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Water Companies Request Guidance on Public-Private Partnerships.

Michael Deane of the National Association of Water Companies has written to Treasury regarding the application of the rules on tax-exempt bonds in the context of public-private partnerships involving water and wastewater treatment systems, focusing on the possible loss of the tax exemption on outstanding debt under such arrangements.

July 11, 2014

The Honorable Mark Mazur
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable William Wilkins
Chief Counsel
Internal Revenue Service
1111Constitution Avenue, NW
Washington, DC 20224

RE: Guidance under section 141

Dear Mr. Mazur and Mr. Wilkins:

On behalf of the National Association of Water Companies (NAWC), I am writing to follow up on our previous discussions with the Treasury tax policy staff regarding the application of the rules related to tax-exempt bonds in the context of public-private partnerships (P3s) involving water and wastewater treatment systems. In our previous meetings, we discussed a particular impediment — possible loss of the tax exemption on outstanding tax exempt debt — to the utilization of private capital in water and waste water infrastructure projects in cases where a state or local government desires to enter into a long-term lease, concession, or operating agreement with a private company under which the company would assume the operation of water facilities that have been financed with tax-exempt debt. Treasury regulations under section 141 outline several "remedial actions" that the bond issuers in such cases may take to preserve the tax-exempt status of the debt, but as we discussed in the meetings, those actions are unavailable as a practical matter in typical cases involving water facilities. To ensure that the relief intended in the Treasury regulations is, in fact, available, we request that the Treasury issue guidance, as explained below, to clarify that one of the allowable remedial actions — alternative use of disposition proceeds — applies in the case of long-term leases, concessions, and operating agreements.

Background

NAWC is the trade association for private water operating companies. Private water companies serve more than 73 million Americans, nearly one-fourth of the population. Our member companies are eager to assist in the badly needed improvement of the country's water infrastructure.

As you know, President Obama has repeatedly called the public's attention to the distressed state of the country's basic infrastructure; he has expressed support for private sector participation in infrastructure improvement. Just recently he signed the Water Resources Reform and Development Act — a measure that envisions P3s — and reiterated that the federal government must step up its efforts to bring infrastructure up to world standards by addressing the $2 trillion of deferred maintenance in the country's basic infrastructure. In addition, in his FY 2015 budget, the President proposed lifting the state-by-state volume cap on issuances of private activity bonds for water and waste water infrastructure projects, as a way attracting more private capital and private-sector managerial expertise to such projects. As the President recognizes, clean, safe and affordable water and water treatment services are fundamental and basic infrastructure needs of all Americans.

There is a growing interest among local governments today in entering into concession/lease agreement P3 transactions as a means of improving the management, financial and operational condition of their drinking and wastewater systems by upgrading water and wastewater systems and other types of infrastructure assets. These transactions generally take the form of long-term leases, concessions, or operating agreements (referred to collectively hereafter as "concessions"), where a private company essentially leases specified infrastructure assets for a 30-40 year period. Although these arrangements do not typically transfer tax ownership of the related facilities, they generally result in the concessionaire being responsible for the operation and maintenance and capital improvements with respect to the facilities. Both the term of these concessions and the manner in which the concessionaires are compensated generally prevent these arrangements from qualifying under the safe harbors for management contracts provided under Revenue Procedure 97-13.

Private water companies currently operate over 2,000 municipally owned water and wastewater facilities under P3s — which largely were set up under a contract operations and maintenance structured agreement, rather than as a concession-lease-based agreement. P3 contractual agreements combine the skills, assets, and resources of the public and private sectors to deliver water service or maintain water facilities for the benefit of the general public. The benefits to the country of private-sector capital through P3s are clear: The country's drinking water systems face an annual shortfall of at least $11 billion to replace aging facilities and to comply with existing and future federal water regulations (without including the growth in the demand for drinking water over the next 20 years).1 Similarly, the Environmental Protection Agency has estimated that the nation must invest more than $380 billion over the next 20 years to update or replace existing water systems and build new ones to meet increasing demand.

Treasury Regulations

The Internal Revenue Code generally provides that interest on "private activity bonds" is not excluded from gross income for federal income tax purposes. The private activity bond prohibition contains exceptions for bond-financed "exempt facilities," including water and wastewater facilities. The applicable Treasury regulations provide that the private activity bond prohibition is applied based on the issuer's reasonable expectations on the issue date of tax-exempt bonds and also applied subsequently if a "deliberate action" is taken by the issuer that causes such bonds to meet the private activity bond tests. Generally, the execution of a long term concession for a facility financed by tax-exempt bonds will be considered a deliberate action that causes the private activity bond tests to be met.

Under Section 1.141-12 of the Treasury Regulations, a post-issuance deliberate action that results in the associated bonds meeting the private activity bond test will cause the interest on the bonds to become taxable unless a permitted remedial action is taken by the issuer. In the context of bonds for water and wastewater treatment systems in which a P3 transaction is entered into, there are three possible remedial actions that can be taken:

(1) Defeasance and redemption of the bonds.
(2) Compliance with the “alternative use of facilities” rule through a deemed reissuance of the bonds.
(3) Compliance with the “alternative use of disposition proceeds” rule.

As a practical matter, the first remedial action, defeasance, is impractical in typical circumstances today because of the country’s low-interest-rate environment. To defease bonds bearing an interest rate of five or six percent by creating an escrow account to pay those bonds and funding it with Treasury securities yielding one percent or less would require a capital outlay substantially exceeding the principal balance of the outstanding debt. We estimate that defeasance could reduce as much as 15 percent of the value of typical transactions to the communities undertaking them.

The second possible remedial action, alternative use of facilities, is also impractical. Under that rule, a deliberate action will not result in loss of tax-exempt status if the bonds can be treated as newly issued bonds and, as such, can satisfy all of the requirements for newly issued tax-exempt bonds for the facility financed. For example, since water facilities are exempt facilities, it is possible that the bonds deemed to be reissued would satisfy the tax rules at the time of reissuance. However, one of the regulatory requirements is that the issuer obtain an allocation of the state private activity bond volume cap in an amount equal to the amount of the outstanding bonds. For a P3 transaction that can take years to consummate, that requirement can be an insurmountable problem because of the difficulty in receiving assurance from state officials that sufficient volume cap will be made available at the time the P3 transaction is closed. Further, in certain states the applicable volume cap allocation legislation or process seems not to permit volume cap to be used for this type of deemed reissuance. Another roadblock for the deemed reissuance approach is the re-characterization of the interest on the bonds as a type of income subject to the alternative minimum tax. To deal with that consequence without forcing the bondholders to have a change in tax treatment, the IRS permits the issuer in these circumstances to make a payment equal to the present value of the product of .0014 and the amount of the bonds outstanding in each remaining year. That payment is a further hurdle to the transaction, with no benefit to the residents of the community served by the utility.

Request for Guidance

The third possible remedial action, alternative use of disposition proceeds, permits issuers to avoid the loss of the tax-exempt status of bonds upon a cash sale “or other disposition” of a facility financed by the bonds, provided the issuer uses the cash for other governmental purposes within 2 years, such as other infrastructure projects. The regulations, however, are unclear as to the application of that remedial action in some situations. In particular, the application of this rule is uncertain in the case of concession arrangements since it is unclear whether this type of arrangement is a “disposition” and, if so, how concession payments made over the term of the arrangement are dealt with under this remedial action. As described above, concession arrangements in which a private party obtains operational control of a facility for a substantial period of years but with a state or local government retaining ownership, have become the preferred form of P3s for water and waste water facilities today.

A simple clarification in the regulations that would have the effect of substantially unleashing P3s would be the following:

Revise the definition of “disposition proceeds” in the regulations to include amounts derived from a concession, provided the arrangement does not have the effect of transferring tax ownership of the property to the new user.

Revise the cash consideration requirement of the regulations for transactions other than sales to require the consideration to be exclusively cash, paid either at the time of the transaction or later pursuant to the terms of the concession.

Modify the two-year expenditure window of the regulations to require that the issuer reasonably expect to expend the cash disposition proceeds within three years of the execution of the arrangement or, if later, within one year of the receipt of any cash installment under the arrangement.

Clarify that permitted alternative uses of disposition proceeds include the payment of debt service on other obligations of the issuer or to make contributions to public pension funds, provided that the other applicable tax requirements are satisfied. These clarifications would facilitate sales of infrastructure facilities, and long term leases or concession arrangements that are treated as sales for tax purposes, while still resulting in the disposition proceeds being used for purposes that qualify for tax-exempt financing. As a result, these changes are consistent with the purpose of the existing regulations; we see no policy reason for the regulations to prohibit these uses of disposition proceeds. For example, distinguishing between the redemption of the bonds that financed the facility being sold and the redemption of other tax-exempt bonds of the issuer of those bonds serves no policy imperative, as both are valid governmental purposes.

We believe the Treasury should provide guidance reflecting the above changes in the regulations as soon as possible. There is certainly nothing in the statute to preclude the Treasury from issuing such guidance, and such guidance would be fully consistent with the President's policy of promoting investment in U.S. infrastructure.

The regulations clearly were originally intended to provide state and local governments a reasonable path for preserving the tax-exempt status of bonds in cases of transfers of facilities financed by the bonds, particularly where those facilities could have qualified for tax-exempt private activity bond financing. The above guidance would provide precisely such a path with respect to transfers of facilities through the standard type of P3 arrangement used today — concessions.

We would be pleased to discuss this further with you.

Sincerely,

Michael Deane
Executive Director
National Association of Water
Companies
Washington, DC

cc:
Mr. Kent Hiteshew, Office of State and Local Finance
Ms. Vicky Tsilas, Office of Tax Legislative Counsel

FOOTNOTE

1 The American Society of Civil Engineers 2009 Report Card for America's Infrastructure

END OF FOOTNOTE