

2010-5108

**IN THE 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

**REPLY BRIEF FOR PLAINTIFF-APPELLANT
WELLS FARGO & COMPANY AND SUBSIDIARIES**

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ARGUMENT

Wells structured the Trial Transactions to comply with tax law and accounting principles applicable to leveraged leases. The transactions also comply with commercial law principles defining whether a transaction is a lease, as codified in the Uniform Commercial Code (“UCC”). Commercial law is integral to whether a lease is respected for tax purposes because *Frank Lyon* directs that tax law must follow the “attributes of the traditional lessor status.” 435 U.S. at 584. The Trial Transactions satisfy both tax and commercial law lease tests because:

- (A) WFEFI has a meaningful residual interest in the leased equipment;
- (B) WFEFI’s lessees are not certain to exercise their purchase options;
- (C) WFEFI’s nonrecourse debt is genuine because the transactions are leveraged leases in substance and form; and
- (D) WFEFI’s leases satisfy the economic substance doctrine because the transactions are profitable on a pretax basis and WFEFI entered the transactions for legitimate business and regulatory reasons.

To divert attention away from these conclusions, the United States (“US”) misrepresents the applicable legal standards and asks this Court to create new law. Specifically, US argues:

(A) WFEFI’s ownership of the leased equipment does not depend on whether it has a meaningful residual interest. *Section I.A. explains that US’s assertion is contrary to established law, and that WFEFI owns the leased equipment because it has the **key** attribute of ownership—a meaningful residual interest.*

(B) WFEFI is not the owner of the leased equipment because lease rents and service contract payments allow WFEFI to recoup its equity investment without relying on residual value. *Section I.B. explains that this “recoupment” theory is contrary to law.*

(C) The purchase option is irrelevant to whether WFEFI owns the equipment. *Section II explains that WFEFI has a meaningful residual interest, and therefore must be treated as the owner of the equipment, because its lessees are not certain to exercise their purchase options.*

(D) The nonrecourse debt is not genuine. *Section III explains that because the underlying transaction has economic substance, and is*

a leveraged lease in substance and form, the debt used to acquire the leased equipment must be respected as genuine.

(E) The Trial Transactions do not produce a pretax profit and therefore lack economic substance. *Section IV demonstrates that US's and the CFC's "profit" measurement methods are contrary to decades of precedent.*

US agrees that "traditional" leases should be respected (USBR2-3), but labels the Trial Transactions "SILOs," "abusive," and "a raid on the Treasury," apparently because the lessees are "tax-exempt" entities. USBR2,40. This rhetoric masks WFEFI's legitimate reasons for entering into the Trial Transactions. First, for sound business reasons, WFEFI entered into the transactions to diversify its lease portfolio. WFBR11-12. Second, as US concedes, the federal government, acting through the FTA, *encouraged* leases to transit agencies. USBR25. Accordingly, regulatory and business realities supported these transactions. *Frank Lyon*, 435 U.S. at 583.

The Code specifically authorizes leases to such tax-exempt entities—which US never mentions—but limits the amount of tax benefits available as compared to "traditional" leases. WFBR9. For

instance, in Caltrans, depreciation deductions during the first five years totaled 13% of the equipment cost. JA15173,JA15184,JA15199, JA15208. By comparison, depreciation deductions in the first five years of “traditional” leases with UP and BNSF (tax-paying railroads) represented 78% of the equipment cost. JA10861,JA10892,JA21684, JA21697. US agrees that these “traditional” leases were not abusive, *even though they provided higher tax deductions than so-called “SILOs.”* US has no basis to claim the Trial Transactions were “abusive” when WFEFI had sound business and regulatory reasons for the transactions and received *less* tax benefits than from “traditional” leases.

US falsely claims that the Treasury Department stopped the FTA’s leasing program “[i]n 2003, after learning about SILOs.” USBR26. The Treasury Department knew about so-called “SILOs” *as early as 1993*, when the FTA met with it to obtain “guidance with respect to the IRS’s view” of a sale-leaseback involving a tax-exempt transit agency. WFBR15-16. The IRS provided the FTA with detailed advice summarizing the “relevant considerations regarding whether a transaction is a true lease under federal income tax principles,” but

never suggested leases to tax-exempt entities were impermissible.

JA26478.

US claims that registration of the Trial Transactions as “tax shelters” demonstrates “abuse.” USBR39. But these filings were made “on a protective basis” only, which the Treasury Regulations encourage. §301.6111-2T(b)(6) (subsequently moved to §301.6111-2T(b)(5) (8/2/01)). JA19744. Thus, US twists good faith tax compliance into “evidence of abuse.”

Finally, US relies on the 2004 change in law as evidence that the Trial Transactions were abusive. USBR6-7. That change, however, was *prospective only*. Pub. L. No. 108-357, §849(b)(1)-(2), 118 Stat. 1418, 1606-07 (2004). Prior law governs all leases entered into *before* March 13, 2004, including the Trial Transactions.

Congress specifically intended to protect sale-leasebacks of transit equipment that had been submitted to the FTA for approval between June 30, 2003 and March 13, 2004, but that had not been finalized. JA3207(769-70),JA11141,JA11933-34. These transactions involving “Qualified Transportation Property” (“QTP”) would be respected under prior law, even if completed after March 12, 2004. WFEFI entered into

five leases of QTP, which the IRS respected under prior law even though they are structurally indistinguishable from the Trial Transactions. JA3207-11(771-86),JA11173. Since Congress intended to sustain the “anticipated federal tax benefits” of QTP leases under prior law (JA11141), it follows that the structurally indistinguishable Trial Transactions *also* were in compliance with prior law. The inclusion of a prospective date protecting prior leases and the QTP rule protecting pending leases proves that Congress intended to shield the interests of those which had entered into leases *encouraged* by the FTA. *See Mars, Inc. v. Comm’r*, 88 T.C. 428, 434-35 (1987).

I. WFEFI Is the Owner of the Equipment Because It Faces Residual Value Risk

US’s principal argument is that WFEFI is not the owner of the leased equipment because it never assumed the risk of equipment depreciation. USBR40-48,53-55. According to US, this question turns on “whether the taxpayer has undertaken ‘substantial financial risk’ in the underlying property.” USBR41. US claims WFEFI fails this test because it will “recoup[] its entire investment in each transaction” from rents and service contract Basic Fees, and not from “the Equipment’s

residual value.” USBR43. This argument is contrary to tax law and commercial law prescribed in the UCC.

A. A Meaningful Residual Interest Is the Key Attribute of Ownership

US claims that despite WFEFI having a 20% residual interest, it is not the equipment owner because the rents and Basic Fees are sufficient to recoup its equity investments. USBR41,43,48. Decades of settled tax law contradict this argument.

As explained in Wells’s Opening-Brief (WFBR41-42), the key indicium of ownership is “the potential to realize a profit or loss on the sale or re-lease” of the equipment after the original lease expires. *Levy*, 91 T.C. at 862. To qualify as a “true lease” for tax purposes, the equipment must have a useful life that extends significantly beyond the leaseback term. *E.g.*, *Consol. Edison*, 90 Fed. Cl. at 270; *Levy*, 91 T.C. at 860.

Similarly, common law provides that the “hallmark” of a true lease is that the lease term is for a “period less than” the equipment’s “economic life,” providing a lessor with “an economically meaningful residual interest.” *In re Gateway Ethanol, LLC*, 415 B.R. 486, 499

(Bankr. D. Kan. 2009). This common law principle is codified in the UCC. *Id.* at 503.

Here, US agrees that 20% residual life periods are sufficient to establish ownership under tests set forth in the IRS's Leasing Guidelines and case law. USBR48;WFBR17-18,41-42. US is therefore forced to fabricate a new test that contradicts tax law and the UCC.

B. US's "Recoupment" Theory Is Contrary to Tax and Commercial Law

The fundamental flaw in US's novel "recoupment" argument is that it disregards WFEFI's ownership risks during the residual interest period and the effect those risks have on its ultimate profit or loss, in violation of established case law.

US relies on *Estate of Thomas*, but that opinion stated "[t]his court has upheld lease transactions *where total rentals over the lease terms equaled or even exceeded the total cost of the equipment.*" 84 T.C. at 436 (emphasis added). In *LTV* the rentals exceeded the leased equipment's purchase price, providing the lessor with a 3% annual return. 63 T.C. at 42. Similarly, in *Kansas City Southern Railway Company v. Commissioner*, the "rental rates allowed [the lessor] to recoup the cost of the equipment plus a 3-percent return." 76 T.C. 1067,

1101 (1981) (emphasis added). And, in *Lockhart Leasing Company v. Commissioner*, “the total amount to be paid by the lessee during the primary term of the lease was...in excess of the cost of the equipment to [the lessor].” 54 T.C. 301, 306 (1970), *aff’d*, 446 F.2d 269 (10th Cir. 1971) (emphasis added). In each case, the Tax Court nonetheless concluded that the leases were leases in substance as well as form.

US claims—relying solely on a CRS-Report that is not in the record and was not offered as an expert report at trial—that “recoupment” distinguished “SILOs and LILOs from traditional leveraged leases.” USBR5. *LTV, Kansas City*, and *Lockhart* are to the contrary, establishing that “recoupment” of an equity investment from rental payments is a common feature of “traditional” leases.

US recently made the same “recoupment” argument in *Consolidated Edison*. 90 Fed. Cl. at 297. Judge Horn recognized the error in this argument: during the residual period, the equipment’s “residual value” is “at risk and subject to the potential for both gains and losses,” because “plaintiff would be exposed to a large variety of risks and opportunities with respect [to the leased equipment],” including “any economic failures.” *Id.* at 248, 298, 327.

US's argument is wrong here for these same reasons. The equipment will be returned to WFEFI when it is expected to have a meaningful residual life of at least 20% of its originally expected useful life (longer than the residual period in *Consolidated Edison*). WFEFI will face both opportunities and risks during this residual period, and will be solely responsible for “any economic failures” of the equipment. *Id.* at 248. Any losses during the residual period will directly reduce WFEFI's net income.

The “recoupment” argument is also contrary to commercial law defining traditional lessor status. UCC section 1-203(c)(1) provides that a lease cannot be recharacterized “merely” because the lessor is expected to recoup its investment from rental proceeds. Revision of UCC, Article 1, §1-203, 29 (2001). Therefore, if a lease satisfies the other common law true lease requirements, including the lessor having a meaningful residual interest, it must be respected as a lease. Adopting US's recoupment test would place this Court—and tax law—at odds with the substantive law governing commercial transactions.

C. US Relies on Cases that Confirm a Meaningful Residual Interest Is the Key Ownership Criterion

The cases US relies on do not support its “recoupment” claim, but instead support WFEFI’s argument that the presence of a meaningful residual interest is the key test of ownership. In *Kwiat*, the lessor had a “put” by which it could force the lessee to buy the equipment, thus transferring all residual risk to the lessee and eliminating the lessor’s exposure to residual value. 64 T.C.M. (CCH) at 329-30, 333; *accord Aderholt Specialty Co. v. Comm’r*, 50 T.C.M. (CCH) 1101, 1103-04, 1107-09 (1985).

WFEFI’s leases are markedly different. WFEFI has no contractual right to force the lessees to buy the leased equipment. US emphasizes that WFEFI can elect the service contract at the lease expiration. But even if WFEFI exercises the service contract option, the service contract will terminate at a point no later than 80% of the equipment’s originally expected useful life, leaving WFEFI with a 20% residual exposure. JA14178,JA16765,JA15236,JA18255.

In *Aderholt*, the court recognized the result would have been the opposite if the lessor “could not compel [the lessee] to purchase the airplane.” *Id.* at 1107. In those circumstances, the lessor would retain

exposure to residual value risk and the “risk of depreciation” would be “very real.” *Id.* n.13. *That is exactly the situation here:* WFEFI cannot compel its lessees to bear any equipment risk beyond the termination of the service contract.

Swift Dodge v. Commissioner is another case where contractual terms insulated the lessor from *any* residual value risk. The lessee was required to reimburse the lessor if the actual residual value was less than a specified amount, and the lessor was required to reimburse the lessee for any excess. The lessor’s total compensation was therefore fixed, which insulated it from residual risk. 692 F.2d 651, 654 (9th Cir. 1982). In WFEFI’s case, its income is not fixed but will rise or fall with the equipment’s residual value.

Finally, in *Coleman v. Commissioner*, the lessor had no meaningful residual interest because the residual value of the leased property was significantly less than the lessor’s debt, and the lessor would thus abandon the property. 16 F.3d 821, 827-28 (7th Cir. 1994). *Coleman* directly *supports* WFEFI’s position because it holds that “residual value” should be the “foremost consideration” in determining ownership. *Id.* at 827.

D. Service Contracts Expose WFEFI to Residual Risks

Because rental payments in the Transit Transactions will not repay WFEFI's equity investment, US's "recoupment" argument necessarily includes the service contract fees in the "recoupment" calculation and assumes that such fees are not subject to the risks of ownership. That assumption is contrary to economic reality and the Code.

Section 7701(e)(1)(D) distinguishes "lease[s]" from "service contract[s]" because a service provider (as opposed to a lessor) faces the "risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract." By contrast, in a leveraged lease, a lessor faces no such risks because the lessee has an unconditional obligation to pay rent. WFBR18-19.

WFEFI is subject to risk of loss during the service contract if it is unable to provide service. US misreads the service contract to provide that if WFEFI's Basic Fees "are reduced due to equipment unavailability, then the third-party operator must pay WF 'an amount equal to such reduction.'" USBR47. But that provision applies *only if the "equipment unavailability" is due to the "negligence, malfeasance, or*

misconduct of the Operator.” JA14565. In all other circumstances where the promised services are not provided, WFEFI will *not* be paid (or reimbursed) by either the operator or service recipient.

Because a service provider assumes greater risks and responsibilities than a lessor, service contracts generally provide service providers with greater revenues. Section 7701(e)(1)(F) reflects this economic reality, recognizing service contract fees should “substantially exceed” the rental value of the property. Thus, even if US’s “recoupment” theory were correct, it would have no application in a transaction where a lessor’s “recoupment” depends on fees that necessarily exceed normal rental income. JA14190,JA15286.

Similar to its claims regarding the service contract fees, US argues that the presence of residual value insurance and residual value guarantees in some, but not all, of the Trial Transactions undermines WFEFI’s residual interest in the equipment. USBR23. This contention is wrong. The insured amounts are significantly below the expected values of the property, necessarily exposing WFEFI to the residual value of the equipment. *See Gefen*, 87 T.C. at 1490-92 (residual value insurance indicative of meaningful residual). And it is extremely

unlikely that the equipment's value will decrease enough for these provisions to come into play. JA15294-95,JA16821-22,JA18311-12,JA14184.

E. WFEFI Is Entitled To Take Depreciation Deductions

US claims that WFEFI does not have a depreciable ownership interest because its "investment" is not subject to "consumption" through a decline in equipment value. USBR41. This argument ignores the fact that when the lessees return the equipment to WFEFI, it will be worth far less than its original cost. In NJT, WFEFI purchased railcars for \$71,560,000. When the lease expires, the value of WFEFI's railcars is expected to be \$41,185,608. JA14173-76,JA14201. At the end of any service contract, the value of the equipment is expected to be \$16,548,374. *Id.* Because the leased property will decline in value, WFEFI's investment has been subject to consumption.

II. The Lessees' Purchase Options Do Not Defeat WFEFI's Ownership

Relying on its "recoupment" argument, US asserts that whether WFEFI's lessees are certain to exercise their purchase options is "irrelevant" to the "substance-over-form" inquiry. USBR38,49. This

argument contradicts both tax and commercial law. If exercise of the lessee's purchase option is not certain, the lessor necessarily holds a meaningful residual interest. *See Gateway Ethanol*, 415 B.R. at 500 (certain exercise of option "leave[s] no meaningful reversion for the lessor").

Judge Horn refuted US's argument in *Consolidated Edison*, explaining that it "*hinges on* [the] assertion that the Sublease Purchase Option is certain to be exercised." 90 Fed. Cl. at 294. But when "the exercise of the Sublease Purchase Option is *not guaranteed*, the residual value in the [leased equipment]...is at risk and subject to the potential for both gains and losses." *Id.* at 298, 331-32 (emphasis added).

By reaching opposite conclusions, two Claims Court cases illustrate this point because certainty (or uncertainty) that the purchase options will be exercised depends on the option prices. In *Transamerica*, 15 Cl. Ct. at 442, the court held that the lessor owned the leased property because exercise of the purchase option was "not a certainty." In contrast, in *Transamerica*, 7 Cl. Ct. at 448, the court held that the lessor was not the owner of the leased property because the purchase option price was substantially below FMV. *See also Lockhart*

Leasing, 446 F.2d at 270-71; *LTV*, 63 T.C. at 50. Indeed, *Frank Lyon* upheld a lease where the purchase option was set at FMV, and its exercise was uncertain. 435 U.S. at 569.

US relies on *AWG*, but that case directly contradicts its argument that the purchase option is “irrelevant” to the substance-over-form inquiry. In *AWG*, the district court ruled that the lessor did not acquire ownership of the leased equipment because “*it is nearly certain that AWG will exercise [its option].*” 592 F. Supp. 2d at 981-82 (emphasis added).

US’s reliance on *BB&T* is likewise misplaced. In *BB&T*, decided on summary judgment, US produced expert reports demonstrating that the lessee had “no economic incentive” to do anything other than exercise the purchase option and the taxpayer did not provide any evidence to the contrary. 523 F.3d at 473, 475-76. In both *AWG* and *Consolidated Edison*, the courts recognized that in *BB&T* “exercise of the purchase option” was “near-certain.” 592 F. Supp. 2d at 979; 90 Fed. Cl. at 331 (option “virtually certain” of exercise).

A. WFEFI's Leases Must Be Respected Unless the Lessees Were Certain To Exercise Their Options

US incorrectly argues that the relevant standard is merely whether the lessee is “*expected*” to exercise its option. USBR59 (original emphasis). This argument is contrary to decades of authority establishing that a purchase option deprives the lessor of its ownership interest only if the lessee is *virtually certain* to exercise its option. *Consol. Edison*, 90 Fed. Cl. at 294; *Transamerica*, 15 Cl. Ct. at 442; *AWG*, 592 F. Supp. 2d at 958, 981-82, 984, 985, 990 (referring to “certain[ty]” of purchase option five times). WFBR42-43. A mere expectation that the option will be exercised is insufficient. WFBR56.

The only authority US cites for its “expected” standard is *Stobie Creek Inv. v. United States*, 608 F.3d 1366 (Fed. Cir. 2010), which is not a leasing case and does not involve a purchase option, and therefore cannot possibly support US’s argument. The issue in *Stobie Creek* was not whether exercise of an option was “expected,” but whether the investor “expected” an economic profit. *Id.* at 1378.

US incorrectly argues that a purchase option analysis is properly part of the “economic substance test,” not the “substance-over-form” test. Case law has always analyzed purchase options under the

“substance-over-form” test. *E.g.*, *Transamerica*, 7 Cl. Ct. at 447-48 (“substance” of lease was a conditional sale because purchase option was certain to be exercised); *AWG*, 592 F. Supp. 2d at 981-82 (analyzing purchase option under “substance-over-form” analysis).

US wrongly claims that the CFC’s purchase option analysis was included in the “economic substance” portion of the CFC’s opinion. USBR58. The CFC discussed the effect of the purchase option at JA61 and JA63, which are part of the opinion (beginning at JA59) that discusses the substance-over-form issue. The CFC’s “economic substance” discussion begins at JA68 and does not contain any discussion of the purchase option.

B. The Purchase Options Are Not Certain To Be Exercised

Apart from the opinion of Lys, no other evidence in the record supports “certainty” of exercise of the purchase option.

Indeed, US’s brief asserts not that that exercise was “certain,” but that it was “expected” or “most likely.” *See* USBR59-63. A hope or expectation that the option would be exercised is insufficient as a matter of law. WFBR56. *Breece Veneer & Panel Co. v. Comm’r*, 232 F.2d 319, 323 (7th Cir. 1956); *Benton*, 197 F.2d at 750, 753. And even as to

“expectation,” US misconstrues the record. For instance, it plucks a prediction that Belgacom is “expected” to exercise its purchase option from a WFEFI document, yet omits another statement that “Belgacom will most likely purchase the equipment for Fair Market Value” by exercising a separate purchase option to buy the equipment for FMV. JA12429; *see* WFBR55. If Belgacom exercises the FMV option, rather than the fixed-price option, WFEFI will be exposed to all the risks affecting the value of its residual interest. US’s argument regarding the Belgacom option even contradicts its own expert witness, who agreed it was “speculative” whether Belgacom would exercise the fixed-price option. WFBR54.

Other evidence confirms that exercise of the lessees’ purchase options is uncertain. Most telling, the transit lessees testified that their exercise of the option is necessarily uncertain because relevant factors will change during the 20-year period before the option exercise date. WFBR48-49. This evidence of the lessee’s contemporaneous intent is critical. *In re WorldCom Inc.*, 339 B.R. 56, 67-68 (Bankr. S.D.N.Y. 2006). US does not refute this testimony, or that of *both* parties’ transit

and telecommunication experts, who agreed that the lessees were *not* certain to exercise their purchase options. WFBR52-56.

US incorrectly contends that service contract provisions compel the lessees to elect their purchase options to avoid the service contracts. But US's transit expert admitted that the lessees would *not* be compelled to exercise their options. WFBR53. In approving the transactions, the FTA concluded that no compulsion existed. JA16659,JA10912,JA18238-39. And though US claims that finding an operator to run the transit service would be "difficult and onerous," in the "short time period" allotted, the record proves that a variety of companies are "willing and able" to provide such services and that WMATA negotiated the period allowed to find an operator and considered it sufficient. JA3229(857-58),JA5242(2235-36);USBR20.

US ignores the evidence that transit agencies plan for their equipment needs years in advance. JA6850(3335-36). Therefore, if a lessee decides it does not want to exercise the purchase option, it has years to plan for a service contract. WMATA is already preparing to replace the cars it leases from WFEFI and has at least 15 years to review its options. JA27508.

C. Lys's Methodology Is Contrary to Law Because It Is Not Based on the Equipment's Expected FMV

Tax and commercial law both hold that whether a purchase option is certain to be exercised must be evaluated based on the projected *fair market value* of leased equipment. WFBR45-48. *WorldCom*, 339 B.R. at 66-67. If the option price is nominal compared to the equipment's projected FMV, the lessee will exercise the option and the lessor's residual interest is negated. *See In re QDS Components, Inc.*, 292 B.R. 313, 328-31 (Bankr. S.D. Ohio 2002).

The proper discount factor to be used to measure the expected residual value of the leased equipment as of the purchase option date is therefore central to the dispute between the parties. *See* WFBR46-48; USBR65-66. US defends the methodology used by Lys, which was not based on FMV at all, but instead calculated a unique value each lessee would supposedly place on its own equipment. WFBR45.

By contrast, WFEFI's appraisers used the FMV standard to evaluate the purchase option. WFBR44. US claims that the discount rates used by WFEFI's appraisers are "excessive." USBR65n.21. But at trial US presented no evidence challenging those discount rates,

claiming instead they were “irrelevant.” JA9620(5094-95),JA9621(5099-100).

In fact, WFEFI’s appraisers used appropriate discount rates to determine FMV, while Lys used a rate that substantially overvalued the leased assets. Although US criticizes WFEFI’s appraisers for using a discount rate appropriate for “profit-seeking enterprises” (USBR65), there is universal agreement among economists and finance experts that government agencies *should* use the same discount rates as “profit-seeking enterprises,” and that use of low government borrowing rates advocated by Lys would result in government agencies overvaluing and overpaying for assets. WFBR47-48. This is why other experts agreed that government agencies should use “market prices for choosing the discount rate.” WFBR47-48. At trial, Lys conceded (and US does not deny) that his method does not calculate “fair market value” prices for assets held by government agencies. JA8809(4500-01),JA8852(4675). His overvaluing the leased equipment leads directly to his conclusion that the lessees will exercise their options. WFBR45.

Citing three documents, US claims that Lys’s discount rates were supported by “published authority and factual evidence regarding how

the Tax-Exempts analyzed similar decisions.” USBR65. This statement is simply not true. The first document, JA26411, is a letter from NJT to the FTA, which was not “published” or available to any party seeking to evaluate the options. *See WorldCom*, 339 B.R. at 67-68 (purchase option evidence must relate to parties’ contemporaneous expectations). And despite US’s reliance on this document, the document does not reference any interest rate to be used by NJT.

The next document is JA26414, an unpublished attachment to JA26411. JA26414 refers to “Appendix B,” which includes a financial analysis of leasing railcars, in which NJT’s *rental payments* are discounted by a 4.5% discount rate. That calculation was prepared pursuant to 49 C.F.R. §639, which Lys never cited in his report but US now claims supports his analysis. USBR66. This regulation provides instructions on how to assess the costs of “future payments” under a lease, but contains nothing suggesting that a transit agency should use its borrowing rate to determine the value of the uncertain residual interest in leased equipment. Discounting rental payments by a lower borrowing rate makes sense because rental payments—unlike the equipment’s residual value—are fixed. But Appendix B does not apply

the 4.5% discount rate to determine the buses' residual value and therefore does not support US's claim.

The final document US cites is JA26783, which is nothing more than a page from Lys's own unpublished report stating that a WFEFI document "implies" that WFEFI "estimates NJT's cost of borrowing to be 5.46%." This document does nothing more than "estimate" NJT's low borrowing rate and nowhere indicates that NJT would value the equipment using a borrowing rate.

Accordingly, the record contains no published authorities supporting Lys's methodology. At bottom, Lys's analysis is based not on material available to or considered by WFEFI or its lessees, but solely on Lys's subjective, unsupported opinions. WFBR46-47. It cannot be used to prove that the purchase option would "certainly" be exercised.

D. Exercise of the Option Is Not "Free" to the Lessees

US asserts that exercise of the option comes "at no cost" to the lessees because funds have been set aside in a defeasance account. USBR48n.15,62. The Fourth Circuit adopted this analysis in *BB&T*, where the option price was paid out of the lessor's funds, not the

lessee's, and therefore exercise of the option was "free" to the lessee. 523 F.3d at 473 n.13.

The facts here are quite different. US concedes that the lessees will "receive the funds from the defeasance accounts" if they do not exercise the purchase options. USBR30. Thus, if NJT chooses not to exercise the purchase option, it will receive back \$122 million in its own funds from the defeasance accounts. JA3259-60(980-81),JA26784(¶68). Because NJT can either keep this amount or keep the leased equipment, keeping the leased equipment will cost NJT \$122 million. Even Lys agreed that exercising the option will cost NJT \$122 million and was not "free": his analysis explicitly included this amount as a *cost* to the lessee for exercising the purchase option. JA26784(¶68).^{1/}

Judge Horn in *Consolidated Edison* pointed out this error in US's argument. The funds in the defeasance accounts are available to the

^{1/}US edits the transcript to claim that "one appraiser conceded" that defeasance "could give rise to compulsion to exercise a purchase option." USBR67. The transcript actually reads as follows:

Q Could defeasance become an element that could give rise to compulsion to exercise a purchase option?

A I guess it could. I don't really know, though, for sure.

JA5655(2538).

lessees, without regard to which option the lessees and WFEFI select. The availability of the funds across all options would have no effect on the lessees' choice of options. *Consol. Edison*, 90 Fed. Cl. at 285.

US suggests that the lessees would be unlikely to receive their defeasance funds because they must use them to pay fees under the service contract. USBR30n.11. This statement is incorrect. Lessees have the option to locate another transit agency willing to serve as the service recipient. Both WFEFI's expert and US's leasing expert testified that it would be feasible for the lessee to find another transit agency willing to serve as service recipient. JA6863(3387-89),JA8016(3986-88). The defeasance funds then would be returned to the lessees. JA8012-13(3972-76).

III. WFEFI Incurred Genuine Indebtedness

A. Wells Challenged the CFC's Holding with Respect to the Loans

US erroneously claims that Wells failed to challenge the CFC's holding that the nonrecourse loans are not genuine. Wells's brief argued that WFEFI is entitled to "*interest deductions* on the debt incurred to buy the equipment" and "*interest on acquisition indebtedness.*" WFBR4-5. Wells's brief demonstrated that it was entitled to these deductions

because “the Trial Transactions are *genuine* leveraged leases.” WFBR60 (emphasis added). A leveraged lease, by definition, is a lease financed with nonrecourse debt. WFBR8. Wells therefore challenged the CFC’s holding that it is not entitled to interest deductions.

By challenging the CFC’s holding that the Trial Transactions failed the substance-over-form and economic substance tests, Wells necessarily challenged the CFC’s holding that the nonrecourse debt, which is integral to the Trial Transactions, was not genuine. In *Consolidated Edison*, Judge Horn held—without a separate discussion of the interest issue—that tax deductions, including interest deductions, are permissible where the underlying transaction meets “the doctrines of substance over form and economic substance.” 90 Fed. Cl. at 301. Similarly, in *Levy, Mukerji*, and *Estate of Thomas*, the Tax Court upheld the challenged transactions without engaging in a separate analysis of whether the debt was genuine. 91 T.C. 838; 87 T.C. 926; 84 T.C. 412. A separate analysis of the debt was unnecessary because the transactions had “economic substance” and their substance matched their form.

B. Contrary to US's Claims, the Nonrecourse Loans Are Real

US contends that the loans here are not “real” because “WF repaid the ‘loan’ the same day it was made.” USBR57,35. This claim is wrong. The lessees retained ownership of the defeasance accounts, and thus, contrary to US’s claim, the loans were not repaid at the closing.

A defeasance account involves an obligor (here, the lessee) setting aside funds that, together with interest, should be sufficient to pay a future obligation, such as rent. WFBR14. In an economic defeasance, a lessee remains liable for its payment obligations notwithstanding the creation of the defeasance account. If there is a shortfall in the account, the lessee must cover the shortfall using another source of funds.

Consol. Edison, 90 Fed. Cl. at 322-23; Rev. Rul. 85-42, 1985-1 C.B. 36, 37; Municipal Securities Rulemaking Board, http://www.msrb.org/MSRB1/glossary/view_def.asp?param=DEFEASANCE.

Because the lessee remains at risk if the defeasance funds are lost or diminished, the lessee is the owner of the funds under tax law.

WFBR14. *Douglas v. Willcuts*, 296 U.S. 1, 9-10 (1935); *Ossorio v. U.S.*, 18 F. Supp. 959, 964-65 (1937); *Consol. Edison*, 90 Fed. Cl. at 305, 322-

23; *see* Rev. Rul. 85-42. Therefore, any payment of rent made from the defeasance account on the lessee's behalf involves a transfer of wealth from the lessee to the lessor, which diminishes the lessee's assets.

Consol. Edison, 90 Fed. Cl. at 305, 322-23.

Here, Wells paid each lessee the property's FMV at closing. The lessees used a portion of these proceeds to fund defeasance accounts that obligate the defeasance provider to make rental payments on the lessees' behalf. The lessees, however, remain unconditionally responsible for paying rent if the "deposit taker does not perform." JA8021(4006-07),JA6016(2657-60),JA14807,JA13778,JA16088,JA16121,JA16158,JA17650,JA12868-69. As US recognizes (*see* USBR30), after the lessees' obligations are satisfied, all remaining funds in the defeasance accounts will revert to them. *E.g.*, JA14531(NJT).

US apparently claims the loan was repaid the "same day it was made" because the lessee placed its defeasance account with an affiliate of the lender. But the lessee retains ownership of the defeasance account, and thus the lessee's funds are not used to "repay" the loan. The lessee uses its defeasance account to pay rent to WFEFI, which in

turn uses rental income to repay its debt, as is common to all leveraged leases. *See Levy*, 91 T.C. at 860. Undisputed evidence demonstrated that WFEFI was able to obtain a lower interest rate because the lessee agreed to hold the defeasance account at an affiliate of the lender. JA3610(1053-54). Thus, there was a sound business reason for placing the defeasance account at an affiliated bank.

Although the lenders and defeasance holders are related, each operates its own independent business. JA13821,JA13823-24. The lender does not have the power to control the defeasance holder. JA13822. The lender and the defeasance holder also waived any rights of offset that they may have against the other. JA13822,JA14804. Thus, the lender has no ability to seize the defeasance funds to satisfy WFEFI's loan. JA7263(3650-51).

The record proves that the defeasance accounts here addressed business and regulatory concerns, including non-appropriation risk, currency risk, and the FTA's requirements. JA8020(4004-05). *See Consol. Edison*, 90 Fed. Cl. at 243. US denies that the FTA required defeasance, even though the head of the FTA's leasing program testified that defeasance was a "*de facto*" requirement. JA2867(728). There is no

dispute, however, on one fact: *the FTA never approved a lease without defeasance*. JA11347,JA2867(727-28). Thus, defeasance accounts were, at a minimum, “encouraged by” the FTA. *See Frank Lyon*, 435 U.S. at 583-84 (structure “encouraged by...regulatory realities”).

The CFC and US recognize that defeasance accounts do not eliminate risk, only *reduce* the risks of nonpayment. JA7; USBR54n.17. *See Consol. Edison*, 90 Fed. Cl. at 306. The FTA also understood that “even under defeased transaction structures,” lessees could face catastrophic losses. JA10703; WFBR13-14. US’s leasing expert agreed WFEFI could lose its entire investment in the event of default by a defeasance party. JA7647(3850).

The events that might lead to a catastrophic default are not remote: the recent financial crisis has led to defaults in so-called “SILOs,” resulting in threatened bankruptcies, and several of WFEFI’s leases are in default. WFBR58-59. *Hoosier Energy*, 582 F.3d 721.

IV. WFEFI’s Transactions Had Economic Substance

US claims that the CFC determined the Trial Transactions lacked economic substance because (i) the lessees would exercise their purchase options (see Section II, above), (ii) WFEFI had no reasonable

expectation of profit, and (iii) WFEFI entered into the transactions solely for tax purposes. USBR58-59. These arguments are without merit.

A. WFEFI Had a Reasonable Expectation of Profit

WFEFI has proven that the Trial Transactions are expected to generate from \$62 to \$83 million in profits (before any profit or loss from residual value) under the “cash-in, cash-out” standard that consistently has been followed in case law and IRS guidance. WFBR28-34. US does not dispute these calculations. This profit takes into account all transaction costs. *See, e.g.,* JA13750 (investment amount includes transaction costs).

In response, US claims, and the CFC held, that the Trial Transactions were not profitable under a net present value (“NPV”) analysis and a nominal accounting profits/cost of funds analysis. USBR68-73. Both of these analyses conflict with accepted measures for determining profit in leasing transactions.

1. The CFC’s NPV Analysis Is Contrary to Law

To support the CFC’s NPV analysis, US relies primarily on *ACM*. 157 F.3d at 259. Wells has explained why *ACM* has no application here. WFBR32-33. US has not disputed Wells’s demonstration that all

leases—including “traditional” leases—would fail *ACM’s* NPV test.

WFBR31n.10,33-34.

The only leasing cases cited by US (one of which Wells also cited, WFBR30n.9) are the exceptions that prove the rule. *Schillinger*, 1 F.3d 954, *aff’g* 60 T.C.M. (CCH) 1470; *Rogers v. Comm’r*, 60 T.C.M. (CCH) 1386 (1990). In these cases, the Tax Court applied an NPV analysis but expressly limited this approach to unique cases involving energy management systems (“EMS”). *Schillinger*, 60 T.C.M. at 1474, 1477. The facts of these cases were egregious: equipment was valued at 80 times its FMV, \$10,000 in advance rentals were paid on equipment worth \$1,000, and there was doubt the equipment even existed. *Id.* at 1474, 1478-79. WFEFI’s case does not involve similar facts.

US mistakenly relies on the recently codified economic substance doctrine as an endorsement of Lys’s NPV analysis. USBR68. As US recognizes, the new law applies only “prospectively” and has no impact on the Trial Transactions. USBR68.

And in enacting §7701(o), Congress rejected Lys’s profit calculation that artificially calculates a loss by discounting future cash flows using a benchmark rate of return: the new law “does not require

or establish a specified minimum return that will satisfy the profit potential test.” H.R. Rep. No. 111-443 at 298 (2010). WFBR28-29. The new law applies present value concepts only for the limited purpose of valuing (not calculating) net profits that have been calculated using the cash-in, cash-out method. §7701(o)(2)(A); Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the Reconciliation Act of 2010, JCX-18-10 (2010). Accordingly, although reducing net profits to present value causes profits to have a lower value, it would never convert a profitable transaction to one that generates a *loss*. US is therefore asking this Court to adopt a new profit calculation that conflicts with settled law and the economic substance test that Congress just enacted.

2. The CFC’s Cost of Funds Analysis Is Flawed

US states that the CFC properly adopted Lys’s “nominal-accounting profits” method, which attributes an interest cost to WFEFI’s equity investment. USBR72. But WFEFI did not borrow its equity investment. In citing Johnson’s testimony to claim that WFEFI borrowed a “portion of its SILO equity investment” (USBR73), US omits Johnson’s explanation that his testimony related to “*theoretical*”

borrowing, not any actual borrowing. JA4837(1966-67). Lys confirmed that he saw no evidence that WFEFI actually borrowed funds. JA8829-30(4583-84).

Accordingly, Lys's testimony necessarily rests on an *imputed* interest cost, not any *actual* interest cost. US does not address the authorities discussed on page 34 of Wells's Opening-Brief, which hold that imputing an interest cost to a lessor that did not actually borrow funds for its investment is improper.

Even Lys's imputation of hypothetical costs fails to show that the transactions were unprofitable. JA26796. The hypothetical costs Lys used were the rates of interest on the nonrecourse loan and Wells's "implied cost of fund[s]." JA21334-35. Lys's workpapers show that he performed the same analysis using Wells's actual "Average Borrowing Rate." *Id.* But Lys conceded that he did not use these *actual* borrowing rates in his calculations. JA8843-44(4636-41). Replacing Lys's hypothetical rates with Wells's *actual* borrowing rates reversed Lys's conclusions: the Trial Transactions then became profitable. JA9239-40(4888-92),JA21333-37. Lys apparently discarded Wells's actual borrowing rates only because they did not fit his preordained result.

B. WFEFI Had a Business Purpose for Entering into the Trial Transactions

US offers not a word to defend the improper “but for” standard used by the CFC in analyzing business purpose. USBR74. The CFC determined that the Trial Transactions lacked business purpose because WFEFI would not have entered into them “[w]ithout the claimed tax benefits.” JA70. This “but for” test is contrary to settled law, including *Coltec*, 454 F.3d at 1355, n.13, which permits a taxpayer to consider tax benefits so long as taxes are not the *sole* motive. WFBR38.

Lys *agreed* WFEFI was not motivated *solely* by tax when he testified WFEFI needs “both the before-tax cash flow and the tax benefits for this transaction to make sense.” JA8866(4728). Further, as explained above, the Trial Transactions were expected to produce a pretax profit under the correct cash-in, cash-out standard, and thus necessarily have a non-tax business purpose. *Estate of Thomas*, 84 T.C. at 440 n.52.

In short, the CFC erred as a matter of law by applying an improper “but for” test to determine whether the Trial Transactions have economic substance. *See* WFBR38-40.

US also claims that the CFC properly rejected, as a business purpose, the favorable financial earnings provided by FAS13. USBR74-75. US and the CFC rely on *American Electric Power*. But in that case, unlike the Trial Transactions, the earnings and cash flow came *solely* from tax deductions. 326 F.3d at 743-44. WFBR36. In contrast, US's leasing expert agreed that the Trial Transactions' earnings are attributable to *pretax cash flow*, not tax deductions. JA8006(3948-49).

US finally invokes the recent codification of the economic-substance doctrine, which disregards financial accounting benefits as a business purpose “if the origin of such financial accounting benefit is a reduction” of taxes. USBR75. But this statutory provision supports WFEFI. As explained above, WFEFI's FAS13 earnings have their “origin” in pretax income, not tax deductions. Although tax benefits affect the period in which FAS13 earnings are recognized, US's expert admitted the earnings are attributable solely to pretax cash flow, not tax benefits. JA8006(3948-49).

CONCLUSION

The CFC's judgment should be reversed, with instructions to enter judgment in Wells's favor.

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