OVERVIEW OF SELECTED PROVISIONS RELATING TO THE FINANCING OF SURFACE TRANSPORTATION INFRASTRUCTURE

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on June 25, 2015

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CONTENTS

INTRODUCTION AND SUMMARY

The Senate Committee on Finance has scheduled a public hearing on June 25, 2015, regarding the various methods of financing of infrastructure projects. The Congressional Budget Office projects that the Highway Trust Fund will have a cumulative shortfall of $168 billion over the next 10 years, assuming current levels of spending. Transportation Secretary Foxx has noted " . . . [O]ur current levels of investment are falling short of what is needed just to keep our existing system safe and in good condition."[1] Independent of the projected funding shortfall some have proposed additional project financing mechanisms, which, while not directly addressing the project Highway Trust Fund shortfall, could increase the amount of infrastructure constructed. Such mechanisms include increasing public-private partnerships (also referred to as "P3s"), expanding and creating new categories of tax-preferred bonds (*e.g.*, private activity bonds and tax-credit bonds), and establishing a national infrastructure bank.

This document,[2] prepared by the staff of the Joint Committee on Taxation, provides an overview and examples of public private partnerships and their tax treatment, a discussion of present law as it relates to tax-preferred bonds for surface transportation (including private activity bonds for surface-freight facilities), and a brief discussion of the Transportation Infrastructure Finance and Innovation Act ("TIFIA") program (a loan and credit enhancement program administered by the Department of Transportation). This document concludes with highlights of several proposals related to these areas, as well as proposals relating to the creation of a national infrastructure bank.

Public Private Partnerships

The Department of Transportation defines public-private partnerships broadly to include "contractual agreements formed between a public agency and a private sector entity that allow for greater private sector participation in the delivery and financing of transportation projects."[3] State and local governments have shown increasing interest in public-private partnership arrangements as a means of shifting the costs and risks of infrastructure development and maintenance to private parties, in exchange for those private parties receiving some economic benefit, as those costs continue to increase.

There are many types of public-private partnership structures, with varying degrees of risk and responsibility. For purposes of discussion, this pamphlet focuses on two types of public-private partnerships. One involves long-term leases of existing infrastructure assets by a

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[1] U.S. Department of Transportation, Briefing Room, *Secretary Foxx's Infrastructure Week Travel Shows Need for Robust Funding Strategy* http://www.transportation.gov/briefing-room/secretary-foxxs-infrastructure-week-travel-shows-need-robust-funding-strategy.

[2] This document may be cited as follows: Joint Committee on Taxation, *Overview of Selected Provisions Relating to the Financing of Surface Transportation Infrastructure*, (JCX-97-15), June 23, 2015. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

[3] U.S. Department of Transportation, Federal Highway Administration, *Innovative Program Delivery - P3 Defined* http://www.fhwa.dot.gov/ipd/p3/defined/default.aspx.

private party, and the other involves the responsibility to design, build, finance, operate, and maintain ("DBFOM") new infrastructure assets by a private party.

While the facts and circumstances of each transaction control its tax treatment, the parties commonly view these long-term lease arrangements involving existing infrastructure assets as a sale and purchase of a trade or business. The concession agreement can be expected to include a provision describing the intended tax treatment in this manner, including the depreciation of certain infrastructure-related assets, and amortization of intangible assets. Accordingly, with respect to public-private partnerships that are treated as a purchase and sale of existing assets for tax purposes, the main tax issues involve identification and valuation of each asset and the appropriate cost-recovery methods for such assets.

In contrast, the private party in a DBFOM concession agreement generally is not treated as owning the infrastructure assets being constructed; rather the public agency is contracting with the private party for the construction of new infrastructure assets that the public agency will own. Accordingly, with respect to public-private partnerships involving a DBFOM arrangement, the main tax issues involve accounting for project construction income and costs. The private party in a DBFOM concession arrangement generally accounts for its construction income and costs using the percentage-of-completion method of accounting. Under this method, the taxpayer generally recognizes income from the contract based on the percentage of the contract completed each year.[4]

Tax-preferred bonds

Debt also may be used to finance infrastructure projects. Tax-exempt bonds issued by State and local governments may be classified as either governmental bonds or private activity bonds. Present law does not limit the types of facilities that can be financed with governmental bonds. Thus, State and local governments can issue tax-exempt governmental bonds to finance a broad range of transportation infrastructure projects, including highways, railways, airports, etc. However, while the types of projects eligible for governmental bond financing are not circumscribed, present law imposes restrictions on the extent to which private parties may benefit from tax-exempt financing. State and local governments may issue qualified private activity bonds for certain transportation infrastructure such as airports, port facilities, mass commuting facilities, high-speed intercity rail facilities and qualified highway or surface freight transfer facilities.

The qualified highway or surface freight transfer facility bond provision was enacted in 2005 as part of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users ("SAFETEA-LU"). As of May 2015, the Department of Transportation has made allocations of approximately $11 billion of the $15 billion it is authorized to allocate. Of the $11 billion that has been allocated, approximately $5.8 billion of bonds have been issued.

Another form of tax-preferred financing is the tax-credit bond. A taxpayer holding a tax credit bond on a credit allowance date is entitled to a tax credit. Examples of tax-credit bonds

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[4] See further discussion *infra*.

are qualified zone academy bonds, qualified school construction bonds, new clean renewable energy bonds, and qualified energy conservation bonds.

The American Recovery and Reinvestment Act of 2009[5] ("ARRA") created a new category of bond, the Build America Bond. Authority to issue Build America Bonds expired on December 31, 2010. There were two types of Build America Bonds, the "tax-credit" Build America Bond and the "direct-pay" Build America Bond. The tax-credit Build America Bond provided a Federal tax credit to the bondholder equal to 35 percent of the interest payable by the issuer.[6] At the election of the issuer, a direct-pay Build America Bond provided the State or local government issuer with a 35 percent interest subsidy, in the form of a cash payment from the Federal Government, in lieu of providing a tax credit to the bondholder. Direct-pay Build America Bonds were to finance only capital expenditures that could have been financed with tax-exempt governmental bonds.

Transportation Infrastructure Finance and Innovation Act ("TIFIA")

The Transportation Infrastructure Finance and Innovation Act ("TIFIA") program is administered by the Department of Transportation. TIFIA provides credit assistance for large-scale, surface transportation projects *e.g.*, highway, transit, railroad, intermodal freight, and port access projects are eligible for assistance. Eligible applicants include State and local governments, transit agencies, railroad companies, special authorities, special districts, and private entities. TIFIA assistance may be used for up to 49 percent of a project's cost.

Proposals

Many of the recent proposals are intended to encourage more public-private partnerships. The proposals create new categories of private activity bonds for public infrastructure. The use of approved qualified private activity bond authority is intended to free State and local governments from the limits on private management contracts when using governmental bonds. If certain requirements are not met, a management contract with a private party may make an otherwise tax-exempt governmental bond a taxable private activity bond because the terms of the contract may constitute private use in the entity's trade or business. Creating a new private activity bond category is intended to encourage a State and local government to utilize the expertise of the private sector without making the interest on the governmental debt taxable.

Other proposals would create a national infrastructure bank to make loans to assist in the construction of significant transportation or other infrastructure projects, such as water and sewer facilities. The capitalization of such banks varies from general Federal funds to reverences derived from the taxation of repatriated overseas corporate earnings.

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[5] Pub. L. No. 111-5.

[6] Although Build America Bonds could have been issued as traditional tax-credit bonds, affording a tax credit to the bondholder, it is understood generally that this authority was not used and that most, if not all, Build America Bonds were issued as direct-pay bonds.

I. SELECTED METHODS FOR INFRASTRUCTURE PROJECT FINANCE

A. Public-Private Partnerships

In general

The Department of Transportation defines public-private partnerships broadly to include "contractual agreements formed between a public agency and a private sector entity that allow for greater private sector participation in the delivery and financing of transportation projects."[7] The private sector historically has participated in the design and construction of U.S. highways, most commonly as contractors to the public sector. A public-private partnership, however, generally is understood as shifting more of the economic risks (and attendant rewards) of a transportation project to the private sector than would be the case in a traditional public owner-private contractor relationship. For example, a public-private partnership might contemplate a private firm taking on all the design and construction risks for a new project, or a private firm operating a project for a period of years following construction, and obtaining an economic return based on the relative success of its management. State and local governments have shown increasing interest in public-private partnership arrangements as a means of shifting the increasing costs and risks of infrastructure development and maintenance to private parties, in exchange for those private parties receiving some economic benefit.[8]

Examples of public-private partnerships[9]

Long-term leases of existing infrastructure assets

Some private firms have acquired economic interests in the financing, maintenance, and operation of public highways after they are built.[10] Two arrangements, involving the Chicago

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[7] U.S. Department of Transportation, Federal Highway Administration, *Innovative Program Delivery* ,"P3 Defined" http://www.fhwa.dot.gov/ipd/p3/defined/default.aspx.

[8] For background on infrastructure investment, see Congressional Budget Office, *Issues and Options in Infrastructure Investment* (May 2008) (public-private partnership discussion pp. 32-33). See also, Department of the Treasury, Office of Economic Policy, *Expanding our Nation's Infrastructure through Innovative Financing* (September 2014), available at http://www.treasury.gov/press-center/press-releases/Documents/Expanding our Nation's Infrastructure through Innovative Financing.pdf.

[9] For purposes of discussion, this pamphlet focuses on public-private partnerships involving long-term leases of infrastructure assets by a private party, as well those involving the responsibility to design, build, finance, operate, and maintain new infrastructure assets by a private party. The Department of Transportation classifies public-private partnerships into seven categories. For new build facilities, there are five categories: private contract fee services, design-build, design-build-operate-maintain, design-build-finance, and design-build-finance-operate-maintain-concession. For existing facilities, there are two categories: operations and maintenance ("O&M") concession, and long-term lease concession. U.S. Department of Transportation, Federal Highway Administration, *Innovative Program Delivery*, "P3 Defined" http://www.fhwa.dot.gov/ipd/p3/defined/default.aspx.

[10] For background on public-private partnerships, see CRS Report R43410, *Highway and Public Transportation Infrastructure Provision Using Public-Private Partnerships (P3s)*, by William J. Mallett (March 5, 2014); U.S. Government Accountability Office, *Highway Public-Private Partnerships, More Rigorous Up-front*

Skyway and the Indiana Toll Road, illustrate how the public-private partnership concept can be applied to transfers of economic interests in existing highways from the public sector to private firms. The Chicago Skyway and Indiana Toll Road deals are structured as very long-term arrangements: 99 years in the former case, and 75 years in the latter case. For tax purposes, each transaction can be seen as comprising three operating relationships, each of which in turn runs for the length of the overall arrangement:

1. A lease of the existing infrastructure (the highway itself and associated improvements) from the public owner to the private firm;

2. A grant by the public owner to the private firm of a right of way on the public lands underlying that infrastructure; and

3. A grant of a franchise from the public entity permitting the private party to collect tolls on the highway.

In return, the private party paid a large up-front amount to the public owner, and agreed to operate and maintain the road, to invest specified amounts in future improvements, and to accept restrictions on the maximum tolls it could charge.[11] An umbrella concession agreement sets out the long-term rights and obligations of each party including dispute resolution mechanisms.

More specifically, in 2004, the City of Chicago leased the Chicago Skyway, a 7.8 mile toll road south of downtown Chicago that connects two major highways, in the first long-term lease of an existing toll road in the United States. Under the 99-year concession agreement with Skyway Concession Company Holdings LLC, a joint venture between Cintra of Madrid, Spain, and Macquarie of Sydney, Australia,[12] the City of Chicago received a $1.8 billion up-front payment in exchange for granting the private concessionaire the exclusive right to use, possess, operate, manage, maintain, rehabilitate, and collect tolls from the Chicago Skyway.

In 2006, the Indiana Finance Authority ("IFA") entered into a 75-year concession agreement with ITR Concession Company LLC ("ITR"), also a joint venture between Cintra and Macquarie, in respect of the Indiana Toll Road. IFA received a $3.8 billion up-front payment in exchange for granting ITR the exclusive right to operate, manage, maintain, rehabilitate, and collect tolls from the Indiana Toll Road.

Analysis Could Better Secure Potential Benefits and Protect the Public Interest, GAO-08-44 (Washington, DC: February 2008).

[11] See summaries of these arrangements at U.S. Department of Transportation, Federal Highway Administration, *Innovative Program Delivery* "Project Profiles," http://www.fhwa.dot.gov/ipd/p3/project_profiles/**.**

[12] "Cintra" and "Macquarie" refer to these companies generally. In the case of Skyway Concession Company Holdings LLC, the investment is owned, indirectly, by Cintra Concesiones de Infraestructuras de Transporte, SA and Macquarie Infrastructure Group.

Design, build, finance, operate, and maintain new infrastructure assets

Alternatively, some private firms take on all the design and construction risks for a new project (in accordance with standards specified by the public agency), as well as the financing, maintenance, and operation of the infrastructure assets after they are built. Two arrangements, involving the Denver Eagle, an approximately 40-mile commuter rail project (the "Eagle P3") and the Colorado U.S. 36 Express Lanes Project ("U.S. 36 P3") are examples of a private-public partnership where the public sector transferred the responsibilities to design, build, finance, operate, and maintain the project to the private firm. This type of public-private partnership arrangement can be seen as comprising an exclusive right to design and build new public-use infrastructure assets in accordance with the public agency's specified standards, and a lease of the new infrastructure assets from the public owner to the private firm for the term of the concession agreement. Unlike public-private partnerships involving long-term leases of previously existing infrastructure assets, the private party in a DBFOM concession arrangement does not pay a large up-front amount to the public owner. Rather, the costs of construction are generally funded with equity capital, third-party debt, tax-exempt financing, federal loans, and/or federal grants. In return for operating and maintaining the infrastructure assets, the private party agrees to collect fees for the term of the agreement (*e.g.*, tolls from end users or availability payments from the public owner), which are structured to meet the debt service requirements, costs of operating and maintaining the infrastructure assets, and payments to equity investors. An umbrella concession agreement sets out the long-term rights and obligations of each party including dispute resolution mechanisms.[13]

More specifically, in 2010, Denver's Regional Transportation District ("RTD") entered into a 34-year concession agreement with Denver Transit Partners ("DTP"), a partnership between Fluor Enterprises, Inc., Denver Rail (Eagle) Holdings, Inc., and Aberdeen Infrastructure Investments (No. 4) USA LLC to expand and operate commuter rail transit across the Denver metro region (*i.e.*, approximately 40 miles of commuter rail lines). The Eagle P3 is a $2.2 billion project, including $1.03 billion in federal funding and $450 million in private financing. Under the 34-year concession agreement, DTP will collect availability payments from RTD to operate and maintain the commuter rail system based on established performance standards for the operation and maintenance of the project (*e.g.*, incident management, days the infrastructure is available for use, closures, snow removal, *etc.*), while RTD will retain ownership of the assets, set fares and fare policies, and keep project revenues.[14]

In 2014, Colorado High Performance Transportation Enterprise ("HPTE," a division of the Colorado Department of Transportation ("CDOT")), entered into a 50-year concession agreement with Plenary Roads Denver LLC ("Plenary") to expand and operate U.S. 36. The U.S. 36 P3 is a $208.4 million project, funded with Federal, State, local, and private financing.

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[13] See summaries of these arrangements at U.S. Department of Transportation, Federal Highway Administration, *Innovative Program Delivery* "Project Profiles," http://www.fhwa.dot.gov/ipd/p3/project_profiles/**.**

[14] Note that in the case of the Eagle P3, the rights of way are granted to RTD by railroad companies (*i.e.*, RTD entered into rights of way with: Union Pacific for the East Corridor Line, BNSF Railway Company for the Gold Line, and BNSF Railway Company for the Northwest Electrified Segment).

Under the 50-year concession agreement, Plenary will collect and retain tolls from the project[15] to repay loans and equity contributions and cover operating and maintenance costs (*e.g.*, pothole repairs, snow and ice removal, striping, *etc.*), but will be required to share any excess revenues with the State. CDOT will maintain ownership of all the assets and specify operating and maintenance standards. In addition, HPTE's board of directors must approve all tolls and penalty charges.

Tax treatment of certain public-private partnerships

Overall characterization of arrangement

The parties to the representative public-private partnerships involving infrastructure assets summarized above entered into an umbrella concession agreement that describes the overall business relationship. In general, whether involving existing or new infrastructure assets, the deals are structured not to constitute partnerships for tax purposes.[16]

To the extent the property under the concession agreement is owned directly or indirectly by non-U.S. persons, the U.S. business operations related to the property generally are subject to net-basis U.S. taxation in the same manner as if the property were owned by U.S. persons. If those U.S. business operations were conducted through a domestic corporation, the corporation would be subject to corporate tax on the income from the operations.[17] Certain payments (such as dividends) to foreign owners of the corporation would be subject to U.S. withholding tax (subject to reduction or elimination under bilateral income tax treaties). If the U.S. business operations were conducted through a foreign corporation, the corporation would be subject to U.S. tax on its effectively connected income.[18] Moreover, the foreign corporation could be subject to branch profits tax and branch interest tax on, respectively, dividend-like withdrawals from the U.S. business and certain interest paid by and interest allocable to the U.S. business.[19] "Earnings stripping" rules also could apply to disallow deductions for certain interest payments to related parties and interest payments on debt guaranteed by related parties. Finally, the special

[15] Tolls will only be collected on the express tolled lanes on I-25 and US 36. See "US 36 PUBLIC PRIVATE PARTNERSHIP Frequently Asked Questions," available at https://www.codot.gov/projects/US36ExpressLanes/88th-to-table-mesa/faqs-for-us-36-p3/view.

[16] If the transaction were characterized as a constructive tax partnership, there would be many adverse consequences for the parties, including the possible application of section 470 which limits deductions allocable to property used by governments and tax-exempt entities, as well as differences in the tax depreciation rules for the assets (see, *e.g.*, section 168(h)).

[17] Sec. 11.

[18] Sec. 882.

[19] Sec. 884(a) and (f).

U.S. tax rules applicable to foreign investment in U.S. real estate[20] may affect the U.S. tax treatment of foreign investors.

Long-term leases of existing infrastructure assets

As described above, the arrangements involving long-term leases of infrastructure assets are intended to be treated for tax purposes as transfers of three separate bundles of property rights from the public owner to the private firm, all in exchange for the lump sum cash payment:

1. A "lease" of the infrastructure assets;

2. A lease of the land underlying the infrastructure assets (the right of way); and

3. A grant of an intangible "franchise" right to collect tolls.

Under U.S. tax principles, the "lease" of the infrastructure assets generally is characterized as an outright purchase of those assets by the private firm because the "lessee" has acquired all the benefits and burdens of ownership of those assets for a term that significantly exceeds their expected remaining useful lives.[21] Land, by contrast, is deemed for tax purposes to have a perpetual useful life, and as a result the long-term ground lease would be expected to be characterized as such.

The concession agreement signed by the parties generally is for a period much longer than the economic useful life of the highway assets, which (along with operating control) is the critical question in determining whether a purported lease should be recharacterized as a purchase of assets for tax purposes. The Bureau of Economic Analysis estimates the service life of highways and streets to be 45 years,[22] while the Chicago Skyway and Indiana Toll Road agreements are for terms of 99 years and 75 years, respectively. The private party's responsibilities under the agreement may include all operations of the toll road, payment of

[20] The rules of the Foreign Investment in Real Property Tax Act ("FIRPTA"), Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. *See* section 897, 1445, 6039C and 6652(f).

[21] Some commentators have supported the position that the intangible franchise right is "inseparable" from the underlying property and therefore is an interest in real property for purposes of section 897. Other commentators have supported a contrary view. In 2008, the Internal Revenue Service issued Announcement 2008-115, 2008-48 IRB 1228 (the "Announcement"), describing its intent to issue proposed regulations regarding treatment of these infrastructure improvement projects for FIRPTA purposes. In the Announcement, the IRS and Treasury Department express their view that "in some of the transactions," the franchise right may be characterized as real estate for FIRPTA purposes, without clearly articulating the rationale for this treatment. Such proposed regulations have not yet been issued. Treating the franchise right as an interest in real property would make it more likely that a domestic corporation that owned the right would be a U.S. real property holding corporation under section 897(c)(2) and, therefore, that tax under section 897 would be triggered by, for example, a sale of the corporation by foreign investors.

[22] U.S. Department of Commerce, Bureau of Economic Analysis, *BEA Depreciation Estimates*, http://www.bea.gov/national/FA2004/Tablecandtext.pdf.

utilities, maintenance, taxes, capital improvements, risk of loss, and liabilities that arise during the term.[23] Accordingly, while the facts and circumstances of each transaction control its tax treatment, the parties may most likely view these arrangements as a sale and purchase of a trade or business, and the concession agreement can be expected to include a provision describing the intended tax treatment in this manner.[24]

Allocation of up-front payment

The large up-front payment made by the private party to the transaction is treated as paid to acquire different bundles of business assets. As a result, the parties must allocate the initial consideration to the following categories: (1) the acquisition of infrastructure assets, such as land improvements, computers, toll booths, and other property used to operate and maintain the highway; (2) a lease of the underlying land; and (3) the acquisition of intangible assets, such as a franchise and license for the right to collect tolls (along with any generally unstated goodwill or going concern value).

The tax treatment of the assets in each of these categories varies. The tax allocation of the consideration therefore will determine the timing of the tax deductions associated with the investment. The tax rules provide that the parties must allocate purchase price in accordance with the relative fair market value of the assets acquired.[25]

Recovery of investment (depreciation and amortization)

For Federal income tax purposes, a taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income.[26] Under the modified accelerated cost recovery system ("MACRS"), the amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined for different types of property based on an assigned applicable depreciation method, recovery period, and convention.[27] The applicable recovery period for an asset is

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[23] The terms of an agreement will vary depending on the particular arrangement. For example, the private party may not be required to pay certain real estate, sales, and other taxes. This discussion is not intended to be an exhaustive list of responsibilities.

[24] For example, Section 2.8 of the *Indiana Toll Road Concession and Lease Agreement*, (April 12, 2006) states: "This Agreement is intended for U.S. federal and state income tax purposes to be a sale of the Toll Road Facilities and Toll Road Assets to Concessionaire and the grant to the Concessionaire of an exclusive franchise and license for and during the Term to provide Toll Road Services within the meaning of sections 197(d)(1)(D) and (E) of the Internal Revenue Code of 1986, as amended, and sections 1.197-2(b)(8) and (10) of the Income Tax Regulations thereunder," available at http://www.in.gov/ifa/files/4-12-06-Concession-Lease-Agreement.pdf.

[25] Section 1060 sets out detailed rules for the allocation of consideration in certain asset acquisitions.

[26] Sec. 167(a).

[27] The Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 201 (1986).

determined in part by statute and in part by historic Treasury guidance.[28] The "type of property" of an asset is used to determine the "class life" of the asset, which in turn dictates the applicable recovery period for the asset.

The MACRS recovery periods applicable to most tangible personal property range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods,[29] switching to the straight-line method for the first taxable year where using the straight-line method with respect to the adjusted basis as of the beginning of that year yields a larger depreciation allowance. Nonresidential real property and residential rental property are assigned lives of 39 years and 27.5 years, respectively, using the straight-line method.

The most significant tangible infrastructure assets acquired by the private party in a public-private partnership are the highways and any related bridges.[30] To the extent the assets are classified as land improvements,[31] these assets generally are depreciated under MACRS over a 15-year recovery period using the 150-percent declining balance method. The roadbed underlying the highway, however, is treated as having an indefinite useful life, and therefore is not depreciable.[32]

Other tangible assets that may be acquired include computers, equipment, toll booths, building structures, and other tangible assets associated with operating and maintaining a toll highway. As with the land improvements, these assets generally are recovered through accelerated depreciation under MACRS using various recovery periods, generally five to seven years, or through straight-line depreciation over 39 years in the case of certain structures.[33]

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[28] Exercising authority granted by Congress, the Secretary issued Revenue Procedure 87-56, 1987-2 C.B. 674, laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Revenue Procedure 88-22, 1988-1 C.B. 785. In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property. Revenue Procedure 87-56, as modified, remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.

[29] Under the declining balance method, the depreciation rate is determined by dividing the appropriate percentage (here 150 or 200) by the appropriate recovery period. This leads to accelerated depreciation when the declining balance percentage is greater than 100.

[30] In addition to acquired tangible assets, the private party will incur capital improvement costs throughout the lease term. The costs of newly constructed assets will also be recovered through depreciation deductions.

[31] Asset class 00.3 of Rev. Proc. 87-56 provides examples of "land improvements" that include (among other things) sidewalks, roads, canals, waterways, bridges, fencing, and landscaping.

[32] Rev. Rul. 88-99, 1988-2 C.B. 3. In a public-private partnership transaction, the roadbed is likely included as part of the right-of-way lease of the underlying land.

[33] To the extent several requirements are met (including the property acquired being qualified property, as well as the acquisition date and the original placed in service date being within the requisite timeframe), an additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property

To the extent any of these assets were originally constructed or acquired with proceeds of tax-exempt bonds,[34] depreciation is calculated under the alternative depreciation system ("ADS") using the straight-line method generally over longer recovery periods.[35] For example, land improvements are recovered over 20 years using the straight-line method if the project is financed with tax-exempt bonds, instead of 15 years under MACRS using the 150-percent declining balance method. The treatment of assets as tax-exempt bond financed property in the hands of the original owner (resulting in use of the longer recovery periods and the straight-line method) continues even if the tax-exempt bonds are no longer outstanding or are redeemed.[36] Furthermore, any subsequent owners who acquire the property while the tax-exempt bonds are outstanding also are subject to the ADS.[37]

As previously noted, significant value generally is assigned in public-private partnership arrangements to the intangible franchise right, *i.e.*, the right of the private party to collect tolls from users of the highway. The taxpayer's rationale for this allocation likely is that the right to collect tolls is the main revenue source and is the primary economic motivation for entering into the transaction.[38]

Under section 197, when a taxpayer acquires intangible assets held in connection with a trade or business, any value properly attributable to a "section 197 intangible" such as a franchise right is amortizable on a straight-line basis over 15 years.[39] Additionally, any value attributable to licenses, permits, and other rights granted by governmental units (even if the right is granted for an indefinite period or is reasonably expected to be renewed indefinitely) is subject to 15-year amortization.[40] Goodwill and going concern value similarly are amortized on the same

placed in service before January 1, 2015 (January 1, 2016, for certain longer-lived and transportation property). Sec. 168(k).

[34] See discussion of tax-exempt financing below.

[35] Sec. 168(g)(1)(C) and (g)(5).

[36] Treas. Reg. sec. 1.168(i)-4(d)(2)(ii)(B).

[37] H.R. Rep. No. 97-760, 516 (1982). State and local governments may redeem outstanding tax-exempt bonds prior to the public-private partnership arrangement so that the acquired assets are not subject to ADS rules. To the extent State and local governments retire tax-exempt bonds and taxable bonds are issued or other taxable debt is incurred to finance the private party payment pursuant to a public-private partnership arrangement, the migration from tax-exempt to taxable financing may result in increased Federal tax receipts.

[38] There also may be value in a license by the government for the right of the private party to use the name of the highway.

[39] Sec. 197(a), (c), (d)(1)(F) and (f)(4). A franchise is defined as "an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area." Sec. 1253(b)(1).

[40] Sec. 197(d)(1)(D). Examples include a liquor license, a taxi-cab medallion, an airport landing or take-off right, a regulated airline route, or a television or radio broadcasting license. Renewals of such governmental rights are treated as the acquisition of a new 15-year asset. Treas. Reg. sec. 1.197-2(b)(8). A license, permit, or

schedule.[41] However, interests in land, including leases, easements, grazing rights, and mineral rights granted by a government, may not be amortized over the 15-year period provided in section 197, but instead must be amortized over the period of the grant of the right.[42]

Some toll road transactions have been reported to include revenue-sharing provisions not unlike royalty payments of a typical business franchise. These revenue-sharing provisions are viewed by some as a method for the public party to share in possible future economic upside from toll collections.[43] To the extent payments are made by the private party pursuant to the arrangement, the revenue-sharing payments may be considered "contingent serial payments" and deductible in the year paid or incurred.[44] If a payment does not meet the requirements for contingent serial payments, the amount may be treated as contingent purchase price allocated to the franchise and recovered over the remaining life of the franchise intangible asset.[45]

The amount of any up-front consideration allocated to the lease of land generally is deductible to the lessee for tax purposes over the term of the lease under section 467. Very generally, those rules take time value of money concepts into account, and effectively convert the lump-sum payment into a constructive loan used to fund a stream of level rent payments.[46]

Design, build, finance, operate, and maintain new infrastructure assets

Unlike public-private partnerships involving long-term leases of previously existing infrastructure assets, the private party in a DBFOM concession arrangement does not make a large upfront payment to the public agency, and is generally not treated as owning the new infrastructure assets for tax purposes upon completion of construction. The concession agreement signed by the parties generally is for a period shorter than the economic useful life of the infrastructure assets. For example, the Bureau of Economic Analysis estimates the service

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other right granted by a governmental unit is a franchise if it otherwise meets the definition of a franchise. Treas. Reg. sec. 1.197-2(b)(10). Section 197 intangibles do not include certain rights granted by a government not considered part of the acquisition of a trade or business. Sec. 197(e)(4)(B) and Treas. Reg. sec. 1.197-2(c)(13).

[41] Sec. 197(d)(1).

[42] Sec. 197(e)(2) and Treas. Reg. sec. 1.197-2(c)(3). An interest in land does not include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television service. The cost of acquiring a license, permit, or other land improvement right, such as a building construction or use permit, is taken into account in the same manner as the underlying improvement. Treas. Reg. sec. 1.197-2(c)(3).

[43] Government Accountability Office, *Highway Public-Private Partnerships, More Rigorous Up-front Analysis Could Better Secure Potential Benefits and Protect the Public Interest*, GAO-08-44 (Washington, DC: February 2008), p. 44.

[44] Sec. 1253(d)(1). In general, contingent serial payments must be payable at least annually throughout the entire term of the agreement in either substantially equal amounts or in amounts based on a fixed formula.

[45] Treas. Reg. sec. 1.197-2(f)(2).

[46] Sec. 467(a).

lives of railroad replacement track and other railroad structures to be 38 and 54 years, respectively,[47] while the Eagle P3 agreement is for a term of 34 years. The private party's responsibilities under the agreement are generally to design, build, finance, operate, and maintain the project.[48] In addition, while the concession agreement might require the private party to maintain and repair assets as they wear out, the public agency might be treated as owning the parts for tax purposes, depending on the terms of the agreement.

While the facts and circumstances of each transaction control its tax treatment, upon completion of construction, the parties most likely view these arrangements as a lease of the assets to the private party from the public agency.[49] Accordingly, with respect to public-private partnerships involving the responsibility to design, build, finance, operate, and maintain new infrastructure assets, the main tax issues involve accounting for project construction income and costs.[50]

Project construction income and costs

The private party in a DBFOM concession arrangement generally accounts for its construction income and costs using the percentage-of-completion method of accounting.[51] Under this method, the taxpayer must include in gross income for the taxable year an amount equal to the product of (1) the gross contract price and (2) the percentage of the contract completed during the taxable year.[52] The percentage completed during the taxable year is determined by comparing costs allocated to the contract and incurred before the end of the taxable year with the estimated total contract costs.[53] Costs allocated to the contract typically include all costs (including depreciation) that directly benefit or are incurred by reason of the taxpayer's long-term contract activities.[54] The allocation of costs to a contract is made in accordance with regulations.[55] Costs incurred with respect to the long-term contract are

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[47] U.S. Department of Commerce, Bureau of Economic Analysis, *BEA Depreciation Estimates*, http://www.bea.gov/national/FA2004/Tablecandtext.pdf.

[48] The terms of an agreement will vary depending on the particular arrangement.

[49] See, *e.g.*, Part 2 of the *Regional Transportation District and Denver Transit Partners, LLC Concession and Lease Agreement*, (July 9, 2010), available at http://www.rtd-fastracks.com/ep3_18.

[50] With respect to the tax treatment of any rights of way necessary to construct, operate, and maintain the infrastructure assets, see discussion above under "Long-term leases of existing infrastructure assets."

[51] Sec. 460(a).

[52] See Treas. Reg. sec. 1.460-4. This calculation is done on a cumulative basis. Thus, the amount included in gross income in a particular year is that proportion of the expected contract price that the amount of costs incurred through the end of the taxable year bears to the total expected costs, reduced by the amounts of gross contract price included in gross income in previous taxable years.

[53] Sec. 460(b)(1).

[54] See sec. 460(c).

[55] Treas. Reg. sec. 1.460-5.

deductible in the year incurred, subject to general accrual method of accounting principles and limitations.[56] Upon the completion of a long-term contract, a taxpayer must pay (or receive as a refund) interest computed under the look-back method to the extent that taxes in a prior contract year were underpaid (or overpaid) due to the use of estimated contract price and costs rather than the actual contract price and costs.[57]

A long-term contract is defined as any contract for the manufacture, building, installation, or construction of property when such contract is not completed within the same taxable year in which the contract was entered into.[58] Thus, since the construction of the infrastructure assets by the private party is in connection with a long-term contract with the public agency (*i.e.*, a contract for the construction of property that spans more than one tax year), section 460 generally applies to the private party's construction activities. Note, however, that the private party's operation and maintenance activities under the concession agreement are not subject to section 460, but rather should be accounted for using a permissible method of accounting other than a long-term contract method.[59]

As previously noted, the private party in a DBFOM concession agreement generally is not treated as owning the infrastructure assets being constructed; rather the public agency is contracting with the private party for the construction of new infrastructure assets that the public agency will own. Thus, upon completion of the construction phase, the private party generally does not own any assets subject to depreciation or amortization.[60]

Issues may arise during the operation and maintenance phase of the concession agreement if the private party is responsible for repair and maintenance costs, and is treated for tax purposes as owning any improvements made, based on the terms of the agreement.[61] In

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[56] Treas. Reg. secs. 1.460-4(b)(2)(iv) and 1.460-1(b)(8).

[57] Sec. 460(b)(2). The rate of interest for both underpayments and overpayments is the rate applicable to overpayments of tax under section 6621. Sec. 460(b)(2)(C) and (b)(7).

[58] Sec. 460(f)(1). See also Treas. Reg. sec. 1.460-1(b)(1). However, a contract for the manufacture of property is not considered a long-term contract unless the contract involves the manufacture of (1) any unique item of a type which is not normally included in the finished goods inventory of the taxpayer, or (2) any item which normally requires more than 12 calendar months to complete. Sec. 460(f)(2).

[59] See Treas. Reg. sec. 1.460-1(d) and (e) (requiring the bifurcation of a contract into two (or more) contracts for purposes of the tax accounting rules if the contract covers activities that are subject to section 460 (*e.g.*, construction) and activities not subject to section 460 (*e.g.*, operation and maintenance services)).

[60] See also section 263A(c)(4) (exempting costs accounted for under section 460 from the general capitalization requirements of section 263A).

[61] Treasury regulations provide that a taxpayer may deduct the repair and maintenance costs of tangible property if such amounts are not otherwise required to be capitalized. Treas. Reg. sec. 1.162-4(a). Section 263(a)(1) prohibits a current deduction for certain capital expenditures. Treasury regulations generally require taxpayers to capitalize amounts paid or incurred that are for a betterment to a unit of property, restore a unit of property, or adapt a unit of property to a new or different use. Treas. Reg. sec. 1.263(a)-3(d).

general, unless a lessee's construction of improvements on leased property are intended by the parties to constitute rent, the lessee's improvement costs should be capitalized and depreciated by the lessee.[62] Depreciation allowances for improvements made on leased property are determined under MACRS (as discussed above), even if the MACRS recovery period assigned to the property is longer than the term of the lease.[63] This rule applies whether the lessor or lessee places the leasehold improvements in service.[64]

[62] Note that the gross income of a lessor of real property does not include any amount attributable to the value of buildings erected, or other improvements made, by a lessee that revert to the lessor at the termination of a lease. Sec. 109.

[63] Sec. 168(i)(8); Treas. Reg. sec. 1.167(a)-4. The Tax Reform Act of 1986 ("1986 Act") modified the Accelerated Cost Recovery System ("ACRS") to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The denial of component depreciation also applies under MACRS, as provided by the 1986 Act.

[64] Former sections 168(f)(6) and 178 provided that in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. These provisions were repealed by the 1986 Act.

B. Tax-Exempt Financing for Transportation Infrastructure

Overview

Interest paid on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes. Because of the income exclusion, investors generally are willing to accept a lower rate on tax-exempt bonds than they might otherwise accept on a taxable investment. This, in turn, lowers the borrowing cost for the beneficiaries of such financing.

Bonds issued by State and local governments may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (*e.g.*, private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds") and other Code requirements are met.

Like other activities carried out and paid for by State and local governments, the construction, renovation, and operation of governmental transportation infrastructure projects such as public highways or governmental mass commuting systems (*e.g.*, rail and bus) are eligible for financing with the proceeds of governmental bonds. In addition, certain privately-used transportation infrastructure projects may be financed with qualified private activity bonds.

Tax-exempt governmental bonds

In general

Present law does not limit the types of facilities that can be financed with governmental bonds. Thus, State and local governments can issue tax-exempt, governmental bonds to finance a broad range of transportation infrastructure projects, including highways, railways, airports, etc. However, while the types of projects eligible for governmental bond financing are not circumscribed, present law imposes restrictions on the parties that may benefit from such financing. For example, present law limits the amount of governmental bond proceeds that can be used by nongovernmental persons. Use of bond proceeds by nongovernmental persons in excess of amounts permitted by present law may result in such bonds being treated as taxable private activity bonds, rather than governmental bonds. The Code defines a private activity bond as any bond that satisfies (1) the private business use test and the private security or payment test ("the private business test"); or (2) "the private loan financing test."[65] Generally, private activity bonds are taxable unless issued as qualified private activity bonds.

Generally, governmental bonds are not subject to certain additional eligibility restrictions that apply to qualified bonds used to finance private activities. For example, governmental

[65] Sec. 141.

bonds are not subject to issuance cost, maturity, and annual volume limitations that generally apply to qualified private activity bonds.

Private business tests

Under the private business tests, a bond is a private activity bond if it is part of an issue in which both:

1. More than 10 percent of the proceeds of the issue (including use of the bond-financed property) are to be used in the trade or business of any person other than a governmental unit ("private business use test"); and

2. More than 10 percent of the payment of principal or interest on the issue is, directly or indirectly, secured by (a) property used or to be used for a private business use or (b) to be derived from payments in respect of property, or borrowed money, used or to be used for a private business use ("private payment test").[66]

A bond is not a private activity bond unless both parts of the private business tests (i.e., the private business use test and the private payment test) are met. Thus, a facility that is 100 percent privately used does not cause the bonds financing such facility to be private activity bonds if the bonds are not secured by or paid with private payments. For example, land improvements that benefit a privately-owned factory may be financed with governmental bonds if the debt service on such bonds is not payable or secured by payments or property used by the factory owner or other private businesses.

Private business test component 1: The private business use test

In general, for purposes of the private business use test, a broad standard applies under which private business use includes use of bond-financed property by a nongovernmental person as a result of ownership of property, a lease of property, or other actual or beneficial use of property under certain management or incentive payment contracts, output-type contracts, or certain other arrangements in which a nongovernmental person has legal contractual rights to use property.[67]

Management contracts and private business use

A contract between a private management or other service company and a governmental unit to operate bond-financed governmental facilities may result in private business use depending on the terms of the contract.[68] Management contracts include management, service or

[66] The 10 percent private business test is reduced to five percent in the case of private business uses (and payments with respect to such uses) that are either unrelated or disproportionate to any governmental use being financed by the issue.

[67] Treas. Reg. sec. 1.141-3(b).

[68] Treas. Reg. sec. 1.141-3(b)(4).

incentive pay contracts between a governmental person and a service provider for all or a portion of a financed facility, or any function of a financed facility. A management contract that provides for compensation based in whole or in part on the net profits of the financed facility generally results in private business use. A management contract also results in private business use if the service provider is treated as the lessee or owner for Federal income tax purposes.

Treasury regulations identify four management contract arrangements that do not give rise to private business use:[69]

- Incidental services: Contracts for services incidental to the facility's primary functions (*e.g.*, janitorial, office equipment repair, hospital billing or similar services);
- Hospital admitting privileges: The granting of hospital admitting privileges to a doctor if such privileges are available to all qualified physicians in the area;
- Certain public utility property contracts: Contracts for the operation of public utility property if the only compensation reimbursement for actual, direct expenses of the service provider and reasonable administrative overhead expenses of the service provider; or
- Certain expense only reimbursement contracts: Contracts for services if compensation is limited to reimbursement of the service provider for actual direct expenses paid by the service provider to unrelated third parties.

In general, a management contract gives rise to private business use if the compensation under the contract is based on net profits. For example, a management contract with respect to a commuter rail facility that compensates the management company based on the profits of such facility would result in private use.

In Revenue Procedure 97-13, as modified by Rev. Proc. 2001-39, the IRS provided safe harbor guidelines under which certain management contract arrangements are treated as not giving rise to private business use, depending on the term of the contract and the nature of the management compensation arrangement.[70] Under these safe harbors, the permitted term of the contract generally depends on the extent to which the management compensation arrangement is based on periodic fixed fees. Thus, for example, these safe harbors permit a 15-year contract in which 95 percent of the management compensation consists of periodic fixed fees, and also a 5-year contract in which 50 percent of the management compensation consists of periodic fixed fees. The revenue procedure provides five "safe harbor" arrangements that if met, do not give rise to private business use:

- 95 percent periodic fixed fee arrangements: At least 95 percent of service compensation for each annual period during the term of the contract is based on a periodic fixed fee, and the term of the contract (including renewals) does not exceed

[69] Treas. Reg. 1.141-3(b)(4)(iii)(A)-(D).

[70] Rev. Proc. 97-13, 1997-1 C.B. 632.

the lesser of 15 years (20 years for public utility property) or 80 percent of the expected useful life of the related property.

- 80 percent periodic fixed fee arrangement: At least 80 percent of the compensation for services for each annual term during the term of the contract (including renewals) is based on a periodic fixed fee, and the term of the contract does not exceed the lesser of 10 years (20 years for public utility property) or 80 percent of the expected useful life of the related property.

- 50 percent periodic fixed fee arrangement: 50 percent of more of the compensation for services for each annual period is based on a periodic fixed fee or all of the compensation is based on a capitation fee[71] or a combination of a capitation fee and a periodic fixed fee. The contract term (including renewals) cannot exceed five years. The contract must be terminable at the option of the qualified user at the end of three years.

- Per unit fee[72] arrangement: 100 percent of the compensation must be based on a per-unit fee or a combination of a per-unit fee and periodic fixed fee, the term of the contract (including renewals) cannot exceed three years (and must be terminable by the qualified user after two years).

- Percentage of revenue or expense fee arrangements: 100 percent of the compensation must be based on a percentage of fees charged or a combination of a per-unit fee and a percentage of revenue or expense fee. During start up, compensation may be based on gross revenues or expenses of a facility. The term of the contract cannot exceed two years, and the contract must be terminable by the qualified user in one year. This exception applies only to service contracts under which the service provider primarily provides service to third parties or during an initial start-up period where there is no reasonable estimate of annual gross revenues and expenses.

In Notice 2014-67, the IRS further modified the safe harbor guidelines for private management contracts.[73] A modified safe harbor for five-year contracts allows the compensation is based on a stated amount, a periodic fixed fee, a capitation fee, a per unit fee, or a combination of the foregoing. These five-year contracts need not be terminable by the qualified user. In addition, the IRS provided a safe harbor against private business use for arrangements for participation in Medical Shared Savings Programs by Affordable Care Organizations under the Affordable Care Act if the arrangements meet certain conditions.

[71] "Capitation fee" means a fixed periodic amount for each person who is covered by the contract as long as the quantity and type of services actually provided to covered persons is substantially different (*e.g.*, a monthly fee for each member of an HMO).

[72] "Per-unit fee" means a fee based on a unit of service provided which is specified in the contract by an independent third party (*e.g.* Medicare administrator) or the qualified user.

[73] Notice 2014-67, 2014-46 I.R.B. 822 (November 10, 2014).

Private business test component 2: The private payment test

For purposes of the second component of the private business test, the private payment test, both direct and indirect payments made by any private person treated as using the financed property are taken into account. Payments by a person for the use of proceeds generally do not include payments for ordinary and necessary expenses (within the meaning of section 162) attributable to the operation and maintenance of financed property.[74]

Private loan financing test

In addition to the two-part private business test, a bond may be classified as a private activity bond if it meets the "private loan financing test." A bond issue satisfies the private loan financing test if proceeds exceeding the lesser of $5 million or five percent of such proceeds are used directly or indirectly to finance loans to one or more nongovernmental persons. Private loans include both business and other (*e.g.*, personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments that are subject to the private business test.

Qualified private activity bonds

Qualified private activity bonds are tax-exempt private activity bonds issued to provide financing for specified privately used facilities. The definition of a qualified private activity bond includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond.[75]

To qualify as an exempt facility bond, 95 percent of the net proceeds must be used to finance an eligible facility.[76] Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, high-speed intercity rail facilities, and qualified highway or surface freight transfer facilities); privately owned and/or operated public works facilities (sewage, solid waste disposal, water, local district heating or cooling, and hazardous waste disposal facilities); privately-owned and/or operated residential rental housing; and certain private facilities for the local furnishing of electricity or gas. Bonds issued to finance "environmental enhancements of hydro-electric generating facilities," qualified public educational facilities, and qualified green building and sustainable design projects also may qualify as exempt facility bonds.

Generally, qualified private activity bonds are subject to a number of additional eligibility restrictions that do not apply to governmental bonds. For example, the aggregate volume of most qualified private activity bonds is restricted by annual State volume limitations (the "State

[74] Treas. Reg. sec. 1.141-4(c)(3).

[75] Sec. 141(e).

[76] Sec. 142(a).

volume cap").[77] For calendar year 2015, the State volume cap, which is indexed for inflation, equals $100 per resident of the State, or $301,515,000, if greater.[78]

Qualified private activity bonds also are subject to additional limitations under section 147, including a substantial user limit, a bond maturity restriction, a limit on financing land acquisition, a limit on financing existing property absent substantial rehabilitation, certain prohibited facilities, a public approval requirement, and a limit on financing issuance costs. Further, qualified private activity bonds (other than qualified 501(c)(3) bonds) are ineligble for advance refundings.[79] In addition, the interest income from qualified private activity bonds (other than qualified 501(c)(3) bonds) generally is a preference item for purposes of calculating the alternative minimum tax ("AMT").[80]

Rules governing private activity bonds for certain surface transportation infrastructure

Airports

Exempt facility bonds may be issued to finance airports. Exempt facility bonds for airports are not subject to the State volume cap. However, all tax-exempt-bond-financed airport property must be governmentally owned. Property eligible for this financing includes land, terminals, runways, public parking facilities, and related equipment. Airplanes are not eligible for tax-exempt financing. Additionally, certain real property facilities (and related equipment) are excluded from this financing:

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[77] The following private activity bonds are not subject to the State volume cap: qualified 501(c)(3) bonds, exempt facility bonds for airports, docks and wharves, environmental enhancements for hydroelectric generating facilities, and exempt facility bonds for solid waste disposal facilities that are to be owned by a governmental unit. The State volume cap does not apply to 75 percent of exempt facility bonds issued for high speed intercity rail facilities, 100 percent if the high speed intercity rail facility is to be owned by a governmental unit. Qualified veterans mortgage bonds, qualified public educational facility bonds, qualified green building and sustainable project design bonds, and qualified highway or surface freight transfer facility bonds also are not subject to the State volume cap, but the Code subjects such bonds to volume limitations specific to the category of bonds.

[78] Rev. Proc. 2014-61.

[79] See sec. 149(d)(2).

[80] Sec. 57(a)(5). Special rules apply to exclude refundings of bonds issued before August 8, 1986, and to certain bonds issued before September 1, 1986. Further, tax-exempt interest on private activity bonds issued in calendar years 2009 and 2010 is not an item of tax preference for purposes of the alternative minimum tax and interest on tax-exempt bonds issued in 2009 and 2010 is not included in corporate adjustment based on current earnings.

1. Hotels and other lodging facilities;

2. Retail facilities (including food and beverage facilities) located in a terminal, if the facilities are in excess of a size necessary to serve passengers and employees at the airport;

3. Retail facilities for passengers or the general public (including, but not limited to, rental car lots) located outside the terminal;

4. Office buildings for individuals who are not employees of a governmental unit or of the public airport operating authority; and

5. Industrial parks or manufacturing facilities.

<u>Port facilities</u>

Exempt facility bonds may be issued to finance port ("dock and wharf") facilities and related storage and training facilities. Facilities that are specifically ineligible for financing with airport bonds may not be financed with port bonds. Further, ships and other vessels are not eligible for private activity tax-exempt bond financing. All property financed with these bonds must be governmentally owned. Exempt facility bonds issued for ports are not subject to the State volume cap.

<u>Mass commuting facilities</u>

Exempt facility bond financing for mass commuting facilities is subject to restrictions similar to those which apply to such bonds for airports and ports. All property financed with these bonds must be governmentally owned. Further, "rolling stock" (*e.g.*, buses and rail cars) is not eligible for financing with exempt facility bonds.

<u>High-speed intercity rail facilities</u>

The definition of an exempt facility bond includes bonds issued to finance high-speed intercity rail facilities.[81] A facility qualifies as a high-speed intercity rail facility if it is a facility (other than rolling stock) for fixed guideway rail transportation of passengers and their baggage between metropolitan statistical areas.[82] The facilities must use vehicles that are reasonably expected to be capable of attaining a maximum speed in excess of 150 miles per hour between scheduled stops, and the facilities must be made available to members of the general public as passengers.

Unlike other bond-financed transportation facilities, high-speed intercity rail facilities may be privately owned. However, if the bonds are to be issued for a nongovernmental owner of

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[81] Sec. 142(a)(11) and sec. 142(i).

[82] A metropolitan statistical area for this purpose is defined by reference to section 143(k)(2)(B). Under that provision, the term metropolitan statistical area includes the area defined as such by the Secretary of Commerce.

the facility, such owner must irrevocably elect not to claim depreciation or credits with respect to the property financed by the net proceeds of the issue.[83]

The Code imposes a special redemption requirement for these types of bonds. Any proceeds not used within three years of the date of issuance of the bonds must be used within the following six months to redeem such bonds.[84]

Seventy-five percent of the principal amount of the bonds issued for high-speed rail facilities is exempt from the volume limit.[85] If all the property to be financed by the net proceeds of the issue is to be owned by a governmental unit, then such bonds are completely exempt from the volume limit.

Qualified highway or surface freight transfer facility bonds

Present law authorizes the issuance of tax-exempt private activity bonds to finance qualified highway or surface freight transfer facilities. A qualified highway facility or surface freight transfer facility is any surface transportation or international bridge or tunnel project (for which an international entity authorized under Federal or State law is responsible) which receives Federal assistance under title 23 of the United States Code or any facility for the transfer of freight from truck to rail or rail to truck which receives Federal assistance under title 23 or title 49 of the United States Code.

Qualified highway or surface freight transfer facility bonds are not subject to the State volume limitations. Rather, the Secretary of Transportation is authorized to allocate a total of $15 billion of issuance authority to qualified highway or surface freight transfer facilities in such manner as the Secretary determines appropriate.[86]

Similar to the requirement for high-speed intercity rail facilities, the Code imposes a special redemption requirement for qualified highway or surface freight transfer facility bonds. Under present law, the proceeds of qualified highway or surface freight transfer facility bonds must be spent on qualified projects within five years from the date of issuance of such bonds. Proceeds that remain unspent after five years must be used to redeem outstanding bonds.

The qualified highway or surface freight transfer facility bond provision was enacted in 2005 as part of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy

[83] Sec. 142(i)(2).

[84] Sec. 142(i)(3).

[85] Sec. 146(g)(4).

[86] See Department of Transportation, *Notice of Solicitation for Requests for Allocations of Tax-exempt Financing and Request for Comments*, 71 Fed. Reg. 642 (January 5, 2006) and Internal Revenue Service, Notice 2006-45, *Exempt Facility Bonds for Qualified Highway or Surface Freight Transfer Facilities*, 2006-20 I.R.B. 891 (May 15, 2006).

for Users ("SAFETEA-LU").[87] As reflected below, as of May 12, 2015, the Department of Transportation has made allocations of approximately $11 billion of the $15 billion it is authorized to allocate. Of the $11 billion that has been allocated, approximately $5.8 billion of bonds have been issued.[88]

Bonds Issued

Capital Beltway HOT Lanes, Northern Virginia……………………………….....	$ 589,000
North Tarrant Express, Fort Worth, Texas……………………………………....	$ 400,000
IH 635 Managed Lanes (LBJ Freeway), Dallas, Texas………………………….....	$ 615,000
Denver RTD Eagle Project (East Corridor & Gold Line), Denver, Colorado…...	$ 397,835
CentralPoint Intermodal Center, Joliet, Illinois…………………………….....	$ 150,000
CentralPoint Intermodal Center, Joliet, Illinois…………………………….…...	$ 75,000
Downtown Tunnel/Midtown Tunnel/MLK Extension, Norfolk, Virginia…….....	$ 675,004
I-95 HOV/HOT Lanes, Northern Virginia……………………………………..…	$ 252,648
Ohio River Bridges East End Crossing, Louisville, Kentucky…………………..	$ 676,805
North Tarrant Express Segments 3A & 3B, Forth Worth, Texas………………..	$ 274,030
Goethals Bridge, Staten Island, New York………………………………………	$ 460,915
U S 36 Managed Lanes/BRT Phase 2, Denver Metro Area, Colorado……….…	$ 20,360
I-69 Section 5, Bloomington to Martinsville, Indiana…………………….……..	$ 243,845
Rapid Bridge Replacement Program, Pennsylvania…………………………..…..	$ 721,485
Southern Ohio Veterans Memorial Highway……………………………….……	$ 227,355
Subtotal…………………………………………………………………	**$ 5,779,282**

[87] Section 11143 of Pub. L. No. 109-59.

[88] Federal Highway Administration, *Innovative Program Delivery* (website), *Tools & Programs: Federal Debt Financing Tools, Private Activity Bonds*, http://www.fhwa.dot.gov/ipd/finance/tools_programs/federal_debt_financing/private_activity_bonds/default.aspx#current.

Allocations

Knik Arm Crossing, Anchorage, Alaska………………………………………….....	$ 600,000
CenterPoint Intermodal Center, Joliet, Illinois……………………………………	$ 700,000
I-77 Managed Lanes, Charlotte, North Carolina………………………………….	$ 350,000
SH-288, Houston Metro Area, Texas……………………………………………..	$ 600,000
Purple Line, Maryland……………………………………………………………….	$1,300,000
All Aboard Florida…………………………………………………………………	$1,750,000
Subtotal……………………………………………………………………….	**$5,300,000**
Grand Total……………………………………………………………………….	**$11,079,282**

C. Other Methods for Infrastructure Project Finance

1. Overview: tax-credit bonds and direct-pay bonds

Tax-credit bonds provide tax credits to investors to replace a prescribed portion of the interest cost. The borrowing subsidy generally is measured by reference to the credit rate set by the Treasury Department. Current tax-credit bonds include qualified tax credit bonds, which have certain common general requirements, and include new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds ("QZABs"), and qualified school construction bonds. The authority to issue two other types of tax-credit bonds, recovery zone economic development bonds and Build America Bonds, expired on January 1, 2011.

General rules applicable to qualified tax-credit bonds[89]

Unlike tax-exempt bonds, qualified tax-credit bonds generally are not interest-bearing obligations. Rather, the taxpayer holding a qualified tax-credit bond on a credit allowance date is entitled to a tax credit. The amount of the credit is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit rate for an issue of qualified tax credit bonds is determined by the Secretary and is estimated to be a rate that permits issuance of the qualified tax-credit bonds without discount and interest cost to the qualified issuer.[90] The credit accrues quarterly and is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. Unused credits may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds. Qualified tax-credit bonds are subject to a maximum maturity limitation, a three-year spending requirement, arbitrage restrictions, and IRS reporting requirements.

Direct-pay bonds and expired tax-credit bond provisions

The Code provides that an issuer may elect to issue certain tax credit bonds as "direct-pay bonds." Instead of a credit to the holder, with a "direct-pay bond" the Federal government pays the issuer a percentage of the interest on the bonds. The following tax credit bonds may be issued as direct-pay bonds: new clean renewable energy bonds, qualified energy conservation bonds, and qualified school construction bonds. QZABs may be issued as direct-pay bonds but such an election is not available regarding any allocation of the national zone academy bond allocation after 2010 or any carryforward of such allocations. The ability to issue Build America Bonds and Recovery Zone bonds, which have direct-pay features, has expired. The Build America Bonds program is discussed below.

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[89] Separate rules apply in the case of tax-credit bonds which are not qualified tax-credit bonds (*e.g.*, "recovery zone economic development bonds," and "Build America Bonds").

[90] However, for new clean renewable energy bonds and qualified energy conservation bonds, the applicable credit rate is 70 percent of the otherwise applicable rate.

Build America Bonds

The Build America Bonds program, part of the American Recovery and Reinvestment Act of 2009 ("ARRA"[91]), provided a subsidy to State and local governments to finance capital projects, including the development of surface transportation infrastructure. The authority to issue bonds under the program expired December 31, 2010.

Under the Build America Bonds program, an issuer could elect to have an otherwise tax-exempt bond, issued prior to January 1, 2011, treated as a "Build America Bond."[92] In general, Build America Bonds are taxable governmental bonds whose, interest is subsidized by the Federal government by means of a tax credit to the holder ("tax-credit Build America Bonds") or, in the case of certain qualified bonds, a direct payment to the issuer ("direct-pay Build America Bonds").[93]

The holder of a tax-credit Build America Bond accrues a tax credit in the amount of 35 percent of the interest paid on the interest payment dates of the bond during the calendar year.[94] The interest payment date is any date on which the holder of record of the Build America Bond is entitled to a payment of interest under such bond.[95] The sum of the accrued credits is allowed against regular and alternative minimum tax; unused credits may be carried forward to succeeding taxable years.[96] The credit, as well as the interest paid by the issuer, is included in gross income, and the credit may be stripped under rules similar to those provided for qualified tax-credit bonds.[97]

Although the authority existed to issue Build America Bonds that provided for a tax credit to the bond holder, most Build America Bonds were issued as "direct-pay Build America Bonds." Under a special rule, in lieu of the tax credit to the holder, the issuer is allowed a refundable credit equal to 35 percent of each interest payment made under such bond.[98]

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[91] Pub. L. No. 111-5.

[92] Sec. 54AA.

[93] Tax-credit Build America Bonds may be issued to finance any governmental purpose for which tax-exempt governmental bonds (excluding private activity bonds under section 141) could be issued under section 103. The eligible uses of proceeds and types of financings for direct-pay Build America Bonds are more limited than for tax-credit Build America Bonds. Direct-pay Build America Bonds are to finance only capital expenditures that could have been financed with tax-exempt governmental bonds.

[94] Sec. 54AA(a) and (b).

[95] Sec. 54AA(e).

[96] Sec. 54AA(c).

[97] Sec. 54AA(f).

[98] Sec. 54AA(g)(1).

2. Transportation Infrastructure Finance and Innovation Act ("TIFIA") Program

TIFIA provides federal credit assistance in the form of secured loans, loan guarantees, and lines of credit. Eligible applicants include State and local governments, transit agencies, railroad companies, special authorities, special districts, and private entities. In most cases, a TIFIA loan is just one piece of a financing package for a project whose total cost may be several times the amount of the loan. New public private partnerships have sought to reduce their borrowing costs by borrowing through both the TIFIA program and through qualified private activity bonds issued by local municipalities.[99] TIFIA assistance may be used for up to 49 percent of a project's cost.

[99] Congressional Budget Office, *Testimony: Status of the Highway Trust Fund and Options for Paying for Highway Spending* (June 17, 2015) at 17.

II. SELECTED PROPOSALS FOR INFRASTRUCTURE FINANCE

A. Public-Private Partnership and Bond Proposals for Infrastructure Project Financing

As a supplement to existing financing mechanisms for infrastructure, there have been proposals and initiatives to encourage the use of public-private partnerships for providing capital financing for transportation and infrastructure projects. The most recent proposals and initiatives are briefly described below.

Build America Investment Initiative

In July 2014, President Obama commenced the Build America Investment Initiative ("Initiative") as part of a government-wide effort to grow U.S. infrastructure using a variety of strategies, including a plan to expand the market for public-private partnerships.[100] As part of the Initiative, the Honorable Jacob J. Lew, Secretary of the Treasury, and the Honorable Anthony R. Foxx, Secretary of Transportation, co-chair an interagency working group ("Working Group") with the purpose of analyzing how to increase public and private sector collaboration for infrastructure development and financing, and to achieve other related efficiencies.[101] On January 15, 2015, the Working Group published its recommendations, which included with respect to tax considerations, a recommendation to "Review existing tax provisions for inappropriate barriers to investment, and consider specific proposals to better align federal tax policies with infrastructure finance policies. Such review should focus on updated and modernized regulatory tax guidance and legislative proposals to encourage greater use of [public-private partnerships or] PPPs in the development and financing of public infrastructure."[102]

Move America Act of 2015 (S. 1186)

On May 4, 2015, Senators Wyden and Hoeven introduced the "Move America Act of 2015,"[103] proposing to expand the categories of tax-exempt private activity bonds by providing for the issuance of Move America bonds, which finance specified infrastructure projects, and allow the authority to issue such bonds to be converted into a new infrastructure tax credit that could be sold in support of public-private partnerships.

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[100] The White House, Office of the Press Secretary, *FACT SHEET: Build America Infrastructure Investment Summit*, September 9, 2014, available at http://www.whitehouse.gov/the-press-office/2014/09/09/fact-sheet-build-america-infrastructure-investment-summit.

[101] Department of the Treasury press release, *Treasury and Transportation Host Infrastructure Investment Summit*, September 9, 2014, available at http://www.treasury.gov/press-center/press-releases/Pages/jl2623.aspx.

[102] Department of Transportation, *Recommendations of the Build America Investment Initiative Interagency Working Group*, p. 10, available at http://www.treasury.gov/resource-center/economic-policy/Documents/Build America Recommendation Report 1-15-15 FOR PUBLICATION.pdf.

[103] S. 1186 (114^{th} Cong., 1^{st} Sess.).

The bill would create Move America Bonds ("MABs"), a new category of exempt facility bonds. The term MABs means any bond issued as part of an issue 95 percent or more of the net proceeds of which are used to provide airports, docks and wharves, mass commuting facilities, railroads (as defined in sec. 20102 of Title 49) and any associated rail and road infrastructure for the purpose of integrating modes of transportation, certain projects eligible for title 23 assistance (surface transportation projects, and international bridge or tunnel projects), certain freight transfer facilities eligible for Title 23 or Title 49 assistance, flood diversions, or inland waterways (including construction and rehabilitation expenditures for navigation on any inland or intracoastal waterways of the United States (within the meaning of section 4042 of the Code). MAB facilities would not have to be governmentally owned, however, as an exempt facility bond, MAB facilities are to serve, or be available on a regular basis for, general public use.[104] Certain rules that apply to exempt facility bonds for high-speed rail, and highway surface transportation facilities would not apply. MABs would be subject to a separate State volume cap restriction equal to 50 percent of the respective State's current law private activity bonds limit.[105] An issuing authority is permitted to elect to carry forward any unused volume cap for three years.

A MAB facility may be located outside an issuing authority's State if the issuer establishes that the State's share of the use of the facility (or its output) will equal or exceed the State's share of private activity bonds issued to finance the facility. A MAB may be used for certain rehabilitation expenditures under modified requirements. Up to 50 percent of a MAB issuance is permitted for land acquisition. In addition, the interest on a MAB is not a preference item for purposes of the AMT.

The bill also creates a Move America credit certificate ("MACC") which is sold by a State and the proceeds of which may be used to finance a facility that qualifies as an eligible MAB facility which is a public-private partnership. To obtain the ability to sell a MACC, the State must exchange MAB volume cap for MACC authority, where the MACC authority is equal to 25 percent of the MAB volume cap exchanged. The aggregate value of the MACC sold by a State as relating to a qualified project cannot exceed the lesser of 20 percent of the estimated cost of the project or 50 percent of the total amount of private equity invested in the project. In the case of a MACC purchased by a taxpayer there is a credit allowed against Federal income tax liability for ten years beginning in the taxable year the project is placed in service. The annual credit is equal to one tenth of the value of the certificate and is in the form of a general business credit or a personal credit. States may allocate MACCs to the sponsor of the qualified project for (1) sale by the project sponsor, or (2) use by the project sponsor as an income tax credit as if the project sponsor had purchased the MACC from the State.

[104] See, Treas. Reg. sec. 1.103-8(a)(2) regarding general public use requirements for exempt facilities.

[105] Under present law (for calendar year 2015) the annual private activity bond volume limit for any State is the greater of $100 per resident of the State or $301.52 million.

Qualified public infrastructure bonds (QPIBs)

Among its Fiscal Year 2016 budget proposal, the Administration proposed the creation of a new category of tax-exempt qualified private activity bonds called "Qualified Public Infrastructure Bonds" ("QPIBs") that would be eligible to finance the following specific categories of infrastructure projects that are permitted to be financed with exempt facility bonds under current law: (1) airports; (2) docks and wharves; (3) mass commuting facilities; (4) facilities for the furnishing of water; (5) sewage facilities; (6) solid waste disposal facilities; and (7) qualified highway or surface freight transfer facilities.

The proposal would impose two core eligibility requirements for QPIBs: a governmental ownership requirement and a public use requirement. The proposal would require that the projects financed by QPIBs must be owned by a State or local governmental unit. The proposal would provide a safe harbor for establishing governmental ownership of financed projects that would follow the same principles as the existing safe harbor under section 142(b)(1)(B) for governmental ownership of airports, docks and wharves, mass commuting facilities, and environmental enhancements of hydro-electric generative facilities that are financed with exempt facility bonds. In addition, the proposal would require that projects financed by QPIBs meet a public use requirement by serving a general public use or being available on a regular basis for general public use. Further, except as otherwise provided, the proposal would require that QPIBs meet the existing eligibility restrictions for qualified private activity bonds.

The proposal would make the bond volume cap requirement inapplicable to QPIBs. The proposal also would make the AMT preference for interest on specified private activity bonds inapplicable to QPIBs.

Additional volume allocation for surface freight facility private activity bonds

The Administration also proposes increasing the national limitation on private activity bonds for surface freight transfer facility bonds from $15 billion[106] to $19 billion, which would expand the incentive to use additional public-private partnerships for financing this type of infrastructure project.

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[106] See sec. 142(m).

B. National Infrastructure Bank Proposals

As a supplement to existing financing mechanisms for infrastructure, there have been proposals put forth in the last several years to create a "national infrastructure bank" or fund to provide additional financing for infrastructure projects of national and/or regional significance. Such assistance could take the form of loans, loan guarantees or grants. Generally, the proposals initially capitalize the bank with Federal funds. Some proposals would allow the bank to issue debt to provide financing for infrastructure projects.

On June 16, 2015, Senator Warner introduced S. 1589, the "Building and Renewing Infrastructure for Development and Growth in Employment Act" or the "BRIDGE Act." The bill establishes the Infrastructure Financing Authority as a wholly-owned government corporation. The authority is to provide direct loans and loan guarantees for certain transportation, water, and energy infrastructure projects. The projects are required to have reasonably anticipated costs that equal or exceed $50 million ($10 million for rural infrastructure projects).

On May 12, 2015, Senator Fischer introduced S. 1296, the "Build USA" Act, which would establish the American Infrastructure Bank to make loans to States and local governments for core infrastructure projects (a Federal-aid highway or highway (as those terms are defined in section 101 of title 23, United States Code) project of a State that is eligible for funding under chapter 1 of title 23, United States Code).

On January 16, 2014, Senator Bennet introduced S. 1957, the "Partnership to Build America Act of 2014." The bill establishes the American Infrastructure Fund ("AIF") as a wholly-owned government corporation. The AIF is authorized to issue up to $50 billion in bonds to provide loans and loan guarantees for certain transportation, energy, water, communications, and educational infrastructure projects, as well as provide equity investments in such projects (not to exceed 20 percent of the total project cost).

The Administration also has proposed the creation of a $10 billion national infrastructure bank that would provide loans and loan guarantees for transportation, energy, and water projects.