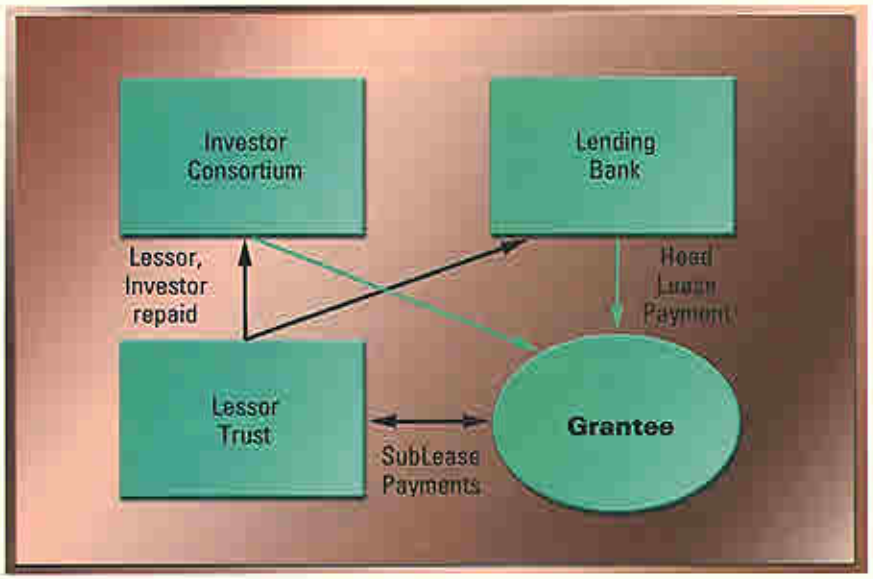
Domestic Leasehold

This is a similar transaction to the Sale/Leaseback, which is made possible by Section 467 of the Internal Revenue Code. It involves a transit system leasing an asset to a private entity (this is called a Head Lease), such as a bank or an investor consortium, then leasing the asset back from that investor (called a Sublease).

The investor prepays the Headlease, and the transit operator must make semi-annual lease payments for the term of the Sublease. The Head Lease prepayment is between 7 percent and 11 percent more than is required for the transit agency to make the lease payments. That amount is the Gross Benefit realized by the transit authority. After transaction costs, the transit agency will realize a Net Benefit of between 6 percent and 9 percent on the transaction. The following diagram illustrates this transaction in simplified form.



This transaction is fairly expensive to undertake. It usually requires at least $50 million in assets to interest an investor, and the transaction costs are likely to exceed $1 million. FTA has reviewed leasehold transactions (often referred to as LILO, for 'Lease-in/Lease-out') as large as $576 million. The transactions are also highly interest rate sensitive. When the transit agency receives the Head Lease payment, it invests most of it in securities that will mature over the term of the Sublease. Thus, a narrow spread between the investor's cost of borrowing and the rate of return on the transit agency's securities will limit the amount of Gross Benefit the transit agency can realize.

Finally, these are fairly long-term transactions. They tend to involve rail rolling stock or facilities, and Sublease terms of at least 12 to 15 years. Currently, IRS rules require the Headlease to be no more than 80 percent of the useful life of the asset, and the Sublease to be no more than 80 percent of the Headlease. In Fiscal 1999, FTA reviewed over $1 billion in leasehold transactions.

In June of 1999 the Internal Revenue Service published its final regulations regarding Section 467 Leases and similar tax-advantaged leases. In essence, the final rule establishes a more stringent test of business purpose, and it designates the IRS Commissioner as the only competent authority to determine the business purpose of such a transaction. Given the defeased nature of these transactions in the transit sector, and the fact that tax deferral provides the investors with significant benefit, FTA does not anticipate that many more of these transactions will be proposed.

If, in specific instances, there are multiple purposes for the leasehold structure, such as to attract private sector interest in operating and maintaining an entire bus garage or multiple transit routes, then it may be worthwhile for transit operators to pursue this form of lease structure. Otherwise, the predominance of tax benefit over other business benefits will make this transaction type unattractive both to private sector investors and to transit boards of directors.