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Client Alert

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Tax Department

IRS Considers Regulations to Address Whether Certain Infrastructure Assets are "Interests In Real Property"

"The IRS is of the view that in some transactions the governmental permit acquired to operate an infrastructure project is a United States real property interest for purposes of Section 897 of the Code."

The IRS has stated, in an advance notice of proposed rules issued on October 30, 2008, that it is considering issuing proposed regulations to address whether certain rights granted by a governmental unit that are related to the lease, ownership or use of toll roads, toll bridges and other infrastructure assets are "interests in real property" under Section 897(c) of the Internal Revenue Code (the "Code").

Background

Under Section 897 of the Code, gain from the disposition of a "United States real property interest" is treated as income that is effectively connected with a US trade or business and non-resident aliens and foreign corporations are required to pay US federal income tax on such income. A "United States real property interest" includes (i) an interest in real property located in the United States[1] and (ii) an interest in a domestic corporation that is or has been a US real property holding corporation (a "USRPHC") within the shorter of (a) the period during which the taxpayer held such interest or (b) the five year period ending on the date of the disposition of such interest.

A USRPHC is generally defined as a corporation the fair market value of whose United States real property interests equals or exceeds 50 percent of the sum of the fair market value of (i) its worldwide interests in real property (including its interest in United States real property interests) and (ii) any other of its assets which are used or held for use in a trade or business. Assets used or held for use in a trade or business include certain intangible property such as goodwill, going concern value, franchises, licenses and similar intangibles.

For purposes of determining whether a corporation is a USRPHC, a corporation that is a partner in a partnership is generally treated as owning its proportionate share of the assets owned by the partnership. In addition, any assets that a corporate partner is so treated as owning that are used or held for use in the partnership's trade or business are treated as so used or held by the corporate partner.

A Typical Infrastructure Transaction

In a typical infrastructure transaction, a domestic partnership leases or purchases from an unrelated third party infrastructure assets within the United States and land underlying the infrastructure assets (such assets are referred to as "specified infrastructure assets"). A typical infrastructure transaction includes a toll road or toll bridge. Often as a condition to operating the specified infrastructure assets and to collecting tolls, the domestic partnership is required to obtain a governmental license, permit, franchise or other similar right (a "governmental permit"). The domestic partnership may also own or acquire property that is used in the trade or business of operating the specified infrastructure assets, such as signs, snow plows and electronic sensors.

In many cases, domestic partnerships that own infrastructure projects have partners that include domestic corporations and the domestic corporations have foreign shareholders. Foreign persons often hold their interests in partnerships that own US infrastructure projects through corporations to avoid being engaged in the US business that is conducted by the partnership. If the foreign person owned a direct interest in such a partnership, the foreign person would be required to file a US income tax return and pay US income tax on its share of the income generated by the underlying partnership. Although the domestic corporation is required to pay tax on its share of the income generated by the partnership (so the tax on such income is not avoided), the foreign person is not required to file a US income tax return. In addition, if the interest in the domestic corporation is not a USRPHC, the foreign person can generally dispose of stock in the domestic corporation without incurring US federal income tax on the sale of such stock.

Reasons for Issuing Proposed Regulations

The IRS is aware that taxpayers may be taking the position that the governmental permit that is acquired in an infrastructure transaction is not a United States real property interest under Section 897 of the Code. Instead, taxpayers may be taking the position that the governmental permit is an intangible asset used or held for use in a trade or business and a significant portion of the fair market value of the domestic partnership's assets is allocable to the governmental permit rather than the specified infrastructure assets.

Accounting for the partnership's assets in this manner reduces the likelihood that a domestic corporation that is a partner in a partnership that owns such assets is a USRPHC. As explained above, if the domestic corporation is not a USRPHC then foreign shareholders of such corporation can generally dispose of the stock of such corporation without incurring US federal income tax. This is not the case if the domestic corporation is a USPRHC.

The IRS is of the view that in some transactions the governmental permit acquired to operate an infrastructure project is a United States real property interest for purposes of Section 897 of the Code. Accordingly, the IRS is considering issuing proposed regulations to address whether certain licenses, permits, franchises or other similar rights granted by a governmental unit that are related to the use or ownership of toll roads, toll bridges and other similar assets are "interests in real property" under Section 897(c) of the Code. The proposed regulations would also address how the fair market value of such licenses, permits, franchises or other similar rights should be taken into account when determining if a corporation is a USRPHC.

Requests for Comments; Effective Date

The scope of the proposed regulations could be modified. In particular, the IRS has asked for comments on a number of issues, including:

- The scope of the regulatory project, the types of licenses, permits, franchises or other similar rights granted by a governmental unit with respect to infrastructure assets that might be treated as related to the value of the lease, ownership or use of an interest in real property and what characteristics should be taken into account in making that determination; and
- Whether the regulatory project should address the allocation of the consideration paid for the lease or purchase of specified infrastructure assets and the license, permit, franchise or other similar right to operate such specified infrastructure assets for purposes of determining the fair market value of such property.

It's anticipated that proposed regulations would apply for transactions occurring on or after the date that such regulations are finalized. Because, however, the applicable transaction is the disposition of an interest in a USRPHC, final regulations are likely to apply to the sale of stock of a domestic corporations that occurs after final regulations are issued even if the domestic corporation owned an interest in the underlying partnership prior to such date.

Endnote

[1] Real property includes land, improvements and personal property associated with the use of real property. Improvements are defined to include inherently permanent structures and the applicable Treasury Regulations provide that pavement and bridges are examples of inherently permanent structures. An interest in real property includes fee ownership, co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon and options to acquire leaseholds of land or improvements thereon.

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