

May 10, 2018

The Honorable Steven Mnuchin
Secretary of the Treasury
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20549

re: Interest Expense Limitation of Section 163(j) for Infrastructure Public-Private Partnerships

Dear Secretary Mnuchin:

As representatives of the infrastructure industry, we are writing today to express our concerns that Section 163(j) of the Internal Revenue Code (the “Code”), as amended by the Tax Cuts and Jobs Act of 2017 (the “Act”), may be interpreted as having the unintended effect of creating a substantial disincentive for private investment in public infrastructure through the use of public-private partnerships (P3’s). The result of this interpretation, we believe, could cause substantially increased costs to U.S. taxpayers, and State and Local governments pursuing such P3 procurements.

P3s play a critical role in accelerating the delivery of US infrastructure projects and are a component of the President’s infrastructure plan. Since 2010, over \$40 billion in US transportation infrastructure P3 projects have been developed, delivering an average 25% lifecycle cost savings, while creating economic growth, and drawing \$4-5 billion in private investment. Failure to clarify section 163(j) could impose yet another barrier in the tax code further disincentivizing private investment in public infrastructure.

In general, Section 163(j) of the Code, as amended by the Act, restricts the ability of a company to utilize interest deductions to the extent that its interest expense exceeds 30% of “adjusted taxable income.” The Act does provide for an exception to the new Section 163(j) interest limitation rules for certain “real property” trades or business. If the real property exemption is not applicable to these transactions, in which debt is a major component of the capital structure, Section 163(j) would result in a skyrocketing of the effective tax rate on P3s, by restricting the P3 project company’s deductions for interest payments. For example, during a typical 5-year construction period for a P3 project, the P3 project company’s net income before interest expense might be \$100M and its interest expense could easily be \$80 million, leaving it with only \$20M of net income after interest expense. If the real property exception to the application of the interest limitation rule in Section 163(j) is not available to the project, the company could be faced with a disallowance of \$50M of interest expense, which previously would have been deductible prior to the Act.

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To address these concerns, we believe that Treasury's Guidance offers an important opportunity for the Administration to clarify the intent of key provisions of the Act and to ensure these unintended consequences do not harm the Nation's efforts to rebuild its infrastructure as efficiently and cost-effectively as possible. We have outlined below suggested Guidance that is consistent with the Act and its legislative intent, that could ameliorate this issue for the ultimate benefit of the taxpayer.

Thank you for considering our views as you develop guidance to the tax law. Please feel free to contact any one of our organizations with questions or comments, and we look forward to meeting with you as soon as possible to discuss these matters further.

Sincerely,

American Council of Engineering Companies
American Highway Users Alliance
American Road & Transportation Builders Association
Associated General Contractors of America
Association for the Improvement of American Infrastructure (AIAI)
BPC Action
Design-Build Institute of America
Performance Based Building Coalition

- A. **The Interest Expense Limitation of Code Section 163(j)**. The new tax act commonly referred to as the Tax Cuts and Jobs Act (the “Act”) contains a limitation on the deductibility of interest in newly amended Code Section 163(j). This provision limits the deductibility of net interest expense (business interest expense less business interest income) to 30% of a taxpayer’s adjusted taxable income, which is largely equivalent to EBITDA for tax years beginning before January 1, 2022 and EBIT thereafter. Business interest does not include investment interest.

There is an unlimited carryforward for interest deductions disallowed due to the limitation of Code Section 163(j). For purposes of this rule, all members of a consolidated group are treated as a single taxpayer. In the case of partnerships or S corporations, the limitation is applied at the partnership or S corporation level with the excess interest limitation amount in the case of a partnership carried over by each partner but deductible only against the income from the relevant partnership in future years. There are certain exceptions:

1. Taxpayers with average gross receipts of \$25 million or less for the three preceding taxable years or portion thereof are exempt.
2. Interest accrued or paid pursuant to floor plan financing to finance certain motor vehicles held for sale is exempt.
3. Certain regulated utilities are exempt.
4. Taxpayers engaged in certain real property and farming trades or businesses can elect to be exempt from the limitation.

Any taxpayer electing out of the business interest limitation of Code Section 163(j) is required to use the alternative depreciation system for certain of the assets of such trade or business. The provision would require a real property trade or business that elects out of the limitation on the interest deduction under Code Section 163(j) to use the alternative depreciation system to depreciate any of its (i) non-residential real property, (ii) residential rental property, and (iii) qualified improvement property.

- B. **The Exception for a Real Property Trade or Business**. Eligible real property businesses are defined broadly by reference to Code Section 469(c)(7)(C), which includes real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or businesses. The legislative history also notes that a real property trade or business includes such a trade or business carried on by a corporation or a real estate investment trust and that real property operation or a real property management trade or business exception includes the operation or management of a lodging facility.

Additional Guidance Needed - Unintended Consequences

We believe that the real property exception was intended to be available to real property infrastructure projects operated pursuant to Public Private Partnership Arrangements (“P3 Arrangements”). However, it is not clear that P3 Arrangements will be able to qualify for this exception.

For businesses engaged in designing, building, financing, operating, managing or maintaining (“DBFOM”) real property for or from governmental entities through a variety of P3 Arrangements the real property trade or business exception appears to offer a means of preserving or, after giving effect to the tax rate reductions in the Act, improving the economics of those P3 Arrangements ultimately for governmental authorities.

Under current law, Code Section 469(c)(7)(C) typically deals with situations where it is usually clear whether the claimed activity involves a real property activity. However, in certain P3 Arrangements, the taxpayer may be engaged in a variety of business activities, including a real property activity as defined in Code Section 469(c)(7)(C). Other activities that are integral and related to the defined real property activity are also activities of these P3 Arrangements.

If the other activities that are integral and related to the real property activity are not allowed to be grouped together as a “real property trade or business” to avail themselves of the real property exception in the context of P3 Arrangements, or if the definition of real property businesses is not expanded, the potential for lost deductions due to the application of Code Section 163(j) could be considerable and affect the economic viability of billions of dollars of infrastructure projects.

Under current law, there is little in the way of direct administrative or judicial guidance that covers the issues at stake here. As direct guidance does not exist, guidance is needed to affirm the real property trade or business exception is applicable to the full scope of P3 Arrangements.

1. Participants in P3 Arrangements are seeking clarity as to what constitutes real property for purposes of Code Section 163(j). We suggest that the term “real property” as used in the context of a real property trade or business in Code Section 163(j)(7) have the meaning given such term in Code Section 897 and the Treasury Regulations promulgated thereunder (the “FIRPTA Rules”), but applied without regard to whether the real property is located within the United States, which would include any “interest in real property,” as such term is defined in the FIRPTA Rules and would specifically include contractual rights and obligations with respect to real property and interests in real property. Referencing the FIRPTA Rules seems appropriate because those Rules are well developed and generally applicable, and would not give rise to the concern that might arise with other real property definitions in the Code where the industry specific source of such rules might render them inapplicable in certain instances.

2. Participants in P3 Arrangements are seeking confirmation that they should be eligible to be treated as a real property trade or business, including businesses engaged in designing, building, financing, managing or maintaining real property for or from government entities through a single contract with multiple performance obligations. The single contract allows the government entity to transfer risk through the P3 Arrangement to the participant over the life cycle of the entire P3 Arrangement. We believe guidance given pursuant to Code Section 163(j)(7) should provide that an electing real property trade or business may include trade or business activities other than solely real property trade or business activities provided that such other activities are appropriately grouped with a real property trade or business pursuant to rules similar to those set forth in Treasury Regulations Section 1.469-4. This would allow participants in P3 Arrangements to determine whether activities related to a specific infrastructure project could be grouped as a single trade or business. We anticipate that the typical P3 Arrangement would be eligible for such a grouping and be treated as a single trade or business. For example, this would mean that a trade or business involving the construction, operation or maintenance of infrastructure assets as part of a single contract with a government entity could be grouped, along with related financing activities, with the trade or business activities of providing rail transportation, pipeline services, fiber optics transmission, or other infrastructure activities requiring the use of such real property where the infrastructure-related activities and the real property trade or business activities have common control, common ownership, common geographic location and are otherwise integrated financially and operationally. A grouped trade or business as part of a single contract with a government entity would constitute a real property trade or business that could elect to be treated as such for purposes of Code Section 163(j) because the real property activities of such a grouped trade or business are the primary activities of the trade or business. If the real property activities (measured by the expenses incurred) or the assets acquired are greater than the non-real property activities or assets involved, and the real property activities constitute one of the types of activities set forth in Code Section 163(j), the taxpayer should be able to elect to treat such a grouped trade or business, as a real property trade or business for purposes of Code Section 163(j).
3. Participants in P3 Arrangements are seeking confirmation that a real property trade or business can be conducted by a taxpayer either by its employees or solely through independent contractors (as is common in P3 Arrangements).

4. Participants in P3 Arrangements are seeking confirmation that a real property trade or business will be treated as a single trade or business even where as part of a single contract with a government entity its activities change over time, such as where the activities of such trade or business initially involve acquisition, construction, development, redevelopment and/or similar activities and then involve the operation, management, maintenance, leasing or similar activities. We believe this is appropriate because the election to be treated as a real property trade or business under a P3 Arrangement applies to a single contract with a government entity where the government entity has transferred certain risks to the participant over the life cycle of the entire P3 Arrangement.
5. Participants in P3 Arrangements are seeking clarification of the definition of “properly allocable.” As discussed above, the Code Section 163(j) limitation applies to business interest. For purposes of Code Section 163(j), the term “business interest” means any interest paid or accrued on indebtedness “properly allocable” to a trade or business. (See Code Section 163(j)(5).) Also, the term “business interest income” means the amount of interest includible in the gross income of the taxpayer for the taxable year which is “properly allocable” to a trade or business. (See Code Section 163(j)(6).) Such term does not include investment income. Without additional guidance in the statute, Treasury would appear to have broad authority to draft regulations and/or issue guidance concerning the meaning and applicability of the term “properly allocable.” Many other provisions of the Code and Treasury Regulations include the term or concept “properly allocable,” but such term/concept is not uniformly interpreted. Such provisions of the Code include, for example: Code Sections 263; 263A; 464; 469; 470; 514; 861; and 904. We suggest that the term “properly allocable” include the concept of direct tracing of the use of debt proceeds or refinancing of such debt (i.e., the debt was incurred to finance the Code Section 469(c)(7)(C) real property trade or business) and apply to allocate the interest on the debt to identified expenditures into the future. For example, the proposed Treasury Regulations under Code Section 263(g) support a reading of the term “properly allocable” to include amounts incurred to develop and support the continuing use of the property. For P3 Transactions, the use of the federal income tax basis of the property to allocate interest (e.g., Code Section 861) would not provide a workable means for such interest allocation because in availability payment P3 transactions the participant incurs debt, but does not obtain ownership of property for federal income tax purposes (e.g., where such expenditures are a condition to the right to receive availability payments in P3 transactions). Similarly, use of the income generated from the property for federal income tax purposes (e.g., Code Section 263A) where the taxpayer generates income from the operation, management, maintenance, leasing or similar activities (e.g., an integrated infrastructure activity) and not from any assets owned by the taxpayer may not provide a workable allocation method in certain P3 transactions.