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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

PROGRAM ANALYSIS DIVISION

March 15, 1982

B-206479

The Honorable Adam Benjamin, Jr.
Chairman, Subcommittee on
Transportation
Committee on Appropriations
House of Representatives

Dear Mr. Chairman:

Subject: Assessing New York Metropolitan Transit Authority Safe Harbor Leasing Deals (PAD-82-30)

At the request of your office on February 10, 1982, we assessed the costs to the Federal Government of the safe harbor lease arrangements engaged in by the New York City Metropolitan Transit Authority (MTA). We then compared these costs with those incurred by the Federal Government under the Urban Mass Transit Administration's (UMTA) 80 percent grant program. Our analysis indicates that from the Federal Government's perspective, safe harbor leases are less costly than the grant program.

We obtained our information on the mechanics of the UMTA grant program from UMTA officials in the Department of Transportation. Information on the MTA lease was obtained from your office; we did not contact MTA.

BACKGROUND

The arrangement between MTA and Metromedia, Inc., is typical of safe harbor leasing arrangements permitted under the 1981 Economic Recovery Tax Act (ERTA). MTA transfers qualified capital investments (buses and rail passenger cars) to Metromedia for tax purposes only, retaining legal title to the property.

Metromedia purchased the property from MTA for the full purchase price, made a down payment, and gave a promissory note for the balance. At the same time, MTA leased the property from Metromedia. The constant level installment payments specified in the promissory note coincide in both timing and amount to MTA's rental payments under the terms of the lease. At the end of the the lease (12 years for buses and 30 years for rail passenger cars), MTA may repurchase the equipment for one dollar. In return, Metromedia can deduct the accelerated cost recovery system (ACRS) depreciation expenses from its taxable income.

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The only peculiarity with the transaction in question is that it involves equipment used by a public agency, whereas most leasing arrangements are between for-profit firms. Any down payment MTA receives from safe harbor leases reduces its equipment costs. However, not all public transportation equipment is eligible for these leases. Any equipment paid for with Federal money cannot be leased for tax benefits.

Currently, the UMTA grant program pays 80 percent of the cost of new mass transit vehicles--far more than the contribution made to the equipment costs by the down payment on a safe harbor lease. Consequently, an UMTA grant would ordinarily be much more attractive to the transit authority. Enough UMTA grant money is available to to meet the mass transit needs of most jurisdictions. However, the case of New York City is unique because of its enormous estimated capital requirements over the next few years. UMTA officials estimate that they will be able to finance only about 20 percent of the capital needs of mass transit in New York during this period. Consequently, MTA must self-finance much of its own equipment either through direct expenditures or municipal bonds; safe harbor leases only help offset some of these costs.

ASSESSING THE MTA LEASE

In calculating the cost of the lease to the Government, we made assumptions regarding Metromedia's profits, treatment of depreciation, and method of financing the purchase. We assumed that:

- --Metromedia is sufficiently profitable throughout the lease period that it is always subject to the maximum 46 percent corporate tax rate;
- --the first year depreciation benefits are realized immediately by Metromedia and thus are not discounted; and
- --Metromedia uses equity capital to finance the down payment.

Under these assumptions, we calculated the net present discounted value of the 5-year ACRS deductions, the interest expense deduction, and the increase in taxable income resulting from the stream of rental payments. Using an 18 percent discount rate (the same as the interest rate on the promissory note), we found that the present value of the tax benefits received by Metromedia (or revenue the Government foregoes) to be approximately $23.7 million as compared to a cost of $81 million under an UMTA grant program, had the equipment qualified for the grant. 1/ In comparing what MTA actually received with the benefits accruing to Metromedia, we find that after paying fees and expenses MTA received $14.1 million, or 60 percent of Metromedia's tax saving.

There are three reasons why a seller/lessee like MTA will never realize 100 percent of the present value of the tax benefits. First, unless both parties mutually benefit from such transactions, an agreement will never be reached. Second, legal, accounting, and other types of fees associated with arranging the transaction will always account for some discrepancies between the net amount received by a lessee like MTA and the present value of the benefits accruing to a lessor like Metromedia. Third, Metromedia faces some risk that it may not be able to fully realize all of the expected tax benefits associated with the property; e.g., if it is not sufficiently profitable in the future, if the maximum tax rate falls, or if some event affects its title to the property for tax purposes.

CONCLUDING OBSERVATIONS

Clearly, the cost to the Federal Government of a safe harbor lease is less than the cost of an UMTA grant. However, there are virtually no controls over the total cost of such leasing provisions. They appear as tax expenditures in the budget. On the other hand, the total costs of UMTA grants are directly controllable through the budget appropriations process.

With the New York MTA, it is possible that a total substitution of tax leasing for the UMTA grant program could produce the same dollar subsidy to New York City because UMTA grants fund such a small portion of MTA's needs. However, on a national level, such a total substitution is unlikely to produce the same dollar subsidy since UMTA is expected to help finance most of the mass transit needs of most jurisdictions. The current system provides MTA with the best of both worlds in that equipment not financed through UMTA or a State agency can be sold and leased back.

1/In our calculations we did not evaluate the effects safe harbor leases have on State and local corporate income taxes and the effects State and local income taxes have on Federal income taxes. If the State of New York and New York City follow Federal ACRS and safe harbor leasing rules for their corporate taxpayers, the value to Metromedia of the lease increases, since the same tax deductions apply to State or local income taxes. However, the deductibility of State and local income taxes from Federal taxable income reduces our calculated value of foregone Federal taxes.

At the request of your office, we did not obtain agency comments on this report. We will make copies available to others on request, as discussed with your office. If you have any questions about this letter or if we can be of further assistance, please call us.

Sincerely yours,

Morton A. Myers

Morton A. Myers
Director