

Client Alert

Tax and Infrastructure Practice Groups

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Tax Planning Aspects of Investing in U.S. Infrastructure Projects

On February 12, 2018, the Trump administration released an extensive infrastructure proposal that would increase U.S. federal infrastructure funding and incentives, provide state and local authorities greater discretion over infrastructure investments, and encourage cooperation between state and local governments and the private sector in developing and operating infrastructure projects. If enacted, these proposals likely would produce increased opportunities for private companies, both foreign and domestic, to participate in U.S. infrastructure projects. When private companies enter into contractual agreements with state and local governments for the development and/or operation of infrastructure projects, the arrangements commonly are referred to as “public-private partnerships” (“PPPs”). Private investors, including individuals, partnerships, or companies (hereinafter “private companies”) that enter into PPPs must navigate a host of U.S. federal tax issues. As a result, careful consideration of the tax issues and opportunities available is critical. This alert provides a general overview of certain issues that private parties may encounter when entering into a PPP.

Characterizing the Arrangement and Cost Recovery

As an initial matter, private parties must decide how to characterize a PPP for U.S. federal tax purposes. Tax consequences vary significantly depending on a PPP’s tax characterization. PPPs may vary dramatically in their contractual terms, and such terms can impact their tax characterizations. Often, a PPP involves some form of payment by a private company to a governmental agency in exchange for certain rights, such as a long-term lease of existing real property improvements (e.g., a highway) and underlying land, or a franchise to operate infrastructure (e.g., the right to collect tolls). A private party might also make ongoing payments to the agency for the right to operate the infrastructure facility.

Although PPPs frequently are referred to as “partnerships” colloquially, they are not necessarily treated as such for U.S. federal tax purposes. Absent certain partnership-like characteristics, such as profit-sharing with the governmental agency, a PPP ordinarily would not be treated as a partnership for U.S. federal tax purposes. Instead, a PPP often is treated merely as a contractual arrangement, or a series thereof, among the parties that is characterized, for example, as a lease, a purchase of property, or a service

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contract for U.S. federal tax purposes. The characterization of these contractual rights determines whether payments thereunder are rent, royalties, service fees, or purchase price. For example, when a private party acquires a long-term leasehold interest in infrastructure assets constituting real property improvements and personal property, the arrangement typically is treated as a purchase for tax purposes, because the term over which the lessee has the right to use the various assets exceeds the economic lives of the assets. Accordingly, the private company will typically receive the benefit of tax depreciation and amortization deductions. By contrast, because a lease of land will not exceed the economic life of land, such a right typically would be respected as a lease for tax purposes, giving rise to rent deductions.

The applicable cost recovery method of property acquired in a PPP can vary significantly by asset type. Consequently, the allocation of purchase price to the various acquired assets is important. For example, the cost of acquiring intangible rights, such as government licenses, permits, and franchises to operate an infrastructure project, likely would be amortized on a straight line basis over fifteen years. The cost of real property improvements, such as bridges and highways, likely would be depreciated at a rate over fifteen years under an accelerated method. Cost recovery periods for buildings, however, are significantly longer. Importantly, under the recent Tax Cuts and Jobs Act (“TCJA”), Congress has provided for immediate, 100 percent expensing of certain tangible personal property. Finally, it is important to note that investors in infrastructure projects may be able to utilize certain tax-preferred state and local bonds to finance infrastructure projects. The use of these financing methods, however, may lengthen the cost recovery periods for certain assets.

Non-U.S. Investors

Foreign investors must consider an additional set of issues when participating in U.S. infrastructure projects. Most importantly, the development and operation of a U.S. infrastructure project likely will be considered a U.S. trade or business and thus may create a taxable nexus between a foreign investor and the United States. Accordingly, a foreign investor that invests directly in a U.S. infrastructure project risks being taxed by the U.S. on income “effectively connected” to the project, as well as being subject to the additional branch profits tax and a U.S. return filing obligation. As a result, most non-U.S. investors strongly consider investing in U.S. infrastructure indirectly through a U.S. corporation (frequently referred to as a “blocker”). Although the blocker corporation must pay U.S. corporate tax (at the now reduced rate of 21 percent), the non-U.S. investor would be subject only to withholding tax on dividend distributions or related party interest received from the corporation until such time as the non-U.S. investor disposes of its interest, discussed below. An applicable tax treaty may reduce the withholding tax on dividends and interest below the general rate of 30 percent or eliminate it altogether. Subject to recently enacted interest limitations, the use of debt financing may reduce the taxable income of the blocker. But, the TCJA exempts certain electing real property businesses from the recently enacted interest limitation under Section 163(j) of the Internal Revenue Code, and that exemption potentially could apply with respect to infrastructure projects. Real property businesses that elect this exemption, however, must utilize an alternative depreciation system that imposes longer cost recovery periods and precludes immediate expensing for any nonresidential real property, residential rental property, and qualified improvement property.

The Foreign Investment in Real Property Act (FIRPTA) also typically represents an additional consideration with respect to foreign investment in U.S. real property, including all or a portion of most infrastructure investments. Under FIRPTA, a foreign stockholder of a U.S. corporation is subject to U.S. federal income tax on gain derived from the disposition of the stock if the corporation is a “U.S. real property holding corporation” (“USRPHC”). Certain distributions received from the USRPHC also could be taxable under FIRPTA. Generally, a U.S. corporation constitutes a USRPHC if 50 percent or more of its assets consist of real property interests. Investment in a U.S. infrastructure project frequently involves acquisition of various property interests classified as real property for U.S. tax purposes. Unfortunately for foreign investors, administrative guidance issued by the Internal Revenue Service has

expressed the view that, in addition to real properties such as land and buildings, many contractual rights granted by governmental agencies in relation to infrastructure projects may constitute real property interests for purposes of FIRPTA.¹ This view appears to increase the likelihood that a blocker corporation formed to invest in U.S. infrastructure often will be considered a USRPHC. As a consequence, a foreign investor may be subject to tax under FIRPTA when the investor disposes of an interest in such a blocker corporation, as well as when the investor receives certain distributions from the blocker corporation. With proper planning, a foreign investor may fully or partially avoid FIRPTA tax, for example, by utilizing debt financing (subject to certain limitations) and exiting the investment only after the blocker corporation disposes of its real property assets.

Select foreign investors may be eligible for special treatment under the Code that reduces or eliminates the burden of U.S. tax. For instance, in December 2015, Congress, through the Protecting Americans from Tax Hikes Act of 2015, enacted certain changes to FIRPTA. In particular, Congress excluded “qualified foreign pension funds” from the application of FIRPTA.² Thus, certain foreign pension funds may be eligible to avoid FIRPTA altogether.

In addition, foreign governmental investors (i.e., foreign governments and certain controlled entities thereof) that invest in U.S. infrastructure projects may be eligible for an exemption from U.S. income and withholding tax under section 892 of the Internal Revenue Code. That provision exempts a foreign government from taxation on certain types of income, which include income and gain derived from stocks, bonds, and other U.S. securities. This exemption generally does not apply to income derived from real property or income derived from the conduct of “commercial activities.” Thus, like most foreign investors, it is inadvisable for a foreign government to invest directly in U.S. infrastructure projects if it wishes to avail of the benefits of section 892. Gain derived from the disposition of stock in a USRPHC, however, may be exempt, provided that the foreign government did not own a controlling interest in the USRPHC.³

Concluding Thoughts

In summary, investments in U.S. infrastructure involve consideration of numerous and potentially complex U.S. federal tax effects. The tax treatment of infrastructure projects can vary significantly depending on the specific contractual terms. Cost recovery is just one example of a tax attribute or benefit that investors must consider. Foreign investors must also consider additional layers of complexity to avoid creating a taxable nexus with the United States and to manage exposure to FIRPTA. Nonetheless, with proper planning, investors can successfully participate in U.S. infrastructure projects tax efficiently.

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¹ Announcement 2008-115, 2008-48 IRB 1228.

² I.R.C. § 897(l).

³ Treas. Reg. §§ 1.892-3T(a)(1); 1.892-5T(b)(1). The exemption for foreign governments does not apply with respect to direct interests in real property or controlling interests in USRPHCs.