

SECTION 305 FINANCE SUB COMMITTEE

MINUTES

JUNE 4, 2014

3:00PM EASTERN

CONFERENCE CALL

FACILITATOR	<i>Brent Thompson, Vice Chair of the S305 Finance Subcommittee</i>
ATTENDEES	<i>Darrell Smith as proxy for Gerald Sokol, Brent Thompson, Brian Beeler II, Brian Beeler also as proxy for Tim Hoeffner, Vincent Brotski, Kevin Kesler, Arun Rao, Lori Hostetler, Shayne Gill, Steve Hewitt, David Ewing, Larry Salci, Jennifer Moczygembo, Ashok Sudararajan, Eric Curtit</i>
ABSENTEES	<i>Tim Hoeffner, Jeff Gordon, Gerald Sokol, Martha Gebbie,</i>

DECISIONS MADE

1. Welcome and Open Meeting –Brent Thompson:

Subcommittee vice Chair Brent Thompson, Washington State DOT, opened the conference call and asked Steve Hewitt to call the roll.

2. Roll Call – Steve Hewitt:

Steve Hewitt called the roll, and confirmed the presence of a quorum.

3. Review of Action Items – Steve Hewitt:

Steve Hewitt provided a brief status update on Finance subcommittee action items:

Action Items Status

On the last call, the Finance subcommittee approved the work plan for exploring options for financing equipment as presented, and directed David Ewing to begin contacting presenters and setting a schedule.

Status: Two presentations are planned for today's call – Agenda items #5 and 6, and David will provide an update on the schedule for future presentations under agenda item #7.

4.

Approval of minutes from 4-9-14 – Brent Thompson:

On a motion by Darrell Smith, Amtrak, and a second by Arun Rao, Wisconsin DOT, the minutes from the April 9, 2014 conference call meeting were approved without objection.

5.

Presentation: Federal Tax Code and Passenger Rail Car Financing - Larry Salci:

Larry Salci, Salci Consult, provided the following presentation on the Federal Tax Code and Passenger Rail Car financing:

Chronological Summary and Transaction Structures:

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 eliminate 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 an 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?

Discussion:

Eric Curtit asked if it would be possible to tighten the tax law to limit the scope for potential future use.

Mr. Salci noted that the time to do this would be during the re-authorization process. Talk to congressional staff to see if there is an appetite to "capture the depreciation" and narrow down the scope to show a public benefit. Whether it can get done all depends on the political environment and what the appetite of the financial institutions such as Wells Fargo and others is. After what has happened in the past they would be very hesitant unless the law is made very clear.

Eric commented that it would seem the approach needs to be to get it narrowed and made clear through the legislative process rather than through the courts or judicial system.

David Ewing asked "building on Eric's question" – is it feasible that with a narrowed and clearer scope, "a fee could be

paid to a successor to the NGEC to fund that entity?’

Mr. Salci replied – that this could be a way to go, but, I would still depend on what Congress’ appetite is.

David elaborated “it could provide money for funding the NGEC and funding a standardized fleet...this would feed the goal of standardization and economic development.’ David added, and Larry agreed, this would need to be an “education and outreach” effort.

6.

Presentation: Transportation Development Credits - Jennifer Moczygemba. Hatch Mott MacDonald:

Jennifer Moczygemba, Hatch Mott MacDonald, provided a summary report on the use of Transportation Development Credits.

Jennifer was formerly (over 20 years) with Texas DOT where she worked on passenger rail efforts – working with both AASHTO and S4PRC. She is now with Hatch Mott MacDonald and a focus has been on the legislative issues related to toll credits and gaining the flexibility (and eligibility) to have access to money when in need of coming up with the match. Toll credits – or Transportation Development Credits -rather than cash – is seen as a potential remedy.

Jennifer provided the following link as additional information for the Finance subcommittee members:

<http://ftp.dot.state.tx.us/pub/txdot-info/lgp/tech-memo-transportation-development-credits.pdf>

The general concept behind Transportation Development Credits (TDC) or toll credits is to leverage federal funds without using cash. States have issues with finding sources of revenue for non-highway activities because for the most part they cannot use the gas tax revenues for other modes. TDC’s are meant to provide the ability to flex those funds through toll credits.

Currently, however, while transit type projects can be eligible, intercity passenger rail or bus projects are excluded.

Because toll credits can give states to federal funds without putting out actual cash, it can be a viable solution, but not for rail unless flexibility and eligibility changes are made.

The impetus needs to be to push congress to allow for the use of TDC’s for intercity passenger rail as well as transit.

Larry Salci asked if the toll credits can be used only from revenue from existing toll roads or can it be used for interstate highways being converted to toll roads.

Jennifer referred Larry to the link (above) but responded in regard to converted interstates “probably not without an agreement with Federal Highways.”

David Ewing noted that in its Re-authorization proposal – Grow America allows for the ability to toll existing interstates to generate funds for repairs and maintenance. He asked “would this then give us a chance to utilize the funds as additional ‘soft match?’”

The response was that in identifying new tolling it would be necessary to define how the funds are structured. The money would need to be in excess of the O&M and road repairs.

7.

Future Presentations – schedule status - David Ewing:

David Ewing reported that he has identified Allan Rutter as the next potential presenter for the Finance subcommittee’s effort to explore potential options for funding/financing intercity passenger rail equipment.

He will work with Steve Hewitt in setting a date for the next presentation and then work with Alan Rutter and his schedule.

It was agreed that the July 2 Finance subcommittee call will likely be cancelled due to the July 4th holiday. David suggested the possibility of looking a July 9th.

Steve will work with Darrell Smith and Jerry Sokol (Chair) to get a sense of when the next call will take place.

Shayne Gill, AASHTO, suggested that if the next or future presentations have a strong rolling stock tie in, they could be used as a part of the RR202 effort and be advertised to a broader audience. If David will provide Shayne with the description of future sessions, he will run it by the FRA to see if it fits the criteria to be sponsored through the NGENC RR202 series.

David noted that he will do that, but also commented that the goal of the Finance subcommittee series is to migrate towards developing some potential tools for the purchase and financing of rolling stock and to help the NGENC Future working group in its efforts in moving the NGENC forward.

David noted there will be a compilation at the end of the series of presentations which will, hopefully, assist the Future working group in its efforts.

Following today's (6-4-14) call – it was learned that Darrell Smith, Amtrak, has been appointed by CFO Jerry Sokol to serve as his representative to the NGENC. Darrell will assume Jerry's responsibilities as Finance subcommittee Chair and as NGENC Treasurer. Darrell and Steve Hewitt connected after today's call and have scheduled the next Finance subcommittee call for July 30, 2014.

8.

Other/Issues/Questions - All:

With no other business to come before the subcommittee today, the conference call meeting was adjourned at approximately 4:05 PM Eastern.

**Next Finance subcommittee conference call –July 30, 2014
866 209 1307 access code: 9786620#**

Decisions and Action Items

Darrell Smith will work with Jerry Sokol and provide Steve Hewitt with potential dates for the next Finance subcommittee call (July 2nd will be cancelled)

Following the call – Steve Hewitt and Darrell Smith connected and the next call is now scheduled for July 30th, 2015.

David Ewing will work with Allan Rutter in regard to his availability to participate on the July 30th conference call.

David will keep Shayne Gill informed as to the description of future presentations. Shayne will then work with FRA to see if they fit the criteria to qualify as a part of the broader RR202 series.

Shayne will post the presentations on the website and will distribute them to the broader email list – beyond just the NGENC.

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ATTACHMENTS



The NGEC will provide national leadership in standardization, acquisition, financing and management of passenger rail equipment.

SECTION 305 Finance Subcommittee Conference Call

**June 4, 2014
3:00pm. Eastern
866 209 1307 pass code 9786620#**

AGENDA

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| 1. Welcome/Open | Brent Thompson |
| 2. Roll Call | Steve Hewitt |
| 3. Review of Action Items | Steve Hewitt |
| 4. Approval of minutes from 4-9-2014 | Brent Thompson |
| 5. Presentation: Federal Tax Code and Passenger Rail Car Financing | Larry Salci |
| 6. Presentation: Transportation Development Credits | Jennifer Moczygemba |
| 7. Future Presentations – schedule status | David Ewing |
| 8. Other issues/questions? | All |

Next Finance subcommittee call: July 30, 2014 – 3:00PM Eastern

Call in # 866 209 1307 passcode 9786620#