

TAX TRANSACTIONS UPDATE

US Internal Revenue Service Requests Comments Regarding the Proper Characterization of a Government Permit to Operate Certain US Infrastructure Assets Under FIRPTA

November 5, 2008

On October 31, 2008, the Internal Revenue Service (IRS) and the Treasury Department (Treasury) published an Advanced Notice of Proposed Rulemaking (the “Notice”), Infrastructure Improvements Under Section 897, relating to the Foreign Investment in Real Property Tax Act (FIRPTA) provisions of the Internal Revenue Code.¹ In particular, the Notice explains that in some transactions certain rights granted by a governmental unit in connection with the lease, ownership, or use of real property used as a toll road, a toll bridge, or certain other physical infrastructure (the “specified infrastructure”) may properly be characterized as a United States Real Property Interest (USRPI), increasing the likelihood that gain derived by foreign investors from a disposition of a US domestic corporation that has been granted such rights could be subject to US net basis taxation. The proposed regulations would be prospective and would only be effective after final regulations were published in the *Federal Register*. The Notice indicates that no inference is intended with respect to how these arrangements are treated or characterized under current law.

The IRS and Treasury have concerns regarding the manner in which taxpayers have been characterizing, for purposes of applying section 897, the governmental license, permit, franchise or other similar right to operate the specified infrastructure (the “government permit”) obtained by a domestic partnership, which has among its partners domestic corporations owned in part by non-US persons, in connection with the lease or purchase of such specified infrastructure. Section 897(a) generally treats gain or loss derived by a non-US person from the disposition of a USRPI as effectively connected with the conduct of a US trade or business conducted by such person and, therefore, subject to net taxation in the United States.²

Section 897(c) broadly defines the term USRPI to mean an interest in real property located in the United States or the Virgin Islands, and any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes that such corporation was at no time a United States real property holding corporation (USRPHC) during the five-year

period ending on the date of the disposition of such interest. A USRPHC is any corporation whose fair market value of its USRPIs equals or exceeds 50 percent of the fair market value of (i) its USRPIs, (ii) its interests in real property located outside the United States, plus (iii) any other of its assets which are used or held for use in a trade or business.

For purposes of section 897, real property includes land, unsevered natural products of the land, improvements, and personal property associated with the use of real property.³ The term improvement includes, for example, “paved parking areas and other pavements” and bridges.⁴ An interest in real property includes a fee ownership, co-ownership, or leasehold interest in real property, as well as “any direct or indirect right to share in the appreciation in the value, or in the gross or net proceeds generated by, the real property.”⁵ For purposes of testing a corporation for USRPHC status, assets used or held for use in a trade or business include certain intangible property described in Treas. Reg. § 1.897-1(f)(1)(ii) (e.g., franchises and licenses).⁶ For purposes of determining whether any corporation is a USRPHC, assets held by a partnership are considered to be held proportionately by its partners.⁷ Similarly, assets used or held for use by a partnership in a trade or business are treated as so used or held by the partner.⁸

The IRS and Treasury have become aware that taxpayers may be taking the position that the government permit is not a USRPI within the meaning of section 897(c).

Rather, these taxpayers may take the position that the government permit is an asset used or held for use in a trade or business. The IRS and Treasury have suggested that taxpayers have taken the position that a significant portion of the fair market value of the assets of the domestic partnership that acquired the specified infrastructure is allocable to the government permit rather than the underlying infrastructure assets. Accordingly, if the fair market value of the government permit is treated as an asset used or held for use in a trade or business, and not as a USRPI, the government permit would be taken into account in the denominator, but not the numerator, of the calculation used to determine whether the domestic corporation is a USRPHC. This would reduce the likelihood that the tested corporation will be treated as a USRPHC.

The IRS and Treasury, however, are of the view that in some unspecified instances the government permit may properly be characterized as a USRPI. Accordingly, the IRS and Treasury are considering issuing proposed regulations that would amend the definition of an interest in real property as it relates to certain government permits. The amended definition would address how the fair market value of such government permits should be taken into account when determining the fair market value of a corporation’s USRPIs and interests in real property located outside the United States for purposes of determining whether a corporation is a USRPHC.

The IRS and Treasury have requested comments with respect to this issue. Specifically, the IRS and Treasury have requested comments on (i) the scope of this project, (ii) the types of government permits with respect to specified infrastructure “that might be treated as related to the value of the lease, ownership or use of an interest in real property,” and (iii) what characteristics should be taken into account in making this determination. Additionally, the IRS and Treasury have requested comments with respect to whether this project should address the allocation of the consideration paid for the lease or purchase of specified infrastructure and the government permit that permits the holder to operate that specified infrastructure for purposes of determining the fair market value of such property.

With respect to the allocation of purchase price between the lease or purchase of the specified infrastructure and the government permit, the IRS and Treasury also request comments relating to whether the length of the lease (including whether the lease is for the useful life of the property) should be taken into account. In this regard, the Notice explains that in many cases the true value of the leasehold interest in the specified infrastructure derives not from the physical attributes of the specified infrastructure itself (e.g., a relatively narrow roadway), but rather from the right to charge and collect tolls. Accordingly, it appears that the proposed regulations might amend the definition of “real property” to capture the value embedded in the governmental permit.

Endnotes

- ¹ All section references are to the Internal Revenue Code of 1986, as amended or to the Treasury regulations thereunder. REG-130348-08, 73 Fed. Reg. 64,901 (Oct. 31, 2008).
- ² The rate of tax that would be applied to such gain depends on whether the USRPI is properly characterized as a capital asset or an asset used in the taxpayer’s trade or business and whether the taxpayer is a nonresident alien or a corporation. Generally, a nonresident alien would be subject to US tax at marginal rates of up to 35 percent and if the property is a capital asset, such taxpayer may qualify for the 15 percent capital gains rate. Generally, a corporation would be subject to tax at marginal rates of up to 35 percent. In addition, taxpayers could be subject to alternative minimum tax with respect to such gains.
- ³ Treas. Reg. § 1.897-1(b)(1).
- ⁴ Treas. Reg. § 1.897-1(b)(3)(iii)(B).
- ⁵ Treas. Reg. § 1.897-1(d)(2)(i).
- ⁶ All intangible property listed in Treas. Reg. § 1.897-1(f)(1)(ii) may be considered an asset used or held for use in a trade or business subject to certain valuation rules.
- ⁷ Section 897(c)(4)(B); Treas. Reg. § 1.897-2(e)(2).
- ⁸ *Id.*

If you have any questions with regard to the Notice, or would like additional information about the topics addressed in this Client Update, please contact the Mayer Brown lawyer with whom you regularly work or one of the contacts below.

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