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P3 Industry Gets an Early Holiday Present in IRS Guidance on Interest Deduction: Nossaman

Contractors and investors in P3s can continue taking a full tax deduction for interest on debt under recent IRS guidance (Revenue Procedure 2018-59, issued November 26). Many P3s are highly leveraged, and the interest deduction is a valuable tax benefit for developers. Were this deduction restricted, P3 developers' (and by extension governments') costs would rise; potential investors would demand higher rates of return; and infrastructure projects would be more costly. Without this guidance, the 2017 tax law would otherwise severely restrict the interest deduction for businesses.[1] The IRS' position is welcome (and a relief) and caps an intense letter-writing campaign by industry groups – including the Design-Build Institute of America, Associated General Contractors of America, Performance Based Building Coalition, and Association for the Improvement of American Infrastructure – to the IRS and Treasury.[1]

The deduction restriction (new section 163(j)) emerged from last year's Tax Cuts and Jobs Act ("TCJA") and generally caps a business' interest deductions at 30% of "adjusted taxable income" (which is similar to, but not the same as, EBITDA or EBIT).[2] "Real property trades or businesses" can elect out of these new deduction limits, but at the price of less-generous depreciation for their buildings and other improvements. The actual section 163(j) language is a good deal more complicated, and the Treasury proposed regulations accompanying the IRS guidance consist of 400-plus pages trying to explain everything.[3]

Revenue Procedure 2018-59 provides a safe harbor – which most P3s should meet – under which a P3 will be a "real property trade or business."[4] As a result, companies and investors in a P3 can elect out of the restricted interest deduction rules – and, because the tax-exempt government agency in a P3 usually owns the improvements which otherwise give rise to depreciation deductions, giving up the more generous depreciation treatment usually is not an issue. Because Revenue Procedure 2018-59 is an administrative promulgation and not a regulation, it is effective immediately and not subject to the comment period and other delays with the accompanying Treasury proposed section 163(j) regulations.

Revenue Procedure 2018-59 follows a trend of mostly favorable treatment for infrastructure by the IRS and Congress, including continuing to allow an exemption for interest on private activity bonds used to funds P3s[5] and proposed regulations issued in June clarifying that investment of bond proceeds in infrastructure projects will not trigger rebates to the government under the Code's exempt bond arbitrage provisions.[6]

[1] The letter can be viewed here.

[2] The text of Code section 163(j) is available here. The text of the TCJA and accompanying Congressional reports, can be viewed here.

[3] The proposed regulations (REG-106089-18) are available here.

[4] Revenue Procedure 2018-59 is available here.

[5] Earlier drafts of the TCJA would have ended this tax exemption (see our prior post (November 10, 2017) but the final bill kept it.

[6] The proposed regulations (REG-106977-18) are available here.

Nossaman Infra Insight Blog

By Douglas Schwartz on December 11, 2018