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Auto Industry Bill Would Have Expanded the Infamous "Wells Fargo Ruling" and Provided a Bailout for Illegal Tax Schemes

If Congress decides to again consider legislation to save the automobile industry from collapse, it should exclude (or dramatically revise) two tax provisions included in the bill approved by the House of Representatives and rejected by the Senate this week.

The first provision would waive a section of the tax code (for the auto industry only) that prevents the use of mergers as abusive tax shelters. The second provision would essentially provide a bailout for public transit agencies suffering from the consequences of participating in an illegal tax scheme.

Provision in Auto Bailout Bill Would Expand the Wells Fargo Ruling

Section 382 of the tax code sharply restricts a company from using the tax losses of a company it acquires to reduce its own tax liability. Before this section was signed by President Reagan as part of the Tax Reform Act of 1986, mergers often took place not because they made economic sense but because they offered a tax shelter.

In October of this year, however, the IRS issued a two-page notice that simply declared, with no authorization from Congress, that Section 382 does not apply to banks. This notice is often called the "Wells Fargo ruling" after its largest beneficiary to date. Based on the amount of tax losses financial institutions are currently carrying on their books, one widely-cited analysis projects that this IRS action will reduce federal revenue by as much as $140 billion by the time all the failing banks are acquired or reorganized. Over a hundred national, state and local organizations signed a letter to Congress this week urging lawmakers to pass legislation to reverse the Wells Fargo ruling.

Apparently, they didn't get the message. Instead, the bailout legislation passed this week by the House of Representatives and later rejected by the Senate would have *extended* the Wells Fargo ruling to the automobile industry.

Some people knowledgeable about the auto bailout legislation have argued that this provision is necessary because, under current law, limitations on the use of losses can be triggered by some situations that may occur as a result of the auto bailout but which are not what the section was intended to prevent. For example, they say, an automobile manufacturer could be restricted from using its losses if the government acquires equity or if debt-holders acquire equity in return for discharging the debt of the automobile manufacturer.

But the legislative language in the bill passed by the House of Representatives this week simply provided an open-ended waiver from Section 382 for any reorganization made as part of an approved plan under the bailout.

What's particularly disturbing about this is that the public has been reassured that the funds being provided to the auto industry are loans that will be paid back, but this is obviously not true if a significant portion of the benefits take the form of a tax break. The fact that this tax provision was inserted in the end of the bill at the last minute and with no debate or discussion makes it even more alarming.

If Congress takes up similar auto bailout legislation in the future, it should leave out this tax provision. Or, at very least, the language should be changed to simply say that any acquisition of equity by the federal government, or by debt-holders in return for discharging debt, as part of a restructuring plan pursuant to the auto bailout act will not trigger the loss limitations in Section 382 of the Internal Revenue Code.

Provision to Bail Out Entities When Their Tax Planning Is Found Illegal

Another section of the auto bailout bill approved by the House and rejected by the Senate would have the federal government guarantee lease arrangements made between public transit agencies and banks in abusive tax avoidance schemes — schemes which were later found to be illegal.

These schemes were called sale-in, lease-out (SILO) arrangements or lease-in-lease-out (LILO) arrangements. Essentially, some tax-exempt entities, such as public transit systems, abused their tax-exempt status to allow banks and other corporations to get huge federal tax write-offs. The tax-exempt entities were paid large fees for their cooperation in these abusive (and illegal) schemes.

Tax-exempt entities don't pay taxes, of course. But many do own assets that would generate write-offs if the tax-exempts were taxable. Tax-shelter proponents devised a scheme under which, for example, a transit system pretends to sell its subway cars to a bank, and then pretends to lease the cars back from the bank. The transit agency would have to pay "rent" to use the cars, but that cost would be exactly offset by payments from the bank to the transit agency as part of the sale. So, except for the fee paid by the bank to the transit agency for the use of its tax-exempt status, no money actually changed hands. But the bank would get big "depreciation" write-offs over the term of the "lease." Banks such as UBS and Wachovia cut their federal tax bills by tens of billions of dollars before the IRS cracked down on these schemes.

These deals were banned by a law enacted in 2004 by Congress, but that ban left in place the deals made before then. Many lawmakers balked at stopping the older deals, arguing that this would amount to a "retroactive" tax increase. Others argued that these schemes are clearly illegal and always have been. The latter position has been vindicated as the IRS has successfully challenged many of these deals, and companies have had to pay back the taxes they illegally avoided. The IRS has now offered to settle the remaining cases and most of the participants in these deals have agreed to settle.

The tax schemes have been struck an additional blow recently. The back-and-forth "payments" between the tax-exempt entities and the banks were usually guaranteed by a third party, which was often American International Group, Inc. (AIG). But AIG can no longer play this role as a result of its damaged credit rating.

As a result, lenders participating in these deals have threatened to declare the transit agencies in "technical default" and demand large immediate payments by the transit authorities, which had never expected that any actual cash would change hands. The auto bailout bill includes a section that would have the federal government step in to guarantee these deals.

To be sure, the last thing state and local transit needs right now is a blow to available funding. But bailing out tax-exempt entities for facilitating illegal tax evasion schemes is unwarranted. It would send them a message that it is okay to go ahead and engage in obviously abusive tax schemes, because even if they don't work, out the federal government will bail them out!

By the way, it's important not to overstate the threat to transit agencies that have participated in these phony lease arrangements. They can work something out without federal intervention. For example, the Washington Metropolitan Area Transit Authority (WMATA) was paid to participate in a tax-shelter deal with the Belgian bank KBC. Recently KBC tried to declare WMATA in default and collect after the turmoil at AIG, which had guaranteed the deal.

Did the unraveling of this deal lead to the shutting down of the Washington Metro system? Has KBC come to Washington to collect the subway cars and haul them back to Belgium?

Of course not. The two parties entered a settlement. While banned by court order from discussing the details of the settlement, both parties appear to be relatively satisfied with the result.

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