Dangerous Tax Shelters

By David Cay Johnston

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Taxes exert a pervasive influence on our lives, although the effects are often as invisible as the waves of energy that flow around electrified wires.

Often the influence of taxes is beneficial, making our lives better — just as those unseen waves of electromagnetic energy make possible that ubiquitous modern device, the electric motor. But bad tax actions can result in awful outcomes, as demonstrated by the June 22 Metro crash in Washington that killed nine people.

The proximate cause of the crash, in which one urban train car traveling at freeway speeds slammed into another stopped on the Red Line rails, appears to be the failure of aging safety switches and circuits. But beneath the failed devices powered by the unseen forces of electromagnetism was a series of tax decisions by the Washington Metropolitan Area Transit Authority board, which decided again and again to engage in schemes to cheat the fisc. (For prior coverage, see *Tax Notes*, June 29, 2009, p. 1514, *Doc 2009-14510*, or *2009 TNT 121-1*.)

The National Transportation Safety Board even warned Metro that it was operating unsafely after an earlier crash. The safety board wanted older cars, including the one that slammed into a newer rail car, replaced. But the board's recommendations were rejected by Metro because it had signed on to 16 separate sale-in, lease-out deals, and they were arranged in such a way that the agency could not put safety first without incurring financial penalties for prematurely demolishing the SILO tax shelters. As Sarah Lawsky, who teaches tax at George Washington Law School, has pointed out at the concurringopinions.com blog, the language of the SILO contracts may not have paid enough attention to safety.

The safety board, powerless to force appropriate action, labeled Metro's response "unacceptable." Thus the June 22 tragedy was truly death by tax shelter.

Why would Metro do that? Why would it let taxes trump safety? And why would Metro, itself a government authority, join in what can reasonably be seen as a conspiracy to cheat the highest level of government, Uncle Sam?

The answer is a story of how tax policy, on several levels, subtly changes official behavior in ways that can produce ominous results. It is a story of how bad government policy begets tragedy.

If Metro was unique in participating in these illegal tax shelters, it would be an anomaly of no broad significance; a deadly tax curiosity. Unfortunately, transit agencies across America sold their rolling stock, computerized traffic systems, and even their welded steel rails to banks and others trying to beat the tax system.

The investors in these SILO deals benefited through what amounted to an interest-free loan from the government caused by depreciating property that the taxpayers already paid for. Depreciating public property ought to be illegal. It would be easy for Congress to enact language stating that no property paid for by tax dollars may ever be depreciated for tax purposes. Now there's change we can believe in, a real and easy reform that awaits only the interest of a few key lawmakers or even just the engaged attention of our policy wonk in chief, President Obama.

Assuming a 15-year write-off schedule for all of the property that Metro sold and then leased back, the investors got the equivalent of an interest-free loan for half of the $1.6 billion face value of the deals. Even with legal and other fees for the contracts, one of which runs to 359 pages, and the kickbacks to Metro to induce it to participate in this charade, 15 years of having $800 million interest free is a sweet deal. Keep in mind that when these deals were done in the 1990s and earlier this decade, nominal interest rates for quality borrowers were running in the mid-single digits and close to double digits for many deals.

Of course nothing was actually sold here in the usual sense because title to the property remained with Metro. What was sold was the right to depreciate, a right I cannot find in either my copy of the Constitution or the court cases in LexisNexis.

The major flaw in these deals, from the point of view of the investors, is that they were for finite periods of time. To keep borrowing money interest free from Uncle Sam required coming up with new public property that could be sold and leased back. It is easy to imagine that once all of the rail cars and buses and traffic lights in America had been sold and leased back, the more aggressive dealmakers, left unchecked, would gin up deals on anything, even sewers. And indeed, the sewage pipes owned by an agency serving some of the old industrial towns on the New Jersey side of the Hudson River were sold and leased back. Like what the sewers carry, the moral and legal standards of those making these deals flowed downhill.

But however it was done, the trick was to find ever more taxpayer property to depreciate through these arrangements. Find a steady supply of taxpayer assets to depreciate and that 15-year interest-free loan becomes a permanent source of nearly free capital.

On the other hand, what is nearly free capital to the investors in these deals (after fat fees for the bankers and

tax professionals who arrange them) is a real expense to taxpayers. It is John and Joan Q. Taxpayer who must bear the real costs of this financing through higher taxes, reduced government services, or more debt with its attendant interest expense.

All of this tax trickery, and more, took place unseen by the public, just like the waves of energy invisibly emanating from electric wires and magnets. Michael Faraday, one of the greatest scientists, first envisioned invisible forces emanating from the electrified metal conductors he worked with in the mid-19th century. Faraday, who was self-taught, grasped that electricity and magnetism are related, and from this insight gave us both dynamos that produce electricity and electric motors, including the ones that powered the Metro rail cars.

Despite his decades of brilliant insights that changed the world we live in, when Faraday told colleagues that he envisioned fields of energy flowing from metal conductors charged with electricity, those around him thought the aging scientist had gone daft. Invisible forces? Bah, humbug.

In the same vein, we do not always see the forces that are unleashed through taxes, or the lack of them, and yet they influence us in ways as subtle as they are powerful. The results are not powerful motors, but powerful motivators for conduct both good and, however unintentionally, evil.

Metro's board and managers were presented with urgent and unmet needs for revenue to keep operating the trains that carry 231 million passengers a year around Washington and its suburbs. But the $526 million of revenue it expects to collect from train passengers this fiscal year is not sufficient to pay all of its costs.

When it was created, Metro was not given the power to tax, a curious omission given that urban transit ceased to be a viable commercial enterprise decades ago and has been a subsidized service nearly everywhere in America since before construction for Metro was begun back in the Nixon era. This made the agency reliant on the kindness of strangers in Congress. But Congress, and recent administrations, have been ever more stingy when it comes to urban transit.

Desperate to raise capital, Metro's board, management, and professional advisers did what they had to do. They engaged in the calculated efforts required to negotiate 20 contracts, including the one that runs to 359 pages, with SILO vendors like SunTrust Bank and Belgian bank KBC Bank NV.

It should come as no surprise that a Cayman Islands paper entity was also central to these tax cheating deals — the Georgetown government specializes in promoting frauds on the American taxpayer no matter how much its hacks deny the obvious. And then there was the role of AIG, whose financial products division was supposed to guarantee Metro would keep up its end of the deal by making lease payments to the tax-evading investors.

Metro dealt with the tensions between inadequate resources and constant demands for service by accepting not one, but nearly a score of proposals to join in conspiracies to steal from the federal government. That no grand jury will ever be asked to indict for that offense does not change the dynamics of what happened.

What Metro and the bankers did was not just illegal, but morally repugnant. Those nine unnecessary deaths should haunt them all, because it was pure luck that it was strangers and not their loved ones who died because of this conspiracy to cheat the government through tax thievery.

It is beyond dispute that the 16 SILO deals that Metro entered into were improper, because Congress shut down the deals, including those involving Metro. In court papers Metro filed to avoid paying a $43 million penalty because the government stopped the deals, Metro admitted the impropriety of the SILO shelters.

KBC Bank sought the penalty after the IRS offered to settle with the miscreant investors if they would return 80 percent of their ill-gotten gains. The bank's theory was that AIG was in technical default because it was in no position to guarantee the lease payments by Metro, a position strengthened when then-Treasury Secretary Henry Paulson said that his $700 billion bailout was for his fellow bankers, not public agencies like Metro.

SunTrust and others settled with Metro once the gig ended. Not so the Belgians, who extracted a settlement of unknown amount because the settlement papers were sealed. Public agencies like Metro ought not to be able to settle such claims without full disclosure since it is public funds they are paying out, an idea as old as article I, section 9, clause 7 of the Constitution.

Circumstances growing from bad tax policy — including the lack of power to levy — forced Metro into deals that should have been rejected outright the moment they were suggested. That so many transit agencies did the same thing screams that this is a problem of structure and of a failure of our system of self-governance to address problems and needs forthrightly.

Charged as a conspiracy or not, the SILO effect was the same as if one of a group of associates recommended robbing a bank or dealing drugs to raise cash. Metro's board was no different from the jobless who steal a loaf of bread, burglarize homes, or deal drugs so their children can eat. Desperate agencies, like desperate people, do what they must to survive.

We need a tax system that serves our needs and creates a society where SILO tax shelters are not just demolished after the fact, but are without buyers because agencies like Metro are not so desperate that they will engage in immoral contracts.

The wages of bad tax policy are not just anemic economics and unfair distribution of the rewards of hard work, but also, as the Metro crash revealed, the needless loss of innocent lives. Now that the unseen power of bad tax policy has become visible, will our elected officials actually do anything to make sure this problem is not repeated in future generations?

Your thoughts? E-mail me at *JohnstonsTake@tax.org*.