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A primer on infrastructure M&A and related US tax considerations

As the requirements for US infrastructure investment continue to grow in the coming years, many investors are considering investing in this space. The following items represent key related tax considerations for those transacting in this space.

Overview

As we discuss below, a number of complex and inter-related US tax considerations arise when considering the tax implications of infrastructure transactions and investments. As the reader will note, many of the relevant US tax determinations turn on various qualitative and quantitative factors that can vary greatly by transaction. Investors should carefully consider these considerations, including how they apply to their transaction, and how the various tax issues and determinations impact each other.

In planning for the transaction, it is important for the parties to consider future reporting of the tax implications of the transaction in meeting their tax compliance and financial reporting obligations. Furthermore, tax positions that may have been carefully contemplated in advance of the transaction need to be diligently monitored over the investment's lifecycle. Thus, well-advised investors—and their advisers—must work together to ensure seamless integration between preinvestment tax planning, postinvestment tax reporting, and ongoing tax planning and consulting.

Infrastructure defined

Infrastructure generally: "Infrastructure" as an asset class represents a broad sector, and investors that are active in this space have different views on what meets the definition of infrastructure. However, it may generally be defined as facilities, structures, equipment, or similar physical assets—and the materials required to support these—that enable people and society to thrive.

Common attributes: Some common attributes of infrastructure investments include:

- High barriers to entry
- Substantial tangible asset(s) and large user base, generating economies of scale
- Inelastic user demand
- Long-term, secure, stable cash flows
- Lower volatility/correlation to financial markets
- Less sensitive to macroeconomic conditions
- Low default rates
- Inflation hedging—value growth in line with economic/demographic change
- Government participation in the investment.

Sectors

The infrastructure asset class may be represented by the following sectors and subsectors:

Transportation:

- Toll roads/lanes
- Bridges/tunnels
- Parking
- Ports
- Airports and aviation
- Rail/transit
- Shipping and logistics

Social infrastructure:

- Correctional facilities
- Educational institutions and student housing
- Hospitals and public health facilities
- Courthouses and civic buildings
- Sports facilities
- Housing
- Municipal utilities (water/sewer/gas/electric)
- Solid waste management

Energy and natural resources:

- Power generation, transmission, storage, and distribution, including renewable energy sources
- Oil and gas extraction, storage, and transportation
- Mining (coal, metals, etc.)
- Timber, including carbon offset credit production
- Water and wastewater

Telecom and digital:

- Telecom infrastructure, including satellite communication
- Data centers and fiber
- Chip and other digital manufacturing

Market participants

The infrastructure asset class may involve the following market participants.

Investors:

- Infrastructure funds
- Sovereign wealth funds
- Pension funds
- Institutional investors
- Corporate investors
- High-net-worth/family offices

Government:

- Public-private partnerships (PPP or P3)
- Seller/lessor of infrastructure assets

Developers/operators:

- Developers/construction companies/civil engineers
- Contractors
- Operators

Financiers/lenders:

- Traditional banks and lending syndicates
- Debt funds
- Corporate investors
- The public, through public bonds

Overview of PPPs

A PPP or P3 is a contractual arrangement between a public agency and a private sector entity structured to meet the need of the parties by optimizing the skills and resources of each party (both public and private), and allocating the risks in the delivery of the service and/or facility to the parties best able to manage them.

In a typical PPP:

- The private partner receives adequate compensation to (i) design, build, operate, and/or maintain the asset, and (ii) establish and service project debt. The public sector typically controls the asset through an operating lease agreement and may receive an up-front concession fee and transfers significant operational risk to the private sector for the lease term.

The commercial terms of these arrangements are structured carefully to manage stakeholders' risk. Therefore, these agreements are unique and give rise to an array of tax characterizations.

Common tax considerations in infrastructure investments

Given the broad nature of the infrastructure asset class and the different tax profiles of its investors and other market participants, a complete exposition of all related tax considerations is beyond the scope of this article. However, below are some US federal income tax (USFIT) issues that commonly arise in infrastructure transactions and investments.

Tax ownership

Tax ownership: Determining which party to a transaction is considered the owner of related assets for USFIT purposes is key to properly understanding and modeling the overall tax profile and implications of a transaction. For example, the tax owner of property is entitled to the tax benefits therefrom, including tax depreciation, amortization, and depletion, as well as eligibility to claim certain tax credits. Conversely, in the event that tax ownership of the assets does not transfer, investors should carefully consider the tax form of the transaction to ensure appropriate tax treatment (i.e., lease, prepaid rent, or other intangible assets).

Under USFIT standards, in general, the courts and the IRS look to the economic substance of the transaction (as opposed to its form) in determining ownership for tax purposes. A common legal form for infrastructure transactions may involve leases or concessions that provide the lessor or concessionaire access to certain property for a period of time (these are common in PPP transactions and many telecom/digital infrastructure transactions). In such a transaction, the lessor/concessionaire is generally considered the tax owner if it retains significant economic benefits and burdens of ownership even though the legal ownership of the assets may be retained by another party in the transaction (e.g., a governmental authority).

Some of the relevant criteria considered in the determination of tax ownership are as follows:

- Whether legal title passes
- The intention of the parties
- The expected residual value of the leased property at the end of the lease term (significant residual value indicates a lease, while a lease term for the full economic value indicates a transfer of ownership)
- Profit from operations (ability of the concessionaire to earn "entrepreneurial" profits from third parties indicates tax ownership of the underlying assets)
- Which party bears risk of loss or damage to the property
- The presence/absence of a bargain purchase option

Cost recovery

Tax depreciation: While tax depreciation is a common consideration in many investments and M&A transactions, investments in the infrastructure space include some unique considerations, including:

- Qualified private activity bonds (PABs) financing – If assets are acquired through the use of PABs, they are required to be depreciated using the Alternative Depreciation System (ADS) to the extent of such financing. ADS depreciation is straight-line over relatively longer recovery periods, as compared to MACRS which is accelerated over relatively shorter recovery periods (and may be eligible for bonus deprecation).
- Tax-exempt property – ADS must also be used for assets that are owned by certain tax-exempt entities, including partnership assets to the extent of tax-exempt partners which often invest, indirectly, via infrastructure funds.
- The potential application of Section 470, which could limit deductions—including depreciation—related to tax-exempt property, to the extent of income from the property.

Tax amortization: Acquired intangible assets are typically amortized straight-line over 15 years, irrespective of the economic useful life of the intangible asset. For example, a Section 197 intangible may include the right to collect fees or tolls granted by a governmental authority, with this intangible asset amortized over 15 years, without regard to the term of the agreement. Alternatively, where a taxpayer bears the up-front cost of a tangible property asset, but is not the tax owner, and the transaction is not treated as a lease, the cost may be amortizable as an intangible using the economic life or a 25-year safe harbor.

Tax depletion: The owner of an economic interest in mineral property or timber is entitled to a depletion deduction. In the case of leased property, the depletion deduction is divided between the lessor and the lessee. Tax depletion may be recovered through "cost depletion" (generally a recovery of the property's tax basis) or "percentage depletion" (based on a statutory percentage of related gross revenue).

Prepaid rent: In general, Section 467 requires the accrual of rents and the recognition of interest income and expenses under certain true leases of tangible property that provide for deferred or prepaid rents or increasing or decreasing rents over the lease term, and if the aggregate of the rents under the lease is at least $250,000. In certain circumstances, the taxpayer's upfront costs may be viewed as if such amounts were incurred as prepaid rent payments for the right to use the leased property in the future and the associated revenue streams thereof. Consideration should be given if the arrangement, or a portion thereof, could be viewed as prepaid rent which could impact the timing of tax deductions related to the amount treated as prepaid rent.

Long-term contracts: On "greenfield" projects in which a taxpayer does not hold tax ownership (e.g., design, build, finance, operate, and maintain (DBFOM) projects), certain income and expenses from the arrangement can be subject to long-term contract accounting method rules under Section 460. Generally, under Section 460, income generated from long-term contracts must be reported under the percentage-of-completion method. This method recognizes profit on a long-term construction contract in proportion to the costs incurred and the income earned over the construction period. In general, the amount of income reported under the percentage-of-completion method is determined by multiplying the total contract income by the contract costs (inclusive of any special purpose vehicle (SPV) costs and applicable markup) incurred during the tax year over the estimated total contract costs. The costs associated with the construction are deducted in the year incurred.

Upon completion of construction, the asset is generally handed over to the governmental authority and the taxpayer is then compensated to operate and maintain the asset (e.g., through availability payments, operation and maintenance fees, demand risk revenue). In situations in which there is not a direct or contingent cash payment for the construction, the contract income may be received in the form of a concession right, and the amount of contract revenue reported gives rise to basis in the intangible concession right. There can be differing views among tax advisors regarding whether such amounts are able to be recovered over a 15-year period (as a Section 197 intangible asset) or must be ratably amortized over the concession period (among other methods). In cases in which the concessionaire is guaranteed to receive a minimum amount of concession revenue irrespective of future services, a portion of the costs may instead be considered a loan.

Lease versus service contract

The application of Section 7701(e) should be considered in determining whether an applicable agreement is characterized as a lease rather than a service contract. If the contract is characterized as a lease, the taxpayer is required to depreciate the assets over a period that equals at least 125 percent of the maximum lease term, inclusive of extensions, using the straight-line method. The following six factors are nonexclusive and demonstrate lease treatment:

- The service recipient is in physical control of the property.
- The service recipient controls the property.
- The service recipient has a significant economic or possessory interest in the property.
- The service provider does not bear any risk of substantially diminished receipts or substantially increase expenditures if there is nonperformance under the contract.
- The services provider does not use the property concurrently to provide significant services to entities unrelated to the recipient.
- The total contract price does not substantially exceed the rental value of the property under for the contract period.

Government funding

Increasingly, infrastructure projects rely in part on some form of federal, state, or local government funding, which may take the form of grants or expense reimbursement (e.g., milestone payments). Careful consideration should be given to the tax character and timing recognition of such funding, including under Sections 118 and 460. In some cases, the government funding may result in an income recognition without an immediate offsetting deduction, while in other cases taxpayers may be able to offset the funding with related construction costs or other expenses. Additionally, investors should consider the level of participation by the government in the arrangement and intent of the parties to ensure the arrangement does not create a partnership between the government and the investors for USFIT purposes.

FIRPTA

FIRPTA generally: Broadly, the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) rules treat gains on disposal of a United States Real Property Interest (USRPI) as Effectively Connected Income (ECI) for a nonresident individual or foreign corporation. A USRPI generally includes a direct interest in real property located in the US or Virgin Islands and an interest in a corporation that is or was a US real property holding corporation (USRPHC) during the relevant look-back period. A direct interest in real property is defined as an interest other than solely as a creditor in (i) land and unsevered natural products of the land; (ii) improvements on land (e.g., buildings, inherently permanent structures, and structural components); and (iii) certain personal property associated with the use of real property (e.g., property used in mining, farming, improving real property, operating a building, etc.). Certain Section 197 intangible assets may also be considered USRPIs depending on the nature of the intangible asset and whether its value is economically derived from an underlying USRPI.

Many infrastructure investments involve some exposure to USRPIs, and a careful analysis of the specific facts and circumstances is required to determine if a given investment is a USRPI.

Given that non-US pension funds frequently invest in infrastructure assets, the potential for these investors to avail themselves to the exception from FIRPTA for qualified foreign pension funds (QFPFs) should be fully considered. Furthermore, certain institutional investors such as sovereign wealth funds and foreign pension funds may qualify under Section 892 for an exemption to FIRPTA for investments in (or held through) U.S. corporations."

Section 163(j) interest limitations and exceptions

Section 163(j) generally: Generally, the business interest expense deduction allowed for a tax year is limited to the sum of business interest income and 30 percent of the adjustable taxable income (which is approximately equal to earnings before interest and taxes (EBIT) for tax years 2022 and later under current law). If the Section 163(j) limitation applies, generally the amount of any business interest expense that is not allowed as a deduction under Section 163(j) for the tax year is carried forward to the following year as a disallowed business interest expense carryforward. Two exceptions to Section 163(j) that often arise in infrastructure investments are discussed below.

The regulated utility exception: The Section 163(j) limitation does not apply to interest expense incurred in connection with the trade or business of furnishing or sale of electrical energy, water, or sewage disposal services, gas or steam through a local distribution system or the transportation of gas or steam by pipeline, if the rates for such furnishing or sale have been established or approved by a state or political subdivision thereof, by any agency, or instrumentality of the United States, by a public service or public utility commission, or other similar body of any state or political subdivision thereof, or by the governing ratemaking body of an electric cooperative.

The real property trade or business (RPToB) exception generally: This exception exempts any interest incurred by an "electing real property trade or business"—meaning "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business" that elects to avail itself of the RPToB exception. Businesses making the RPToB election cannot benefit from the temporary full expensing ("bonus depreciation") and will need to utilize the ADS method for certain assets (generally nonresidential real property, residential rental property, and qualified improvement property).

RPToB infrastructure safe harbor: Revenue Procedure 2018-59 provides a safe harbor that allows taxpayers to treat certain infrastructure trades or businesses as real RPToBs for purposes of qualifying as an electing RPToB. The revenue procedure applies to a taxpayer with a trade or business that fits within the revenue procedure's definitional framework:

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

"Qualified infrastructure property" means infrastructure property if it is either (i) owned by a government; or is owned by a private trade or business that operates under an arrangement in which rates charged for the use of services provided by the infrastructure property are subject to regulatory or contractual control by a government, or government approval; and the infrastructure property is, or will be available for use by the general public or the services provided by the infrastructure property are made available to members of the general public. "Infrastructure property" includes specifically listed types of infrastructure assets, including:

- Airports
- Docks and wharves
- Maritime and inland waterways and ports
- Mass commuting facilities
- Facilities for the furnishing of water
- Sewage facilities
- Solid waste disposal facilities
- Facilities for the local furnishing of electrical energy or gas
- Local district heating or cooling facilities
- Qualified hazardous waste facilities
- High-speed intercity rail facilities
- Hydroelectric generating facilities
- Qualified public educational facilities
- Flood control and stormwater facilities
- Surface transportation facilities
- Rural broadband service facilities
- Environmental remediation costs on Brownfield and Superfund sites

While this revenue procedure provided welcome guidance, it does not explicitly address a number of businesses commonly considered as infrastructure, and applying the revenue procedure to a given investment may require significant analysis.

REIT considerations

Many infrastructure assets could potentially be "REITable"—that is to say, they are of a nature that would allow for them to be held by a real estate investment trust (REIT). Some infrastructure assets that may not have traditionally been thought of as real estate that have been considered qualifying REIT assets may include data centers, cell towers, correctional facilities, and timber assets. The potential for infrastructure assets to be held by REITs can impact transactions in several ways, including: (i) M&A targets for infrastructure investors may include REITs (public or private), (ii) infrastructure investors may consider holding such assets in a REIT structure, and (iii) infrastructure investors may consider exiting/monetizing their investments through a REIT structure. A REIT is afforded an attractive tax benefit as a corporation that is generally not subject to US corporate income tax. However, the cost of that benefit includes strict rules addressing the nature of assets owned, gross income generated, cash flow distribution, and other organizational requirements.

Regulated utilities—tax in ratemaking

Investments in regulated utilities involve unique tax considerations, including:

- Tax in ratemaking—considering whether the "regulatory books" for purposes of making the utility's rate case reflect the proper taxes
- Tax normalization requirements—considering whether the utility meets the normalization requirements of Section 168(i)(10).

Tax credits

Investments in infrastructure assets may qualify for a number of USFIT credits, including pursuant to the Inflation Reduction Act of 2022 (IRA). In some cases, these credits may be refundable or transferrable. The impact of these credits should be properly modeled and considered when analyzing the tax implications of an infrastructure investment.

CAMT

The IRA introduced a 15 percent corporate alternative minimum tax (CAMT), which under this new regime's aggregation rules may impact many large investors that are not traditionally thought of as "corporate" taxpayers. This should be considered when analyzing and modeling the tax impact of a potential infrastructure investment.

Tax profiles of investors

Given the various types of investors that invest in infrastructure assets, understanding the unique tax profile of each investor is critical to understanding the tax implications to the investment and their investors. Some examples include:

- Section 892 investors (e.g., sovereign wealth funds and some foreign pension funds), USFIT controlled commercial activity rules and local-country restrictions on taking controlling stakes in assets
- QFPF investors
- Tax-exempt investors
- Large, CAMT-sensitive investors

Infrastructure—tax work streams

The following is a list of some common tax work streams in infrastructure transactions:

- Tax due diligence assistance
- Tax analysis of the relevant legal agreements, including concessions agreements, leases, purchase agreements, etc.
- Structuring assistance related to the transaction and its funding and tax planning for upstream investors and investment vehicles
- Consideration of tax ownership related to the transaction
- Reviewing and commenting on the tax calculation and assumptions in the transaction model, including:
  - Character and timing of revenue and expense recognition
  - Tracking and utilization of tax attributes, including net operating losses and investment and production tax credits
  - Applicable tax depreciation and amortization
  - Treatment of interest expense, including under Section 163(j) and applicable exceptions
  - Applicability of state and local taxes, and related incentives and abatements
  - FIRPTA considerations and analysis during hold period and upon future exit.
- Valuation assistance, including related to FIRPTA, purchase price allocations, and cost segregation studies
- Transfer pricing assistance related to related-party transactions, including loans (debt capacity and interest rate benchmarking)
- Tax treaty consideration and qualification and QFPF certification
- Assistance with employee and management compensation arrangements
- Tax reporting for project companies and upstream structures.

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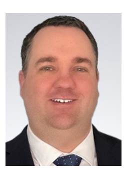

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