Infrastructure investing: Global trends and tax considerations

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With infrastructure one of the few asset classes that is growing in the current environment, and the Obama stimulus package likely to provide significant infrastructure in the US, tax-efficient fund formation and deal structures are important.

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Global trends

Infrastructure is a rapidly growing investment class. Despite tougher capital-raising conditions brought on by the credit crisis fund raising continues, with various new infrastructure funds launched in 2008. Meanwhile, global demand for infrastructure is soaring; the need is particularly acute in emerging economies such as India and China. The Organisation for Economic Co-operation and Development (OECD) estimates that more than US$71 trillion in infrastructure investment will be required globally by 2030.[13]

The worldwide economic slowdown is likely to increase the impetus for infrastructure investment. China, for example, has recently announced a stimulus package including US$586 billion of infrastructure investment over the next two years.[14] In the US, the Obama administration has indicated that its first priority is boosting the economy and creating jobs. It is expected that the US$775 billion stimulus package being developed will involve significant infrastructure investment and that the Obama administration will develop a detailed long term strategy for infrastructure.[15]

The key players in the infrastructure market are infrastructure funds, pension funds, construction funds and sovereign wealth funds. Funds and institutional investors will seek high yields and equity-like returns from the debt facilities and look for cross-border opportunities.

Tax and structuring considerations

With the increased focus and cross-border investment in infrastructure, it is important to understand the international tax framework for structuring infrastructure funds and investments in infrastructure assets.

Fund formation and investment structuring

Infrastructure fund formation and deal structuring is complex. Infrastructure consortiums' distinct funding and yield requirements, as well as applicable tax and regulatory considerations, often necessitate complex structures which, at times, may need to meet conflicting objectives. The optimal fund structure will depend on the investor profile and should also accommodate efficient structuring of carried interest for key portfolio managers.

12 The authors wish to thank Emily Fett, associate in the International Tax Financial Services Practice for her contributions to the article.

13 OECD, "Infrastructure to 2030" report, 2007. This estimate includes investments in road, rail, telecoms, electricity and water infrastructure; it does not include seaports, airports or social infrastructure.

14 "Beijing Unveils $568bn Stimulus Plan," The Washington Times, November 10, 2008; "China Unveils Sweeping Plan for Economy," The New York Times, November 10, 2008.

15 "Obama Weighs Government Spending and Tax Cuts," Financial Times, December 28, 2008. See also, for example, "Obama Vows Swift Action on Vast Economic Stimulus Plan," The New York Times, November 23, 2008.

In determining the location and structure of the acquisition vehicles, the location of the asset will be a key consideration. The acquisition structure must take into account relevant aspects of the investee jurisdiction's tax environment, including corporate taxes, withholding taxes, transfer taxes and other indirect taxes, as well as its regulatory regime. Exposure to source country income and withholding taxes can be mitigated by establishing a treaty-protected special purpose holding company (Hold Co) below the level of the fund. The Hold Co would invest into the local entity acquiring the asset, usually by way of debt, and rely on treaty benefits to reduce the source country income and withholding taxes. The Hold Co must be a qualifying resident under the relevant treaty and it is critical that the Hold Co has sufficient substance in the jurisdiction where it is formed.

US tax considerations

Many US infrastructure investments utilize a flow-through structure and the US tax considerations of such investments will largely depend on the profile of investors. Although they are typically long-term passive investments from the investors' perspective, infrastructure investments usually give rise to operating income such as tolls or user fees, rather than to passive-type income such as dividends or interest. This type of income can subject non-US investors and US tax-exempt investors to US federal income tax in the form of Effectively Connected Income (ECI) for non-US investors and Unrelated Business Taxable Income (UBTI) for US tax exempt investors. Non-US investors could also be subject to tax on the gains from the disposal of their investments under the Foreign Investment In Real Property Tax Act (FIRPTA) rules which apply to investments in US real property. Currently there are rules being proposed that would expand the application of the FIRPTA rules to include government licenses.[16] Sovereign Wealth Fund investors are typically exempt from US federal income tax under Section 892, however this exemption may not apply to operating income earned from infrastructure investments.

Many of these tax issues can be resolved by investing through a corporate structure, and although the corporation would be subject to US income tax, this can be minimised by funding the corporation with debt. For non-US investors, interest payments are typically subject to a 30% withholding tax, however this can be reduced by planning.

As an alternative to forming the fund in a tax-free jurisdiction, the investors may want to take advantage of one of the fund regimes which have been introduced in various jurisdictions. In Ireland, for example, a Qualifying Investor Fund (QIF) is a tax-exempt vehicle which in many cases is eligible to take advantage of the Irish treaty network and EU Directives. Luxembourg may also be an attractive jurisdiction for establishing the fund.[17]

Management company structuring

When setting up a management company which may be involved in sourcing the deal as well as managing the investment, care should be taken to limit the fund's taxable presence in the management company jurisdiction. Certain countries have special regimes in place that exempt the fund from taxation of income generated by the activities of the management companies. For example, funds established in the Cayman Islands should carefully review whether the activities of their US based management company fall within the 864(b) trading safe harbour rules.[18] Similarly, a management company presence in India or China, for example, or extensive travel to such countries, could potentially subject the fund to corporate income tax in these jurisdictions.

16 Advanced Notice of Proposed Rulemaking on Infrastructure Improvements Under Section 897 (Federal Register: October 31, 2008 (Volume 73, Number 212)).

17 The fund may be established as a Société d'investissement à capital variable ("SICAV"), a Société d'investissement à capital fixe ("SICAF"), or a Fonds Commun de Placement ("FCP"). These vehicles can be used to make investments across various jurisdictions with a low level of tax in Luxembourg, and the potential to access Luxembourg's treaty network at the fund level.

18 IRC Section 864(b)(2)

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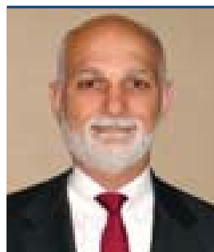

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