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How Big Tax Shelter With Cities Shortchanges Federal Treasury

Use of Sale, Leaseback Deals, Worth Billions Each Year, Is a Target of a New Bill Chicago Sells Its 911 System

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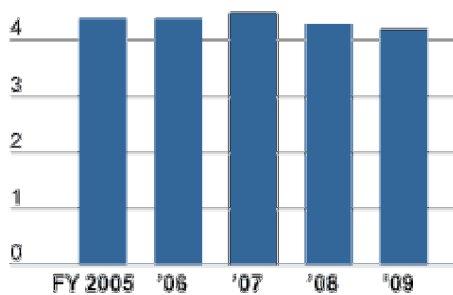
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While Chicago shoppers hunted for bargains a few days after Christmas last year, two big financial firms landed their own sweet deal. FleetBoston Financial and Sumitomo Mitsui Banking bought Chicago's 911 emergency-call system.

FULL SILOS

Projected losses of U.S. tax revenue from 'Sale In, Lease Out' tax shelters, absent congressional action

\$5 billion



Source: Congressional Joint Committee on Taxation

Chicago wasn't in the throes of privatization. It was playing its part in a complicated tax shelter, in which banks and insurers buy municipal assets and lease them back to the city. The investors claim big tax deductions, the city reaps a revenue windfall, and middlemen take a cut. The loser is the U.S. Treasury.

Of all the tax shelters currently reducing taxpayers' bills, municipal leasing may be the most costly to the Treasury. Absent new legislation, the deals are projected to cost the U.S. \$4.4 billion in uncollected taxes this fiscal year, the congressional Joint Committee on Taxation estimates. Cities have sold and leased back \$60 billion to \$80 billion in assets over the past four years, the Equipment Leasing Association says. Even if there are no new leasing deals, those already in place would generate deductions that cut tax revenue by billions of dollars in future years.

"These deals are so clearly egregious that we need to shut them down immediately," says a top Treasury tax official, Greg Jenner.

But the deals have vociferous defenders -- and not just the financial firms that reap the tax deductions they create. Because big cities also benefit from the arrangements, mayors staunchly defend them, as an innovative way to shunt federal aid to hard-pressed municipalities.

Chicago and other cities have added their voices to the already-heavy lobbying clout of financial firms seeking to preserve the tax shelters. The result has been to dilute a legislative attack on the shelters by the head of the Senate Finance Committee, Charles Grassley. His Senate-passed bill sought to block such deals in the future and unwind some existing ones. The House voted to block new deals but let existing ones stand.

Yesterday, a House-Senate conference committee settled on legislation close to the House's milder version, as it voted out a broad tax bill. Cracking down on the shelters is expected to raise \$27 billion over 10 years. (See related article1)

Cities and local transit agencies completed more than 100 of the lease deals, according to materials supplied by supporters. Federal transit officials gave approval for Atlanta's transit agency to sell off rail cars, for Houston's transit agency to sell bus equipment, for San Francisco's to sell train-control equipment and for New York's to sell subway cars.

The essence of the deals -- which the Internal Revenue Service dubs SILO, for "sale in, lease out" -- is a sale of depreciation rights. If a city builds, say, a subway system, it can't deduct the cost from its income taxes over future years, for a simple reason: Cities don't owe income taxes. So the city sells the subway to someone who does.

The buyers, typically financial firms, then can depreciate the subway -- that is, deduct a portion of its cost from their income each year for several years running. In a final step, the buyers, having no use for a subway, immediately lease it back to the city. The terms of the deals are structured to leave the city with a packet of cash. (The city often conveys the property to the investors in a long-term lease, which is treated for tax purposes as a sale.)

In Chicago, FleetBoston and Sumitomo paid about \$140 million, much of it borrowed, for the city's 911 system. It's difficult to say exactly how much the investors will save in taxes. The deal's terms suggest the investors' depreciation and interest deductions may total as high as \$219 million over future years, and might produce a total tax saving of as much as \$77 million. That's on top of the money they get from lease payments.

The calculation assumes the highest corporate tax rate of 35%, which is higher than many companies actually face. The net tax saving would be further reduced as lease payments from the city become taxable income to the investors.

Chicago -- leasing back the 911 system -- has put the bulk of its sale proceeds into a trust invested to produce enough income to guarantee the lease payments. Chicago gets to keep \$18 million of the proceeds, except for \$1.6 million in fees to middlemen.

So Chicago ends up with \$16.4 million that it didn't have before. That helps its budget. But the cost to the U.S. Treasury might be several times this. It's an expensive way to send federal aid to a city, says Sen. Grassley, an Iowa Republican. He says the deals "don't meet the test of common sense."

Sale-and-leaseback arrangements are common in the business world. In effect, they put depreciation rights in the hands of whoever can make the most use of them. For instance, a business that regularly has losses can't use a big slug of depreciation, because without profits, it can't make use of deductions. So it may sell a building to a bank or insurer that has steady profits.

The IRS has traditionally accepted these deals, which often have some economic substance through business risk-taking. But critics say the leasing deals done with cities are designed solely to generate tax breaks, and the buyers incur no economic risk because the city invests its proceeds to guarantee lease payments.

The firm that arranged the Chicago 911 deal, San Francisco-based Babcock & Brown, filed with the IRS an "Application for Registration of a Tax Shelter." But the firm also said it wasn't conceding that this was the kind of "confidential" shelter that had to be registered. And the IRS, in accepting the application, said it wasn't conceding that the arrangement was legitimate.

Sumitomo Mitsui Banking Corp. says the Chicago transaction "conformed to all applicable laws and regulations, but as a matter of policy, SMBC does not comment on customer matters." Bank of America Corp., which acquired FleetBoston this year, says it "follows the tax laws, and if they change the tax laws, we'll adhere to the changes."

The IRS has begun auditing some of the city leasing deals, but blocking them administratively would be complex and time-consuming because the deals vary in their specifics. A court challenge could take years. So the Treasury says the quickest cure is a change in tax statutes.

Municipal leasing shelters first flowered in the early 1980s. Congress shut down many of the first ones in 1984 by tightening depreciation rules relating to tax-exempt entities. It stretched out the depreciation period enough to make the deals far less advantageous.

Some cities then cut deals with foreign investors, who could use the depreciation rights they'd bought to cut taxes in their home countries. And consultants soon dreamed up a new domestic shelter that got around the federal clampdown, focusing on generating interest deductions instead of depreciation. The Chicago Transit Authority did an early leasing deal in 1995, involving rail cars, and picked up \$50 million as its cut. The city was weighing another deal, for its Orange Line transit line to Midway airport, when the Treasury shut down the new variety of shelter as well, with a tax ruling in 1999.

Then came the Sept. 11 terrorist attacks, which plunged Chicago's budget deep into the red as tax receipts fell and preparedness costs rose. Newly eager to get revenue wherever it could, the city turned to

Babcock & Brown, which had long been active in marketing tax shelters. Like several other firms, Babcock & Brown was pitching a new deal that seemed to get around the federal crackdown. It was SILO. The new plan tinkered with the leases to restore a more advantageous depreciation period.

Babcock & Brown told Chicago officials that other municipalities, including Miami/Dade County, Fla., had profited from leasing deals involving high-tech equipment, says a person close to the Chicago 911 deal. Documents show Babcock & Brown told Chicago that over the years it had done 146 lease deals for cities and other tax-exempt entities, including overseas cities, with a total cost of \$36.7 billion. Chicago Comptroller Tariq Malhance was reassured, and the city hired the firm in June 2003 to set up a SILO deal involving the city's 911 system.

But Chicago was in a race with Sen. Grassley and the Treasury, which were hoping to shut down this new variety of leasing shelters.

In May, Sen. Grassley's committee pushed for a broad tax-shelter crackdown that would have harmed the 911 deal and others like it, promoters feared. The provision didn't survive, dropped at the behest of House members, who'd been lobbied heavily by a group of 30 banks and insurance companies calling itself the Big Ticket coalition. Around the same time, the IRS told Sen. Grassley's staff the agency had received 400 registrations for lease deals similar to Chicago's. The Finance Committee began investigating.

Hoping to soften Sen. Grassley's attitude, Babcock & Brown invited him to speak via teleconference at a client outing in Pebble Beach, Calif., last Oct. 20. It was bad timing. The senator had scheduled a committee hearing for the next day to attack the SILO shelter. In the teleconference, he blasted the deal, saying that it mimicked a sale but "the only thing that moves are the tax benefits."

There was more heat at the Senate hearing the next day. An anonymous witness -- behind a screen and using the fake name "Mr. Janet" -- contended SILO was "a massive scandal" involving "the greed of senior management of large U.S. corporations and their financial advisers."

On Nov. 18, 2003, Sen. Grassley announced he would introduce legislation that would bar new SILO leasing shelters as of that day.

With their 911 deal not yet completed, Chicago officials leapt to action. Mayor Richard Daley sent off a letter to House Speaker Dennis Hastert, an Illinois Republican, who lent his support of the leasing deals.

The Big Ticket coalition, led by lobbyist Kenneth Kies, a former top congressional staffer with close ties to the House, held an emergency teleconference. Member firms decided to focus on House members, and poured money into representatives' campaign chests.

Among the biggest beneficiaries were Speaker Hastert, who has received \$70,000 since October 2003. A spokesman for the speaker said this was "a drop in the bucket." Big Ticket firms have made a total of \$500,000 in campaign contributions in two years, according to the nonpartisan Center for Responsive Politics in Washington, D.C.

Then Treasury officials ordered the Federal Transit Authority to approve no new SILO deals involving transit facilities bought with FTA-administered federal grants. The action in November froze transit-related deals in the pipeline, including a new bid by Chicago to sell and lease back its Orange Line to Midway airport.

The 911 investors decided to go forward in the face of the Senate bill, provided they could cut their risk. So in the deal reached four days after Christmas last year, Chicago agreed that if the Senate's anti-shelter legislation became law in 2004, the city would pay the investors' lost tax benefits, a cost that could easily exceed the city's hoped-for profit.

Chicago officials were betting they could defeat the Grassley initiative in the House. At a House Ways & Means Committee hearing in February, Chairman Bill Thomas remarked that cities were telling legislators "we are into this up to our eyeballs, and please do not stop it."

Among those lobbying were California's transit agencies, which told Congress they had \$170 million riding on pending lease deals. A California rail-transit agency, Metrolink, reminded Rep. Thomas, a California Republican, that it operated a station in his rural district. It suggested that money from leasing

deals could help improve service.

When Rep. Thomas released his version of anti-shelter legislation in March, it went easier on SILO than the Senate version, generally barring new lease deals but letting old ones stand. The Senate had voted to let existing deals by U.S. cities stand, but block new ones and unwind those involving foreign cities' facilities. The conference committee yesterday generally sided with Rep. Thomas and the House but borrowed a few of the Senate's tougher terms.

The firms that put the municipal lease deals together have been harmed by the controversy. Because of the unsettled legal situation, no new deals have closed since the spring. Babcock & Brown, which operates in 14 countries, plans to move its headquarters to Australia, a move it terms a "practical necessity" because many of its managers live there. Skeptics note that the foreign address could allow the firm to set up tax-avoidance transactions from an offshore location, where it's easier. That isn't its purpose, Babcock & Brown said in an e-mail, while declining requests for interviews on the subject of leasing deals.

Tax lawyers already are pondering new kinds of lease deals that wouldn't be blocked by the proposed legislation. One idea is leasing intangible city property. And Chicago, according to its controller, Mr. Malhance, has heard from lawyers looking to put together deals that would involve overseas investors.

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