OVERVIEW OF SELECTED FEDERAL INCOME TAX PROVISIONS RELATING TO TRANSPORTATION INFRASTRUCTURE

Scheduled for a Hearing
Before the
SUBCOMMITTEE ON OVERSIGHT
of the
HOUSE COMMITTEE ON WAYS AND MEANS
on July 25, 2000

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of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a public hearing on July 25, 2000, to review the operation of selected present-law Federal income tax provisions affecting the financing of transportation infrastructure. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides an overview of the present-law rules on tax-exempt financing, capital cost recovery, capital construction funds for vessels, special cost recovery provisions for electric and clean-fuel vehicles, and a one-time net operating loss carryback for Amtrak.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Overview of Selected Federal Income Tax Provisions Relating to Transportation Infrastructure,* (JCX-83-00), July 21, 2000.

I. SUMMARY

Tax-exempt financing

Interest on State and local government bonds is excluded from income when the bond proceeds are used for activities of those governmental units or the bonds are repaid with revenues of those entities. Public highways and mass commuting systems are examples of the activities that may be financed with governmental tax-exempt bonds.

The Internal Revenue Code (the "Code") also allows States and local governments to issue tax-exempt private activity bonds, which permit these governments to act as conduits to provide financing for private parties. Tax-exempt private activity bonds may be issued to finance airports, ports, private mass commuting facilities, and high-speed intercity rail facilities. Vehicles, or "rolling stock," may not be financed with the proceeds of tax-exempt private activity bonds.

Capital construction funds for vessels

A taxpayer that owns or leases a qualified vessel is allowed a deduction for certain amounts contributed to a capital construction fund established under section 607 of the Merchant Marine Act of 1936. In addition, the investment earnings on amounts contributed to a capital construction fund are excluded from gross income for regular tax purposes.

If a withdrawal from a capital construction fund is used to acquire, construct, or reconstruct a qualified vessel, the amount withdrawn generally is not included in gross income and the basis of the qualified vessel generally is reduced by the amount withdrawn. A qualified vessel is a vessel constructed or reconstructed in the United States and documented under the laws of the United States. In addition, the taxpayer maintaining the capital construction fund must agree that the vessel will be operated in the United States foreign trade, Great Lakes trade, or noncontiguous domestic trade or in the fisheries of the United States.

General capital cost recovery rules for transportation property

A taxpayer generally must capitalize the cost of property used in a trade or business and recover that cost over time through annual deductions for depreciation, depletion, or amortization. Tangible property generally is depreciated under the Modified Accelerated Cost Recovery System ("MACRS"), which determines depreciation by applying specific recovery period, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property. Depreciation deductions for tangible property used in transportation (rail, water, highway, and air) generally are determined under these rules. However, in certain cases special exceptions to cost capitalization and special recovery periods are assigned for certain types of transportation property.

Special cost recovery provisions for electric and clean-fuel vehicles

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000. The credit phases down in the years 2002 through 2004 and is unavailable for purchases after December 31, 2004.

Certain costs of qualified clean-fuel vehicle property and clean-fuel vehicle refueling property may be expensed and deducted when the property is placed in service. Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels (natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which methanol, ethanol, or any other alcohol or ether). The deduction phases down in the years 2002 through 2004 and is unavailable for purchases after December 31, 2004.

Net operating loss carryback provision for Amtrak

The Taxpayer Relief Act of 1997 provides elective procedures that allow the National Railroad Passenger Corporation ("Amtrak") to consider the tax attributes of its predecessors (i.e., those railroads that were relieved of their responsibility to provide intercity rail passenger service as a result of the Rail Passenger Service Act of 1970) in the use of Amtrak's net operating losses. The aggregate amount of tax considered paid by Amtrak and thus eligible to be offset by Amtrak's net operating losses, equals the least of (1) 35 percent of Amtrak's existing qualified carryovers, (2) the net tax liability for the carryback period, or (3) $2,323,000,000.

II. OVERVIEW OF PRESENT-LAW PROVISIONS

A. Tax-Exempt Financing for Transportation Infrastructure: Highways, Airports, Ports, and Mass Commuting and High-Speed Intercity Rail Facilities

In general

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (sec. 103). Like other activities carried out or paid for by States and local governments, the construction, renovation, and operation of governmental transportation infrastructure projects such as public highways or governmental mass commuting (rail and bus) systems are eligible for this financing.

Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person, is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called Aprivate activity bonds.@ The term "private person" includes the Federal Government and all other individuals and entities other than States or local governments.

Private activities eligible for financing with tax-exempt private activity bonds

The Code includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities.

States or local governments may issue tax-exempt Aexempt-facility bonds@ to finance property for certain private businesses. Property eligible for this financing includes transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, and hazardous waste disposal facilities); privately-owned and/or operated low-income rental housing; and certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." Tax-exempt financing also is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), local redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses.

Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code may be financed with tax-exempt private activity bonds ("qualified 501(c)(3) bonds").

Finally, tax-exempt private activity bonds may be issued to finance limited non-business purposes: student loans and mortgage loans for owner-occupied housing (Aqualified mortgage bonds@ and Aqualified veterans= mortgage bonds@).

In most cases, the volume of tax-exempt private activity bonds is restricted by aggregate annual limits imposed by the Code on bonds issued by issuers within each State. These annual volume limits equal $50 per resident of the State, or $150 million if greater. The annual State private activity bond volume limits are scheduled to increase to the greater of $75 per resident of the State or $225 million in calendar year 2007. The increase will be phased in ratably beginning in calendar year 2003. The increases were enacted by the Tax and Trade Relief Extension Act of 1998.

Tax-exempt private activity bonds for financing of airports, ports, and governmentally owned high-speed intercity rail facilities are not subject to these volume limits. Private activity bonds for mass commuting facilities, however, are subject to the limits; such bonds for privately owned high speed intercity rail facilities must receive a volume limit allocation equal to 25 percent of the amount of the bonds.

Rules governing private activity bonds for transportation facilities

Airports

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, the following real property and related equipment are excluded from this financing:

(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.

Ports

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.

Mass commuting facilities

Private activity tax-exempt bond financing for mass commuting facilities is subject to similar restrictions as the restrictions that apply to such bonds for airports and ports. All property financed with these bonds must be governmentally owned. Further, "rolling stock" (buses and rail cars) are not eligible for this financing.

High-speed intercity rail facilities

High-speed intercity rail facilities eligible for tax-exempt bond financing include facilities (not including rolling stock) for the fixed guideway rail transportation of passengers and their baggage between metropolitan statistical areas using vehicles that are reasonably expected to operate at speeds in excess of 150 miles per hour between scheduled stops. As with other private transportation facilities receiving tax-exempt financing, these facilities must be available to members of the general public as passengers. Unlike other bond-financed transportation facilities, high-speed intercity rail facilities may be privately owned.

Arbitrage restrictions on tax-exempt bonds

The Federal income tax does not apply to income of States and local governments that is derived from the exercise of an essential governmental function. To prevent these tax-exempt entities from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than necessary, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds. In general, arbitrage profits may be earned only during specified periods (e.g., defined Atemporary periods@) before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., Areasonably required reserve or replacement funds@). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

The Code includes three exceptions applicable to bonds for transportation infrastructure facilities. First, issuers of all types of tax-exempt bonds are not required to rebate arbitrage profits if all of the proceeds of the bonds are spent for the purpose of the borrowing within six months after issuance. In the case of governmental bonds (including bonds to finance public highways) the six-month expenditure exception is treated as satisfied if at least 95 percent of the proceeds is spent within six months and the remaining five percent is spent within 12 months after the bonds are issued.

Second, in the case of bonds to finance certain construction activities, including governmentally owned transportation infrastructure facilities, the six-month period is extended to 24 months for construction proceeds. Arbitrage profits earned on construction proceeds are not required to be rebated if all such proceeds (other than certain retainage amounts) are spent by the end of the 24-month period and prescribed intermediate spending percentages are satisfied.

Third, governmental bonds issued by Asmall@ governments are not subject to the rebate requirement. Small governments are defined as general purpose governmental units that issue no more than $5 million of tax-exempt governmental bonds in a calendar year. The $5 million limit is increased to $10 million if at least $5 million of the bonds are used to finance public schools.

B. Capital Construction Funds for Vessels

In determining taxable income for regular tax purposes, a qualified taxpayer who owns or leases a qualified vessel (an "agreement vessel") is allowed a deduction for certain amounts contributed to a fund established under section 607 of the Merchant Marine Act of 1936 (a "capital construction fund") (Code sec. 7518). In addition, the investment earnings on amounts contributed to a capital construction fund are excluded from gross income for regular tax purposes.

If a withdrawal from a capital construction fund is used to acquire, construct, or reconstruct a qualified vessel, the amount withdrawn generally is not included in gross income and the basis of the qualified vessel generally is reduced by the amount withdrawn to the extent attributable to amounts previously deducted or excluded from income. In the case of any other withdrawal from a capital construction fund, the amount withdrawn generally is included in gross income to the extent attributable to amounts previously deducted or excluded from income and interest on the tax liability attributable to such inclusion generally must be paid from the date of the deduction or exclusion.

Under section 607(k) of the Merchant Marine Act, 1936, as in effect as of the date of enactment of the Tax Reform Act of 1986, a qualified vessel generally is a vessel constructed or reconstructed in the United States (the "U.S.-build requirement") and documented under the laws of the United States (the "U.S.-flag requirement"). In addition, the person maintaining the capital construction fund must agree with the Secretary of Commerce or the Secretary of Transportation that the vessel will be operated in the United States foreign trade, Great Lakes trade, or noncontiguous domestic trade or in the fisheries of the United States.

C. General Capital Cost Recovery Rules for Transportation Property

In general

A taxpayer generally must capitalize the cost of property used in a trade or business and recover that cost over time through annual deductions for depreciation, depletion, or amortization. Tangible property generally is depreciated under the Modified Accelerated Cost Recovery System ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property (sec. 168).

Personal property

Classification of assets and recovery periods

Personal property is classified under MACRS based on the property's "class life" unless a different classification is specifically provided in section 168. The class life applicable for personal property is the asset guideline period (midpoint class life as of January 1, 1986). Based on the property's classification, a recovery period is prescribed under MACRS. In general, there are six classes of recovery periods to which personal property can be assigned. For example, personal property that has a class life of four years or less has a recovery period of three years, whereas personal property with a class life greater than four years but less than 10 years has a recovery period of five years. The class lives and recovery periods for most property are contained in Rev. Proc. 87-56[2] (as clarified and modified by Rev. Proc. 88-22[3]).

Depreciation methods

The cost of personal property with a recovery period of 10 years or less is recovered using the 200-percent declining balance method. The cost of personal property included in the 15-year or 20-year class is recovered using the 150-percent declining balance method. Under both methods, a taxpayer switches to the straight-line method for the first taxable year for which using the straight line method will yield a larger deduction. In addition, a taxpayer may elect to use the straight-line method over the applicable MACRS recovery period or an alternative depreciation system based on class lives for property that is otherwise eligible for MACRS.

Placed in service conventions

A half-year convention applies under which all personal property placed in service or disposed of during a taxable year is treated as placed in service or disposed of at the midpoint of such year. As a result, a half-year of depreciation is allowed for the first year the property is placed in service, regardless of when the property is placed in service during the year, and a half-year of depreciation is allowed for the year in which property is disposed of or is otherwise retired from service.

A mid-quarter convention is applied to all personal property if more than 40 percent of all depreciable personal property placed in service by a taxpayer during a taxable year is placed in service during the last three months of the taxable year. The mid-quarter convention treats all property placed in service during any quarter of a taxable year as placed in service on the midpoint of such quarter.

Real property

The cost of residential rental property is recovered using the straight-line method of depreciation, and a recovery period of 27.5 years. The cost of nonresidential real property is recovered using the straight-line method of depreciation, and a recovery period of 39 years.

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[2] 1987-2 C.B. 674.

[3] 1988-1 C.B. 785.

Placed in service convention

In the case of both residential rental property and nonresidential real property, a mid-month convention applies. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

Alternative depreciation system

An alternative depreciation system is provided for property that is predominantly foreign-use property, tax-exempt use property, financed tax-exempt bond financed property, or with respect to which a taxpayer elects to apply the alternative depreciation system.[4] In these cases, depreciation allowances are computed under the alternative depreciation system, which provides for straight-line recovery and use of the placed in service conventions described above.

Unless specifically prescribed by section 168, the recovery period under the alternative system generally is equal to the property's class life (12 years for personal property with no ADR midpoint life, and 40 years for real property).

Rules governing cost recovery deductions for transportation property

Rail transportation

The applicable recovery periods for property used in the commercial and contract carrying of passengers and freight by rail generally follow the MACRS rules described above. The recovery periods range from seven years to 20 years. The recovery period in many cases is determined based on the classification of the property in the Interstate Commerce Commission accounts. MACRS provides special rules for railroad track and railroad grading or tunnel bore.

MACRS specifically assigns a recovery period of seven years and a class life of 10 years for railroad track. In addition, MACRS specifically provides that the cost of railroad grading and tunnel bore is recovered on a straight-line basis over a period of 50 years. The term "railroad grading or tunnel bore" means all improvements resulting from excavations (including tunneling), construction of embankments, clearing, diversions of roads and streams, sodding of slopes, and from similar work necessary to provide, construct, reconstruct, alter, protect, improve, replace, or restore a roadbed or right-of-way for railroad track.

A special rule provides that in the case of expenditures in connection with the rehabilitation of a unit of railroad rolling stock (except a locomotive) used by a domestic common carrier by rail which would be properly chargeable to a capital account, a taxpayer can

[4] In addition, the alternative depreciation system is required for property imported from a foreign country with respect to which an Executive Order is in effect because the country maintains trade restrictions or engages in other discriminatory acts.

elect to treat such expenditures as deductible repairs provided that the expenditures do not exceed 20 percent of the basis of such rolling stock (in any 12 month period) (sec. 263(d)).

In addition, another special rule provides an exception to the general capitalization rules for a domestic common carrier by rail that uses the retirement-replacement method of accounting for depreciation of its railroad track (sec. 263(f)). The exception permits a current deduction for expenditures of acquiring and installing replacement ties where an existing tie is replaced with a tie of a different material or improved quality.

<u>Air transportation</u>

The applicable recovery period for property used in the commercial and contract carrying of passengers and freight by air follows the general MACRS rules described above. The recovery periods range from five years to seven years.

<u>Highway transportation</u>

The applicable recovery period for property used in the commercial and contract carrying of passengers and freight by road follows the general MACRS rules described above with a primary recovery period of five years. MACRS provides that the recovery period of any automobile or light general purpose truck is five years, irrespective that the general MACRS rules would permit these assets a recovery period of three years.

<u>Water transportation</u>

The applicable recovery period for property used in the commercial and contract carrying of passengers and freight by water follows the general MACRS rules described above. The recovery periods range from 10 years to 15 years.

D. Special Cost Recovery Provisions for Electric and Clean-Fuel Vehicles

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000 (sec. 30). A qualified electric vehicle is a motor vehicle (1) that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current, (2) the original use of which commences with the taxpayer, and (3) that is acquired for the use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2002. The credit phases down in the years 2002 through 2004 and is unavailable for purchases after December 31, 2004.

Certain costs of qualified clean-fuel vehicle property and clean-fuel vehicle refueling property may be expensed and deducted when such property is placed in service (sec. 179A). Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels (natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which methanol, ethanol, any other alcohol or ether). The maximum amount of the deduction is $50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with seating capacities of at least 20 adults; $5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and $2,000 in the case of any other motor vehicle. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction.

Clean-fuel vehicle refueling property includes property for the storage or dispensing of a clean-burning fuel, if the storage or dispensing is the point at which the fuel is delivered into the fuel tank of a motor vehicle. Clean-fuel vehicle refueling property also includes property for the recharging of electric vehicles, but only if the property is located at a point where the electric vehicle is recharged. Up to $100,000 of such property at each location owned by the taxpayer may be expensed with respect to that location.

The deduction phases down in the years 2002 through 2004 and is unavailable for purchases after December 31, 2004.

E. Net Operating Loss Carryback Provision for Amtrak

The Taxpayer Relief Act of 1997 provides elective procedures that allow Amtrak to consider the tax attributes of its predecessors in the use of Amtrak's net operating losses. The benefit allowable under these procedures is limited to the least of: (1) 35 percent of Amtrak's existing qualified carryovers, (2) the net tax liability for the carryback period, or (3) $2,323,000,000. One half of the amount so calculated was treated as a payment of the tax imposed by chapter 1 of the Internal Revenue Code of 1986 for the Amtrak's taxable year ending December 31, 1997, and a similar amount for Amtrak's taxable year ending December 31, 1998.

The existing qualified carryovers are the net operating loss carryovers that are available under section 172(b) in Amtrak's first taxable year ending after September 30, 1997. The net tax liability for the carryback period is the aggregate of the net tax liability of Amtrak's railroad predecessors for all taxable years beginning before January 1, 1971, for which there is a net Federal tax liability. Amtrak's railroad predecessors are those railroads that were relieved of their responsibility to provide intercity rail passenger service as a result of the Rail Passenger Service Act of 1970 and their predecessors. In the case of a railroad predecessor who joined in the filing of a consolidated tax return, the net tax liability of the predecessor is the net tax liability of the consolidated group.

The net operating losses of Amtrak are required to be reduced by an amount equal to the amount obtained by Amtrak under this provision, divided by 0.35. The Treasury Department may adjust the tax account of each predecessor railroad for the carryback period to reflect the utilization of the net operating losses. The amount of the adjustment equals the amount of the benefit and is to be taken into consideration on the tax accounts of the predecessor railroads on a first-in, first-out basis, starting with balances for the earliest year for which any predecessor railroad has a net tax liability. No additional refund to any taxpayer other than Amtrak is allowed as a result of these adjustments.

The availability of the elective procedures is conditioned on Amtrak: (1) agreeing to make payments of one percent of the amount it receives to each of the non-Amtrak States to offset certain transportation related expenditures and (2) using the balance for certain qualified expenses. Non-Amtrak States are those States that are not receiving Amtrak service at any time during the period beginning on the date of enactment and ending on the date of payment.

No deduction is allowed with respect to any qualified expense whose payment is attributable to the proceeds made available as a result of this provision. The basis of any property must be reduced by the portion of its cost that is attributable to such proceeds. An item of cost or expense is attributable to such proceeds if it is: (1) paid from the proceeds of the refund or (2) paid from the proceeds of borrowings to the extent the principal and interest of such borrowings are paid from the proceeds of the refund.

Amtrak's earnings and profits will be increased by the amount of the refund. However, this amount is not included in adjusted current earnings for alternative minimum tax purposes, consistent with section 1.56(g)-1(c)(4)(ii) of the Treasury regulations.