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Financing Public-Private Partnerships for Infrastructure Assets

Mitigating Legal Risks and Anticipating Tax Consequences of PPP Deals

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Today's faculty features:

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Public-Private Partnerships in the United States: Key Legal Issues and Risk Allocation Framework

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Federalism Framework

- 50 States
- State Constitutions
- State Legal Systems

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Local and Regional Government

- Dillon's Rule
- Home Rule Powers
- Regulatory Oversight

The Authority

- Creatures of Statute
- Off-balance Sheet
- Quasi-Government

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US P3 Transactions

- State and State Departments
- Local and Regional Governments
- Agencies and Authorities

Concession Structures

- Real Toll
- Shadow Toll
- Availability Payment

Demand Risk vs. Government Payment

		Government Payment	
		Yes	No
Demand Risk	Yes	Shadow Toll	Real Toll
	No	Availability Payment	

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Appropriation Risk

- Constitutional Limits on Debt
- Prop 13/TABOR
- Payment Obligations Beyond a Year

Appropriation Credit

- Rating Agency View
- PPP Market Acceptance
- Tools for P3 Transactions

Security Interest

- Lien
- Lease/Leaseback
- Threat of Service Termination

Essentiality

- Factual Essentiality
- Practical Essentiality
- Statements of Essentiality

Non-Substitution

- Enforceability
- Non-Competition
- “Practical Compulsion”

Budget Covenant

- Department of Government
- Commitment
- Default v. ENA

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Moral Obligation

- Public Commitment
- Detrimental Reliance
- Market Access

Impoundment Procedures

- Reserve Fund
- Aid Trap
- Practical Compulsion

Service Contract

- Subject to Appropriation
- Continue to Provide Service
- Enforceability by Courts

Risk Framework

- Political Risk
- Sovereign Risk
- Legal Risk
- “Risk of Politics”

Overview of Risk Allocation

- Traffic risk v. availability payment
- Construction
- Operation
- Permits
- Environmental
- Force majeure

Traffic Risk v. Availability Payment

- Traffic risk
  - Forecasting
  - Competition
  - Toll setting
- Availability payment
  - Reverse auction
  - Performance deductions
  - Authority credit
  - Acceptance/progress payments

Construction

- Delays
  - Milestones
  - Long stop date
  - IE drawdown certificate
  - Liquidated damages
  - Security
  - Limitation of liability
- Funded equity return

Operation

- Performance deductions
- Pass-through of concession agreement obligations
- Limitation of liability

Permits

- Right of way
- Authority v. contractor responsibility

Environmental

- Cleanup obligation
- Delays
- CERCLA liability
- Authority v. contractor responsibility

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Force Majeure

- Excuse from obligations
- Insurance
- Change in law
- Termination

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Public-Private Partnerships for Infrastructure Assets -- Concession Tax Considerations

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Overview

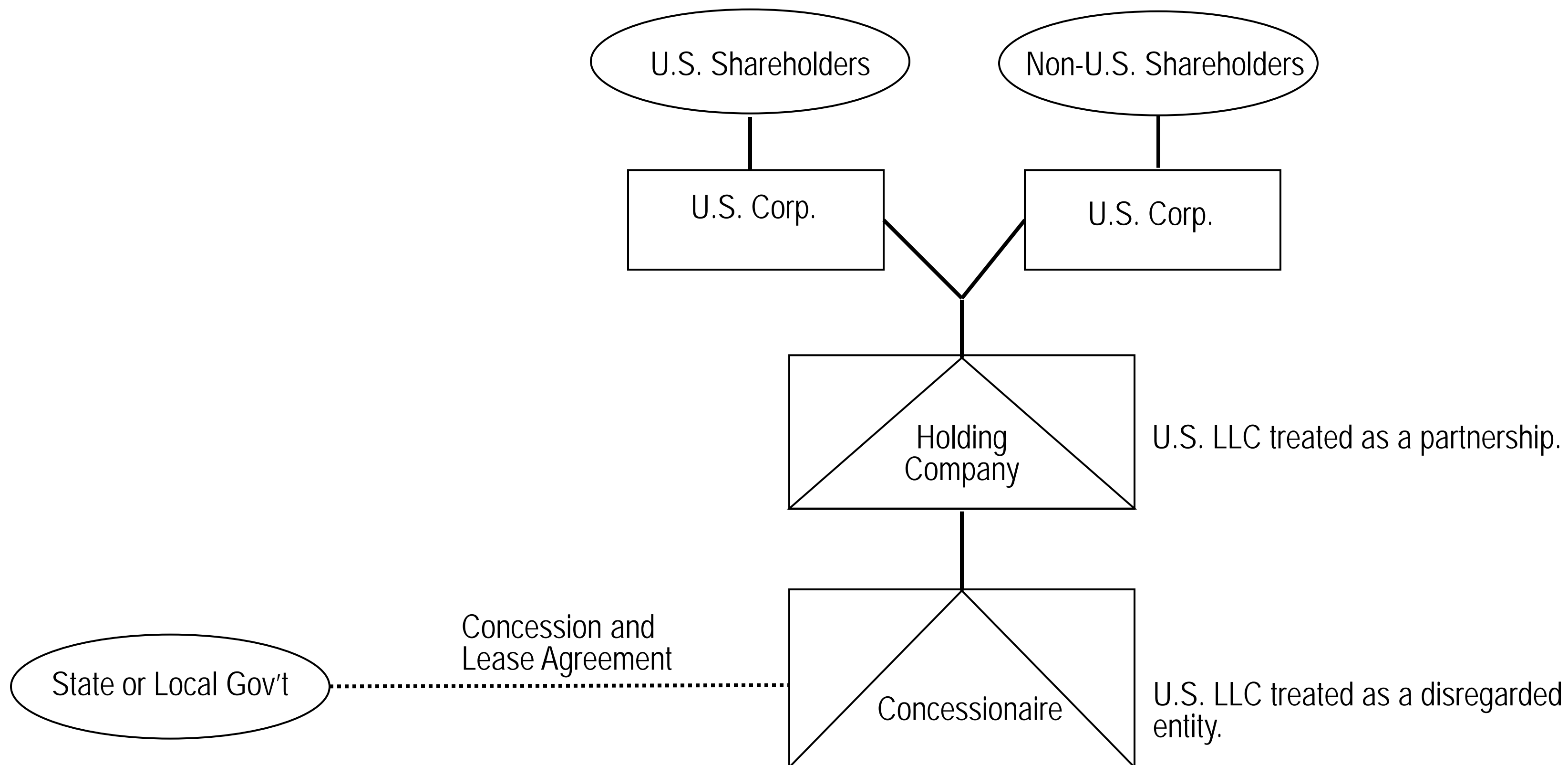
I. Federal Income Tax Treatment of Brownfield Projects

II. Federal Income Tax Treatment of Greenfield Projects

III. Conclusions

I. Federal Income Tax Treatment of Brownfield Projects

A. Typical Investment Structure.



I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

B. Rights Granted by the State or Local Government under the Concession and Lease Agreement.

1. Real property and real property improvements that constitute a public infrastructure asset (the "Facility") are leased to the Concessionaire for a term of years that exceeds the estimated remaining economic life of the improvements (typically between 50 and 99 years).
2. The Concessionaire is conveyed, transferred, or assigned:
   a. Any personal property that the state or local government owns that it uses in the operation of the Facility; and
   b. Contracts to which the state or local government is a party that relate to the operation of the Facility.
3. The Concessionaire is granted the right to operate the Facility and collect fees for the use of the Facility.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

C. Concessionaire's Obligations Under the Concession and Lease Agreement.

1. Make an upfront payment to the state or local government.
2. Make additional payments to the state or local government during the term of the agreement if specified "windfall" revenues or refinancing gains are realized by the Concessionaire.
3. Pay all costs of operating, maintaining, and repairing the Facility, and return the Facility to the state or local government at the end of the agreement in the condition specified in the concession and lease agreement.
4. Bear all operational and financial risks relating to the Facility, including risks of casualty losses, during the term of the agreement.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

D. Typical Financing.

1. The Concessionaire will typically fund the upfront payment with equity capital and debt from third-party lenders.
2. Additional capital improvements to the Facility also may be eligible for tax-exempt private activity bond ("PAB") financing from the state or local government.
3. Additional capital improvements to highway projects also may be eligible for federal loans or federal loan guarantees under the Transportation Infrastructure Finance and Innovation Act ("TIFIA") program.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

E. Principal Federal Income Tax Issues Relating to Brownfield Projects.

1. Treatment of the arrangement as a de facto partnership between the Concessionaire and the state or local government.
2. Lease versus sale treatment for real property improvements acquired by the Concessionaire.
3. Characterization of the assets acquired by the Concessionaire.
4. Allocation of the upfront payment (and other consideration) among the assets acquired by the Concessionaire.
5. Tax treatment of amounts allocated to the assets acquired by the Concessionaire.
6. Tax treatment of payments made by the Concessionaire.
7. Taxation of non-U.S. investors.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

1. Treatment of the arrangement as a de facto partnership between the Concessionaire and the state or local government.

   a. Typically, the parties disavow any intent to form a partnership in the governing documents.

   b. Revenue sharing payments (if any) with the state or local agency are based on gross, not net, income.

   c. The Concessionaire is liable for all losses from the project.

   d. Although the operation of the project is subject to specified standards or regulations, the Concessionaire has exclusive control over how it conducts the venture within the parameters of those regulations or standards.

   e. On balance, these factors tend to negate the existence of a de facto partnership between the Concessionaire and the state or local government.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

2. <u>Lease or sale of real property improvements</u>.

   a. Factors that have been considered by the courts and IRS in determining whether an agreement, which in form is a lease, is in substance a sales contract include:

      i. Whether legal title passes;

      ii. How the parties treat the transaction;

      iii. Whether an equity interest was acquired in the property;

      iv. Whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments;

      v. Whether the right of possession is vested in the purchaser;

      vi. Which party pays the property taxes;

      vii. Which party bears the risk of loss or damage to the property; and

      viii. Which party receives the profits from the operation and sale of the property.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

2. Lease or sale of real property improvements (cont'd).

   b. The typical concession and lease agreement should be treated as a sale, rather than a lease, of the real property improvements included in the Facility because:

      i. Possession of the real property improvements is conveyed to the Concessionaire for a period of years that exceeds the remaining economic life of such improvements (*e.g.*, buildings, roads, bridges, sidewalks, parking lots, fences, sewers, landscaping);

      ii. The Concessionaire bears the risk of loss or damage with respect to the real property improvements;

      iii. The Concessionaire operates the Facility in a trade or business, maintains the Facility, and is dependent on the profitability of the Facility for the return of its investment; and

      iv. The Concessionaire makes one or more payments that are not less than the fair market value of the tangible and intangible property leased or conveyed to the Concessionaire.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

2. Lease or sale of real property improvements (cont'd).

   c. The concession and lease agreement should be treated as a lease of the land on which the Facility is located because the Concessionaire does not acquire possession and use of the land for a period that exceeds the economic useful life of the land.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

3. Characterization of the assets acquired by the Concessionaire.

   a. A lease of the land on which the public infrastructure asset is located.

   b. Ownership of the real property improvements located on the land.

   c. Ownership of any tangible personal property conveyed to the Concessionaire.

   d. Assignment of rights and obligations under contracts assigned to the Concessionaire.

   e. Ownership of any intangible assets conveyed to the Concessionaire, including intangible assets associated with the trade or business assets such as government licenses, customer lists, know-how, goodwill, or going concern value.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

4. Allocation of consideration among assets acquired by the Concessionaire.

   a. Because the assets acquired under a concession and lease agreement constitutes a "trade or business," the consideration paid by the Concessionaire for such assets must be allocated under section 1060 among such assets under the so-called "residual method."

      i. The consideration paid by the Concessionaire includes consideration it pays to the state or local government and any transaction costs that the Concessionaire is required to capitalize and treat as part of its basis in the acquired assets.

      ii. If the assets transferred from a seller to a purchaser include more than one trade or business, all of the assets transferred are treated as a single trade or business for purposes of section 1060.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

4. Allocation of consideration among assets acquired by the Concessionaire (cont'd).

   b. Allocation of consideration under the residual method:

      i. First to cash and cash equivalents, to the extent thereof;
      ii. Next to actively traded personal property;
      iii. Next to debt instruments and assets that are marked-to-market at least annually;
      iv. Next to inventory and stock in trade;
      v. Next to the leasehold interest in the land, ownership of the improvements to the land, ownership of any tangible personal property conveyed to the Concessionaire as part of the public infrastructure asset, and any contracts assigned to the Concessionaire, to the extent of the fair market values of those assets;
      vi. Next to any section 197 intangibles acquired by the Concessionaire, other than goodwill or going concern value, to the extent of the fair market values of such intangibles; and
      vii. Finally, any remaining amount of the consideration is allocated to goodwill or going concern value.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

5. <u>Tax treatment of amounts allocated to assets</u>.

   a. Leasehold interest in land.

      i. The portion of the upfront payment made by a Concessionaire that is allocable to the lease of land should be treated as an upfront rental payment under a rental agreement that is subject to section 467.

      ii. Under section 467, the upfront payment by the Concessionaire generally should be treated as a loan by the Concessionaire to the state or local government, which the state or local government repays, with interest, in level payments over the term of the lease.

      iii. Under section 467, the Concessionaire would be allowed level payment rent deductions equal to the imputed level loan repayments. However, the Concessionaire's rental deduction net of deemed interest income would be "back loaded."

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

5. Tax treatment of amounts allocated to assets (cont'd).

b. Tangible property acquired by the Concessionaire.

i. The Concessionaire may irrevocably elect to use either the Modified Accelerated Cost Recovery System ("MACRS") or the alternative depreciation system described below in which property is depreciated on a straight-line basis over prescribed recovery periods that are longer than the MACRS recovery periods.

ii. Investors may wish to elect to use the alternate depreciation system to reduce the amount of net operating loss carryforwards generated in the early years of a concession and lease agreement.

iii. Generally, "land improvements," including roads, bridges, drainage, walls, and foundations are eligible for 15-year MACRS using the 150-percent declining balance method. Lighting, signage, and tolling equipment assets generally are depreciated using five- or seven-year MACRS and the 200-percent declining balance method. Nonresidential buildings and their structural components are depreciated over 39 years on a straight-line basis under MACRS.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

5. Tax treatment of amounts allocated to assets (cont'd).

b. Tangible property acquired by the Concessionaire (cont'd).

iv. MACRS depreciation is not allowed for "tax-exempt bond financed property," which must be depreciated using the straight-line method over the alternative recovery periods specified in section 168.

v. The term "tax-exempt bond financed property" is defined as property financed (directly or indirectly) by an obligation the interest on which is exempt from tax under section 103 (relating to interest on state and local bonds).

a) In brownfield projects, the original construction and improvements to the Facility have generally been financed with the proceeds of tax-exempt state or local bonds and the state or local government is required to retire or legally defease any outstanding bonds upon entering into the concession agreement.

b) It is unclear how the Facility is treated in the hands of a transferee if the bonds (or refunding bonds) are not retired, but are legally defeased.

c) TIFIA financing does not constitute tax-exempt bond financing.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

5. Tax treatment of amounts allocated to assets (cont'd).

   c. Intangible assets acquired by the Concessionaire.

      i. 15-year amortizable section 197 intangibles include:

         a) Goodwill and going concern value;
         b) Workforce in place;
         c) Business books and records, operating systems, and other "information base" intangibles;
         d) Customer lists and other "customer-based" intangibles;
         e) Favorable supplier contracts and other "supplier-based" intangibles;
         f) Rights, permits, and licenses granted by a governmental unit; and
         g) Franchises.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

5. Tax treatment of amounts allocated to assets (cont'd).

   c. Intangible assets acquired by the Concessionaire (cont'd).

      ii. Any intangible that is an "interest in land," such as a fee simple interest, life estate, remainder, easement, mineral right, timber right, grazing right, air right, zoning variance, or similar right, is excluded from treatment as an amortizable section 197 intangible and is depreciable on a straight-line basis over the useful life of the asset.

      iii. In states in which private persons that have a possessory interest in an asset may not charge tolls for the use of such asset without the express authorization of the state, the government authorization to charge tolls should be treated as a separate amortizable section 197 intangible.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

6. Treatment of payments made by the Concessionaire.

   a. Frequently, the Concessionaire is required to make regular payments to the state or local government equal to a percentage of gross revenues from the Facility over a threshold amount.

      i. These payments should be deductible by the Concessionaire under section 162.

      ii. Note that basing the payments on net profits (rather than gross revenues) would create a risk that the entire arrangement might be treated as a de facto partnership for federal income tax purposes.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

6. Treatment of payments made by the Concessionaire (cont'd).

   b. The Concessionaire may be required to make payments based on gains from certain refinancings of the Facility.

      i. To the extent a portion of such a payment is treated as additional rent for the land, such portion should be capitalized and treated as prepaid rent for the remaining term of the lease.

      ii. To the extent a portion of such a payment is treated as an additional amount paid for a section 197 intangible, such portion should be capitalized and amortized over the remaining portion of the 15-year recovery period or deducted if such 15-year period has expired.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

7. Taxation of non-U.S. persons.

   a. Dividends paid by U.S. corporations to non-U.S. shareholders are subject to the 30-percent U.S. withholding tax on dividends, which may be eliminated or reduced under an applicable income tax treaty.

   b. Under section 897, non-U.S. shareholders of a U.S. corporation are subject to U.S. federal income tax on gain from the sale or disposition of stock in such U.S. corporation (or distributions from such U.S. corporation that are treated as amounts paid in exchange for stock of the U.S. corporation) if such U.S. corporation is a USRPHC.

   c. A 10% U.S. withholding tax applies to amounts realized by non-U.S. persons from the disposition of stock in a USRPHC

   d. A U.S. corporation is a USRPHC if 50 percent or more of the fair market value of its assets is attributable to USRPIs (including the corporation's share of assets held through partnerships and disregarded entities).

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

7. Taxation of non-U.S. persons (cont'd).

   e. USRPIs include interests in land and real property improvements such as structures, buildings, roads, bridges, and parking lots.

   f. A government right or franchise that does not convey with a possessory interest in real property should not be treated as a USRPI.

   g. In an advanced notice of proposed rulemaking published on October 31, 2008, the IRS and Treasury announced they are considering issuing proposed regulations that would treat certain licenses, permits, franchises, and other similar rights granted by a governmental unit with respect to toll roads, toll bridges and other public infrastructure assets as interests in real property. No action has been taken and this project is not on the current IRS Business Plan.

I. Federal Income Tax Treatment of Brownfield Projects (cont'd)

8. Pending Legislation Would Apply to "Applicable Leased Highway Property" Leased After Date of Enactment.

   A. "Applicable Leased Highway Property," which would include brownfield property, would be subject to special rules under legislation currently being considered.

   B. MACRS depreciation would not apply to brownfield property and the recovery period for such property would be straight line over 45 years.

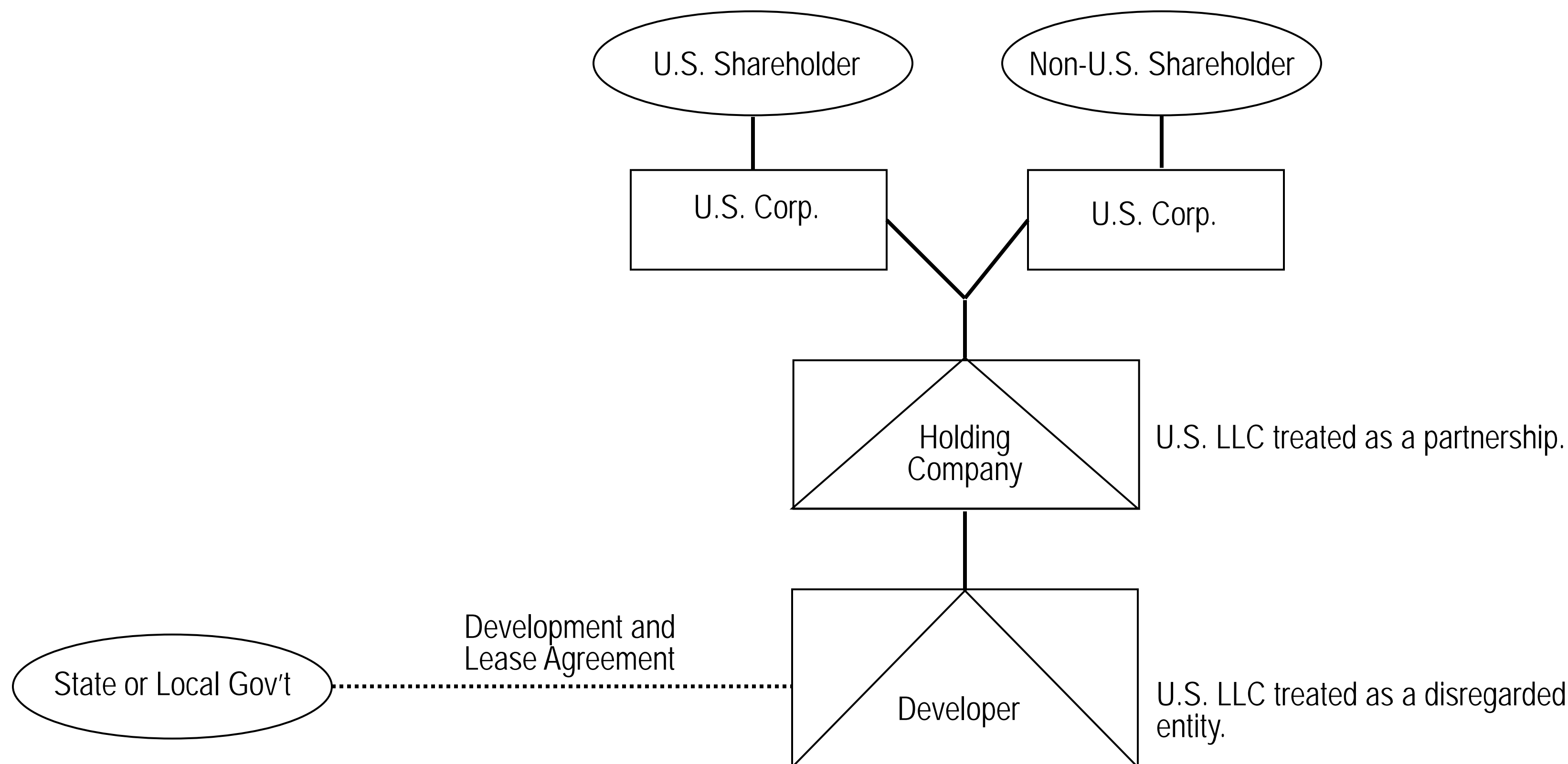
   C. Section 179 15 year amortization would not apply to intangibles associated with a brownfield property, and the recovery period for such intangibles would be straight line over the term of the lease.

   D. In addition, no PAB financing would be available for brownfield projects.

   E. Pending legislation would not affect greenfield projects.

I. Federal Income Tax Treatment of Greenfield Projects

A. Typical Investment Structure is the same as for Brownfield Projects.



II. Federal Income Tax Treatment of Greenfield Projects (cont'd)

B. Rights granted by the state or local government under the Development and Lease Agreement.

1. The Developer is granted the exclusive right to develop and construct a new public-use infrastructure asset (the "Facility") in accordance with specified standards.

2. Upon completion of construction of the Facility, the Developer is granted the right to operate the Facility and collect fees for the use of the Facility for a term of years (typically between 35 and 50 years).

II. Federal Income Tax Treatment of Greenfield Projects (cont'd)

C. Developer's obligations under the Development and Lease Agreement.

1. Pay all costs of operating, maintaining, and repairing the Facility and return the Facility to the state or local government at the end of the agreement in the condition specified in the development and lease agreement.

2. Bear all construction, operational, and financial risks relating to the Facility, including risks of casualty losses, during the term of the agreement.

3. Make additional revenue sharing payments to the state or local government during the term of the agreement, if specified windfall revenues or refinancing gains are realized by the Developer.

II. Federal Income Tax Treatment of Greenfield Projects (cont'd)

D. Typical Financing.

1. The Developer generally is not required to make an upfront payment to the state or local government.

2. The Developer's costs of constructing the asset typically will be funded with equity capital and debt from third-party lenders.

3. The state or local government may be required to invest public funds in the development of the asset.

4. The state or local government also may provide tax-exempt PAB financing to the Developer for qualifying projects. The Facility also may be eligible for federal loans or federal loan guarantees under the TIFIA program.

II. Federal Income Tax Treatment of Greenfield Projects (cont'd)

E. Principal federal income tax issues that are specific to greenfield projects.

1. Treatment of the Developer's costs of construction as rent, consideration for a share of project revenues, or a tenant's depreciable costs of leasehold improvements.

2. Treatment of public funds as income to the Developer or the costs of leasehold improvements owned by the state or local government.

3. Tax treatment of the Developer's capitalized costs.

II. Federal Income Tax Treatment of Greenfield Projects (cont'd)

1. Treatment of the Developer's costs of construction as rent, consideration for a share of project revenues, or a tenant's depreciable costs of leasehold improvements.

   a. The improvements constructed and paid for by the Developer should not be treated as rent paid to the state or local government unless the agreement expressly provides that the improvements are intended to be treated as rent. See *Blatt Co. v. United States.*

   b. Because the Developer has the state law rights of a lessee, it should be treated as constructing the improvements to the Facility for its own use as a tenant and should not be treated as constructing the improvements in consideration for a share of revenues from the project.

   c. The Developer's costs of constructing the improvements, including its capitalized construction period interest, should be included in the Developer's depreciable tax basis for the improvements. See sections 263 and 263A.

II. Federal Income Tax Treatment of Greenfield Projects (cont'd)

2. <u>Treatment of public funds as income to the Developer or the costs of leasehold improvements owned by the state or local government</u>.

   a. If:

      i. The public funds must be used to pay or reimburse costs of constructing the improvements and are not required to be repaid by the Developer (even if the Developer terminates the development and lease agreement before the end of its term);

      ii. The improvements funded with the public funds will revert to the state or local government when the lease is terminated or expires; and

      iii. The economic usefulness of the improvements funded with the public funds will not cease upon the termination or expiration of the lease:

         a) The public funds should be treated as amounts paid by the state or local government for leasehold improvements that it owns;

         b) The public funds should not be treated as income to the Developer; and

         c) The public funds should not be included in the Developer's depreciable basis for leasehold improvements.

II. Federal Income Tax Treatment of Greenfield Projects (cont'd)

2. Treatment of public funds as income to the Developer or the costs of leasehold improvements owned by the state or local government (cont'd).

   b. If public funds are not excluded from the Developer's income as amounts paid by the state or local government for improvements owned by the state or local government:

      i. The public funds may nevertheless be excluded from the Developer's income as non-shareholder capital contributions under section 118 if the Developer is a corporation.

      ii. Property acquired with tax-exempt capital contributions has a depreciable basis of zero.

      iii. Section 118 does not apply to partnerships and the IRS asserts that contributions to the capital of a partnership by a non-partner constitute income to the partnership. Some argue, however, that under *Edwards v. Cuba R. Co.*, there is a common law exception that applies to non-partner contributions to the capital of a partnership.

II. Federal Income Tax Treatment of Greenfield Projects (cont'd)

4. Tax treatment of the Developer's capitalized costs.

   a. The Developer's capitalized costs of constructing the improvements to the Facility (including its capitalized construction period interest) should be treated as its depreciable costs of constructing such property and should be depreciable under MACRS or the alternative depreciation system, as described above with respect to tangible property included in brownfield projects.

   b. The alternative depreciation system would be mandatory for the portion, if any, of the Facility that is financed with PABs. TIFIA financing does not constitute tax-exempt bond financing.

   c. Under section 168(i), a tenant's costs of leasehold improvements are recovered under MACRS over the statutory recovery period without regard to the term of the lease and the tenant is allowed a deduction under section 165(a) upon the termination of the lease for any unrecovered costs.

III. Conclusions

Privatization of public infrastructure assets provides needed capital to state and local governments with no extraordinary tax benefits for the private investors.

1. The U.S. federal income tax treatment of infrastructure privatization transactions mirrors the tax treatment of other investments in U.S. businesses.
2. There are no unique rules that enhance the tax benefits of infrastructure privatization transactions.
3. Non-U.S. investors are subject to the same tax rules that apply to non-U.S. investors in other U.S. businesses.
4. Pending legislation wcould adversely impact the taxation of future brownfield projects.

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