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New IRS Ruling on Port and Airport Leases: Orrick

In a private letter ruling (PLR 201918008) publicly released earlier this week, the IRS addressed the statutory safe harbor relating to the allowable term for leases of port and airport facilities financed with tax-exempt private activity bonds. For tax-exempt port and airport private activity bonds, one of the tax requirements is that the assets financed must be owned by a state or local governmental entity. Long-term leases can sometimes result in the lessee being treated as the owner for tax purposes, but Section 142(b)(1)(B) of the Internal Revenue Code of 1986 provides a safe harbor for leases and other possessory interest arrangements with private operators that allows ports and airports to be certain that the governmental ownership requirement is satisfied. The ruling specifically addresses the safe harbor requirement that the lease term cannot be longer than 80% of the economic life of the financed assets.

Basic Facts

The ruling describes a port that hoped to substantially extend the terms of three long-term leases of its maritime terminals to private terminal operators. The port had financed various terminal improvements with tax-exempt private activity bonds, and many of those improvements were now old. The ruling focuses on how 80% of the economic life of the financed assets is determined for each individual lease. For simplicity, the discussion below assumes the port was simply executing a single new lease rather than discussing the extensions of the three separate leases.

Conventional Approach Confirmed

Much of the ruling validates what we believe is a common approach taken by bond counsel when evaluating this safe harbor: (1) the lives of the bond-financed assets are determined based on the remaining lives determined as of the execution of the lease, (2) only the assets financed by outstanding bonds and subject to the lease are taken into account, and (3) land is taken into account and given a 30-year life, but only if land is more than 25% of the bond-financed assets that are leased. Based on those considerations, the weighted average remaining life of the bond-financed assets is then calculated and compared to the term of the lease.

New Ground Broken

In addition, the ruling breaks some new ground in the manner in which the cost and the remaining life of the leased and bond-financed assets were determined. The cost of the assets was simply the amount of bond proceeds originally spent on the assets in connection with the initial financing of the assets. There was no change to the weighting of the asset costs based on amortization of principal or later refunding transactions.

Most interesting, the determination of remaining life was undertaken by looking at the remaining life of the larger asset classes that made up the leased maritime terminal. In this case, there were only five asset classes: (1) buildings, with the remaining life of each building determined separately; (2) yard improvements, such as paving, fencing and utilities; (3) wharves and pilings; (4) cranes; and (5) land (ignored if less than 25% of the cost of the leased and bond-financed assets is land). The

actual bond-financed improvements were placed into one of the five asset classes, so that a total dollar amount could be assigned to the asset class, but the remaining life of any individual improvement was then not relevant. Instead, the port determined the remaining life of the asset class (or each building in the case of the buildings class) based on a current assessment of the actual asset class or building in question and taking into account actual wear and tear as well as subsequent improvements and replacements. For example, if a specific yard improvement with an originally expected 20-year life was installed 15 years before the execution of the lease, the remaining life of that specific yard improvement from the original placed-in-service date was not relevant. What was relevant was the remaining life of the entire yard, based on its condition as of the date the lease was executed, treating the yard as a single asset with a single life!

Observations

A few interesting observations about the approach approved in this ruling are:

The number of bond issues that financed the leased assets is not meaningful. The normal, issue-b--issue approach for determining tax compliance is replaced by a lease-by-lease approach. This was true even if there are multiple leases with the same private party.

Due to the averaging of remaining lives and the use of the larger asset classes with a single life, a specific bond-financed improvement with a short remaining life does not cause a problem even though the remaining life of that specific improvement, determined on its own, might be substantially shorter than the lease term.

The ruling approves the use of the expected remaining economic lives, determined as of lease execution. As such, the economic lives are updated for wear and tear as well as subsequent improvements and replacements, whether or not bond-financed. It is not clear how this approach could or should apply to an issuer that uses safe harbor economic lives determined under the asset depreciation range class life.

Using the economic lives of larger asset classes, rather than individual, bond-financed improvements, and determining what larger assets classes are appropriate, appears to require some judgment based on all the facts and circumstances. The ruling is very helpful for maritime terminals but may require some further analysis to be applied to airports.

The “80% of the economic life” language of Section 142(b)(1)(B) is very similar to language found in IRS Revenue Procedure 2017-13 relating to qualified management contracts. Thus, the approach in the ruling is a strong analogy for interpreting the similar requirement in Revenue Procedure 2017-13. In contrast, the “120% of economic life” test under Section 147(b) provides that the economic life shall be determined based on the later of the date the bonds are issued or placed-in-service date, and therefore the approach described in this ruling does not appear to be relevant to that 120% requirement.

Importantly, the ruling describes only one way, and not the only way, for determining compliance with the government ownership safe harbor.

by Charles C. Cardall

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