



JOINT COMMITTEE ON TAXATION

July 24, 2008

JCX-62-08

**TESTIMONY OF EDWARD D. KLEINBARD
CHIEF OF STAFF
OF THE
JOINT COMMITTEE ON TAXATION**

**AT A HEARING OF THE SUBCOMMITTEE ON ENERGY, NATURAL RESOURCES,
AND INFRASTRUCTURE OF THE COMMITTEE ON FINANCE ON
“TAX AND FINANCING ASPECTS OF
HIGHWAY PUBLIC-PRIVATE PARTNERSHIPS”¹**

JULY 24, 2008

Mr. Chairman, Senator Bunning, members of the Subcommittee, my name is Edward D. Kleinbard and I am the Chief of Staff of the Joint Committee on Taxation. I am pleased to have the opportunity to appear before you today to discuss the Federal income tax issues raised by the use of public-private partnerships² to build, manage and own highways in the United States. At the request of the Subcommittee, my remarks are focused on “brownfield” highway projects, which involve very long-term leases of existing infrastructure from a State or other public owner to private parties. I also cover the present law treatment of tax-exempt bond financing for highway projects, in the context of both public and private owners of highway infrastructure.

¹ This document may be cited as follows: Joint Committee on Taxation, *Testimony of Edward D. Kleinbard, Chief of Staff of the Joint Committee on Taxation, at a Hearing of the Subcommittee on Energy, Natural Resources, and Infrastructure of the Committee on Finance on “Tax and Finance Aspects of Highway Public-Private Partnerships”* (JCX-62-08), July 24, 2008. This document is available at www.jct.gov.

² Although referred to as “public-private partnerships,” the parties generally do not intend the arrangement to be treated as a partnership for Federal income tax purposes. The discussion in this testimony assumes that this intended treatment is respected.

Overview of public-private partnerships

The Department of Transportation defines public-private partnerships broadly to include “contractual agreements formed between a public agency and private sector entity that allow for greater private sector participation in the delivery of transportation projects.”³ The private sector historically has participated in the design and construction of United States 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 the cost of infrastructure development and maintenance continues to increase.⁴

Some private firms have acquired economic interests in the financing, maintenance, and operation of public highways after they are built.⁵ Two well-publicized arrangements, involving the Chicago 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. In my testimony, I will use the similar structures of these two transactions as a template, but my remarks should be understood as generic in nature, and do not rely on any taxpayer-specific information not in the public domain.

The Chicago Skyway and Indiana Toll Road deals were structured as very long-term arrangements: 99 years in the former case, and 75 in the latter. 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;⁶

³ U.S. Department of Transportation, Federal Highway Administration, Public-Private Partnership Website, “PPPs Defined,” [<http://www.fhwa.dot.gov/PPP/defined.htm>].

⁴ For background on infrastructure investment, see Congressional Budget Office, *Issues and Options in Infrastructure Investment* (May 2008) (public-private partnership discussion at page 32).

⁵ For background on public-private partnerships, see CRS Report RL34567, *Public-Private Partnerships in Highway and Transit Infrastructure Provision*, by William J. Mallett (July 9, 2008); GAO, *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).

⁶ Technically the private party in each case was itself a partnership among several private firms, but this point is not relevant to the tax issues considered in my testimony.

- (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.⁷ 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,⁸ 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.

The remainder of my testimony provides background on the Federal income tax policy issues raised by these arrangements and their tax treatment under present law.⁹

⁷ See summaries of these arrangements at U.S. Department of Transportation, Federal Highway Administration, Public-Private Partnership Website, “PPP Case Studies,” [http://www.fhwa.dot.gov/ppp/case_studies.htm]. In addition to the Chicago Skyway and Indiana Toll Road arrangements, the Pocahontas Parkway in southern Virginia is being leased through a public-private partnership arrangement, and other similar transactions are being considered by State legislatures. The Pennsylvania General Assembly, for example, currently is considering a \$12.8 billion bid by Citigroup and Abertis Infraestructuras for a 75-year lease of the Pennsylvania turnpike, [<http://www.efinancialnews.com/usedition/index/content/2451015346>].

⁸ “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.

⁹ For analysis of other public policy issues raised by public-private partnerships, see CRS Report RL34567, *Public-Private Partnerships in Highway and Transit Infrastructure Provision*, by William J. Mallett (July 9, 2008); GAO, *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); U.S. Department of Transportation, *Report to Congress on the Costs, Benefits, and Efficiencies of Public-Private Partnerships for Fixed Guideway Capital Projects* (November 2007); Craig

Characterization of public-private partnerships for tax purposes

The parties to the archetypal brownfield public-private partnerships under consideration here enter into an umbrella concession agreement that describes the overall business relationship. Very importantly, the deals appear to be carefully structured *not* to constitute partnerships for tax purposes. (If the transaction were characterized as a constructive tax partnership, there would be a great many adverse consequences for the parties, including the possible application of Internal Revenue Code section 470 and differences in the tax depreciation rules for the brownfield assets.)¹⁰ Instead, and as described above, the arrangements 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.

The “public-private partnership” label thus generally is a red herring for the tax analysis of these transactions.

To be clear, it is possible that future transactions might raise more difficult questions of whether a constructive tax partnership exists between the public and private entities that enter into a brownfield transaction. In particular, transactions that rely more on back-end revenue sharing and that contemplate a larger continuing management role for the public entity would require analysis. For purposes of this testimony, however, I assume that the transactions will be respected according to their form, as outright transfers of the three bundles of property rights described above.

In turn, under long-established tax principles, the “lease” of the infrastructure assets would be expected to be characterized as an outright purchase of those assets by the private firm for tax purposes, 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 life.¹¹ Land, by

L. Johnson, Martin J. Luby, and Shokhrukh I. Kurbanov, *Toll Road Privatization Transactions: The Chicago Skyway and Indiana Toll Road*, September 2007, [<http://www.cviog.uga.edu/services/research/abfm/johnson.pdf>].

¹⁰ Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”) and all regulation references are to the Treasury Regulations promulgated thereunder.

¹¹ To the extent the property under the concession agreement becomes owned directly or indirectly by non-U.S. persons, the U.S. business operations related to the property generally should be 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. Sec. 11. 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

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.

More specifically, 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,¹² while the Chicago Skyway and Indiana Toll Road agreements were for terms of 99 and 75 years, respectively. The private party's responsibilities under the agreement may include all operations of the toll road, payment of utilities, maintenance, taxes (the private party may not be required to pay certain real estate, sales, and other taxes), capital improvements, risk of loss, and liabilities that arise during the term.¹³ Accordingly, while the facts and circumstances of each transaction will control its tax treatment, these arrangements will most likely be viewed by the parties 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.¹⁴

It also follows from the above that tax considerations are very important drivers of the long-term nature of these arrangements. Private firms can be expected to want to obtain the tax

conducted through a foreign corporation, the corporation would be subject to U.S. tax on its effectively connected income. Sec. 882. 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 payments allocable to the business. Sec. 884(a), (f). "Earnings stripping" rules (discussed later in the "Financing the acquisition" section of this testimony) 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 U.S. tax rules applicable to foreign investment in U.S. real estate (the "FIRPTA" rules of section 897) may affect the U.S. tax treatment of foreign investors. We understand that some advisors have taken the position that the intangible franchise right is an interest in real property for purposes of section 897. Other advisors have taken a contrary view. 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.

¹² U.S. Department of Commerce, Bureau of Economic Analysis, *BEA Depreciation Estimates*, [<http://www.bea.gov/national/FA2004/Tablecandtext.pdf>].

¹³ We have not reviewed all public-private partnership agreements. The terms will vary depending on the particular arrangement.

¹⁴ 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," [<http://www.in.gov/ifa/files/4-12-06-Concession-Lease-Agreement.pdf>].

advantages (in particular, depreciation deductions, as described below) that flow to any owner of an asset. At the same time, the public sector participant will wish to maximize the value it receives for giving up control of the infrastructure assets, by assisting the private firm in being treated as the tax owner of the assets. Because these transactions are nominally leases, the private firm participants will want to assure themselves and their advisors that they will control the assets for a period that clearly exceeds their expected economic life. The result can be seen in the 75 and 99 year terms of the two archetypal transactions considered here.

Tax policy considerations in public-private partnerships

Any transaction between private parties and the public sector — including a public-private partnership with respect to highways or other infrastructure — presents two important sets of questions:

- (1) Does the arrangement allow the private party to obtain tax deductions or other tax benefits in respect of property that economically is controlled by the public entity, or conversely to shield from tax income that belongs economically to the private firm by allocating that income to the nontaxable public entity? In other words, are the parties engaged in a bona fide commercial transaction, or are they primarily trading on the public entity's tax-exempt status?
- (2) Assuming that the transaction is a bona fide commercial undertaking, are the tax consequences to the private party (including the tax aspects of any financing opportunities available to the private party) similar to the tax results achieved in other economically comparable transactions that take place entirely in the private sphere? That is, is the tax law neutral across comparable investments, thereby avoiding tax-induced economic distortions? Or does the tax law, through tax expenditures, indirectly subsidize this particular activity — and if so, is that subsidy intentional (for example, as an instrument of Federal transportation policy)?

Genuine transaction or trading on tax-exempt status?

Turning to the first question, public-private partnership arrangements of the sort considered here as a general matter are genuine commercial transactions. In particular, these arrangements do not present the issues raised by “lease-in lease-out” (“LILO”) or “sale-in, lease-out” (“SILO”) transactions, abusive arrangements that have been curtailed by Federal tax legislation.

In a typical LILO or SILO transaction, governmental entities essentially transferred nominal ownership (and with it the rights to Federal tax benefits) relating to public infrastructure assets, such as sewer systems or subway systems, to taxable parties, and simultaneously leased the assets back. Under the complex arrangements between the parties, the original transfer did not result in any meaningful change in the use or management of those systems, or in the benefits and burdens of ownership of the assets; instead the public entity continued to manage the infrastructure, and bear all the attendant economic risks of doing so, through its lease back of the

facility.¹⁵ Moreover, the private party, as nominal owner and lessor of the infrastructure assets, did not take significant credit risk with respect to the public agency's rental payments, all of which were essentially prefunded. Finally, the arrangements contained complex exit provisions that made it very likely that the public entity would reacquire the infrastructure assets at the end of its lease term, thereby assuring that the public entity's economic ownership of the facility essentially would remain unbroken.

Public-private partnership brownfield arrangements of the sort considered here, by contrast, generally appear in fact to transfer beneficial ownership of the infrastructure assets to the private party. In contrast to the LILO/SILO case, there is no lease back of the assets from the private firm to the original public owner. The private firm takes on the operation of the assets, the obligation to maintain and improve the assets, and the associated economic risks and rewards, for the economic life of the assets. The original public owner receives a large upfront payment that, unlike the LILO/SILO case, is available to the original public owner to use for any purpose; that is, the sales price is not in turn used to "defease" any continuing financial obligations to the private party, because there are none. The original public owner therefore has no continuing economic interest in the property over its expected economic life, or at most a modest interest in the form of revenue sharing payments.

While brownfield public-private partnerships of the sort considered here do not raise the deeply troubling tax policy issues exemplified by LILO and SILO deals, it must be remembered that a "public-private partnership" is an amorphous concept, and future transactions, whether in the brownfield arena or elsewhere, conceivably could be structured in more problematic ways. Congress has amended the Code (in section 470) to deal systematically with this issue; future transactions should be monitored to assure that section 470 is operating to reach those transactions that troubled Congress.

A tax-favored investment?

Assuming that the arrangement is a bona fide commercial transaction, the second relevant question is whether the tax consequences to the private party are comparable to the tax results achieved in other economically comparable transactions that take place wholly within the private sphere. That is, is the tax law neutral across comparable investments, thereby avoiding tax-induced economic distortions?

Non-tax public policy considerations may affect the answer to this question. Congress regularly relies on tax expenditures¹⁶ to subsidize certain economic activities but not others, in furtherance of non-tax policy goals. Whether in this instance the tax law should favor, disfavor, or remain neutral with respect to public-private partnerships therefore may depend in significant part on the resolution of Federal transportation policy issues and the extent to which Federal

¹⁵ See IRS Notice 2005-13, 2005-1 C.B. 630, for a description of a SILO transaction and Rev. Rul. 2002-69, 2002-2 C.B. 760, for a description of a LILO transaction. Both of these transactions have been identified by the Internal Revenue Service as listed transactions.

¹⁶ For a general discussion of tax expenditures, see Joint Committee on Taxation, *A Reconsideration of Tax Expenditure Analysis* (JCX-37-08), May 12, 2008.

subsidies delivered through the tax system are considered an appropriate instrument of those transportation policies. Purely as a matter of economics and tax policy, however, considerations of economic efficiency and consistency would dictate that the tax law should be neutral as between making this type of investment or another type of investment.

It is surprisingly difficult to analyze whether brownfield public-private partnerships are treated neutrally as a matter of income tax economics, for the simple reason that they are very capital-intensive transactions, and the tax rules for the recovery of investments in *all* forms of real (i.e., non-financial) assets are non-neutral. That is, our depreciation system in particular can be argued to grant Federal subsidies for investing in property, plant and equipment, in the form of accelerated depreciation deductions.¹⁷ The practical question here, therefore, is not whether a private investor in a brownfield public-private partnership receives a Federal tax subsidy, when compared to an ideal income tax (the answer may well be yes, it does), but rather whether those subsidies are in some manner disproportionate to those available in transactions wholly within the private sphere.

To shed any light on that issue, we need to address three sub-questions in particular:

- (1) How is the lump sum paid by the private firm at inception allocated among the different property rights it receives?
- (2) How are these allocated amounts recovered for tax purposes (i.e., what are the depreciation/amortization rules applicable to them)?
- (3) What tax-favored financing opportunities are available to the private investor in such transactions?

With these questions in mind, I will now turn to the Federal income tax treatment of public-private partnership arrangements under present law. State governments are generally not subject to Federal income tax, so I will principally focus on the tax consequences to the private party lessee upon entering into these arrangements. The next three sections address in turn the three questions set out immediately above.

Allocation of up-front payment

It follows from the above description of the overall tax analysis that 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).

¹⁷ By the same token, an ideal income tax would consider the effect of inflation on the value of capital investments. Whether accelerated depreciation roughly compensates for the failure of the income tax to address the effects of inflation is a topic beyond the scope of this testimony.

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 are clear that the parties must allocate purchase price in accordance with the relative fair market value of the assets acquired.¹⁸ The parties to the two large transactions used here as templates allocated a substantial part, and perhaps the bulk, of the consideration paid to the third category above (intangible assets). Whether this allocation was correct is the type of issue that the Internal Revenue Service confronts all the time in the examination of large business acquisitions, and is entirely fact-driven.

It might fairly be observed that the public participant in these sorts of transactions is tax-indifferent (because it is not a taxpayer), but eager to maximize the value of the transaction to the private sector firm (and thereby to itself as well). There thus is unlikely to be a true adversarial negotiation of the allocation of the purchase price. The same observation can be made, however, of many transactions that are entirely within the private sphere, either because the seller is tax-indifferent in this context (e.g., it is a foreign entity, or has large net operating loss carryovers), or because it is a domestic corporation, for which ordinary income and net capital gain are taxed at the same rates.

Recovery of investment (depreciation and amortization)

Depreciation of tangible infrastructure assets

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. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system (“MACRS”). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The MACRS depreciation categories generally are set out in the Internal Revenue Code, and are amplified by Internal Revenue Service guidance.¹⁹

The MACRS recovery periods applicable to most tangible personal property range from three to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the taxpayer’s depreciation deduction would be maximized. Nonresidential real property and residential rental property are assigned lives of 39 years and 27.5 years, respectively, using the straight line method.

¹⁸ Section 1060 sets out detailed rules for the allocation of consideration in certain asset acquisitions.

¹⁹ Sec. 168. Rev. Proc. 87-56, 1987-2 C.B. 674.

The most significant tangible infrastructure assets acquired by the private party in a public-private partnership are the highway and any related bridges.²⁰ As “land improvements,” these assets are generally 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 its value is not recovered through depreciation at all.²¹

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 are generally 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.

It might be argued that 15-year accelerated depreciation is not the appropriate depreciation schedule for highways or bridges, and Congress could choose to change that recovery period. (The Internal Revenue Service does not have the authority to set MACRS recovery periods.²²) The MACRS depreciation schedules have their roots in a previous statutory depreciation classification scheme, which in turn was based on economic analyses performed some 40 years ago. It is not always obvious that the MACRS schedules are internally consistent (that is, that they accelerate the depreciable lives of different categories of depreciable assets proportionately to their economic lives). Thus, to take some arbitrary examples, railroad beds are depreciated over 50 years (straight line), and rail track are depreciated using MACRS accelerated depreciation over seven years, while highway roadbeds are not depreciable at all, and the highways themselves are depreciated over 15 years. Commercial airplanes are depreciated under MACRS over seven years. In the absence of quantitative research into the actual useful lives of these (and hundreds of other) asset classes, it is not possible to state as a matter of abstract tax policy whether the MACRS classification of highway assets and other land improvements is appropriate.

To the extent any of these assets were originally constructed or acquired with proceeds of tax-exempt bonds,²³ depreciation is calculated under the alternative depreciation system (“ADS”) using the straight line method generally over longer recovery periods.²⁴ For example, land

²⁰ In addition to acquired tangible assets, the private party will incur capital improvement costs throughout the lease term. The cost of newly constructed assets will also be recovered through depreciation deductions.

²¹ Rev. Rul. 88-99, 1988-2 CB 3. In a public-private partnership transaction, the roadbed is likely included as part of the right-of-way lease of the underlying land.

²² Most MACRS recovery periods originally were established through IRS administrative guidance (Rev. Proc. 87-56, 1987-2 C.B. 674). In November 1988, however, Congress revoked the Secretary’s authority to modify the class lives of depreciable property as part of the Technical and Miscellaneous Revenue Act of 1988. Pub. L. No. 100-647, sec. 6253 (1988).

²³ See discussion of tax-exempt bond financing later in this testimony.

²⁴ Secs. 168(g)(1)(C) and 168(g)(5).

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.²⁵ Furthermore, any subsequent owners who acquire the property while the tax-exempt bonds are outstanding are also subject to the alternative depreciation system.²⁶ These present-law rules tend to prevent taxpayers from arbitraging their tax benefits with tax-subsidized financing.

Amortization of intangible assets

As previously noted, significant value generally is assigned in public-private partnership arrangements to the intangible franchise right; that is, 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 driver of the transaction.²⁷

Under section 197 of the Code, when a taxpayer acquires an operating business, any value properly attributable to a franchise right is amortizable on a straight-line basis over 15 years.²⁸ Additionally, any value attributable to licenses, permits, and other rights granted by governmental units is subject to 15-year amortization, even if the right is granted for an indefinite period or is reasonably expected to be renewed indefinitely.²⁹ Goodwill and going concern value similarly are amortized on the same schedule. However, interests in land, including leases, easements, grazing rights, and mineral rights granted by a government, may not

²⁵ Treas. Reg. sec. 1.168(i)-4(d)(2)(ii)(B).

²⁶ 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.

²⁷ There also may be some value in a license by the government for the right of the private party to use the name of the highway.

²⁸ Secs. 197(d)(1)(F) and 197(f)(4). A franchise is defined "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).

²⁹ 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 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).

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.³⁰

Section 197's 15-year straight-line amortization period applies to a broad class of intangible assets, without regard to whether a different useful life might be determinable.³¹ Prior to the enactment of section 197 in 1993, there was a tremendous amount of controversy between the Internal Revenue Service and taxpayers relating to the assignment of value to intangibles acquired as part of a trade or business.³² Most of the controversy involved the valuation assigned to goodwill, which could not be amortized under prior law. Other disputes in this area addressed the difficulty in ascertaining the lives of intangible assets, including licenses and franchises granted by governmental agencies, and the allocation of consideration to intangible assets with no ascertainable useful life (and thus no amortization).

The 15-year amortization period specified in section 197 is not intended to reflect the actual useful life of any particular intangible asset for which that period is prescribed. Some of those intangibles might have a much longer useful life, others much shorter. The same amortization period is required for all because of concern that taxpayers buying a business that includes numerous intangible assets, all of which together contribute to the success and value of a business, could seek to allocate a disproportionate amount of the value of the ongoing business to shorter-lived intangible assets. The rules of section 197 are designed to minimize the extent to which the Internal Revenue Service must devote resources to review these allocations, given the history of disputes in the area.

Some might argue that 15-year amortization of the franchise is too generous in the context of a toll road, where questions might arise over the appropriate amount to be allocated to the franchise as opposed to the land and easement right-of-way. However, the arrangements may be viewed as no different than many other situations where a government grants a license or right to operate a franchise that might be expected to continue indefinitely (even though such rights might or might not also involve a grant of an interest in land). Moreover, even a monopoly right to collect tolls on a road, with contractual protection against any party being granted a right to build any competing road, might arguably lose value over an unpredictable period of time if economic conditions change (for example, if fewer customers use the road or the economy cannot support high tolls).

³⁰ Sec. 197(e)(2). 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. Res. Sec. 1.197-2(c)(3).

³¹ Pub. L. No. 103-66, sec. 13261(a) (1993).

³² The GAO estimated in 1989 that the IRS had 1,509 open issues relating to intangible asset amortization deductions with total proposed adjustments of \$8 billion. See GAO, *Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets*, GGD-91-88 (Washington, DC: August 1991).

It is the case, however, that section 197's 15-year amortization period was itself somewhat arbitrary (or alternatively, a blend of many different economic useful lives from a wide range of types of intangible assets). As such, Congress could decide to impose a different rule for long-term franchises of toll roads, or of public infrastructure assets generally, without doing any violence to the internal logic of the Code. On the other hand, if consideration were given to lengthening the amortization period for intangible assets associated with toll road infrastructure projects, any such proposal would have to be assessed in relation to its potential for complexity, increased disputes between taxpayers and the IRS, and its ultimate effectiveness, in light of the history of section 197 and the potential for a "next generation" of transactions designed to avoid the new rule.³³

The franchise element of public-private partnerships is similar to other common franchises (e.g., fast-food restaurants, convenience stores, and hotels) in many ways, and the tax treatment of the investment is the same. The rights and restrictions on operating practices, such as the amount of permitted toll increases and required capital improvements, have similarities to the franchisor-franchisee relationship in other franchise settings. One of the main differences between some of the publicly described toll road arrangements and some traditional business format franchises is that the latter typically requires payment of an ongoing royalty, usually based on sales, whereas the toll road agreements may provide for only an up-front lump-sum payment.

Some toll road transactions have been reported to include revenue sharing provisions not unlike the royalty payments of the 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.³⁴ 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.³⁵ 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.³⁶

³³ For example, if a life longer than 15 years, such as the life of the contract, were required to be used for the intangible rights associated with toll road infrastructure projects, then taxpayers might create contracts of a shorter duration that nevertheless are regularly renewed. As another example, if a specified longer life were designated for toll road franchises, taxpayers might attempt to add business rights in addition to the toll road rights under the contracts, and attempt to allocate greater value to those rights with a shorter life.

³⁴ GAO, *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), 44.

³⁵ Sec. 1253(d)(1).

³⁶ Treas. Reg. sec. 1.197-2(f)(2).

Recovery of investment in lease of land

The amount of any up-front consideration allocated to the lease of land is generally deductible to the lessee for tax purposes over the term of the lease under the complex regime of 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.³⁷

In most cases, the lease deductions are the least desirable from a present value perspective, because of their longer recovery period (i.e., the term of the lease). For this reason, the Internal Revenue Service can be expected to review carefully the allocation of value as between the less tax-favored assets (the land and possibly the tangible assets, such as highways and bridges) and the more tax-favored assets (the intangible assets, such as the franchise).

Financing the acquisition

The private sector participant in a brownfield public-private partnership arrangement can be expected to obtain debt financing to fund a significant part (perhaps 60 percent) of the large up-front payment common to these transactions, and to fund the remainder with equity.³⁸ To the extent that the private firm issues genuine indebtedness, a tax deduction generally is permitted for interest paid or accrued during the taxable year.³⁹ The Code contains several limitations, both timing and permanent in nature, that could affect the taxpayer's ability to claim interest deductions. For example, to the extent interest costs are allocable to capital improvements, capitalization may be required as part of the cost of the improvements and recovered through depreciation deductions.⁴⁰ Additionally, interest expense may be disallowed under "interest stripping" provisions if the borrowing is from foreign related parties or if there is a disqualified guarantee under a financing arrangement.⁴¹ The facts and circumstances of the arrangement determine the proper tax treatment of interest on indebtedness.

All of these rules apply with equal force to financing an acquisition that takes place wholly within the private sphere. Brownfield public-private highway partnerships add the additional possibility of using tax-exempt financing for some or all of the debt that the private firm must issue to fund the up-front payment.

³⁷ Sec. 467(a).

³⁸ For this reason, the private participant itself often is a partnership that can raise equity capital from a number of institutional investors.

³⁹ Sec. 163(a).

⁴⁰ Sec. 263A(f).

⁴¹ Sec. 163(j).

Tax-exempt financing: Overview

Tax-exempt bond financing has historically been used by State and local governments to raise funds for infrastructure projects. The remainder of my testimony describes the present law treatment of these instruments.⁴²

Interest paid on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes. Because of this 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 income exclusion for interest paid on 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 debt to fund infrastructure

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, and airports. These debt instruments in turn can be secured by the infrastructure assets, or can be “general obligation” debt of the issuer.

One tax policy consideration that follows from the availability of tax-exempt financing to governmental owners of infrastructure is that, when attempting to quantify the cost to the Federal government of the Federal tax subsidies available to public-private partnerships, a complete analysis would also take into account, on the other side of the ledger, the Federal tax subsidy (the exemption from income tax) available to wholly public infrastructure projects, to the extent they are funded with tax-exempt debt.

⁴² A description of tax-exempt bonds for transportation projects generally can be found in Joint Committee on Taxation, *Overview of Selected Tax Provisions Relating to the Financing of Surface Transportation Infrastructure*, (JCX-56-08), July 8, 2008.

While the types of projects eligible for governmental bond financing are not circumscribed, present law does impose 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. Where bond proceeds are used to finance property, the use of such property is treated as a use of the bond proceeds. 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.

As applied to the archetypal transactions under consideration here, a fundamental consequence of the transfer of the highway infrastructure assets to a private firm is that a purported tax-exempt bond offering used to finance or refinance the acquisition (for example, if the State or local issuer were to lend the proceeds of a governmental debt offering to the private firm and the debt service on the private loan used to service the governmental debt), would be treated as a private activity bond. In the absence of a special qualifying rule, as described below, such an offering therefore would not qualify as a tax-exempt financing.

Private activity 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.”⁴³ Generally, private activity bonds are taxable unless issued as qualified private activity bonds.

Private business test.—Under the private business test, a bond is a private activity bond if it is part of an issue in which:

- a. 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”); and
- b. 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”).⁴⁴

Both parts of the private business test (i.e., the private business use test and the private payment test) must be met for a bond to be classified as a private activity bond. 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.

⁴³ Sec. 141.

⁴⁴ 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 unrelated to any governmental use being financed by the issue.

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 subject to the private business test.

Changes in use.—A bond issue is an issue of private activity bonds if, (1) as of the issue date, the issuer reasonably expects that the issue will meet either the private business tests or the private loan financing test, or, (2) subsequent to the issue date, the issuer takes deliberate action that causes the private business tests or private loan financing test to be met.⁴⁵ A deliberate action affects the taxability of interest from the issuance date, even though it occurs subsequent to issuance. If certain conditions are satisfied, the Treasury regulations allow an issuer to cure a deliberate action by taking a remedial action provided for in the Treasury regulations.⁴⁶ Such remedial actions include redemption or defeasance of bonds, alternative use of disposition proceeds, and alternative use of bond financed facilities.

As an example, assume State A issued governmental bonds to build a public toll road and expects that it will be owned and operated by a governmental authority for the entire period that the bonds are outstanding. Five years later, while the bonds are still outstanding, it sells the toll road to a private company. The change in ownership would be considered a deliberate action that affects the tax-exempt status of the bonds. To prevent the bonds from becoming taxable private activity bonds retroactive to the issuance date, State A could use the proceeds from the sale to retire the bonds within 90 days of the deliberate action, or use such sale proceeds to establish a defeasance escrow within 90 days of the deliberate action to retire the bonds at their earliest call date.⁴⁷

Qualified private activity bonds

Qualified private activity bonds are tax-exempt 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.⁴⁸

⁴⁵ Treas. Reg. sec. 1.141-2(d)(1).

⁴⁶ Treas. Reg. sec. 1.141-12. There are five conditions that are required to be met (1) the reasonable expectations test, (2) the maturity cannot be unreasonably long, (3) the terms of the arrangement that satisfies the private business tests or private loan financing test must be bona fide and arm's length, and the new user pays fair market value for the use of the financed property, (4) disposition proceeds are treated as gross proceeds for arbitrage purposes and (5) the proceeds of the issue that are affected by the deliberate action were expended on a governmental purpose before the date of the deliberate action.

⁴⁷ Treas. Reg. sec. 1.141-12(d).

⁴⁸ Sec. 141(e).

To qualify as an exempt facility bond, 95 percent of the net proceeds must be used to finance an eligible facility.⁴⁹ Generally, qualified private activity bonds are subject to a number of 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 volume cap”).⁵⁰ For calendar year 2008, the State volume cap, which is indexed for inflation, equals \$85 per resident of the State, or \$262.09 million, if greater.

Qualified private activity bonds also are subject to additional limitations on issuance cost and length of maturity. In addition, the interest income from qualified private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986, is a preference item for purposes of calculating the alternative minimum tax.⁵¹

Qualified highway or surface freight transfer facility bonds

In 2005, the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users, added a new category of exempt facility bonds, bonds for qualified highway or surface freight transfer facilities.⁵² Bonds for qualified highway or surface freight transfer facilities are

⁴⁹ Sec. 142(a). 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

⁵⁰ 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 is 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.

⁵¹ 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.

⁵² Pub. L. No. 109-59, sec. 11143 (2005). The Administration's budget for Fiscal Year 2005 (released in February 2004), proposed allowing the Secretary of Transportation to allocate \$15 billion of tax-exempt bond authority to finance highway projects and rail-truck transfer facilities. In describing the proposal, the Department of the Treasury noted that “[e]conomic growth and productivity depend on a modern, well-connected national transportation network. Allowing a limited amount of tax-exempt private activity bonds to be issued for highway projects and surface freight transfer facilities would encourage private sector investment in these projects.” Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2005 Revenue Proposals* (February 2004) at 161. The proposal also was included as part of the Administration’s Fiscal Year 2006 budget proposals. See,

qualified private activity bonds, the interest on which is tax-exempt. A qualified highway facility or surface freight transfer facility is:

- a. 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
- b. 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 cap. 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.⁵³

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.

Qualified highway or surface freight transfer facility bonds may be used as financing for public-private partnership arrangements. However, some commentators have argued that in addition to other limitations, the required use of ADS cost recovery (i.e., straight line depreciation over longer recover periods), as discussed earlier in this testimony, makes these

Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals* (February 2005) at 139.

⁵³ As of July 14, 2008, the Department of Transportation had made the following allocations of the \$15 billion in qualified highway or surface freight transfer facility bond authority:

Project	Allocation
Port of Miami Tunnel, Consortium Miami Access Tunnel	\$980,000,000
Missouri DOT Safe and Sound Bridge Improvement Project	\$700,000,000
Knik Arm Crossing, Alaska	\$600,000,000
Virginia I-495 Capital Beltway HOT Lanes	\$589,000,000
Texas Department of Transportation Interstate Highway 635 (LBJ Freeway)	\$288,000,000
Pennsylvania Turnpike Capital Improvements	\$2,000,000,000
Ambassador Bridge Gateway Project - Phase I (Detroit, Michigan -Windsor, Ontario, Canada)	\$212,600,000
Total approved allocations as of 7/14/08	\$5,369,600,000

Source: Federal Highway Administration

bonds a less attractive financing option, and that a legislative proposal should be considered to allow accelerated depreciation in these cases.⁵⁴

Conclusion

I hope that my testimony provides useful information on the tax policy issues raised by public-private partnerships with respect to the lease of existing highway infrastructure and their present law tax treatment. I am pleased to answer any questions that the Subcommittee may have at this time or in the future.

⁵⁴ Humberto Sanchez, *Roadblocks for P3 PABs; Current Laws Put Curbs on Widespread Use*, Bond Buyer (New York, NY: April 12, 2007). Vol. 360, Iss. 32608, p.1.