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JULY 20, 2006

TO: BOARD OF DIRECTORS

THROUGH: ROGER SNOBLE
CHIEF EXECUTIVE OFFICER

FROM: TERRY MATSUMOTO
EXECUTIVE OFFICER, FINANCE AND TREASURER

SUBJECT: EXCISE TAX ON LEVERAGED LEASE TRANSACTIONS

ISSUE

On May 17, 2006, the Tax Increase Prevention and Reconciliation Act of 2006 (TIPRA) was signed into law. TIPRA contains a provision that imposes an annual excise tax on government entities relating to their existing leveraged lease, aka lease/leaseback, transactions, including transactions entered into prior to its effective date of May 17, 2006. The annual excise tax would be based upon "attributed income," which will be defined by the U.S. Treasury when it issues underlying regulations.

DISCUSSION

Our primary issue is that transactions entered into prior to TIPRA should be exempt from these provisions. During the period from June 2000 through July 2003, we entered into 7 such transactions totaling over $1.2 billion of asset value and earned over $65 million in cash payments. The assets included rail cars, buses, maintenance facilities and the transit plaza. Under a worst case interpretation, including retroactive application, our excise tax liability could be over $300 million, far in excess of the fees that we earned.

The New York MTA, who has done several billion dollars of transactions, recently met with several congressional staff with tepid results. Under the lead of the Government Finance Officers Association (the provision impacts all levels of state and local governments, not just transit agencies) and APTA, NY MTA shared their discussions with affected parties including the transit agencies of Chicago, Boston, Washington DC, St. Louis and BART. NY MTA indicated that they are scheduled to meet with IRS staff shortly and will share those conversations with the group in a follow up conference call.

A transaction covering $150 million of qualified technical equipment, "QTE", was approved by the Board in September 2005. However, the equity investor, Bank of America, recently informed us that they have withdrawn from the deal. Ironically, TIPRA specifically exempted deals like this which were "grandfathered" under the American Jobs Creation Act of 2004.

A briefing paper, prepared in part by our lease counsel, Orrick Herrington Sutcliffe, is attached to provide more details.

NEXT STEPS

- Continue to participate in industry discussions tracking NY MTA's contacts in Washington DC.

- Implement a strategy to enlist the support of our congressional delegation.

ATTACHMENT

1. Excise Tax Briefing

EXCISE TAX BRIEFING

Issue

On May 17, 2006, the Tax Increase Prevention and Reconciliation Act of 2006 (TIPRA) was signed into law. ***TIPRA contains a provision that imposes an annual excise tax on governmental entities relating to their existing leveraged lease transactions, including transactions entered into prior to its effective date of May 17, 2006.*** The annual excise tax would be based upon "attributed income," which will be defined by the U.S. Treasury when it issues the underlying regulations.

Background

Leveraged lease transactions have come under increasing scrutiny from the U.S Treasury. Many State and Local governmental entities have entered into these transactions beginning in the 1990's, including many transportation providers. In fact, federal agencies, including the Federal Transit Administration ("FTA"), actively encouraged transportation agencies to enter into such lease transactions under the banner of "creative financing" and as a way to further leverage federal transportation funding.

Under a LILO ("lease in, lease out") transaction, a U.S. taxpayer (usually a corporation) leases an infrastructure asset (such as railway cars, bridges, or tunnels) from a tax exempt entity (i.e., domestic municipality, state or local government) and then sub-leases it back to the same tax exempt entity. The infrastructure asset continues to be operated by the tax-exempt entity, and the payments on the lease and the sub-lease essentially cancel each other out. U.S. taxpayers are treated as the owners of the infrastructure assets and are able to take the depreciation and interest deductions that these assets generate. In exchange, the tax exempt entity often receives an upfront payment.

In response to concerns regarding LILO transactions, the U.S. Treasury Department issued the following Revenue Rulings:

1. Revenue Ruling 1999-14 which disallowed the depreciation and interest deductions for LILO revenue. (1999)
2. Ruling 2002-69 which defined LILO transactions as abusive tax shelters and as a "listed transaction." (2002)

As a result, standard terms of LILO contracts were changed to structure lease agreements to comply with the IRS rulings and still provide the depreciation and interest deductions to U.S. taxpayers. These transactions are referred to as a SILO ("sale in, lease out").

In a SILO, the U.S. taxpayer structures the deal as a long-term lease (which is treated as a sale for tax purposes) of the infrastructure asset followed by a shorter-term lease of the property back to the tax exempt entity. The lease terms contain provisions that are designed to minimize the risk that the leasor will have to take ownership of the asset at the end of the lease term, such as a purchase option or service contract.

U.S. Treasury continued to scrutinize these transactions, and the FTA, at the request of the U.S. Treasury, suspended its review and support of all leveraged lease transactions on November 26, 2003. Most entities that had used such transactions, ceased to do so based on the concerns being raised.

In October 2004, the President signed into law the American Jobs Creation Act of 2004, P.L. 108-357 ("the "JOBS Act"). The JOBS Act disallowed the depreciation and interest deductions for SILOs. The IRS subsequently issued guidance (Notice 2005-13) which determined that SILO transactions are abusive tax shelters and are included on the list of "listed transactions."

However, the JOBS Act mandated that the FTA review certain transactions, specifically, those involving "domestic property subject to a lease with respect to which a form application – (A) was submitted for approval to FTA after June 30, 2003, and before March 13, 2004, ...and (C) includes a description of such property and the value of such property." This was intended to create a window for a series of "grandfathered" transactions to proceed.

In the worst case, Treasury could include all monetary exchanges, including the escrow cash flows for both the lease and loan payments, in the definition of "income" or "attributed income," which would increase the base amount of the excise tax to an amount in excess of original net benefits, which could subject state and local governmental entities to significant multi-year excise taxes.

Taken together, the IRS rulings regarding LILO's, the JOBS Act impact on SILOs and TIPRA excise tax could result in crippling penalties for state and local governments.

Proposed Action
Leveraged lease transactions entered into in good faith prior to the enactment of P.L. 108-357 should be exempt from being subject to taxation on any part of the proceeds of such transactions. Legislative language that either clarifies the specific transactions that were targeted by the provision or specifically exempts them from this retroactive provision should be included in the next viable tax vehicle.

Reasons the Excise Tax Unfairly Penalizes State and Local Governmental Entities

- Such a tax serves no purpose and is a penalty directly passed-through to taxpayers.
- The federal government itself encouraged U.S. transit agencies to participate.
- The transit agencies have no recourse to the investors in these transactions for reimbursement of any excise taxes the transit agencies are required to pay.
- These transactions were not identified by the IRS as "listed" or "prohibited" transactions when they closed. The provisions of the American Jobs Creation Act of 2004 that curb tax shelter leasing transactions with tax-exempt parties were not intended to target the benefits received by the state and local governmental entities and only go after the allegedly improper deductions claimed by the taxpaying lessors.
- The transit agencies that participated in these transactions have already spent the proceeds on new public transit improvements and any excise taxes will either reduce future funding and availability of public transit or require increased local taxes or fares/user fees to make up the difference.
- Imposing a retroactive penalty has no deterrent effect because state and local governments no longer participate in these types of transactions. Ironically, the only transactions exempt from the excise tax are those entered into after the JOBS Act prohibition.
- The excise tax legislation discriminates against U.S. state and local governments. The majority of the lessee benefits from SILOs and LILOs went to foreign governmental entities that are not subject to the excise tax and won't be penalized. In addition, while the taxpaying lessor has the ability to challenge the legality of the leasing transaction and their tax benefits in court or enter into a settlement agreement with the IRS, the tax-exempt lessee is subject to the excise tax even if a court finds that the IRS determination was wrong and that the underlying transaction was legal.
- There is a question as to the constitutionality of this type of taxation of state and local governmental entities, particularly where Congress has delegated the authority to impose the tax to the IRS by giving the IRS the power to list transactions.

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