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Tax Implications of SILOs, QTEs, and Other Leasing Transactions with Tax-Exempt Entities

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Tax Implications of SILOs, QTEs, and Other Leasing Transactions with Tax-Exempt Entities

Summary

Provisions related to certain leasing transactions became an important part of the American Jobs Creation Act (H.R. 4520) signed into law by President Bush on October 22, 2004 (P.L. 108-357). The original House and Senate versions of the foreign sales corporation/extraterritorial income exclusion (FSC/ETI) bill were different from the enacted version, but in both bills the provisions were major revenue raisers and as such drew considerable interest.

The purpose of the relevant sections of the law is to put limitations on leasing transactions involving tax-exempt entities, such as transit authorities or municipalities. Most commonly these complex arrangements are referred to as

- "lease-in/lease-out" (LILO) — a combination of a lease of an asset from a tax-exempt entity and a lease back to the same entity;
- "sale-in/lease-out" (SILO) — a combination of a sale of an asset by a tax-exempt entity and a lease back to the same entity; and
- "qualified technological equipment" (QTE) transactions — a SILO for certain classes of high-technology equipment.

The Bush Administration's FY2005 budget proposal sought to modify the rules applicable to such leases for the stated purposes of preventing their use for tax avoidance, eliminating significant revenue drain, and ensuring equity of the tax system. H.R. 4520, and its companion S. 1637, built on the Administration's proposals with certain modifications. Similar language was also included into H.R. 3967.

It is difficult to put an exact figure on the total value of SILOs and QTEs. The transactions are designed to mimic other kinds of leases that for the most part have not encountered objections from the Treasury. Estimates of the total volume provided by different parties to the debate vary from a low of $15 billion to a high of $190 billion annually. Hundreds of such transactions were conducted over the last several years. The underlying asset values are usually in the hundreds of millions of dollars, and sometimes exceed $1 billion.

The provisions in the Act (i) include service contracts in the lease term and specify the useful life of tax-exempt use software, and (ii) limit deductions a taxable entity can claim to the amount of income it receives from the transaction. The Act has a range of "safe harbor" requirements a transaction must satisfy for the taxpayer to deduct related losses. The bill's effective date is March 12, 2004, with exceptions for some leases. The estimated revenue gain is $26.6 billion over 2005-2014.

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Provisions related to certain leasing transactions became an important part of the foreign sales corporation/extraterritorial income exclusion (FSC/ETI) Act signed into law by President Bush on October 22, 2004 (P.L. 108-357). The original House and Senate versions of these major corporate tax bills were different from the final version of the provision, but in both bills the provisions were major revenue raisers and as such have drawn considerable interest. This report explains the types of leasing transactions the law targets, briefly discusses the legislative and regulatory history related to leasing, and compares various versions of the bills in question.

Conventional and Leveraged Leases as Financing Tools

Leasing is an important financing technique that gives companies technological and financial flexibility. The leasing industry projects the total volume of transactions will reach about $218 billion in 2004.[1] In 2001 leasing represented 31% of total business investment in equipment in the United States.[2] Most segments of the economy use leasing in one way or another, and in some segments, like airlines, leasing plays a key role.

Leasing as a form of financing is different from other financing vehicles. A lessor, unlike a lender, remains the owner of the asset and bears many of the risks associated with ownership, in particular, a residual value risk. In a conventional lease, a lessee can acquire use of equipment without tying up its working capital or assuming equipment ownership and financial risks. These advantages by themselves may be significant for certain segments of the market, such as start-up businesses. At the same time, special tax benefits generated by leasing transactions often play an important role in selection of this financing technique.

In some transactions, called leveraged leases, a lessor leases out debt-financed property. In these cases the leasing companies serve as intermediaries between other financial institutions and users of the capital. Many of these transactions have

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[1] ELA Online, "Industry Research: Overview of the Equipment Leasing & Finance Industry," visited on June 14, 2004 at [http://www.elaonline.com/industryData/overview.cfm].

[2] Vic Lock, "Review of the Leasing and Asset-Finance Industry," in *Leasing and Asset Finance, The Comprehensive Guide for Practitioners, Fourth Edition,* Chris Boobyer, ed. (London: Euromoney Books, 2003), p. 1.

"economic substance:" the lessors may earn money, for example, by assuming default risks or offering other services. In addition, leveraged leases typically generate some tax benefits for the lessor, who may either receive a higher after-tax profit, or incorporate such benefits into the lower rents charged to its customers. In the past, Congress and the Treasury have conditionally recognized leveraged leases as a valid business practice.[3] LILOs, SILOs, and QTEs[4] are special cases of leveraged leases, but the Treasury and some legislators view them as having undesirable features that set them apart from other leveraged leases.

General Idea Behind Leasing Transactions with Tax-Exempt Entities

How do SILOs, LILOs and QTEs work, and how do the participants benefit from them? When a for-profit corporation owns a piece of equipment, it may deduct its cost from taxable income over a certain period of time (depreciate it), thereby reducing its tax liability. Similarly, if the corporation rents the property instead of purchasing it, it may be able to deduct the rental payments. Furthermore, if the corporation takes out a loan to finance the sale or lease, it may be able to deduct the interest payments.

In contrast, a tax-exempt, or more precisely, a tax-indifferent entity, cannot take advantage of any of these deductions because it does not owe any taxes in the first place.[5] Thus, the tax deductions are "wasted" without bringing any benefit to the equipment owner. This situation creates an incentive for the transfer of tax benefits. Generally, participants of LILOs, SILOs, and QTEs achieve such a transfer when a taxable participant becomes eligible to claim the tax deductions related to the equipment, although the details and legal environment are somewhat different for each kind of transaction.

The benefits to the participants in these transactions come at least in part from the reduction in the present value of federal taxes paid by the taxable participant. From an economic standpoint, the deferral of taxes is equivalent to their reduction, due to the time value of money. The total benefit distributed between all participants is equal to the present value of the reduction of the tax due to the transaction-related deductions less the present value of the tax on the corresponding income. The

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[3] Among other examples, see Rev. Proc. 2001-28, setting forth some guidelines on treatment of leveraged leases for federal tax purposes.

[4] "Lease-in/lease-out" (LILO) — a combination of a lease of an asset from a tax-exempt entity and a lease back to the same entity; "sale-in/lease-out" (SILO) — a combination of a sale of an asset by a tax-exempt entity and a lease back to the same entity; and "qualified technological equipment" (QTE) transactions — a SILO for certain classes of high-technology equipment.

[5] An entity is called tax indifferent if a particular action does not affect its tax position. A for-profit corporation may be tax-indifferent with respect to acquisition of depreciable equipment, if it can completely offset its tax liability, for example, by using carryforward losses.

benefit is often measured in percentage terms, as the ratio of the net present value (NPV) of the tax reduction to the total asset value. Every year the benefit would be equal to the transaction-generated deductions minus transaction-generated income multiplied by the corporation's marginal income tax rate. Accelerating the transaction-related deductions and delaying recognition of the corresponding revenues maximizes the payoff.

The total tax savings are shared between the transactions' various participants. The reduction in the taxes' present value is the incentive for the for-profit corporation to participate in the deal. The tax-exempt party usually receives an implicit "accommodation fee" for participation, usually between 4%-8% of the transaction's total value, although exceptions on both sides of the range abound. Finally, deal arrangers — legal counsels, trustees, lenders, appraisers — receive fees for their services.

The arrangers' fees vary, but they are considerable. "A review of over 30 transactions approved by the Federal Transit Authority indicated that, on average, fees paid to ... agents advising or assisting tax-exempt entities equaled approximately 24% of the benefits received by the tax-exempt entities."[6] Attachments to the letter of Secretary of Transportation Norman Y. Mineta provide details on a December 2002 New York Metropolitan Transportation Authority (MTA) transaction.[7] Total associated fees and expenses were about $5.6 million, of which approximately $1.8 million was paid by the lessors and $3.8 million by MTA. According to *Asset Finance International*, in that month MTA closed the QTE for automatic fare collection equipment worth $506 million with a net present value (NPV) benefit of 10%-11%, or about $51 million-$56 million.[8] If both sources refer to the same transaction, the arrangers' fees would represent over 1% of the deal value and about 10% of the NPV benefit. It is possible that for smaller transactions the percentage shares are higher.

To see how everything works together, consider an example of a recent sale-in, lease-out (SILO) contract. The media obtained details of another MTA transaction under the Freedom of Information Act.[9] In 2002 MTA sold to Wachovia Corp. and Altria Group, Inc. and leased back from them for 30 years subway cars worth $1.18 billion. The transaction generated $104 million for the transit authority. The taxable participants of the deal would be able to deduct the depreciation of the asset over the term of the lease, while recognizing the income from the lease payments from MTA.

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[6] U.S. Congress, Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2005 Budget Proposal*, Joint Committee Print, 108th Cong., 2nd sess., JCS-3-04, (Washington: GPO, 2004), p. 284.

[7] N. Y. Mineta, Secretary of Transportation, attachments to the letter to Sen. Grassley, Jan. 20, 2004.

[8] *Asset Finance International Monthly QTE Research*, "Closed Deals," Jan. 2003, p. 1, visited on July 9, 2004 at [http://www.assetfinance.com/contents/publications/afi/qte/qte3.pdf]].

[9] Ryan J. Donmoyer, "Banks and Others May Lose Lucrative Federal Tax Break; Congress Wants to End Transit Lease Deals That Provide Big Tax Savings," *Charlotte Observer*, March 9, 2004, p. 1D.

It is impossible to determine the monetary value of the transaction for the companies without knowing (i) timing and amounts of the annual depreciation deductions and (ii) timing and amounts of MTA's rental payments by year. (The source article provides a numeric estimate of the benefit to the companies, but its validity is uncertain.) The deal arrangers in this case received $23 million in fees, or over 22% of MTA's benefit.

The general policy issue these specialized leases present is this: does current tax treatment of leases provide desirable or necessary support for the leasing industry, and does it constitute an optimal means of channeling federal aid to state and local governments and other tax-exempt entities? Do the benefits to tax-exempt and taxable participants of these transactions outweigh the revenue losses, tax base erosion, and the overall equity of the tax system? In other words, the question is where to draw the line separating allowable and abusive transactions.

Brief Overview of Tax-Exempt Leasing Legislative and Regulatory History

Congress has addressed the issues of leasing for tax-benefit transfer several times since 1981. Before 1981, such transactions were not allowed, and leasing transactions had to satisfy a special test designed to weed out the deals whose only purpose was tax reduction. However, in 1981 Congress changed its stance and allowed such arrangements as a part of the tax cuts for investments in the Economic Recovery Tax Act (P.L. 97-34), by adoption of the "safe-harbor leasing" rules. The intent of the measure was to encourage investments by means of transferring tax benefits rather than to serve the purpose of determining which person is in substance the owner of the property.[10]

The policy on the issue changed again a year later, with the passage of the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248), when "Congress concluded that it was necessary to reduce safe-harbor leasing and ultimately to repeal it. The principal considerations were the tax avoidance ... , the adverse public reaction to the sale of tax benefits, the revenue loss,...."[11] The 1982 law shut down such deals with certain exceptions after the end of 1983, and reduced the benefits available to participants in the meantime.

In 1984, the Deficit Reduction Act (P.L. 98-369) addressed the leasing-related issues again. Among other changes, it adopted the so-called Pickle rule.[12] The rule provides that the depreciation deduction relating to property leased to a tax-exempt entity, so-called tax-exempt use property, must be computed on a straight-line basis, using the longer of the property's assigned class life or 125% of the lease term. (Of all the commonly used methods, straight-line depreciation is among the least

[10] U.S. Congress, Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, Dec. 31, 1982, p. 45.

[11] Ibid, p. 53.

[12] IRC § 168(g).

favorable for taxpayers.) In addition, the Pickle rule requires the inclusion of possible lease renewals, successive leases, and other similar arrangements in the lease term. The legislation also prescribed certain rules on distinguishing between service contracts and leases to preclude the use of such contracts for tax benefits transfer. It also excluded qualified technological equipment leased to tax-exempt entities from the above general rule.

In 1986, the Tax Reform Act (P.L. 99-514) modified depreciation rules applicable to foreign and tax-exempt use property. However, it maintained a number of exceptions, including the rules that "treat qualified technological equipment with a lease term that exceeds five years as having a recovery period of five years."[13]

Among the most recent developments, in 2003, one of the revenue-raising amendments (S.Amdt. 680) to S. 1054 (108th Congress, 1st session) contained a provision to include service contracts into the lease term for purposes of the Pickle rule. However the provision did not emerge from conference.

Two last administrations included language related to leasing transactions in their budget proposals in various years. The Clinton Administration's FY2000 budget proposal contained provisions prohibiting the deduction of net losses from leasing transactions with tax-exempt entities.[14] Its FY2001 proposal contained provisions to increase depreciation life by the service term of tax-exempt use property leases.[15]

The FY2005 Bush Administration revenue proposals included two similar provisions.[16] One expanded the Pickle rule to qualified technological equipment and computer software and included service contracts in the length of a lease term. Another proposal disallowed net losses related to leases to tax-indifferent parties. It included five conditions that would exclude the transaction from this limitation. The major conditions (i) prohibited tax-exempt bond financing, (ii) prohibited defeasance and similar arrangements exceeding 20% of the leased property cost, (iii) required substantial investment on the taxpayer's part, and (iv) required the tax-indifferent party not to assume more than minimal risk of loss. The proposal would apply to transactions entered into after December 31, 2003.

Throughout the years the regulations governing lease transactions evolved not only legislatively, but also through a number of Internal Revenue Service (IRS) revenue rulings and regulations, as well as through case law. Some of the most relevant IRS rulings include Rev. Rul. 99-14 and Rev. Rul. 2002-69 (modifying and

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[13] U.S. Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, May 4, 1987, p. 106.

[14] For further information, see CRS Report RL30160, *Foreign Tax Shelter Proposals in the Administration's Fiscal Year 2000 Budget*, by David L. Brumbaugh, April 30, 1999.

[15] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals*, Feb. 2000, pp. 135-138.

[16] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals*, Feb. 2004, pp. 124-128.

superceding Rev. Rul. 99-14). They deal with "lease-in/lease-out" transactions and are described in more detail below.

Importantly, while the rules that developed limited the use of various leasing arrangements, they upheld the validity of leveraged leases in general. As mentioned above, the leveraged leases often do generate substantial tax benefits to the lessor, but in addition to tax considerations, they can have economic substance, such as the lessor's assumption of the lessee's default or asset ownership risk, and are a widely used capital funding mechanism.

Transaction Volume Estimates

How widespread are "abusive" leases? It is difficult to determine exactly the aggregate volume of the transactions that raised recent objections by the Treasury and some lawmakers because they may differ from the commonly accepted leveraged leases only in nuances. Lack of well-established definitions and the international nature of many of these deals complicate the problem even further. For example, Treasury Assistant Secretary Pamela Olson estimated their volume at $750 billion over a four-year period (which translates to approximately $190 billion annually).[17] The Equipment Leasing Association questioned this figure and put the value at about 10% of the $218 billion-a-year industry, or about $60 billion-$80 billion in four years ($15 billion to $20 billion a year).[18] During the Senate Finance Committee testimony an unidentified witness referred to conservative industry estimates of "a minimum of $20 billion to $30 billion of foreign infrastructure" leased or sold annually.[19]

Evidence presented by all sides indicates that the transactions are widespread. The *Wall Street Journal* reported that the transactions had been registered as a possible tax shelter more than 400 times in 2001.[20]

A somewhat better grasp on the volume of transportation-related projects is available because the Federal Transit Administration (FTA) reviewed various municipal transportation-related leases which received federal funding. The FTA's 2000 guidance "Financing Techniques for Public Transit" listed LILOs as a funding technique and stated that in 1999 the agency "reviewed over $1 billion in leasehold

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[17] Statement of the Honorable Pamela F. Olson, Assistant Secretary for Tax Policy, U.S. Department of the Treasury, accompanied by Gregory F. Jenner, Deputy Assistant Secretary for Tax Policy, U.S. Department of the Treasury, Testimony Before the House Committee on Ways and Means, Feb. 11, 2004.

[18] *U.S. Newswire*, "Equipment Leasing Association Responds to Treasury Department Testimony; Association Disputes $750B Number for 'SILO' Transactions," Feb. 12, 2004.

[19] Testimony of "Mr. Janet" — a Witness Pseudonym Regarding Abusive Cross-Border Leasing and Leasing with U.S. Municipalities Before the United States Senate Committee on Finance, Oct. 21, 2003.

[20] John D. McKinnon and John Harwood, "Tax Shelters Come Under Fire — Democrats Push Crackdowns, Hope to Cut Bush Approval Ratings," *The Wall Street Journal*, June 6, 2003, p. A4.

transactions."[21] The FTA suspended the program in 2003. Between 2000 and early 2003, "U.S. transit authorities have entered into over $7 billion worth of lease financing transactions, primarily involving rolling stock and facilities."[22] According to the American Public Transportation Association (APTA), the leaseback program has guaranteed transit agencies an additional $848 million since 1998. "The suspension of the program has put on hold about 15 deals that already were in the works, which would have netted benefits of about $262 million to the transit agencies," according to the APTA.[23]

The data on the transportation-related transactions volume and their benefit to localities appear to be a bit inconsistent among themselves. Most sources estimate a typical benefit to a locality at about 4%-8%, and rarely as much as 10% of the transaction value. The numbers in the previous paragraph imply an average benefit of 10% or more. This inconsistency opens the possibility that either the volume of transactions is being underestimated, or the benefit is overestimated, or a combination of the two, which is entirely possible given the fact that the parties reporting the numbers (i) could use different sources and (ii) could have opposing motivations.

In response to a November, 2003, letter from Senator Grassley, Secretary of Transportation Mineta provided an updated list of cross-border and domestic leveraged lease transactions reviewed by FTA since 1988.[24] The list has 97 entries, with the total asset value of $17.1 billion and the transactions' cumulative net present value (NPV) of $1.1 billion. It is unclear if this NPV includes benefits to the private party as well as the public entity. Furthermore, the list appears not to include some deals. For example, the MTA 2002-D and 2002-E trusts that closed on December 17, 2002, and were mentioned in another attachment to the same letter, are not on the list.

The analysis of leasing transactions reviewed by the FTA since 1988 shows that four municipalities — Atlanta, Chicago, New York, and Newark — conducted approximately half of the transactions by value of assets. Four more cities — Los Angeles, Philadelphia, San Francisco, and Washington, DC — account for another quarter of the total volume.[25]

Another federal agency that requires review of lease transactions is the Department of Energy (DOE). On March 11, 2004, Senators Grassley and Baucus

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[21] Sen. Grassley, letter to N. Y. Mineta, Secretary of Transportation, Nov. 17, 2003.

[22] *Structured Finance Review,* "Domestic Lease Structures: for U.S. Transit Authorities, Their Time Has Come," March 2003, p. 10, also available at [http://www.atlasinform.com/pdf/SFR0303.pdf].

[23] Heather M. Rothman and Katherine M. Stimmel, "House Panel to Examine Issues Relating to Suspended Transit Leaseback Program," *Daily Tax Report*, No. 42, March 4, 2004, p. G-12.

[24] N. Y. Mineta, Jan. 20, 2004.

[25] U.S. Congress, Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2005 Budget Proposal*, Joint Committee Print, 108th Cong., 2nd sess., JCS-3-04, (Washington: GPO, 2004), p. 285.

requested information from the agency on the transactions approved since 1995.[26] As of yet there has been no publicly released response from the DOE. The Senators also reportedly contacted the Federal Aviation Administration and the Environmental Protection Agency for similar information.[27]

Lease-in/Lease-out Transactions

It is useful to consider the mechanisms of each type of leasing transaction separately, beginning with the oldest of them (almost extinct by now) — "lease-in/lease-out." In this case, a U.S. taxpayer leases a piece of property — e.g., a power plant, traffic control system, or railcars — from a tax indifferent party, such as a foreign municipality or tax-exempt organization, under a "headlease," and simultaneously leases it back to the same party under a "sublease" or "leaseback." In practical terms, the tax-indifferent party continues to use the property as it did before the transaction. The U.S. taxpayer, meanwhile, is able to defer its tax liability by deducting its rental payments, amortizing certain transaction costs, and, depending on its financing arrangement, deducting any interest payments.

The IRS believes that in the late 1990s there were "hundreds of deals with billions of dollars at stake" conducted by 56 customers, with some taxpayers participating in as many as 30 to 60 deals.[28] According to some estimates, during LILOs' heyday the volume of U.S. leases to foreign entities increased from $3 billion to $20 billion between 1994 and 1998.[29] In 1999 the IRS issued regulations and a Revenue Ruling (99-14) that effectively stopped the practice of LILOs.[30] On the other hand some transactions closed as recently as August 2002, while structured as SILOs for federal purposes, were LILOs for state income tax purposes.[31]

Consider an example. Assume that the U.S. taxpayer is corporation X, and the tax-indifferent party is municipality FM.[32] X leases a certain property from FM under a headlease with a 34 year term. X immediately leases it back to FM under a 20-year sublease with a buy-back option. The headlease requires X to make just two

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[26] Sen. Baucus and Sen. Grassley, letter to S. Abraham, Secretary of Energy, March 11, 2004.

[27] *Accounting Today*, "Taxing Issues. Tax Practice," vol. 18, No. 6, April 5, 2004.

[28] Lee A. Sheppard, "Challenging LILOs and Their Successors," *Tax Notes*, May 26, 2003, p.1134; Brant Goldwyn, "IRS Appeals Close to Issuing Guidelines on Lease-In/Lease-Out, Lease Stripping," *Daily Tax Report*, No. 184, Sept. 23, 2003, p. G-6.

[29] David Nemschoff, "A Growing Substantial Role; Financial Intermediaries and U.S. Leases to Tax-Exempt Entities," *Equipment Leasing*, Jan. 1999, vol. 18, No. 1, p. 5.

[30] 26 C.F.R. § 1.467-4. Revenue Ruling 99-14 has been modified and superceded by Revenue Ruling 2002-69.

[31] *Asset Finance International Monthly QTE Research*, Closed Deals, Dec. 2002, p. 2, visited on July 9, 2004, at [http://www.assetfinance.com/contents/publications/afi/qte/qte2.pdf].

[32] This is a simplified example from the Rev. Rul. 99-14.

payments: $89 million as a prepayment in the beginning of the first year and a postpayment at the end of the last year of the headlease. FM would deposit most of the prepayment in a separate account, and pledge it to X as security for the municipality's obligations under the sublease. The excess of the prepayment over the pledge constitutes FM's fee for participation in this deal.

FM's obligations under the lease and buy-back option are completely covered by X's prepayment. The sublease requires FM to make annual rental payments to X in equal installments. The payments would come from the pledged part of the $89 million prepayment. At the end of the sublease, FM has an option to purchase from X the right to use the property for 14 years that would still be remaining under the headlease at that time. This buy-back option's cost would be at or slightly above the fair market value of the headlease residual and also can be paid from the money received with X's prepayment. X is relieved of its obligation to make the postpayment if FM chooses to buy back the headlease residual. In reality FM always exercises its buy-back option, and the postpayment is never made.

The discrepancy in the timing of the payments between the headlease prepayment and regular sublease payments would allow X to defer its tax liability and generate a net gain for X. X would be able to amortize the first $89 million payment over the first six years of the lease, or about $15 million each year. At the same time, it would have to recognize revenues from the sublease, but these revenues would be much smaller than $15 million, thus X's taxable income becomes lower in the first six years and it can pay less in taxes. In the later years, X may not be able to offset the revenues from this deal and therefore may have to pay higher taxes, but because of the time value of money, the present value of the deductions exceeds the present value of the rental income.

In reality, the deals are usually more complex and generate additional tax savings for X. For example, X could finance its $89 million prepayment with a loan from a bank. In this case, X would deduct its interest expense in addition to the prepayment. X's interest payments would be frequently set equal to FM's sublease rental payments. X would thus be simply transferring funds from FM to the bank. In addition, X could get the loan from the same bank that FM would use to deposit the prepayment. In this case, the actual funds would never even leave the bank for the duration of the LILO.

Finally, both sides would sign an agreement as part of the contract to ensure that neither one of them becomes exposed to additional risks throughout the transaction's length. In doing so, the parties have to strike a balance between limiting their exposure to risks on one hand, and making sure the provisions do not disqualify the transaction as a lease on the other. Under U.S. legal doctrine (the "economic substance" doctrine) a transaction is respected for federal tax purposes if "there is a genuine multiple-party transaction with economic substance which 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."[33] There are a number of factors to consider, and the parties' advisors try to ensure that the legal requirements are satisfied and the deal will pass regulatory muster.

Nonetheless, in 1999, the IRS significantly undermined LILOs' value as a tax shield, when it issued regulations that treat a rent prepayment as a loan.[34] Additionally, the IRS has issued rulings concerning LILO-type transactions where the agency disallows deductions for rent and interest due to the finding of lack of economic substance.[35] As a result, lease-in/lease-out transactions were largely discontinued and replaced with sale-in/lease-out deals (SILOs), sometimes referred to as "sale/leasebacks" or "sale/service contracts." (A note of caution is in order: there is no set terminology, and these terms do not always designate the type of transaction described below.)

Sale-in/Lease-out Transactions

The parties to a sale-in/lease-out transaction agree to either an outright sale by a tax-indifferent to a taxable entity of a piece of property or a headlease for a term exceeding the property's useful life. Such a lease would be considered a sale for federal tax purposes. Taking this route helps to avoid the "pure" sale restrictions often imposed on municipal property. The property is immediately leased back to its, by now former, tax-indifferent owner (FM) for 12 to 20 years, who continues to operate it. The transactions are based on the same general idea of the tax benefits transfer as LILOs, but achieve it in a somewhat different manner. In a SILO, the U.S. taxpayer (X) can deduct depreciation rather than rental payments. Interest deductions would also be available to X, just as in a LILO deal.

As long as the sum of the depreciation and interest deductions exceeds rental income, X receives a net reduction in taxable income and pays lower income taxes. The present value of the benefit to X is greater the sooner it receives the deductions, relative to the rental income. In return, FM keeps an accommodation fee of 4%-10% of the transaction value which may be implicitly included in the original purchase price or as a rent reduction. The exact fee value is determined by the individual deal conditions, such as an asset class and value, length, each side's relative bargaining powers, as well as the prevailing interest rates. It is common for the transaction value to exceed the fair market value of the property, making it even more attractive to the participants.

From the financial gain standpoint, it is to X's benefit to deduct as much of the depreciation as soon as possible. However, as noted above, the Pickle rule in IRC § 168(g) prevents accelerated deductions by requiring straight-line depreciation over the longer of the property's assigned class life or 125% of the lease term, including possible lease renewals and other similar arrangements. It is unclear whether service

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[33] *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978).

[34] 26 C.F.R. § 1.467-4.

[35] Rev. Rul. 99-14; Rev. Rul. 2002-69 modifying and superceding Rev. Rul. 99-14.

contracts, whose important role in the SILO's structure is discussed further in this section, are included in the lease term.[36] This ambiguity means that the IRS may have to make a special determination in every individual case, which is not practical.

The contract includes special defeasance provisions requiring the parties to set aside cash or bonds sufficient to service their obligations. Typically FM would be required to pledge enough funds from an initial sale to meet its commitments under the lease. Usually FM wants to be sure that there is no chance of losing the property upon the lease termination. For example a transit authority would like to be certain that it never loses control over its railcars or ticket-dispensing machines. A typical SILO would include a provision for FM to have an option to buy the property at a fixed price at the end of the lease. The funds sufficient to exercise it also have to be set aside at the beginning of the deal.

On the other hand, X is interested in shielding itself from any risks related to the property ownership after the lease expires. So, the SILO would include service contract provisions to protect X's interests at the time of the lease termination. Usually, the provisions stipulate that FM has to find a service contractor to take over the management of the property and is required to buy the property if such a contractor is not found. This arrangement ensures that if for some reason the property declines in value, FM cannot simply walk away from it, leaving X with all the "burdens of ownership."

Presence of the defeasance provisions is one of the controversial features of the SILOs. The opponents of the practice point to it as one of the indicators of the circular nature of these deals. In their view the provisions eliminate default risks for the lessor, one of the determinants of a transaction's economic substance. To counter that, the advocates point out that similar arrangements are present in many other business transactions, for example, when one of the parties has poor credit, and their mere presence does not automatically rid the transactions of their economic substance.[37]

It might appear more logical to have a simple mandatory buy-back clause at the lease's end instead of a combination of the buy-back option and service contract provisions. However, the mandatory buy-back provision would violate the "genuine" ownership doctrine and indicate that FM, rather then X, is the true owner of the property for tax purposes entitled to the deductions. This would make the SILO pointless. Thus, the service contract arrangement becomes very convenient, as an alternative to the mandatory buy-back and at the same time as an incentive for FM to "reacquire" the property without slowing down the depreciation deductions under the Pickle rule.

In the words of one expert, "U.S. lessors enter into these transactions with the understanding that, to be entitled to the tax treatment that is an important part of the investment decision, they must be able to demonstrate that the lessee's alternative to

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[36] IRC § 168(i)(3)(A) and 26 C.F.R. § 1.168(i)-2.

[37] B. Cary Tolley III, "Leasing to Tax-Exempt Entities: Setting the Record Straight," *Tax Notes*, April 12, 2004, p. 244.

purchase option exercise is a realistic and commercially viable alternative, and that it would meet the requirements for a service contract. Should they be unable to do so their transactions will fail."[38]

The deal details have to satisfy numerous other requirements. For example, the lease term should be less than 80% of the property's remaining useful life to avoid being treated as a sale for federal tax purposes. The lessee's financing of the lessor's property acquisition may raise a red flag for the IRS. Therefore the structure of the transaction has to take into account all the potential legal consequences of the SILO's form.

Qualified Technological Equipment

Qualified technological equipment leases (QTEs) are essentially SILOs for special equipment classes defined in the Internal Revenue Code Section 168(i)(2): computer, high-technology telephone, and medical equipment. This equipment is explicitly exempt from the Pickle rule and can be depreciated over five years — much faster than most other types of equipment. The rationale behind this exclusion was the relatively short useful lives of many types of technological equipment, but it also made this equipment a prime property for leasing purposes. This is one of the reasons why the QTEs appear to be the fastest growing segment of the market today.

Another reason for QTE's growth is technological change which broadens classes of eligible equipment. As computers become an integral part of what previously was a low-tech infrastructure, the assets become eligible for the QTEs. The leasing industry is very enthusiastic about these developments and is constantly searching for new QTE-eligible asset classes.[39]

Although the Internal Revenue Code has distinguished qualified technological equipment since 1984, QTEs were a relatively rare occurrence until recently. According to some sources, the first QTEs appeared in 1995.[40] U.S. transit authorities completed the first domestic QTE leases in 2002 for rail signaling, control, and communication equipment. According to the early 2003 data, "approximately $610 million in QTE financings for U.S. transit authorities closed in 2002; another $490 million is expected to close in the near future."[41]

It is possible, though, that these data are incomplete. For example, the above-mentioned December 2002 MTA automatic fare collection equipment transaction

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[38] William A. Macan IV, "LILOs and Lease/Service Contract Transactions: A Response," *Tax Notes*, June 30, 2003, p. 1973.

[39] Among numerous examples, see *Structured Finance Review*, "New Opportunities for QTEs in Gas and Electricity," Aug. 2003, also available at [http://www.atlasinform.com/pdf/SFR0803.pdf].

[40] Robert Sheridan, "QTEs: Past, Present and Future," *Asset Finance International*, Nov. 2002, Iss. 299, p. 14.

[41] *Structured Finance Review*, March 2003, p. 10.

alone was worth $506 million. The same issue of *Asset Finance International* lists a New Jersey Transit deal worth $150 million that closed in November 2002. It may be missing from the above totals.[42] Adding these two QTEs would almost double the 2002 total to $1.2 billion.

As the above examples indicate, individual QTEs are usually very large in terms of underlying asset values. They normally run in hundreds of million dollars, and some may exceed $1 billion.[43] "Financiers say first time entrants to the QTE market should be looking at deals of $150 million or higher — even though commercial banks have been known to consider deals as small as $50 million."[44] There are indications that since publication of the quoted article, small value deals became more common, possibly because the costs of arranging an individual transaction decreased as the practice became more popular. Some examples included deals as small as $2 million, although this is probably an exception.[45]

The leases normally extend for more than 16 years, and require asset lives of over 20 years, which is one of the major barriers to their growth.[46] For instance, MRI equipment satisfies the definition of the qualified technological equipment, but the asset's five year useful life makes a QTE deal uneconomical.[47] On the other hand, new potential asset classes include electronic toll collection equipment (like "E-ZPass" systems) or flight simulators, which have lives of up to 40 years.

Legislative History of Leasing Provisions in the American Job Creation Act

Two pieces of legislation addressing leasing with tax-exempt entities under consideration by 108th Congress in 2003-2004 were S. 1637 and H.R. 4520. The Senate passed its version of the bill on May 11, 2004. The provisions in sec. 475 and sec. 476 of the engrossed version would (i) include service contracts in the lease term and specify the useful life of tax-exempt use software, and (ii) limit, with exceptions, deductions a taxable entity can claim to the amount of income it receives from the transaction.[48] Effectively, the first provision extended the Pickle rule to service

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[42] *Asset Finance International Monthly QTE Research*, Jan. 2003, p. 2.

[43] Milbank, "Project and Asset Finance," web page visited on June 14, 2004, at [http://www.milbank.com/MilbankEurope/practice_project.htm].

[44] *Trade Finance*, "Leasing Finds a New Direction," Oct. 1, 1999, p. 9.

[45] Sheridan, p. 14.

[46] Shoomon Perry, "Technology and the Leveraged Lease," *Asset Finance International*, April 2002, Issue 293, p.31.

[47] Sheridan, p. 14.

[48] Descriptions available in Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2005 Revenue Proposal*, Feb. 2004, pp. 124-128; and U.S. Congress, Committee on Finance, *Jumpstart Our Business Strength (JOBS) Act*, report to accompany S. 1637, 108th Cong., 2nd sess., S. Rept.108-192, (Washington: GPO, 2004), (continued...)

contracts, and the second one applied a mechanism similar to passive loss limitation to leases with tax-exempt entities.[49] Another tangentially related part of the bill was sec. 401, clarifying the economic substance doctrine.

The Senate bill in many ways matched the Bush Administration proposal mentioned in an earlier section of this report. The most important exception was the effective date of sec. 476 limiting the allowable deduction. It specified that the bill would apply after January 31, 2004, to leases entered into after November 18, 2003 and before that for any transaction with a foreign entity. The Administration proposal, as well as sec. 475 of the bill dealing with service contracts, would be effective for leases entered into after December 31, 2003.

The final (engrossed) language of S. 1637 was different from the reported version's sec. 472 and sec. 476. The reported version did not apply to QTEs and transactions with foreign non-governmental entities. On the other hand, it did not contain the five conditions of the Administration's proposal that would exempt certain transactions from the limitations of the bill. There were also differences in effective dates.

The revenue estimates reflected the evolution of the measure. The Administration initially estimated the revenue gain of its proposal at $33.4 billion over FY2005-14, but the Joint Committee on Taxation (JCT) later reduced this number to $21.3 billion over 2004-14.[50] The JCT's latest estimate of the reported version of S. 1637 was $8.9 billion over 2004-13.[51] The substitute version's leasing sections were first ("very preliminary") estimated by JCT to yield on a stand-alone basis $24.0 billion in the same period, and over $1.5 billion more if economic substance doctrine section were enacted.[52] The latest estimate substantially increased the stand-alone impact to $40.6 billion, while keeping the interaction portion at $1.5 billion.[53]

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[48] (...continued)
pp.192, 193, 197-200.

[49] Passive loss limitation rule prevents deducting losses from passive activities, i.e. activities an investor does not actively participate in, to offset income from other sources, such as salaries and wages.

[50] U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal year 2005 Budget Proposal,* JCX-14-04 R, March 3, 2004.

[51] U.S. Congress, Joint Committee on Taxation, *Updated Estimated Budget Effects of S. 1637, the "Jumpstart Our Business Strength ("JOBS") Act," as Reported by the Committee on Finance,* JCX-15-04, March 3, 2004.

[52] U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of the Substitute Amendment for S. 1637, the "Jumpstart Our Business Strength ("JOBS") Act,"* (very preliminary), March 23, 2004.

[53] U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of S. 1637,the "Jumpstart Our Business Strength ('Jobs') Act,"* JCX-36-04, May 20, 2004.

The relevant provisions in the corresponding House bills, first H.R. 3967 and then H.R. 4520, also bore similarity to the Administration's proposal.[54] The key distinctions were: (i) the leasing limitations would be effective for leases entered into after February 11, 2004, versus the Administration's December 31, 2003 deadline; (ii) it would grandfather some of the deals in the pipeline; and (iii) it would reduce the authority given to the Treasury to close down other types of transactions.[55] The effective date of H.R. 4520 was postponed by a month to March 12, 2004 compared to H.R. 3967.

The changes introduced into H.R. 4520 before the committee hearing made the bill less restrictive compared to S. 1637. The Senate bill had a range of requirements a transaction had to satisfy for the taxpayer to deduct related losses. The House bill dropped some of the requirements, most importantly a prohibition of tax-exempt bond or federal fund financing. Additionally, leases with terms of less than five years were exempt from two more requirements dealing with substantial equity investments and minimal lessee risk of loss. QTEs could be extended by up to 24 months more than was allowable under then-existing law and still qualify for a short-term lease exemption. Beyond that, the bill grandfathered transactions under consideration by FTA, subject to certain time frames.[56] The JCT's June 22 estimate of the revenue impact of the provision was $19.6 billion over 2004-14.[57]

The limitations of the House bill attempted to protect the leasing industry from unintended burdens caused by the new legislation and to minimize the retroactive effects. The opponents of S. 1637 were concerned with its possible impact on "legitimate" leasing transactions and the retroactivity of the bill.[58] As discussed above, the leasing transactions in question normally last for years; therefore the bill's retroactivity could affect a number of active deals. Other advocates of the practice asserted that SILOs and QTEs are merely typical representatives of leveraged leases, and therefore there were no distinct features that would allow one to distinguish

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[54] There were indications that similar provisions were considered for inclusion in an early version of the House FSC/ETI bill (H.R. 2896), but eventually dropped, see Alison Bennett, "Jenner Optimistic for Action on SILOs, Says Shelter Tide Appears to Be Turning," *Daily Tax Report*, No. 60, March 30, 2004, p. G-6.

[55] Alison Bennett, "Thomas Marking Up Highway Tax Raisers, But Not SILOs, for Export Tax Repeal Bill," *Daily Tax Report*, No. 50, March 16, 2004, p. GG-1.

[56] U.S. Congress, Joint Committee on Taxation, *Description Of H.R. 4520, The "American Jobs Creation Act Of 2004,"* Joint Committee Print, 108th Cong., 2nd sess., JCX-41-04 (Washington: GPO, 2004), pp. 199-206.

[57] U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 4520, The "American Jobs Creation Act Of 2004," as Passed by the House of Representatives*, Joint Committee Print, 108th Cong., 2nd sess., JCX-45-04, (Washington: GPO, 2004), p. 6.

[58] Equipment Leasing Association Letter to Senate Finance Chairman Charles Grassley (R-Iowa) Calling Senate Substitute for S. 1637 "Crisis" for Investors, *Daily Tax Report*, Primary Source Material, April 12, 2004.

SILOs and QTEs from other bona fide business transactions. The new limitations in H.R. 4520 received favorable reaction from the leasing industry.[59]

On the other hand, supporters of the more restrictive language of the Administration's proposal and S. 1637 asserted that "the detailed SILO proposal in the President's budget permits legitimate lease transactions to continue."[60] For example, they argued with respect to inclusion of service contracts in the lease term "it is difficult to envision a non-tax business reason for a tax-exempt entity structuring a transaction that converts a 20, 30, or 40-year lease into a service contract."[61]

The House Ways and Means Committee approved H.R. 4520 on June 14. The bill passed the House on June 17, 2004.

After the conference the final version of the bill retained the "safe harbor" limitations of the House version (Part 3 of the bill, Sections 847-849), but covered leases with Indian tribal governments and applied to intangible assets.. The bill's effective date is March 12, 2004 with some exceptions for FTA-approved and Indian government leases. The estimated revenue gain is $26.6 billion over 2005-2014.[62] The bill was signed into law by President Bush on October 22, 2004 (P.L. 108-357).

Even though the effective date of the bill is March 12, 2004, IRS still may question the transactions completed earlier under the rules effective before the enactment of the bill. There were indications that IRS was planning to continue this process.[63]

Early reactions from the experts indicated that the bill should succeed in curbing the leasing transactions with tax-exempt entities in the form they had at the time of the bill signing.[64] At the same time the law may not necessarily achieve the broader policy goals of tax system equity and revenue drain prevention. Conceptually, the alleged abusive behavior of taxpayers is the result of the differential treatment of various entities and activities by the existing Tax Code. It creates the incentives for tax benefits transfer inducing the otherwise unnecessary transactions. For as long as

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[59] Letter From Coalition of Power and Local Government Groups to House Ways and Means Chairman William Thomas (R-Calif.) Praising Changes to SILO Arrangements in New Export Tax Repeal Bill (H.R. 4520), *Daily Tax Report*, Primary Source Material, June 14, 2004.

[60] Statement of the Honorable P. F. Olson, Feb. 11, 2004.

[61] U.S. Congress, Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2005 Budget Proposal,* Joint Committee Print, 108th Cong., 2nd sess., JCS-3-04, (Washington: GPO, 2004), p. 289.

[62] U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects Of The Conference Agreement For H.R. 4520, The "American Jobs Creation Act Of 2004,"* Joint Committee Print, 108th Cong., 2nd sess., JCX-69-04, October 7, 2004, p. 8.

[63] Allen Kenney, "SILO Shutdown: How the New Law Could Cripple the Industry," *Tax Notes,* Nov. 1, 2004, p. 638-639.

[64] Ibid.

this differential treatment exists, the incentives for this type of behavior remain. SILOs and QTEs may become non-existent, but some other kind of transaction may replace them