Transactions (WMATA, Houston Metro, and NJT) required FTA review and approval.⁷

WFEFI rejected for business reasons 40% of all leveraged leases presented to it in 2002, including 13 leases the U.S. would characterize as “SILOs.” JA4065-66(1519-22), JA11009. For example, WFEFI rejected a leveraged lease of buses with NJT because the Houston Metro lease had filled its annual limit for buses. JA11010.

In each Transit Transaction, the lessee has an option to buy the equipment at the end of the lease term. If the lessee does not exercise this option, WFEFI may require the lessee to enter into a service contract for a limited term. Alternatively, the original lessee has the option to locate a new entity to enter into the service contract, ridding itself of all future obligations. Under a service contract, WFEFI would use its equipment (most likely through an operator) to provide transit service to the original lessee or another party designated by the lessee (“service recipient”) for a fee.

When the service contract ends, the equipment is expected to retain significant value, which WFEFI can exploit through a lease or sale. (WFEFI could also exploit the equipment’s value through lease or sale at the end of the lease by foregoing its service contract option.) WFEFI would reap any profit or suffer any loss from

⁷/The Caltrans sale-leaseback did not require FTA approval because the equipment was not purchased with FTA funds. The State of California, however, also encouraged sale-leasebacks and applied requirements similar to those imposed by the FTA. JA4005(1279-80). In particular, California required defeasance of Caltrans’ obligations. JA3623(1105).

fluctuations in the equipment's value during this residual period at the end of the service contract (or lease). The length of the combined lease and service contract period is less than 80% of the equipment's remaining economic useful life as of closing. Therefore, even if WFEFI elects the service contract, it will still be exposed to substantial residual risk during the 20% residual period, which satisfies the IRS's Leasing Guidelines' requirement.

Service contracts are commonly used in the transit industry—NJT, Houston Metro, and Caltrans all use service contracts in their operations, and WMATA is authorized to do so. JA3234(878-79), JA3258(975-76), JA3624(1108-09), JA3643-44(1187-88), JA19675. WFEFI considered service contracts an additional means of exploiting the equipment's residual value when the lease ends. JA4059(1493-94), JA4460-61(1775-76).

In 1984, Congress adopted rules distinguishing leases from service contracts. §7701(e); General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 47, 59 (“General Explanation”). The principal difference between a “lease” and a “service contract” relates to the risk of loss with respect to the equipment used in the contract. §7701(e)(1)(D). Leveraged leases typically contain “hell-or-high-water” provisions in which the lessor's compensation is fixed during the lease term, regardless of the equipment's condition. *Equipment Leasing*, 29-90. In service contracts, however, the service provider does not get paid if services are not performed. Thus, during a service contract, WFEFI is responsible for any losses

attributable to the condition of the equipment. If, due to equipment failures or other problems, service is delayed, WFEFI's income will be reduced. JA6059(2831-32).

Furthermore, if equipment failures, accidents, strikes, or other incidents leave WFEFI unable to provide service, its fees will not be paid. *Id.* Thus, not only is WFEFI exposed to substantial residual value risk after any service contract (if elected), it also remains exposed to asset risk during the service contract to a greater degree than if the lease simply continued through the service contract term. These transactions therefore present more asset risk for Wells than traditional leveraged leases.

G. The Trial Transactions Are the Result of a Competitive Bidding Process

The bidding process in the Trial Transactions was the same process used for all of WFEFI's leveraged leases. Potential lessees initiate transactions by sending requests for proposals to potential equity investors. JA7638-40(3813-22), JA13627-32. Equity investors evaluate the transaction and make a bid if they are interested. WFEFI declined to bid on proposed transactions that did not meet its objectives. JA4065-66(1519-22), JA10847-57, JA11006-08.

WFEFI's bids contained its proposed economic terms. JA4404-05(1550-52). Terms were negotiated through several bidding rounds, which pitted bidders against each other. Lessees selected the bid that provided the most favorable economics, including purchase price and rents. JA4061(1501-02), JA4404-05(1550-53). WFEFI

lost bids, including for “SILO” transactions, when its proposed economic terms were less favorable than those of other potential investors. JA4404(1549-50), JA11010.

The CFC’s statement that “all parties” benefitted from a higher sales price is thus contrary to the record. JA22. If the CFC’s claim were correct, WFEFI could have simply outbid the competition. The record shows it was unwilling to do so. JA4065-66(1520-22).⁸

H. WFEFI Conducted Extensive Due Diligence on the Trial Transactions

For all leveraged leases, WFEFI undertook extensive due diligence before closing the transaction. JA4405-07(1555-61). WFEFI prepared a Credit Approval Presentation (“CAP”) for each transaction summarizing its analysis. JA12038-43, JA13687-739, JA15060-156, JA16549-653, JA18111-88. CAPs contain detailed information on each transaction, including a financial analysis of the lessee and financial guarantors. JA2053(216), JA2056-57(228-29).

1. WFEFI Reviewed the Trial Transactions’ Economics

WFEFI reviewed each Trial Transaction to ensure its expected profit, which was WFEFI’s most important consideration. JA4842(1989), JA4405(1554). WFEFI used industry standard software that took into account the terms of each transaction

⁸/The CFC states that the NJT equipment had been purchased for \$144 million, but was sold by NJT for \$160 million. JA71. Testimony established this difference was from NJT’s design costs, financing costs, and other “soft costs” properly included in the equipment’s FMV. JA3619(1089), JA4023-24(1350-53). Significantly, the U.S. presented no testimony questioning WFEFI’s appraisers’ valuation of the property.

and projected FAS 13 pretax profit, taxes, after-tax profit, and corresponding yield for several different scenarios. *See* JA4417(1600).

Under each scenario, regardless of which option is selected, WFEFI expects to earn a “profit from the transaction” as that term is defined in the IRS’s Leasing Guidelines. For example, in the NJT transaction, WFEFI invested \$13,341,084.76 (including transaction costs) and borrowed \$60,650,607.24. JA13750. If WFEFI elects the service contract option, it expects to receive \$252,489,545.98 in rent and service contract fees. JA13761 (“Rent” column). This revenue will exceed WFEFI’s debt service (\$218,334,497.71 (“Debt Service” column)) by \$34,155,048 (“Free Cash” column). This “Free Cash” will exceed WFEFI’s equity investment by \$20,813,964, which represents pretax profit. JA13762 (“Before Tax Cash” column). WFEFI will pay \$7,853,108 in tax on this profit, leaving it with \$12,960,855 in after-tax profit. (“Taxes Saved (Paid)” and “After Tax Cash” columns). Similar analyses for the remaining Trial Transactions prove each is profitable. JA12101-04, JA16691, JA16720, JA16749, JA18203, JA18227.

The NJT pricing runs demonstrate how WFEFI’s pretax and after-tax profits are reported for purposes of FAS 13. The bulk of the pretax profit is allocated to 2001-2018, although some is deferred to 2030-2036. JA13766-67 (“Pre-Tax Income” column). Under FAS 13, the after-tax rate of return on the NJT lease is 7.42960%, *id.* (“Cash Flow Allocated to Income at 7.42960%” column), and the pretax rate of

return is 11.93%. JA13767, JA21185. Cumulative book profit equals total expected pretax profit.

The NJT service contract (if elected) would expire on February 1, 2036, at which time the railcars will have remaining useful lives of 9 years (20% of their original expected useful lives). During these 9 years, WFEFI could earn additional profit from selling, leasing, or using the cars and also faces a risk of loss if the expenses attributable to the railcars exceed their income. Actual useful lives may also be shorter or longer than anticipated, exposing WFEFI to additional financial risk and opportunity as owner.

Undisputed evidence demonstrates that the total pretax profits for all the Trial Transactions would be **\$61,554,016** if the lessees exercise their purchase options. If WFEFI exercises its service contract options in the Transit Transactions, this profit would be **\$82,844,008** (assuming WFEFI performed its obligations under the service contract and before counting any gain or loss during the residual value period). JA30390-92.

2. WFEFI Ensured that the Trial Transactions Complied with the Leasing Guidelines

WFEFI wanted to be careful that its leases complied with the IRS's Leasing Guidelines. JA4468(1806-07), JA4822(1907). Thus, as it does for all leveraged leases, it obtained independent appraisals of the equipment in each transaction, JA4409(1568), JA13178-252, JA14143-256, JA15223-352, JA16752-17000, JA18241-589, selecting

appraisers who satisfied the Leasing Guidelines' requirement of "a qualified expert who has professional knowledge of the type of property subject to the lease." Rev. Proc. 75-28, §4.02.6; JA5639(2473-74), JA7658(3892-93), JA14250. Performing extensive due diligence, these appraisers assessed the equipment's FMV and remaining useful life, and analyzed whether the lessee would be compelled to exercise the purchase option by comparing the purchase option price to the expected FMV of the equipment as of the exercise date. JA4408-09(1567-68), JA8006(3949). For example, the purchase option price in the NJT transaction was \$123,477,355 and the equipment's projected FMV was \$97,100,201 as of the option date. JA13750. The appraisers also compared the purchase option price to the lessees' costs of foregoing the option (including the FMV of the equipment interest given up) and concluded that the purchase option price exceeded the costs of foregoing the option and therefore the lessees were not compelled to exercise the purchase option. JA13209-16, JA14184-86, JA15277-80, JA16802-05, JA18295-98. WFEFI therefore understood that NJT (and WFEFI's other lessees) would not be under any compulsion to exercise their purchase options.

In addition, to comply with the Leasing Guidelines, WFEFI also ensured that (1) its equity investments were consistent with the 20% equity investment requirement, Rev. Proc. 75-21, §4(1)(A); (2) its leases, including service contract periods, did not exceed 80% of the equipment's useful life, ensuring that Wells maintained a significant residual interest in the property, *id.* at §4(1)(C); and (3) it

expected to receive an economic profit as defined in Rev. Proc. 75-28, §4.07 and Rev. Proc. 75-21, §4(6).

I. The CFC's Decision

Despite these extensive efforts to ensure compliance with IRS standards, the CFC held that Wells Fargo was not entitled to the claimed tax deductions for three reasons. First, the Trial Transactions lack economic substance because they “provide no reasonable possibility of profit” aside from tax deductions. JA70. The parties are in agreement, however, that WFEFI’s pretax revenues from each Trial Transaction will exceed its costs by millions of dollars, thus producing significant pretax profit. The CFC’s conclusion that the Trial Transactions cannot produce a profit results solely from its application of two benchmark rate of return analyses (“net present value” (“NPV”) and “nominal accounting profits”) to artificially reduce these pretax profits. JA69.

Second, the CFC held that the Trial Transactions do not have a “business purpose” since WFEFI “would not have entered into” the Trial Transactions “[w]ithout the claimed tax benefits.” JA70. In addition to applying an incorrect legal standard, the CFC acknowledged that lessors are “motivated in part by the...earnings available under accepted accounting procedures,” JA18, and thus acknowledged that WFEFI had motives other than claiming tax benefits.

Finally, the CFC concluded, WFEFI’s lessees are “virtually certain” to exercise their purchase options at the end of their respective leases, depriving WFEFI of the

risks and benefits of ownership. JA50. The CFC relied on an “economic analysis” prepared by Thomas Lys that was not based on the expected FMV of the leased equipment, but was instead based on a method that purportedly measured the unique value of the equipment to each particular lessee. JA51. The evidence at trial proved that Lys’s methodology has absolutely no support in Lys’s field of expertise.

SUMMARY OF THE ARGUMENT

In October 2009, the CFC decided *Consolidated Edison*. 90 Fed. Cl. 228. Wells’s case and Consolidated Edison’s case are similar:

- both involve leveraged leases with similar levels of pretax profit;
- in both, lessors retain significant residual interests following expiration of the lease;
- in both, expert testimony from both sides established that the lessees are not certain to exercise their purchase options, creating residual risk for the lessor;
- both include significant due diligence by the taxpayer;
- both involve lessors diversifying into new asset classes as a result of the regulatory and business environment; and
- like all leveraged leases, both involve temporary tax benefits.

Nevertheless, the courts in *Consolidated Edison* and *Wells Fargo* reached opposite results, with Judge Horn ruling for the taxpayer in *Consolidated Edison* and Judge Wheeler ruling for the U.S. in *Wells Fargo*. These divergent results are attributable to the court’s failure in *Wells Fargo* to apply the settled legal principles followed by the court in *Consolidated Edison*.

First, the *Wells Fargo* court erred as a matter of law when it held that, in applying the economic substance doctrine, the pretax profits that WFEFI expects to earn should be in excess of a benchmark rate of return using an NPV analysis. This holding is contrary to well-established precedent (followed by the court in *Consolidated Edison*) that rejects the NPV analysis for measuring a lease's pretax profit. Argument, Part I.

Second, the *Wells Fargo* court erroneously held that WFEFI's leveraged leases lack a business purpose because WFEFI would not have entered into these leases "but for" the availability of temporary tax benefits. This holding violates longstanding precedent permitting taxpayers to take tax considerations into account when making business decisions, so long as they are not the taxpayer's "sole" motivation. *Consol. Edison*, 90 Fed. Cl. at 267, 311-13; see *Frank Lyon*, 435 U.S. at 580, 583-84; *Coltec*, 454 F.3d at 1355, 1357. In contrast, the *Consolidated Edison* court applied the correct standard, holding that Consolidated Edison's investment had business purpose even though it was partially motivated by tax considerations. *Consol. Edison*, 90 Fed. Cl. at 311. Argument, Part II.

Third, the *Wells Fargo* court wrongly held that WFEFI's leases are not leases in substance, based on its legally erroneous conclusion that WFEFI's lessees are certain to exercise their purchase options. In making that determination, the court departed from settled precedent, which establishes that the correct analysis asks whether the option price is so far below the expected FMV of the property that the lessee will be

economically compelled to exercise the option. Rather than follow this settled law, the CFC relied solely on Lys's expert testimony. Lys conceded that he did not calculate the FMV of the leased property, as required by governing case law, but instead calculated a unique value of the property for each specific lessee, directly contrary to accepted practice in his field. The court ignored the testimony of other expert witnesses, including witnesses for the U.S., who agreed that the purchase options are not certain of exercise, and of the lessees, who confirmed that the uncertainty of future conditions precluded them from predicting whether they would exercise their options. Argument, Part III.

Finally, the *Wells Fargo* court erred by relying on the presence of ordinary lease features, such as net leases, in holding that the substance of the leases differed from their form. JA64. Its ruling departed from prior precedent, which establishes that net lease provisions are typical. *Consol. Edison*, 90 Fed. Cl. at 270, 300; see *Frank Lyon*, 435 U.S. at 567. The court's opinion also contravenes Federal banking law, which *requires* Wells to use net leases. Argument, Part III.E.

As a matter of law, each of the Trial Transactions fully complied with the requirements establishing their status as "true leases" for tax purposes. Wells's refund claims should therefore be granted.

ARGUMENT

STANDARD OF REVIEW

The characterization for tax purposes of the 26 transactions at issue is a question of law subject to *de novo* review. *Frank Lyon*, 435 U.S. at 581 n.16 (characterization of a sale-leaseback for tax purposes is a matter of law).

I. The Trial Transactions Have Economic Substance

In *Frank Lyon*, which also involved a sale-leaseback, the Supreme Court held that a transaction has economic substance when it is “compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped *solely* by tax-avoidance features that have meaningless labels attached.” 435 U.S. at 583-84 (emphasis added). Since *Frank Lyon*, courts reviewing leasing transactions uniformly have held that the presence of a pretax profit is proof of economic substance. *See, e.g., Johnson v. United States*, 11 Cl. Ct. 17, 25-26 (1986) (“a mere ‘modicum’” of profit will satisfy the “economic substance” test); *Estate of Thomas*, 84 T.C at 438-39.

The CFC concluded that the Trial Transactions lack economic substance because they “produce an overall loss without the tax benefits.” JA7. The undisputed evidence proves, however, that the Trial Transactions will produce at least \$61,554,016 in pretax profit, resulting in \$23,224,331 in additional income tax. JA30171. The CFC’s conclusion results from its application of NPV and “nominal accounting profits” methods to measure WFEFI’s pretax profits. JA7, JA52. Both

methods involve comparing the pretax profits from the Trial Transactions to a “benchmark” rate of return. For instance, under the NPV method adopted by the CFC, future cash flows are discounted to present value using a “benchmark” rate of return. Thus, if the cumulative cash flows do not exceed the “benchmark,” the Trial Transactions are deemed to have produced a “loss.” *But see Johnson*, 11 Cl. Ct. at 36 (rejecting the NPV method). Such methods are contrary to decades of settled law and leasing authorities, and GAAP as applied to leveraged leases.

A. The Trial Transactions Are Expected to Produce a Pretax Profit

Courts have universally held that a leasing transaction has economic substance when a lessor can expect to receive a positive, pretax net cash flow from the transaction on a “cash-in, cash-out” basis, i.e., its cash receipts from rental income and residual value exceed its cash disbursements, including its cash investment and debt payments. This standard has been followed in the case law, the IRS’s published and private rulings, the advice the IRS gave to the FTA, and GAAP.

1. Case Law Has Followed the “Cash-In, Cash-Out” Standard

For decades, courts consistently have used the “cash-in, cash-out” standard for measuring profit from leasing transactions. *See, e.g., Torres v. Comm’r*, 88 T.C. 702, 719 (1987) (projected rent exceeds “up front cash payments”); *Mukerji v. Comm’r*, 87 T.C. 926, 968 (1986) (taxpayers will “at least recoup their initial cash investment”); *Estate of*

Thomas, 84 T.C. at 433 (predicted residual value “would have enabled the Partnership to recoup its original cash investment and to break even”); *see also Gilman v. Comm’r*, 933 F.2d 143, 147 n.4 (2d Cir. 1991) (taxpayer lost because cash receipts unlikely to exceed cash investment).⁹ *Cf. Jade Trading, LLC v. U.S.*, 598 F.3d 1372, 1377, n.6 (Fed. Cir. 2010) (non-lease lacked economic substance because not profitable on “cash-in, cash-out” basis).

Most recently, *Consolidated Edison* applied the “cash-in, cash-out” formula for measuring pretax profit:

In order to produce a pretax profit, [plaintiff/lessor] must realize shared rent and residual value in excess of ... the amount of its negative cash flow from the sale and leaseback transaction.

Consol. Edison, 90 Fed. Cl. at 326 (quoting *Emershaw v. Comm’r*, 59 T.C.M. (CCH) 621, 625 (1990), *aff’d*, 949 F.2d 841 (6th Cir. 1991)).

Courts repeatedly have rejected the argument that NPV and other benchmark analyses should be applied to determine the lessor’s profit. *See, e.g., Consol. Edison*, 90 Fed. Cl. at 328-29; *Johnson*, 11 Cl. Ct. at 36 (rejecting U.S. claim that pretax profit must exceed prime rate of interest); *Gefen v. Comm’r*, 87 T.C. 1471, 1499 (1986) (rejecting

⁹The exception that proves the rule is a series of Tax Court cases limited to “energy management systems.” *See, e.g., Schillinger v. Comm’r*, 60 T.C.M. (CCH) 1470, 1477-78 (1990). These transactions had numerous flaws, including valuing the equipment at 80 times its FMV. *Id.* at 1479.

IRS claim that pretax profits must exceed a hurdle rate); see *Estate of Thomas*, 84 T.C. at 440 n.52.¹⁰ This court should do so again here.

2. IRS Rulings Have Followed the “Cash-In, Cash-Out” Standard

Longstanding IRS published rulings apply the “cash-in, cash-out” standard. Revenue Procedure 75-28, §4.07, states that a lease is profitable if the rent paid to the lessor plus the equipment’s residual value at the end of the lease exceeds the lessor’s equity investment and direct financing costs. The IRS rulings have never required that a “present value” test be applied to the lessor’s pretax profit.

Both Congress and courts have recognized that the IRS’s Leasing Guidelines represent a “safe harbor” for determining whether a transaction qualifies as a lease. *Estate of Thomas*, 84 T.C. at 440 n.51 (Leasing Guidelines are a “safe haven”); H.R. Rep. No. 98-861 at 768 (1984) (Conf. Rep.); General Explanation at 14. Therefore, the CFC’s ruling that a “cash-in, cash-out” profit is insufficient violates the principle that a taxpayer is entitled to rely on IRS published rulings. *Beneficial Found., Inc. v. U.S.*,

¹⁰The CFC found that the pretax internal rate of return (“IRR”) from the Caltrans transaction is 2.6%. JA20. An IRR provides a lower rate of return than the method mandated in FAS 13 because it does not front-load a lessor’s lease earnings. The U.S.’s leasing expert testified that IRRs are not used in the leasing industry JA8022(4011), which relies on returns calculated under FAS 13. See JA7651(3863-65). Nevertheless, the pretax IRRs of the Trial Transactions (ranging from 2.03% to 3.62%) are within the range of IRRs common to leveraged leases. See *Consol. Edison*, 90 Fed. Cl. 326 (U.S.’s leasing experts testified that pretax IRRs “between 2% and 4%” are common); *AWG Leasing Trust v. U.S.*, 592 F. Supp. 2d 953, 980 (N.D. Ohio 2008) (banks “typically receive...between 2.5% and 3.5% on their leveraged lease transactions”).

8 Cl. Ct. 639, 644-45 (1985). WFEFI was entitled to rely on the “continued vitality” of the “cash-in, cash-out” test, which has never been revoked or modified. *See Dillon, Read & Co., Inc. v. U.S.*, 875 F.2d 293, 298-99 (Fed. Cir. 1989); *Equipment Leasing*, 4-110 n.286 (IRS updated the Leasing Guidelines in 2001, but retained the “cash-in, cash-out” test).

The IRS’s 1993 advice to the FTA likewise defines “economic profit” as the “excess of the rent plus the anticipated residual value of the property over the debt service.” JA26479. IRS private rulings also apply this standard, and state that a “present value” standard like that adopted by the CFC “should not be used” in measuring pretax profit. *See, e.g.*, I.R.S. Tech. Adv. Mem. 82-32-001 (8/31/81).

3. The Authorities Cited by the CFC Are Inapplicable

Ignoring these precedents, the CFC instead followed *dicta* in *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), and a non-tax case, *U.S. v. Broderson*, 67 F.3d 452 (2d Cir. 1995), to support its use of an NPV method. Both cases are distinguishable.

ACM did not involve a lease. Therefore the court did not consider the unique aspects of the leasing industry, including the unbroken line of authority upholding the “cash-in, cash-out” standard in leasing cases. And the *ACM* transaction, unlike the Trial Transactions, did not present *any* possibility of a pretax profit, whether measured using an NPV or “cash-in, cash-out” method. Any potential gain in the *ACM*

transaction was “obliterated by the transaction costs.” 157 F.3d at 249. In contrast, WFEFI’s “cash-in, cash-out” profit takes transaction costs into account.

In *Consolidated Edison*, the court recognized that *ACM* “does not direct the use of a discount rate,” but rather “simply did not ‘preclude’ its use.” 90 Fed. Cl. at 328. Whether an NPV analysis is applicable turns on the “specific and unique characteristics and conditions of the individual transaction under review.” *Id.* at 329. The court in *Consolidated Edison*, like all prior courts, declined to apply an NPV analysis to determine if a lease is profitable.

Broderson is a criminal case, not a tax case, and did not address the economic substance doctrine. 67 F.3d at 457. It is not authority for the amount of pretax income necessary to uphold a leasing transaction for tax purposes.

4. The CFC Adopted Profit Measures that Are Contrary to Law

The CFC’s conclusion that WFEFI could not earn a profit from the Trial Transactions is based solely on the testimony of Thomas Lys. JA52-53. Lys is not an expert in the leasing industry. JA8805(4486). He has no knowledge whether the pricing of the Trial Transactions was typical of leveraged leases in general. JA8846(4649-50). Lys is also not an expert in FAS 13, the method WFEFI is required to use to report its leasing profits. JA8808(4498).

In using an NPV analysis to claim that the Trial Transactions are not profitable, Lys contradicted judicial and administrative precedent and GAAP. WFEFI’s expert,

David Ellis—who, unlike Lys, is a leasing expert—demonstrated that *all* leveraged leases would fail Lys’s NPV test. JA6028(2707). Lys admitted that he did not know whether typical leveraged leases would pass his test. JA8846(4649-50).

Lys’s alternative benchmark approach was to invent a method he called “nominal accounting profit”—a misnomer because this method is not recognized in *accounting* literature and is contrary to GAAP’s profit measure for leveraged leases. JA8841(4630). Lys’s method imputed a hypothetical borrowing cost to “the borrowed portion” of WFEFI’s equity investment (thereby comparing WFEFI’s profits to a benchmark, as in his NPV analysis). JA26796. This method rests on a fundamental error—WFEFI did not borrow its equity investment in the Trial Transactions, and Lys saw no evidence to the contrary. JA8829-30(4583-84).

Imputing a borrowing cost to an investor that did not borrow funds to make its equity investment is unprecedented. The “cash-in, cash-out” method described in the case law and Leasing Guidelines accounts for interest actually paid on the nonrecourse loan, but does not account for imaginary interest. *Equipment Leasing*, 4-111 n.289. Therefore neither of the benchmark return methods the CFC used correctly determine actual profits; they merely measure whether actual profits exceed a benchmark.

B. FAS 13 Confirms the Economic Substance of the Trial Transactions

The favorable financial reporting provided by FAS 13 underscores the economic substance of WFEFI's transactions. *See Consol. Edison*, 90 Fed. Cl. at 264, 289. The Trial Transactions provided Wells with an 11-13% pretax book return on its investment and a minimum of \$61,554,016 in additional earnings. These additional earnings had an objective effect on Wells's financial statements as presented to the public and thus have an objective effect on Wells's "financial position." *See Frank Lyon*, 435 U.S. at 577 ("accepted accounting methods...gave the transaction a meaningful character consonant with the form it was given"); *Coltec*, 454 F.3d at 1356 (quoting *In re CM Holdings, Inc.*, 301 F.3d 96, 103 (3d Cir. 2002)).

The U.S.'s leasing expert testified that "one of the reasons that lessors find leveraged leases attractive is because of the way that earnings are recognized." JA8006. The desire for earnings represents a legitimate business purpose other than the reduction of tax, and thus the Trial Transactions satisfy the subjective "business purpose" test as well. *Consol. Edison*, 90 Fed. Cl. at 332. The CFC acknowledged that "[i]nvestors in leveraged leases such as Wells Fargo are *motivated in part* by the pattern of earnings available under accepted accounting procedures." JA18 (emphasis added). If, as the CFC correctly concluded, WFEFI was "motivated in part" by the "pattern of earnings available" (which reflects expected pretax profits), tax benefits were obviously not its "sole reason" for entering the Trial Transactions.

The CFC, relying on *American Electric Power, Inc. v. U.S.*, stated that the favorable accounting results of FAS 13 “cannot provide a non-tax business purpose.” JA71-72 (citing 136 F. Supp. 2d 762, 791-92 (S.D. Ohio 2001), *aff’d*, 326 F.3d 737 (6th Cir. 2003)). The earnings and cash flow in *American Electric*, however, came *solely* from tax deductions, and the taxpayer’s claimed business purpose was to use these tax benefits to fund various corporate objectives. 326 F.3d at 744. By contrast, the U.S.’s expert here agreed that WFEFI’s earnings are attributable to pretax cash flow, not tax deductions. JA6803-04(3149-50), JA8006(3948-50).

C. Federal Policy Promoted Lease Financing to Domestic Transit Agencies

The CFC acknowledged that from 1995-2003¹¹ the Federal government promoted leveraged leases of transit assets “*because they provided significant private funding to transit agencies for capital programs.*” JA54 (emphasis added). WFEFI and each transit agency involved in this case understood that leveraged leasing was a federally approved means for public transportation agencies to acquire additional capital. JA3253(956), JA3639-40(1168-72), JA3230(862), JA4421-22(1617-21). The Transit

¹¹/In 2004, Congress changed the law *on a prospective basis only* to disallow deductions for future transactions similar to those involved here. §470. Simultaneously, a “grandfather clause” explicitly allowed tax deductions for certain pending transit leases, including several of WFEFI’s leases. JA11141. The IRS has allowed deductions for WFEFI’s “grandfathered” leases, which structurally are identical to the Transit Transactions and involve similar equipment (buses). JA11173. After 2003, for leases subject to the new rules, lessors, including WFEFI, could no longer share tax benefits with lessees in the form of lower rentals and therefore such leases became uneconomic. JA4464(1790-91).

Transactions were therefore “encouraged” by “regulatory realities.” *Frank Lyon*, 435 U.S. at 583.

Although the CFC acknowledged the FTA “*encouraged* transit agencies to participate in” leveraged leasing, it stated that the FTA did so “without seriously considering the probable adverse tax treatment of the transactions.” JA7 (emphasis added). This is wrong. Undisputed evidence demonstrates that the FTA sought the IRS’s “guidance,” JA3205-06(764-67), and proceeded only after obtaining, reviewing, and implementing this guidance. Facts, §E.

Wells is perplexed by the CFC’s statement that WFEFI’s sale-leasebacks are “offensive to the Court.” JA7. WFEFI reasonably understood that it was working in concert with the Federal government as part of a program that the CFC agrees had the goal of providing “significant private funding to transit agencies.” JA54. WFEFI and its lessees were well aware that the FTA had sought the IRS’s guidance: the FTA publicly described its attempts to conform its leasing program to the IRS’s guidance. JA4427-28(1641-44). The FTA reviewed and approved WFEFI’s leases, imposing the conditions required by the IRS. And WFEFI was careful to follow established “safe haven” rules included in the IRS’s Leasing Guidelines—guidelines the CFC does not even mention.

WFEFI had no reason to think that its claimed tax deductions were abusive, particularly since it complied with the statutory limitations on leases to tax-exempt entities imposed by Congress, and could have claimed more accelerated deductions by

entering into leases with taxable companies. JA7600(3899-3900). WFEFI acted in complete good faith and understood that its leases were in compliance with Federal transit policy and the IRS's rules. The IRS has no basis for challenging the "economic substance" of transactions that the Federal government encouraged, reviewed, and approved, and that included features (such as defeasance, to which the IRS now objects) imposed by the Federal government.

II. The CFC Erred in Holding that a Transaction Lacks Economic Substance if the Taxpayer Would Not Have Entered the Transaction "But For" Tax Benefits

The CFC concluded that the Trial Transactions lack a business purpose because WFEFI would not have entered into them "[w]ithout the claimed tax benefits." JA70. For simplicity, we refer to this as the "but for" test because, according to the CFC, "but for" the claimed tax benefits, Wells would not have entered into the Trial Transactions.

The "but for" test is contrary to settled law. Since *Frank Lyon*, it has been clear that a taxpayer is free to consider tax benefits in making an investment decision so long as tax motives are *not* its "sole" purpose. 435 U.S. at 583-84; *see Coltec*, 454 F.3d at 1355; *Stobie Creek Inv., LLC v. U.S.*, No. 2008-5190, p.15 (Fed. Cir. 6/11/2010). The desire to obtain the benefits of a "tax shelter" was one of Frank Lyon's motivations, but the Supreme Court recognized that "[w]e cannot ignore the reality that the tax laws affect the shape of nearly every business transaction." *Frank Lyon*, 435 U.S. at 580. In *Coltec*, this Circuit affirmed the principle that "structuring a real transaction in

a particular way to provide a tax benefit” is “legitimate.” *Coltec*, 454 F.3d at 1357. The CFC’s “but for” test flips *Frank Lyon* and *Coltec* on their heads.

The CFC’s approach is particularly destructive in the leasing context, where the availability of tax benefits plays a major role in structuring leases. *Consol. Edison*, 90 Fed. Cl. at 234 (“tax advantage is normal and expected”); *Johnson*, 11 Cl. Ct. at 30 (“concern with tax benefits...economic reality”); *Gefen*, 87 T.C. at 1498-99 (taxpayer considered both projected tax benefits and potential profits from a leasing transaction).

The U.S.’s finance expert, Lys, confirmed that WFEFI was not motivated “solely” by tax considerations. He testified that the transactions would be “dogs” without the tax benefits. JA8828(4579). But during cross-examination, he testified that the transactions would be “super dogs” without the pretax cash flow they generated. JA8865(4726-27). He agreed WFEFI needed “*both* the before-tax cash flow *and* the tax benefits for this transaction to make economic sense.” JA8866(4728) (emphasis supplied). This relationship holds true for all leveraged leases. *Equipment Leasing*, 6-4; *see* OCC Handbook 11. Since WFEFI needed the “before-tax cash flow” for the transaction to make “economic sense,” WFEFI was obviously not motivated “solely” by tax considerations. Counsel for the U.S. instructed Lys to apply an incorrect legal standard, i.e., the “but for” test in which a transaction lacks economic substance if it would not have been undertaken “absent tax benefits.” JA8865(4727).

The CFC's error is also evident in its discussion of "tax capacity." The CFC stated that "without the company's tax capacity to use the claimed tax benefits," Wells would not have entered into the Trial Transactions. JA70. The CFC acknowledged, however, that *all* of WFEFI's leases, not just those disputed, included a tax capacity review. JA18. The U.S.'s leasing expert agreed that "tax capacity" is a necessary condition for "traditional leasing activities." JA7638(3812-13).

Wells's rigorous due diligence is further evidence of business purpose beyond tax benefits. *See Consol. Edison*, 90 Fed. Cl. at 312; *Johnson*, 11 Cl. Ct. at 28-29; *Estate of Thomas*, 84 T.C. at 428 n.21. WFEFI turned to leases of passenger rail and telecommunications equipment to diversify its leasing portfolio, which has been recognized as a legitimate business purpose. *Frank Lyon*, 435 U.S. at 582-83; *Levy v. Comm'r*, 91 T.C. 838, 855 (1988). WFEFI was also careful to diversify its transit leases among assets (buses and trains) and by region.

The CFC therefore erred as a matter of law in applying a "but for" test in which a transaction lacks economic substance when tax considerations played an important role in an investor's investment decision. The proper standard is the "solely" test applied in *Frank Lyon* and recently followed in *Coltec* and *Consolidated Edison*. Because business reasons (including profit, FAS 13 earnings, and diversification) and regulatory realities, as well as tax considerations motivated WFEFI's investments, the Trial Transactions easily satisfy this test.

III. WFEFI Acquired the Benefits and Burdens of Ownership of the Leased Property

A lease must be respected as a “true lease” in substance and form when the lessor has retained the benefits and burdens of ownership. *Frank Lyon*, 435 U.S. at 584. WFEFI acquired the equipment for its entire useful life in exchange for a payment equal to the equipment’s FMV, JA14264, and thus WFEFI owns the property for tax purposes. WFEFI has retained ownership because the property will revert to WFEFI upon any default during the lease or at the end of the lease (or service contract, if applicable). The most important benefit and burden of ownership is the lessor’s possibility of earning additional profit or incurring a loss during the “residual period” after the lease ends. *See, e.g., Consol. Edison*, 90 Fed. Cl. at 269-72; *Levy*, 91 T.C. at 861-62; *Gefen*, 87 T.C. at 1492.

The Leasing Guidelines provide that the anticipated residual period should be at least 20% of the property’s expected economic useful life, although case law permits a smaller interest. Rev. Proc. 75-21, §4(1)(C); *see Consol. Edison*, 90 Fed. Cl. at 297-98 (collecting cases). This ensures that a meaningful amount of a lessor’s return will depend on the asset’s residual value. Even if WFEFI elects the service contract option in any Transit Transaction, the combined lease and service contract period will terminate at 80% of the equipment’s expected useful life, leaving WFEFI with a 20% residual interest. Furthermore, during the service contract itself, WFEFI will be subject to operational and equipment risks not present in a lease.

In holding that WFEFI did not bear the benefits and burdens of ownership, the CFC relied on cases such as *Kwiat v. Comm’r*, 64 T.C.M (CCH) 327 (1992). JA60. In *Kwiat*, however, the lessor had a “put” by which it could force the lessee to buy the property, thus transferring to the lessee the entire residual value risk. WFEFI has no such right—if the lessee does not exercise its purchase option, WFEFI has no ability to force the lessee to take the property back, and the service contract period would still leave WFEFI with a 20% residual life.

WFEFI’s residual interests thus meet or surpass both the Leasing Guidelines’ 20% residual interest test and the baselines established in case law. During these residual periods, WFEFI may either earn additional profit or suffer a loss. *See, e.g., Consol. Edison*, 90 Fed. Cl. at 297, 327; *Levy*, 91 T.C. at 861-62; *Gefen*, 87 T.C. at 1492; *Estate of Thomas*, 84 T.C. at 433-34. The CFC stated that the “critical fact” of ownership “is whether the taxpayer has undertaken ‘substantial financial risk’ of loss of its investment, based on the value of the underlying property.” JA60. This risk of loss is present in the residual value period. *See Consol. Edison*, 90 Fed. Cl. at 298; *Estate of Thomas*, 84 T.C. at 434.

Since WFEFI’s residual interests in the equipment are sufficient to establish ownership, the CFC’s holding that WFEFI is not the property owner necessarily hinges on its conclusion that the exercise of the purchase options is “virtually certain.” JA50; *see Consol. Edison*, 90 Fed. Cl. at 294 (ownership “hinges on” whether the lessee’s purchase options are “*certain* to be exercised”) (emphasis added). If the exercise of the

options is not “certain” or “guaranteed,” WFEFI has the benefits and burdens of ownership and must be treated as the owner of the leased equipment. *Id.* at 271-72, 294, 298 (if exercise “is not guaranteed, the residual value” to the lessor “is at risk and subject to the potential for gains and losses”); *see Transamerica Corp. v. U.S.*, 15 Cl. Ct. 420, 442 (Cl. Ct. 1988) (lessor is the owner when exercise of options “not a certainty”).

The CFC’s conclusion that the lessees’ purchase options were certain of exercise rests solely on the “economic analysis” of Lys, JA51, who was the only witness to testify that the purchase options are compelled. Lys admitted that his methodology was not based on the FMV of the equipment, but was instead based on his “value” unique to a specific lessee. This measurement of “value” is contrary to accepted practice in Lys’s field and is nothing more than his subjective opinion. This methodology is also *contrary to governing case law*, which focuses on the FMV of the property in examining whether the option is certain to be exercised. WFEFI cannot be required to anticipate that Lys would disregard the established FMV standard. *See Gilman*, 933 F.2d at 149 (“inquiry ... limited to what was reasonable to believe in 1980, not which expert was correct in 1990”); *Mukerji*, 87 T.C. at 966-67. Lys failed to cite *any* authority supporting his methods, and thus WFEFI could not possibly have anticipated the application of Lys’s novel methodology.

Finally, the CFC's judgment as to the likelihood of the purchase option being exercised was contrary to the testimony of the lessees,¹² the analysis and conclusions of WFEFI's appraisers, and the testimony of both parties' transportation and telecommunications experts. By relying solely on Lys's testimony, the CFC failed to take into account the "vagaries" of future events. *Transamerica*, 15 Cl. Ct. at 442.

A. Lys's Compulsion Analysis Is Incorrect as a Matter of Law Because It Is Not Based on FMV

Lys undertook a compulsion analysis nearly identical to that of WFEFI's original appraisers (who, unlike Lys, have experience with the relevant equipment), except that Lys, by his own admission, did not attempt to calculate the equipment's future FMV. JA8809(4501-03). To estimate the equipment's FMV at the option date, each appraiser determined the value of future cash inflows and outflows related to the equipment's use by discounting these cash flows using a rate reflecting inflation and the riskiness of the future cash flows. JA9258(4963-65). The appraisers used the widely accepted "weighted average cost of capital" ("WACC") method to determine the discount rate. *See* JA9244(4908-09), JA9605(5035-36), JA21196.

¹²In *AWG*, 592 F. Supp. 2d 953, and *BB&T Corp. v. U.S.*, 2007 WL 37798 (M.D.N.C. 2007), *aff'd*, 523 F.3d 461 (4th Cir. 2008), the trial courts determined that the lessees were "virtually certain" to exercise their purchase options. *Consol. Edison*, 90 Fed. Cl. at 331, 334. In those cases, unlike this case, there was no testimony from the lessees establishing that they were not certain to exercise their purchase option. In addition, the *AWG* and *BB&T* cases, unlike this one, did not include any evidence of regulatory reality supporting the form of the lease.

In contrast, Lys used the transit agency's low (because tax exempt) borrowing rate to discount future cash flows rather than a WACC rate. Lys agreed that his low discount rates do not account for the "risk of uncertainty" concerning the equipment's future value, and therefore he arrived at significantly higher future equipment "values" than the appraisers had determined. JA8806(4488), JA8851(4671). Lys opined that the lessees would always exercise their purchase options, because the higher "values" he computed were always higher than the option prices.

Lys admitted that his calculated "values" are not the equipment's FMV, but claimed that they are the unique values each lessee would place on its equipment. JA8809(4500-01), JA8852(4675) (agreeing his method is "different" from "fair market value"). *That methodology contradicts 50 years of administrative and judicial precedent regarding how compulsion of purchase options should be determined.*

In 1955, the IRS expressed approval of option prices that "approximate" the FMV of equipment. Rev. Rul. 55-540, §§2.02(a), 4.04. Case law has held that the likelihood of a purchase option exercise must be judged by comparing the option price against the expected FMV. *See Frank Lyon*, 435 U.S. at 569 (respecting trial court's conclusion that option prices "represented fair estimates of market value on the applicable dates"); *Lockhart*, 446 F.2d at 272 (option prices "related realistically to actual market values"); *Consol. Edison*, 90 Fed. Cl. at 270 n.23, 274, 281, 285, 294 (referencing FMV); *LTV Corp. v. Comm'r*, 63 T.C. 39, 50 (1974); *In re Mesa*, 65 B.R. at 727-28 (comparing option price to FMV); *see also Transamerica Corp. v. U.S.*, 7 Cl. Ct.

441, 448 (1985) (purchase option exercise “reasonably certain” when price is “substantially below” the contemplated FMV). Congress has recognized that FMV is the legal standard for determining whether a purchase option is compelled. General Explanation at 37; *see* Bittker and Lokken, *Federal Taxation of Income, Estates and Gifts*, ¶4.4.3 (3d ed. 1999) (ownership determinations examine whether “the existence of a purchase option” is “at less than fair market value”).

The dispute regarding discount rates between Lys and WFEFI’s appraisers and experts results solely from one difference in approach: Lys selected discount rates by examining the *source* of the transit agencies’ funds, i.e., their borrowing costs, while WFEFI’s appraisers—explicitly rejecting the borrowing cost approach (JA15301)—chose discount rates based on the *use* of the transit agencies’ funds in operating transit service. JA9257(4960-62). WFEFI presented two rebuttal experts to Lys who demonstrated that the appraisers used reasonable discount rates and that Lys’s methodology is contrary to the accepted practice in Lys’s field of expertise. *See, e.g.*, JA9244(4908-09), JA9257(4960-62).

There is no evidence in the record which supports Lys’s claim that a discount rate should be based on the *source* of funds (borrowing rates) rather than their *use* (investments in uncertain future cash flows). His report provides no citation to *any* authority supporting this view. Based on the record, Lys’s choice of a discount rate is nothing more than his subjective opinion and should not have been relied on by the CFC. *See, Libas, Ltd. v. U.S.*, 193 F.3d 1361, 1366-67 (Fed. Cir. 1999) (expert

testimony rejected when methodology not reliable). Lys's analysis leads to the absurd conclusion that otherwise identical assets will have starkly different "values," based simply on the borrowing rates of the entities owning the assets.

WFEEF's rebuttal experts identified numerous published authorities demonstrating the error in Lys's reasoning. Frank Graves described a paper by Robert Hartman, a former Congressional Budget Office ("CBO") economist, that explains why governmental entities should not use their borrowing rates as their discount rate to value future cash flows:

[P]rivate sector bidders were sure to use a discount rate much higher than the government rate [the yield on government securities]. If the CBO advocated using a government rate, the requisite price would be well above any likely private bid for the assets. Indeed, discounting by the government rate would imply that the government should buy all income-producing assets and sell none of them!

JA21248. Using a low "government [borrowing] rate" as his discount rate, Lys systematically overvalued the equipment in the hands of the transit agencies, leading to his conclusion that the transit agencies should always exercise their purchase options. Lys therefore concluded that transit agencies will pay more than FMV for their assets and give the benefit of their low borrowing rates to the sellers. In the CBO's words: "This did not strike us as the right answer!" *Id.*

Other sources that contradict Lys's testimony on the choice of discount rates include Brealey, Meyers & Allen's leading corporate finance treatise, JA21246, and a paper authored by Deborah Lucas, Lys's colleague at Northwestern University.

JA21641-83. Lucas’s paper explains why governments should use “market prices for choosing the discount rate”: use of low government borrowing rates would result in government entities overpaying for their assets, thus transferring the benefit of their low borrowing rate to a third party. JA9628(5126-27). Lys, whose analysis rests on no published authorities supporting his methods, ironically criticized Lucas’s article as not having been published. JA9629(5130). But her article has subsequently been published by the University of Chicago. MEASURING AND MANAGING FEDERAL FINANCIAL RISK, Ch. 3, pp. 29-54 (2010).

Correcting the CFC’s legal error in relying on Lys’s unsupported valuation methodology leaves undisputed evidence (Argument, Parts III.B. and C.) demonstrating that the strict “virtually certain” legal standard cannot be satisfied. *Consol. Edison*, 90 Fed. Cl. at 91.

B. Contemporaneous Evidence Established that the Exercise of the Options Was Uncertain

1. The Transit Agencies Neither Knew at Closing, Nor at Trial, Whether They Would Exercise Their Purchase Options

Employees of each transit agency testified that, when they entered into the leases, they did not know whether their agency would exercise its option. JA3235-36(884-85), JA3259(979), JA3624(1108), JA3643(1187), JA3645(1193-94), JA3659(1248-49); JA8041(4087). This uncertainty continued through the trial. The purchase option decision is necessarily uncertain because factors influencing the

decision will undoubtedly change between the closing date and the option exercise date, approximately 20 years into the future. *Id.* For example, an agency would be unlikely to exercise the option on equipment that performed poorly or depreciated more rapidly than expected. JA3259(979-80). *See Benton v. Comm’r*, 197 F.2d 745, 753 (5th Cir. 1952) (exercise of option expected, but not exercised due to changed circumstances). In fact, WMATA is already planning to replace the model of railcars leased from WFEFI. JA7230-31(3518-23), JA27508. The Claims Court has recognized that the exercise of an option often depends on events that are “unforeseeable,” including “technological advances that require[] changes in old patterns.” *Transamerica*, 15 Cl. Ct. at 442.

2. Appraisers Retained By WFEFI Concluded that the Lessees Were Not Compelled to Exercise Their Options

In each Trial Transaction WFEFI relied on appraisals from appraisers who qualified under the Leasing Guidelines as experts with “professional knowledge of the type of property subject to the lease.” Rev. Proc. 75-28 at §4.02.6; JA5638-39(2471-72), JA7658(3892-93). Each appraiser determined that the lessee’s purchase option price exceeded the estimated FMV of the equipment as of the option exercise date. For example, in the Caltrans transaction, the combined purchase option prices for the two equipment lots equaled 176% of the equipment’s expected future FMV. JA15235, JA15237, JA15269-70, JA15280. Option prices above the expected FMV ensured that

the lessees would not acquire an equity interest in the leased property. *In re Mesa*, 65 B.R. at 727.

The appraisers used WACC discount rates to determine the equipment's future value. The U.S. did not present any evidence challenging the WACC rates used by the appraisers. The appraisers did not determine the lessees' unique value of the leased property using their tax exempt borrowing rates because the literature that existed 10 years ago (and even current literature) does not support such a methodology. *See* JA9259-60(4967-71).

3. WFEFI's Expert Consultants Confirmed that the Service Contracts Are Feasible

As part of its due diligence, WFEFI retained two transportation experts (one for buses, one for rail) to determine whether the service contract options at the end of the transit leases were commercially reasonable. These experts testified at trial and confirmed their original opinions that the service contracts were commercially reasonable. JA5242-45(2235-45), JA5603(2328-29). The service contracts therefore do not impose noncommercial burdens on the lessees. In addition, WFEFI's experts and the lessees testified that the use of service contracts is increasing and would continue to increase because they provide a cost-effective means for providing service. *Id.* The CFC nonetheless relied on three features of the service contracts in concluding that the possibility of a service contract would force the lessees to exercise their purchase options.

None of the features identified by the CFC has support in the record, and none would preclude use of a service contract. First, the CFC pointed to “requirements” necessary to fulfill the terms of the service contract. JA30. The CFC did not, however, claim that these requirements were difficult or onerous, and there is no evidence in the record to support such a conclusion. *See* JA7216(3463). As described below, Wilson, the U.S.’s own transit expert, agreed the lessees would not be compelled to exercise the purchase option.

Second, the CFC asserted that labor protection laws “present obstacles” to the use of service contracts. JA51. NJT, Houston Metro, and Caltrans have obviously found ways to overcome such “obstacles” because all three actually use service contracts. The CFC cites the testimony of Britton, Salci, and Shuman, but all three testified that service contracts can be used while abiding with federal regulations. JA3654(1229-30), JA5625(2416), JA6859-60(3370-73), JA7214(3454-55). Wilson participated in the preparation of a report funded by the FTA that concluded that labor restrictions do not have an “important effect” on the use of service contracts. JA8431(4326-27), JA21439.

Finally, the CFC observed that technological issues “may” complicate transfers of equipment from one system to another. Significantly, the court did not state that such issues “would” complicate or prevent transfers. Salci testified in detail that while some modifications would be necessary, the leased equipment could be transferred to another agency at a relatively small cost. JA6861-62(3380-83), JA20976-88.

The CFC failed to recognize that a lessee that does not exercise its purchase option will keep the defeasance funds it would otherwise use to exercise the purchase option. Shinderman, the U.S.'s leasing expert, agreed that lessees could use some of these funds to subsidize another transit agency's entry into a service contract (including, if necessary, modifications to the cars), and that lessees would still be ahead by not exercising the purchase option. JA8016(3886-88). There is, in short, no practical barrier to use of a service contract.

C. Both Parties' Transit Industry Experts Agreed the Lessees Are Not Certain to Exercise Their Options

Of greatest significance, both parties' transit industry experts *agreed* that the transit agencies were under no compulsion to exercise their purchase options. Wells offered the testimony of Larry Salci, and the U.S. offered the testimony of Nigel Wilson. The CFC was "impressed with the transit industry experts of both parties," JA58, but particularly with Salci, who has extensive experience in railcar manufacturing, transit agency management, transit equipment procurement, and labor union negotiations involving transit agencies. JA58, JA6831-34(3258-73). Salci concluded that none of the Transit Lessees would be compelled to exercise their purchase options. JA6849-51(3332-38), JA6859-63(3373-89).

Salci explained that in 2000-2002 it would have been impossible for the lessees to predict whether they would exercise their purchase options so many years into the future. JA6849-51(3332-38). Unknowns like future technological advancements and

transit agency funding levels will affect the exercise of the options. JA6849(3332-33). In Salci's experience as CEO of St. Louis Metro, lack of funding resulted in railcars sitting idle, even as ridership was increasing. JA6852(3343-44). As a result of recent economic conditions, many transit agencies are facing funding cuts and service cutbacks. <http://menendez.senate.gov/newsroom/press/release/?id=37c92764-0045-4f66-899a-ae9c6a352eb2>.

Wilson, the U.S.'s expert, agreed that the lessees were not compelled to exercise their options:

A: ...I have not been arguing that WMATA or any of these agencies are compelled to exercise the purchase option.... I'm arguing that the likelihood is that they will exercise the purchase option.

Q: [So] Your testimony is that it is not compelled that they will exercise these options.

A: Absolutely, yes.

JA8433(4332-33). A mere "likelihood" that the options will be exercised is insufficient. *See Transamerica*, 15 Cl. Ct. at 442 (requiring "certainty"). The facts of this case are therefore identical to those of *Consolidated Edison*, where the government's expert "confessed the absence of certainty." 90 Fed. Cl. at 293.

D. Belgacom Was Not Compelled to Exercise Its Purchase Option

The same legal errors infect the CFC's ruling on the Belgacom transactions. Using WACC rates for participants in the telecommunications industry, WFEFI's appraisers determined that the option price would be greater than the projected FMV

of the equipment leased to Belgacom, and that Belgacom therefore would not be compelled to exercise its option. In conducting its analysis, WFEFI's appraiser also analyzed return costs, i.e., the costs that Belgacom would incur to return the equipment to WFEFI. The appraiser concluded that these costs would not be enough to compel Belgacom to keep the equipment. JA13209-13. WFEFI therefore acted reasonably in concluding that the exercise of the purchase option was not compelled. *See, e.g., Gilman*, 933 F.2d at 149.

1. Both Parties' Telecommunications Experts Agreed that the Purchase Option in Belgacom Was Not Compelled

Wells presented the expert testimony of Michael Coyne regarding the Belgacom purchase option. The U.S. presented the expert testimony of Cooper Chastain. Both were qualified experts in telecommunications. Coyne concluded that it would have been impossible for Belgacom to predict whether it would exercise its purchase option, in large part due to rapid and unpredictable change in the wireless communications market. JA6430-31(2995-97).

Chastain's conclusions matched Coyne's. Chastain confirmed that it would have been "speculative to suggest" in 1997 "which option might be exercised" because Belgacom itself "probably would not know" in 1997 whether it would exercise its future purchase option. JA8460(4440-41). Therefore, *all* trial witnesses with experience in the telecommunications industry *agreed* that the purchase options were *not* compelled. The CFC did not mention this testimony in its opinion.

2. The CFC Erred in Holding that Belgacom Was Compelled to Exercise Its Purchase Option

The CFC speculated that the costs of the return conditions at the end of the lease to Belgacom would force Belgacom to exercise its purchase option. JA31. There is no basis for this speculation. WFEFI's appraiser took these costs into account in performing the compulsion analysis, and concluded that the amount of these costs would not force Belgacom to keep the equipment rather than incur these costs. JA13209-13. On cross-examination, the U.S.'s expert agreed that his estimate of return costs was "very close" to the amounts calculated by WFEFI's appraiser. JA8460(4441-42). There is no other evidence in the record that would support the view that the return costs would force Belgacom to exercise the option.

More significantly, both the CFC and Chastain ignored the fact that, if Belgacom chooses not to exercise its fixed price purchase option, the parties' agreements allow Belgacom to buy the equipment at its FMV only 2.5 years later. JA12885. Chastain failed to notice this provision in his review of the documents. JA8459(4436-37). Under cross-examination, *he admitted that such a provision would allow Belgacom to avoid any return costs*, JA8459-60(4437-40), and therefore return costs could not possibly compel the fixed price option. If Belgacom exercises the FMV option, WFEFI's profit or loss would directly reflect the value of the equipment, and thus WFEFI would clearly have the burdens and benefits of ownership.

To support his conclusion that Belgacom was compelled to exercise its fixed price purchase option, Lys adjusted the discount rate that WFEFI's appraiser had used downward to 13.5% from 16.37%. JA21339. But Lys did not offer a critique of the discount rate chosen by WFEFI's appraiser. Instead of using Belgacom's WACC rate, Lys pulled a single rate from a marketing document distributed by Salomon Brothers, which described a "generic valuation model." Lys is not an appraiser and, unlike WFEFI's appraiser, has no experience in telecommunications, and thus is not qualified to give an appraisal opinion. The CFC's adoption of Lys's testimony presents a classic case of allowing an expert to second guess, years after the fact, a reasonable, contemporaneous judgment made by WFEFI's appraiser. *Gilman*, 933 F.2d at 149.

The CFC's assertion that Belgacom's exercise of its purchase options was virtually certain also relied on the fact that Belgacom actually exercised the options, about 10 years after the transactions closed. JA52. Actual exercise is irrelevant. As a matter of law the issue is whether the exercise was *certain at the time of the transaction*, not whether it was likely or even expected or actually occurred. *See Transamerica*, 15 Cl. Ct. at 441-42 (option respected even though parties expected exercise and option was in fact exercised); *Benton*, 197 F.2d at 750, 754 ("desire and hope" to exercise option not controlling). Even the U.S.'s expert agreed it was "speculative" in 1997 whether the option would be exercised. JA8460(4440). The CFC therefore erred as a matter of law in recharacterizing the Belgacom transaction. *See Frank Lyon*, 435 U.S. at 581 n.16.

E. The CFC Erred in Relying on Certain Common Leveraged Lease Features that Other Courts Have Viewed as Neutral

The CFC recast the Trial Transactions as “loans” to the various lessees. This recharacterization cannot stand unless it more accurately describes the parties’ obligations than the form the parties adopted. *See Frank Lyon*, 435 U.S. at 576, 579-80. The evidence shows that the Trial Transactions created risks and obligations typical of those found in leases, not loans. The CFC erroneously relied on several ordinary lease provisions in holding that the Trial Transactions did not have the substance of a lease. JA28, JA64. None of these provisions are relevant to whether the transactions at issue are “true leases” as a matter of law. *See Frank Lyon*, 523 U.S. at 583-84 (stating the “true lease” legal standard).

First, in a loan, if the borrower defaults, its liability generally is limited to the loan principal and interest due on the loan. The default remedies under the Trial Transactions are completely different; WFEFI can repossess the equipment and/or demand a termination payment. JA14672-74.

Leveraged leases, including the Trial Transactions, contain schedules of termination payments, which equal the outstanding loan balance plus the equity investor’s original investment and the equity investor’s expected return on its investment. *Equipment Leasing*, 2-24; JA7663(3911-12). This amount could significantly exceed the lessee’s benefit from entering into a lease, resulting in a significant out-of-pocket loss for the lessee. *See Hoosier*, 582 F.3d at 724 (out-of-pocket loss of \$99

million). The FTA recognized the risk that lessees could incur large liabilities from entering into sale-leasebacks. JA10715.

Because of this, the FTA required the lessees in the Transit Transactions to maintain defeasance arrangements. The contracts between WFEFI and its lessees required the parties holding the defeasance accounts to maintain certain credit ratings. A failure to maintain the required ratings would result in a default by WFEFI's lessees. Wells could then repossess the equipment and/or demand a termination payment. *See Hoosier*, 582 F.3d at 724 (default arising from downgrade in credit rating).

Following the “credit crunch of 2008”, *id.* at 728, several of WFEFI's lessees defaulted. The credit ratings of AIG and Ambac, defeasance and credit support providers in the WMATA, Caltrans, and NJT transactions, deteriorated and triggered requirements that the lessees replace them. JA4446(1716-17). *Hoosier*, 582 F.3d at 724 (default triggered by downgrade of Ambac).

Due to the defaults by these lessees, WFEFI has the legal right to repossess the equipment and can demand a termination payment, which would likely cause extreme financial distress to the lessees. A failure by AIG or Ambac would lead to disastrous consequences for WFEFI's lessees, as they would be obligated to pay rent notwithstanding the loss of their defeasance funds. They would, in effect, pay rent twice: once to the defeasance provider, and once to WFEFI after the failure of the defeasance provider. JA3616(1077-78). And if WFEFI's lessees are unable to pay rent, that could lead to an “equity squeeze” in which the lender repossesses the equipment

from WFEFI. In such circumstances, the U.S.'s leasing expert agreed WFEFI could lose its entire investment. JA7647(3850).

On November 24, 2008, Congressman Barney Frank, Chairman of the Committee on Financial Services in the House of Representatives, sent a letter to Wells asking that it “refrain” from placing its lessees in default. JA12008. WFEFI has granted the lessees limited waivers for their defaults and has allowed extensions of time to replace AIG and Ambac. JA4448(1724-27), JA12009-10. *These circumstances would not have occurred if WFEFI had simply made a loan to the lessees.*

Second, net lease provisions, as the U.S.'s leasing expert testified, are “universal” for leveraged leases. JA7664(3915-16). *See, e.g., Frank Lyon*, 435 U.S. at 567; *Equipment Leasing*, 29-90–29-91 (net lease provision required for banks).

Third, rental income typically equals the debt service in a leveraged lease, and it is common for the rent to be paid directly to the lender. *Equipment Leasing*, 29-84; *see Estate of Thomas*, 84 T.C. at 436; OCC Handbook at 11.

Forth, lessees always retain use of the property in sale-leasebacks. *See, e.g., Frank Lyon*, 435 U.S. at 572 n.10 (stating that “benefits of occupancy” are a standard term in lease agreements); *see Torres*, 88 T.C. at 721.

Fifth, the use of nonrecourse debt is necessary to comply with FAS 13, JA10519-20; *Equipment Leasing*, 29-63, and is common in leasing. *See Estate of Thomas*, 84 T.C. at 436-37.

In short, true to their form and universal industry practice, the Trial Transactions are genuine leveraged leases and not commercial loans.

CONCLUSION

The CFC's judgment should be reversed and Wells should be awarded the requested refunds.

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June 14, 2010

(Date)

CERTIFICATE OF SERVICE

I, David F. Abbott, certify that on this 14th day of June, 2010, I served two copies of the foregoing Brief and attached addendums (Federal Circuit Rule 28(a)(12) and FRAP Rule 28(f)) upon Defendant-Appellee using UPS next day delivery, to the following address:

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