Testimony of Linda E. Carlisle

At a Hearing of the Subcommittee on Energy, Natural Resources and Infrastructure of the Committee on Finance on "Tax and Financing Aspects of Highway Public-Private Partnerships"

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Mr. Chairman, Ranking Member Bunning, and Members of the Subcommittee, my name is Linda Carlisle, and I am a partner in the law firm of White & Case LLP in Washington, D.C. I have been invited to discuss the U.S. federal income tax treatment of investments in highway public-private partnerships. I specialize in federal income taxation and advise clients with respect to the U.S. federal income tax issues that arise with respect to U.S. and foreign investments. In particular, I have provided advice regarding the federal income tax treatment of transactions involving private investments in public toll road facilities in the United States.

My testimony will discuss the general structure of private investments in public toll road facilities and the principal federal income tax issues that arise as a result of such investments.

Background

With increasing frequency in the past few years, state and local governments have sought to obtain funds for infrastructure development and maintenance from private investors rather than from tax revenues or from issues of tax-exempt bonds. These privatization transactions result from a competitive bidding process through which the most qualified and well-funded investors are awarded the right to enter into the privatization transaction. Authorization for the state or local government to enter into the final terms of the agreement typically requires approval by the state legislature and/or the legislative body of the local government.

Investments in public toll roads are attractive to private investors because toll roads may produce predictable cash flows and growth potential, provide returns on investment that have a low correlation to other asset classes (thereby providing diversification of investment risks), and may provide predictable returns over relatively long periods compared to other asset classes.

Private investments may be made with respect to existing toll roads ("brownfield projects") or may be made with respect to new toll roads ("greenfield projects").

A. "Brownfield" Toll Road Privatizations

Private investment in an existing public toll road typically takes the form of an agreement for the lease of the toll road to an entity formed by the private investors and the grant to such entity of the right to toll the toll road for the term of the agreement, as described below.[1] These agreements are called "concession and lease agreements," and the entity formed by the private investors that enters into the concession and lease agreement with the state or local government is called the "Concessionaire."

The Concessionaire typically is a limited partnership or limited liability company that is treated for federal tax purposes as a partnership. The Concessionaire is required to make an upfront payment to the state or local government. The upfront payment to the state or local government typically will be funded with equity capital and debt from third-party lenders. The Concessionaire also may obtain debt financing in the form of loans from some of its partners or members or their affiliates.[2] Concession and lease agreements for brownfield projects may contain provisions requiring the Concessionaire to make payments to the state or local government during the term of the agreement if specified "windfall" toll revenues or refinancing gains are realized by the Concessionaire.

Under the concession and lease agreement, the Concessionaire leases the toll road for a specified term of years that generally gives the Concessionaire possession and use of the toll road for a period that exceeds the estimated remaining economic life of the real property improvements included in the toll road (e.g., between 75 and 99 years). The Concessionaire agrees to pay all costs of operating, maintaining, and repairing the existing toll road, and to return the toll road to the state or local government at the end of the lease in the condition specified in the concession and lease agreement. The Concessionaire bears all risks relating to the operation of the toll road, including risks of casualty losses, during the term of the agreement.

Tax-exempt bonds used by a state or local government to finance the construction of a toll road will retroactively cease to qualify as tax-exempt bonds if the toll road is transferred to a private company, unless the state or local government takes a remedial action specified in Treasury regulations.[3] The Concessionaire also will want the toll road and its revenues unencumbered by any debt incurred by the state or local government. Accordingly, at the inception of the concession and lease agreement, the state or local government will typically retire or legally defease any outstanding tax-exempt bonds that are secured by the toll road or the revenues from the toll road.

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[1] Examples of private investments in existing public toll roads include the Chicago Skyway toll bridge (2005), the Pocahontas Parkway in Richmond, Virginia (2006), the Indiana Toll Road (2006), the Northwest Parkway in Colorado (2007), and the Pennsylvania Turnpike (2008). Similar transactions have been entered into, or are being developed, with respect to other kinds of existing public infrastructure, including the public parking facilities in Harrisburg, Pennsylvania, the public parking facilities in Chicago, Illinois, and the Chicago Midway International Airport.

[2] If the Concessionaire is also required to make capital improvements to the toll road, tax-exempt private activity bond financing may be available to finance such improvements.

[3] Reg. §§ 1.141-2(d)(1) and 1.141-12. All "section" references are to the U.S. Internal Revenue Code of 1986, as amended, and all "Reg. §" references are to the U.S. Treasury Regulations promulgated thereunder.

Through such brownfield projects, state and local governments are able to monetize the fair market value of a toll road in order to use the proceeds to fund other capital needs and shift the burden of operating, maintaining, and repairing the toll road during the term of the agreement to the private investors.

B. "Greenfield" Toll Road Privatizations

Private investment in a greenfield project typically takes the form of an agreement pursuant to which an entity formed by the private investors first develops and constructs the toll road in accordance with specified standards of the state or local government and then leases the completed toll road from the state or local government for a term of years typically ranging from 35 to 50 years, as described below. At the same time, the state or local government grants such entity the right to charge and collect tolls for the use of the toll road during the term of the agreement.[4] These agreements are called "development and lease agreements," and the flow-through entity formed by the private investors is called the "Developer."

The Developer is a limited partnership or limited liability company that is treated for federal tax purposes as a partnership. The Developer bears all risks relating to the construction and operation of the toll road, including risks of casualty losses, during the term of the agreement. The Developer generally is not required to make an upfront payment to the state or local government. Rather, the state or local government may be required to invest public funds in the toll road development. The state or local government also may provide tax-exempt private activity bond financing to the Developer.

As with brownfield projects, private investments in greenfield projects may contain provisions requiring the Developer to make payments to the state or local government during the term of the agreement if specified windfall toll revenues or refinancing gains are realized by the Developer.

The costs of constructing the toll road typically will be funded with equity capital and debt from third-party lenders. The Developer also may obtain debt financing in the form of loans from some of its partners or members or their affiliates and may obtain tax-exempt private activity bond financing.

Through greenfield investments, state and local governments shift the capital costs of needed additional public highway capacity to private investors and relieve the state or local government of the financial and operational risks associated with the toll road for the term of the agreement.

Federal Income Tax Treatment of Investments in Public Toll Road Facilities

The U.S. federal income tax treatment of private infrastructure investments mirrors the tax treatment of other investments in property in the United States.

4 Examples of private investments in new public toll roads include the Dulles Greenway in Northern Virginia (1990), the South Bay Expressway in San Diego, California (1991), and the Trans-Texas Corridor (2005).

A. Federal Income Tax Treatment of Private Investment Structure

Since the Concessionaire/Developer is generally structured as a flow-through entity, the entity itself is not subject to U.S. federal income tax. U.S. individuals and U.S. corporations that are partners or members of the Concessionaire/Developer are subject to U.S. federal income tax on their distributive shares of the income, gain, loss, or deduction from the operation of the toll road by the Concessionaire/Developer, regardless of whether the Concessionaire/Developer makes any distributions to its partners or members.

Dividend distributions by U.S. corporations that are partners or members of the Concessionaire/Developer to non-U.S. shareholders also will be subject to the 30-percent U.S. withholding tax on dividends, which may be eliminated or reduced under an applicable income tax treaty between the United States and the country in which the non-U.S. shareholder is a resident for tax purposes. In addition, non-U.S. shareholders of a U.S. corporate partner or member of the Concessionaire/Developer may be subject to U.S. federal income tax on gains from the disposition of their stock in the U.S. corporate partner or member if such U.S. corporate partner or member is treated as a "United States real property holding corporation" ("USRPHC"), as discussed below.

Non-U.S. individuals and non-U.S. corporations that are partners or members of the Concessionaire/Developer are subject to U.S. federal income tax on their share of the taxable income from the operation of the toll road by the Concessionaire/Developer because such individuals and corporations are treated as engaged in the conduct of a trade or business located within the United States. Accordingly, such individuals and corporations would be subject to U.S. federal income tax on their distributive shares of the income, gains, losses, and deductions from the operation of the toll road by the Concessionaire/Developer, regardless of whether the Concessionaire/Developer makes any distributions to such partners or members. Such non-U.S. individuals and corporations also would be subject to U.S. federal income tax on any gain or loss from the disposition of their interests in the Concessionaire/Developer.

Non-U.S. corporations that are members of the Concessionaire/Developer also would be subject to the U.S. 30-percent branch profits tax on the corporation's "dividend equivalent amount" for each taxable year. A non-U.S. corporation's dividend equivalent amount for a taxable year generally is the corporation's earnings and profits for the year that are effectively connected with the conduct of its trade or business within the United States that are withdrawn from such trade or business. Distributions by the Concessionaire/Developer to a non-U.S. corporate partner or member therefore may result in imposition of the U.S. branch profits tax, which may be eliminated or reduced under an applicable income tax treaty between the United States and the country in which the non-U.S. corporation is a resident for tax purposes.

B. Federal Income Tax Treatment of Brownfield Projects

The principal federal income tax issues relating to private investments in existing public toll road facilities are:

(1) whether the concession and lease agreement is characterized as a lease or sale of the toll road land and the real property improvements to the toll road;

(2) how the assets conveyed by the agreement should be characterized;

(3) how the amounts paid to the state or local government at the inception of the agreement should be treated; and

(4) whether a U.S. corporate partner or member of the Concessionaire/Developer will be treated as a U.S. real property holding corporation for purposes of the rules regarding foreign investments in U.S. real property ("FIRPTA").

1. Lease Versus Sale Treatment

Whether an agreement, which in form is a lease, is in substance a sales contract depends on whether the benefits and burdens of ownership of the subject property have been transferred.[5] In making this determination, the Internal Revenue Service and the courts have looked to the substantive rights and economic interests of the parties, notwithstanding the legal form of the transaction at issue.[6] Some of the factors that have been considered by the courts in making this determination are: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity interest was acquired in the property; (4) 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; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property.[7] None of these factors is necessarily controlling, and the incidence of ownership depends upon all the facts and circumstances of the particular case.[8]

If the agreement conveys possession of the property to the taxpayer for substantially all of the remaining economic life of the property in exchange for a lump-sum payment that approximates the price for which the property could be purchased, the agreement should be treated for federal income tax purposes as a transfer of beneficial ownership of the property even though the agreement prohibits the transfer of legal title to the taxpayer.[9]

The typical concession and lease agreement conveys possession and control of the toll road to the Concessionaire for a period of years that is in excess of the remaining economic life

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5 See Grodt & McKay Realty, Inc. v. Comm'r, 77 T.C. 1221 (1981).

6 See Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939) (substance, not form, of lease transaction controls for U.S. federal income tax purposes). See also Weiss v. Weiner, 279 U.S. 333 (1929) (depreciation allowed where taxpayer has made investment in depreciable property, whether as lessee or owner); City National Bank Co. v. Helvering, 98 F.2d 216 (D.C. Cir. 1938) (depreciation allowed lessee only where lessee has invested capital in property).

7 Grodt & McKay Realty, Inc. v. Comm'r; Coleman v. Comm'r, T.C. Memo. 1987-195, aff'd, 16 F.3d 821 (7th Cir. 1994).

8 Int'l Paper Co. v. U.S., 33 Fed. Cl. 384, 393-94 (1995); Baird v. Comm'r, 68 T.C. 115, 124 (1977).

9 Rev. Rul. 55-541, 1955-2 C.B. 19.

of the real property improvements included in the toll road, such as roads, bridges, sidewalks, drainage facilities, fences, sewers, landscaping, buildings, parking lots, and toll plazas, even though legal title to such improvements remains with the state or local government. During the term of the agreement, the Concessionaire bears the risk of loss or damage with respect to the real property improvements to the toll road. The upfront payment by the Concessionaire will exceed the fair market value of the real property improvements located on the land leased to the Concessionaire. Under these circumstances, the Concessionaire should be treated for federal income tax purposes as having acquired, rather than leased, the real property improvements.

In contrast, land is deemed for tax purposes to have a perpetual useful life. Accordingly, the lease of the land on which the toll road is located should be treated for tax purposes as a lease of the land.

2. Characterization of Assets Conveyed by the Agreement

In addition to acquiring ownership of the real property improvements, the Concessionaire has: (1) leased the land on which the toll road is located; (2) acquired ownership of any tangible personal property conveyed to the Concessionaire as part of the toll road; (3) acquired any goodwill or going concern value associated with the toll road; and (4) been granted the right to charge and collect tolls.

Government licenses, permits, and franchises that are not "interests in land" are amortizable section 197 intangibles that are amortized over a 15-year period. Interests in land include fee interests, life estates, remainders, easements, mineral rights, timber rights, grazing rights, air rights, zoning variances, and similar rights.[10]

There is no authority directly addressing whether a right to charge and collect tolls for the use of a public highway is an interest in land for purposes of section 197. In many states, private persons are prohibited from operating toll roads or charging tolls without the express authorization of the state. In such states, the right to charge tolls for the use of a public highway located on land owned or leased by a private person requires the express authorization of the state. In such states, the license or franchise to toll a toll road should not be treated as an interest in land because it is not a right that inheres in the fee simple interest or lessee interest in land. Accordingly, in such states the right to charge and collect tolls for the use of public highway should be treated as a section 197 intangible that is amortizable over a 15-year period. If the franchise to charge and collect tolls is not treated as a section 197 intangible, the franchise should be amortized on a straight-line basis over the term of the concession and lease agreement.

3. Treatment of the Upfront Payment

a. Prepaid Rent

Prepaid expenses, including prepaid rent, must be capitalized. The portion of the upfront payment made by a Concessionaire that is allocable to the lease of land therefore generally would be required to be capitalized and deducted ratably over the term of the agreement.

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[10] Reg. § 1.197-2(c)(3).

Section 467 and the regulations thereunder, however, provide special rules for payments made pursuant to "section 467 rental agreements." Reg. § 1.467-1(c)(1) defines the term "section 467 rental agreement" as a rental agreement that either has "increasing or decreasing rents" or has "deferred or prepaid rents." Accordingly, a rental agreement that provides for a single lump-sum payment at the inception of the lease has decreasing rents and is a section 467 rental agreement. Reg. § 1.467-1(d)(2)(i) prescribes a "constant rental accrual" method for section 467 rental agreements that are "disqualified long-term agreements." A rental agreement is "disqualified" if a principal purpose for increasing or decreasing rents is tax avoidance.

It is not clear that section 467 would apply to the prepayment of rent under a concession and lease agreement. However, if section 467 is applicable, the prepayment of rent would be treated as a loan by the Concessionaire to the state or local government and the Concessionaire would be required to recognize interest income on the deemed repayment of the deemed loan over the term of the agreement. The Concessionaire also would be treated as making level annual rental payments equal to the level loan payments it is deemed to receive.

b. <u>Costs of Acquiring Intangible Assets and Real Property Improvements</u>

Because the toll roads acquired under concession and lease agreements constitute trades or businesses, the upfront payment made to the state or local government is required to be allocated among the assets acquired by the Concessionaire under the so-called "residual method."[11] Under the residual method, the upfront payment by the Concessionaire is allocated to the leasehold interest in the land, the real property improvements to the land, and any tangible personal property conveyed to the Concessionaire as part of the toll road, to the extent of the fair market values of those assets. To the extent the upfront payment exceeds the fair market value of such assets, the excess is allocated 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. Any remaining amount of the upfront payment is allocated to goodwill or going concern value.

The Concessionaire should be allowed to amortize its investment in any intangible property that it acquires under the concession and lease agreement. As discussed above, the right to charge and collect tolls for the use of the toll road in most states should be treated as an amortizable section 197 intangible, which is amortizable over a 15-year period beginning with the month in which such right was acquired. Any goodwill or going concern value acquired by the Concessionaire also would be treated as amortizable section 197 intangibles.

The Concessionaire also should be allowed to depreciate the real property improvements acquired and any other tangible personal property conveyed to the Concessionaire. Tangible depreciable property is generally depreciable under the Modified Accelerated Cost Recovery System ("MACRS"), which generally provides for accelerated depreciation over recovery periods specified in section 168. Nonresidential buildings and their structural components, however, are depreciated on a straight-line basis under MACRS.

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[11] Section 1060.

In brownfield projects, the original construction of the existing toll road and improvements to the toll road have generally been financed with the proceeds of tax-exempt state or local bonds. As discussed above, the state or local government typically retires or legally defeases those bonds when it enters into the concession and lease agreement. MACRS depreciation is not allowed for "tax-exempt bond financed property," which must be depreciated using the straight-line method over alternative recovery periods specified in section 168.[12] 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).[13]

It is unclear whether property financed by a state or local government with the proceeds from tax-exempt bonds is treated as tax-exempt bond financed property when such property is transferred to a taxable entity and such tax-exempt bonds are retired or legally defeased. Accordingly, to the extent that toll road property was ever financed with the proceeds of tax-exempt bonds, such property may be ineligible for MACRS depreciation in the hands of the Concessionaire, regardless of whether the state or local government retires or legally defeases such tax-exempt bonds when it enters into the concession and lease agreement.

4. Possible FIRPTA Issues

A non-U.S. corporation or non-resident alien individual that is a shareholder in a U.S. corporation that is a partner or member of the Concessionaire/Developer is not treated as engaged in the conduct of a U.S. trade or business and is not subject to U.S. federal income tax on income from the operation of the toll road. Rather, as discussed above, the U.S. corporate partner or member of the Concessionaire/Developer is subject to U.S. federal income tax on its distributive share of the income, gain, loss, or deduction from the Concessionaire/Developer's operation of the toll road and dividend distributions to non-U.S. shareholders are subject to the U.S. 30-percent withholding tax, which may be reduced or eliminated under an applicable income tax treaty.

Non-U.S. corporations and non-resident alien individuals who are not engaged in the conduct of a U.S. trade or business generally are not subject to U.S. federal income tax on gains from the sale or exchange of property. Under section 897, however, non-U.S. shareholders of a U.S. corporate partner or member of the Concessionaire/Developer will be 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.

A U.S. corporation is a USRPHC if 50 percent or more of the fair market value of its assets is attributable to U.S. real property interests ("USRPIs"). For this purpose, a corporation is treated as owning its share of assets held by a partnership in which it is a partner. USRPIs include interests in land and real property improvements such as structures, buildings, roads, bridges, and parking lots. The leasehold interest in the land on which a toll road is located and the real property improvements located on such land should be treated as USRPIs. Tangible

[12] Section 168(g)(1).

[13] Section 168(g)(5).

personal property and goodwill or going concern value are not treated as interests in real property.

There is no guidance that directly addresses whether a license or franchise to charge and collect tolls for the use of a toll road constitutes an interest in real property for purposes of section 897. In those states in which private persons are prohibited from operating toll roads or charging tolls without the express authorization of the state, fee simple ownership of land or a leasehold interest in land does not give the owner or lessee of the land the right to charge tolls for the use of a public highway located on such land. In such states, the license or franchise to toll a toll road should not be treated as an interest in real property because it is not a right that inheres in the fee simple interest or leasehold interest in land. Accordingly, for purposes of determining whether the fair market value of USRPIs held by a U.S. corporate partner or member of the Concessionaire/Developer is 50 percent or more of the fair market values of all assets held by such U.S. corporation, the fair market value of the right to charge and collect tolls in such states should not be treated as the fair market value of a USRPI.

C. Federal Income Tax Treatment of Greenfield Projects

The principal federal income tax issues that relate specifically to private investments in greenfield projects are:

(1) how the public funds provided by the state or local government for construction of the toll road should be treated; and

(2) whether the amounts paid by the Developer for real property improvements are rent.

1. Treatment of Public Funds

In a greenfield project, the state or local government may agree to provide a specified amount of funds to pay for a portion of the costs of constructing the toll road. The Developer pays for all of the other costs of constructing the toll road. When construction of the toll road is completed, the Developer leases the toll road built with both public and private funds from the state or local government.

In the typical development and lease agreement, the Developer is not given funds by the state and local government without restrictions. The funds provided by the state or local government must be used to pay or reimburse costs of constructing the toll road. In a typical development and lease agreement, the economic usefulness of the real property improvements paid for with public funds will not expire at the end of the agreement, and such property will revert to the state or local government at the termination of the lease. Thus, the state or local government is the ultimate beneficiary from the use of the funds it provides. In addition, the Developer is not required to repay any of the public funds amount, even if the Developer terminates the development and lease agreement before the end of its term. Under these circumstances, the amount of funds that a state or local government provides to pay for a portion of the construction costs of the toll road should not constitute gross income of the Developer and should not be included in the Developer's depreciable basis for the improvements to the toll road. Rather such public funds should be treated as funding leasehold improvements paid for by the state or local government.

2. Construction Payments Made by the Developer

Development and lease agreements for greenfield toll roads typically do not provide that any portion of the improvements constructed by the Developer are intended to be treated as rent. Unless a tenant's construction of improvements on leased property are intended by the parties to be treated as rent, the tenant's expenditures to construct such improvements should be capitalized and recovered by the tenant through allowances for depreciation.[14] Therefore, the Developer should be allowed to claim depreciation deductions with respect to its capitalized costs of constructing leasehold improvements to the toll road. As discussed above, such capitalized costs would not include any public funds amount and the Developer would not be allowed to claim depreciation deductions with respect to leasehold improvements paid for with funds provided by the state or local government.

Conclusion

The upfront payment made to a state or local government in a brownfield project is in exchange for the transfer of: (i) the tax ownership of real property improvements to the existing toll road; (ii) a lease of the land on which the real property improvements are located; (iii) a government franchise to charge and collect tolls; and (iv) any goodwill or going concern value in the brownfield project. The cost of such assets may be depreciated or amortized for tax purposes. A U.S. or non-U.S. investor in such a project is engaged in the business of operating the toll road and pays tax on income earned from the project. The U.S. branch profits tax and FIRPTA withholding tax also may apply.

These are the same results that would apply to any acquisition of a U.S. business. Accordingly, there are no unique rules that enhance the tax benefits of brownfield transactions. To the contrary, because most brownfield projects have been financed with tax-exempt bonds, private investors in a brownfield project may receive less tax benefits through depreciation deductions than would an investor in a private business.

Similarly, greenfield investments result in depreciation only with respect to amounts paid as leasehold improvements by the Concessionaire. No extra deductions are provided. It is possible, however, that tax-exempt bond financing can be used, but this is not a special result for greenfield projects. Moreover, non-U.S. investors are also subject to tax as they would be in any U.S. investment.

In summary, public-private infrastructure investments provide needed infrastructure for state and local governments with no extraordinary tax benefits to the private parties. I would be pleased to respond to any questions.

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14 Section 263(a); section 263A; Reg. § 1.167(a)-4; section 168(i)(8).