Infrastructure/Leasing Tax Update

September 26, 2017
Non-Reliance Disclosure

Any U.S. tax advice contained herein was not intended or written to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions.
Agenda

► Political and regulatory update
► Leasing Industry overview
► PPP Industry overview
► PPP Concessionaire project-level US Federal Income Tax considerations
Leasing Industry overview
New leases standard
Overview

► Under ASC 842, Leases, lessees recognize assets and liabilities for most leases but recognize expenses in a manner similar to today’s accounting
► For lessors, the new guidance modifies the lease classification criteria and the accounting for sales-type and direct financing leases
► The new guidance eliminates today’s real estate-specific provisions for all entities
► All entities classify leases to determine how to recognize lease-related revenue and expense
  ► Classification continues to affect what lessors record on the balance sheet
► Effective date
  ► Public business entities (PBEs) and certain not-for-profit entities and employee benefit plans – annual periods beginning after 15 December 2018, and interim periods within those years
  ► All other entities – annual periods beginning after 15 December 2019, and interim periods the following year
  ► Early adoption permitted for all entities
The new guidance could have broad implications for entities’ finances and operations.

Entities should plan to explain the effects of adopting the new leases standard to stakeholders, including making disclosures discussed in the US Securities and Exchange Commission Staff Accounting Bulletin Topic 11.M.

Implementing the standard could require an entity to develop new processes and controls or adjust existing ones to identify and account for leases.

The IASB issued a similar standard, but there are significant differences (e.g., lessees don’t classify leases under IFRS and can elect to account for leases of low-value assets under a model similar to today’s operating leases).
New leases standard
Lease classification – lessees

At lease commencement, lessees classify a lease as a finance lease if the lease meets any of the following criteria:

► The lease transfers ownership of the underlying asset to the lessee by the end of the lease term
► The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise
► The lease term is for the major part of the remaining economic life of the underlying asset*
► The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset
► The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of lease term

* Not applicable for leases that commence at or near the end of the underlying asset’s economic life.
New leases standard
Lease classification – lessors

Does the lease meet **any** one of the classification criteria?

- Yes → **Sales-type lease***
- No

Does the lease meet **both** of the following criteria?

- The present value of the sum of lease payments and any residual value guaranteed by the lessee and any other third party unrelated to the lessor equals or exceeds substantially all the fair value of the underlying asset
- It is probable that the lessor will collect the lease payments plus any amounts necessary to satisfy a residual value guarantee

- Yes → **Direct financing lease**
- No → **Operating lease**

* ASC 842 does not require lessors to assess the collectibility of lease payments and any residual value guarantee provided by the lessee in the sales-type lease classification test. However, lessors are required to assess the collectibility of lease payments and any residual value guarantee provided by the lessee to determine the recognition and initial measurement of sales-type leases.

▶ Lessors reassess lease classification upon a modification that is not accounted for as a separate contract
Sale and leaseback transactions no longer provide seller-lessees with a source of off-balance sheet financing.

A seller-lessee and a buyer-lessee apply ASC 842 and ASC 606 when determining whether the transfer of an asset should be accounted for as a sale and purchase.

Adjustments for any off-market terms of sale and leaseback transactions are required if the transfer of an asset is a sale.

Based on the difference between (1) the sale price of the asset and its fair value or (2) the present value of the lease payments and the present value of market rental payments, whichever is more readily determinable.

Generally expect more real estate sale and leaseback transactions to be accounted for as sales and leasebacks under ASC 842 than under ASC 840 due to the elimination of the real estate-specific requirements in today’s sale and leaseback accounting guidance.
## New leases standard

### Effective date and transition – effective date

<table>
<thead>
<tr>
<th>Year</th>
<th>SAB Topic 11.M</th>
<th>Effective</th>
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<tbody>
<tr>
<td>2016</td>
<td>Final leases standard and early adoption permitted</td>
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<td>2017</td>
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<td>2019</td>
<td>Prior periods presented</td>
<td>2019</td>
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<td>2020</td>
<td>Modified retrospective application (public entities*)</td>
<td>2020</td>
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<tr>
<td>2021</td>
<td>Modified retrospective application (all other entities)</td>
<td>2021</td>
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</tbody>
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* Public entities includes public business entities and certain not-for-profit entities and employee benefit plans

- Full retrospective adoption is prohibited
- An entity that adopts ASU 2016-02 before it adopts ASU 2014-09, *Revenue from contracts with customers (Topic 606)*, may need to apply certain concepts in ASC 606 in accounting for the leases
New leases standard
Effective date and transition – practical expedients

► Lessees and lessors are permitted to make an election to apply a package of practical expedients that allow them not to reassess:

- Whether contracts are or contain leases
- Lease classification
- Whether IDCs quality for capitalization

Apply to all expired or existing leases as a package

► Entities are also permitted to make an election for all existing leases to use hindsight when determining the lease term (i.e., evaluating a lessee’s option to renew or terminate the lease or to purchase the underlying asset) and assessing impairment of ROU assets (lessees only)

► Use of hindsight election may be elected separately or in conjunction with the package of practical expedients above

► Certain disclosures are required in accordance with ASC 250, Accounting Changes and Error Corrections
Tax Considerations

- Recognition of lease-related assets and liabilities that are not on the balance sheet today would affect many aspects of accounting for income taxes, such as:
  - Recognition and measurement of deferred tax assets and liabilities
  - Assessment of the recoverability of deferred tax assets (i.e., the need for and measurement of a valuation allowance)
- Uncertainty around whether the right-of-use asset would be:
  - State and local tax: included in the property factor for apportionment of income
  - Sales and use tax: subject to sales tax
  - Property tax: included in property tax base subject to property taxes
- Federal income tax review
  - No effect on current classification for federal income tax purposes
  - Many taxpayers follow book and may use this opportunity to review classification for federal income tax purposes.
- Method change issues
Lease Characterization Method Changes

- Automatic consent generally available for change of lease characterization
  - **6.03 Sale, lease, or financing transactions** (automatic change # 10)
  - The change in method of accounting under this section 6.03 is made using a cut-off method and applies to transactions entered into on or after the beginning of the year of change. Accordingly, a § 481 (a) adjustment is neither required nor permitted.
  - A taxpayer does not receive audit protection under section 8.01 of Rev. Proc. 2015-13 in connection with this change.
Lease Characterization Method Changes

- If a taxpayer wants to change its method of accounting for sale, lease or financing transactions entered into before the beginning of the year of change, the taxpayer must file a Form 3115 under the non-automatic change procedures of Rev. Proc. 2015-13, 2015-5 I.R.B XX.

- A change involving sale, lease, or financing transactions entered into before the beginning of the year of change will require a § 481 (a) adjustment.

- The IRS will generally not consider a taxpayer's request to change a method of accounting for a sale, lease, or financing transaction entered into before the beginning of the year of change unless the taxpayer's proposed method of accounting is consistent with the method used by the counterparty to the agreement.

- IRS may require a signed penalties and perjury statement from counterparty

- In absence, IRS will not issue requested change (except in unusual and compelling circumstances)
Lease Timing of Income Method Changes

- Automatic consent generally available for change to use rent allocation method under section 467
  - App. Sec. 20.01 of Rev. Proc. 2015-14, as modified by Sec. 2.24 of Rev. Proc. 2009-39 (automatic change # 136)
  - Not applicable to taxpayers required to use constant rental accrual method or proportional rental accrual method
  - Must attach to Form 3115 copy of one of section 467 rental agreements to be covered by change (or at least rent allocation pages)
  - No audit protection if IRS determines section 467 rental agreement is disqualified leaseback or long-term agreement
Lease Timing of Income Method Changes

- Automatic consent (cont.)
  - Generally see when taxpayers have been inadvertently following book
    - Taxpayer recognizes deferred rent on straight-line basis over term of rental agreement even though required to use rent allocation method under section 467
  - All other changes generally non-automatic
    - Rev. Proc. 2015-13
- Section 481(a) adjustment spread period
  - Unfavorable (positive) adjustment – 4 years
  - Favorable (negative) adjustment – 1 year
Market Considerations and New Structures

- Lease modifications (Lease reassessment versus lease modification)
  - Change in fact versus method change
  - Lessor request/Lessee request (e.g., payment)
- Lease terminations
  - Lessor request/Lessee request (e.g., payment)
- Short term (or shorter term) leases
  - Renewal terms
  - Lessee guarantee of residual value
- Bifurcation of lease and services
- Movement toward “Net Leases”
- Movement toward variable lease structures rather than fixed rent
- Synthetic Leases
  - Operating lease for financial accounting purposes but financing for federal income tax purposes where purported lessee is treated as the tax owner
Infrastructure is a broad asset class

<table>
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<tr>
<th>Economic infrastructure</th>
<th>Social infrastructure</th>
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<td>Transport</td>
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<td>and other systems</td>
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<td>and facilities</td>
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<td>Convention centers</td>
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<td>Public housing</td>
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<td>Community facilities</td>
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Public Private Partnerships (PPPs) provide a financing alternative

Broadly speaking, a PPP is a form of procurement that is based on a long-term, performance-based contract where appropriate risks can be transferred cost-effectively to a private sector “partner.”

These risks can include construction, schedule, functionality of design, financing and the long-term performance of the asset through the transfer of responsibility for operations, maintenance and rehabilitation.

PPPs can also be structured so that the private partner assumes demand and price risk based on the availability of a facility, and they can also assume varying degrees of commercial risk with respect to market rents, tolls and other types of revenue.
Investor Level Tax Considerations – Types of Investors

► U.S. Corporate
► U.S. Funds
  ► Bank-sponsored
  ► Private equity
  ► Alternative investment
  ► Pension
► Foreign Investors
► Sovereign Investors
Investor Level Tax Considerations – Potential Investor Specific Issues

- UBTI
- ITS/Cross-border Issues
  - FIRPTA
  - U.S. tax treaties
  - Interest deduction limitations
  - Withholdings on distribution/payments to foreign investors
  - Holding company structure; legal entity, and jurisdictional considerations with respect to the investment in concessionaire
  - With respect to a new investor fund, organization and structure of the fund itself
- Section 892 (sovereign investors)
Investor Level Tax Considerations – SALT Considerations

► Income/Franchise Tax
► Margin/Gross Receipts Tax
► Property/Possessory Interest Tax
► Sales and Use Tax
Concessionaire project-level US Federal Income Tax considerations
Tax Overview

► Tax analysis will vary depending on:
  ► Types of assets
    ► Road, bridges, tunnels
    ► Seaports
    ► Airports
  ► Form of investment
    ► Direct
    ► Indirect – e.g., funds
  ► Characteristics of Investor
    ► U.S. taxpayer
    ► U.S. tax-exempt – e.g., pension
    ► Non-U.S. person
  ► Type of arrangement with public sector
Overview
Tax analysis matrix

PPP Concession

- Market-risk
  Property Rights
- Availability
  Payments – Service Contract
Tax analysis matrix
Market-risk

PPP Concession

Markets-risk
Property Rights

Consideration to/FBO Government

Timing
- Periodic
- Upfront

Consideration to construct/acquire tangible assets

Purchase Price Allocation
- Intangibles
  - Concession/Franchise
  - Leasehold
  - License/permit
- Tangibles
  - Brownfield Assets
  - Tax-exempt bond financed property
- Construction
  - Capitalization
  - IDC
  - G&A
  - DB
- Asset Class

Purchase Price Allocation
- Asset Class
Market-risk Example

► Toll Road: Design, Build, Finance, Operate & Maintain (DBFOM)
  ► Term: 50 years
    ► 5 Years to Build
    ► 45 Years to Operate and Maintain
  ► Payments
    ► Upfront Payment to Government
    ► Periodic Payments over Term
  ► Requirement to Design, Build and Finance Toll Road
  ► Right to Charge Tolls
  ► Requirement to Operate and Maintain
  ► Financed through Private Bonds
Market-risk project-level tax issues

► Cost recovery for consideration paid to/for benefit of Government
  ► Upfront payments
    ► Directly to Government
    ► To fund costs of Government (may occur in “greenfield” where no other payment to Government or even when Government otherwise contributes public funds to project)
      ► Fund Government payment to losing bidders
      ► ROW acquisition
    ► May not be material; BUT still need to account for on tax return
  ► Periodic payment
    ► Fixed to or for benefit of Government
    ► Contingent (e.g., percentage of revenues above certain level)
  ► Tax cost recovery may be –
    ► Rent (IRC Section 467)
    ► Tangible property purchase price (funded by proceeds of tax-exempt bonds?)
    ► Intangibles (IRC Sections 197, 1253(d)(1))
Market-risk project-level tax issues

- Treatment of public funds contributed to project to help fund construction cost
  - Worst case: Current inclusion as gross income, with associated tax deductions commencing when assets are placed in service
- Alternative characterizations that may be applicable
  - Concessionaire has no dominion and control over the public funds
  - Concessionaire has no accession to wealth
  - Public funds are for services rendered by Concessionaire to the Government
  - Public funds are a purchase price adjustment with respect to Concessionaire’s acquisition/construction of the project
  - Loan by Government to Concessionaire
  - Contribution of the public funds constitutes a non-shareholder contribution to capital (corporations only)
The Code & Regulations

► IRC § 118(a)
   “In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.”

► Treas. Reg. § 1.118-1
   “[T]he exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of inducing the corporation to expand its operating facilities.”
Supreme Court Cases Defining a “Contribution to Capital”

► **United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401 (1973) (“CB&Q”)**

► Supreme Court held that assets received from state governments, including highway under and overcrossings, crossing signals, signs, floodlights, and etc., were not contributions to capital

► Court identified some of the characteristics of a nonshareholder contribution to capital

(1) the contribution must become a permanent part of the taxpayer’s working capital;

(2) the contribution must not be compensation for specific quantifiable services rendered;

(3) the contribution must be bargained for;

(4) the contribution must foreseeably benefit the corporation in an amount commensurate with its value; and

(5) the contribution must ordinarily be employed to generate additional income
Tax analysis matrix
Availability Payments

PPP Concession

Availability Payments

- DB Revenues
  - Section 460 PCM
- O&M Revenues
  - Accrual
- Finance /Equity Revenues
  - Accrual
Availability Payment Example

► Toll Road: Design, Build, Finance, Operate & Maintain (DBFOM)
  ► Term: 50 years
    ► 5 Years to Build
    ► 45 Years to Operate and Maintain
  ► Payments
    ► Periodic Payments From Government to Concessionaire over Term
  ► Requirement to Design, Build and Finance Toll Road
  ► Requirement to Operate and Maintain
  ► Financed through Private Bonds
Availability Payments

► Overall relationship more of a services contract than grant of property rights
► Allocation of payments
  ► Must allocate Availability Payments received among Concessionaire’s project responsibilities (as applicable)
  ► How many buckets of income? (2, 3, or 4)?
    ► Design/Build, Operate/Maintain, Finance, Equity
      ► What are the facts?
        ► Does Project solely provide for unitary “availability payment” or are there additional milestone/completion payments for construction?
        ► How do actual construction costs compare with contract-specified (if any) construction payments?
  ► How do you determine what goes in each bucket?
► Substantiate allocation
  ► Schedule in contract
  ► Transfer pricing or other report supporting economic substance of allocation
Questions?
Glenn M. Johnson is a Principal in Ernst & Young LLP’s US National Tax Department. Glenn leads the US PPP Infrastructure Tax Practice and is the Director of the Leasing Tax Services. Glenn is experienced in planning leasing and other asset-based structured transactions. Also, Glenn has provided US tax services with respect to many infrastructure projects where he advises on a wide range of tax and operational issues.

Glenn, who joined Ernst & Young in 1998, earned his LL.M. in Taxation from Georgetown University Law School; his J.D., with honors, from Boston University School of Law; and his B.A. in Economics from Wesleyan University. Glenn also is active in a number of civic and charitable organizations.

Select recent engagement experience:

- Westchester Airport
- Gordie Howe International Bridge
- Capital Beltway I95 Expansion and 395 Expansion
- I66
- Ohio State University
- LaGuardia Airport
- LAWA: APM
- Virginia International Gateway
Thank you!