



**GLOBAL INVESTMENT IN INFRASTRUCTURE ASSETS**

**A US Federal Income Tax Perspective**

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**MAYER • BROWN**

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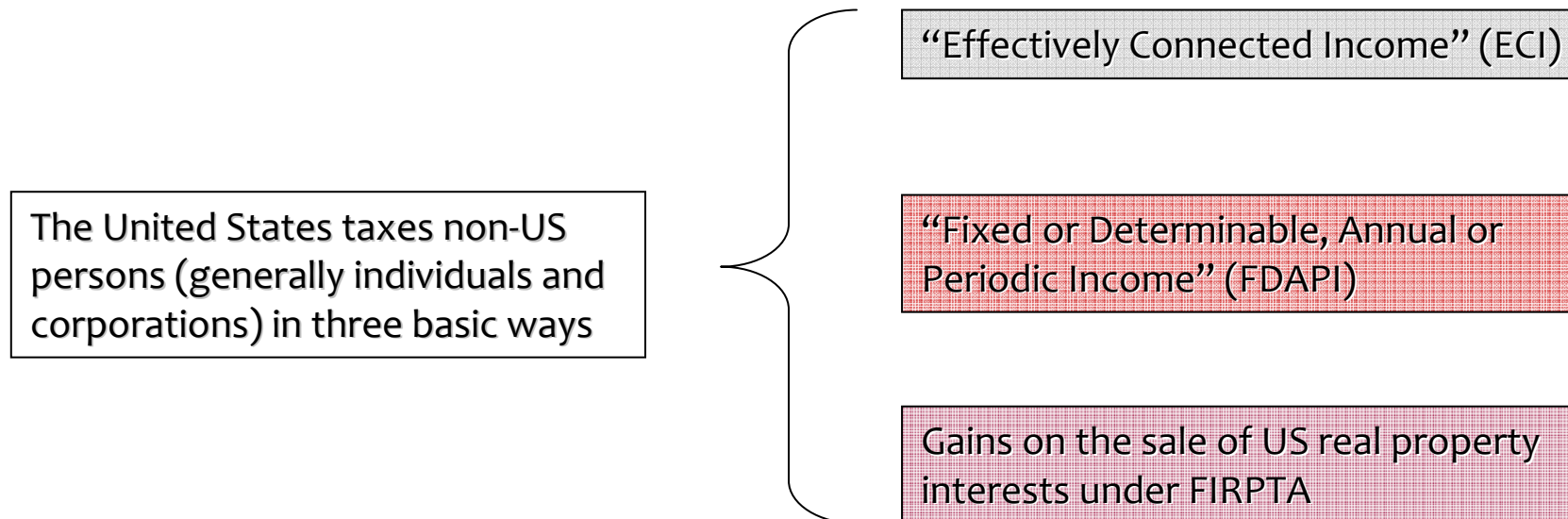
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## Overview

- Non-US investors investing in US assets
- US investors investing in non-US assets
- Infrastructure specific issues
- Hot topics

## Non-US investors investing in US assets

## Non-US investors - overview of US tax rules



## Non-US investors - ECI

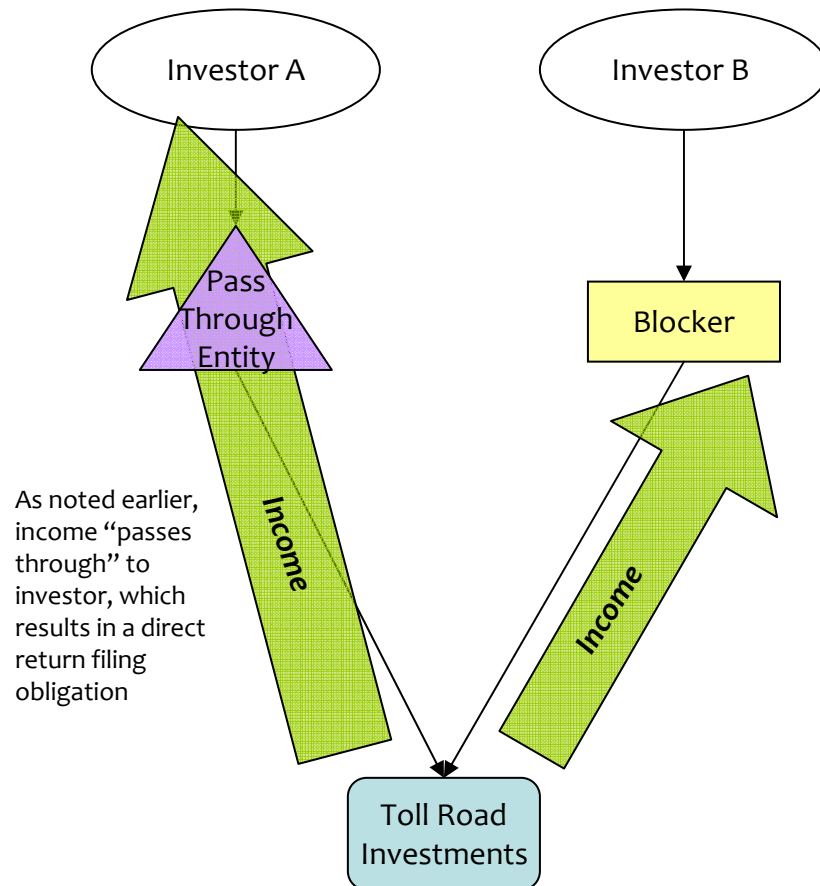
ECI is income that is “effectively connected” with the conduct of a US trade or business

In general, ECI will include income from US infrastructure investments (such as toll roads, utilities) made directly or through a pass through entity such as a partnership.

Foreign individuals taxed at 35% on net taxable income (15% on long term capital gain), plus applicable state taxes. Must file US and state income tax returns.

Foreign corporations taxed at 35% on all income, plus applicable state taxes. Also subject to branch profits tax (BPT) of 30% on after tax income, although treaties may reduce BPT. Must file US and state income tax returns.

## Non-US investors - ECI – Use of “blocker”



As noted earlier, income “passes through” to investor, which results in a direct return filing obligation

- A “blocker” is an entity taxed as a corporation for US income tax purposes
- Blocker shields the investor from being treated as the taxpayer for US income tax purposes – no ECI for the investor
- Blocker pays the applicable taxes and files the applicable income tax returns
- Blocker’s taxable income can be managed:
  - FMV purchase should produce substantial deductions for depreciation and amortization
  - Debt financing of blocker can produce interest expense deductions
    - Earnings stripping rules may limit deductions for interest paid to “related” lenders
    - Debt also must qualify as such for US tax purposes, which requires a reasonable debt/equity ratio, market rate of interest, and demonstrated ability to repay the debt
      - No strict “thin cap” rules
    - May be structured to avoid US withholding tax on interest payments under portfolio interest exemption
    - No deduction for interest accrued to related foreign lender until interest is paid

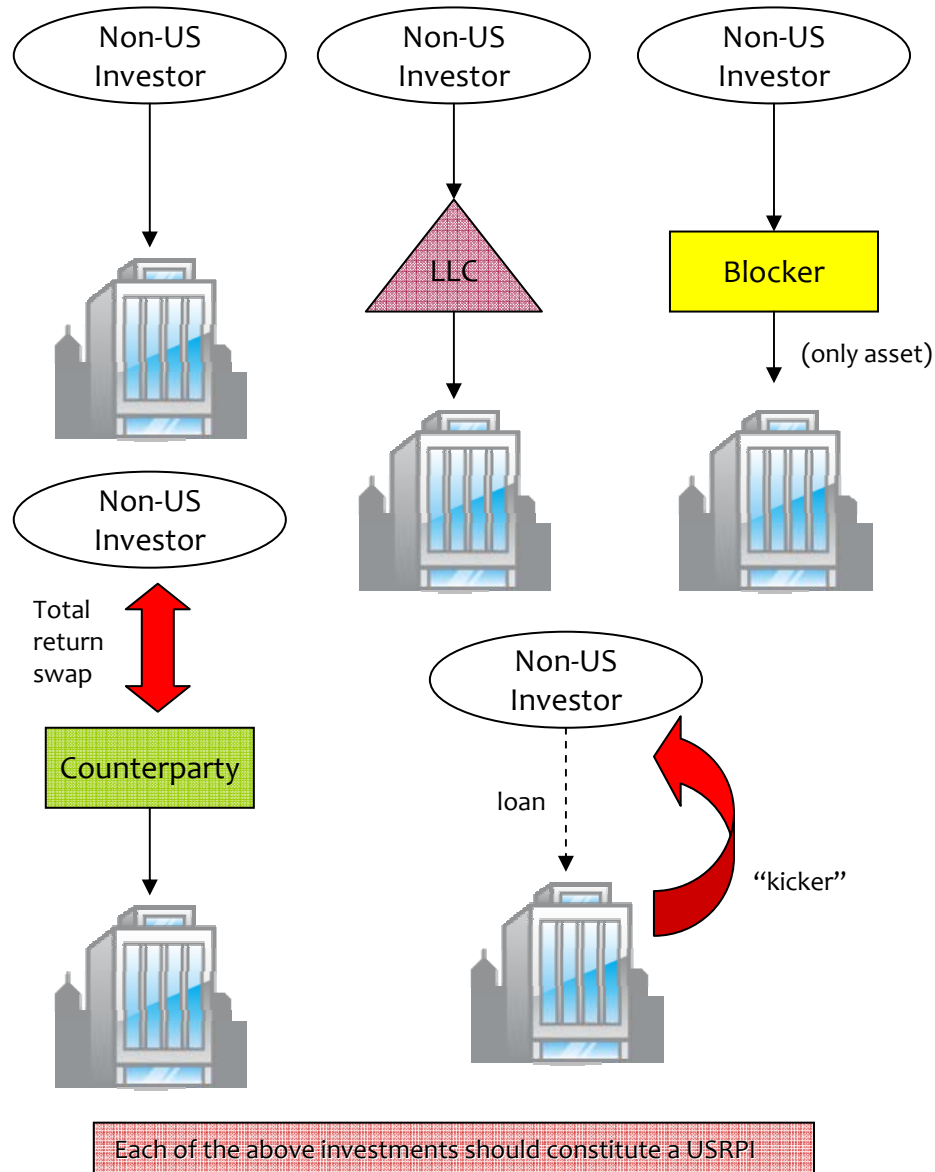
## Non-US investors - FDAPI

- Whereas ECI is taxed on a net basis (i.e., tax base reduced by available deductions), FDAPI from US sources is taxed on a gross basis by means of withholding
  - FDAPI generally consists of income from passive investments, such as ordinary corporate dividends and interest that doesn't qualify for the “portfolio interest” exception
  - The applicable statutory rate of withholding on such income is 30%
    - This rate is often subject to reduction under an income tax treaty
    - For instance, under the US-Australia treaty, dividends are subject to a maximum rate of 15% US withholding tax, and interest is subject to a maximum rate of 10% US withholding tax
    - Prerequisite for obtaining benefits is that recipient is a resident and qualified person under relevant treaty, and that Section 894 of the Internal Revenue Code doesn't otherwise change the result

## Non-US investors – FIRPTA

- FIRPTA – “Foreign Investment in Real Property Tax Act” of 1980
  - Gain recognized by non-US investors on sale of a US real property interest (a USRPI) subject to US income tax
    - USRPI - any interest in US real estate (other than an interest solely as a creditor)
    - If a US corporation has a majority of the value of its assets as USRPIs, stock in that corporation likely also to be a USRPI
  - FIRPTA tax: generally 35% (15% for non-corporate persons on long-term gains)
    - Foreign pension funds organized as trusts: may qualify for 15% FIRPTA tax (based on non-corporate status)
      - May require a ruling from the IRS for this result
  - Tax is enforced via a withholding regime imposed on purchasers of USRPIs
  - Any non-US person subject to FIRPTA must file a US income tax return
  - Importantly, FIRPTA does not cause ongoing income from a real estate investment to be subject to US income tax
    - Of course, if such income is earned directly or through a pass-through entity, such income may constitute ECI in any event (but not as a result of FIRPTA)

## Non-US investors - FIRPTA



- What is a USRPI?
  - direct investments in US real property
  - investments in “US real property holding corporations” (USRPHCs)
    - In general, a USRPHC is a corporation more than 50% of the assets of which are USRPIs
    - Thus, gain on the sale of stock in a USRPHC is subject to US income tax, which “trumps” the general rule that foreign investors are not subject to US income tax on gain realized on the sale of stock in a US corporation
  - Indirect rights to share in the appreciation of USRPIs
    - e.g., shared appreciation mortgages, certain swaps
- Critical issue: are infrastructure assets USRPIs?
  - Power plants, transmission towers, cell towers, etc. -- likely USRPIs, but depends on the individual asset
  - Toll roads and other concessions that have a real estate component – answer unclear (highly fact-specific)

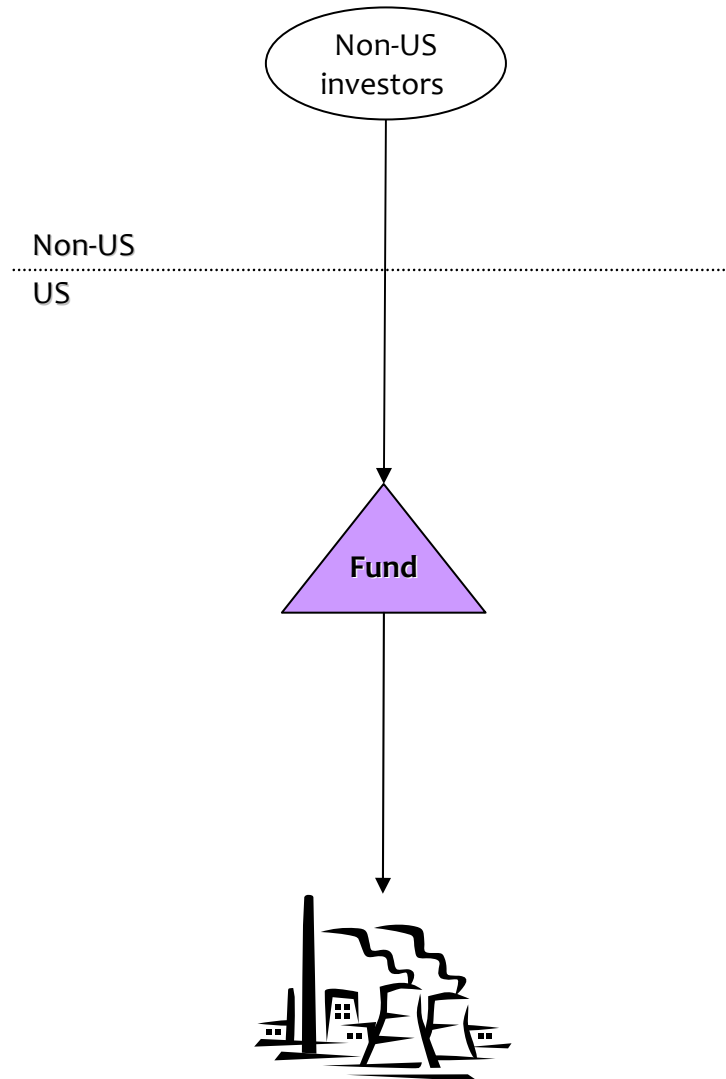
## Non-US investors - special categories

- Governmental investors (such as sovereign wealth funds) or international organizations (such as the United Nations)
  - Under Section 892, such investors generally not subject to US income tax on dividends or interest or gain on the sale of stock or securities (including shares in a USRPHC)
    - This would not include income from an entity controlled (i.e., 50% or more owned) by the foreign government
    - However, the relevant entity may be controlled entirely by foreign governments, but not by any one foreign government
  - However, gains from the sale of USRPI (e.g., a direct interest in US real estate) would be subject to US income tax
- Pension plans
  - Under many income tax treaties, pension plans will be exempt from US tax on dividends and interest
  - Pension plans are fully subject to FIRPTA
- Australian superannuation funds
  - Under the US-Australia income tax treaty, supers generally are subject to reduced rates of withholding tax on dividends and interest
  - Supers are fully subject to the FIRPTA rules
    - If a super were to receive a ruling from the IRS that it is treated as a trust for US tax purposes, maximum FIRPTA tax rate would be 15% (i.e., the non-corporate rate), rather than 35%

## Non-US investors - challenges and goals

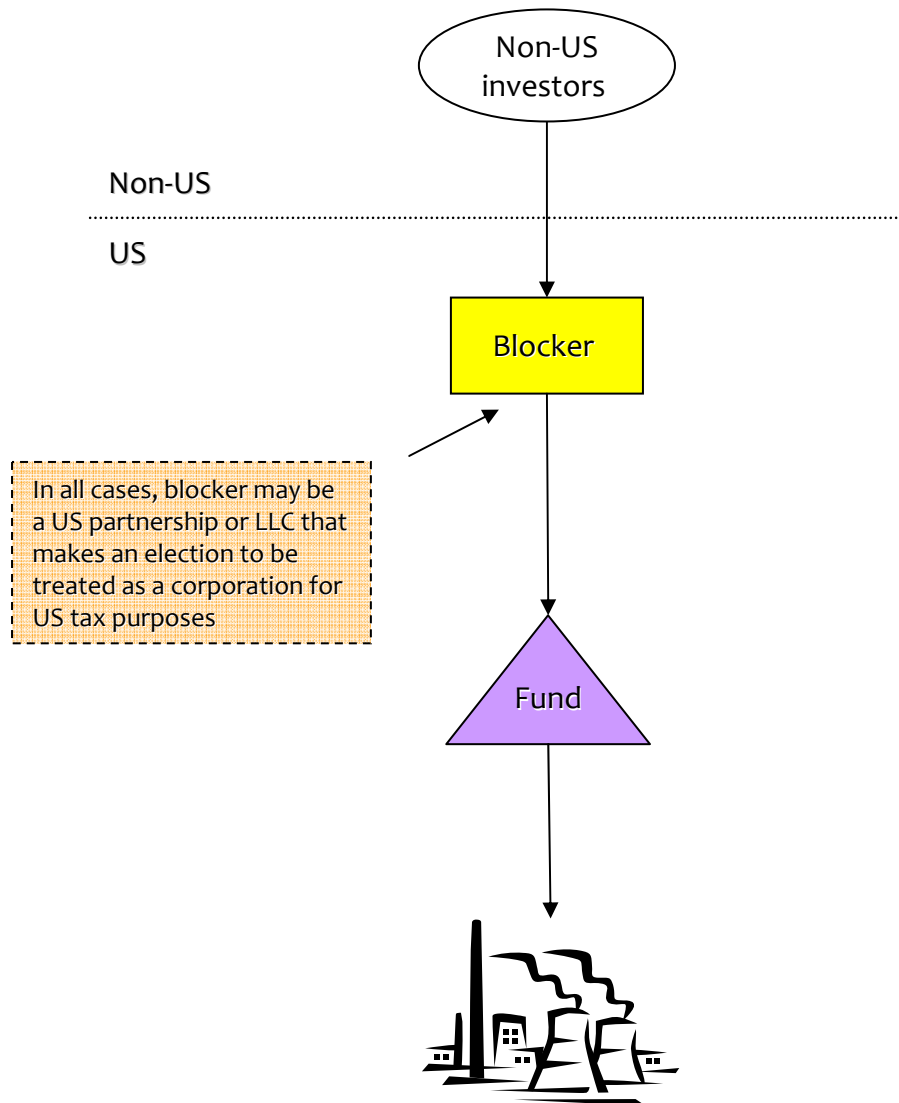
- Direct investment can be tax-inefficient for non-US investors
  - Pay US income tax (at a rate of up to 35%), plus applicable states taxes, on ECI
  - 30% branch profits tax for non-US corporations
    - Branch profits tax attempts to tax non-US corporations operating through US branches in the same way as if they operated through US subsidiaries
  - File US income (and potentially state) tax returns
  - FIRPTA (to extent assets constitute real property)
    - Generally no treaty protection from FIRPTA
- Goals
  - Minimize US tax on US structure
    - Due to interest expense, depreciation, and amortization, this normally is not an issue in the first few years of investment
  - Minimize US tax on gains from sale of infrastructure assets
    - FIRPTA may apply
  - No direct filing of US tax returns by investors
  - Convert current income into income more favorably taxed under US tax laws or treaties
  - Maintain possibility of crediting US taxes in home jurisdiction

## Non-US investors - direct investment



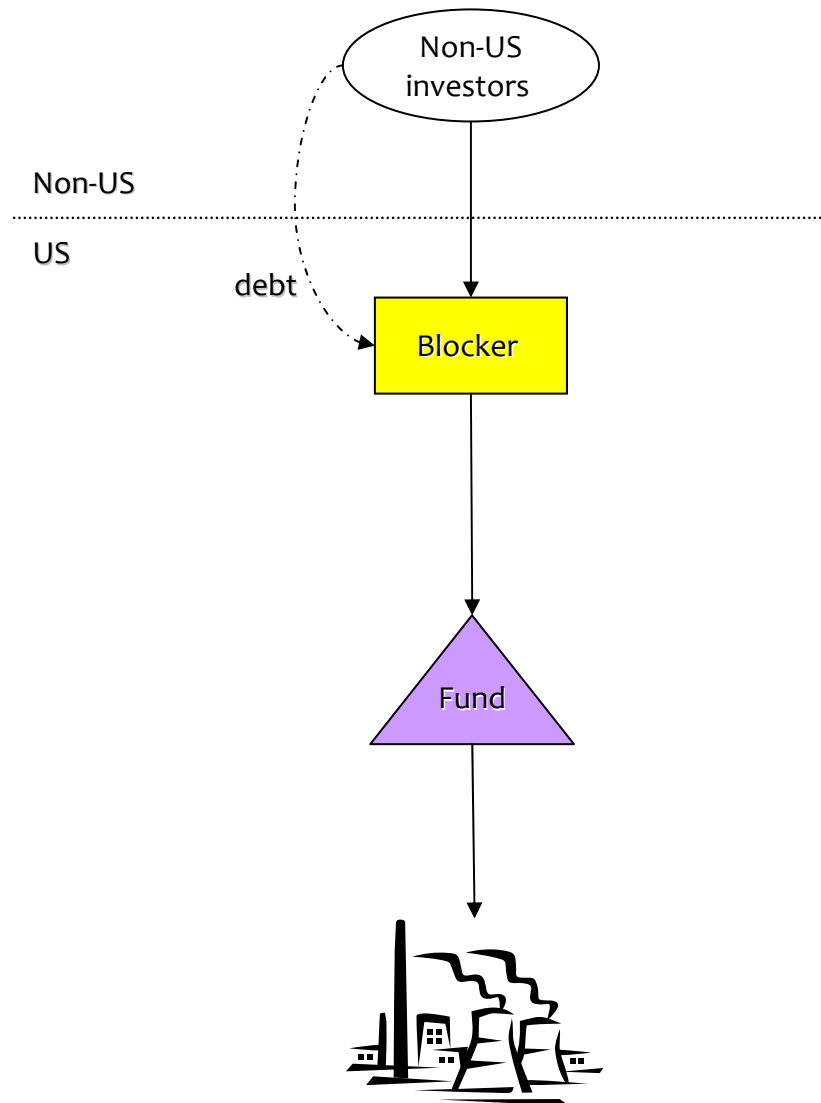
- Advantages
  - Simple
  - One level of tax (at investor level)
- Disadvantages
  - US tax returns
  - FIRPTA withholding on exit
  - Branch profits tax for non-US corporations

## Non-US investors - investment through a blocker



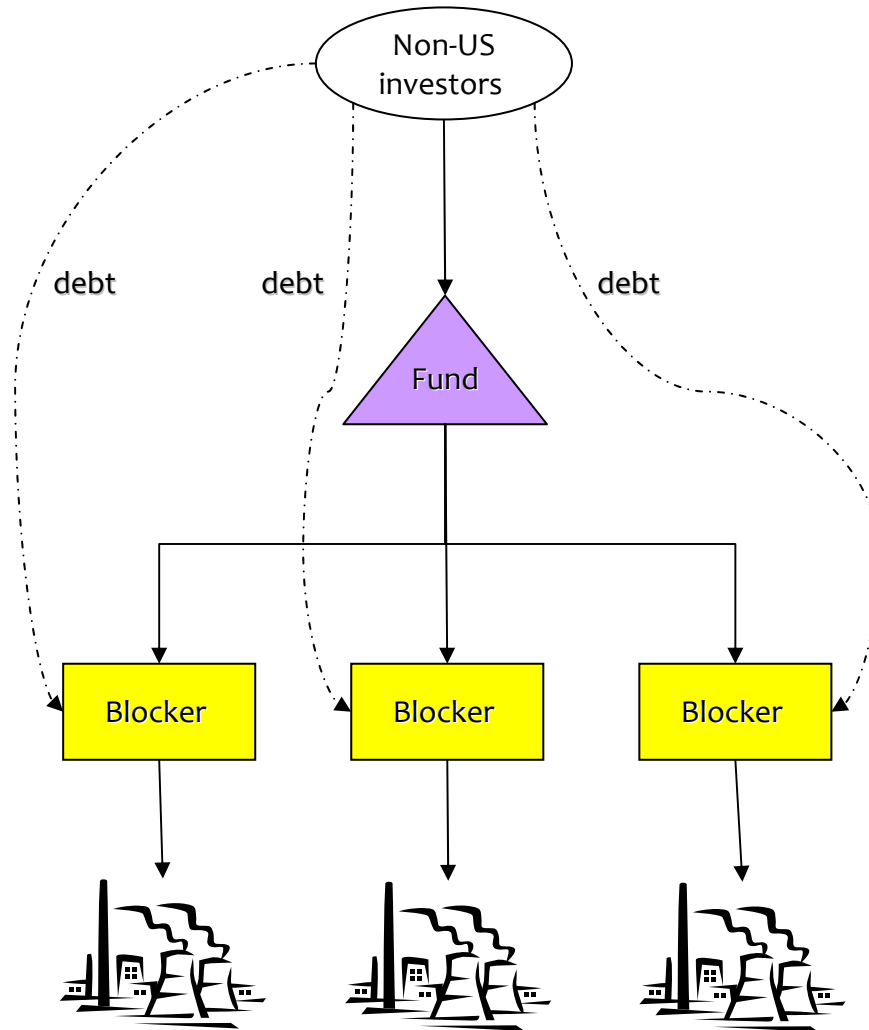
- Advantages
  - Investors need not directly file US tax returns
  - No branch profits tax
- Disadvantages
  - Up to 35% tax on blocker's income
  - Withholding tax on dividends
    - May be reduced under treaty
    - Any withholding tax makes investment through a blocker (without debt structuring or credit for US taxes) less efficient than direct ownership
  - Credit for US withholding tax may be available
  - Exception from withholding if US property sold and blocker liquidates
  - FIRPTA may still apply on sales of shares in blocker or from distributions out of subsequent refinancings

## Non-US investors - blocker/debt structure



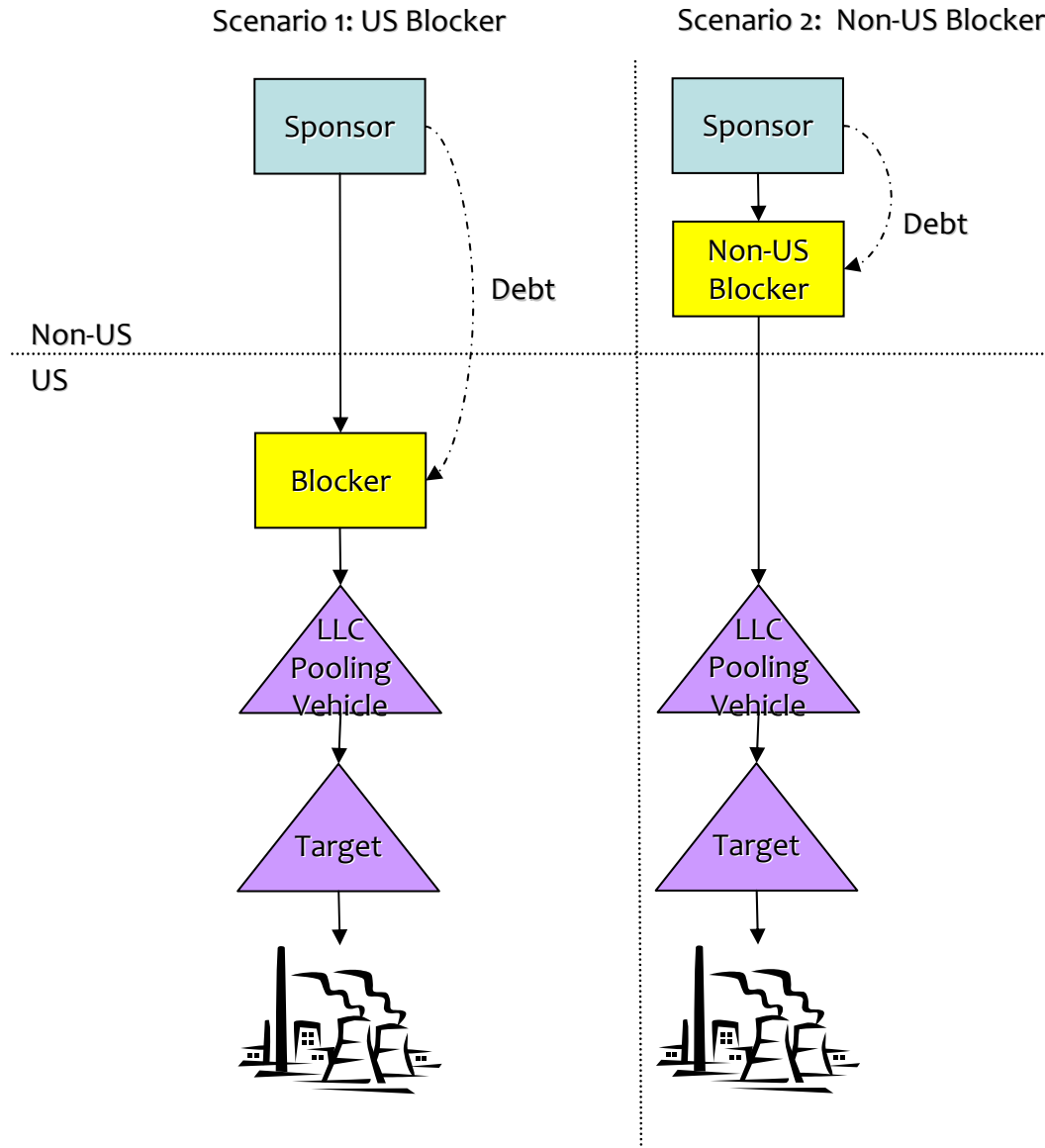
- Can reduce blocker’s net effective income tax rate
- If debt is properly structured for US tax purposes, 30% US withholding tax on interest can be avoided
  - Most treaties reduce rate of withholding tax
  - Withholding tax potentially reduced to 0% withholding under “portfolio interest” rule
    - Investor cannot own 10% or more of the voting stock of blocker to qualify
- Earnings Stripping: these rules may result in deferral of deduction for some interest expense
  - Rules apply only to related party interest expense; true third party interest is not restricted under these rules
  - Rules apply if blocker’s debt-equity ratio exceeds 1.5:1 **and** the blocker’s total interest expense exceeds 50% of EBITDA

## Non-US investors - blocker/debt fund structure



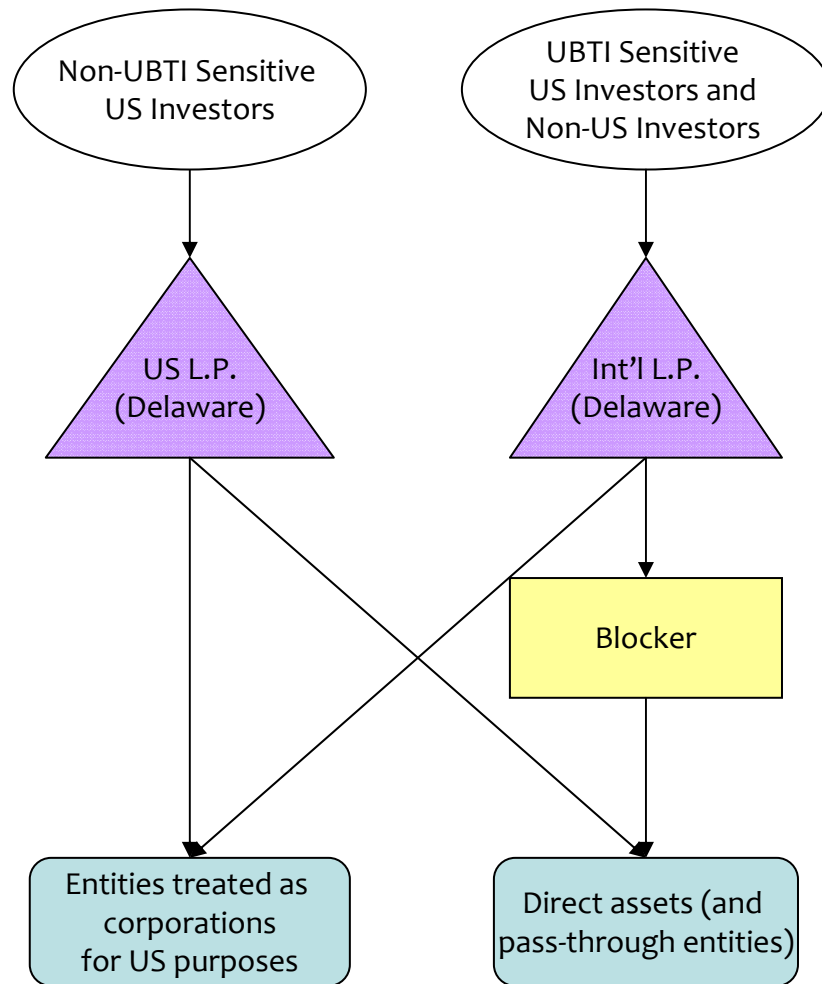
- Applies advantages of the blocker/debt structure to multiple properties
- Use of blocker for each asset permits liquidation of blocker on disposition
  - Cleansing Rule: Instead of making dividend distributions, each blocker retains earnings until asset is sold or earnings paid out in as P/I on debt. Once asset is sold, blocker can be liquidated, and retained earnings may be distributed without US withholding tax or FIRPTA tax
- Investors commit to investing via debt directly to the US blockers and equity into the fund vehicle
  - No investor may own more than 10% of the offshore fund vehicle, in order to obtain 0% US withholding on interest payments (portfolio interest) and to ensure that earnings stripping rules will not apply (because no investor is related, i.e., no investor owns 50% or more of vehicle)

## Non-US investors - global fund (warehouse period)



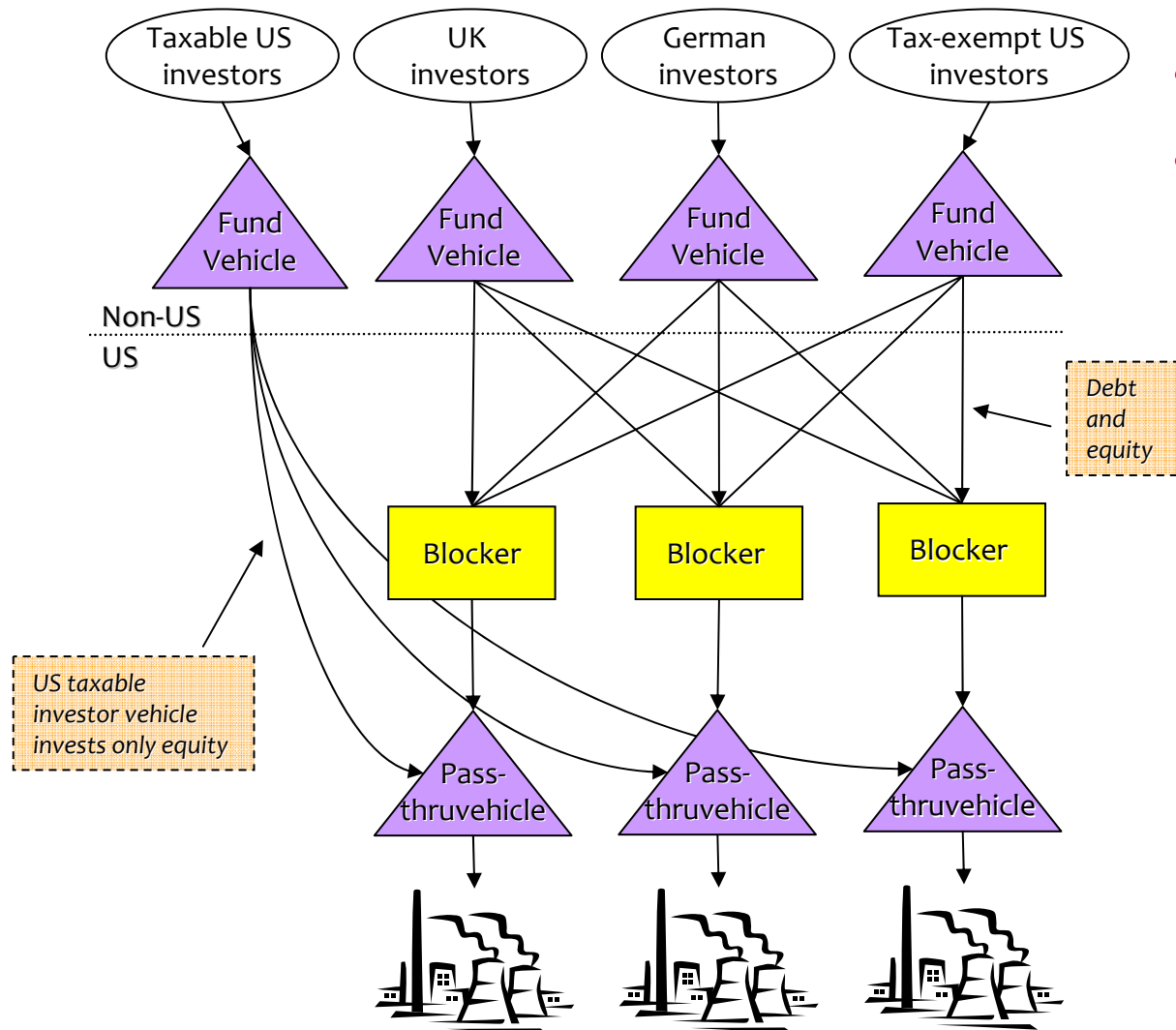
- Sponsor’s acquisition of an asset prior to transfer to a fund can affect tax cost of the transfer
- Sponsor’s subsidiary funds its investment in acquiring subsidiary with debt and equity to facilitate similar investment by future fund
- In Scenario 1, any gain on sale of the blocker results in US tax at Sponsor level if the infrastructure asset in question is a USRPI; otherwise, stock may be sold without US tax
- In Scenario 2, the non-US blocker may be sold in all cases (whether or not the asset in question is a USRPI) without US tax
  - Transferee will in effect inherit the inherent US tax liability on the asset
  - The non-US blocker also will be taxed in the United States on a current basis, as this would constitute a direct investment in the relevant asset

## Non-US investors – basic parallel fund structure



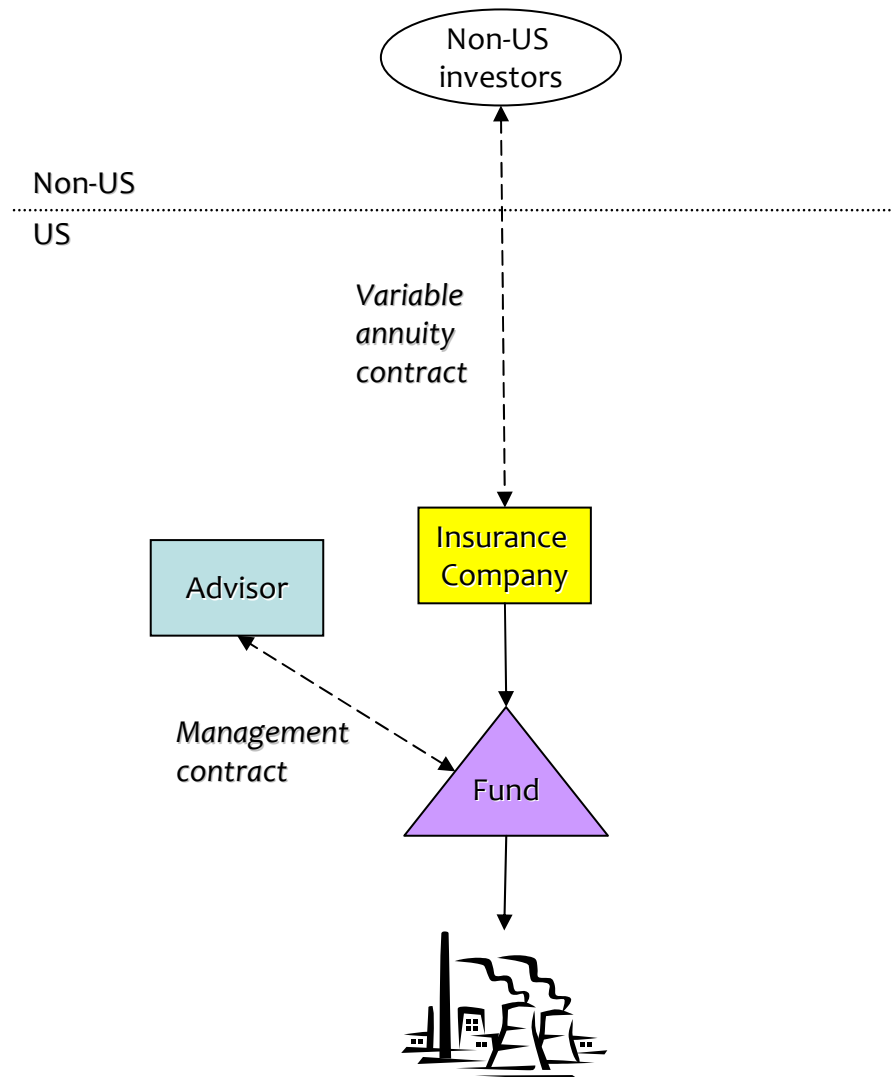
- Basic parallel fund structure
- Blocker established for each deal (where necessary), such that non-US investors should not receive ECI (subject to the application of FIRPTA) and tax-exempt investors should not receive UBTI
  - **There is flexibility to put a loss-generating asset into a blocker along with profitable assets to optimize US tax savings**
- For portfolio investments that are operating partnerships or other pass-through vehicles (such as toll roads), depreciation, amortization and interest expense may result in tax loss position for a number of years
  - Result is little or no US tax “drag” on returns other than the potential impact of FIRPTA on the terminal value
- For portfolio investments in corporations (e.g., utilities), due to inherited inside basis, there will be less available depreciation and amortization, and thus a shorter potential tax loss period
  - Effect on IRR can be modeled

## Non-US investors – global fund structure



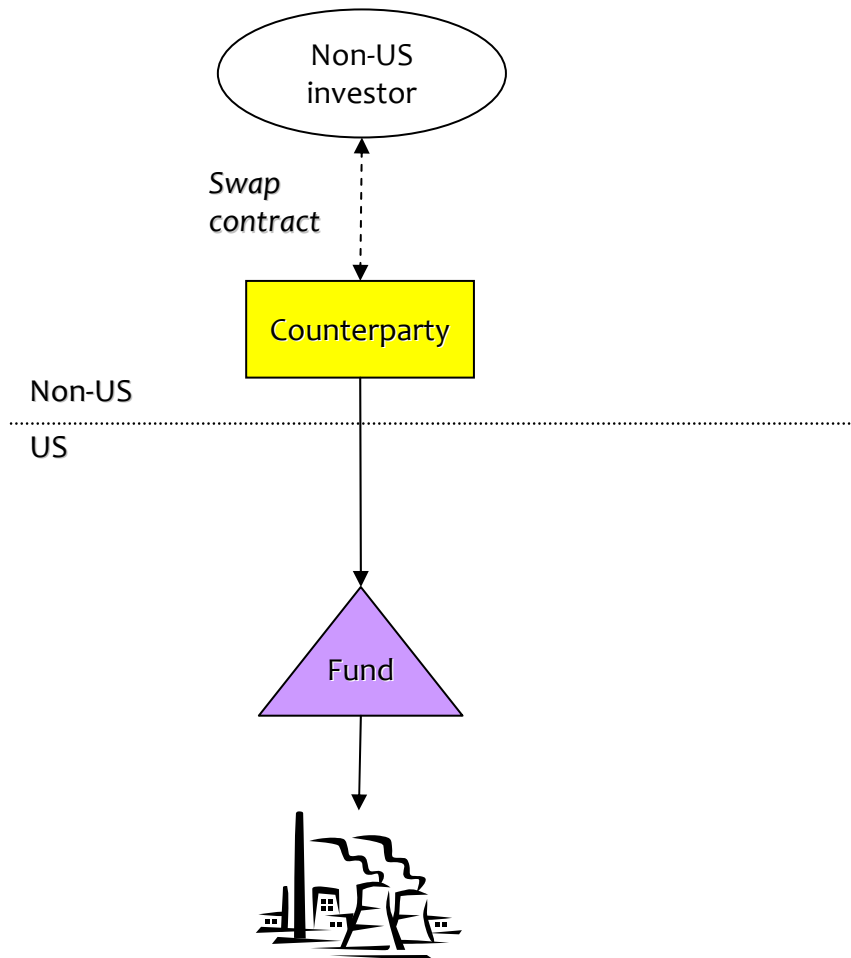
- Largely the same benefits of the blocker/debt fund outlined above
- However, structure permits fund vehicles to lend directly (**as opposed to investors**) to blockers (**for greater simplicity**)
  - No fund vehicle can own 50% or more of a blocker (to avoid earnings stripping rules)
  - No investor (looking through the fund vehicles) can be treated as owning 10% or more of a blocker in order to qualify for 0% withholding tax on interest (i.e., the portfolio interest exemption)

## Non-US investors – insurance company separate account



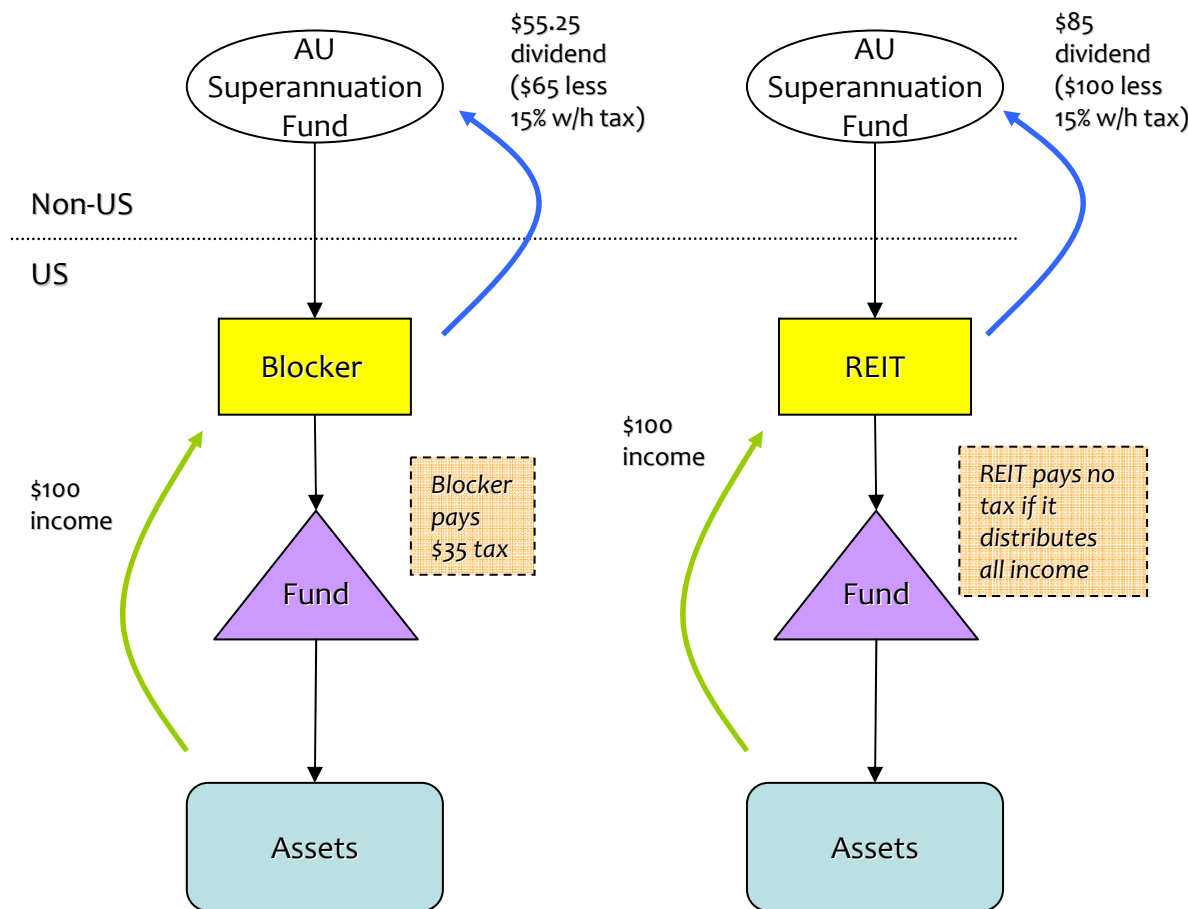
- Advantages
  - Insurance company treated as tax owner of US property
  - Annuity income received by non-US investors may not be subject to US tax under treaties
    - FIRPTA may still apply
  - Annuity income received by government investors likely not subject to US tax (including FIRPTA)
- Disadvantages
  - Customary investor controls (such as advisory committees, GP removal, key man rights, etc.) not permitted
  - All investors in fund must go through insurance company
  - Potential diversification rules

## Non-US investors – total return swap



- Advantages
  - No direct ownership of US property
  - Swap payments generally not subject to US withholding tax
- Disadvantages
  - Tax ownership question not settled
  - Market not robust
  - Pricing difficult
  - No control over property
  - FIRPTA may still apply

## Non-US investors – use of REITs



- REIT (a real estate investment trust) is effectively a blocker that is not subject to tax
  - Of course, the REIT must be properly structured and operated
  - Unlike ordinary blockers, REITs can deduct their distributions from income
- As infrastructure and real estate markets converge, REITs may become more common in infrastructure space
- Main issue – whether infrastructure assets can be held by REITs
  - Many assets constitute operating businesses, which REITs cannot hold
  - Goal is to convert a portion of operating business into real estate income stream that is “REITable”

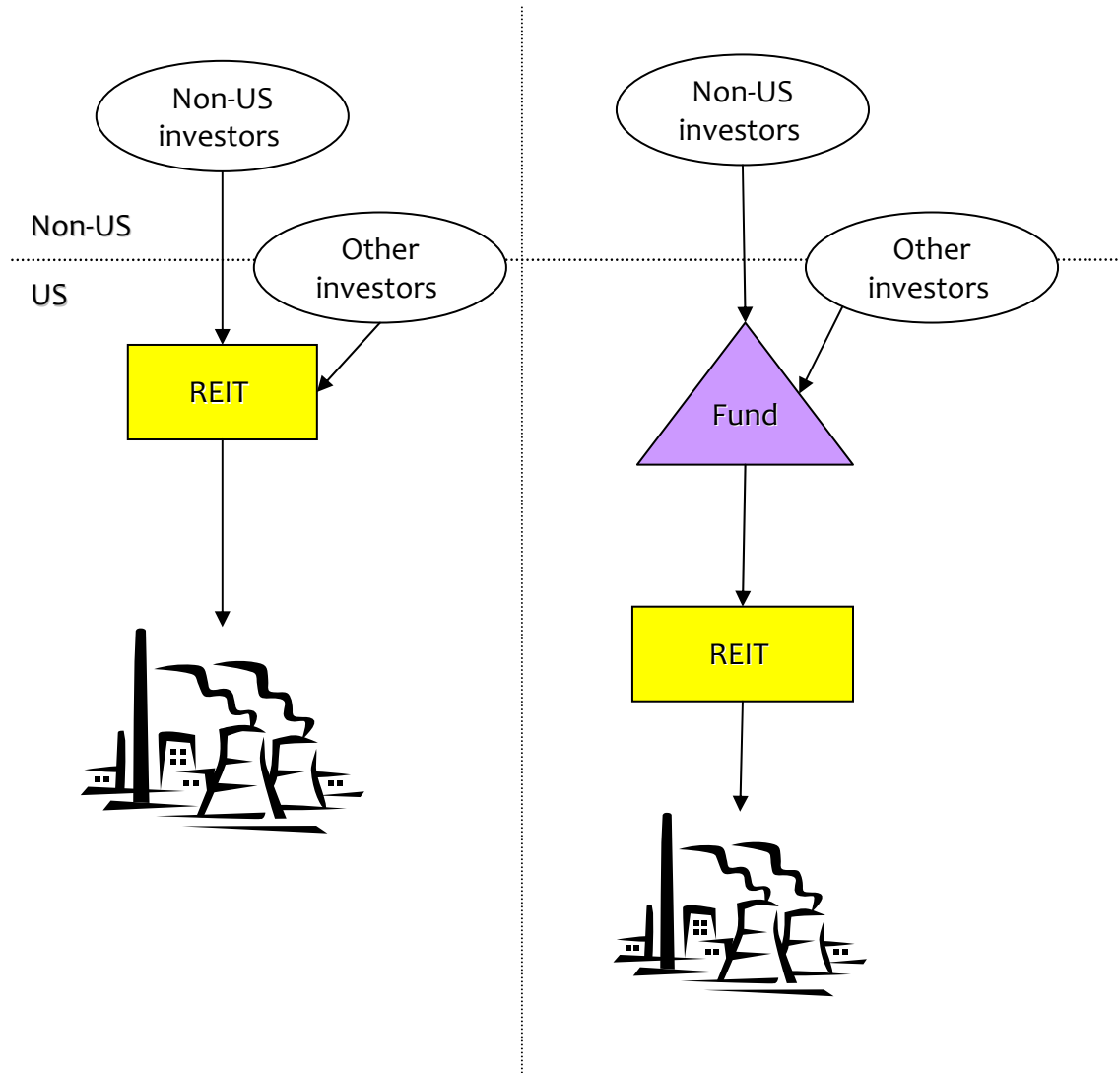
## Non-US investors - benefits of REITs for infrastructure

- REIT – real estate investment trust
- REITs provide many advantages over direct investment
  - Rents are “converted” into ordinary dividend income, which in most cases is eligible for a reduced rate of US withholding tax (from 30% to 15% under many treaties)
    - Under many US treaties, an ordinary dividend paid by a REIT will be subject to reduced US withholding tax if the beneficial owner of the dividend (i) is an individual that owns 10% or less of the REIT, (ii) owns 5% or less of the REIT and the REIT is publicly traded, or (iii) owns 10% or less of the REIT and the REIT is “diversified”
    - Thus, reduced withholding would not be available to a wholesale investor that owns more than 10% of the REIT in question
- The dreaded “FIRPTA” tax: gains from the sale of REIT shares (unless the REIT is domestically controlled), and REIT dividends of gains from the sale of US property, may be subject to 35% US tax (and potentially branch profits tax)
- No investor-level US income tax return if investor receives only ordinary dividend income
- No entity-level tax if dividends strip out 100% of taxable income
- There is some cost to using REIT – primarily, cost of compliance with REIT requirements

## Non-US investors - REIT requirements

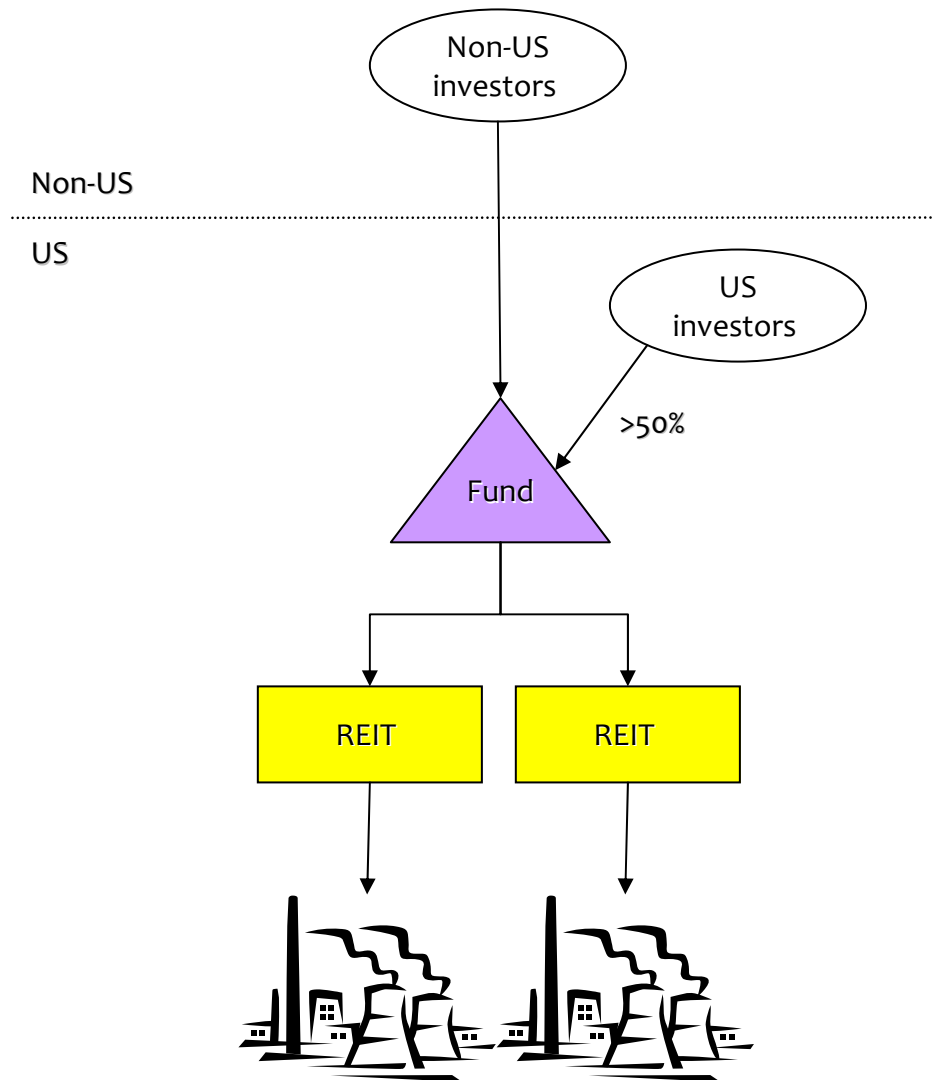
- Taxable as a corporation
- Managed by a board of directors or trustees
- Transferable shares or equity interests
- At least 100 shareholders
  - Options for meeting this test include (i) selling shares through a third party service, (ii) employee investment, and (iii) distributing shares to employees as a bonus
- Not closely held: no more than 50% of equity interests held by five or fewer individuals during the last half of year)
- Asset tests:
  - At least 75% of REIT's total gross assets consist of real estate assets
    - This is the KEY issue for infrastructure – many infrastructure assets will not qualify
  - Other 25% may be invested as desired, subject to certain limitations
- Income tests:
  - $\geq 75\%$  of gross income is rent on real estate property or mortgage interest
  - $\geq 95\%$  of its gross income is from the 75% “bucket,” plus certain other types of passive income, such as dividends and interest
- Distribute at least 90% of its taxable income in the form of shareholder dividends
  - Practically, REIT should distribute 100% to avoid entity level tax

## Non-US investors – direct investment/fund-owned REIT



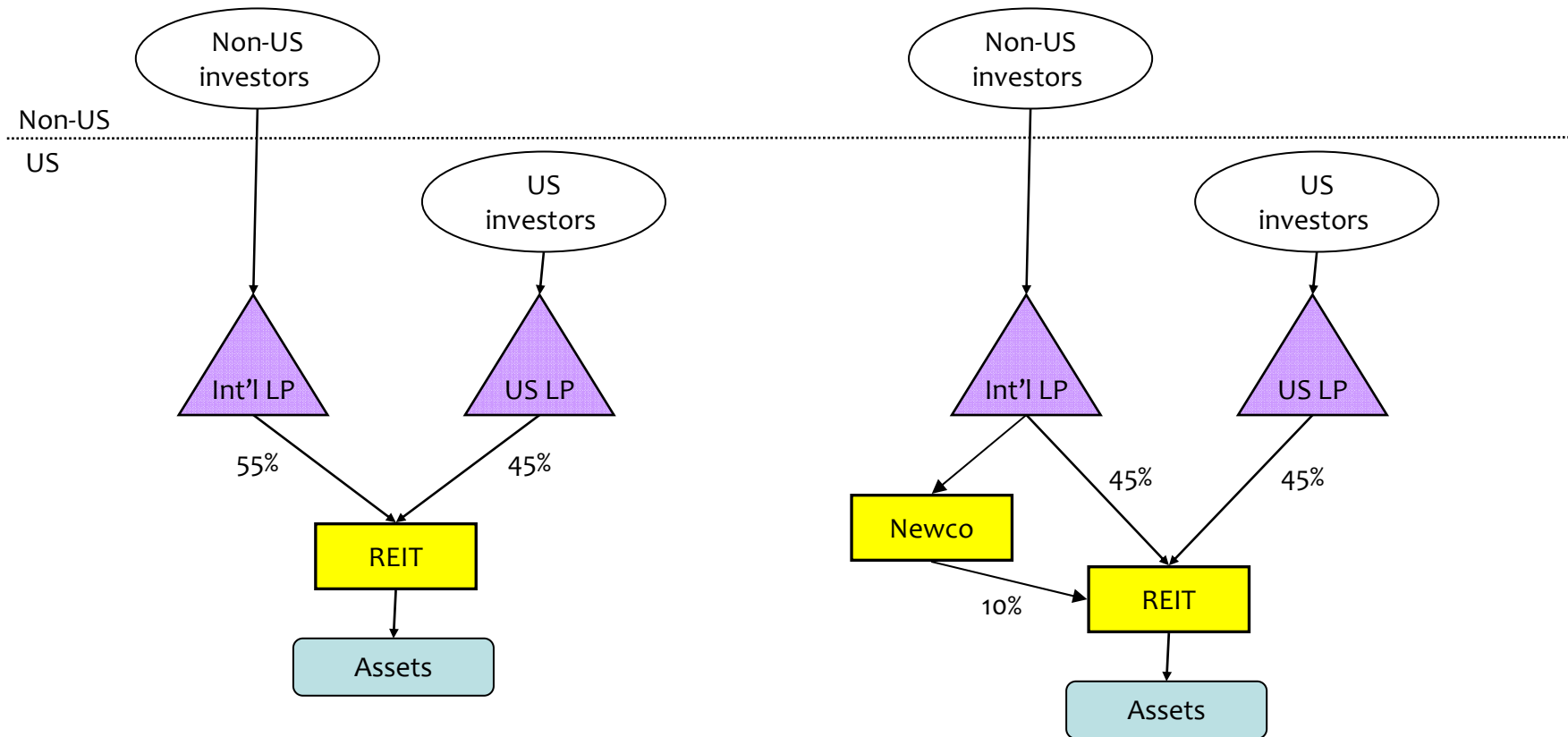
- Advantages
  - Under most treaties, w/h tax on ordinary dividends generally will be lower than 30%
    - AU treaty – rate is 15% (provided the investor owns less than 10% of the REIT)
  - Effective W/h Tax Less than 15%. Because distributions generally will be in amount in excess of earnings and profits of the REIT (such excess being a return of capital for US tax purposes), the effective rate of tax on distributions generally will be lower than 15%
    - Certain procedures must be undertaken to avoid withholding on such returns of capital
- Disadvantages
  - REIT dividends of gains from the sale of US property subject to 35% withholding tax (FIRPTA tax)
  - Gain from sale of REIT shares or interests in Fund subject to 35% tax (FIRPTA tax), unless REIT is domestically controlled

## Non-US investors – domestically controlled REIT fund



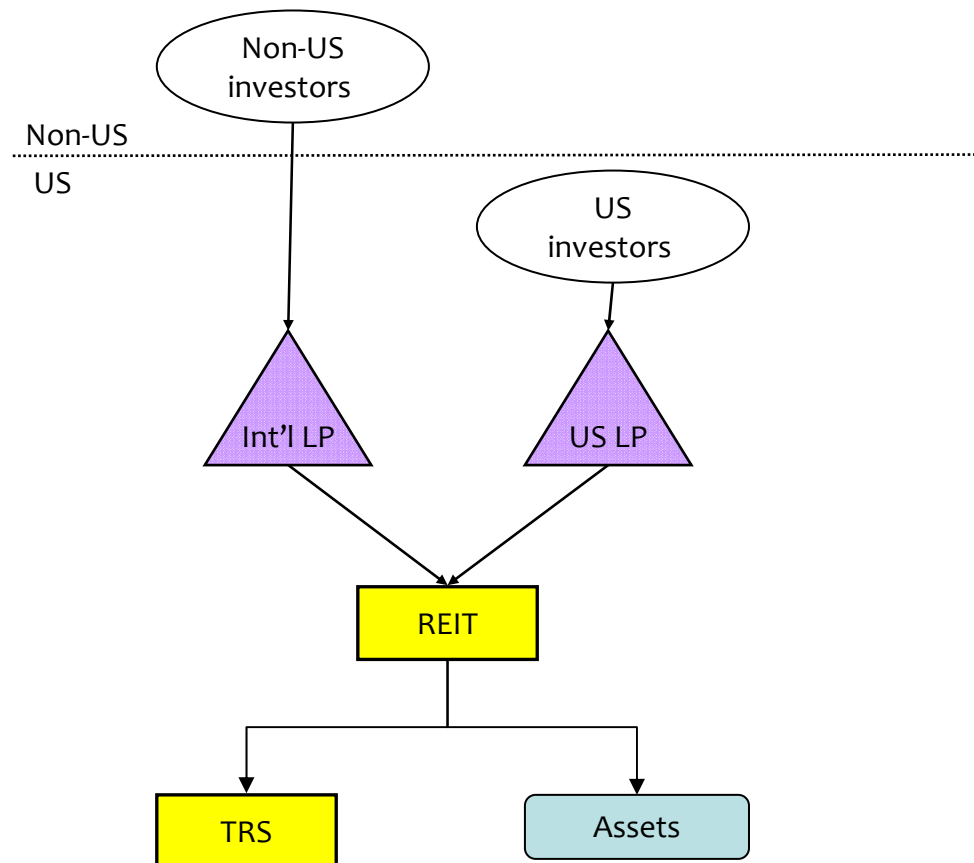
- Rental income is “converted” into dividend income
  - Under this structure, fewer treaties will provide for lower w/h tax, as the REITs will not be “diversified” (i.e., they will each own a single asset)
- However, no US tax on sale of interests in Fund because REIT is domestically controlled
- Fund sells assets through sale of REIT stock: as a result, no US capital gain tax is due
- No US tax return for non-US investors
- Overall effective US tax rate on income and gains can be less than 10%, depending on investment profile

## Non-US investors – creating domestic control



- Domestic control
  - As noted above, no FIRPTA tax on sale by non-US persons of shares in a domestically controlled REIT, which is a REIT in which at all times during the testing period less than 50% in value of the stock of the REIT was held directly or indirectly by foreign persons.
  - The testing period is the shorter of (i) the five year period ending on the date of disposition or (ii) the period during which the REIT was in existence

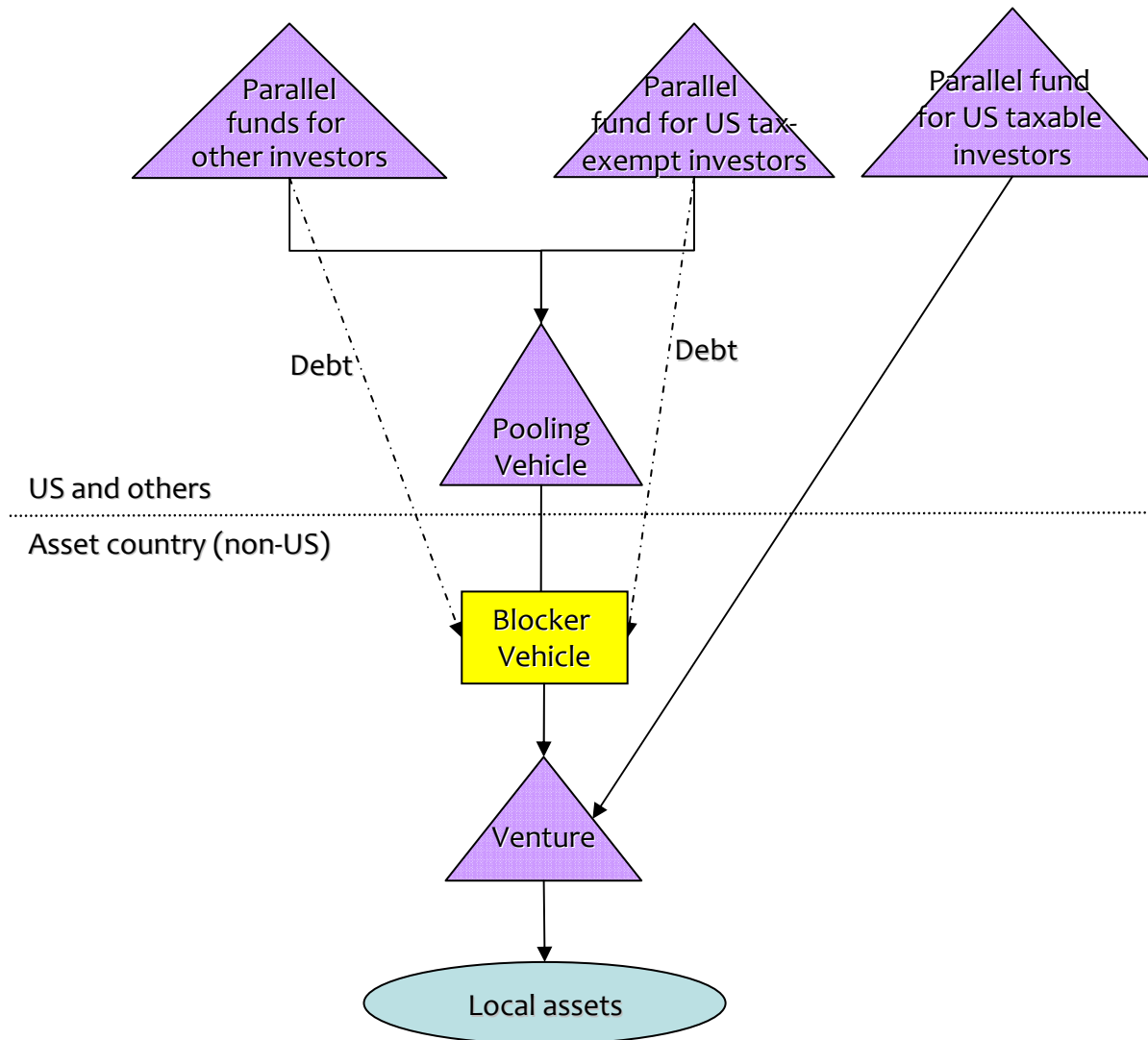
## Non-US investors – taxable REIT subsidiary



- It is possible that an infrastructure asset (if “REITable” in the first place) will generate income that is not qualifying REIT income
  - E.g., fee income
    - Fee income earned from managing or subleasing certain assets likely treated as fee income (and not as rental income), and therefore not qualifying REIT income
    - Such activities can be conducted by a taxable REIT subsidiary (TRS) or a separate blocker corporation elsewhere in the fund structure
    - The TRS is subject to US income tax on its net income
      - Dividends from the TRS to the REIT are qualifying income, provided they do not exceed 25% of the REIT’s income

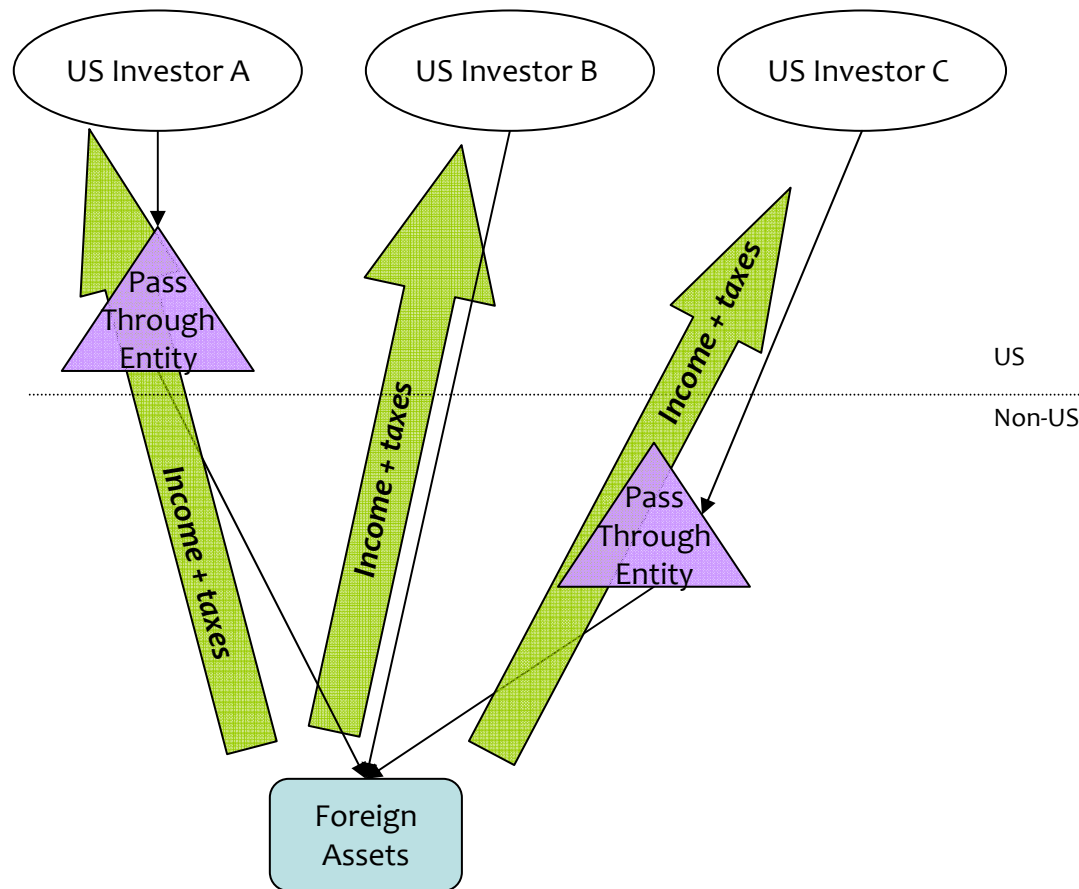
## US investors investing in non-US assets

## US investors - typical investment structure



- Goal of “parallel” structure is to address US tax issues for both US taxable and US tax-exempt investors
- Taxable US investor issues:
  - Flow-through of losses
  - Flow-through of foreign taxes in order to obtain credit in US
  - Avoiding anti-deferral rules (i.e., the CFC and PFIC rules)
  - All of this needs to be weighed against desire to defer income, character differences on exit, and possible “qualified dividend” treatment for individual investors
- US tax-exempt investor issues:
  - Avoiding UBTI
  - Reducing foreign taxes, since tax-exempt investors generally cannot take a credit for foreign taxes

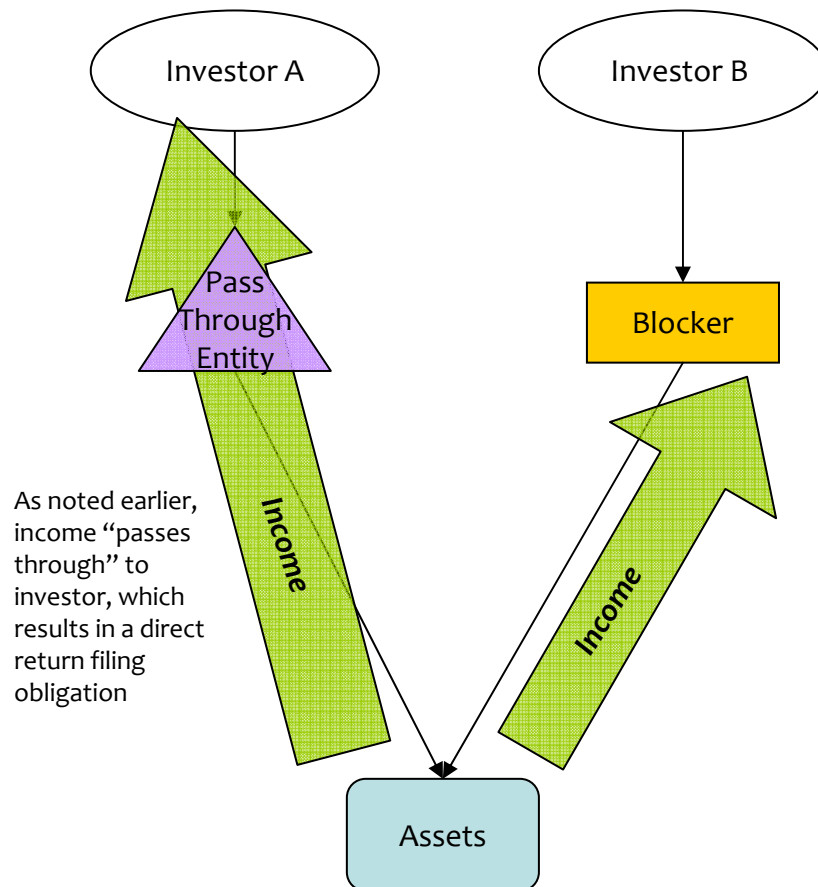
## US investors - direct investment



All US investors taxed identically on income generated by foreign assets

- US taxpayers are taxed on their worldwide income
  - Foreign source income taxed identically to US source
    - Consider effect on foreign tax credits
- US taxpayers who directly conduct business in foreign countries are usually eligible for a foreign tax credit (FTC) for foreign income taxes paid in the foreign country
  - This includes investments owned through entities treated as pass-through for US tax purposes
  - Jurisdiction where pass-through entity is organized is irrelevant
- Losses and deductions generally flow through as well

## Use of “blocker”



- As noted earlier, a blocker is an entity taxed as a corporation for US tax purposes that shields the investor from being treated as the taxpayer for US income tax purposes
- Investor receives only dividend income (or interest, if blocker funded with debt)
  - If blocker organized in US, income taxed at maximum rate of 35%, plus applicable state taxes,
  - If blocker organized outside US, no US tax on blocker’s income
    - Income taxed on repatriation, or under anti-deferral regimes
    - Foreign tax credits - US corporations owning 10% or more of the foreign corporation can obtain an indirect credit for foreign taxes paid by the foreign corporation
- Entity classification – making a blocker
  - Most business entities are treated as partnerships or corporations for tax purposes
  - Except for those entities that are always treated as corporations (the “per se” list of corporations), the treatment of foreign entities as partnerships or corporations is at the election of the taxpayer
    - Australian public limited companies are “per se” corporations

## US investors - goals

- Both taxable and tax-exempt investors want to minimize foreign taxes
  - US taxable investors are subject to various foreign tax credit limitations
  - US tax-exempt investors often cannot claim credit for foreign tax credits
  - Interest payments subject to low withholding taxes can reduce high-taxed business income
    - Treaties often reduce withholding taxes on interest (as well as dividends)
    - The US has a treaty with Australia, and many major Asian trading partners, including China, Japan, India, and South Korea
      - Hong Kong is NOT covered by the treaty between the US and China
  - Also, want to avoid filing foreign tax returns where possible

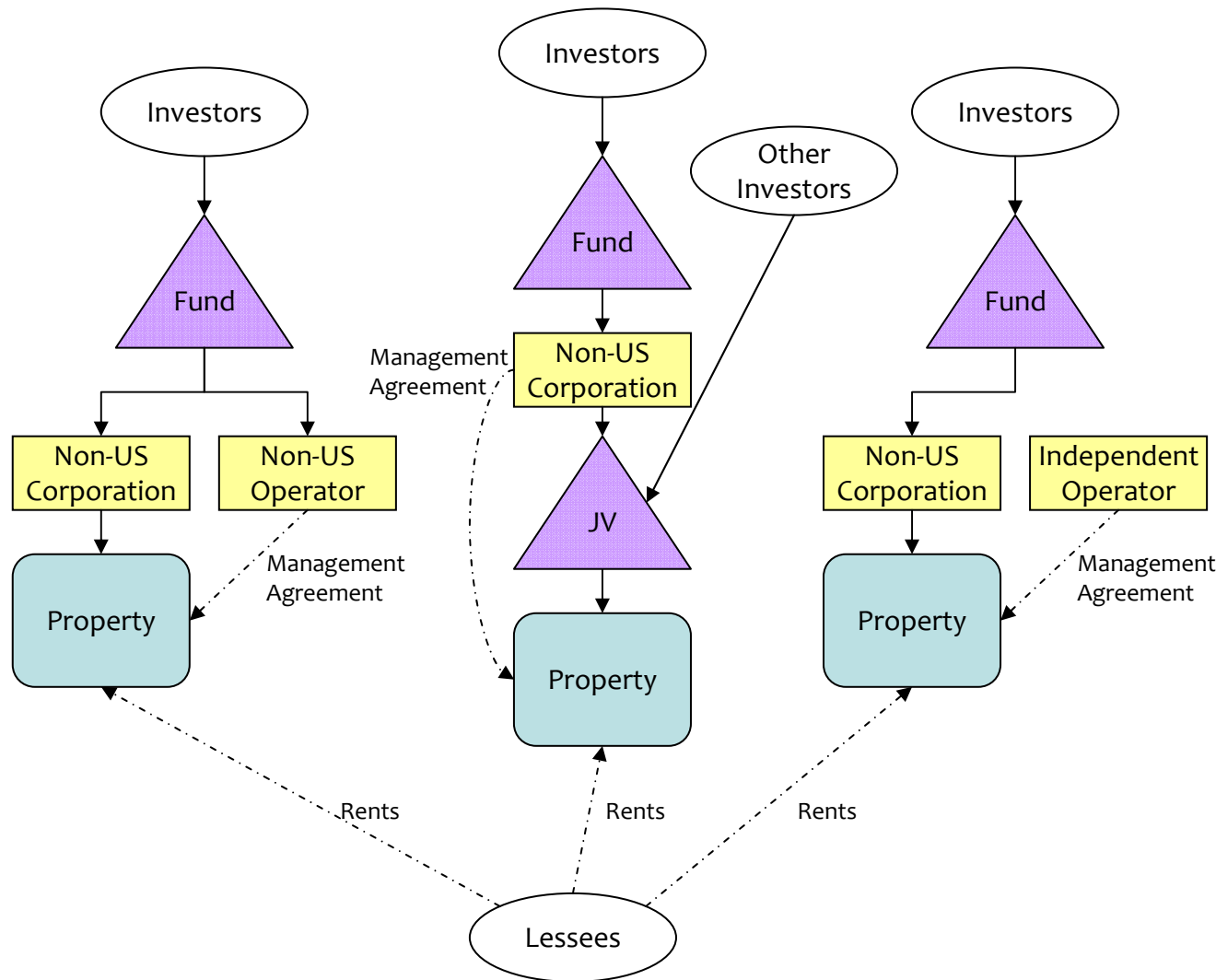
## US investors - goals

- Minimize US taxes
  - Taxable investors do this by investing directly or through pass-through entities
    - Flow-through of capital gains, depreciation and amortization
    - Avoid application of anti-deferral regimes, which apply to blockers only
      - controlled foreign corporation (CFC)
      - passive foreign investment company (PFIC)
    - Far fewer limitations on crediting foreign taxes
  - Tax-exempt investors do this by investing through blockers
    - Tax-exempt investors investing directly or through pass-through entities taxed on business income unrelated to their tax-exempt purposes
      - “unrelated business taxable income,” or UBTI
    - Dividends and interest paid by blockers usually are tax-exempt
    - Tradeoff – blockers may pay full income tax on their earnings (unless organized in low-tax jurisdictions or as pass-through entities under local law)

## US investors - passive income

- Both US anti-deferral regimes (CFC and PFIC) tax US investors currently on passive income earned by foreign corporations
- What is passive income for this purpose?
  - Includes dividends, interest and rents and gain from sale of assets that produce such income
  - **Important Exception:** rents derived in an active business
    - In order to be an active business, activities must be conducted by the foreign corporation's own officers and employees
- This issue arises for US investors in US and non-US funds that invest in foreign real estate and infrastructure

## US investors - passive income



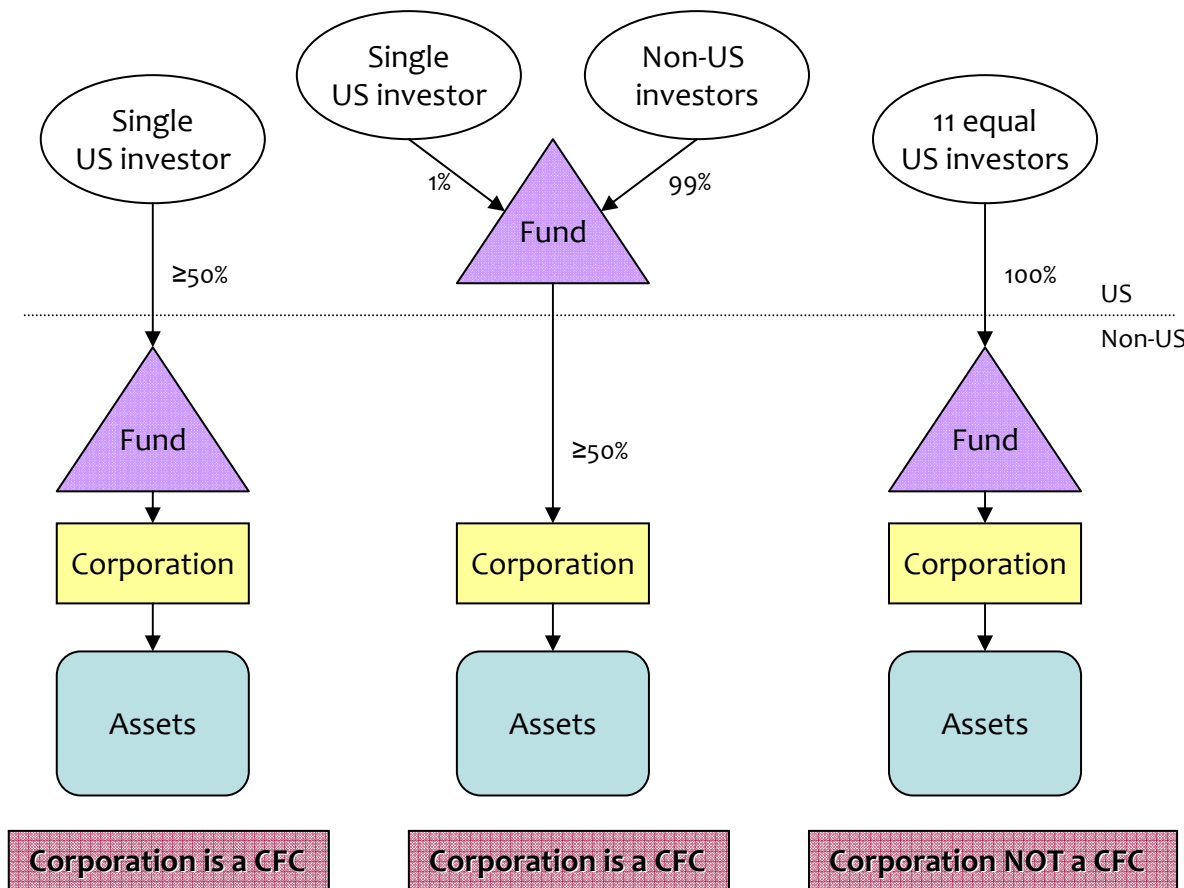
All examples of rents that would be treated as passive

- Active trade or business - foreign corporation's own officers or staff or employees must regularly perform active and substantial management and operational functions
  - Related person activities do not count
  - Independent contractor activities do not count, unless corporation's own activities rise to the level described above, without regard to the IC activities
  - Where the corporation owns property through a partnership, only the activities of the partnership, not the separate activities of the foreign corporation, count

## US investors - passive income

- Gains from sales of dealer property not passive income
- Dealer property is stock in trade or inventory (if on hand), or property held for sale in the ordinary course
- Inherently factual determination
  - Number, frequency, and continuity of sales
  - Purpose for acquisition and reason property is held
  - Length of ownership
  - Development activities
  - Efforts to sell property
- For passive income determination, property may be dealer property if it is not held for investment or speculation, and the foreign corporation regularly and actively offers to, and in fact does, enter into transactions with customers that are unrelated in the ordinary course
- Pure development projects usually OK
- No “own officers or employees” requirement for sales
- If otherwise dealer property generates rental income in advance of sale, passive asset treatment may attach (for PFIC purposes)

## US investors – subpart F/CFC regime



- A CFC is any foreign corporation if US persons own (directly, indirectly, or constructively) more than 50% of the corporation's stock (by vote or value), but taking into account only US persons owning 10% or more of such stock (measured by vote only)
- In a diverse fund, risk of CFC treatment is low, given the ownership thresholds involved
  - Of course, as demonstrated in the middle scenario, a US fund vehicle (even where the fund is diverse) can lead to CFC treatment
  - Nevertheless, the foreign corporation may still be treated as a PFIC (see the discussion below)

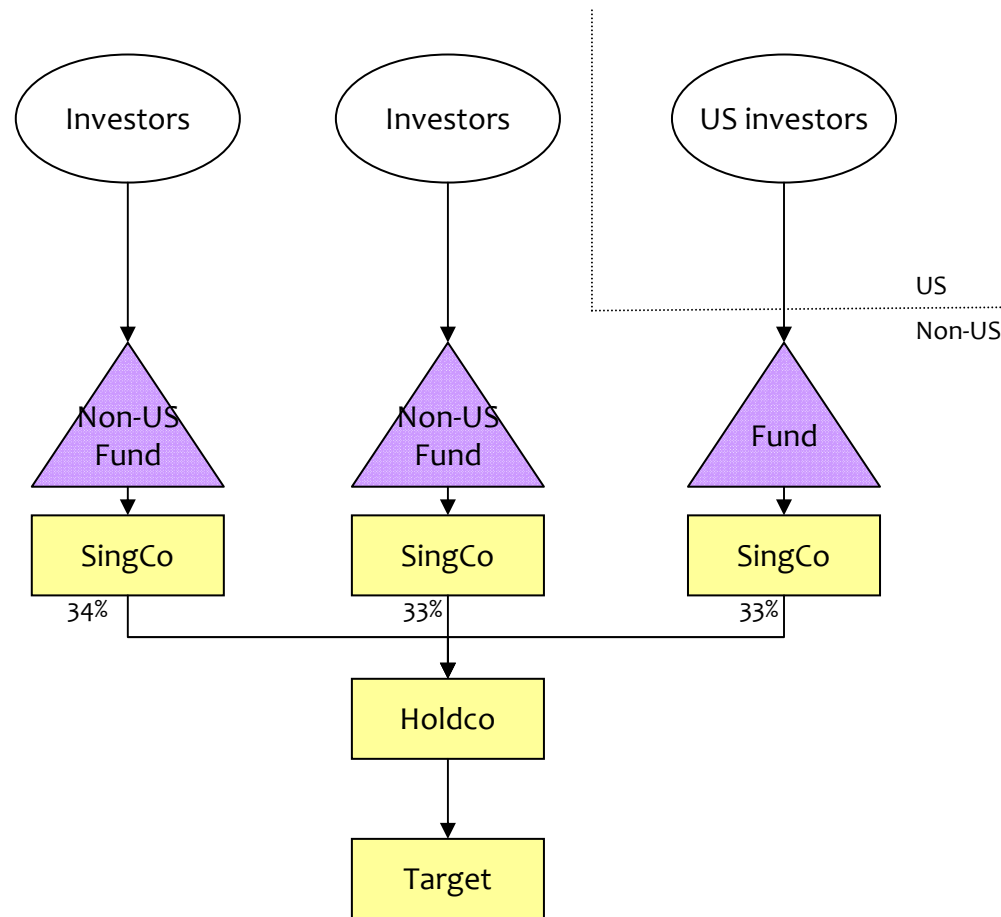
## US investors - subpart F/CFC regime

- US person owning 10% or more of a CFC taxed on its pro rata share of certain income earned by CFC (so-called “subpart F income”), regardless of whether such income is distributed
  - Subpart F income generally will be passive income (as described above)
  - In effect, US 10% shareholders treated as receiving deemed distribution from CFC
- CFC planning
  - No earnings and profits – subpart F income “pickup” limited to current E&P
    - Recapture may be required in later years if E&P is generated
  - High tax exemption – no pickup if CFC’s subpart F income subject to at least 90% of US tax rate (i.e., at least 31.5% tax)
  - De minimis exemption – no pickup if subpart F income less than \$1M or 5% of CFC’s gross income
  - Check the box elections – treat certain entities as pass-through entities to blend income and losses from entities
    - May not be desirable for tax-exempt investors, if it gives rise to UBTI
- Sale of stock in a CFC usually requires pickup of subpart F income not previously included in income as a dividend (i.e. ordinary treatment instead of capital gain treatment, subject to qualified dividend rules for individual investors)

## US investors - PFIC

- A passive foreign investment company (“PFIC”) is any foreign corporation if either:
  - 75% or more of its gross Income is passive income
  - 50% or More of its assets are passive assets
    - That is, they produce or held for the production of passive income
      - Based on average percentage of assets, based on each quarter of taxable year
        - » Generally – based on FMV
        - » If the corporation is not publicly traded, is a CFC, or makes an election, adjusted basis of assets may be used
- Look through rules apply for making these determinations
  - Foreign corporation treated as owning proportionate share of assets/income of 25% or greater owned subsidiary
  - Foreign corporation treated as owning proportionate share of assets/income held through a partnership
  - Dividends/interest/rents received from related parties not treated as passive, to the extent attributable to non-passive activities of related person
- Trap for unwary – rules could easily apply to companies that recently raised significant capital, company with depressed stock price (negative goodwill can cause company to fail asset test), and start-up companies that are PFICs beyond their first taxable year

## US investors - PFIC



- Subsidiary look through example
  - Because each Singapore company owns >25% of stock in Holdco, the SingCos may look through to Target's trade or business activities
  - If exit is an IPO of Holdco, each SingCo's ownership in Holdco could fall below 25%, thereby causing each SingCo to be treated as a PFIC, as their only asset would be stock in Holdco insufficient to permit look-through
  - A check the box election on SingCo would allow test to be done (more favorably) at Holdco/Target level

## US investors - PFIC

- Absent a “QEF election” or “mark to market election,” US persons who beneficially own shares in a PFIC are subject to a severe tax regime
  - The PFIC rules apply potentially to any US person that owns shares in a foreign entity treated as a corporation for US income tax purposes
    - Attribution rules apply for this purpose
  - Tax-exempt investors should be indifferent, provided their investment in the foreign entity is not debt financed
- PFIC status can be avoided in a number of ways
  - Electing to be treated as a partnership or disregarded entities
    - May not be desirable for tax-exempt investors
  - Being a CFC – PFIC rules not applicable to 10% US shareholders of a CFC
  - Structuring activities to qualify activities as “active,” perhaps by using officers and employees

## US investors - PFIC

- The “severe” tax regime
  - Gain on the sale of stock in a PFIC or the receipt of an “excess distribution” (a distribution in excess of 125% of the average distribution over the prior three years) is treated as earned ratably over the shareholder’s entire holding period in the stock
  - The gain or excess distribution allocable to any year is taxed at the highest rate for that year
  - Interest is due on the amount of tax that would have been due on the income allocated to the earlier period as if it had been earned in that year
    - The rate of interest is the short-term federal rate plus 3.0%
    - Interest begins accruing from the due date of the return for the relevant year

- Example

- Assume a US investor purchased stock in a PFIC on 1/1/2008 for \$100 and sold the stock on 12/31/2012 for \$600. Assuming the interest rate is 7%, the \$500 in gain would be taxed as follows:

• Year	Gain allocated	Tax (35%)	Interest due	
• 2008	\$100	\$35	4 years of 7% on \$35, or \$9.80	
• 2009	\$100	\$35	3 years of 7% on \$35, or \$7.35	
• 2010	\$100	\$35	2 years of 7% on \$35, or \$4.90	
• 2011	\$100	\$35	1 year of 7% on \$35, or \$2.45	
• 2012	\$100	\$35	none	
• Total	\$500	\$175	\$24.50	<b>Total tax/interest - \$199.50</b>

## US investors - avoiding PFIC regime

- The “severe” PFIC tax regime can be avoided through the use of either a “qualified electing fund” election (“QEF election”) or a “mark to market” election (“MTM election”)
  - By making a QEF election, the US shareholder elects to be taxed currently on profits of the foreign corporation (income, but not losses, flow through)
    - Amount included would be shareholder’s pro rata share of income and net capital gain, whether or not distributed
    - Investor, not the corporation, makes the election by filing Form 8621 with the IRS
      - US partnership holding shares could make election for all US investors
    - Corporation must provide statement to investor showing its share of income and gains (or other information that would permit the investor to calculate these amounts), and must be calculated using US income tax principles
      - International GAAP or IFRS not acceptable
  - By making a MTM election, the investor includes as ordinary income in each taxable year the excess of the FMV of the PFIC stock over adjusted basis
    - May deduct losses to the extent of prior MTM inclusions
    - Election made on Form 8621
    - Applies only to PFICs that are traded on certain US and foreign stock exchanges

## US investors - UBTI

**UBTI** is “unrelated business taxable income,” or gross income earned by an otherwise tax-exempt entity from a trade or business not substantially related to the tax-exempt entity’s exempt purpose

Tax-exempt entities may receive passive-type income free of tax, but not UBTI. Earning UBTI generally does not affect the tax-exempt status of most tax-exempt entities. Instead, earning UBTI will require a tax-exempt investor to file a US federal income tax return and pay tax on the UBTI (maximum rate of 35%)

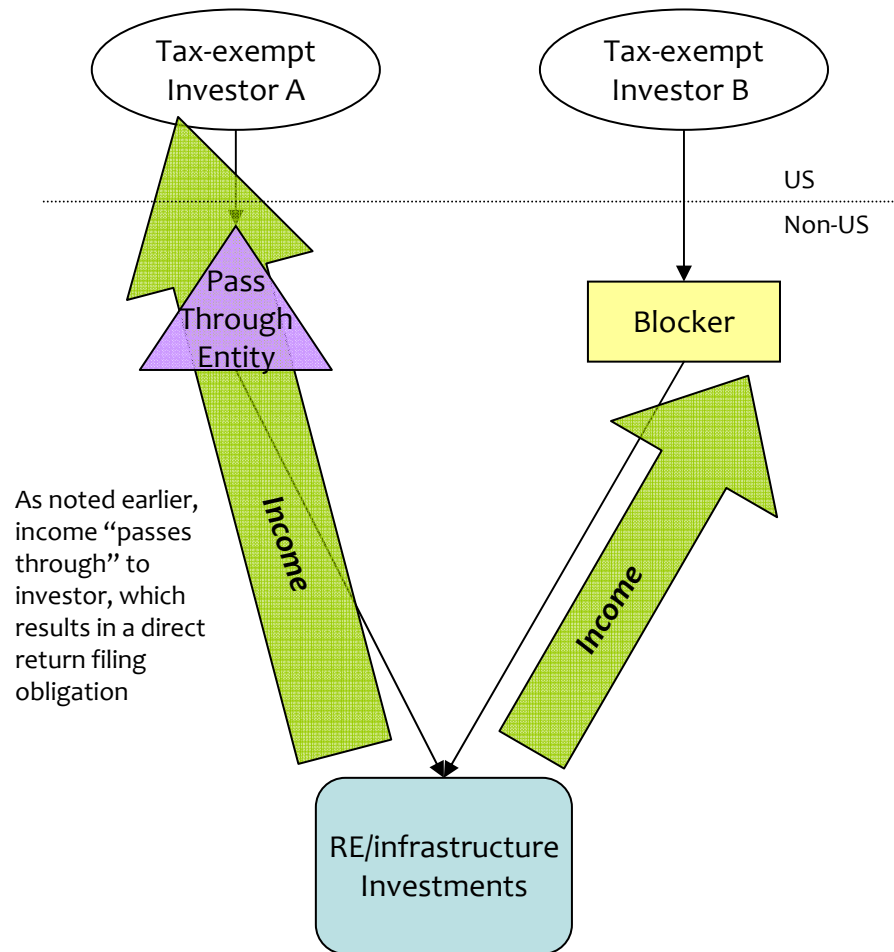
UBTI recognized by a pass-through entity is allocated to the tax-exempt investors and retains its character as UBTI in the hands of the tax-exempt investor. Pass-through entities also must report UBTI to its partners or members.

A tax-exempt entity generally is ineligible for the foreign tax credit. However, a credit may be taken for foreign taxes imposed on UBTI. A tax-exempt corporation may claim both direct and indirect foreign tax credits, but only the direct credit may be taken by tax-exempt trusts.

## US investors - UBTI

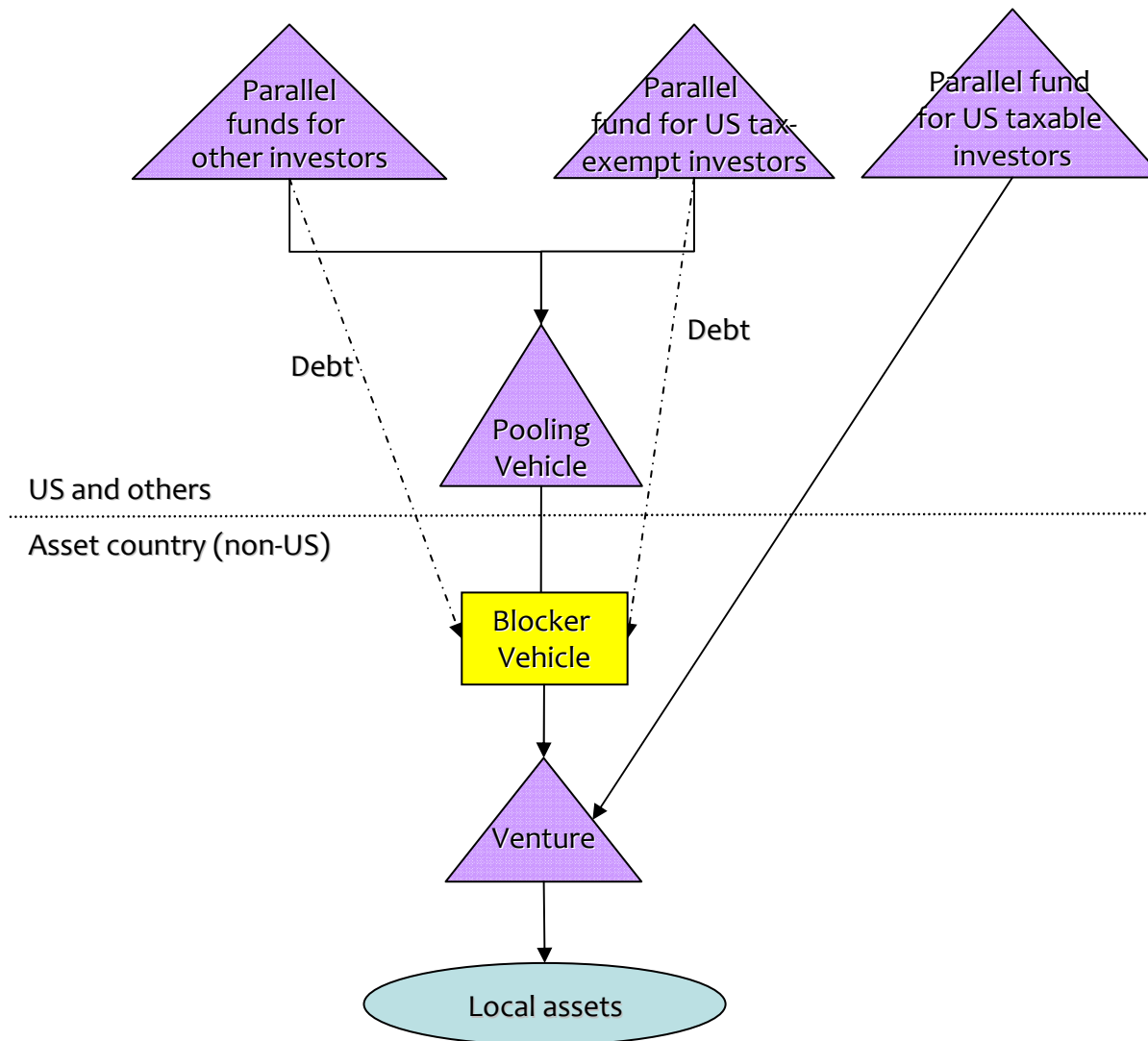
- UBTI does not include many types of passive investment income :
  - Dividends
  - Interest
  - Rents from real property (with certain exceptions)
  - Gains or losses from sale of property (other than dealer property)
- Passive investment income can be treated as UBTI if the property generating the income is debt-financed
  - This includes any income received by the tax-exempt investor to the extent such income is attributable to debt incurred by a fund in which a tax-exempt entity invests to acquire or improve the property
  - However, certain debt incurred to acquire real property may not cause a tax-exempt investor to incur UBTI
- UBTI rules apply equally to foreign income as to US income
- CFC and PFIC rules generally do not affect tax exempts
- Foreign tax credit regime only useful if used to reduce taxes on UBTI

## US investors – use of blocker to avoid UBTI



- Taxation of a blocker
  - Blocker shields the tax-exempt investor from being treated as the taxpayer for US income tax purposes – no UBTI for the tax-exempt investor
  - Blocker can either be below fund vehicle or tax-exempt entity can establish its own blocker entity
  - Interest received from a controlled blocker (i.e., more than a 50% ownership) will be UBTI to the extent the payment reduces the net income of the blocker (or increases an NOL)
  - Investment in blocker cannot be debt financed

## US investors - review



- Taxable US investors avoid CFC/PFIC rules by investing in pass-through (i.e., non-corporate) entity
  - Able to use losses
  - Able to credit foreign taxes paid by venture with greater ease
  - Debt not necessary from taxable US investor
- Tax-exempt investors invest in blocker, thereby avoiding UBTI
  - Debt reduces tax at blocker level (for which tax-exempt investor would not have received any credit)
  - Ideally, interest subject to little or no withholding tax (again, since tax-exempt investor would not get credit)

## Infrastructure basics

## Infrastructure - Outright Ownership v. Leasehold Interest

- Outright sale of a government-owned infrastructure asset sometimes not possible under local law or policy
  - In addition, property taxes may be avoided with long-term lease rather than sale
- A long-term lease can be treated as a sale for US income tax purposes (but a lease for all other purposes) if all of the economic attributes of an asset are transferred to the lessee for the entire useful life of the asset
  - Key issue: whether risk of loss/opportunity for gain for the entire economic life of the asset have been transferred to the lessee
    - Lessor should not be able to terminate lease without cause or share in, or guarantee any portion of, the earnings from the asset
    - An appraisal report should be obtained to demonstrate that the lease term equals or exceeds the reasonably anticipated remaining useful life of asset
- Benefits of sale treatment
  - Depreciation/amortization deductions
  - Goodwill deductions over 15 years

## Infrastructure - Tax-exempt financing

- A key benefit of tax-exempt financing is lower debt costs
- Current tax law sharply restricts the ability of private developers to finance construction of public infrastructure facilities via tax-exempt bonds
  - Available for certain “exempt” facilities including airports, docks and wharves, water, wastewater and solid waste disposal facilities
  - Projects such as highways, conventional passenger rail facilities and schools developed through public/private partnerships remain entirely ineligible
- In addition, the tax-exempt financing of eligible facilities is limited by stringent state volume caps, which force the largest projects into the taxable financing markets
  - Amount of bonds that can be issued in any year is the greater of \$75 multiplied by the state’s population or \$225,000,000
  - AMT limits tax advantage of these bonds
- Sale of governmental infrastructure asset to a private company constitutes a so-called “change of use” with respect to the tax-exempt bonds presently outstanding used to finance the asset
  - “Remedial action” required to avoid prospective and possible retroactive taxation of bond interest (subject to statute of limitations)
  - In general, remedial action requires all outstanding tax-exempt bonds that financed the asset be redeemed at their earliest call date

## Infrastructure - Investment-type credits

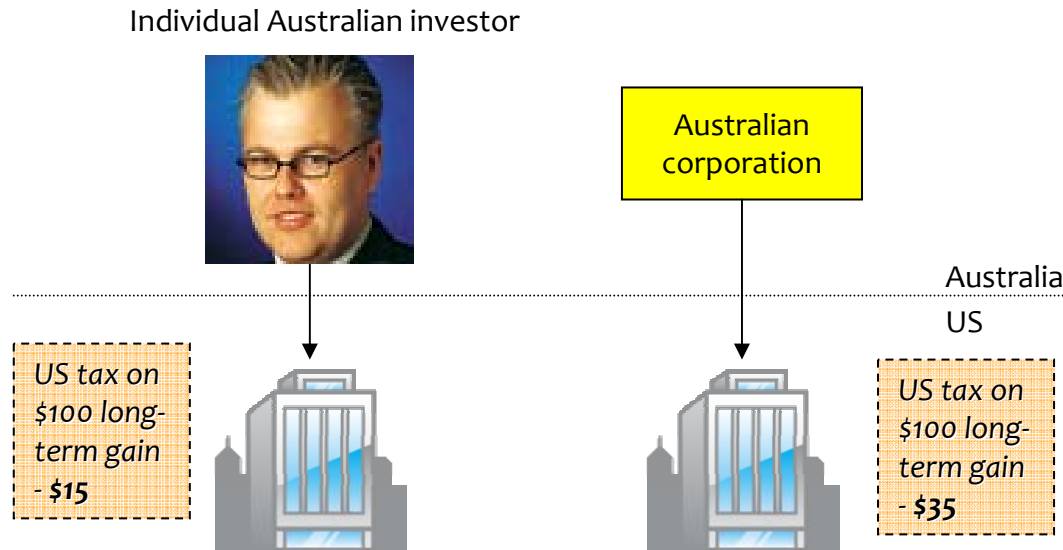
- Prior to tax reform in 1986, there was (i) an investment tax credit available for certain kinds of infrastructure projects, and (ii) accelerated depreciation lives (and other tax provisions) that provided incentives for big leveraged projects
- Currently, the only credit generally available is the “general business credit,” which comprises numerous credits, but subjects all of them to uniform rules about dollar limitations, carrybacks and carryforwards, and other technical details. Few of these would apply to infrastructure assets
  - An energy credit is allowed for 10 percent of the cost of certain property placed in service during the year: (1) equipment that uses solar energy to generate electricity, heat or cool a structure, provide hot water, or provide solar process heat; or (2) equipment used to produce, distribute, or use geothermal energy stored in rocks, water, or steam. The property must be depreciable (i.e., used in your business)
  - A renewable resources electricity production credit is available and is based on electricity that is produced from wind or closed-loop biomass (organic material grown exclusively for electricity production) and sold to third parties, from facilities placed in service after 1992 and before January 1, 2008, or wind energy facilities placed in service after 1993 and before January 1, 2009
- State level credits/incentives may be available

## Infrastructure - FIRPTA

- Whether as the result of an outright sale or a long-term lease, non-US investors should be treated as owning an infrastructure asset
- A critical question is whether the asset will be treated as a USRPI for FIRPTA purposes
  - As noted above, FIRPTA treats as a USRPI any interest in real property, which includes possessory right in real property or any right to share in the appreciation in the value of, or gross or net proceeds or profits generated by real property
  - Sale price (or upfront lease payment) or sale proceeds must be allocated for purposes of depreciation/amortization purposes
    - Allocable to “right of way” first, and then franchise
    - IRS seems to agree (in discussions) that some portion may be allocable to the franchise, but clearly believes more should be allocated to right of way
  - Franchise right – if it’s a separate intangible, there is an argument that it should not be viewed as possessory interest in real property
  - However, there is no guidance on the question as to whether the franchise, which is inextricably linked to the underlying real property, constitutes a right to share in the appreciation of the asset
    - In other words, the allocation for depreciation/amortization purposes may be different for FIRPTA purposes

## Hot topics

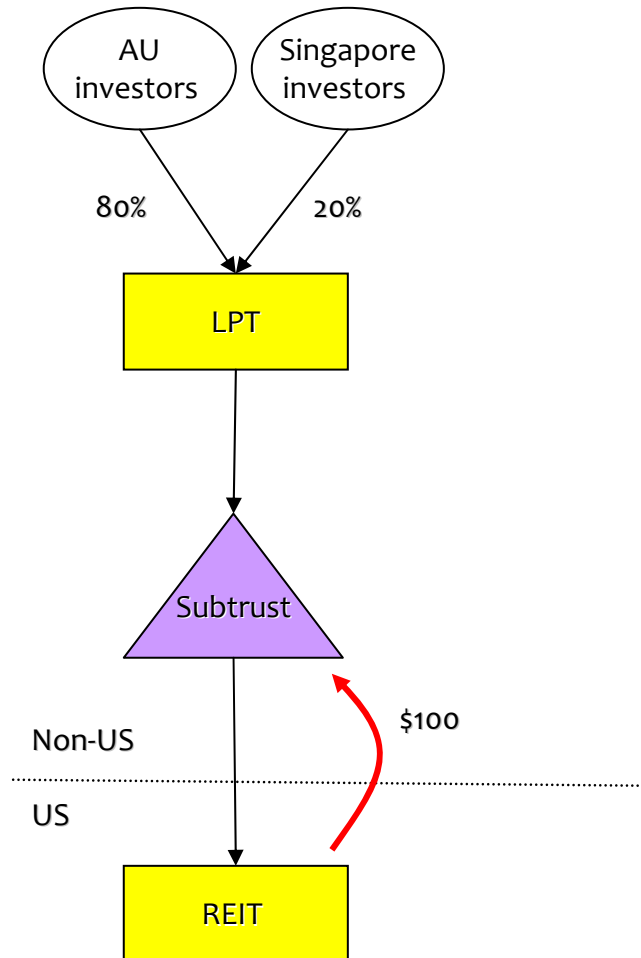
## Convert 35% FIRPTA Tax to 15% Tax



Ruling results in the super being taxed like an individual rather than a corporation

- Dutch pension plans have received rulings to the effect that they are trusts for US federal income tax purposes
- As a result, they qualify for non-corporate US tax rates (15% rather than 35%) on long-term capital gains from the sale of real estate (i.e., FIRPTA gain)
- It may be possible for certain Australian trusts (such as superannuation funds) to obtain such rulings
  - Whether an arrangement will be treated as a trust depends on whether it can show that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit
    - These are admittedly vague standards, the application of which is highly fact specific
  - We have received considerable interest in this option, and expect to file one or more rulings with the IRS in 2008

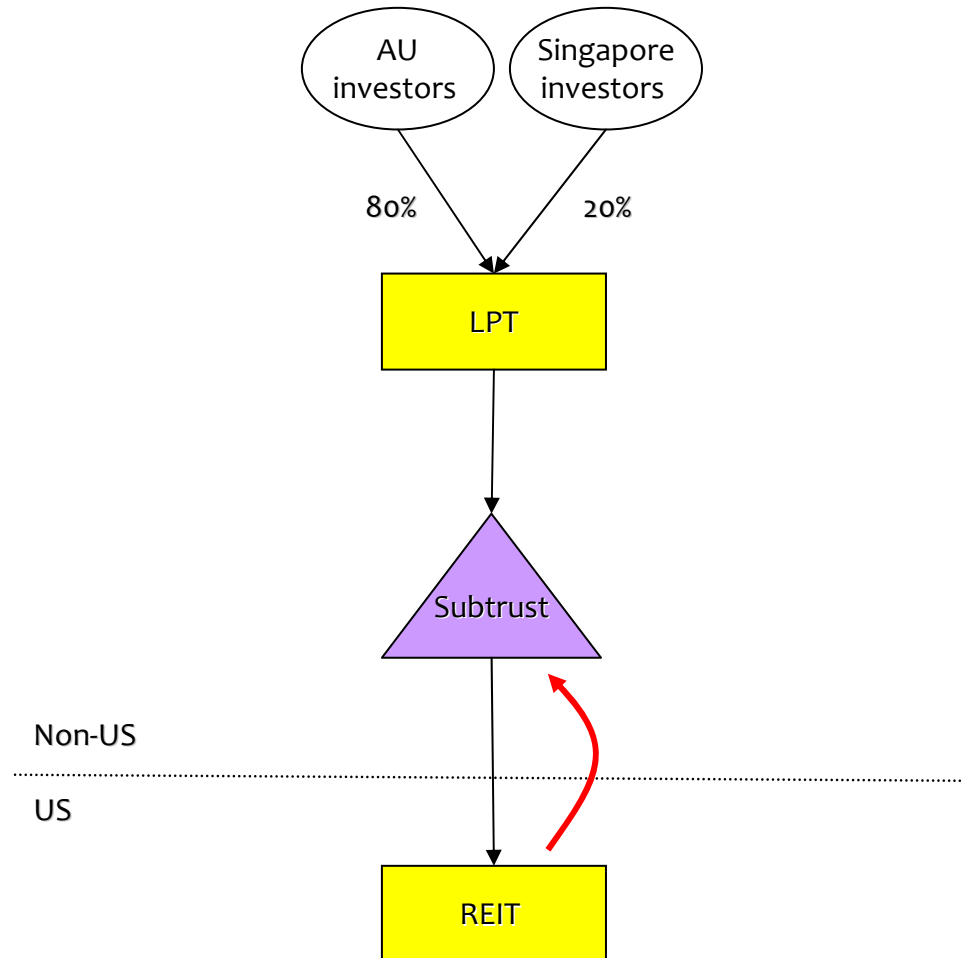
## Residency of Australian trusts



*If LPT and subtrust resident only to extent of ultimate AU investors, withholding tax on \$100 dividend is 15% on \$80 and 30% on \$20, or \$18 (and this results only if AU investors provide US tax forms)*

- In order to be eligible for benefits of the US-Australia treaty, recipient of income must be (i) resident of Australia under the treaty and (ii) a qualified person under the LOB provision of the treaty
  - LPTs (and their wholly-owned sub-trusts) should be qualified persons under the LOB provision
  - But, are they residents in the first place? The issue has been raised by at least one accounting firm
- Under the treaty, a trust is a resident of Australia if it is a resident of Australia under Australian tax law, but only to the extent that the income is subject to Australian tax as the income of a resident, either in the trust or in the hands of a beneficiary
  - Trusts usually resident for Australian domestic tax purposes
  - Trusts usually taxed on worldwide income, but only to the extent no distributions are made
    - However, if a trust fully distributes its income (which is often the case), the trust’s beneficiaries generally are taxed on receipt (but payments to non-AU beneficiaries not subject to withholding)
- Result – possibility that US source payments received by an LPT (or a subsidiary trust) are eligible for lower withholding only to the extent of the trust’s ultimate Australian owners
  - More importantly, US tax forms from all owners would be required to demonstrate eligibility

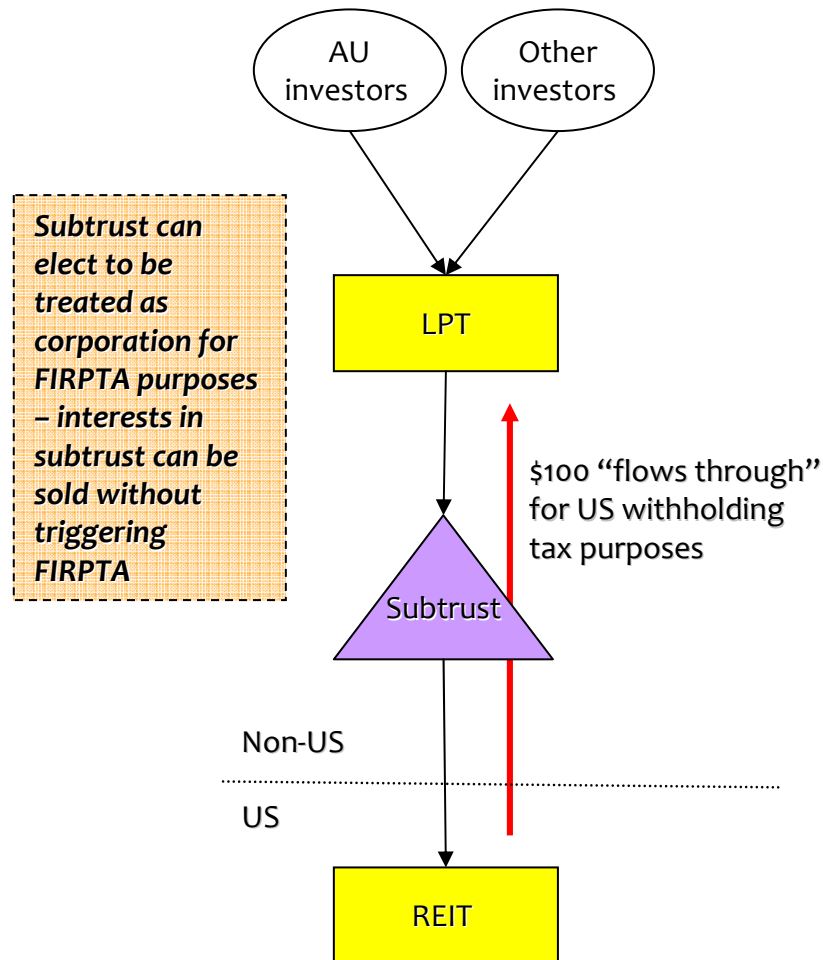
## Residency of Australian trusts



*If LPT and subtrust are wholly resident in Australia, withholding tax on \$100 dividend is 15% on \$100, or \$15*

- Arguments on both sides of this issue
  - In support of the look-through position is (i) the treaty language and technical explanation (despite ambiguities) and (ii) that trusts need not withhold on payments made to non-AU beneficiaries of income from non-AU sources
  - In support of treating trusts as wholly-resident is (i) commentary on the US model treaty and private rulings suggesting that residence is determined by whether trust is “liable to tax” (like a US REIT) and (ii) that AU trusts may be “liable to tax” under such authorities

## Fiscal transparency

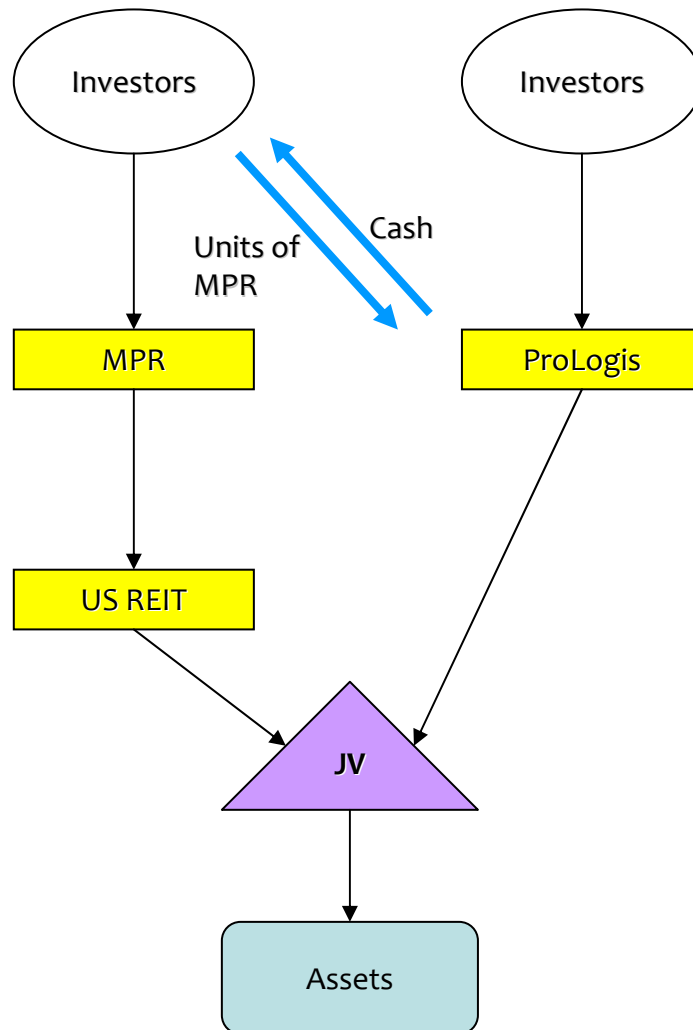


Subtrust can elect to be treated as corporation for FIRPTA purposes – interests in subtrust can be sold without triggering FIRPTA

- Assuming the residency issue is resolved favorably, a final hurdle for obtaining treaty benefits is Section 894 of the Code (fiscal transparency)
- If an entity is fiscally transparent (FT) (under US or foreign law), and the treaty does not address the issue, the US will look to see who ultimately derived the income, and apply withholding on that basis
- Under Section 894, an entity is FT if (i) the owner, wherever resident, must separately take into account on a current basis its share of the item of income paid to the entity, whether or not distributed to the owner and (ii) the character and source of the item passes through the entity
  - If the items of income are not separately taken into account, the entity can still be FT with respect to an item of income provided there is no difference between the owner’s tax liability, with respect to that item of income, and what the owner’s liability would have been had it separately taken the item of income into account
  - Some have suggested that this means that all aspects of an owner’s tax outcome must be exactly the same as a result of investing through the entity, taking into account not only the netting of items of income and loss at the entity level, but also any other income or loss item received by the owner outside of the entity in question
- Example of importance-
  - In the case of a wholly-owned subtrust of an LPT, if the subtrust is not treated as FT, the dividends it receives from a US REIT would not be eligible for lower LPT rate because not derived by the LPT, but by the subtrust
- Local counsel advice on this point is critical
- Important point - subtrust can elect to be treated as corporation for FIRPTA purposes – interests in subtrust can be sold without triggering FIRPTA

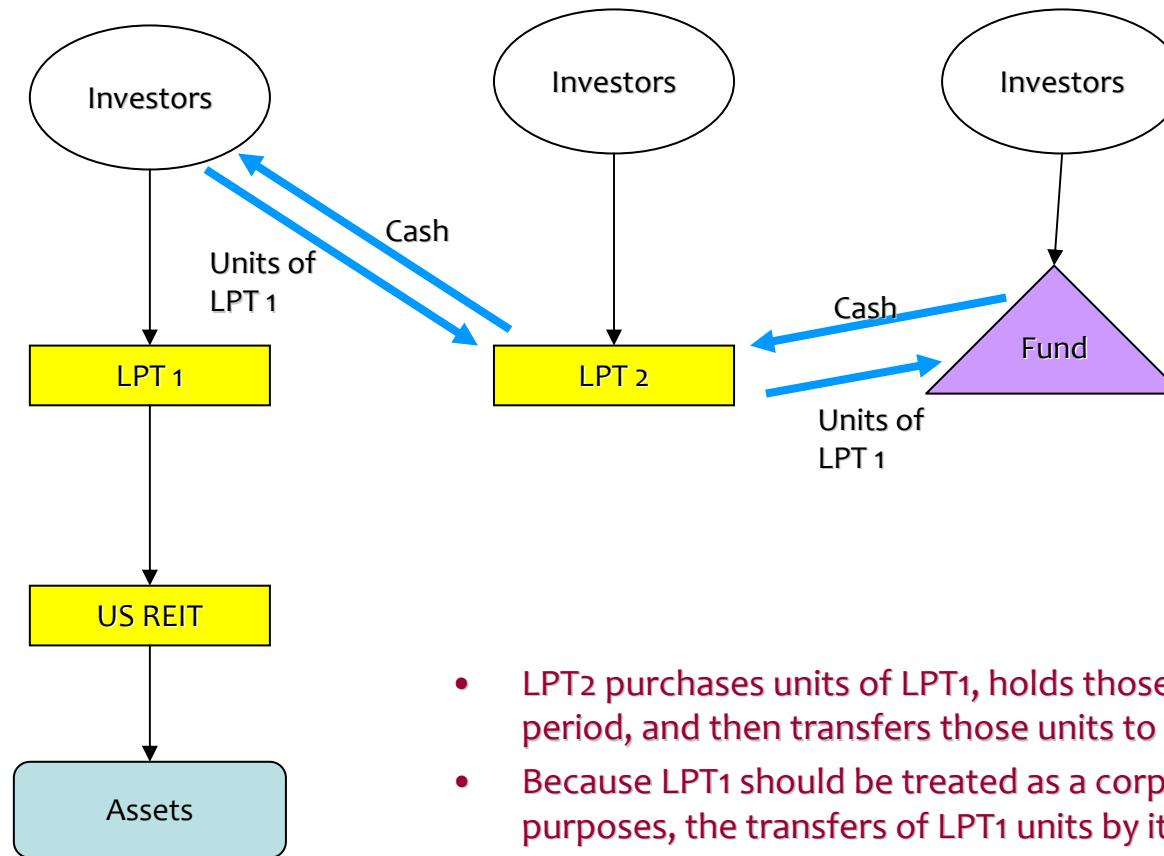
\*\* Winner, 2008 “Most Text on a Single Slide” Award

## Privatizing LPTs - MPR



- Market conditions and private equity activity are leading to increased interest in privatizing LPTs
  - MPR
  - Others will likely follow
- In MPR, ProLogis acquired units of MPR with intention to liquidate (to own US REIT directly)
- While sale by MPR unitholders in itself not subject to US tax, liquidation would have subjected MPR to tax on all of the inherent gain in its shares of US REIT
- MPR made an election to be treated as a US corporation for FIRPTA purposes only
  - Many requirements (e.g., PE, consents, election form, and toll charge payable by MPR)
  - Toll charge equal to the amount of tax that would have been due during prior 10 years on dispositions of MPR interests by persons who beneficially owned more than five percent of MPR at any time during the five year period prior to their disposition, as if MPR been a US corporation (much less than otherwise, though)
  - Issues arise if acquisition of the LPT does not close
- Election in itself did not affect unitholders. However, any MPR investor that owned more than five percent of MPR following the election would have been subject to US tax on their gain at rates up to 35%

## Privatizing LPTs – wholesale fund context



- LPT2 purchases units of LPT1, holds those units for a warehouse period, and then transfers those units to a wholesale fund
- Because LPT1 should be treated as a corporation for US tax purposes, the transfers of LPT1 units by its original investors and LPT2 should not be subject to FIRPTA

## PFIC – Keeping US tax books

- Many questions about this in the past year from US investors
  - This issue only affects LPTs with US investors
- PFIC (passive foreign investment company): a foreign corporation if either (i)  $\geq 75\%$  of gross income for the taxable year is passive income (such as dividends, interest, rents) or (ii)  $\geq 50\%$  of the value of its assets produce passive income
  - PFIC rules are an issue for US investors regardless of the level of US ownership
- Without a QEF election, a US shareholder of a PFIC that receives an “excess distribution” from the PFIC or transfers its PFIC stock pays US tax at the top ordinary income tax rate (not capital gains rate), plus an interest charge to reflect the value of deferral
  - With a QEF election, a US shareholder includes in income a pro rata share of the PFIC’s earnings (whether or not distributed)
- The foreign corporation, in turn, must agree to provide information regarding its earnings, calculated under US income tax principles
  - Keeping a separate set of books for a foreign corporation under US income tax principles will be expensive and difficult in any event
  - It may be possible to seek a regulatory change or a ruling to obtain relief from this requirement, thereby allowing US investors to make a QEF election more easily