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INSIGHT: The Public-Private Partnership Infrastructure Exception to the Interest Deduction Limitation

BY STEVEN GARDEN

A public-private partnership is an arrangement that is generally considered an alternative to a governmental entity's traditional procurement strategies when seeking to develop and place in service a public project like a highway, courthouse, or storm-control system. In recent years, public agencies have increasingly looked to the public-private partnership delivery model for project development. Since 2010, there has been over $40 billion of U.S. transportation infrastructure public-private partnership projects alone.

While a public-private partnership can take various forms, in general, a public-private partnership is an arrangement in which a governmental body contracts with the private sector to develop, build, finance, operate and/or maintain an asset that is typically considered a ''public'' asset. In many cases, the revenue associated with the project is a long term proposition in that either the project will take some time to come online and generate meaningful revenue and/or the governmental body is making payments to the private sector through some combination of delayed and incremental payments.

As such, these arrangements feature a significant financing component in order for the private party or consortium of private parties to finance any upfront payments to the governmental body and/or its costs for the performance of services (e.g., construction and concessionaire services). Given this role of financing in the project, the recent amendments to tax code Section 163(j), enacted as part of the December 2017 tax legislation commonly known as the Tax Cuts and Jobs Act, that limit taxpayers' ability to deduct business interest expense impact these public-private partnerships.

Generally, under Section 163(j), on an annual basis, taxpayers can only deduct net business interest expenses up to 30 percent of their adjusted taxable income, which does not include a reduction for depreciation and amortization for tax years beginning before Jan. 1, 2022. After that, adjusted taxable income includes a reduction for depreciation and amortization, making taxpayers more likely to be subject to the limitation.

In addition, Section 163(j) applies at the partnership level and generally limits a taxpayer's ability to access interest expense deductions based on the items of income at that particular partnership. Often the private party providing the services in the public-private partnership arrangement is a consortium that uses a special purpose entity taxed as a partnership (or disregarded entity of a partnership) to contract with the governmental body. The combination of Section 163(j)'s limitations on a partnership and the function of financings in a discreet public-private partnership project increases the possibility that the specific nature of revenue receipt in the public-private partnership arrangement will not efficiently allow utilization of interest expense deductions from the financing.

Prior to the enactment of new Section 163(j), the private party in a public-private partnership arrangement would generally expect to deduct the interest costs of its financing. The disallowance of the deductions could result in a substantial increase to the cost of delivering the public-private partnership services and affect the utilization of this framework to improve and enhance United States infrastructure.

The Electing Real Property Trade or Business Exception

Business interest is defined to include ''any interest paid or accrued on indebtedness properly allocable to a

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trade or business.'' For this purpose, ''trade or business'' excludes a number of types of businesses, including any ''electing real property trade or business.'' Infrastructure projects typically entail in one form or another the development and maintenance of real property related assets. As such, the infrastructure industry believed that a possible solution to the issue described above may be found in the election of a real property trade or business exception.

Under Section 163(j)(7)(B), a taxpayer with a trade or business described in Section 469(c)(7)(C) (''any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business'') that makes an election will not be subject to the Section 163(j) limitations on interest expense allocable to that trade or business. Instead, a taxpayer that makes this election will be subject to a slower alternative depreciation system described in Section 168(g) with respect to assets used in that trade or business.

Proposed regulations with respect to Section 163(j) released on Nov. 26, 2018, amend the regulations under Section 469 to provide more direction on the sort of businesses that are included as a real property trade or business. However, the definitions in those proposed regulations are not constructed in a way that is easy to apply to the nuances of infrastructure transactions.

Prior to release of the proposed regulations, the infrastructure business community already anticipated this obstacle and infrastructure industry groups delivered comment letters to Treasury shortly after the enactment of Section 163(j) (and prior to the proposed regulation release), requesting that future guidance for Section 163(j) clarify the application of the electing real property trade or business exception to public-private partnership infrastructure transactions. On November 26, together with the proposed regulations, the Internal Revenue Service also released Revenue Procedure 2018-59 to address the treatment of public-private partnership infrastructure transactions within the context of Section 163(j).

The Revenue Procedure

Rev. Proc. 2018-59 describes its guidance as a ''safe harbor.'' Under the safe harbor, a taxpayer may treat a trade or business pursuant to a ''specified infrastructure arrangement'' as an ''electing real property trade or business'' under Section 163(j)(7)(B) and, therefore, not subject to the Section 163(j) limitations on interest deductions (in which case the taxpayer will be subject to the slower alternative depreciation system provided for in Section 168(g)).

The proposed regulations contemplate that an election will be made for each particular trade or business and that a taxpayer may have multiple trades or businesses eligible for an election. The election statement would specify the different electing trades or businesses. It seems, then, that a taxpayer would determine under general tax principles the extent to which a particular ''specified infrastructure arrangement'' is its own trade or business that is an ''electing real property trade or business'' or part of a larger trade or business that is an ''electing real property trade or business.''

A ''specified infrastructure arrangement'' is defined as a contract with a term in excess of five years between a government and a private trade or business under which a private trade or business has contractual responsibility to provide one or more of the functions of designing, building, constructing, reconstructing, developing, redeveloping, managing, operating or maintaining ''qualified public infrastructure property.''

''Qualified public infrastructure property'' is in turn defined as ''infrastructure property'' (1) that is owned either (a) by a governmental entity (whether foreign or domestic), or (b) by a private trade or business that operates under an arrangement in which rates charged for the use of services are subject to regulatory or contractual control or approval by a governmental entity; and (2) that is or will be available for use by the general public or the services of which are made available to members of the general public (including commercial users as long as the availability is on the same basis as individual members of the general public).

''Infrastructure property'' includes a range of types of property, including airports, docks and wharves, ports and waterway infrastructure, mass commuting facilities, water facilities, sewage and solid waste disposal facilities, electrical and gas facilities, local district heating or cooling facilities, qualified hazardous waste facilities, high-speed intercity rail facilities, hydroelectric generating facilities and environmental enhancements of hydroelectric generating facilities, qualified public educational facilities, flood control and stormwater facilities, surface transportation facilities, rural broadband service facilities, and environmental remediation costs on brownfield and Superfund sites.

Rural broadband service facilities are defined as certain broadband communication assets that serve a rural area. Rural area is generally defined as (a) any area that is not located within a city, town or incorporated area that has a population of greater than 20,000 inhabitants, or (b) an urbanized area contiguous and adjacent to a city or town that has a population of greater than 50,000 inhabitants. It appears that there is a typo in the revenue procedure's definition of ''rural area'' in that clause (b) should read in the negative like clause (a).

A Few Observations

A few observations are in order:

- The revenue procedure borrows heavily from the eligible projects for exempt facility bond financing under Section 142 for generating the list of eligible infrastructure projects and, in fact, defines most of the projects as being ''within the meaning of section 142.'' However, the ''qualified public infrastructure property'' list is broader in some ways than the Section 142 exempt facility list.
  - Whereas Section 142 addresses state and local sponsored projects, a ''specified infrastructure arrangement'' applies to arrangements with any government, whether the U.S. federal government, U.S. state and local governments, or foreign governments.
  - The list of projects include projects not listed under Section 142 such as projects relating to certain waterway improvements and flood/stormwater control, rural broadband service, and environmental remediation. The guidance also defines surface transportation projects more broadly than the similar category under Section 142, as surface transportation here does not require any federal funding or specified federal allocation to be ''infrastructure property.''

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■ The ''infrastructure property'' list is also narrower than the tax-exempt bond facility list in that it omits certain Section 142 projects, such as qualified residential rental projects, that presumably are not considered sufficiently infrastructure-related.

■ The revenue procedure does not indicate whether it considered any ancillary consequences of defining certain projects by the Section 142 cross-reference. For example, Section 142(b) contains a requirement that an airport, dock and wharf must be owned by a governmental unit to be a facility described under Section 142(a). How does this requirement reconcile with the revenue procedure's permissiveness for the infrastructure property to be owned by a private business as long as the rates charged are subject to governmental control or approval?

■ The revenue procedure lists a variety of services that, if a taxpayer is contractually obligated to conduct them pursuant to a contract with a governmental entity, may be considered a ''specified infrastructure arrangement'' that is an ''electing real property trade or business'' for the entire period of the arrangement, even during a preliminary period where the ''qualified public infrastructure property'' is being designed or built. One function not mentioned is ''financing.'' A taxpayer in a public-private partnership usually provides financing to the infrastructure project, whether characterized for income tax purposes as equity or debt, in addition to the design, build, operate and maintain services.

■ Presumably the guidance nevertheless intends that the financing component provided by the party that is engaged in one or more of the functions approved by the safe harbor is part of the same trade or business as the ''specified infrastructure arrangement'' (as the financing is embedded in the public-private partnership design, build, operate and maintain arrangement) and thus excepted from Section 163(j). If not, the revenue procedure would be creating complications that appear inconsistent with its goal.

■ In addition, the omission of financing means that a taxpayer solely providing financing to a qualified public infrastructure property is not eligible for this safe harbor of being an ''electing real property trade or business.'' This is unlikely to have much of a practical impact.

■ Rev. Proc. 2018-59 states that the ''specified infrastructure arrangement'' is treated as real property for purposes of applying Section 163(j). However, the outer limits of this statement are not clear. In particular, while no allocation is necessary for a taxpayer whose sole trade or business is excepted from Section 163(j), such as a taxpayer whose only trade or business is an electing real property trade or business, a taxpayer that has both excepted trades or businesses and other trades or businesses must allocate its interest income and expense between the excepted and non-excepted trades or businesses based on the adjusted tax basis of the taxpayer's assets.

■ For purposes of allocating interest expense between excepted trades or businesses and other trades or businesses, basis in tangible depreciable property (other than land) is generally calculated under the alternative depreciation system provided for in Section 168(g); and basis in intangible property is calculated using ordinary Section 167 and Section 197 rules, but self-created intangible assets are not taken into account.

■ As indicated by the revenue procedure, there are ''specified infrastructure arrangements'' where the taxpayer is not treated as owning the infrastructure assets. In such cases, a taxpayer needing to allocate interest expense to its ''specified infrastructure arrangement'' will need to determine for this purpose the location of its tax basis derived from any capitalization of payments for or with respect to the ''specified infrastructure arrangement.''

■ If the ''specified infrastructure arrangement'' is ''real property'' for purposes of the allocation rule, then perhaps any capitalization of any such payments into the ''specified infrastructure arrangement'' is all that is necessary to confirm that the taxpayer has tax basis to attract the allocation of interest expense. On the other hand, if the ''specified infrastructure arrangement'' is not ''real property'' for this purpose, then the taxpayer will need to confirm that any capitalization of any such payments is not in self-created intangible assets.

Relevant Dates

Rev. Proc. 2018-59 is effective as of Dec. 10, 2018, but may be applied for taxable years beginning after Dec. 31, 2017.

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