**UNITED STATES SENATE**
**COMMITTEE ON FINANCE**
**Charles E. Grassley, Chairman**
**Tax Shelters: Who's Buying, Who's Selling, and What's the Government Doing About It?**
**Tuesday, October 21, 2003**

# TESTIMONY OF "Mr. JANET" – A WITNESS PSEUDONYM REGARDING ABUSIVE CROSS-BORDER LEASING AND LEASING WITH U.S. MUNICIPALITIES

Good morning Senators. This morning I will describe a massive scandal that has allowed major U.S. companies to receive huge tax deductions by pretending to lease the infrastructure of foreign countries, such as dams, bridges, and subways, and then pretending to lease that infrastructure back to the country or municipality that own the infrastructure. This scheme is so pervasive that much of the old and new infrastructure throughout Europe has been leased to, and leased back from, American corporations. The sole purpose of this scheme is to generate a tax shelter for U.S. corporations that invest in these schemes.

I know first-hand what I am talking about. I am a former leasing executive with between 10 and 25 years of industry experience. I was a leader in the industry, but left in large part because of my unwillingness to do the types of transactions that I will describe today. I appear before you anonymously to protect my wife and children from certain retaliation if my identity were disclosed.

The best way to explain this scheme is by the example of a car lease. Under a normal car lease, you pay a set amount each month and at the end of the lease you either buy the car or give it back to the leasing company.

In this structure, let's say you are a foreign person who owns the car. An investment banker comes to you and says "I will give you a thousand dollars if you agree to sign papers saying that you have leased the car to, and leased it back from, an American taxpayer. You will have no continuing financial responsibility or loss exposure. You will make no lease payments, you will continue to own the car as you always have – no one can take it from you, and you get to dispose of the car as you please once the lease if over. In effect you're still the owner. We are just going to pay you a fee to sign some papers that back up our deduction claim to the IRS." What would you say to such an offer?

If you are an American taxpayer, you might hesitate. But if you are an European or other foreign person, what risk do you have? Well, that is the scenario that has played

out over the past 10 years on a much larger scale. Here is the detail on how this scam works.

The deals generally involve a foreign governmental unit that is not subject to taxes, such as a municipality, a water authority, flight control agency, a subway or rail system, or similar organization that has control over large immovable infrastructure assets with long useful lives. The long lives are important so that the depreciation deductions in the U.S. can be maximized over time. In many cases, the useful life of the asset exceeds the U.S. depreciation period for the asset, so that the U.S. taxpayers will obtain deductions well in excess of the actual decline in value. Although various tax rules attempt remove this benefit, they have been easily circumvented by the promoters of these transactions. Because they are infrastructure assets, they have a more stable value over time. Using a tax exempt governmental unit is important because the governmental unit is non-taxable and does not need their own depreciation deduction for those assets. Accordingly, they are willing to "pretend" to give up ownership of the infrastructure property to someone who can use the depreciation deduction.

The municipalities are paid a large up-front fee to enter into a long-term lease of their railways, subways, dams, water lines, or air traffic control systems to American promoters. The U.S. investors will be able to claim U.S. depreciation deductions over the life of the lease, and in some cases over a much shorter time frame.

As part of the same agreement, the American promoters will agree to simultaneously lease the assets back to the foreign municipality at a cost equal to what they are receiving from the municipality, less the municipality's up-front payment. The foreign municipality will be responsible for operating and servicing the assets over the lease term. At the end of the lease term, the infrastructure assets revert back to the municipality. To be clear, let me again emphasize that in most cases, the municipality makes no lease payments. All of their obligations are prepaid through "phantom" debt, which is described below

There are two concerns for the foreign municipalities and the U.S. promoters. The foreign municipalities don't want to owe rental payments to the U.S. promoters or run the risk that the infrastructure assets would actually be repossessed by the U.S. promoters from defaulting on the lease. Similarly, the U.S promoters don't want to take possession of the infrastructure assets in the event of default, nor do they want to actually make lease payment to the foreign country. To answer these concerns, the U.S. promoters will borrow an amount equal to the lease payments they owe to the municipality. The loan proceeds are placed on deposit in a bank account of the municipality. However, the amounts deposited can only be released to pay for lease payments owed by the municipality to the U.S. promoters, which by coincidence is the same as the payments owed to the municipality. As a result, neither the U.S. promoters nor the municipality is taking any credit or ownership risk.

The only risk in the overall transaction is whether the IRS will attack the depreciation deductions of the U.S. investors. All too often, the IRS will settle the case

rather than risk a loss at trial. Even if the settlement requires the U.S. investors to disgorge 50% of their tax deductions, they are way ahead of the game by keeping the remaining 50%.

It is important to note that these contrived transfers are structured as leases, rather than an outright purchase of the foreign infrastructure. This is because in 1984, Congress enacted the so-called “Pickle Rules” that severely limit depreciation deductions for U.S.-owned foreign assets. In order to avoid the Pickle Rules, the deals are structured as a head lease and a sublease to avoid the longer tax depreciation period required under those rules.

The IRS has initiated enforcement actions against some of these types of transactions, which are called LILOs – an abbreviation of their industry name “lease-in-lease-out” transactions. But the leasing industry is always one-step ahead of the IRS. They have now replicated these benefits through service agreement contracts, which are called SILOs - “sale in-lease out.” They operate in the same manner, but with a different reason for the contrived lease payments.

The numbers involved in these deals are staggering. A minimum of $20 to $30 billion dollars a year of foreign infrastructure is purportedly leased or sold in this manner. As I said, most of the existing infrastructure of Europe – bridges, railroads, waterways, subways, air traffic control systems, and the like – have been leased to Americans under these deals. Investment bankers scour the countryside looking for municipalities that are interested in the easy money of the up-front payment to enter the deal. Foreign officials are routinely enticed to enter into these transactions through promoter sponsored golf outings, expense paid trips, and similar arrangements.

On the chart behind me is a picture from a July 10th New York Times article entitled “Latest German Fad: Leasing Out the Subway.” It describes protests by the citizens of Frankfurt against leasing their subway system. I have included a copy of this article with my testimony.

The other chart is a recent press release from a Canadian air traffic control group proudly announcing that it has leased and leased back the Canadian air traffic control system to Bank of America for an up-front payment of $25 million from B of A. I have no idea how much B of A is getting out of the deal.

What is even more shocking is that these transactions are arranged by some of the largest multinational financial advisors in Europe and the U.S., and include major U.S. cost center banks and Fortune 500 corporations.

I have to tell you that the leasing industry has not always been this way, nor are all leasing companies involved in this scam. As companies became increasingly profitable during the 1990s, they opted to own their assets rather than lease them. Faced with a downturn in the domestic market for real asset leases, the leasing industry was forced to find new deals and new revenues. What you have heard today is the result.

There is enormous pressure to continue these deals, which is why LILOs were quickly replaced with SILOs. In today's market, the types of deals are the only game left for the leasing industry to make the big bucks. This is because the market for leasing real assets has dried up. I'm not talking about copying machines. I'm referring to the multimillion dollar assets.

During the 1990s, leasing made a large percentage of its profits doing off-balance sheet financings, which were perfectly legal at the time. But Sarbanes-Oxley changed all of that. No one is touching those deals today. Because of the current recession, few companies are investing in new assets. If a company does need new assets, it will issue debt in lieu of leasing because of the record low interest rates and the ability of the company to take depreciation. So the only alternative left for the big ticket leasing is to do LILOs or SILOs. That's why there is so much pressure to keep doing these deals -- they are the only thing keeping the large ticket leasing industry in the money.

There is one more development you need to know about. I said earlier that U.S. municipalities have historically been hesitant to enter into these deal. That is no longer the case. Faced with local budget deficits, state and local governments are leasing off infrastructure assets at a record rate. The subway systems of Boston, Chicago, and Washington D.C. have been leased and leased back to U.S. corporations. I have reason to believe that the New York and Chicago water authorities are about to engage in a scheme to lease the waterlines under their streets.

Consider the irony of this situation. Infrastructure is built with the taxpayer dollars of working men and women and with tax exempt bond funds. They are then leased and leased back in a phony transaction to provide tax deductions for some of the most profitable companies in America. I cannot believe this is what Congress intended in writing its tax leasing laws.

As I briefly mentioned, Congress in 1984 did enact rules to limit this type of behavior. These rules are routinely evaded and have proven to be of little value in achieving the intent of Congress to stop this type of activity. I reference your recent FSC-ETI Committee bill which would add a provision to subject these types of leases to rules similar to the passive activity loss rules enacted in 1986. Those 1986 rules were effective at stopping the individual tax shelters of the 1980s, but the 1986 rules only applied to individuals and not to corporations. As a result, it left a huge gapping hole for leasing fraud. Your Committee's current proposal would greatly, if not completely, stop these abusive transactions. One suggestion for improvement would be to subject certain technological equipment to the rules enacted in 1984. This is long overdue, and it is how Bank of America can legally get U.S. tax deductions by leasing and leasing back the air traffic control system of Canada.

One final point. As I said, not all leasing companies participate in this. The leasing industry is represented primary by the Equipment Leasing Association here in Washington. Not all of their members are doing this. It is mostly the ones belonging to

the “Big-Ticket Leasing Group” within ELA. You will hear a lot of banter about how leasing lowers the cost of capital, stimulates the economy and drives economic efficiency. In fact, allowing this loophole to stay in place reduces U.S. economic stimulus, and here is why.

In doing these deals, a U.S. leasing company can shelter taxable income without the risk of having to take possession of leased equipment and without any credit risk. So why in the world would they take a risk by leasing to a capital-starved U.S. company? There is no incentive to take that kind of risk when they can get these juicy risk-free returns by doing LILOs and SILOs and shelter their income.

Moreover, I fail to see how the U.S. economy is stimulated by giving U.S. tax deductions for assets built by the French, funded by the French, and used by the French. I also don’t see how the economy is stimulated by taking subways that are built with taxpayer dollars, and allowing corporations to get a deduction for them. These transactions lack any economic substance or business purpose, and should be shut down.

Thank you for this opportunity to present my testimony. I welcome questions from the Committee.