NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON IRS ANNOUNCEMENT 2008-115 ON FIRPTA TREATMENT OF RIGHTS GRANTED BY A GOVERNMENTAL UNIT

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Report No. 1195

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This report[1] responds to Internal Revenue Service Announcement 2008-115 (the "Advance Notice"), which requests comments on future proposed Regulations under Section 897[2] regarding the definition of an interest in real property with respect to certain governmentally granted rights that relate to the lease, ownership, or use of real property.[3]

In the case of a toll road,[4] these rights are often granted together with a lease or sale of the land on which the road and various improvements are located. The land, improvements, and the right to toll the road (the "toll right"),[5] may be owned, directly or indirectly, by a U.S. corporation that has non-U.S. investors. Since the land and improvements constitute United States Real Property Interests ("USRPIs"), a U.S. corporation whose sole asset is a toll road may be treated as a U.S. Real Property Holding Corporation ("USRPHC") unless (a) the toll right is an asset that is separate from the lease or fee interest in the underlying property, (b) the toll right, as a separate

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1 The principal drafter of this report was Robert Cassanos. Substantial contributions were made by Jason Weinstein, Andrew Moin, and, in particular, Jordan Barry. Helpful comments were received from Erika Nijenhuis, Stephen Lefkowitz, Richard Wolfe, Kim Blanchard, Guy Bracuti, David Miller, and Diana Wollman.

2 All Section references are to the Internal Revenue Code of 1986, as amended (the "Code") and to the regulations promulgated thereunder (the "Regulations"). Section 897 was enacted by the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). Pub. L. No. 96-499, 94 Stat. 2682 (1980) (codified as amended at 26 U.S.C. §897 (2009)).

3 IRS Announcement 2008-115 (REG-130342-08) (Dec. 1, 2008). The Service released a similar notice in October 2008. IRS Advanced Notice of Proposed Rulemaking, 26 CFR Part 1 (REG-130342-08) (Oct. 30, 2008).

4 The Advance Notice specifically refers to toll roads and bridges. For simplicity, this report frequently uses the terms "toll roads" as a shorthand for a road, bridge, or tunnel. We note that, while tunnels are not specifically mentioned in the Advance Notice, they would appear to present issues that are very similar, if not identical, to toll roads and bridges.

5 The phrase "toll right" is used to refer to the right to charge the public a toll for the privilege of traveling on one's road, bridge, or tunnel. We note that at least one other commentator has also used the term "toll right" for this purpose. *See* Victor Hollender, *Privatizing Our Infrastructure: Taxing the Toll or Tolling the Tax*, 122 Tax Notes 1479, 1480-81 (Mar. 23, 2009).

asset, is not itself a USRPI, and (c) the value of the toll right is more than the value of the land and improvements.[6] This report addresses each of those issues.

The report is divided into six parts. Part I describes the Advance Notice and provides some background information. Part II provides a brief summary of the recommendations that this report makes in subsequent Parts. There are a number of possible correlative consequences of treating a toll right as a USRPI and in order to set a framework for consistency – a principal recommendation of this report – Part III briefly describes some of the implications that the Service might choose to address in trying to harmonize the treatment of toll rights under these provisions with their treatment under other areas of the Code. In Part IV, this report addresses various arguments regarding whether a toll right could be treated as either: (i) an ancillary, inseparable part of a lease or fee interest in the underlying real property or (ii) a separate asset.

Parts V and VI assume that a toll right constitutes a separate asset. Part V considers various frameworks that the Internal Revenue Service (the "Service") could apply to determine whether a toll right constitutes a USRPI. Part VI discusses several possible approaches for valuing a toll right. As suggested above, it is important to note that a method for valuing toll rights is only relevant to the administration of FIRPTA if the Service chooses to treat a toll right as an asset that is separate from the concessionaire's underlying real property interest and that is not a USRPI. Otherwise, all of the value of the combination of the real property interest and the toll right will inhere in USRPIs.[7]

I. Background

A. Transaction Contemplated in the Advance Notice

Private investors and state governments have increasingly begun to enter into transactions in which the investors purchase or lease existing toll roads, bridges, or tunnels from governmental authorities. As the Advance Notice notes, these transactions are frequently structured so that the

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6 Such a corporation may have other intangible assets, such as goodwill, workforce in place, etc., which could affect its status as a USRPHC.

7 However, assuming that, contrary to our recommendation, the toll right is treated as a severable asset, valuation of the toll right would remain potentially important for many other Code provisions (e.g., Section 197, Section 1031, REIT qualification, etc.), as discussed in Part III.

state government receives an up-front payment from the private investors.[8] In exchange, the private investors receive a fee or long-term leasehold interest in the real property underlying the toll road, bridge, or tunnel, as well as in the improvements thereon, and the right to charge and collect tolls.[9]

The Advance Notice states that the Service is considering issuing Regulations that will address how toll rights that are issued by a governmental unit and that are "related to the value of the use or ownership of an interest in real property" should be classified for purposes of FIRPTA and asks for guidance.[10] It also states that the Service is of the view that, in some transactions, these toll rights may properly be characterized as USRPIs.

B. Scope of This Report and Terminology

This report attempts to provide the Service with some conceptual approaches that it might adopt in evaluating infrastructure concessions, as well as the factors on which it might wish to focus regulatory guidance under each conceptual approach. Because the Advance Notice only asks for guidance on transactions involving existing toll facilities, this report focuses on these types of toll rights. However, we believe that there may also be instances in which states grant concessions to private parties to build toll roads, bridges, or tunnels (so-called "greenfield" facilities, as compared to "brownfield" facilities), and some parts of this report discusses these transactions as well.

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8 The Advance Notice does not explicitly state that the private investor acquires both the real property interest and the concession from the government, but this transaction structure is implied from the context. *See* IRS Announcement 2008-115, 2008-48 IRB 1128 (Dec. 1, 2008).

9 *See, e.g.*, Noah Bierman, *Leasing Pike May Pay Off, But at Cost*, Boston Globe, Dec. 3, 2008, at 1 (discussing a possible lease of the Massachusetts Turnpike and the tunnels of the Big Dig and mentioning transactions involving the lease of a Chicago toll bridge and an Indiana toll road, as well as deals that have been discussed in New York, Florida, and Pennsylvania); *Court Clears Way for Toll Road Lease Deal*, Chi. Trib., June 21, 2006, at 8 (reporting on a court challenge to Indiana's attempt to lease the Indiana Toll Road to a private party); Jenny Anderson, *Willing to Lease Your Bridge*, N.Y. Times, Aug. 27, 2008, at C1 (discussing several possible and consummated leasing deals, including Chicago's Midway Airport and the Alligator Alley toll road in Florida).

10 Although this report does not take any position on the policy implications, we note that any Regulations classifying infrastructure concessions, either as USRPIs or not, could have an effect on the price at which such transactions occur, which, in turn, could have fiscal impacts on state and federal governments. *See* Hollender, *supra* note 5, at 1480-81.

When referring to a transaction involving a toll facility, a toll right is generally defined as the "right to toll," or charge for passage over, one's own real property.[11] When referring to certain other types of transactions, such as granting a private party the right to operate a ferry route or a bus line, a concession means a license, granted by a governmental authority, to provide a particular service within a defined geographic area that is neither owned by nor leased to the concessionaire. In many cases, the grant of such a concession will carry with it the ancillary right to use certain real property (for example, a particular ferry slip at a pier or gate at a bus station), but these are usually either in the nature of, or equivalent to, licenses (for example, the ferry line can move to a different slip at the same pier or to a different pier altogether). In essence, the service provided is performed on the property of other people. This report will not generally discuss these types of concessions.

C. Legal Background

In the Advance Notice, the Service posited that, in the "typical" structure of toll right transactions, the state government sells or leases the toll road to a domestic partnership. The partners of the domestic partnership include U.S. corporations (or entities treated as corporations for U.S. federal income tax purposes) that are owned by non-U.S. persons. Because non-U.S. persons are generally not treated as being engaged in a U.S. trade or business solely by virtue of investing or trading in U.S. stocks or securities,[12] when the owners of the stock of these upper-tier corporations sell their stock, the proceeds are generally not subject to U.S. federal income taxation.

If such stock is the stock of a USRPHC, however, the gain or loss on the sale is taken into account by the non-U.S. person as if such gain or loss were effectively connected with a U.S. trade or business conducted by the non-U.S. person and the seller is subject to U.S. federal income tax on any gain.[13] A corporation is considered a USRPHC if USRPIs comprise a

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11 The operator may hold a fee, leasehold, or other possessory interest in the road. These terms are generally used interchangeably throughout this report, unless the context otherwise requires.

12 Section 864(b)(2)(A). This rule does not apply to taxpayers who are dealers in stocks or securities.

13 Section 897(a)(1); *see also* Part V, *infra*.

sufficient percentage of the value of the corporation's assets.[14] When applying this test, a corporation is generally treated as owning its proportionate share of the assets of any partnership in which it is a partner.[15]

If, as would typically be the case, an investment in the partnership comprises all or substantially all of the upper-tier corporation's assets, such corporation will look solely to its proportionate share of the partnership's assets to determine its status as a USRPI. Generally, the assets of a partnership operating such an infrastructure project will primarily consist of the partnership's leasehold or fee interest in the infrastructure improvements (e.g., roads, bridges, etc.) and the land beneath the infrastructure (or, in the case of a greenfield toll road, the land upon which the infrastructure will be built), as well as whatever rights the partnership may have to "toll the road" by virtue of the granting document or otherwise.

The Advance Notice suggests that taxpayers are taking the position that (1) the right to toll is a separate asset that is distinct from the lease of the land, (2) such right constitutes a large portion of the partnership's assets, and (3) such right is not a USRPI. Accordingly, the Advance Notice suggests that taxpayers may seek to treat each of the upper-tier corporations investing in an infrastructure project as not being a USRPHC, even though all of the partnership's assets, other than the toll rights, are clearly USRPIs. If this treatment is correct, a foreign investor who exits her investment by selling the stock of the corporation generally will not be subject to U.S. federal income tax on exit.[16] On the other hand, if these toll rights actually constitute USRPIs, these

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14 More specifically, a corporation is a USRPHC if the fair market value of its USRPIs exceeds 50% of the sum of the fair market value of (i) its USRPIs, (ii) its real property located outside of the United States, and (iii) any other assets it holds for use in a trade or business. Section 897(c).

15 Treas. Reg. § 1.897-2(e)(2).

16 While the corporation is subject to tax on its operations, it may be the case that the corporation pays little or no tax for a long period of time, particularly if the toll right is also treated as a depreciable asset that, under Section 197, is amortizable over fifteen years. *See* Sections 197(d)(1)(F) and 197(f)(4); Joint Committee on Taxation, *Testimony of Edward D. Kleinbard, Chief of Staff of the Joint Committee on Taxation, at a Hearing of the Subcommittee on Energy, Natural Resources, and Infrastructure of the Committee on Finance on "Tax and Finance Aspects of Highway Public-Private Partnerships"* (JCX-62-08), July 24, 2008, *available at* www.jct.gov; Hollender, *supra* note 5, at 1481 n.12 ("In some cases, the present value to taxpayers of [the losses from the initial years of a toll road business] may outweigh the present value of tax costs resulting from profits in later years, resulting in a net loss of tax revenue if viewed on a present-value basis.").

upper-tier corporations are USRPHCs and their owners will be subject to U.S. federal income tax on the sale of their stock.

II. Summary of Recommendations

We believe that it is very important for the Service to provide guidance on the federal income tax treatment of toll road transactions of the type described in the Advance Notice. The Service should consider: (1) whether, and under what circumstances, toll rights are severable assets from the real property to which they relate; (2) the circumstances under which severable toll rights constitute USRPIs; (3) the proper method for valuing toll rights; and (4) whether the treatment of toll rights under FIRPTA should be consistent across the Code.

This report ultimately has four principal recommendations, addressed more fully in each of the following sections:

> Part III: The treatment of a toll right under FIRPTA should be consistent with its treatment throughout the Code (e.g., Sections 197, 1031, the REIT provisions of the Code, etc.) to the extent feasible unless there is a clear policy rationale for inconsistent treatment.
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> Part IV: A toll right, particularly of the type described in the Announcement, should be treated as part of a single asset, inseverable from the underlying real property to which it relates.
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> Part V: If, contrary to our recommendation, the Service finds a toll right to be an asset severable from underlying real property, a toll right of the type described in the Announcement should be treated as a USRPI.
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> Part VI: If the Service concludes further that as a separate asset, a toll right is not a USRPI, we recommend the Service provide taxpayers with a clear valuation policy. We recommend the Service consider adopting a rebuttable presumption, described in more detail in Part VI.

It would be helpful for the Service to harmonize the treatment of toll rights under FIRPTA with the treatment of toll rights under other Code Sections to the extent that it is feasible to do so. Consistent treatment is particularly important with respect to the REIT rules, Section 1031, and Section 197. Given the different histories and purposes of these provisions, complete harmony is not likely to be achievable, but the ultimate effect of treating a toll road concession as a USRPI or non-USRPI may vary dramatically depending, for example, on whether the concession is treated as a real estate asset for REIT purposes. Accordingly, conclusions already reached by the Service as to how to draw lines between real estate and non-real estate assets in those areas should inform the conclusion reached by the Service under FIRPTA, and such conclusions may need to be revisited.

As indicated above, our bottom-line conclusion is that a toll right should be treated as a USRPI, whether because it is viewed as inseverable from the underlying real property or because if severable it is itself classified as a USRPI. The question of whether a toll right should be treated as an asset that is separate from the underlying real property to which it pertains is a difficult one as a technical matter. The issue is a conceptual one, and can be analyzed within multiple frameworks. We believe that, for U.S. federal income tax purposes, a toll right should not be treated as an asset that is (or, equivalently, that has value) separate from the underlying real property to which it relates (the "Inseverable Approach"). This conclusion is especially appropriate in the case posited in the Advance Notice, where the toll right is granted together with a leasehold or fee interest in real estate, and cannot be transferred separately from that interest in real estate. This conclusion is founded in part on the belief that, unlike other cases where similar technical issues arise in connection with government grants of rights to use property, in the case of toll roads the real property (the road) cannot realistically be used for any purpose other than as a road. In fact, the lease of such a road may well be a liability if accompanied with obligations to maintain and improve it without any grant of authority to use the road in a profit making business (as would be true of any commercial lease with similar prohibitions). As a result, we do not believe that it is meaningful to treat the road as separate from the tolling right. As a practical matter, no one would acquire the rights to the real property unless they realistically believed they could acquire tolling rights to receive commensurate compensation, and vice versa.

However, in recognition of the fact that this view is at odds with those of some other commentators, we have set forth both sides of the technical and conceptual position. We discuss in Part IV both the Inseverable Approach and the arguments that can be made that a toll right should be treated as an asset that is severable from the underlying real property (the "Severable Approach"). One important question in this regard is the extent to which the severability conclusion should depend on the state law rules for treating tolling rights as severable from a fee interest in land.

Assuming that a toll right is properly considered a separate asset from the underlying real property, there are a number of different possible analyses of the question of whether a toll right ought to constitute a USRPI. This report discusses the possible treatment of a toll right as a real property interest under state law, as an interest in real property under the FIRPTA rules, as personal property associated with real property under the FIRPTA rules, or as a right to run a business, which may or may not constitute a USRPI. An evaluation of these alternatives depends on the basis for concluding that the toll right is severable in the first place—that is, the analysis as to why a toll right is severable may also drive the determination of the nature of that separate asset. If, contrary to our recommendation above, the Service were to adopt the Severable Approach, we believe that the toll right should be treated as a USRPI.

If neither of our prior recommendations regarding severability and USRPI status is adopted, then valuing the toll right would become critical to the administration of FIRPTA with respect to infrastructure projects of this type. Assuming that a toll right is a separate asset, it may be difficult to determine the proper value of the toll right. The most obvious ways to value the toll right lead to almost diametrically opposite consequences: Either they assign little value to the assemblage value of the required parcels of land (a unique assemblage that is made possible by the exercise of a state's condemnation power and other sovereign powers), which is clearly an essential aspect of a toll road, or they assign all residual value to the land. The former generally has the effect of treating the toll right as having the bulk of the value in the overall transaction, and the latter has the effect of treating it as having very little value. As an alternative to these approaches, we suggest that the Service consider adopting a presumption, further described in

Part VI, and establish a process by which taxpayers can rebut that presumption by showing the actual relative values of the concession, the land, and the improvements.

III. Correlative Consequences of Proposed Regulations

A rule classifying certain infrastructure concessions as USRPIs (or not) could have implications for the treatment of such concessions under numerous other Code provisions. We are of the view that to the extent feasible classification of toll rights under FIRPTA should be consistent with their treatment under other Code Sections unless there is a compelling policy rationale for inconsistent treatment. Some of these topics are briefly addressed below in order to help the Service take them into account when issuing its guidance.

A. REITs

We note that there are some situations in which the Service has allowed intangible assets to be treated as "real estate assets" for REIT purposes.[17] This authority opens at least the possibility that a toll right could be treated as a real estate asset for REIT purposes regardless of its treatment for purposes of FIRPTA or Section 197.

Suppose that it were to be determined that a toll right was not a USRPI for FIRPTA purposes, but that it was a real estate asset for REIT purposes. Assume further that the owner of a toll right can either (x) lease the toll road to an unrelated party[18] or (y) successfully take the position that tolls are "rent" for REIT purposes.[19] In that case, a toll road could be held through a REIT

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17 *See* PLR 200813009 (ruling that, on the facts presented, goodwill representing to the location and physical structure of the properties at issue and the value attributable to the hotel name portion of the real estate intangibles relating to such properties' uniqueness in history and heritage were "real estate assets" under Section 856(c)(5) and real estate assets for purposes of Section 856(c)(4)(A), and that rents attributable to such intangibles were rents from real property for purposes of Section 856(d)); PLR 9843020 (ruling that ski permits from the United States Forest Service were interests in real property for purposes of Section 856(c)(5)(C) and real estate assets for purposes of Section 856(c)(4)(A)). The Service has taken a similar approach to integrally related tangible personal property as well. *See* PLR 200725015.

18 This appears to have been the structure contemplated in PLR 200725015, in which the Service ruled that the entire tangible infrastructure of an electrical distribution system was real property for REIT purposes. *But see* Adam M. Handler & Stephanie T. Tran, *Infrastructure Investment Trusts: A Proposal for Attracting Capital*, 122 Tax Notes 1127, 1132 (Mar. 2009) ("[M]ost infrastructure investments are operated by a developer rather than leased to an unrelated party.").

19 There is no authority on point as to whether or not tolls constitute rent for REIT purposes. There is significant authority concerning parking fees in the REIT and UBTI areas that suggests that they should

without violating the REIT asset or (under the apparent logic of the PLRs cited above) income tests. The following federal income tax consequences would result:

- o The REIT that owns the toll road would not pay corporate income tax on its earnings so long as it met the REIT distribution requirement.

- o Assuming that the toll right can be amortized over 15 years as a Section 197 intangible, it is conceivable that, after allowing for interest expenses and other charges, the REIT might not have any distribution requirement for many years.[20] Therefore, there would be no shareholder-level tax during this period, even for those non-U.S. shareholders that are not the beneficiaries of an income tax treaty with the United States.

- o Assuming that, contrary to the discussion in Part VI, *infra*, it is proper to ascribe the majority of the value of the toll road to the toll right, the REIT may not be a USRPHC. If so, gain on the sale of the REIT's stock would not be subject to FIRPTA, regardless of whether the REIT is domestically controlled.

- o Although not entirely clear, it would seem that the portion of gain on any sale of the REIT's assets that was not attributable to a USRPI (i.e., the toll rights in this example) would not be subject to FIRPTA tax.[21]

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not. *See, e.g.*, H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess. II-220 (P.L. 99-514) (Sept. 18, 1986) ("[T]he conferees intend that income derived from the rental of parking spaces on a reserved basis to tenants, or income derived from the rental of parking spaces to the general public, would not be considered to be rents from real property unless all services are performed by an independent contractor."); Rev. Rul. 2004-24 (describing instances in which parking fees are rents from real property); *see also* Treas. Reg. § 1.512(b)-1(c)(5) (providing that income from the rental of parking spaces does not constitute rent for purposes of the UBTI rules); PLR 7852007 (same); PLR 7841061 (same); GCM 39825 (same). *But cf.* PLR 200621031 (renting parking spaces to tenants of building owned by tax-exempt entity does not create UBTI); Handler & Tran, *supra* note 18, at 1132 (stating that tolls collected would be "operating income that would be 'bad income' under the 95 percent income test").

20 This would be because the REIT distribution requirement is based on the REIT's taxable income, and net operating loss carryovers reduce taxable income. *See* Section 857(a)(1) (setting for the REIT dividend requirement); Section 857(b)(2) (defining REIT taxable income); Section 857(b)(3)(E) (coordinating the REIT rules with the net operating loss provisions).

21 The underlying logic is that, presumably, the rule of Notice 2007-55, which provides that capital gain dividends paid by a REIT are subject to FIRPTA tax, would not apply.

Thus, if the Service were to conclude that (x) toll rights are not USRPIs, and (y) toll rights are real estate assets for REIT purposes (as some commentators apparently believe them to be),[22] it may be possible to create a structure in which little or no corporate-level tax is paid on the operations of the toll road and either (x) no tax is paid on disposition (if stock is sold) or (y) most gain is exempt from tax even though the buyer gets a stepped-up basis (if assets are sold).

Given the somewhat counterintuitive nature of these results, we recommend that the Service develop a coordinated policy with respect to the REIT rules for real estate assets and the FIRPTA rules for USRPIs before issuing guidance on the treatment of toll rights under FIRPTA.

We further recommend that infrastructure concessions be treated consistently for FIRPTA and REIT purposes.[23] So, for example, if a toll right is not a USRPI, it should not constitute a real estate asset for REIT purposes, and vice versa. We recognize that this approach, if broadly applied, may present some potential theoretical issues, particularly with respect to assets that are commonly thought of as being predominantly real estate but that also contain associated or stapled intangibles (such as hotel goodwill). We are not suggesting that it is a prerequisite that the Service provide guidance on when intangible assets generally may be considered to be real estate assets for REIT purposes. But, given the focus on infrastructure concessions, we believe that consistency is a very relevant consideration in this area.

B. Section 1031

Another area in which the classification of toll rights as USRPIs could have corollary consequences is with respect to their treatment as "real property" under Section 1031, which

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22 *See, e.g.*, National Association of Real Estate Investment Trusts, Letter to the IRS re: Notice 2009-43: 2009-2010 Guidance Priority List Recommendations (May 28, 2009) (requesting that the IRS "confirm . . . that [infrastructure assets] are 'real estate assets' under 856(c)(5)(B) for REIT asset test purposes"); Ryan Chittum, *Running Down the REIT Highway*, Portfolio (Sept./Oct. 2008), *available at* www.nareit.com/portfoliomag/08sepoct/feat1.shtml (discussing PLR 200725015 and quoting one commentator as saying that toll roads are "likely" to be treated as real property for REIT purposes). *But see* Handler & Tran, *supra* note 18, at 1132 ("[I]t is impractical to consider REITs a viable vehicle for infrastructure investments. As an initial matter, while some infrastructure assets are real property under the REIT rules, there is considerable uncertainty regarding the extent to which the assets comprising toll roads and other infrastructure assets constitute real property . . . .").

23 *See also* National Association of Real Estate Investment Trusts, Comments in Response to IRS Announcement 2008-115, at 2 (Jan. 29, 2009), *available at* www.reit.com/Portals/0/Files/Nareit/htdocs/policy/NAREIT%20Comment%20Letter%20-%20IRS%20FIRPTA%20(1-29-09).pdf.

provides for nonrecognition treatment upon the exchange of property for other property of a like kind. Generally, most real property is of like kind to most other real property,[24] though U.S. and non-U.S. property are explicitly stated to not be of like kind.[25] Courts have been somewhat flexible in categorizing intangibles as real property for purposes of Section 1031. For example, in the *Peabody* case,[26] the Tax Court held that a valuable contract to sell coal for an above-market price that was held by an entity that owned a coal mine was an inherent part of the ore body and hence a real property asset for Section 1031 purposes.[27] The Service has been similarly open-minded.[28]

It is worth considering some of the possible corollary consequences of inconsistent treatment. For example, assume that toll rights are not treated as USRPIs for FIRPTA purposes, but are treated as real property for Section 1031 purposes. In such a scenario, under reasoning analogous to the *Peabody* court's, it would presumably be possible for USRPHCs to swap out of FIRPTA assets by exchanging them for toll roads or interests therein. While the USRPHC taint lasts five years, after that point a sale of the stock of the USRPHC which held the toll right would not be subject to FIRPTA tax.

These sorts of anomalies would probably multiply if the treatment of a toll right under either Section 1031 or FIRPTA were dependent on the toll right's status under the law of any particular state, since as discussed below state laws appear to differ. It may be argued (probably correctly) that similar anomalies are sprinkled throughout the USRPHC rules. Nonetheless, coordination would seem preferable to increasing the number of such anomalies.

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24 Treas. Reg. § 1.1031(a)-1. *But see, e.g.*, Peabody Natural Resources v. Comm'r, 126 T.C. 261 (2006) (stating that exchanges of real property interests are not all like-kind exchanges under Section 1031); Smalley v. Comm'r, 116 T.C. 450, 453-54 (2001) (same).

25 Section 1031(h)(1).

26 Peabody Natural Resources Co. v. Comm'r, 126 TC 261 (2006); *see also* Richard A. Wolfe, Tax Club Paper Series, Peabody Natural Resources Co. v. Commissioner: Turning Gold into Coal—Tax-Free (discussing *Peabody* in great detail).

27 Peabody Natural Resources v. Comm'r, 126 T.C. 261 (2006). *Peabody* involved the exchange of a gold mine for a coal mine and the assumption of coal contracts to which that coal mine was subject and which provided an above-market price for the mine's coal. *Id.*

28 *See* PLR 200901020 (ruling that development density rights are of like kind to interests in real property); PLR 200805012 (same).

C. Section 197

The Service's framework for determining the circumstances in which a toll right is a USRPI may have implications for how the cost allocated to that asset should be recovered.[29] If a toll right is treated as a separate intangible asset that is neither an interest in land nor a lessee's interest in a lease, then presumably it would be considered to be a "license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof."[30] As such, under current law, it would be treated as a Section 197 intangible that is amortizable over a 15-year period.[31]

On the other hand, if a toll right were classified as a USRPI, under the rationale, discussed below, that it is inextricably linked to the underlying real estate, then it might not constitute a Section 197 intangible, which is specifically defined to exclude "any interest in land."[32] Further, under this view, the underlying real property to which it is inextricably linked has an unlimited useful life. Therefore, it would stand to reason that, under this approach, the useful life of the toll right would be its term length. Often, the term length of a toll right is far longer than the 15-year usable life that Section 197 prescribes. If treated as an inseverable part of the real estate or an "interest in land" (for example, a covenant), then presumably the allocated cost of the toll right would be treated as "rent" and amortized over the life of the toll right under Section 467 rather than being amortized over 15 years under Section 197. Note that if an infrastructure consortium made periodic payments over the life of the toll right that were treated as rent, such payments would generally be deductible on a current basis, whereas if they were treated as payments for the purchase of the toll right, each periodic payment made during the first 15 years of the lease term might be amortized over the remainder of that 15-year period.[33]

There are intermediate approaches as well. For example, if the Service were to conclude that toll rights were severable assets and then, as discussed in Part IV.C, *infra*, promulgate Regulations

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29 *See* Hollender, *supra* note 5, at 1481-87 (discussing these issues in much greater detail).

30 *See* Section 197(d)(1)(D).

31 Section 197(a). This assumes, of course, that it meets the other requirements of that Section. *See, e.g.*, Section 197(c).

32 Section 197(e)(2).

33 *See* Treas. Reg. § 1.197-2(f)(2).

treating toll rights as personalty associated with realty, then it would perhaps be easier to treat these rights as governmental licenses or permits without treating them as either an interest in land or a lessee's interest in a lease. The foregoing simply illustrates that the Section 197 conclusion may be influenced not only by the "bottom line" FIRPTA conclusion, but also by the specific rationale for that conclusion.

IV. Severability of the Toll Right

It is not entirely clear whether the Service has taken a position on whether a toll right is a separate asset from the property to which it relates. One commentator has stated that the Advance Notice appears to presume that it is inseverable;[34] however, an employee of the IRS Office of Chief Counsel's office has suggested that bifurcating the toll right and the property may be appropriate.[35]

As an initial matter, we note that the Advance Notice does not contemplate all the transactions that could occur with respect to infrastructure concessions, or even with respect to toll roads. Instead, it focuses on what might be called a "standard" toll road privatization, in which an existing toll road that is owned and operated by the state is leased to a private operator for a term of years. The threshold question in the "standard" toll road privatization is whether the transaction should be bifurcated into two transactions. If it is bifurcated, the transaction would presumably be treated as the grant of a lease (or, with respect to certain improvements, an outright sale) and the grant of a right to "toll the road" (i.e., charge for passage over the road). If it is not, the transaction should simply be treated as a lease—that is, the grant, by the grantor, of a portion of the grantor's interest in the land and improvements, subject to the conditions set forth in the granting documents.

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34 *See* Kim Blanchard, *Infrastructure and FIRPTA: Advanced Notice of Proposed Rulemaking*, Tax Mgmt. Int'l J. (Mar. 2009), *available at* http://www.bna.com/tm/ insights_blanchard11.htm ("Nothing in the [Advance Notice] mentions or even alludes to the possibility that an investment in an infrastructure project might be bifurcated between the inherent value of the tangible property and the income-producing potential thereof. The 'Transactions at Issue' section of the [Advance Notice] points out that, in the case specified, 'the value of the leasehold interest in the specified infrastructure derives from the right to charge and collect tolls.' This language might be read to suggest that the Service would reject any bifurcation approach.").

35 *See IRS Official Discusses Tax Issues in Infrastructure*, 2007 Tax Notes Today 71-77 (reporting that John P. Huffman of the IRS Office of Chief Counsel stated at a conference, "[E]ven without helpful state law, there are court cases that allow bifurcation of interests even if they cannot be obtained or sold separately.").

Further, if the Service is providing guidance on the "standard" toll road privatization, it should issue guidance that is broad enough to address a wider range of infrastructure transactions. These transactions pose the same threshold bifurcation question. The Service may wish to consider whether the answer to this question depends, in whole or in part, on either the form of the transaction or on local law.

Under the Severable Approach, the transaction contemplated in the Advance Notice should be bifurcated into two transactions: the grant of a lease and the grant of a toll right. Under the Inseverable Approach, the transaction should be treated as a single transaction and the toll right should not be treated as a separate asset. As described in Part II above, we believe that the Inseverable Approach is the right answer for U.S. federal income tax purposes in part because of the real-world consideration that we do not believe there is any meaningful possibility that someone would acquire rights to the real property unless the acquiror also realistically believed that it would be allowed to exploit the road for profit, whether that required the grant of a toll right in states requiring such a grant, or the ability to otherwise derive commensurate compensation for the asset being acquired, constructed or leased. The technical analysis is more complicated.

Toll rights, like almost all legal relationships, are creatures of state law. Therefore, one important question is what effect state law should have on the analysis of a toll right. Possible answers include: (1) tax treatment should follow state law (with the result that federal tax treatment of toll rights may differ across different states); (2) tax treatment should follow the most common state law rule (treating the right to toll as a right separate from ownership of land); or (3) disregard state law as not relevant to the tax analysis, in which case some other criterion must be chosen to evaluate toll rights.

The argument in favor of bifurcation has two basic elements. First, many or most states restrict or reserve the right to toll to the state. In some of these states, this reservation appears to derive from the common law, although some states also have statutes relating to toll rights. Therefore, it is argued, a landowner does not have a common law right to toll, at least in the jurisdictions that have reserved that right historically. The right to charge tolls simply is not a "stick" in the landowner's "bundle." Accordingly, the right to toll, even when granted in connection with a lease of a road, should be treated as a separate asset for federal income tax purposes. One variant of the Severable Approach is to limit bifurcation to those states that reserve the right to toll to the state; another is to bifurcate without regard to state law.

The second argument in favor of bifurcation is that a toll right is really a right to conduct an active business, a right that should be treated as a separate asset. Under this theory, a toll road concession is analogous to other types of legal rights to run a business. For example, consider the value of a franchise to sell cars. A part of the value of that legal right may be attributable to the real property on which the business is carried out, especially if the real property is particularly suitable for that purpose, but the tax law treats the legal right as separate from the lease or ownership of the property. The proponents of this argument draw support from an analogy to Section 197, which treats "any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof" as a separate Section 197 asset, unless it is, inter alia, an interest in land or a lessee's interest in a lease.[36]

The Inseverable Approach reasons that, absent the special state law status of "toll rights," the transaction described in the Advance Notice is simply a relatively straightforward leasing transaction: A landlord (the state) leases property (the road) to a tenant (the consortium) for a prepaid rent. The lease sets forth the tenant's obligations with respect to the leased premises, including, but not limited to, setting a rate schedule that specifies what the tenant can charge people for crossing the premises (the toll). The fact that the landlord permits the tenant to conduct some businesses on the premises and not others is not unusual, nor does the fact that the tenant's business is an active business (to the extent that it is) have any bearing on whether the landlord-granted right to conduct that business on the leased premises is a separate asset. It may well be that the business has goodwill or going concern value, but these are separate from the concession, as well as from the land, and should be treated as such.

Under the Inseverable Approach, the fact that some states may have reserved certain rights to charge tolls to themselves or their designees is neither determinative of the tax characterization of the transaction described in the Advance Notice generally, nor for purposes of FIRPTA in

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36 *See* Section 197(d)(1)(D); Section 197(e)(2); *see also* Treas. Reg. §§ 1.197-2(b)(8), 1.197-2(c)(3).

particular. The FIRPTA Regulations specifically state that an asset's status under local law does not determine its status as real property under FIRPTA.[37] Moreover, the state laws pertaining to tolling rights seem to vary considerably from state to state, may be subject to conflicting interpretations, and are continually subject to change.

More generally, the Inseverable Approach posits that there are certain intangible rights that are associated with tangible property and/or "run with the land," and that these intangible assets are typically merged into the larger estate held by the grantee for tax purposes. The Inseverable Approach would treat rights as simply being a part of the real property whenever they are sufficiently linked to the exploitation of the subject real property and have no "alternative source of value." For example, this is true with respect to zoning rights, property tax concessions, subsurface rights, and so forth, all of which are grants by the sovereign. The Inseverable Approach evaluates toll rights within this framework, both in the example posited in the Advance Notice and in toll road cases more generally.

The balance of this section explores these arguments in more detail.

A. Severable Approach

The Severable Approach holds that the toll right should be treated as an asset that is separate from the underlying real property. This report presents two related arguments that support this position. The first argument centers around the state law treatment of toll rights. The second argument centers around the nature of tolling as an active business. Each of these arguments is discussed in turn below.

One argument is that tolling is a unique activity because states often reserve the right to toll to themselves and their grantees.[38] In such states, even though a landowner can own a road or

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37 Treas. Reg. § 1.897-1(b)(1).

38 Blanchard, *supra* note 34 (stating that "many states" require state authorization for a private person to operate a toll road); Hollender, *supra* note 5, at 1483 (stating that, "often," fee ownership does not include the right to toll); Linda E. Carlisle, Macquarie/Cintra—Comments on Regulations to Be Issued Under Section 897, Tax Analysts Document Service Document 2009-2350, Jan. 29, 2009, at 7 ("Macquarie/Cintra") ("In many states, a private person's fee simple ownership or leasehold interest in a

facility and can exclude others from the premises, without an express authorization from the state, a private actor cannot charge tolls in exchange for deciding *not* to exclude others (or at least the public) from the premises.[39] This argument sees the modern toll right as the direct legal descendant of the concept of a "franchise," or the proposition that certain rights inhere with the sovereign, not the fee owner of the land.[40] It relies upon authorities that trace tolling back through history as a sovereign prerogative, including case law[41] and early 18th-century English common law commentary.[42] Since, historically, landowners have not had the right to toll their land, the right to toll is not a "stick" in the fee owner's "bundle." Accordingly, when a right to toll a road is granted, whether together with or separately from a lease of that road, the right to toll constitutes a separate asset.

An additional argument for treating a toll right as separate from the lease of the improvements and the underlying real property is that a toll right is a right to conduct a particular business, as

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public highway or bridge does not give the owner or lessee the right to charge tolls or fees for the use of such highway or bridge.").

39 Bartram v. Central Turnpike Co., 25 Cal. 283, 290 (1864) ("[A]ny person who can procure from the landholder the right of way may construct and maintain a road. It is only in respect to the right to collect tolls on his road when constructed, that he must make application to the Legislature or some branch of the Government vested by the Legislature with the power to grant the franchise."). Presumably, a private landowner in any state can, in exchange for consideration, grant another person an easement to use a private road crossing the landowner's property and, presumably, the grant of such an easement is the transfer of a USRPI. See discussion in Part V.A, *infra*.

40 For example, in the Indiana Toll right and Lease Agreement, the "concessionaire" was granted both a lease in the land and facilities comprising the toll road as well as an "exclusive franchise and license" to "toll the Toll Road" for the term of the lease. Indiana Toll right, Section 2.1.

41 *See, e.g.*, Turner v. Eslick, 240 S.W. 786, 787 (Tenn. 1922); Peru Turnpike Co. v. Town of Peru, 100 A. 679, 680 (Vt. 1917) ("The right to collect tolls is a franchise, a sovereign prerogative, and vests in an individual or corporation only when and only so far as granted by the Legislature."). One of the best known cases addressing the state's right to grant concessions is *Charles River Bridge v. Warren Bridge*, 36 U.S. 420 (1837). The legislature of Massachusetts had granted a concession to the Charles River Bridge Company to construct a bridge across the Charles River and collect tolls. Subsequently, the legislature granted a concession to the Warren Bridge Company to build another bridge across the Charles River that did not charge a toll. The Charles River Bridge Company filed suit, arguing that the state had violated the terms of its concession. The Supreme Court ruled in favor of the state, rejecting the Charles River Bridge Company's construction of the concession.

42 *See* Sir William Blackstone, Commentaries on the Laws of England: In Four Books (Thomas M. Cooley, ed.) (3d ed. 2003) 345 ("[A f]ranchise . . . is . . . a royal privilege, or branch of the king's prerogative, subsisting in the hands of a subject. Being therefore derived from the crown, they must arise from the king's grant . . . ."); *id.* (stating that franchises include "the right of taking toll . . . at any . . . public places, [including] at bridges, wharfs, or the like, which tolls must have a reasonable cause of commencement (as to consideration of repairs, or the like), else the franchise is illegal and void"); California v. Central Pac. R. Co., 127 U.S. 1, 40 (1888) (quoting same).

compared to a right to use the leased property in a particular way. Support for this position may be found in Section 197, which specifically lists "any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof" (other than, inter alia, "any interest in land" or a lessee's interest in a lease) as an intangible asset.[43] The Regulations further expand upon this definition, noting that it specifically includes a number of government permits that allow the holder to engage in a particular business, such as "a liquor license, a taxi-cab medallion (or license), an airport landing or takeoff right (sometimes referred to as a slot), a regulated airline route, or a television or radio broadcasting license."[44] A Section 197 intangible, unlike an interest in real property such as a lease, is amortizable over a 15-year period.[45] The Regulations define an interest in land as including "a fee interest, life estate, remainder, easement, mineral right, timber right, grazing right, riparian right, air right, zoning variance, and any other similar right, such as a farm allotment, quota for farm commodities, or crop acreage base," as well as construction and use permits for land or improvements.[46] An "interest in land" does not include "an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television service."[47] Under this view, these enumerated exceptions—two of which are concessions regarding transportation services and the third of which involves the right to conduct a business[48]—constitute strong evidence that a toll right is an intangible asset that is separate from the underlying real property.

Two recent private letter rulings, PLR 200922003 and PLR 200922005, may shed some light on how the distinction between an interest in land and a governmentally granted license is to be construed. These rulings raised the issue of how a combined license that gave the taxpayer the right to construct improvements on property, as well as the right to conduct a particular business using those improvements, should be treated for purposes of Section 197. The two rulings are extremely similar. In each instance, the license at issue was a combined license to construct and

43 Section 197(d)(1)(D).

44 Treas. Reg. § 1.197-2(b)(8).

45 Section 197(a).

46 Treas. Reg. § 1.197-2(c)(3).

47 *Id.*; *see also* GCM 39606 (Mar. 9, 1987) (addressing airplane takeoff and landing rights and treating them as separate assets).

48 *See* Part IV.B.3, *infra*.

operate a nuclear power plant on the property. The taxpayer requested a ruling that the combined license was a "§ 197 intangible within the meaning of § 197(d)(1)(D) . . . and that [it] is not excepted from the definition of § 197 by reason of § 1.197-2(c)(3)."[49] The Service granted each taxpayer the requested ruling, analogizing the combined license to FCC broadcast licenses, which had previously been treated as intangibles in certain Tax Court cases.[50] While the rationale for the conclusions in the PLRs is not entirely clear, they suggest that a permit granted by a third party to conduct a specified activity on a particular piece of land should not be assimilated into the value of the real estate, at least in certain cases. That is, such a permit may be different in kind from the zoning rights associated with a particular piece of real estate or a construction and use permit and more like a license.

Although it is a valuation case, *Pensacola Greyhound Racing, Inc. v. Comm'r*, 32 T.C.M. 1064 (1973), also supports treating a toll right as a separate asset.[51] In *Pensacola*, the issue before the Tax Court was how to allocate the taxpayer buyer's purchase price among a dog racing track, the land on which it was located, and various intangible assets, most notably a racing permit. The parties agreed that the intangibles constituted separate assets, but disagreed about which valuation method should be used to allocate purchase price among those assets. The racing permit allowed the operation of a dog track only in the exact location of the existing facility and prevented the operation of any other dog racing facilities within 100 miles.[52] The tax court treated the various liquor and gaming licenses as intangible assets that were separate from the underlying real property for purposes of allocating purchase price.[53] The *Pensacola* court distinguished between the value of (1) the land itself and the physical improvements to it, and (2) the various intangible assets that the buyer acquired, most notably the racing permit, which were treated as intangible assets with value that was severable from the land itself.

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49 PLR 200922003; PLR 200922005.

50 PLR 200922003 (discussing *Radio Station WBIR, Inc. v. Comm'r*, 31 T.C. 803 (1959), and *KWTX Broadcasting Co. v. Comm'r*, 31 T.C. 952, *aff'd per curiam*, 272 F.2d 406 (5th Cir. 1959)); PLR 200922005 (same).

51 *See also* Part VI, *infra*.

52 From the facts, it does not appear that its physical facilities had been obtained from the state, either by the taxpayer or his predecessor.

53 *See also* Macquarie/Cintra, *supra* note 38 (discussing *Pensacola*).

Some authorities that address the taxation of mining activities reach a similar conclusion as *Pensacola*. In a 1998 Field Service Advice Memorandum, the Service adopted a similar approach, treating mining permits as separate intangible assets for purposes of Section 197.[54] In another tax court case, *H.G. Fenton Material Co. v. Comm'r*, 74 TC 584 (1980), the tax court ruled that expenses incurred by a taxpayer to acquire various mining permits could not be deducted currently. The court had two separate rationales for its decision, one of which was that the permits were an amortizable intangible.[55]

There are also instances in which rights granted by landlords to tenants who are conducting businesses are treated as separate from the leases. For example, a fast-food franchisor who is also a landlord may grant the tenant the right to use physical premises as well as valuable intangible property, such as trademarks and brand names, that belongs to the franchisor. The right to use this intangible property would ordinarily be treated as separate from the grant of the leasehold interest in the premises.

At least one commentator has embraced the state law approach and argued that state law should control the issue of severability:

> If, under state law, a private person's fee simple ownership or leasehold interest in a public highway or bridge does not give the owner or lessee the right to charge tolls or fees for the use of such highway or bridge, a separate grant of such a right must be obtained from the state. The governmental permit is a separate intangible property right, the value of which is not included in such person's fee simple ownership or leasehold interest in such highway or bridge.[56]

That commentator went on to say that:

> If, under state law, a person's fee simple ownership or leasehold interest in real property gives such person the right to charge tolls or fees for the use of such property, the right to charge tolls or fees for the use of such property is part of

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54 1998 Field Service Memorandum LEXIS 592 (December 24, 1998); *see also* Hollender, *supra* note 5, at 1485-86 (discussing the 1998 FSA).

55 The court's other rationale was that the case was indistinguishable from *Geoghegan & Mathis, Inc.*, 55 TC 672 (1971), discussed below. This rationale generally is not consistent with *Pensacola*.

56 Macquarie/Cintra, *supra* note 38, at 16.

> such person's fee simple ownership or leasehold interest in such real property. Accordingly, even if a governmental permit to charge tolls or fees for the use of such real property is granted to the owner or lessee, there is no separate intangible right to charge tolls or fees and the fair market value of the right is part of the fair market value of the fee simple ownership or leasehold interest in such real property. For example, a governmental permit "granting" the right to charge fees for parking in a parking lot or parking garage lease from a city in Pennsylvania [a state that the commentator had identified as allowing all fee simple owners of parking garages to charge fees] is not a separate intangible asset.[57]

Another commentator focuses more on the argument that a toll right is the right to carry out a business and concludes that the toll right is always a separate right, even in states that do not reserve the right to toll to the state (in other words, even in those states in which a private owner has the right to toll his own land, subject to the state's police powers). That commentator reasons that a toll right should be treated like a contract right:

> The policy behind FIRPTA is to tax foreign persons' gains on sales of real property, including real property embedded in a holding company, not to tax gains on stock of real businesses operating in corporate form. In particular, FIRPTA was originally motivated by Congress's distaste for a practice that had developed whereby foreign persons would own a building, make an election to treat that ownership as producing effectively-connected income in order to secure depreciation and other deductions, and then sell the building without "recapture" of the deductions. Those scenarios are not present in the typical infrastructure transaction.
>
> This observation supports the conclusion that, from a policy perspective, it makes sense to try to bifurcate the value of an infrastructure investment, treating the underlying land, buildings, and improvements as an interest in real property and treating the license to collect tolls, etc. as a separate asset in the nature of a contract right that is not an interest in real property.[58]

Based on this determination that a toll right is a contract right, the commentator then draws an analogy to goodwill and other operating intangibles:

> At bottom, an ordinary contract to earn income is an intangible, not an interest in real property, even if one couldn't collect the income without having some kind of access to real property. The contractual right to earn income is

57 *Id.* at 17.

58 Blanchard, *supra* note 34 (footnote omitted).

> analogous to the goodwill of a business. Even if a widget manufacturer's fixed assets consist principally of USRPIs, once its goodwill and going concern value are factored in . . . , it will almost never be a USRPHC, nor would Congress have intended it to be. A license to collect tolls on a toll road should be treated no differently, under FIRPTA, than any other operating intangible.[59]

A third commentator does not address the severability question directly, but seems to assume that a toll right is a separate asset from the underlying real property.[60] Thus, to date, several commentators have written in favor of generally treating a toll right as an asset that is separate from the underlying real property. However, there does not seem to be a consensus as to the appropriate framework for evaluating toll rights.

B. Inseverable Approach

Advocates of the Inseverable Approach believe that the toll right should either be treated as a portion of the underlying real property or, equivalently, that the value of the toll right should be attributed to the underlying real property. Proponents of this view disagree in principle with the argument that, in the transaction described in the Advance Notice, the historic or current state law treatment of toll rights differentiates toll rights from other rights granted pursuant to a lease. Because the toll right is inextricably linked to the particular land with respect to which the right is granted and consists merely of a right to exploit one's own possessory interest in real property, under this view it would not be treated as a separate asset, even in transactions that are not similar to the one described in the Advance Notice. Accordingly, advocates of this view conclude that a toll right should be treated as part and parcel of the real estate to which it relates, no differently from the manner in which any other right to exploit one's own real property would ordinarily be treated. This does not mean that specific infrastructure projects could not have intangible assets associated with them (such as goodwill or going concern value), but that the right to toll itself should not be treated as a separate asset.

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59 *Id.* Presumably, this view assumes that tolls are not "rents" for applicable federal income tax purposes. As noted below, there is no authority in this regard. See discussion in footnote 19, *supra*.

60 *See generally* Hollender, *supra* note 5, *passim*.

1. The Advance Notice

The Advance Notice requests guidance about a very specific transaction: one in which a state that owns and operates a toll road leases that road to an operator and simultaneously grants the operator the right to charge tolls. In the first instance, this fact pattern presents the question of whether the state law status of the toll right makes any difference to the federal income tax treatment of the transaction.

It is apparent that all real property comes associated with certain intangible rights that are usually treated as part and parcel of the underlying real property interest. In many leases, if not most, these rights include the right to possess the leased premises for a period of time and the right to engage in certain activities on the leased premises. In addition, most leases explicitly prohibit the tenant from engaging in certain other activities on the leased premises. For example, a lease may permit or prohibit subleasing, or it may require that the leased space be used to operate a restaurant, or even a particular type of restaurant. This generally does not cause the lease to be bifurcated into two documents, one of which is a "lease" of real estate and one of which is a "concession" (to operate a restaurant, sublease the real property, etc.).[61] This does not mean that "operating a restaurant"[62] is necessarily a "real estate activity," it just means that the grant of the right to run the restaurant contained in the lease is, as common sense would indicate, a part of the lease.[63]

There does not appear to be any doubt that the transaction contemplated in the Advance Notice involves a "lease" of the land within the ordinary meaning of that term for legal and tax

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61 This does not mean that a tenant who is obligated to operate a restaurant on his land has to allocate all the value of his restaurant to the lease; he may well have a number of other tangible and intangible assets that are separate and of value to his business (goodwill, going concern value, tangible personal property, etc.).

62 To take another example, consider a case in which a landlord leases the basement of an office building for use as a parking garage. Suppose that the lease requires that the tenant conduct a parking garage business, and may even specify what types of services are to be provided, rates, etc. Assuming that the landlord and tenant do not structure the transaction in such a way as to constitute a partnership for U.S. federal income tax purposes, presumably this transaction is just a lease, not the grant of a "franchise" or "concession," and would customarily be treated as such.

63 Nor does this mean that the permitted use is not a real estate activity—for example, subrents derived from a permitted sublease are clearly income from real property and interests in those subrents would be USRPIs. But that is separate from the question of whether or not the lease should be bifurcated into a toll right and a lease, and it is discussed elsewhere in this report.

purposes. The question is whether the toll right (i.e., the right to toll the leased road) should be considered an intangible asset that is separate from the bundle of other rights that the lease grants to the lessor, or whether the toll right should simply be considered an ancillary, integral part of the lease. The key point here is that the toll right is a "stick" in the grantor's bundle, which it has, pursuant to the limitations set forth in the transaction documents, granted to the grantee. Therefore, there must be some exceptional reason to distinguish this case from the "garden variety" lease. In this case, unlike in the fast food franchise example cited above, the grantor is not providing access to any valuable intangible assets. It has no secret recipes; if anything, the grantee is more likely to be a capable operator of the road than the grantor. In addition, the grant of the "toll right" is simply the grant of a right to charge a certain type of fee for operating a business (operation of the road) that the lease explicitly permits the lessee to engage in.[64] In other words, bifurcation in this case simply separates the bare right to receive income from the operation of the business from the operation of the business itself. By such logic, the value of all commercial real property could quickly be reduced to zero, at least if the principle of the Severable Approach was applied without regard to state law. For these reasons, there does not seem to be any good reason to deviate from the customary way that leasing transactions are viewed and bifurcate the lease in the transaction posited in the Advance Notice into two transactions. Instead, it seems appropriate to treat the right to earn income from the underlying real property as inseverable from the lessee's possessory interest in the underlying real property itself.

The next section discusses whether there is anything special or unique about toll rights that would or should cause them to be treated as separate assets in cases other than those similar to the one posited in the Advance Notice.[65]

2. The Effect of State Law

State law relating to toll rights varies from state to state, is uncertain in many respects, and is subject to change. Moreover, even if state law were consistent, it is not determinative; the fact

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64 *See* Bartram v. Central Turnpike Co., 25 Cal. 283, 290 (Cal., 1864).

65 Of course, all of the arguments in this Part constitute additional reasons to treat the toll rights in the example in the Advance Notice as inseverable from the underlying real property.

that the state reserves a right at common law does not preclude it from being considered a "stick" in the real estate owner's bundle for tax purposes. There is also considerable case law support for "merging" such sticks with the larger estate to which they relate when they are held by the same person. These considerations suggest that toll rights should be considered an inseverable part of the real estate to which they relate.

Reliance on state law could lead to differing results in different states. None of the commentators who urge reliance on state laws (to a greater or lesser extent) claim that it is uniform. They usually say that "most" states or "many" states adhere to the concept of a sovereign reservation of toll rights,[66] but some cite specific examples of states that do not reserve toll rights to the state.[67]

A more basic problem is that, in many states, the status of toll rights is far from clear. For example, at least one commentator has cited Texas as a state in which there is no right to toll a road, bridge, or tunnel without a state-granted toll right,[68] but it is not clear that the authority on which the commentator relies supports this conclusion.[69] Ambiguity seems to be particularly widespread in this area of the law because much of the relevant case law is of considerable antiquity and uncertain scope. For example, California has at least one nineteenth-century case that explicitly states that a private actor may construct and operate a road, but must obtain a special government franchise to charge tolls.[70] However, a 1996 California statute that authorizes governmental entities to lease infrastructure projects, including highways, bridges, and tunnels, to private entities makes no mention of granting a franchise or other toll right; it

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66 See sources cited in footnote 38, *supra*.

67 *Cf.* Macquarie/Cintra, *supra* note 38, at 7-8 (citing Florida as a state that does not reserve the right to toll to the state).

68 *See id.* at 7.

69 That commentary cites statutes that, by their terms, only appear to reserve the right to toll to the state with respect to toll roads that connect to listed public road facilities. *Id.*; Vernon's Tex. Transp. Code §§ 362.102, 362.051 (2007).

70 Bartram v. Central Turnpike Co., 25 Cal. 283, 290 (Cal., 1864) ("[A]ny person who can procure from the landholder the right of way may construct and maintain a road. It is only in respect to the right to collect tolls on his road when constructed, that he must make application to the Legislature or some branch of the Government vested by the Legislature with the power to grant the franchise.").

only refers to a "lease."[71] The statute could be read as implicitly abolishing California's franchise requirement for toll roads; it could also be read as assuming that, when a state leases a toll road, it includes the franchise to toll the road.

This ambiguity highlights the difficulties and the somewhat arbitrary consequences that result from making the federal income tax consequences of the fairly straightforward transaction set forth in the Advance Notice depend on such complex and changeable matters of state law.[72] Such an approach seems particularly inappropriate in the FIRPTA context, as the FIRPTA Regulations specifically provide that state law does not determine what constitutes real property.[73] At the same time, treating all states as if they had reserved the right to toll to the state is also problematic.[74] Such an approach results in the invention of intangible assets in some instances. Moreover, if such intangible assets can be created for "toll rights" where no state law reservation exists, it is hard to see why such bifurcation would not apply to any lease or transfer of any real estate interest. This seems to be too high of a price to pay for uniformity.

The fact that the sovereign reserves rights to itself and grants those rights to its subjects is not unique to toll rights. For example, historically, certain mineral rights have received the same treatment; would-be miners needed to secure "concessions" from the crown for the privilege of engaging in various mining activities. At British common law, all gold and silver deposits were reserved to the crown, along with the right to mine them.[75] In addition, many of the most

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71 Cal. Gov. Code § 5956.4.

72 *But see id.* at 15-17 (arguing for such a standard). It is also worth noting that an approach that resulted in different federal income tax results depending on individual states' property laws could cause somewhat perverse results. For example, if a private entity leased a road that went from State A into State B, the investor's assets in State A could include both the portion of the land and improvements in State A and a separate toll right, but in State B could only consist of the portion of the land and improvements in State B.

73 As noted in Part V, *infra*, the FIRPTA Regulations specifically provide that state law does not determine what constitutes real property. *See* Treas. Reg. § 1.897-1(b)(1). Technically, this approach would not be inconsistent with this Regulation, because the Regulation does not say that state law cannot be used to determine what constitutes a separate asset for FIRPTA or other federal income tax purposes, but it violates the policy underlying the Regulation (avoiding the non-uniform application of FIRPTA across varying state and local property laws), as well as its spirit.

74 See discussion *supra*.

75 Blackstone at 486 n.20 ("'Mines of gold and silver, by royal prerogative from time immemorial, have belonged to the crown.'" (quoting *Williams on Real Property*, 14 n. (5 Am. Ed. 1879))). This right is quite a bit broader than it might initially seem. *See* Charles Ashworth James, *Mining Royalties: Their Practical Operation and Effect* 15 (1898). Gold and silver are frequently found in connection with other metals, and

important mining states were territories of France, Spain and/or Mexico (which itself was colonized by Spain), and these countries treated all mines and minerals (not just gold and silver) as belonging to the government, not the landowner.[76] The federal government has generally reserved known mineral deposits on its lands to itself,[77] and significant mining states often reserve all mineral rights when they convey land.[78] Mineral rights, including rights to gold and silver, are usually treated as inhering in the underlying real estate for purposes of federal income tax law. All of these rights are treated as real estate interests, not as separate intangible assets. Moreover, they are generally treated as inseverable from any larger estate with which they are granted.[79] Thus, it would not appear that reservation of a right to the sovereign has any necessary bearing on the status of that right as a separate property right or as real property. Mining is, of course, an active business, much more so than tolling, so the active versus passive distinction would not appear controlling, either. It could be argued that mineral rights exploit real property in one way (inseverable), while toll rights exploit them in another way (severable), but this only raises the question of what distinguishes one from the other.

3. Tax Treatment of Rights That "Run with the Land"

As noted above, real property customarily carries with it certain intangible rights. Some of these rights are "sticks" in every fee owner's bundle. Some are state-granted privileges, such as zoning variances or property tax abatements. In this latter case, such a privilege, once granted, is often treated for tax purposes as an inseverable part of the fee, even though it may be conditioned on a particular use of the property by the owner or on his conduct. Under the Inseverable

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some argued that the presence of a small amount of gold or silver rendered the mine a royal mine, Blackstone at 262, and in at least one instance an entire copper mine was found to belong to the Crown because it contained a small proportion of gold, James, *supra*, at 15.

76 *See* 1 Powell on Real Property § 10. ("The antecedent continental view, shared by France and Spain and imported to the United States chiefly through Mexico, . . . treated all mines and minerals as belonging to the government, in an ownership separable from the surface ownership." (footnotes omitted)). Private individuals who wished to mine their lands needed a concession from the government to do so. *Id.*

77 *Id.* ("[Since] the nineteenth century, the [U.S.] practice was to reserve known mineral lands and to lease the privilege of exploiting mineral deposits. . . . If, however, land has been entered and patented without knowledge of its mineral character, the patentee has the full benefits of all minerals found thereon." (footnote omitted)).

78 *Id.* Sometimes the reservation is restricted to deposits that are known at the time of conveyance. *Id.*

79 See also the discussion of zoning rights in Part IV.B.3, *infra*.

Approach, the framework for evaluating whether a concession is a separate asset is to determine whether it is sufficiently linked to the exploitation of the concessionaire's real property and whether there is an "alternative source of value," other than the real property itself and the concession.[80] In general, this alternative source of value would be goods or services provided by the concessionaire, such as the provision of alcohol at an establishment with a liquor license or, in the case of a cable television franchise, the programming delivered over the cable.[81] If a concession is inextricably linked to the concessionaire's real property and there is no alternative source of value, then the concession and the underlying real property would be treated as one asset.[82] This approach produces consistent results, unlike the "state law" version of the Severable Approach discussed in Part IV.A, *supra*, which is subject to the vagaries of state law.

A number of cases have considered the circumstances under which a right to use land that was legally separate from the ownership or leasehold interest in the land should collectively be treated as a unitary asset for tax purposes.[83] The remainder of this Part IV.B.3 discusses these cases and other authorities.[84]

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80 Hollender, *supra* note 5, at 1491-92.

81 *Id.*

82 This framework is consistent with the logic underlying the FIRPTA Regulations that address the circumstances under which personal property constitutes a USRPI. *See* TD 7999 (Dec. 31, 1984); *see also* Hollender, *supra* note 5, at 1492.

83 *See, e.g.*, Estate of Mattie Roberts v. Comm'r, 59 TC 128 (1972) (land enhanced by agency rights), *acq.*, 1973-2 CB 3; Bixby v. Comm'r, 58 TC 757 (1972) (accounts receivable enhanced by guarantee), *acq.*, 1975-1 CB 1; Jack Daniel Distillery v. United States, 67-2 USTC 9499 (Ct. Cl. 1967) (whiskey enhanced by trade name); GCM 37525 (May 4, 1978) (condominium unit enhanced by special assessment fund); GCM 37689 (Sept. 25, 1978) (timber enhanced by ingress and egress rights); Rev. Rul. 86-99 (land enhanced by grazing right on neighboring federal land); *see also* Van Duzer v. Comm'r, 61 TCM 2791 (1991), *aff'd without op.*, 9 F.3d 1555 (9th Cir. 1993) (wind farm enhanced by warranties relating to workmanship, defective parts, minimum levels of power output, etc.); Texas Instruments, Inc. v. United States, 77-1 USTC 9384 (5th Cir. 1977) (seismic tapes enhanced by seismic data); Comshare, Inc. v. United States, 94-2 USTC 50,318 (6th Cir. 1994) (similar); Walt Disney Productions v. United States, 76-2 USTC 9606 (9th Cir. 1976) (movie enhanced by intangible elements); Rev. Rul. 71-177, 1971-1 CB 5 (computer enhanced by software); Treas. Reg. §§ 1.597-5(c)(3)(ii), 1.597-5(d)(2)(iii) (value of government guarantee included in basis of asset acquired from certain troubled financial institutions).

84 In addition to the cases discussed in this Part, there are a number of valuation cases that are consistent with the Inseverable Approach, because they attribute the value of an intangible asset to the tangible asset whose value it enhances. For example, in *Perrault v. Comm'r*, 25 T.C. 439, 451 (Dec. 9, 1955), the taxpayer held a patent right that increased the value of certain of his machinery. *Perrault* cited and relied upon *Susquehanna Power Co. v. State Tax Comm'r of Maryland*, 283 U.S. 291 (1931). In that case, the issue before the Court was whether the value of a permit that gave its holder the legal right to dam a river in a

Peabody Natural Resources Co. v. Comm'r, 126 T.C. 261 (2006), a recent Tax Court case decided under Section 1031, determined that an "in-the-money" coal supply contract should be treated as an inseverable part of the coal mine to which it related. Section 1031 provides for non-recognition of exchanges in which a taxpayer exchanges property for property of "like kind."[85] Peabody argued that Section 1031 applied to a transaction in which it, essentially, exchanged a gold mine for a coal mine that was subject to two long-term coal supply contracts. These contracts were highly valuable, because they enabled the coal mine to sell its coal at a price above the then-prevailing market price; Peabody estimated that they represented approximately two-thirds of the coal mine's value.[86] The court agreed with Peabody that the contracts created equitable servitudes on the coal mine under applicable state law, but found that state law was not determinative for Section 1031 purposes.[87] And, while the court ruled that both the contracts and the gold mine were real property assets for purposes of Section 1031, it never stated whether they were of like kind.[88] Instead, it held that the supply contracts were inextricably bound up with, and could not be separated from, the particular coal mine's coal reserves.[89] Whether the supply contracts added or subtracted value to the coal mine made no

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particular location should be attributed to the land. Arguably, the fact pattern of the transaction contemplated by the Advance Notice is more amenable to unitary treatment than that in *Susquehanna*. The transaction in the Advance Notice involves acquiring both assets from the same party (the state), in the same transaction and pursuant to the same document or integrated series of documents. On the other hand, in *Susquehanna*, the land and permit were acquired from different sources, which would seem to be a factor that weighs strongly in favor of treating them as separate assets. In both *Perrault* and *Susquehanna*, the value of the intangible asset was attributed to the related tangible property. These cases, as well as similar cases and rulings, such as those cited in footnote 83, support the Inseverable Approach because, for purposes of FIRPTA, the practical effect of including the value of the toll right in the value of the underlying real property is essentially identical to that of treating a toll right and the underlying real property as a single inseverable asset. These authorities are discussed more fully in Part VI.B, *infra.*

85 Section 1031(a).

86 Peabody Natural Resources v. Comm'r, 126 T.C. 261 (2006).

87 *See id.*

88 *Id.*

89 *Id.* ("[R]espondent argues those two supply contracts can be fragmented and are not inextricably bound up with Peabody's ownership of the Lee Ranch mine's coal reserves. We disagree."); *id.* ("Peabody's right to mine and extract coal from the [coal mine] and its supply contracts payment rights for the coal cannot be separated from its ownership of the [coal mine's] coal reserves."); *id.* ("[T]he right[s] to payment under the contracts for coal furnished . . . are ancillary to Peabody's ownership of the coal reserves."); *id.* ("[W]e hold that the right to receive income from the tenant is part of the bundle of rights ancillary to and inherent in the ownership of the realty . . . .").

difference;[90] this question only affected the coal mine's quality, not its fundamental nature.[91] Accordingly, it ruled that Peabody was entitled to nonrecognition treatment under Section 1031 because it had simply exchanged a gold mine for a coal mine.[92]

Peabody relied on a prior case, *Koch v. Comm'r*, 71 T.C. 54 (1978), in which the taxpayer sought nonrecognition treatment under Section 1031 for an exchange of commercial property for other commercial property subject to long-term leases.[93] The Tax Court held that the right to rental income is "not a separate and distinct item of property but is part of the bundle of rights incident to the ownership of the fee. That bundle of rights and its related obligations are inextricably bound up in the fee simple interest."[94] The logic underlying this line of reasoning does not require that the rights benefiting or burdening the real estate be treated as real property themselves,[95] only that they be inextricably linked to the underlying real property.

Geoghegan & Mathis, Inc., 55 TC 672 (1971), is also consistent with the Inseverable Approach. In that case, the taxpayer operated an open pit mine. As the face of the mine was pushed back, it approached a pipeline right-of-way easement that the mine had granted to a utility company. At issue was how the taxpayer should treat the payments it made to the utility company to buy back the easement. The Service argued, and the court agreed, that they could not be deducted currently as mine development expenses, as "The payment was for a *right* to engage in an

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90 *Id.* ("[T]he question of whether the supply contracts afford an advantageous or detrimental coal price to Peabody is immaterial . . . ."); *id.* ("[T]he question of whether the lease was advantageous or detrimental to the fee owner is immaterial.").

91 *Id.* ("[The coal supply contracts'] obligations and restrictions constitute a distinction in the grade or quality of the old and new mining properties rather than a difference in their kind or class. The new coal mine property is of a like nature or character to the gold mining property Peabody exchanged.").

92 *Id.* ("We hold that the coal mine subject to the [coal] supply contracts Peabody received is like kind to the gold mining property transferred and that Peabody's exchange qualifies for nonrecognition treatment under section 1031(a).").

93 Koch v. Comm'r, 71 T.C. 54, 65 (1978).

94 *Id.* The court relied on authority finding that the value of an income stream from a lease is not a separable asset from the reversionary fee interest. *See* LeBelle Michaelis, 54 T.C. 1175, 1180 (May 27, 1970); Friend v. Comm'r, 40 B.T.A. 768 (Oct. 19, 1939); s*ee also* Alstores Realty Corp., 46 T.C. 363 (1966); Peters v. Comm'r, 4 T.C. 1236, 1240 (1945).

95 At least one commentator takes the view that the status of the coal contracts as real property for state law purposes has no bearing on the court's decision. Richard A. Wolfe, Tax Club Paper Series, Peabody Natural Resources Co. v. Commissioner: Turning Gold into Coal—Tax-Free, at 20.

activity, not an expense of carrying out the activity as such."[96] Instead, the Tax Court determined that the cost should be attributed to the ore body.[97]

Revenue Ruling 86-99 presents additional analogous authority. There, a farmer held grazing land in fee simple and held a federal permit allowing grazing on neighboring federal land.[98] The payments due under the permit were at less than arm's-length terms, so the permit had clear value to the holder of the fee interest. The Service ruled that, for estate tax purposes, the value of the grazing permit was part of what a willing buyer would pay for the fee interest. Accordingly, its value was "an element of the value of the land owned in fee" for purposes of valuing the land. Like the permit in *Susquehanna*, discussed in Part VI.B, *infra*, the grazing permit was only valuable to the holder of particular land (that adjoined the federal land), and the Service, like the *Susquehanna* court, attributed the value of the permit to the land.

The Inseverable Approach also finds support by analogy in the financial products area, which provides multiple instances in which complex financial instruments that combine debt-like characteristics and equity-like characteristics must be treated as either one instrument or two.[99] Conceptually, the overarching idea across this area of tax law seems to be whether the holder has both the legal and the economic capacity to separate the assets (i.e., she has a legal right to do so and is not "economically compelled" to keep them together).[100] As a practical matter, the real property and the toll right cannot generally be separated; one cannot make a profit from tolling a

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96 Geoghegan & Mathis, Inc., 55 TC 672, 676 (1971).

97 *But see* H.G. Fenton Material Co. v. Comm'r, 74 TC 584 (1980) (ruling that expenses incurred by taxpayer to acquire various mining permits could not be deducted currently, on two grounds, one of which was that the case was indistinguishable from *Geoghegan* and the other of which was that the permits were an amortizable intangible); 1998 Field Service Advice Memorandum LEXIS 592 (December 24, 1998) (mentioning the latter rationale).

98 Rev. Rul. 86-99, 1986-2 C.B. 159.

99 *See* Chock Full O'Nuts Corp. v. United States, 322 F. Supp. 772 (S.D.N.Y. 1971), *aff'd*, 453 F.2d 300 (2nd Cir. 1971); Edward D. Kleinbard & Erika W. Nijenhuis, *Everything I Know About New Financial Products I Learned From DECS*, in 517 P.L.I., Tax Strategies 1183, 1220 (2001).

100 *See, e.g.*, Rev. Rul. 2003-97 ("Unless a holder has a legal right to separate linked instruments, they generally cannot be considered separable."); Chock Full O'Nuts Corp. v. United States, 453 F.2d 300 (2nd Cir. 1971); Universal Castings Corp. v. Comm'r, 37 T.C. 107 (1961); Rev. Rul. 88-31, 1988-1 C.B. 302.

road unless one has both a possessory interest in the road and the right to toll the road.[101] The right and the property, as with inextricably linked financial instruments, become virtually economically indistinguishable. This therefore points strongly in favor of unitary treatment, at least in cases in which the grantor of both the toll rights and the real estate is the same person (or a related person) and the grantee is required to hold both interests. While it could be argued that different principles should govern the issue of bifurcation in the financial products area as opposed to other areas, there does not seem to be any strong reason why these basic principles—that legal and economic "stapling" are important factors in the analysis—should not apply equally in this area.

In this case, we believe that the two assets being tested for severability are of such a specialized nature that the case for inseverability is difficult to refute. A road has few, if any, uses other than as a road. Similarly, a right to toll that road is simply a bare right to earn income from that purpose-built structure. To treat the road and the right as severable from each other, especially in cases similar to those discussed in the Announcement, is in our view a strained approach to a straightforward transaction.

In addition, the manner in which property is zoned is usually treated as an inseverable part of the fee, not as a separate asset. Similarly, the use of real property in most jurisdictions is usually subject to obtaining a license from the state, such as a "certificate of use and occupancy." Without this certificate, the owner usually cannot use the property (at least not for its intended purpose). There do not appear to be any authorities or commentaries treating such a state-granted license as a separate intangible asset and/or as having any exceptional value.[102] It is also

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101 *Cf.* PLR 200725015 (taxpayer acquired a concession to operate an electrical distribution system and then had to go procure such a system to put the concession to use).

102 One could argue that zoning relates to what might be called "land use," while charging tolls is an "activity." *See* Part IV.B.3, *supra* (discussing this argument and critiques in an analogous context). Moreover, whatever force this argument might normally have would seem to be reduced in the toll road case, as the right granted is not to engage in an activity in a particular manner (or allow others to do so), but merely the right to charge a fee for engaging in an activity (or for allowing others to do so). If landlord A is subject to rent control and landlord B is not, one would not have supposed that landlord B's "right to charge what the market may bear" constitutes a separate asset that does not inure in his real property interest. *Cf.* PLR 200922003 (treating a combined permit that governs both land use (construction and use permits) and activities (operating a nuclear power plant) as a single Section 197 intangible); PLR 200922005 (same); Part IV.A, *supra* (discussing PLR 200922003 and PLR 200922005).

worth noting that a zoning variance or similar permit may effectively grant a property owner the right to use her property in a unique or unusual way and, in some instances, the owner may be able to convey such a right when he leases the property to another person.[103] But, even in such circumstances, the variance or permit still is not treated as a separate asset.[104]

Nor is the Inseverable Approach inconsistent with the Section 197 Regulations, which distinguish between "interests in land" and "governmentally granted licenses or permits" (other than those embodied in a lessee's interest in a lease). The examples cited as permits in the Regulations generally relate to rights to use other people's real property or to perform services thereon. The one example of a license which may be location-specific—a liquor license—clearly falls into the category of a right that is not uniquely suited to a particular location, but, like the dog track in *Pensacola*, happens to be granted only for that location. In each case, there is a source of "alternative value" and there is no link to the specific location like that required under the FIRPTA Regulations which address tangible property associated with the use of real property. On the other hand, interests identified as "interests in land" comprise rights with respect to active businesses (such as acreage base) and land use rights that may be necessary to conduct specified activities.

Thus, treating toll rights as an inseverable part of the road operator's interest in the real property comprising the road is consistent with prior decisions and leads to consistent results across different states.

V. If a Toll Right Is a Separate Asset, Is It a USRPI?

A USRPI is defined as an "interest, other than an interest solely as a creditor" in United States real property or a USRPHC.[105] The term "real property" is defined to include three categories of property: "land and unsevered products of the land, improvements, and personal property

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103 Certain zoning rights to build vertically, which are known as "air rights" when unused, can even be separately transferred to contiguous or nearby properties under very limited conditions. *See, e.g.*, Wing Ming Properties v. Mott Operating Corp., 148 Misc. 2d 680, 561 N.Y.S.2d 337 (Sup. Ct. 1990); 2 Powell on Real Property § 18A.02[2]. Nonetheless, air rights are not generally considered an intangible separate from the fee or occasionally leasehold interest to which they are appurtenant.

104 *See* Section 197(e)(2); Treas. Reg. § 1.197-2(c)(3).

105 Section 897(c); Treas. Reg. § 1.897-1(c)(1).

associated with the use of real property."[106] Both the land underlying the toll road and the toll road improvements constitute real property for FIRPTA purposes.[107] An "interest in real property other than solely as a creditor" is defined to include a "fee ownership, co-ownership, or leasehold interest in real property, a time sharing interest in real property, and a life estate, remainder or reversionary interest in such property."[108]

As noted earlier, the analysis of whether a severable toll right should be treated as a USRPI depends on the basis for concluding that the toll right is severable in the first place. If the toll right is severable because it is a retained sovereign right, for example, is that right one in or relating to real estate, or some other kind of right such as an exercise of taxing authority? Alternatively, if the toll right is severable because it represents the right to run a business, then the question arises whether or not that right is an interest in real property other than solely as a creditor. This Part has four subparts, the first three of which analyze separate grounds under which a toll right could be considered "real property," and the fourth of which discusses policy considerations that militate in favor of and against treating a toll right as real property.

Part V.A considers whether a toll right is real property because it is a "traditional" real property interest such as an equitable servitude, covenant, or easement, or if it is sufficiently similar to such interests to merit being treated as real property. Toll rights have many commonalities with these interests. For example, like a covenant, a toll right touches and concerns the underlying land and, as pointed out above, may not be severable from the interest in land to which it relates. Like an easement, it concerns rights of passage over land. However, there are several potential differences between toll rights and these types of property rights that must also be considered. For example, these property rights generally burden a fee owner's interest in the land and reduce its value, while the toll right, if viewed solely as a bare right to earn income, presumably adds value. Another question is whether these property rights are themselves real property for purposes of FIRPTA; while FIRPTA's legislative history suggests that they are, the Regulations that the Service issued under FIRPTA are silent on this issue.

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106 Treas. Reg. § 1.897-1(b)(1).

107 Treas. Reg. § 1.897-1(b)(3)(i).

108 Treas. Reg. § 1.897-1(d)(2)(i). Note the list is inclusive, not exclusive of qualifying interests.

Another approach, considered in Part V.B, is to treat a toll right as a right to share in gross proceeds or profits from real property. If a bridge is a USRPI, the argument then becomes that the right to charge for crossing the bridge is a right to share in the proceeds or profits generated by that bridge. Those who reject this view argue that while a toll right may literally allow its owner to share in profits generated by the real property, the Regulation has a more limited meaning. Some argue that the Regulation is limited to particular types of income (such as gain, rent or extractive activities) or to particular rights (such as those granted by the owner of the property), or that the Regulation should not be construed literally on policy grounds. Proponents of this view reject these arguments. They contend that they do not flow from anything in the Regulation itself, and that the language of the Regulation should be taken at face value. They also note that the Regulation has been applied far more broadly than some of the detractors' arguments would suggest, including to certain contracts for services. Some contend that the limitations suggested by opponents of this position do not stem from the text or history of the Regulation itself, but ultimately derive from policy arguments that they find unpersuasive.

Part V.C evaluates whether a toll right might appropriately be treated as personal property that is associated with the use of real property. Current Regulations clearly reject this approach, as they limit such property to tangible personal property. Presumably, the original drafters of the Regulation considered this issue and concluded that it was inappropriate to treat any intangible personal property as being associated with the use of real property. Adherents of this view concede these points, but note that the legislative history is ambiguous, and can be read to support or undermine this view. Moreover, they note that the real question is how toll rights *should* be treated, not how they are presently treated; the Service has the power to modify the existing Regulations, and thus the correct answer is what treatment best fits with the policies and principles underlying this area of tax law. They further contend that the same framework should be applied to evaluate both tangible and intangible personal property, and that, when viewed in this light, a toll right is best seen as associated with the use of real property.

Part V.D analyzes the policy issues that run through Part V.A, Part V.B, and Part V.C.

A. Other "Traditional" Real Property Interests

As the severability discussion in Part IV.A, *supra*, indicates, the state law characterization of a toll right may be important, possibly critical, to its characterization for federal income tax purposes. While commentators who have argued in favor of severability have all relied on state law to a greater or lesser degree, there has been little analysis of whether toll rights, considered as separate property from the road to which they relate, could nonetheless constitute an interest in real estate, either for state law purposes or for federal income tax purposes generally, FIRPTA aside.

One commentator, however, has considered whether or not a toll right could be considered an easement and concluded that, on balance, the toll right was more like a license than an easement because it was revocable and subject to continuing government oversight.[109] However, there does not appear to be any law on point and the strength of this conclusion would seem to depend on the particulars of each transaction. Moreover, these agreements are generally revocable only in the sense that the state can alter the agreement in relevant part by paying compensation.

Another possible analysis may be found in the *Peabody* case, discussed above. In that case, a contract to supply coal was held to be both a contract for the sale of goods and an equitable servitude under New Mexico law, and therefore an interest in real property for purposes of Section 1031 of the Code. *Peabody* is interesting because the contract in question appeared to be in the money and therefore it could be argued that it did not burden the landowner's estate.

No one appears to have analyzed whether a toll right could be considered an equitable servitude or a covenant running with the land. If it is determined that state law is of importance in determining whether toll rights are interests in land, then this issue, like the easement characterization discussed above, would seem to merit further exploration.

In performing this analysis, a determination would have to be made as to how to segregate the toll right from the remainder of the agreement. Presumably, the toll right is simply the bare right

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109 Hollender, *supra* note 5, at 1484. Although Hollender references both Section 197 and Section 897 in his easement discussion, his focus is on Section 197.

to charge for passage, as compared to the right to operate the road, as the common law authorities indicate. If so, treatment as a covenant or servitude may be inappropriate because these characterizations contemplate that an estate in land be burdened with an obligation. On the other hand, this would seem to be an extreme example of separating the fruit from the tree; in tax terms, the (literal) bare right to earn income is separated from the rest of the underlying owner's estate, as well as from all of his other contractual or legal obligations, and then treated as a separate asset. To put it another way, once one segregates one integrated agreement into two (or more) parts, it is not entirely clear where one draws the line.

In performing this analysis, it could be argued that the mere fact that a toll right is not literally an easement, covenant or servitude for state law purposes should not be determinative in characterizing it for federal income tax purposes. There are many instances in which federal income tax law recharacterizes one state law arrangement involving real property into another on the grounds that, in substance, the latter treatment of the transaction is more appropriate. To take but one example, in the transaction discussed in the Advance Notice, there is a "lease" of land with improvements. Commentators have no difficulty concluding that a 99-year "lease" of the land is a lease for federal income tax purposes, whereas, say, a lease of a toll booth or a guardrail pursuant to the same agreement is a sale for federal income tax purposes, even though both may be treated as leases for state law purposes. This is because federal income tax law delineates the difference between a lease and a sale in part by reference to the substance of the agreement, as well as its form. If such an approach were applied to classify toll rights for purposes of FIRPTA, the question would not be limited to determining a toll right's state law classification, but would also consider whether that state law classification is consistent with the federal income tax rules for such classification. For example, under a *Peabody*-type analysis, one might conclude that a toll right, if interpreted to include the obligation to operate the road as well as the right to collect tolls, was a covenant or servitude for tax purposes whether or not it was so treated under the laws of one state or another.

Finally, the question arises whether interests in land such as easements, covenants, and servitudes would constitute interests in real property for FIRPTA purposes. The FIRPTA Regulations state that an asset's classification for local law purposes does not determine its classification for purposes of FIRPTA,[110] and they do not explicitly list equitable servitudes, covenants, or easements as interests in real property. The most compelling authority comes from FIRPTA's legislative history, which states that "Real property is intended to have the same meaning for this purpose that it has in the U.S. Treasury's model income tax treaty."[111] The model treaty in place at that time defined real property as including "rights to which the provisions of general law respecting landed property apply," which would seem to include these traditional real property rights.[112] Moreover these interests have been recognized as real property rights in other contexts, and the Regulations under Section 197 indicate that they constitute an "interest in land."[113] This seems to be a sensible conclusion under FIRPTA as well.

B. Gross Proceeds or Profits from Real Property

Treas. Reg. § 1.897-1(d)(2) provides limited clarification as to the circumstances in which an individual or entity's "interest in real property" rises above that of a mere creditor. Generally speaking, "[a]n interest in real property other than an interest solely as a creditor includes a fee ownership, co-ownership, or leasehold interest in real property," along with time sharing interests, life estates, remainder interests, or reversionary interests in real property.[114] In addition to direct ownership interests, the definition also encompasses "direct or indirect right[s] to share

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110 Treas. Reg. § 1.897-1(b)(1).

111 H.R. Rep. 96-1479, House of Representatives Conference Report on HR 7765, Omnibus Reconciliation Act of 1980, 96th Cong. 2d Sess. (Nov. 26, 1980) at 186.

112 *See* U.S. Model Income Tax Treaty of May 17, 1977 art. 6 ¶ 2. That model treaty used the terms "immovable property" and "real property" interchangeably. *See id.* art. 6 ("Income From Immovable Property (Real Property)"); *id.* art. 6 ¶ 1 ("Income derived by a resident of a Contracting State from immovable (real) property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State."); *see also* OECD Model Double Taxation Convention on Income and on Capital (1977) (containing an article 6 with substantially similar provisions to those discussed here and referring only to "immovable property").

113 Treas. Reg. § 1.197-2(c)(3) (defining an interest in land to specifically include an "easement" as well as any "mineral right, timber right, grazing right, riparian right, air right, zoning variance, and any other similar right," which would seem to include covenants and equitable servitudes). Further, at least one commentator has stated that these real property interests can be USRPIs. Blanchard, *supra* note 34 ("Presumably, . . . an interest short of a lease—for example, an easement or other right to use property such as a toll bridge—is an interest in real property if the interest carries with it the right to share in the appreciation of or profits derived by the property.").

114 Treas. Reg. § 1.897-1(d)(2)(i).

in the appreciation in the value [of], or in the gross or net proceeds or profits generated by, the real property."[115]

Commentators have argued that the phrase "gross or net proceeds or profits generated by real property" refers only to proceeds or profits from the disposition of real property, rather than current operating income or rents generated by real property.[116] If this view is correct, the right to collect tolls would not seem to be an "interest in real property" for purposes of this Regulation, as it is better seen as a right to share in current income from real property than as a right to share in proceeds or profits on the disposition of the underlying real property. This argument draws mainly from an example within the Regulations that states that the right to a commission or brokerage fee calculated by reference to the price or rent of real property does not constitute an "interest in real property."[117]

It is true that the example in the Regulations states that the one-time commission is not a "right to share" within the meaning of the Regulation. However, it also specifically provides that if the commission amount were instead based on the "profits of the real property occurring or arising after the date of the transaction with respect to which the professional services were rendered," it would constitute an "interest in real property other than solely as a creditor."[118] This suggests that it may be better to view the Regulations' exclusions of interests as carving out those interests that (1) bear little to no temporal connection to the value of the underlying property (such as a one-time commission that is based only on the value of property at one moment in time) and (2) for which there is either no discrete underlying property or for which the underlying property is exceedingly vague or difficult to determine.[119]

The provision's text and subsequent rulings also appear to support the view that an interest in current income generated by real property is a USRPI. First, the provision refers broadly to

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115 *Id.*

116 *See* Macquarie/Cintra, *supra* note 38, at 18-19.

117 *See* Treas. Reg. § 1.897-1(d)(2)(ii)(E).

118 *See* Treas. Reg. § 1.897-1(d)(2)(ii)(E).

119 *See, e.g.*, Treas. Reg. § 1.897-1(d)(2)(ii)(D) (excluding interest rate and inflation indices); *see also* Rev. Rul. 2008-31 (excluding a broad-based real estate index from the scope of the provision).

"proceeds or profits generated by" property and contains no specific limitation as to the nature of earnings generated by property.[120] It even explicitly includes certain rights to mineral production payments, such as "volumetric production payments," which are generally treated as loans for U.S. federal income tax purposes and which do not, by their terms, include rights to share in gains from the disposition of the underlying real property.[121] Subsequent authorities on the provision also support a broader reading. Although the Service has issued only one formal Revenue Ruling (and it provides little guidance),[122] it has also issued three private letter rulings that have found various "Management Agreements" to be USRPIs.[123] Many of the "Management Agreements" gave the taxpayer the right to acquire distinct property (and an option to acquire an interest in real property is itself an interest in real property for purposes of Section 897).[124] Regardless, some of the Management Agreements lacked this feature but entitled the taxpayer to a percentage of gross revenue and to incentive payments derived from revenues from the property, and the rulings held that all of these were USRPIs. The rulings cited the Regulations as establishing a USRPI when payments are contingent on "proceeds or profits from real property."

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120 Treas. Reg. §1.897-1(d)(2)(i).

121 *See id.* ("A production payment that is limited to a quantum of mineral . . . or a period of time will be considered to convey a right to share in the appreciation in value of the mineral property.").

122 Rev. Rul. 2008-31, 2008-26 I.R.B. 1180 (notional principal contract over an index of real estate values of large geographic areas does not constitute a USRPI because it is not a "direct or indirect right to share in the appreciation in the value . . . [of] the real property"). This ruling was based on the "broad-based nature" of the index. The significance of the "broad-based nature" is not made clear, however. It is possible that the assumption was made that the broad base for the index made it unlikely that a party to the contract would own any material amount of the underlying property. It is not clear from the definitions in the Regulations whether ownership of the underlying real property is relevant in determining whether a "right to share" (and thus a USRPI) exists, and the ruling and the Regulations contemplate instances in which it appears that a "right to share" USRPI may arise from an interest conveyed by a party that does not own any direct ownership interest in the underlying real property. *Cf.* Treas. Reg. § 1.897-1(d)(2)(ii)(D) ("[W]here an interest in real property bears a rate of interest that is tied to an index the principal purpose of which is to reflect changes in real property values, the real property interest will be considered an indirect right to share in the appreciation in value of, or gross or net proceeds or profits generated by, real property.").

123 See PLR 199951027, PLR 199951043, and PLR 199951044, in which the Service ruled that "Management Agreements" entitling a taxpayer to a share of gross revenue and incentive payments, most of which included the right to acquire the underlying property, constituted USRPIs.

124 *See* Treas. Reg. § 1.897-1(d)(2)(ii)(B) ("An option . . . to acquire any interest in real property (other than an interest solely as a creditor) will itself constitute an interest in real property . . . .").

A permit to collect tolls, then, appears similar to interests that constitute USRPIs under the provision. Although a toll road permit does not necessarily give the holder a direct, "one-for-one" exposure to the value of the underlying property, it is likely to provide such exposure in those circumstances in which the underlying road has little value to an owner beyond the value of the tolls that the owner may collect from it (and, therefore, the value of the land would be the net present value of future toll collections). Furthermore, even in those instances in which the land has significant value beyond the value of the tolls that the operator may collect, the right to toll enables the holder to continually derive profits that are literally "profits generated by . . . an interest in real property"—that is, profits derived from the operator's ability to charge individuals to cross a given piece of land. Therefore, a permit to collect tolls would appear to fall within the definition of an "interest in real property other than solely as a creditor" under Treas. Reg. § 1.897-1(d)(2)(i). The question of whether this is an appropriate result is considered below.

C. Personal Property

1. Legal Background

Section 897(c)(6)(B) states, "The term 'real property' includes movable walls, furnishings, and other personal property associated with the use of real property." Under Treas. Reg. § 1.897-1(b)(4)(i), personal property associated with the use of real property is limited to "tangible personal property."[125] However, there does not appear to be any reason why the definition of "other personal property" could not (or should not) include intangible personal property, so long as it has the same nexus to the real property that the current Regulations require of tangible personal property.[126] There are four specific categories of personal property "associated" with real property: mining and farming equipment, property used in the improvement of real property, property used in the operation of a lodging facility, and property used in the rental of furnished

125 Treas. Reg. § 1.897-1(b)(4)(i).

126 *See* Section 897(c)(6)(B). The list preceding the reference to "other personal property" includes only tangible personal property. This could be read as a limitation on the definition of "other" but the list is far from exhaustive, suggesting it was not meant to be exclusive. Further, one would expect the statute to require "other similar" or "other related" personal property if the preceding list was meant to illustrate a limitation. The contrary argument would be that the words "other personal property" were meant to signify "other similar personal property," but the statute does not say that, nor does it appear that the statute compels this reading.

office or work space. Generally speaking, personal property can only be associated with real property if it is held by the owner of such real property.

The tangible personal property rules "associate" assets that are essential to exploiting real property. The preamble to these Regulations states, in response to a comment that mining equipment should not be associated personal property, that the "logical basis" of the personal property rules is that "property constitutes associated personalty if it serves primarily to exploit the real property itself, as opposed to being used in furtherance of some other economic activity that is unavoidably located upon but does not otherwise 'use' real property."[127] In other words, all businesses must be conducted on some sort of real property, but this does not mean that all assets that are associated with a business are associated with real property. Instead, the Regulations create bright line categories of assets that are inextricably linked to the exploitation of real property; the value of such assets is derived from the use of the real property. Hence, a desk used as a furnishing in an office rental business or in a hotel is treated as real property held by the landlord, while a desk owned by a law firm and used for legal work is not.

The same logic behind these rules can also be found in the Regulations under Section 197 that address intangible property treated as an "interest in land." Under those Regulations, intangible assets can be depreciated over 15 years, but not if such assets constitute an "interest in land."[128] An interest in land explicitly includes easements, zoning variances and air rights,[129] but it does not include rights to an airline route or franchises to provide cable television service.[130] These intangible rights may, by necessity, use real property.[131] But, as one commentator suggests, these rights also have an "alternative significant source of value" aside from the real property.[132] For instance, although a liquor license may be granted with respect to a particular property, the

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127 TD 7999, 26 CFR Parts 1 (12/31/1984).

128 Treas. Reg. § 1.197-2(c)(3); *see also* Section 197(e)(2).

129 Treas. Reg. § 1.197-2(c)(3).

130 *Id.*

131 Note that all of the enumerated rights that are specifically excluded from the definition of the term "interest in land" by Treas. Reg. § 1.197-2(c)(3) are concessions of the second type—they provide the grantee with the right to provide services on property not owned or leased by the grantee.

132 *See* Hollender, *supra* note 5, at 1491-92.

value stems from allowing its owner to provide goods and services (serving and/or selling alcohol) rather than unlocking any value in the property itself.[133] Similarly, a cable franchise may require easements across land, but most of the value presumably stems from the programming content that is sent across the cable lines.[134] This distinction is consistent with the discussion above concerning concessions that are limited to the use of one's own real property and concessions whose value is inextricably limited to specific real property.

2. As Applied to Infrastructure Concessions

Many infrastructure concessions will have value that would not exist "but for" the real property to which they relate. But, to the extent that significant value can be attributed to "some other economic activity," the Regulations may provide that rights to conduct such activity are not USRPIs. In fact, the present Regulations can be read to require such a distinction. As noted above, Section 897(c)(6)(B) provides that, for purposes of the statute, "personal property associated with the use of real property" constitutes real property. The Regulations interpret this provision as only being applicable to "tangible personal property." For the purposes of testing whether a corporation constitutes a USRPHC, the Regulations classify intangible personal property, such as franchises, as "assets held for use in a trade or business."[135] A close reading of the Regulations suggests that the Service assumed that a franchise or other intangible asset could not be a USRPI.[136]

This limitation does not derive from the text of the statute, which does not distinguish between tangible and intangible personal property. FIRPTA's legislative history is similarly ambiguous on this point, as it does not clearly indicate whether Congress intended the definition of real

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133 *Id.*

134 *Id.*

135 Treas. Reg. § 1.897-1(f)(1)(ii).

136 Treas. Reg. § 1.897-1(f)(1) defines the term "asset used or held for use in a trade or business" as being composed of three categories of assets. The first category, which includes inventory, depreciable property and livestock, and the third category, which includes cash, stock, securities, receivables, and similar assets, both include clauses that limit their application to assets that do not constitute USRPIs. Treas. Reg. § 1.897-1(f)(1)(i); Treas. Reg. § 1.897-1(f)(1)(iii). Treas. Reg. § 1.897-1(f)(1)(ii), which includes intangible assets, such as goodwill, franchises, and licenses, does not have any such limitation. Presumably the absence of a similar requirement suggests that the Service assumed such intangibles could not be treated as USRPIs.

property to include intangible property or exclude it.[137] It states, "Real property is intended to have the same meaning for this purpose that it has in the U.S. Treasury's model income tax treaty and thus it includes personal property associated with real property."[138] The model income tax treaty existing at that time uses the terms "immovable property" and "real property" interchangeably[139] and defines "immovable property" as including "property accessory to immovable property," "rights to which the provisions of general law respecting landed property apply," and "rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources."[140] One view is that these last two items explicitly include intangible assets, and that the first does by implication. Alternatively, it could be argued that the first item makes no explicit reference to intangible assets, and the last two may be characterized as minor exceptions that prove the rule: intangible assets that are traditional real property interests, not personal property, and payment rights that directly relate to extractable real property.

Under the Regulations currently in effect, it is clear that if a concession were treated as a separate asset, it could not be treated as a USRPI by virtue of being personalty associated with real property. However, it appears that the Service has the authority to expand the notion of "associated" personal property to include specified intangible assets, and that the standard set forth in the Preamble to the current Regulations could provide very useful guidance in this regard. The "logical basis" of the associated personalty rules could be adapted to formulate

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137 *See* Cong. Rec., July 2, 1980, S9318 (not distinguishing between tangible and intangible personal property); H.R. Rep. 96-1167, House of Representatives Committee on the Budget Report on H.R. 7765, Omnibus Reconciliation Act of 1980, 96th Cong. 2d Sess. (July 21, 1980) at 513 (same).

138 H.R. Rep. 96-1479, House of Representatives Conference Report on HR 7765, Omnibus Reconciliation Act of 1980, 96th Cong. 2d Sess. (Nov. 26, 1980) at 186.

139 *See* U.S. Model Income Tax Treaty of May 17, 1977 art. 6 ("Income From Immovable Property (Real Property)"); *id.* art. 6 ¶ 1 ("Income derived by a resident of a Contracting State from immovable (real) property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State."); *see also* OECD Model Double Taxation Convention on Income and on Capital (1977) (containing an article 6 with substantially similar provisions to those discussed here and referring only to "immovable property").

140 U.S. Model Income Tax Treaty of May 17, 1977 art. 6 ¶ 2. The comparable provision in the current U.S. model income tax treaty is essentially identical. U.S. Model Income Tax Convention of November 16, 2005 art. 6 ¶ 2. Interestingly, the Treasury's technical explanation states that this definition includes anything that constitutes real property under Treas. Reg. § 1.897-1(b), but may be more inclusive than the Regulation. United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006 art. 6 ¶ 2.

similar bright-line or factor-based rules to establish when infrastructure concessions are USRPIs. If the Service were to adopt this approach for toll rights or infrastructure concessions generally, similar rules would allow it to appropriately distinguish among infrastructure concessions without finding all concessions to be real property *per se*.

For instance, consider the differences between a ferry concession, a port concession, and a toll right. It is clear that, in the first case, the concession is not, in the words of the preamble, primarily used to "exploit" the underlying real property. Instead, any such real property (e.g., a ferry pier) used in furtherance of such concession is simply a location from which services are provided. By contrast, in the toll road case, the personal property in question merely constitutes a right to exploit the real property. The port concession represents an intermediate case, in the sense that both the location and the services provided are critical to the business carried on by the concessionaire.[141]

Another way of expressing this distinction is the concept, discussed above, of an alternative value-adding activity. This concept could be incorporated into the Regulations as either a set of factors to test or as a bright-line rule. For instance, the ferry operator's transportation of passengers is an activity that occurs on and across bodies of water in which the operator holds no real property interest. Put another way, the passengers on most ferries could cross the river or bay for free if they had their own boat, but they do not. The same would hold true for the operator of a bus line. In both cases, passengers pay for a service that may have a "but for" relation to the real property (i.e., without a dock or a pier, passengers cannot board the ferry), but the passenger is really paying for services (being driven or ferried to particular places) instead of for an easement or license to cross another's real property.

To summarize, the toll right, if viewed as personal property, appears to meet the test set forth in the preamble quoted above. It is certainly as inextricably linked to a physical facility as a television set is to a hotel room or a tractor is to a farm.[142] If the term "personal property" as

141 See discussion in Part IV.B.3, *supra*.

142 *See* Treas. Reg. § 1.897-1(b)(4); *see also* PLR 200725015 (ruling that, for purposes of the REIT rules, taxpayer's electrical distribution system, "a passive conduit" with "physically and functionally

used in the statute need not be limited to tangible personal property, the Service could craft Regulations that adapt the principle of the preamble and extend it to intangible property. If it does so, the Service should be careful to distinguish those intangibles that are not fundamentally linked to exploiting one's own real estate in ways that are integrally related to that particular real estate (the right to operate a toll road, for example) from those which are not (such as ferry concessions).

D. Policy Implications of USRPI Definition

The foregoing sections address the Service's ability to promulgate guidance that would be consistent with the current scope of Section 897 and that would treat toll rights as a USRPI, either by interpreting existing Regulations (treating a toll right as an interest in real property other than solely as a creditor) or by promulgating new Regulations (classifying specific types of intangible personal property as being associated with real property). This Part V.D sets out a number of arguments as to why this would not be an appropriate exercise of the Service's interpretive regulatory power. While there are a number of different arguments that could be made in this regard, they basically fall into two categories.

The first argument is that toll revenues are not "rents," nor are they proceeds from the sale of extracted crops, timber, or minerals. Rather, they are just a type of business income and, accordingly, the grant of a right to earn such income should not be treated as a USRPI.

Opponents of this view argue that, under existing law, the income from conducting certain businesses constitutes revenues derived from USRPIs. For example, the FIRPTA Regulations explicitly list bridges as constituting U.S. real property.[143] Saying that the bridge is real property, but that the right to charge tolls for crossing it is not a "direct or indirect right to share in the . . . gross or net proceeds or profits generated by the real property"[144] seems to run counter to the framework of the FIRPTA Regulations. This seems especially true if one believes that

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interdependent" components that are "not feasible to move," was a real estate asset, and that payments received by the taxpayer from the lease of the system would be treated as "rents from real property").

143 *See* Treas. Reg. § 1.897-1(b)(3)(iii)(B).

144 Treas. Reg. § 1.897-1(d)(2)(i).

most of the value of the toll bridge enterprise resides in the permit to operate the bridge for its intended purpose, not in the bridge itself.[145] The same observation could be made about other infrastructure-like assets, such as pipelines, that are also separately enumerated,[146] as well as those that are not but which are clearly similar to the types of assets mentioned (roads, docks and wharves, etc.).

The second argument is that FIRPTA should be interpreted consistently with what are viewed as the original, narrow goals of the statute, which were to prevent avoidance of U.S. federal income tax with respect to certain passive real estate investments (such as net leased property) and through the use of the (now-repealed) *General Utilities* doctrine in certain contexts. In this view, expanding FIRPTA to a new class of assets is not warranted. Even if FIRPTA is overbroad in its current form, that is no reason to add to its overbreadth in the name of leveling the playing field.[147]

Opponents of this view believe this second argument to be essentially a policy-oriented judgment about the proper scope of FIRPTA. The question should not be whether the scope of FIRPTA is too broad but rather whether the types of infrastructure concessions described in the Advance Notice fit within its current scope. Proponents of this view believe that such concessions fit comfortably within the existing framework. To them, the fact that legislative history from almost thirty years ago may be consistent with a narrower scope of authority than the statute and the Regulations have embodied for decades is not a sound reason to narrow this scope in a manner that favors one industry over other similar industries (for example, toll roads over pipelines). Many years have passed since *General Utilities* was repealed, but FIRPTA still contains the concept of a USRPHC. In the interim, we have continued to sign treaties in which we reserve the right to tax U.S. real estate assets (including stock of USRPHCs), and many of our trading partners have adopted similar concepts. So, while the theoretical arguments for

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145 In this case, the increase in value is outside the FIRPTA net. Conversely, if the toll right is out of the money (i.e., it is burdensome), then, presumably, that would lower the value of the real property under the reasoning of *Oxford Paper*, 194 F.2d 190 (1952), and similar cases.

146 Treas. Reg. § 1.897-1(b)(3)(iii)(B).

147 *See* Alvin Knott, Practising Law Institute, *FIRPTA Then and Now: A Selective Review* (2008) (noting problems with FIRPTA and advocating narrowing the application of the USRPHC rules); Hollender, *supra* note 5, at 1489-91; Blanchard, *supra* note 34.

eliminating this concept entirely may be sound, it does not follow that, absent elimination, a corporation containing nothing but a hotel or a pipeline should be a USRPHC, but that one containing only a toll road or bridge should not. On balance, we believe that if toll rights are treated as severable assets, they fit within the current scope of FIRPTA and, accordingly, should be treated as USRPIs.

VI. Valuation of the Toll Right

This section responds to the request in the Advance Notice for guidance concerning the way in which a toll right should be valued for FIRPTA (and presumably other) purposes.[148] It presumes that, consistent with the Severable Approach, a toll right is treated as a separate asset that is severable from the concessionaire's interest in the underlying real property and further assumes that the toll right is not a USRPI.[149] Thus, this Part is only relevant to the administration of FIRPTA if both of our prior recommendations are rejected. More specifically, this section considers a transaction in which, in exchange for a single lump sum payment at the closing and an obligation to maintain and operate the road, a state which currently owns and operates a toll road transfers to a private actor, for a period of years, (1) the land underlying an existing toll road, right of way, and land improvements and (2) a right to charge tolls for the use of the road. The right to charge tolls may be subject to a rate schedule with regulated increases or an agreed procedure for obtaining toll increases, and the concessionaire may be subject to other types of state regulation and oversight. The question is how the value of the toll right should be calculated.

A. Valuation Regime

To date, there has been scant commentary on this issue. One commentator has stated that conventional valuation approaches should be employed, without explicitly describing how they

148 IRS Announcement 2008-115, 2008-48 IRB 1228 (Dec. 1, 2008) ("The IRS and Treasury Department specifically request comments on . . . the allocation of the consideration paid for the lease or purchase of a specified infrastructure and the license, permit, franchise, or other similar right to operate that specified infrastructure for purposes of determining the fair market value of such property.").

149 As pointed out above, valuation is not a relevant concern for FIRPTA purposes unless a toll right is treated as a severable asset that is not a USRPI, although it may be relevant for other purposes of the Code.

should be applied to the transaction contemplated in the Advance Notice.[150] Other commentators do not appear to have addressed this subject directly.

There appears to be a consensus that, for federal income tax purposes, the "lease" described above is partially a lease and partially an asset purchase transaction that is governed by Section 1060.[151] Under applicable federal income tax principles, it is partially a purchase to the extent that some or all of the land improvements have an economic useful life that is shorter than (or approximately equal to) the term of the agreement.[152] It is partially a lease for federal income tax purposes because, for a term of years, the concessionaire gets a possessory interest in the land, any appurtenant rights of way, and any land improvements with economic useful lives that exceed the term of the agreement.

Presumably, Section 1060 applies to the entire toll road concession transaction.[153] Accordingly, before attempting to value any separate intangible asset, value would first be attributed to the land (which is leased) and the land improvements (which, depending on the length of the agreement and the economic useful lives of the improvements, may be leased, purchased, or a combination of both).[154]

Therefore, the first issue presented is how to value the prepaid lease of the land. Logically, a prepaid lease for the length of time involved (75 to 99 years appears to be typical) would tend to approach the total value of the fee interest. The following discussion assumes that it is, in fact, equal to the value of the fee interest. This, in turn, raises the question of what the value of the fee interest in the land is. To resolve that question, there are two issues that must be resolved.

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150 *See* Blanchard, *supra* note 34.

151 *See, e.g.*, Hollender, *supra* note 5, at 1481-83; Macquarie/Cintra, *supra* note 38, at 10-11, 20-22. Note that the transaction may not be bifurcated in this manner, or at all, for local law purposes.

152 *See, e.g.*, Rev. Rul. 55-540.

153 The toll road itself is an operating business with employees to which going concern value may attach or which might be treated as an active trade or business for purposes of Section 355. *See* Treas. Reg. §§ 1.1060-1(b)(1), 1.1060-1(b)(2).

154 *See* Hollender, *supra* note 5, at 1481-83; Macquarie/Cintra, *supra* note 38, at 10-11, 20-22; *see also* Field Service Advice 200048002 (Dec. 4, 2000).

The first is whether the value of the toll right is properly attributed to the underlying real estate; the second is how to calculate assemblage value for such unique tracts of land.

B. Impact of Toll Right on Land Value

The first question hinges on whether and when an intangible asset that enhances the value of a tangible asset is deemed to have separate value, as compared to having its value inhere in the affected tangible asset. There is case law that supports both approaches. As discussed in Part IV.A above, in *Pensacola Greyhound Racing, Inc. v. Comm'r*, 32 T.C.M. 1064 (1973), the Tax Court allocated the buyer's purchase price among a dog racing track, the land on which it was located, and various intangible assets, most notably a racing permit. The racing permit allowed the operation of a dog track only in the exact location of the existing facility and prevented the operation of any other dog racing facilities within 100 miles.[155] This clearly increased the value of the business, and the tax court treated the various liquor and gaming licenses as intangible assets that were separate from the underlying real property.[156] *H.G. Fenton Material Co. v. Comm'r*, 74 TC 584 (1980), can also be read as supporting this view.[157]

There is also case law that supports the proposition that, when an intangible asset enhances the value of a tangible asset, the enhanced value inheres in the tangible asset, even when there is no "merger" of the intangible asset into the tangible asset. For example, in *Susquehanna Power Co. v. State Tax Comm'r of Maryland*, 283 U.S. 291 (1931), an ad valorem case, the taxpayer, a power company, had dammed the Susquehanna River, creating a reservoir fourteen miles long across land it had previously acquired. The taxpayer argued that the federal license that permitted it to dam the river in that particular location should be treated as a separate asset that was immune from taxation and that represented the majority of the power plant's value. The Court disagreed with the taxpayer and held that the value of the legal right to dam the river and

155 From the facts, it does not appear that its physical facilities had been obtained from the state, either by the taxpayer or his predecessor.

156 *See also* Macquarie/Cintra, *supra* note 38 (discussing *Pensacola*).

157 *See* discussion Part IV.A, *supra*.

build a dam inhered in the land; the license had value because it enabled the landowner to use the land in a particular way.[158]

Similarly, in *Perrault v. Comm'r*, 25 T.C. 439, 451 (Dec. 9, 1955), the question was how to allocate value between a taxpayer's machinery and a patent the taxpayer owned that enhanced the value of that machinery. Citing *Susquehanna*, the court held that, when an intangible legal interest enhances the value of physical property, the increase in value is attributed to the physical property, not the intangible asset.[159] There are a number of other cases and rulings in which the courts or the Service have followed this same approach and allocated the value of intangible property to the tangible property to which it adds value.[160]

We believe the foregoing authorities indicate that the value of a toll right that constitutes an asset separate from the underlying real property should inhere in the underlying real property, a conclusion which is consistent with the view, expressed above, that a toll right should be treated as an inseverable element of the real estate to which it relates. We note, however, that, for

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158 The Court wrote:

> An important element in the value of land is the use to which it may be put. That may vary with its location and its relationship to the property or legal interests of others. Its proximity to means of transportation, highways, railroads, or tidewater, or its location in the vicinity of water power belonging to another but available for use upon it, may increase its utility, and hence its taxable value. A dock on New York harbor may have a greater value than one on nonnavigable waters, even though the advantages of the former may be terminated through the exercise of the superior power of the federal government over navigable waters.
>
> A large part of the value of property in civilized communities has been built up by its inter-related uses; but it is a value ultimately reflected in earning capacity and the price at which the property may be sold, and hence is an element to which weight may appropriately be given in determining its taxable value. It has never been thought that the taxation of such property at its enhanced value is in effect taxation of its owner for the property of others. Nor can we say that the present tax, based upon what must be taken to be the fair market value of [taxpayer's] lands profitably used in the business of developing and selling power, is forbidden because that use would not have been possible without the control which appellant has acquired over navigable waters through the grant of its license.

Susquehanna Power Co. v. State Tax Comm'r of Md., 283 U.S. 291, 296 (1931) (citations omitted).

159 Perrault v. Comm'r, 25 T.C. 439, 451 (Dec. 9, 1955) ("[W]here the value of physical property has been enhanced by reason of the presence of an intangible legal interest, nevertheless the enhanced value still adheres to the property."); *id.* (holding that, although the taxpayer's patent enhanced the value of its pipe-wrapping machines, the value of the machines was attributable only to the machines, not a separate asset).

160 *See* sources cited *supra* note 83.

purposes of FIRPTA, attributing the value of the toll right to the underlying real property has the same practical effect as either (1) treating the toll right and the real property as being one inseverable asset or (2) treating the toll right as a separate asset that constitutes a USRPI.

C. Impact of Assemblage Value on Land Value

In most, if not all, of the recent toll road transactions that are similar to those described in the Advance Notice, the land underlying the toll road was assembled years, if not decades, ago. Even if the state and the concessionaire have agreed on a price allocation (and they may not have), because the state is a tax-exempt entity, there is no adversity of interests to help validate it. Each road, tunnel, and bridge is unique and such assets do not change hands very often, so there are few comparables. Since all of the assets involved in the transaction comprise one inseverable economic unit, the elements of which cannot easily be separately sold or valued, it is not clear exactly how to allocate value to the land.

Presumably, in the case of land improvements, one would look at reproduction costs, then factor in an adjustment for economic depreciation. This approach is arguably inappropriate for land because it cannot be "reproduced" (at least not easily) and it does not depreciate in the same way that constructed improvements do. However, as discussed below, there are several conceptual approaches that could be used to value the land.

1. The Subdivision Method

One approach would be to simply view the land as the sum of multiple smaller tracts. One could then price each of these smaller tracts by looking at comparable transactions in surrounding localities and treat the value of the land as the sum of the values of its constituent smaller tracts.

This approach has the value of simplicity. However, it requires an irrebutable presumption that the value of the whole is equal to the sum of the values of its parts; in other words, it assigns no incremental value to the land as an assemblage. In addition, even if viewed as a measure of cost, it ignores the fact that the concessionaire, as a private actor, would have to bear the cost and expense of negotiating with a multitude of landowners, some of whom might be "hold outs" (people who do not want to sell) and "hold ups" (people who want to sell, but at a price that reflects the incremental cost avoided by having the road go through their property rather than around it). The state could ignore this cost in assembling the land because it has condemnation power.

2. The Motorist-Perspective Method

At the opposite end of the spectrum, one could focus on the value that the motorist receives from having access to the road. The motorist derives no value from the imposition of a toll; from his perspective, it is a burden, not a benefit.[161] The only good or service provided to the motorist is that he is granted permission to cross the land of another person. As one commentator has noted in an analogous context, there is no "source of alternative value."[162] Presumably, the motorist will only be willing to pay a toll that is less than or equal to the incremental costs that he would incur by taking the closest free substitute, i.e., by "shunpiking." In other words, motorists are only paying for the right of access to land and land improvements, not for any other service and, regardless of the rate schedule imposed by the toll road agreement, there are limits to what motorists will be willing to pay.

From this perspective, after assigning value to the improvements using the method outlined above, all residual value would automatically fall to the land, and no value would be allocated to the toll right. This is similar to the way in which many land-intensive businesses are often valued. For example, in rental real estate, intangible assets associated with the property are typically allocated no value.[163] Similarly, extractive industries often allocate residual value to ore body.

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161 In some congested areas, it could be argued that, by paying the toll, the motorist has purchased a less congested passage. Even if this perhaps debatable proposition is true, he is still paying for passage, not for any ancillary services.

162 Hollender, *supra* note 5, at 1491-92.

163 H.R. Rep. No. 213, 103d Cong., 1st Sess. 688 (P.L. 103-66) (1993) ("The bill does not apply to any amount that is . . . not a section 197 intangible. Thus, for example, no portion of the cost of acquiring real property that is held for the production of rental income (for example, an office building, apartment building or shopping center) is to be taken into account . . . (i.e., no goodwill, going concern value or any other section 197 intangible is to arise in connection with the acquisition of such real property). Instead, the entire cost of acquiring such real property is to be included in the basis of the real property . . . .").

3. An Alternative Method

There is an intermediate approach between these two positions that looks to the cost to the concessionaire of reproducing the land assemblage. In other words, if State X awarded the concessionaire a right to build and toll a road on a particular route, what would the concessionaire have to pay in order to obtain the land or right of way (including time value)?

The benefit of this approach is that, while looking to assemblage reproduction cost may understate assemblage value, it at least provides a reasonable proxy for it. As discussed below, the primary difference in reproduction cost between this method and the subdivision method is that the subdivision method ignores the effect of hold outs, hold ups, and other obstacles to assemblage. It may be argued that hold outs and hold ups are simply practicing a legal form of extortion, and that their demands should be ignored in valuing the land. But ultimately, a willing concessionaire would not pay more than the land was worth to him (and presumably he would hope to pay less). So this cost should be a reasonable proxy for a value somewhere between the subdivision method and the motorist-perspective method.

Of course, the problem with implementing this method is that few toll roads are built by private concessionaires, which again raises the issue of how to replicate the bargaining process that would result if a concessionaire had to assemble the land himself. One approach would be to start with the subdivision method and then add a premium to take account of assemblage costs. But this raises the question of how to determine an appropriate premium when there are few if any modern assemblages by private actors of the scale and complexity needed to create a major toll facility.[164]

One possible way of dealing with this issue would be to view the state as the bargainer. The state would be presumed to have set the toll road tariff level so that the anticipated revenues from the tolls collected would equal the price paid for the land and improvements that the state has sold the concessionaire. This would establish a "base case" in which the state would be presumed to have set the toll schedule to provide a fair and reasonable return on the land and

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164 The unusual nature of these assemblages, and the apparently large increase in value created by them, may also be a factor against using a "rule of thumb" approach which simply tacks on a percentage premium to the subdivision value for assemblage. *See* discussion in Part VI.C.4, *infra*.

improvements, which the state sold to the concessionaire for fair value. This approach to valuing the business, which effectively assumes that the toll road is like a regulated public utility, would result in a default toll right value of zero. However, as discussed below in Part VI.C, *infra*, the state or the concessionaire could rebut the presumption by means of an APA or similar process that would enable them to establish a higher value for the toll right by demonstrating that the anticipated toll revenues exceed a fair and reasonable charge for the land and land improvements.

4. Example

To illustrate the impact of these methods, suppose that a state has a statute that would allow any person who meets certain criteria to obtain, for no or nominal consideration, a permit to build a toll road.[165] The statute would basically require the following:

- the permittee must provide a detailed plan;
- the relevant governmental authority must find that the proposed toll road is in the public interest;
- each local government through which the prospective toll road would pass must not have any written objections;
- the permittee must undertake to acquire the land or right of way for the road without resorting to eminent domain (in other words, the permittee must acquire the land himself by bargaining with the landowners along the prospective route); and
- the permittee must provide a toll schedule that is calculated to give the permittee a specified return on its investment (amounts paid for land and land improvements).

Assume that a consortium of private investors wishes to avail itself of the statute and construct a toll road. Assume further that, prior to the state granting the permit and the consortium

165 This example is modeled on an actual statute. *See* Virginia Highway Corporation Act of 1988.

assembling the land, the individual parcels comprising the land at issue would have sold for a total of X, but (because of hold outs, hold ups, etc.) the consortium had to pay X + Y. Thus, when the consortium opened its books, it had a basis in the permit of zero and basis in the land equal to X + Y.[166]

If the subdivision method described above were applied to the consortium's tax basis, it would simply shift Y from land basis to permit basis, even though Y was actually paid for the land and was not paid or incurred to acquire the permit. It would not appear proper for the consortium to shift basis in this manner. The Y component of land acquisition costs was actually paid for the land; there were willing buyers and willing sellers and, unlike in a condemnation proceeding, there was no compulsion to sell.

If one assumes that the subdivision method would not produce a proper result for the permittee who acquired the original permit, would it produce a proper result for any successor purchaser? Assume, for example, that the original builder of the private road paid nothing for the permit, X + Y for the land, and Z for the improvements. At the closing table, the builder sold the road to a buyer who paid X + Y + Z (the same as the seller's costs), but who allocated X to the land, Y to the permit, and Z to the improvements. The question is whether such an allocation would be reasonable on these facts and, if not, whether it would ever be reasonable—for example, if the seller was the state that had assembled the roadbed using the power of eminent domain and had paid only X for the road. If the answer is no, then the subdivision method would not appear to be an acceptable measure of value. If the answer is yes, then the Regulations should distinguish these various cases and provide guidance on when the method is acceptable and when it is not.

We express no view on this matter. However, we think that (1) it is a key issue that ought to be addressed by Regulations and (2) all other things being equal, we believe that an allocation methodology that produces consistent results for private actors who build toll roads and those who buy them would be preferable to a regime that creates inconsistent results.

166 Although the price paid to the state was zero, presumably there were certain out-of-pocket costs incurred in obtaining the permit. This example is therefore somewhat extreme, but it is intended to illustrate the principle.

There are good reasons to think that assemblage costs for toll roads are likely to be significant. The example above is modeled on a Virginia statute that appears to have been drafted with a specific project in mind, now known as the Dulles Greenway.[167] The Dulles Greenway is a 14-mile-long toll road in Virginia that connects Dulles Airport and Route 15.[168] It took ten years to complete. The process of assembling the land has been described in both newspaper accounts and on the Greenway's own website as "lengthy and expensive," even though the negotiations involved only 26 different landowners, the project was heavily favored by the local communities through which it passed, and the lead investor in the consortium was a local family that was itself one of the largest landowners in the area.[169] The roadway appears to have been a commercial success.[170]

Even though Virginia will grant a permit to anyone for free so long as the requirements of the legislation are satisfied, the creators of the Dulles Greenway appear to be the only people who have taken advantage of the legislation in the 21 years since it was enacted. Although Virginia has since privatized other toll roads and bridges, these transactions appear to have been similar to the transaction described in the Advance Notice, rather than privately constructed greenfield roads like the Dulles Greenway. Presumably, if it were possible to easily reproduce the commercial success of the Dulles Greenway, one would have expected many other applicants for permits under this statute. This does not appear to have been the case. While there are many reasons why building a toll road may be difficult, it seems reasonable to conclude that one of those reasons is a private actor's lack of condemnation power.[171] Other data appear to support

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167 *See* Virginia Highway Corporation Act of 1988, *codified at* Virginia Code §§ 56-535 to 56-552. Note that the Virginia statute does not refer to a concession or a toll right, but to a "certificate of authority." Virginia Code § 56-539.

168 *See* Dulles Greenway, http://dullesgreenway.com.

169 *See* James R. Hardcastle, *A $326 Million Private Toll Road to Spur Growth*, N.Y. Times, July 24, 1994, at § 9 p.7.

170 Most of the original investors sold their interest in the concession to the Macquarie Group for $553 million. The original cost of the land improvements was $145 million and, as pointed out above, the concession was free.

171 *Cf.* Hardcastle, *supra* note 169 ("[One of the] most difficult hurdles the road's sponsors had to clear . . . [was] getting the needed right of way and easements from 26 land owners without the power of eminent domain. . . . 'The marvel of it is that it is going to be happening at all after all the fits and starts it has been through,' said John T. Hazel Jr., a Northern Virginia lawyer and real estate developer whose firm represented the venture in the early days of the project.").

this conclusion. For example, Florida reportedly allows private operation of toll roads without a state-granted permit if the road is constructed without state aid,[172] but no privately constructed toll roads appear to have been built there in modern times.

To put it differently, whether a state allows construction of a toll road without a permit, as appears to be the case in Florida, or freely grants a permit if certain requirements are satisfied, as in Virginia, or even grants permits only in its discretion, the result should be the same: If spending X on land and Z on improvements would instantly create a value greatly in excess of X + Z, one would expect some private operator to have seized these opportunities by offering to build greenfield toll roads without state assistance, or even by offering to pay for the privilege. In other words, if completing such a road created such a valuable intangible asset, one would expect to see a network of privately constructed toll roads. The fact that we do not see them suggests that the state's ability to create an assemblage through use of its eminent domain and other sovereign powers adds significant value.[173]

D. Valuing the Rate Schedule

That still leaves open the question of how to solve for "Y" when there are no comparables. This section examines whether the rate schedule that is typically included in a toll road transaction could be used to "reverse engineer" the value of Y. As a theoretical matter, it could be argued that, if tolls are raised above a certain level, fewer people will use the toll road and revenues will fall. So, presumably, the toll schedule in effect is set at or below the level necessary to maximize revenues (otherwise, the operator would prefer to, and presumably would, lower the toll). Since all revenues are derived from fees for passage across land, all of the value should be attributed to the land.

In a sense, this approach is based on the idea that motorists purchase their right to use the toll road in the "spot" market, where the seller announces the price in advance and, on every trip,

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172 Macquarie/Cintra, *supra* note 38, at 7-8.

173 Of course, this may only be one of many significant sources of value provided by the state. For example, a state authority may well face fewer obstacles in obtaining any local permits that are necessary to create a road and may also have immunity from local property taxes, which it may be able to pass on to its lessee. But all of these benefits presumably go into the value of the land assemblage created by the state and granted to the lessee.

each buyer chooses to accept that price or use a substitute. The contrary argument is that, to some extent, toll roads are natural monopolies. As such, demand for access to the land is relatively inelastic. At least in cases in which there is a sufficiently bleak range of alternatives, it could be argued that a toll rate or schedule is more like a long-term contract with a "locked in" buyer, or a lease. In that case, the consumer (that is, the motorist) arguably is paying more than "fair value" for the right to pass. If so, at any given point, it would seem that the toll schedule, if viewed as a separate property right, is either at, in, or out of the money. Under this approach, the contract could be considered similar to the "above market" coal contract in *Peabody* or the long-term lease in *Koch*. However, as discussed above, in those cases, the intangible asset was simply treated as an inseverable part of the value of the fee, since it simply represented the value derived from exploiting the real estate in question. In contrast, if one instead treats the contract as a severable asset, then presumably it only constitutes a separate property right or obligation to the extent and in the amount that it is in the money.[174]

One approach to determining whether or not the toll schedule is initially "in," "at," or "out of" the money would be to presume that, absent evidence to the contrary, (1) the state wanted to treat the concessionaire as having purchased the land and land improvements for the price that a willing buyer would have paid a willing seller and (2) the state wanted to establish a toll rate or schedule that was sufficient to provide a reasonable rate of return on that purchase price. In such a case, the presumption would be that the toll schedule was set to be at the money and that, therefore, the toll right itself had no independent value. The concessionaire and/or the state would have access to an APA-type process that they could use to rebut this presumption and demonstrate to the Service that, in fact, the concession agreement was in the money at inception or acquisition. In order to do so, the concessionaire and/or the state would have to show that the profit from the toll schedule established by the concession agreement exceeded what the concessionaire would have been able to earn if (1) it had acquired the land and constructed the

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174 In the event that a toll road was transferred or created with an out-of-the-money toll right attached to it, the buyer would presumably argue that it had not received separate consideration in the form of a valuable leasehold in exchange for the assumption of a burdensome contract, under the reasoning of *Oxford Paper*, 194 F.2d 190 (2d Cir. 1952), and similar cases. In this respect, severability would be a one-way street: In-the-money contracts would not increase the value of USRPIs, but out-of-the-money contracts would decrease them. Although not entirely clear, this result seems consistent with present law if one presumes that the toll right and the land are severable and the toll right is not a USRPHC.

improvements itself without access to the condemnation power and (2) it had been subject to a cost-of-service rate base with a regulated return on costs incurred, like a typical regulated utility. In making such a determination, the Service would be able to take into account all of the facts and circumstances, including public statements made by the state, legislative findings, etc., as well as the provisions of the contract itself (for example, whether the contract permits or prohibits competition).

There are a number of possible objections to this proposal. First, it could involve the Service in a number of APA rulings, which could consume a significant amount of resources. This would not seem to be fatal. The modern private toll road industry is in its infancy in this country, and there is little if any precedent about how such arrangements should be treated or how their constituent parts should be valued. The fact that the Service issued the Advance Notice is testimony to this uncertainty. Thus, while the APA process could be burdensome for the Service, it would also allow it to acquire first-hand knowledge of industry practices, hopefully with a view toward ultimately tailoring a set of Regulations or appropriate administrative guidance. Moreover, toll road privatizations are not common. When they do occur, they are generally “big ticket” transactions that often involve billions of dollars. These transactions merit close scrutiny, and having an APA process available would provide certainty to taxpayers, the state, and the Service.

Second, it could be argued that there is no way to disentangle the constituent parts of the agreement so as to arrive at a rational split between land value from the assemblage and the value created by the toll right. Ultimately, however, this is simply an argument against severability, as it basically posits that the toll right itself cannot be divorced from the land to which it relates in any meaningful sense.

Third, it could be argued that no concessionaire or state would ever resort to such an APA process because no state would be willing to allow a concessionaire to argue that the state had agreed to a toll schedule that would result in tolls that provided more than a fair and reasonable return on the cost of leasing the land and purchasing the improvements. If the state has not agreed to such a toll schedule, there is nothing to argue about. If it has, then presumably it should be willing to admit that it took such considerations as maximizing revenues or reducing other taxes into account when it chose the winning bid. In other words, if the state chose to favor taxpayers at the expense of toll payers, there does not seem to be any reason why this should not be a worthy choice or why these factors could not be discerned.[175]

Nonetheless, it would clearly be easier to rebut this presumption in the case of a subsequent transfer of a toll road, assuming that rates are not reset, than at the initial grant of a lease/concession. But, in essence, this is no different from the presumption that all contracts are at market at their inception. And, in this case, there is a mechanism to rebut that presumption.

Note that, if this method were adopted, the entire net present value that the owner can derive from simply allowing access to the land and land improvements, without providing any other non-ancillary services, would not necessarily be attributed to the land. That is, the land would still be undervalued compared to the result in *Susquehanna*, *Peabody*, or *Koch*. This method would be employed to distinguish between the value attributable to the fair market cost of the land and improvements and the "excess" value for which a motorist would pay. In effect, this is the value, if any, in excess of assemblage cost. But, if (1) one wishes to treat the toll right as a separate asset that is not a USRPI, and (2) one adheres to the view that the toll right does not inhere in the land, so that the value derived from tolling (but not from other activities) should be excluded from land value, then (3) one needs to bifurcate the value of the land between the reproduction cost and the excess value conferred by the toll right. To put it differently, under this approach there is a rebuttable presumption that there is no difference between assemblage cost and assemblage value. But, to the extent that this presumption is rebutted, the excess of assemblage value over assemblage cost would be attributable to an intangible asset rather than assimilated into the land.

It could also be argued that this method overstates the value of the land because, absent the right to toll the land, the land has little or no value. This argument has two aspects. First, it could be argued that a willing buyer who already has a toll right would not pay a premium for the land.

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175 For example, economists have compared U.S. toll road privatizations to similar toll road privatizations in France, analyzing why two processes appear to result in winning bid prices reflecting dramatically different EBITDA multiples. Germá Bel & John Foote, Comparison of Recent Toll Road Concession Transactions in the United States and France (Xarxa de Referència en Economia Aplicada Working Paper Series No XREAP2007-11, 2007), *available at* http://ideas.repec.org/p/xrp/wpaper/xreap2007-11.html (analyzing reasons for U.S. EBITDA multiples of 60 and French EBITDA multiples of 12).

However, by definition, the seller, whether it is the state or a private actor, presumably has the permits to operate the business itself, and would not sell the land and improvements for a discount. An example of this bargaining process is found in PLR 200725015. In that instance, X, the incumbent electrical power distributor in state S, wished to dispose of its electrical distribution business. An unrelated person, Y, went to the state utility commission and received a concession to distribute electricity throughout the state. Y then proposed to form a consortium with a group of investors that would form a REIT to acquire the electrical distribution assets from X and then lease the assets to Y, the concessionaire. Presumably, the argument that X's assets were worth little without Y's concession did not move X to reduce the purchase price to reflect the fact that it was not selling a concession, since it also held a concession (such rights being infinitely reproducible). Since X and Y had adverse interests, as did Y and the equity investors in the REIT (though to a lesser degree), one would presume that the physical assets would change hands for a price reflecting their income-generating capacity, assuming that the buyer and the seller had the same rights. If so, then no value would be attributed to any intangible assets. In effect, that is what the ruling implicitly holds. In other words, the specialized nature of the assets involved should not be expected to affect their market price.

The second form of the argument is simply that, without the toll right, one cannot operate the road and therefore only minimal value should be attributed to the land. Driven to its logical conclusion, however, this position would presumably produce a zero value for the land and improvements.[176] This does not seem to be a sensible result. Moreover, since there are numerous businesses that cannot operate without various governmentally granted rights and permits, rigorously applying this approach would seem to create great opportunity for uncertainty in valuation. Rather than applying a "but for" test, it would seem more appropriate to value land and improvements at either their income generating capacity or their reproduction cost, factoring in depreciation for land improvements and assemblage costs for land. Then, if there is any residual value, such residual value could be allocated to the toll right (or possibly to another Section 197 intangible, such as a covenant not to compete, if that is also viewed as an asset that is separate from the lease).

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176 This is not necessarily the case. Presumably, if the holder of the road was deprived of the right to toll it, she could shut down the road and bargain for a toll right or for payments from the state.