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Transit Agencies in Bind Due to SILO Deals and AIG Collapse

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Federal Officials Encouraged Leasebacks, Then Made Them Worthless for Creditors

Introduction

Major newspapers are reporting on a financing crisis that is hitting many transit systems in the United States late this month. The situation is a result of (1) a series of leaseback transactions these agencies conducted which included heavy termination penalties, (2) federal policy first to encourage and then to discourage them, and (3) the collapse of insurer AIG. As a result, approximately 30 agencies nationwide may face serious financial shortfalls absent action by the U.S. Treasury Department.[1]

On October 29, 2008, the Washington Metropolitan Area Transit Authority (WMATA) sought an injunction in U.S. District Court against KBG Group, a Belgian bank that is demanding $43 million in termination fees by October 31.[2] Metro warned that unless the injunction was granted, the agency might be forced into default.

Transit Agencies Used Leaseback Transactions to Supplement Funding

When a private company builds an asset, they are permitted under federal income tax law to deduct from their taxes the depreciation (wearing out) of the asset over time, reducing their overall tax bill. Cities and transit agencies also build and own assets, but because they are governmental instrumentalities, they are exempt from federal income taxes. Given that they don't pay taxes, these reductions in taxes owed are worthless to them.

Enter the SILO (sale in, lease out) transaction. Beginning in the 1980s, cities started signing these deals with banks and other private investors. In these contracts, the city agency sells (actually a long-term lease, but it's a sale for tax purposes) a city-owned asset to a private investor. The private investor can thus use the depreciation deductions to reduce his or her taxes over time. Not needing the asset, the investor leases it back to the city, and the city promises to make annual lease payments. The city takes part of the purchase price it received to make these payments for the life of the lease, and a surplus is usually left over that can be used for other projects or needs. The fine print of these SILO deals was ignored for two decades.

One typical example of such a deal was by the San Diego Trolley and a San Diego corporation, Signal Companies, in 1981.[3] The agency's first line had just entered service and it was seeking funds to build an extension. Signal offered to purchase the agency's 14 trolley railcars, which had been paid for by state funds. Signal would immediately lease the cars back to the Trolley for payments that equaled Signal's purchase payment installments.

Such a transaction seems to have no economic purpose—just two entities swapping assets of identical value—but federal taxpayers were providing the hidden profit. As a private corporation, Signal was permitted to deduct the depreciation over five years as well as to deduct the interest on the payments, and these tax deductions provided the profit that would be split between the Trolley and Signal. The Trolley received its share up-front, about 15 to 25 percent of the railcars' cost. It also retained the right to purchase the railcars back at the end of the lease for $1 each. The deal resulted in a net profit to the Trolley of $2.28 million, which was used for construction.

The Federal Government First Encouraged, Then Discouraged Leaseback Deals

Federal transit officials supported the state and local officials who wanted the federal tax deduction to continue, and so they championed the deals as a way to reduce on-budget transit operating and construction subsidies.[4] (Lost revenue is considered a tax reduction, not an appropriation for a program.) In 2003, the Treasury Department estimated that approximately $4.4 billion was lost in revenue as a result of transit agency SILO deals. Never having been a great supporter of the idea, Treasury periodically tightened regulations, such as by denying depreciation deductions to U.S.-based companies but continuing to permit them for foreign companies. Beginning in 2004, Treasury denied all depreciation deductions for SILO deals, making them worthless for banks that had entered into them.

Banks Are Seeking to Escape These Now Worthless Deals

The Treasury action invalidating SILO depreciation deductions encouraged the banks to look for any opportunity to get out of the contracts. The situation is exacerbated by an IRS settlement offer to banks that lets them keep 20 percent of the disallowed deductions if they terminate the agreements with the agencies by the end of 2008.[5]

That's where the fine print comes in. The escape route that the banks have needed since 2004 opened up when American Insurance Group (AIG), an insurer that had guaranteed many of the deals, neared bankruptcy due to heavy defaults on mortgage-backed securities it had

guaranteed. In mid-September 2008, AIG's credit rating fell and then it was bailed out by the U.S. government. The lowering of the guarantor's credit rating triggered a clause in the SILO agreements that placed them in technical default, requiring the transit agencies to either find a new guarantor or pay very large termination fees to cancel the agreements. The credit crisis has eliminated the option of finding a new guarantor.

Faced with the choice of paying huge termination fees or finding a new guarantor, some agencies like Washington, D.C.'s Metro system are demanding that the U.S. Treasury become the new guarantor.[6] Metro estimates that it would cost $400 million to pay the termination fees, money that neither it nor any other agency had budgeted. Los Angeles's MTA estimates that the fees would be $1.8 billion, half its annual operating budget. The agencies have turned to Congress for help, since the Treasury thus far does not see this as a pressing issue.[7]

Conclusion

Broadly, this shows some of the problems with the federal budgeting process, whereby "tax cuts" are seen as more palatable than "spending" even in a case where they are pretty much the same thing. Federal transportation officials wanted to encourage transit capital projects but not to fund them on the spending side, so they championed the use of SILO financing, in effect funding them through the federal tax code. Treasury never favored the arrangement, and in late 2003 they prevailed.

By reversing course, the federal government stopped providing a flow of taxpayer funds that were being split between local transit agencies and private investors. That left the existing agreements without a source of funding and it gave the banks who had already signed SILO deals every reason to try to get out of them. With the failure of AIG, the banks are now presenting their demands to local transit officials who had foolishly signed contracts with termination fees they knew they couldn't pay.

In the short term, it's hard to say what the best option is. The SILO deals are a tax shelter, and it's likely that the U.S. Treasury won't support any action that doesn't unwind these deals. Also, more and more people are beginning question the number of obligations the federal government is guaranteeing. Bankruptcy protection is possible, but a bankruptcy court would likely prioritize continued operation of the transit systems over allowing creditors to seize assets they technically own. At the same time, these agencies just don't have the cash to terminate these agreements into which they freely entered. The agencies are seeking congressional and Treasury help and it is from there that the next move will come.

Below are the transit agencies that made sale/leaseback transactions from 1988 until 2003. The number listed is the total value of the assets underlying the sale/leaseback transaction. The amounts owed in a contract termination would be a fraction of this amount and would vary with the life of the asset.

California

AC Transit, Oakland ($100.0 million)
Bay Area Rapid Transit (BART), Oakland ($422.0 million)

Caltrain, San Mateo ($490.7 million)
Los Angeles MTA, Los Angeles ($1.229 billion)
SCRTD, now part of MTA ($70.0 million)
Metrolink, Los Angeles ($67.8 million)
Muni, San Francisco ($467.9 million)
Sacramento RT, Sacramento ($416,900)
San Diego Trolley (MTS), San Diego ($129.5 million)
VTA, San Jose ($19.6 million)

Colorado
Denver RTD, Denver ($144.7 million)

Connecticut
Connecticut DOT/MTA, Hartford ($502.6 million)

District of Columbia
WMATA, Washington ($889.1 million)

Florida
Miami-Dade Transit Authority, Miami ($142.0 million)

Georgia
MARTA, Atlanta ($3.058 billion)

Illinois
Chicago Transit Authority, Chicago ($1.102 billion)
Pace, Chicago ($120.0 million)

Massachusetts
MBTA, Boston ($539.5 million)

Maryland
MTA (Light Rail), Baltimore ($45.0 million)

Missouri
Bi-State Development Agency (MetroLink), St. Louis ($243.3 million)

New Jersey
New Jersey Transit ($1.856 billion)

New York
MTA, New York ($2.389 billion)

Ohio
Greater Cleveland Regional Transit Authority, Cleveland ($251.0 million)

Oregon
Tri-Met, Portland ($200.0 million)

Pennsylvania
SEPTA, Philadelphia ($1.415 billion)
Port Authority, Pittsburgh ($163.9 million)

Texas
DART, Dallas ($405.8 million)
Metro, Houston ($463.9 million)

Washington
Sounder, Seattle ($146.2 million)
King County Metropolitan Transit, Seattle ($40.4 million)

Total, United States: $16.102 billion in pledged assets.

Source: Federal Transit Administration, U.S. House of Representatives Committee on Transportation and Infrastructure.

Notes

1. Lena H. Sun & Binyamin Appelbaum, "Credit Crisis May Force Metro to Pay Millions," *Washington Post* (Oct. 24, 2008), at http://www.washingtonpost.com/wp-dyn/content/article/2008/10/23/AR2008102303820_pf.html.

2. "DC transit agency seeks injunction against bank," Associated Press (October 30, 2008), at http://ap.google.com/article/ALeqM5iKbVJGbpPur3QnBay3UKERI2J1SAD944DVIO3.

3. Gena Holle, The San Diego Trolley (1990).

4. John D. McKinnon, "How Big Tax Shelter With Cities Shortchanges Federal Treasury," The *Wall Street Journal* (Oct. 7, 2004), at http://online.wsj.com/ad/article/vertex/SB109709864105738420.html.

5. *See* "IRS Publishes SILO and LILO Settlement Initiatives-Sale & Leasebacks," (Sep. 22, 2008) at http://www.irstaxattorney.com/blog/2008/09/irs-publishes-silo-and-lilo-settement.html.

6. WMATA, "Current economic crisis could affect Metro and other transit agencies FAQ," at http://www.wmata.com/faqs/preview.cfm?faqID=49.

7. Steve Hymon & Martin Zimmerman, "MTA may have to cut commuter service," *Los Angeles Times* (Oct. 18, 2008), at http://www.latimes.com/news/printedition/california/la-me-transit18-2008oct18,0,949905.story.

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