CHRONOLOGICAL SUMMARY AND TRANSACTION STRUCTURES

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Lease Definitions

- **True Lease** – A specific type of multi-year lease which does not pass ownership rights of the asset to the lessee. A true lease is an arrangement where the lessor (the person granting the lease) bears both the risks and rewards of ownership of the property.
- **Financial Lease** – Financial leases pass more of the aspects of ownership on to the lessee, such as maintenance and tax benefits from depreciation. Financial leases are often treated as loans (capitalized leases) by the IRS, whereas true leases are not.
- **Leveraged Lease** – A lease agreement that is partially financed by the lessor through a third-party financial institution. In a leveraged lease, the lending company holds the title to the leased asset, while the lessor creates the agreement with the lessee and collects the payment. The payments are then passed on to the lender.

Historical Development of Leveraged Leasing

- **1962**- impetus for equipment leasing was an **investment tax credit enacted in 1962**, including deductions for depreciation on an accelerated basis.
- **IRS issued Rev. Proc. 75-21 establishing guidelines** the IRS would use in determining whether leveraged leases would be respected as leases for tax purposes.
- **However, Rev. Proc. 75-21** expressly stated that its guidelines "**do not define**" as a matter of law, whether a transaction is or is not a **lease for federal income tax purposes.**

Historical Development of Leveraged Leasing

- **1981 –Provisions of the Economic Recovery Tax Act of 1980** substantially liberalized traditional leasing rules under which businesses were required to operate for Federal tax purposes, making it possible for both the lessor and lessee to maximize the benefits of depreciation deductions and tax credits associated with owning property.
- **Safe Harbor Leases** – The 1981 Act created a type of leasing arrangement which became known as safe harbor lease. The new provisions guaranteed that a transaction would be recognized as a lease for Federal income tax purposes, regardless of existing IRS guidelines for determining whether the transaction is a lease, or merely a financing arrangement not subject to the same tax benefits, and also regardless of whether its nontax economic substance would otherwise be recognized as a true lease.
- **Safe Harbor Leases** totaled over **$22 billion in 1981**
- **Railroad equipment (freight cars)** primary beneficiary of transactions

Historical Development of Leveraged Leasing

- **1982- Tax Equity and Fiscal Responsibility Act (TEFRA)** enacted to change the 1981 safe harbor leasing rules which Congress believed "enabled some taxpayers to avoid their equitable share of tax". The modifications increases federal tax revenues by $1.1 billion in 1982
- **TEFRA** restructured the leasing rules of the Economic Recovery Tax Act of 1981 and reduced the tax benefits available to companies through safe harbor leasing.
- **1984 Pickle Rule** – named after Texas Cong. JJ Pickle - property leased to a tax-exempt entity is generally subject to unfavorable straight line (rather than accelerated) depreciation over the longer of the applicable asset class or 125 percent of the lease term. Impact was to eliminated accelerated depreciation for leveraged lease transactions.

LILOs, SILOs and QTEs

- **LILO**- "lease-in, lease-out transaction
- **SILO** – "sale-in, lease-out transaction
- **QTE** – Qualified Technical Equipment (depreciated over 5 years- exempt from Pickle Rule)
- **SILOs and LILOs** are variations on financing transactions born of the storied history of **sale leaseback transactions.**
- **Defenders** of SILO and LILO transactions have argued that they are legitimate investments providing a vital source of funding to public transportation systems.
- **Critics**, such as then Senate Finance Committee ranking minority member Chuck Grassley, have denounced them as nothing more than, "good old fashioned tax fraud".
- **Between 1984 and 2004**, before the Congressional "crackdown" on LILOs and SILOs there were **400 transactions claiming tax deductions of more than $35 billion.**
- **Public Transit Agencies** – in their heyday, these transactions found many willing tax-exempt participants **–there were 99 transactions involving passenger railcars, locomotives, and QTE**

Tax-Driven Benefits of LILOs and SILOs

- LILOs and SILOs are generally unattractive investments from a pretax perspective. Their primary financial benefit is derived by transferring unused or unusable tax benefits to an investor that is able to use them.
- LILOs and SILOs depend on the cooperation of a tax-indifferent party, usually a government agency or foreign entity not subject to U.S. income tax.
- A tax-indifferent party receives no U.S. tax benefit from depreciation or interest deductions attributable to its assets.
- In a SILO transaction, a taxable third party takes advantage of these unusable tax benefits by purchasing property from the tax-exempt entity and then immediately leasing the property back to the tax-exempt entity. The taxable party deducts depreciation on the assets it now claims to own. The investor also claims significant interest expense deductions because it acquired the property primarily with borrow funds.

Tax Driven Benefits of LILOs and SILOs

- A LILO is similar to a SILO, however, instead of purchasing the property, the taxable party first leases the property from the tax-exempt entity and then immediately leases the property back to the tax-exempt entity. The taxable party claims deductions for "rent" (and interest expense for any related financing).
- In both SILOs and LILOs, the tax exempt entity continues to use, operate, and maintain the property during the lease term in the same manner as before.
- The tax-exempt entity receives a fee for participating, generally ranging from 4 to 8 percent of the transactions value. This fee represents a portion of the investor's tax benefits that are shared with the tax-exempt entity.

Structure and Terminology

- LILO –In a typical lease-leaseback the taxpayer acting through a grantor trust, leases assets from a tax-exempt entity under a primary or "head" lease. A LILO attempts to circumvent the "Pickle Rule" by having the taxable party lease, rather than purchase the property from a tax-exempt entity, and then immediately sublease the property back to the tax-exempt entity. Pickle Rule limits depreciation, not rent.
- SILO – A SILO transaction is similar, except that the head lease term is deliberately structured to extend beyond the remaining useful life of the asset, so that it is treated as a sale for tax purposes. The tax-exempt entity then leases the property back for a term shorter than the head lease.
- A service contract SILO attempts to sidestep these rules by using a shorter lease term, followed by a service contract option. The payments on the service contract are economic substitutes for rental payments.

Structure and Terminology

- The tax-exempt lessee thus retains substantially all rights and responsibilities to use and maintain the property during the sublease term.
- U.S. taxpayer typically prepays the entire rent due under the life of the head lease in a single upfront payment. It finances most of the payment (up to 80%) with a non-recourse loan (the debt portion) and provides the remaining portion from its own funds (the equity portion).
- Rather than receiving these rent payments directly and having the free use of them, the tax-exempt entity places all but what the IRS refers to as its "accommodation fee" in payment undertaking accounts with the lender or an affiliate of the lender.

Options at Sublease Termination

- At the end of the sublease, the lessee may terminate the transaction by exercising an option to acquire the taxpayer/lessor's leasehold interest in the property. The exercise price is a fixed amount determined at the inception of the transaction.
- If the lessee does not exercise its option, what happens next varies from LILO to SILO. With a LILO, the taxpayer typically may:

1. Compel the lessee to renew the sublease for an additional period (for rent set at 90% to 95 % of projected rental value) secured by lessee letter of credit
2. Take possession of leased property; or
3. Enter into a replacement sublease with a third party

Options at Sublease Termination

- With a SILO, slightly different options are imposed if the lessee elects not to exercise the purchase option. The lessee must then locate a third- party operator for the property and obtain nonrecourse financing and provide the lessor with at least the same return on its equity contribution that it would have received if the lessee had elected to repurchase the property.
- If the lessee does not exercise its option to buy back the property before the end of the lease term, the lessee incurs substantial responsibilities. These may include obtaining residual value insurance for the benefit of the lessor and reinstalling and upgrading the equipment for the lessor's benefit.

Judicial Doctrines

- Leveraged leaseback transactions have long been controversial and the courts have struggled to enunciate clear rules for dealing with them. A federal judge referred to them as a "morass".
- A well known principle of tax law is that the substance, not the form, of a transaction determines its tax treatment. Thus, a taxpayer may claim ownership of property for income tax purposes only if he actually bears the current benefits and burdens of ownership.
- Similarly, a taxpayer may claim a deduction for interest expense only if the indebtedness is genuine.
- The courts look for business purpose other than obtaining tax benefits in entering into the transaction, and has ruled there is no economic substance if there is no reasonable possibility of profit.
- The application of economic substance doctrine of SILOs and LILOs has had mixed results.

IRS Administrative Rulings

- March 12, 1999 the IRS and Treasury issued Rev. Rul. 99-14, which announced that deductions for rent and interest expense from a LILO would be disallowed. The stated reason was that LILOs lacked economic substance. LILOs were replaced by SILOs regarded as a sale-leaseback, but similar in form
- The IRS contended that the obligations of the head lease were offset by the sublease. Further, the nonrecourse debt and defeasance arrangements offset each other, virtually eliminating the taxpayer's economic risk.
- The IRS believed the LILOs were structured with the intent that the lessee would exercise its purchase option and maintain possession of the property, which would violate the owners claim to ownership.
- In 2004, the U.S. Department of Transportation stopped approving LILO/SILO transactions funded by FTA for U.S. transit and commuter agencies and State DOTs.
- The U.S. taxpayers have been involved in major litigation with the IRS over the deduction of both depreciation and interest on these transactions on a retroactive claim basis. Litigation has been filed both in U.S. Tax Court and U.S. Federal Claims Court. The courts have ruled generally in the IRS favor.

Summary

- In 1999 the IRS issued Rev. Ruling 99-14 that publicly announced that the LILO transaction was an abusive tax shelter, lacking economic substance and in 2002 added Rev. Ruling 2002-69 further adding that the circularity of cash flows and defeasance denied claimed interest and rent deductions.
- SILOs are sale-leaseback, but similar in form to a LILO, except the head lease is replaced with a sale to U.S. investor. But similar to LILOs payments are substantially defeased. Some SILO transactions have been found legal by the courts, especially where the profit motive for a investor is to be reasonably expected. The profit motive standard is measured by the expected pre-tax return. If less than the bank's cost of funds for its leasing business, the courts have ruled that SILO transactions were money losing propositions on a net present value basis.
- Question -What is the environment in Congress for transactions that reduce treasury tax collections during times of large federal budget deficits?