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PROJECT FINANCE NEWSWIRE

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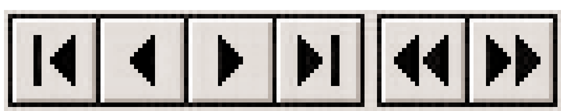

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CHADBOURNE & PARKE LLP

PROJECT FINANCE NEWSWIRE

May 1999

Political Risk Insurance Coverage Expands

by Peter F. Fitzgerald, in Washington

Several recent developments in the area of political risk coverage will help developers, equity participants and lenders in private infrastructure projects.

MIGA — an arm of the World Bank that provides political risk insurance for private-sector projects — said recently that it will begin providing a form of "breach of contract" coverage that should be especially valuable to investors after recent experiences in Pakistan and Indonesia. "MIGA" stands for the Multilateral Investment Guarantee Agency. MIGA has also just significantly increased the capacity it will make available for projects and has improved its coverage for lenders.

At the same time, a number of private insurers have increased their capacity and have indicated they are willing to provide "breach of contract" coverage on a case-by-case basis.

MIGA

MIGA was established in 1988 to provide political risk insurance covering loans and investments for private sector projects in developing countries. MIGA's effectiveness has been hampered by relatively low amounts of available capacity. Until recently, MIGA could not provide more than $50 million in coverage per project and $250 million per country. However, due to a recent doubling of its capital and recent treaty reinsurance agreements entered into with private insurance companies, MIGA is now able to provide political risk coverage of up to $200 million per project and up to $620 million per host country. MIGA can also supplement these amounts with its cooperative underwriting program (see below) and reinsurance and co-insurance with other private and public insur-

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CONGRESS IS EXPECTED TO BEGIN WRITING A TAX BILL IN JULY. The project finance community will be affected by some of the changes.

Deadlines for House and Senate action are in a budget resolution. The House Ways and Means Committee has until July 16 to report a bill. The Senate Finance Committee has until July 23. These dates are significant because any action to take away tax benefits from corporations often are effective for transactions on or after the date of "first committee action." House committee chairman Bill Archer (R.-

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Political Risk Coverage Expands

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ers. The consequence is that MIGA now has the ability to play a major role in large projects.

In addition to the increased capacity, MIGA has also been developing a "breach of contract" coverage that should be of interest to investors after the recent experience of the independent power industry in Pakistan and Indonesia. MIGA will cover the risk that a host-country government will breach its contract obligations to the project company. In order to make a claim, the project company must first obtain an arbitral award against the host-country government, and the host-country government must fail to pay the award for an agreed period of time — typically 90 days. In order to make this coverage more attractive, MIGA will agree to make a provisional payment to the insured before it has the arbitral award, provided the investor is deemed creditworthy by MIGA or otherwise provides security acceptable to MIGA in the event the award is not obtained. A standard form of contract providing this coverage will be available soon.

MIGA is now able to provide political risk coverage of up to $200 million per project and up to $620 million per host country.

There are also new initiatives at MIGA that affect coverage for lenders. MIGA will now cover up to 95% of the principal instead of 90%. In addition, to the extent that lenders obtain political risk coverage from an insurer that covers less than 100% of the principal, MIGA is prepared to cover 95% of the deficiency. Finally, MIGA will now cover solely the debt under certain circumstances, without requiring — as it has traditionally — that an equity investment in the project also be insured with MIGA.

New Private Sector Entrants

Although private-sector insurers can usually issue policies more quickly, and they have more flexibility in structuring coverage than their public-sector counterparts, traditionally the political risk insurance available from private-sector companies, such as Lloyd's, was considered too short-term to be of much benefit in the context of large infrastructure projects requiring long-term loans and investments. For example, until the last few years, obtaining a political risk insurance contract for inconvertibility of currency for a term greater than one year, or for expropriation for a term greater than three years, invariably required the investor to buy the coverage from MIGA, the Overseas Private Investment Corporation or one of the export credit agencies.

However, this has changed within the past few years as both Lloyd's and AIG, or American International Group, began providing long-term coverage for infrastructure and other projects. In addition, over the past few years, a number of important new companies have entered the field adding further to the capacity for these types of projects. AIG and Lloyd's were the first to begin offering coverages for longer terms. AIG, for example, now provides up to $150 million in coverage per project for terms of up to 10 years. Both AIG and Lloyd's will co-insure projects with OPIC, MIGA and the export credit agencies — typically as an excess insurer — on virtually identical terms.

ACE Bermuda Insurance Ltd. and Zurich U.S. are two additional new entrants that have been particularly active.

ACE has complemented MIGA's activities by agreeing to reinsure MIGA and by participating in a CUP program run by MIGA (see below). ACE is led by Leigh Hollywood, who was previously MIGA vice president for guarantees and who worked at OPIC before joining MIGA.

Zurich U.S. — led by Dan Riordan, formerly vice president for insurance at OPIC — has also been very active, issuing more than 60 policies in

1998, its first year of operations. Zurich U.S. has been issuing policies for up to $50 million per project and for terms of up to 10 years. As of May 1, 1999, the company will start issuing policies for up to $100 million per project and for terms as long as 15 years.

CUP Program

Public and private insurers share risks through reinsurance or by co-insuring. MIGA has also pioneered a hybrid form of arrangement called the cooperative underwriting program, or "CUP."

The CUP is a form of co-insurance designed to draw the private sector into the market on the same terms as MIGA. In political risk insurance jargon, the CUP is the functional equivalent of the "B Loan program" run by the International Finance Corporation in the project finance field. In a CUP, a single MIGA contract is issued to the insured investor, but a portion of the risk is participated out to private-sector insurers. MIGA "fronts" for the private sector and is the "insurer of record." MIGA's liability to the insured investor is limited to the amount issued for its own account, but the private-sector insurers benefit after claim payment from MIGA' s claim recovery procedures.

MIGA has entered into CUP arrangements with, among others, ACE, Zurich U.S. and a Lloyd's syndicate called Brockbank Syndicate Mgt. Ltd. ■

Hybrid Debt Survives Test Case

by Keith Martin, in Washington

The US tax authorities upheld a form of hybrid debt in April that many large US corporations use to borrow, but that the Clinton administration has been trying to shut down.

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Texas) said he hopes Congress can finish work on the bill before leaving town for a one-month recess in early August. The problem, if the bill is allowed to sit for a month only half done, is that lobbyists will pick it apart.

Republicans on the House Ways and Means Committee have already submitted their wish lists of what they want to see included in the bill to the committee staff.

The bill is expected to hit hard at corporations that engage in aggressive tax planning (see next story) and extend a so-called active financing exception that lets banks, insurance companies and finance companies defer US taxes on passive income from offshore investments. It might also extend a section 45 tax credit of 1.7¢ a kWh for producing electricity from wind and add other things, like poultry litter, to the list of eligible fuels.

House republicans fret that the bombing against Serbia is taking away most of the money republicans hoped to use for tax cuts this year. Archer now talks about a "wedge" bill that offers little tax relief this year, but plants seeds that will grow into large tax cuts in later years.

A GOVERNMENT CRACKDOWN IS LOOMING AGAINST CORPORATE TAX SHELTERS. A US Treasury "white paper" is expected in May.

Donald C. Lubick, the assistant Treasury secretary for tax policy, told a Senate Finance Committee hearing on April 27 that the government's current efforts against aggressive corporate tax planning are like "a greyhound in pursuit of a mechanical rabbit. We never really catch up."

The Treasury wants to penalize corporations and their outside advisers that engage in "tax avoidance transactions." Treasury prefers a somewhat vague

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Hybrid Debt Survives Test Case

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The debt is called MIPS, or monthly income preferred securities. MIPS have rapidly displaced preferred shares in corporate capital structures since they were first introduced in 1993.

MIPS offer some of the same financial flexibility as preferred stock. They have long terms to maturity, they can bear a fixed or floating return, they are deeply subordinated, ranking just above common shares, and a company using them has the option of deferring payments for up to 18 months to five years during periods when the company is short on cash.

MIPS are treated effectively as debt for tax purposes but companies record them as equity for book purposes.

MIPS are treated effectively as debt for tax purposes. Thus, earnings paid to holders are deducted as "interest." However, companies record them as equity for book purposes, the rating agencies assign them largely equity treatment, and the Federal Reserve Board has approved at least some forms of MIPS as tier I capital for banks. This makes the instruments a valuable tool, given the lengths to which corporations go to keep debt off their balance sheets to preserve borrowing capacity.

MIPS go by various acronyms. MIPS is the term for a product developed by Goldman Sachs. The Merrill Lynch product is called TOPRS. Other investment banks have similar instruments with other names.

The IRS said in 1994 that it would "scrutinize" MIPS wherever it found them. The Clinton administration then went further by proposing to Congress in 1996 and again in 1997 that corporations not be allowed to deduct interest paid on instruments with terms of 15 or 20 years or more unless the instrument is shown as debt on the balance sheet the corporation files with the US Securities and Exchange Commission. Congress has not acted on the proposals. At least one early issuer of MIPS — Enron Corp. — has tentatively settled a case it filed in the US Tax Court after the government denied it interest deductions.

With that background, it was perhaps surprising to see the IRS national office release a "technical advice memorandum" in April that let a company deduct payments to MIPS holders as interest. A technical advice memorandum is a ruling issued by the national office to settle a dispute between a taxpayer and an IRS field agent stemming from an audit. The agent sought to disallow the company's deductions. The ruling does not bind the government in future cases, but it is still helpful.

Structure

The MIPS in the ruling took the following form. The taxpayer — call it "Corporation A" — formed an LLC, or limited liability company, in a foreign country. Corporation A owned the common stock of the LLC. Over the next few years, the LLC sold three classes of preferred shares to the public. The first two were listed on the New York Stock Exchange. The third was denominated in a foreign currency and listed overseas.

The LLC used the funds raised by the shares to onlend to Corporation A.

One set of MIPS paid a fixed dividend each month on the share price of $25. The next paid a fixed dividend changing to floating after a few years. The last set of MIPS simply accumulated dividends at a fixed rate and paid at the end like a zero-coupon bond. The dividends were cumulative. To the extent the LLC lacked the cash to pay full dividends, it made them up later with interest. Corporation A was free to redeem the MIPS at any time after year X at the share price plus any accumulated but unpaid dividends. The shares had priority over the common shares that Corporation A owned in the LLC.

The rates, maturities, payment dates and other features of the loans from the LLC to Corporation A matched the MIPS.

Unfortunately, the rulings don't give the maturities for the different instruments. Early MIPS issues had terms of 50 to 100 years but maturities on more recent issues were cut back to under 15 years after the Clinton proposals.

Corporation A could defer paying interest to the LLC on the first loan for up to 18 months at any time. It could delay up to five years on the second loan. The third loan did not require any payments of interest until maturity.

The LLC was also free to relend the interest it collected to Corporation A, provided Corporation A remained a good credit risk.

The MIPS holders had the right, after a default on any loan, to enforce the loan directly by appointing a trustee to act for the MIPS holders in place of the LLC.

The loans ranked ahead of common shares and trade creditors, were pari passu with each other, but were subordinate to all other lenders, including such lenders making loans in the future.

Book Equity

The IRS said Corporation A "described the loans as debt in filings with the Securities and Exchange Commission and other government agencies." However, the loans disappeared for book purposes because Corporation A prepared consolidated financial statements combining its results with those of its subsidiary, the LLC; intercompany assets and liabilities are ignored under GAAP accounting. The books simply showed the preferred securities issued by the LLC as a "minority equity interest in [a] subsidiary." The rating agencies assigned Corporation A some equity credit for the financing structure since the structure left the company with significant financial

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definition of the term in the hope that companies will steer wide of the line. Meanwhile, the tax committee staffs in Congress have been meeting with outside groups in an effort to refine the definition and decide on the penalties.

One idea receiving serious attention is to require a corporate officer to sign a statement attached to the company's tax return as to whether the company engaged in any large tax shelter and, if so, to attach a detailed description of the transaction. Stefan Tucker, chairman of the tax section of the American Bar Association, told the Senate Finance Committee in late April, "The required statement of business officers of the taxpayer should impose personal accountability . . . ." The ABA advocates a strict liability approach where a corporation would not be able to avoid penalties in certain tax-motivated transactions by showing it had reasonable grounds for its position. "[C]orporate taxpayers would be forced to incur a real risk from entering into such transactions, and would be induced to seek balanced, well reasoned tax advice concerning such transactions rather than tax opinions intended principally to serve as insurance against the imposition of penalties," Tucker said.

If a corporation is penalized by the IRS, the ABA also wants a penalty "imposed on any outside advisers who rendered favorable tax opinions and promotors who actively participated in the sale, planning, or implementation of the tax shelter."

A DEPRECIATION CASE MAY HAVE OPENED THE DOOR TO CLAIMING FASTER TAX WRITEOFFS on some assets.

Most equipment at a project is depreciated over an average useful life for the entire project based on the industry in which the project is used. For exam-

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flexibility compared to commercial paper or long-term senior debt. The ruling does not say the percentage of equity credit. However, credit is usually roughly 70%.

Ruling

The IRS agent wanted on audit to collapse the structure and treat the MIPS also as equity for tax purposes. The IRS national office said no.

It cited the following as key factors pointing to treatment of the loans from the LLC to Corporation A as debt. First, there was "an unconditional promise to pay a sum certain . . . at a fixed maturity date that is in the reasonably foreseeable future." This is a loan by definition. Although Corporation A had the ability to extend each loan by relending the interest payments to itself, there was a reasonable limit and the right was not unconditional. Second, the holders of the MIPS could bypass the LLC and enforce the loans directly against Corporation A. This was important because Corporation A was otherwise in control of the LLC. Third, the loans ranked ahead not only of shareholders, but also trade creditors and unsecured lenders. Fourth, Corporation A was not thinly capitalized.

The IRS cited a number of key factors pointing to treatment of the instruments as debt.

The IRS explained away the inconsistent characterizations for tax and book purposes. It said rating agencies often assign partial equity credit to long-term loans that are clearly debt for tax purposes. As for book treatment as equity, the IRS said that if the books had been prepared for each company on a stand-alone basis, the loans would have been visible as debt.

The agency said the MIPS would have been debt if issued by Corporation A directly. It discussed whether to collapse the two transactions — issuance of MIPS and onlending of proceeds — on grounds that the two legs lacked economic substance, but decided the two legs had substance and that the tax results would have been the same anyway. ■

New US Rules Cut NO_x From Power Plants And Target Haze

by Roy S. Belden, in Washington

Stringent new rules for reducing nitrogen oxide emissions took effect in most northeastern and mid-Atlantic states on May 1.

As a consequence, many power plants in the region may have to install additional pollution controls or pay over $5,000 a ton to emit nitrogen oxide, or NO_x, above allocated allowance levels.

Power plants that sell power and have a rated output of at least 15 megawatts and large industrial combustion facilities — like fossil fuel-fired boilers and indirect heat exchangers with a maximum rated heat input of 250 mmBtu's an hour — are required by the new rules to hold NO_x allowances to emit NO_x during the ozone season from May 1 to September 30. An allowance is the right to emit one ton of NO_x. The new rules will reduce the NO_x emissions allowed by upwards of 65% from 1990 emission levels.

NO_x Reductions Expected to Be Costly

Congress established an Ozone Transport Commission in 1990 to address migration of ozone, precursor gases such as NO_x and volatile organic compounds in the northeast and mid-Atlantic ozone transport region.

The Commission adopted a memorandum of understanding on September 27, 1994 that commits states signing the memorandum to implement a regional NO_x emission reduction program. The District of Columbia and all states in the region, except Virginia, signed the memorandum. Each of the states has put NO_x emission reduction regulations in place. However, implementation of the Maryland NO_x regulations has been delayed by a successful court challenge by the Potomac Electric Power Company and Baltimore Gas & Electric.

States that signed the NO_x memorandum were given until May 1, 1999 to implement regulations requiring facilities in the "inner zone" to reduce their rate of NO_x emissions by 65% from 1990 base-year levels or to emit NO_x at a rate no greater than 0.2 pounds per mmBtu. The "inner zone" consists generally of areas in nonattainment with the federal ozone ambient air standards.

Facilities in other parts of the northeast and mid-Atlantic region, except Vermont and portions of upstate New Hampshire, New York, and Maine, are required to reduce their rates of NO_x emissions by 55% from base year levels or to emit NO_x at a rate no greater than 0.2 pounds per mmBtu.

Additional regulations requiring upwards of 75% reductions from base year levels are scheduled to be implemented by May 1, 2003.

Emission reductions in the northeast and mid-Atlantic states are being implemented through a market-based "cap and trade" program that is based on the acid rain SO_2 emission allowance trading program. Each power plant or large combustion source will receive a NO_x budget allocation authorizing the source to emit one ton of NO_x for each allowance. Facilities typically have until December 31 each year to ensure that they have enough allowances in their compliance accounts to cover their NO_x emissions during the

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ple, equipment at coal-fired power plants that generate electricity primarily for sale is depreciated over 20 years.

Duke Energy Natural Gas Corporation runs an interstate gas pipeline. It depreciated most of its equipment over 15 years by putting its assets in industry class 46.0 for "assets used in the private, commercial, and contract carrying of petroleum, gas and other products by means of pipes . . . ." However, it claimed 7-year depreciation on its gathering lines at gas fields that carry gas from the well to the pipeline. It put these under industry class 13.2 for "assets used by . . . natural gas producers" for producing gas.

The IRS insisted all of Duke's assets had to go into the 15-year class for pipeline companies. The US appeals court for the 10th circuit disagreed. The court said in a decision in mid-April that Duke Energy can depreciate the gathering lines over seven years. It said these lines were literally "used by . . . gas producers" since the producers contracted with Duke Energy to have their gas carried over the lines.

The case may open the door to separating other assets into classes with faster writeoffs. An example is pollution control equipment at coal-fired power plants.

FAVORABLE FINANCING TERMS ARE NOT A SEPARATE ASSET, the IRS said.

Many utilities are divesting generating assets. Companies bidding on these assets sometimes try to allocate part of the purchase price to favorable financing that the buyer will inherit from the seller. An example is where assets come encumbered by a loan or lease at rates that are below market. The idea is to try to write off that part of the purchase price over the remaining term of the financing,

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New US Rules Cut NO_x

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previous ozone season. Some state NO_x regulations currently allow trading among states in the northeast and mid-Atlantic region. However, these interstate trades must usually be approved in advance by the various state environmental regulatory agencies.

The market for NO_x budget allowances is very tight with current prices running to over $5,000 per ton. Some facilities are expected to install costly NO_x pollution control technologies, such as selective catalytic reduction, to meet the NO_x reduction requirements.

Facilities in the northeastern and mid-Atlantic states are required to reduce their NO_x emissions by 55% to 65% from 1990 levels.

Haze Rules May Trigger New Pollution Controls

The US government also moved in late April to cut haze that reduces visibility in the national parks. Vice President Gore announced a final "regional haze rule" on April 22. Regional haze is caused primarily by sulfur dioxide, or SO_2, NO_x and fine particulate matter emissions, and it potentially obscures the clarity, color, texture, and form of scenic vistas.

The new regional haze rule will probably trigger new pollution control requirements for power plants that were installed before 1977 and are suspected of contributing to reduced visibility at certain national parks and wilderness areas like the Grand Canyon and Shenandoah National Park. States are required to submit their own plans to reducing regional haze to the federal Environmental Protection Agency between 2004 and 2008.

The new haze rule is supposed to improve visibility in 156 national parks and wilderness areas — called "class I areas" — across the United States. The rule calls for states to establish long-term strategies for reducing emissions of SO_2, NO_x, and fine particulates that allegedly contribute to visibility impairment. The goal of the rule is to reach "natural visibility conditions" by the year 2064.

The rule requires each state to conduct an analysis to establish visibility goals for each affected class I area to improve visibility on the haziest days and to ensure no degradation occurs on the clearest days. In developing long-term strategies to meet the visibility goals, states are directed to address all types of man-made emissions, including those from stationary sources, mobile sources, area sources, and forest fires.

One key element of the rule is it addresses installation of "best available retrofit technology," or BART, for certain existing stationary sources that went into operation between August 1962 and August 1977 and have a potential to emit at least 250 tons a year of any air pollutant. The final rule allows states to establish BART emission limitations on a source category-wide basis rather than a case-by-case basis. States also have the option of developing an emissions trading program applicable to BART sources as long as the trading program achieves greater emission reductions than would be achieved by applying BART to each individual source.

The federal government plans to coordinate the regional haze rule with the revised ambient air quality standards for ozone and fine particulates, or $PM_{2.5}$. As a result, state implementation plans will generally not need to be submitted to the Environmental Protection Agency until 2004 at the earliest.

Given this timetable, it will be several years before any power plants may need to install BART controls. ■

Progress On Shared Pledge Dilemma

by Kenneth W. Hansen, in Washington

Among the more intractable challenges in structuring and closing infrastructure project financings in emerging markets has been the tug-of-war between project lenders and political risk insurers (of equity) for control of project shares in the event of an expropriation.

The Export-Import Bank of the United States and the Overseas Private Investment Corporation, two US government agencies that have been principal supporters of US businesses active in emerging market infrastructure projects, have also struggled with this dilemma. After years of deal-by-deal negotiations, OPIC and Ex-Im Bank have reached an overall resolution, reflected in a "Joint Claims Agreement" signed in late March.

The Problem

The last decade has seen explosive growth of private business participation in the development and operation of infrastructure in emerging markets. The developers usually seek to leverage their equity investments with significant project debt to be provided on a limited recourse basis, a so-called "project financing." A core piece of the collateral package typically structured to secure project debt is a lien on the shares of stock representing the developer's equity investment.

In the challenging markets where these projects have been undertaken, project sponsors often seek political risk insurance on their equity investments. Under the terms of OPIC's expropriation coverage, the insured investor must deliver to OPIC its *unencumbered* shares in the expropriated company in order to receive compensation. This traditional provision has come into obvious conflict with the now prevalent practice of securing project debt with a pledge of shares. If an expropriation were to occur, the project sponsors could find themselves holding only encumbered

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which may be shorter than the depreciable life of the other assets.

The IRS said no to this approach in two "field service advice" memos released recently to the public. A field service advice is a memo from the national office to an IRS lawyer preparing to litigate against a taxpayer. The IRS said it is "illogical to suggest that an obligation to pay money is an asset." It recommended that "[a]lthough this matter is not entirely free from doubt and has litigating hazards, we believe that there are several arguments that we can assert to demonstrate that the petitioner is not entitled to an amortization deduction for favorable financing."

A SENATE BILL WOULD ALLOW TAX-EXEMPT FINANCING FOR US HIGHWAY PROJECTS.

Senators John Chafee (R.-R.I.) and Daniel Patrick Moynihan (D.-N.Y.) introduced a bill recently to allow up to $15 billion in tax-exempt financing for as many as 15 highway projects selected by the US Department of Transportation as suitable pilot projects. Chafee is the ranking republican on the Senate Finance Committee. Moynihan is the ranking democrat. The bonds would not be subject to state "volume caps," or limits on the volume of tax-exempt bonds that states can issue each year to finance private projects.

To qualify, a project would have to involve construction or reconstruction of a highway. The highway would have to serve the general public. It would have to be located on publicly-owned rights of way, and it would either have to be publicly-owned or ownership would have to revert eventually to the public.

UTILITY ASSET DIVESTITURES MAY HAVE THE EFFECT OF INCREASING PROPERTY TAXES for independent power projects.

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Progress on Shared Pledge

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shares and thus unable to collect from OPIC.

This development led OPIC to ask project lenders to agree, in the event of an expropriation, to release its pledge on project shares. OPIC has asserted three things. First, it needs unencumbered shares in order to have adequate salvage. Second, pricing for the enhanced salvage risk of accepting pledged shares is not feasible. Third, any sharing of claims proceeds needs to be subject to the lender's proof of a valid international law claim against the expropriating government, a hurdle of uncertain height since the actual circumstances of a particular expropriation could not be known in advance.

Political risk insurers and lenders both demand a pledge of the same shares in the project company.

On the other hand, US Ex-Im has maintained the following. First, the political risk insurer of equity should not expect the collateral package supporting project debt to be undermined in order to facilitate equity insurance. Second, it was not feasible to price the risk associated with promising to release the lien on pledged shares in the event of an expropriation. Third, to the extent of any uncertainty as to the legal standing of the debt claim following an expropriation, it was all the more critical to have the right to foreclose on the shares and thus to stand in the shoes of the equity. In addition, because US Ex-Im is typically only one among several lenders, the problem is not solved merely by striking an interagency understanding since an agreement with US Ex-Im would not bind commercial or other official lenders.

The Resolution

Previous interagency discussions were characterized by efforts to elaborate a variety of possible expropriation scenarios and to attempt to agree on a specific way of handling each.

The joint agreement reached in late March was reached by abandoning this approach and by agreeing instead on a principle, namely, that if an expropriation occurs, each agency would cooperate with the other in order to maximize their total joint recovery from the expropriating government. The details of what that would require are left to be determined in the context of the actual expropriation.

The joint agreement also provides that the proceeds of any settlement will be shared between the agencies pro rata in proportion to their respective exposures to the expropriated project. This reflects their agreement that each investor's claim, both debt and equity, should be treated as equally valid and deserving of compensation from the expropriating government.

The joint agreement provides further parameters for post-expropriation cooperation: a stay of execution of the share pledge once OPIC notifies US Ex-Im that an expropriation has occurred; a waiver of any share retention obligations that could impede the assignment of insured shares to OPIC to perfect an insurance claim; a two-year window within which US Ex-Im may choose to accept the credit of the post-expropriation entity and opt out of pressing a joint claim with OPIC, though it would still, if needed, release its share pledge; and a provision regarding the allocation of expenses. However, the fundamental effect of the joint agreement is to commit each agency to the principle of endeavoring to achieve maximum post-expropriation recovery, with the particular steps required to achieve that goal being left to be determined if and when an expropriation of an OPIC- and US Ex-Im-supported project occurs.

The Way Forward

Although OPIC and US Ex-Im have now reached agreement, most major infrastructure projects involve multiple commercial and official lenders and political risk insurers. Where lenders or political risk insurers other than OPIC and US Ex-Im are at the table, the share pledge problem remains a hurdle to be cleared deal-by-deal, posing the continued likelihood of lost time and legal fees as the pledged share battle is continuously re-fought.

Consequently, an important open question is whether other lenders and political risk insurers will be willing to go along with this — or some other — model to resolve the pledged share conflict. A prevalent view amongst those involved in negotiating the joint agreement was that the accord made sense only because the two agencies were part of the same fiscal family so that the taxpayers' sole interest is in maximizing the post-expropriation recovery. The interagency allocation of those proceeds was of no importance to the federal budget.

If insurers and lenders lacked some common institutional bond, there was a presumption that the pledged share conflict would continue.

Most lenders and insurers have no such familial ties. So, if such ties prove to be critical for a once-and-for-all, conventional solution to the pledged share problem to emerge, then the prospects for such a general solution are exceedingly dim.

On the other hand, the principle of maximizing the total — in contrast to permitting an expropriating government to play competing claimants off against each other during settlement negotiations — makes good sense for investors to a project, whether or not they share any affiliation other than their respective exposures to the expropriated project. However, if agreement to act jointly is to be reached, the question of how to allocate settlement proceeds needs to be confronted, as in the OPIC and US Ex-Im agreement. Lenders may continue to insist that satisfaction of equity claims against the expropriating government must be subordinated to their debt claims. Equity insurers may continue to insist on at least pro rata alloca-

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Edison Mission Energy won an auction to buy the Unicom assets in Illinois for just over $4.8 billion. Lobbyists for Commonwealth Edison are now urging that a cap of 20% be imposed on increases in assessed values for other generating facilities in the state.

CHILE WANTS MORE FROM ELECTRIC GENERATING COMPANIES.

Chilean President Eduardo Frei has proposed, and a congressional committee has approved, a proposal to require Empresa Nacional de Electricidad SA, Gener SA, Colbun SA and other privately-held companies to compensate customers directly for power outages, including outages that occur as a result of natural disasters (such as the recent drought). The proposal would require generators to deduct an amount from customers' monthly bills to reflect the period of time the customer was without power due to an outage.

Frei also called on private power companies to build new generators to increase the country's capacity by 500 megawatts. If the companies do not comply, Frei intimated that Chile will re-enter the power business by putting formerly dormant state-owned plants into service. Empresa Nacional de Electridad SA has already agreed to spend up to $100 million by September 1999 to generate an additional 200 megawatts of electricity.

INDIA IMPOSED A 10% SURCHARGE ON CORPORATE AND UPPER INDIVIDUAL INCOME TAX RATES.

The proposal was included in the budget the Hindu nationalist government presented to parliament on February 27. The lower house approved the budget on April 22, notwithstanding the collapse of the ruling coalition, and the upper house was also

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tion and even to hesitate to commit in advance to join forces in pressing joint claims with lenders. If so, then the pledged share standoff may continue to plague international project financings in emerging markets.

Alternatively, each side may conclude, as did OPIC and US Ex-Im, that the details of the post-settlement sharing formula are of less importance than the certain benefits to be achieved by cooperating to maximize joint recovery and by removing this conflict from the agenda of issues needing to be negotiated up front. Such an outcome would guarantee a reduction in the up-front costs of bringing many emerging market project financings to closure.

IRS Addresses Tax Effects of Contract Restructurings

by Keith Martin, in Washington

Two recent tax rulings offer ideas for how to restructure contracts while minimizing the tax consequences. The rulings are private letter rulings. The Internal Revenue Service released both rulings — with the taxpayers' names deleted — in April.

Contract Buyout

In one, the IRS told a utility planning to issue shares of its own stock to buy out power purchase agreements with "qualifying facility" projects that the utility could immediately deduct the market value of the shares issued. This is equivalent to telling the utility it can issue its own scrip. The independent power producers receiving the shares had to pay taxes on the market value. However, if the stock is publicly-traded, then the shares can be easily converted into cash.

The utility to whom the ruling was issued is almost certainly Niagara Mohawk Power Corporation.

Many utilities complain that the prices they are required to pay for electricity under so-called qualifying facility, or QF, contracts negotiated in the 1980's are now significantly above market. Utilities have tried to cancel, renegotiate or buy out such contracts. A key issue in negotiations is how to structure the transaction so that the utility gets as large a tax deduction as quickly as possible for its payment to the QF. The larger and the earlier in time the deduction for the utility, the less the buyout will cost after taxes.

The utility in the ruling had a large number of QF contracts. It entered into a master settlement agreement. Under the terms of this settlement, the utility agreed to pay an amount in cash and to convey a block of common shares in the utility to a dispositary, or escrow agent, acting for the QFs. One QF contract was "amended by modifying the price and certain other contract terms." A number of other QF contracts were "renegotiated and restructured in accordance with certain criteria set out in the [settlement agreement]." The remaining QF contracts were terminated. Each QF received an amount in cash and the rest in shares for renegotiating or terminating its contract.

The IRS said the utility could deduct the fair market value of the shares and amount in cash, but only for payments to QFs whose contracts were terminated.

The agency specifically did not rule on the tax treatment to the utility of payments to QFs whose contracts were merely renegotiated. Ordinarily, such payments must be amortized over the remaining term of the revised contract.

The ruling took an unusually long time to clear the IRS. Private letter rulings usually take three to six months. The utility applied for it in October 1997 and had to send seven more letters with followup information to the IRS — also unusual — before a ruling was issued finally in late December 1998. (Private rulings are released to the public roughly three months after being put in the mail to the taxpayer.)

The IRS said the utility would not have any income by issuing shares to buy out the contracts. It pointed to a number of cases where corporations issue new shares — for example, as compensation to employees — where the corporation is allowed to deduct the fair market value. The recipient must report the market value of the shares as income.

Involuntary Conversion

In the other ruling, a company that received a payment to cancel a contract did not have to report the payment as income because the IRS said the transaction was an "involuntary conversion."

Under US tax rules, proceeds from an involuntary conversion do not have to be reported as income as long as the taxpayer finds suitable replacement property within two to three years.

The ruling involved a paper company that had a 50-year contract with the federal government to buy timber from a particular forest. The contract had favorable pricing. Congress passed a law requiring unilateral changes in the contract, including changes in pricing that the company said were essentially a government abrogation of the original contract.

The company filed suit in federal court. The federal government settled. The company planned to replace the original contract with a series of shorter-term timber-cutting contracts with its parent company or third parties. The IRS said there had been an involuntary conversion of the original contract. It said it would apply a "functional use test" to determine whether the new contracts with the parent and third parties were similar enough to the original contract to qualify as replacement property. Although the ruling did not say, presumably the paper company was able to avoid reporting the buyout or settlement payment from the federal government as income by applying the money to the new contracts. ■

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expected to approve the budget without incident.

The government announced that it has granted "infrastructure status" to power transmission and distribution operations, making them eligible for the same 10-year tax holiday that applies to generating facilities. Such facilities will qualify for a 100% exemption from income taxes for five years and then a 50% reduction for another five years. The benefit is available during any 10-year period in the first 15 years after a project begins commercial operation.

The budget also reduced customs duties on LNG imports from 12% to 5%.

CHINA ANNOUNCED CHANGES IN WITHHOLDING TAXES.

The changes were in circulars issued by the State Administration of Taxation in November, but only available recently. China collects a 20% withholding tax on money leaving the country in the form of interest, rents or royalties. Dividends paid to foreign investors are normally exempted from withholding tax. Under the new policy, withholding taxes will be collected on interest as the interest accrues without waiting for the interest actually to be paid.

China also said it will collect withholding taxes in future on payments from Chinese customers to foreign companies for communications services like satellite, cable, and fiber optics transmissions. China regards the payments as Chinese-source income to the recipients. They are subject to withholding taxes as "rents."

BACK-TO-BACK WARRANTS MAY BE A WAY TO REPATRIATE EARNINGS from foreign operations to the United States without triggering US taxes.

A US parent company sold warrants for $X to an unrelated investor. The investor then sold similar

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Obstacles to Privatizing Sewage Treatment

by James W. Scarrow, in Washington

Municipalities thinking of contracting out operation of their sewage treatment plants to private companies quickly run up against two barriers.

One is a US Environmental Protection Agency, or EPA, rule that sewage treatment plants that were financed with help from federal grants cannot later be sold, leased or otherwise encumbered. The other is a set of restrictions the US tax laws impose on plants that benefited from tax-exempt bonds. Many treatment plants benefited from both forms of subsidy.

EPA Grants

EPA disbursed more than $67 billion in federal grants to local governments for the construction of wastewater treatment plants between 1972 and 1987. Starting in 1987, Congress replaced the grants program with a clean water state revolving fund program that makes low-interest loans to communities for water pollution control projects.

Each grant between 1972 and 1987 was conditioned on the local government's agreement that it would not sell, lease, or otherwise encumber the federally-funded facility.

EPA takes the position that this means, for example, that a local government cannot hire a private operator under a contract that requires the operator to make an up-front payment to the local government, even if the arrangement purports not to encumber the facility. Thus, the operator cannot even be required to pay the local government at the start of the contract an amount equal to the estimated present value of the local government's share of cost savings to be achieved over the life of the contract.

Any contract with a private operator that involves a payment of money by the operator to the municipality — even over time — must first receive a grant deviation from EPA. The only exception is where the private operator will reimburse the municipality for the documented costs of the transaction or will pay an amount no more than 1% of the present value of the contract to the municipality. Because of a general perception that the grant deviation process is unduly time consuming, the great majority of operator contracts for publicly-owned sewage treatment plants to date have been structured to avoid that process.

Somewhat ironically, the grant deviation process has limited the structure and, perhaps, number of private operator contracts at the same time that the federal government is seeking to encourage infrastructure privatization transactions.

Tax-Exempt Financing

Municipalities have traditionally been able to borrow in the tax-exempt bond market to finance public facilities. However, the municipality must be careful not to allow more than 10% "private business use" of the facilities or else the tax exemption on the bonds will be lost. Unless the municipality is careful how it writes the operator contract, hiring a private company to operate will be considered a "private business use" of the facility.

Revenue Procedure 97-13, issued by the Internal Revenue Service, describes the "safe harbor" conditions under which an operator contract for a bond-financed wastewater treatment plant will not be considered "use" of the plant by the private operator. The availability of the safe harbor depends on both the contract's compensation structure and duration. For example, operator contracts for wastewater treatment plants can be for up to 20 years and fall within the safe harbor if at least 80% of the annual compensation is based on a fixed, periodic fee. If the operator contract is for less than five years, then at least 50% of the annual compensation must arise from fixed, periodic fees.

To qualify as a periodic, fixed fee, the compensation cannot be based on the facility's net profit, nor can payment be directly linked to the amount of wastewater treated. However, up to 20% of the private operator's compensation for each annual period can arise from variable payments such as performance-based incentives. These non-fixed fee incentive payments can be linked either to increases in revenues or decreases in expenses, but not both. For example, the private operator might receive a portion of any savings in electricity or chemical costs (both typically pass-through items that do not qualify as "compensation") that are realized beyond a specified performance benchmark. Because the caps on incentive-based compensation are annual caps, an interesting open question is whether an operator contract can be structured so that any incentive payments that would otherwise exceed the cap are carried forward to the following year.

The requirement that at least 80% of compensation be based on fixed periodic payments would appear to be violated if the private operator receives additional compensation for overseeing capital expansion of the plant during the contract's life. However, in a private letter ruling, the IRS said the safe harbor protections of Revenue Procedure 97-13 are not lost where compensation for the private operator's construction management services are provided pursuant to a separate contract the terms of which are similar to those that would have been reached through an arms-length negotiation.

In summary, although care must be taken when structuring operator contracts for publicly-owned sewage treatment plants, a variety of structures are available to accomplish the respective objectives of the local government and private operator. ■

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warrants to an offshore subsidiary of the US parent. At the end of the day, $X left the offshore subsidiary and ended up with the US parent.

Many US companies try to defer US taxes from foreign operations by placing the operations under an offshore holding company. The earnings remain offshore. Tax directors at these companies are under pressure to find ways to bring the money home without triggering taxes. Unfortunately, section 956 of the US tax code treats offshore earnings as having been repatriated to the US — thereby triggering US taxes — if the earnings are invested in "United States property." A loan by the offshore holding company to a US affiliate would be caught by this rule.

The IRS national office discussed the use of back-to-back warrants in a field service advice made public in March. It said the transaction would not necessarily trigger taxes under section 956. "The key factor in determining whether we could successfully collapse a set of transactions is how closely tied the set of transactions is." In this case, the offshore subsidiary had not made a loan to its parent "because there appears to exist no obligation for US parent to repay" the money, and there was no purchase of the parent's stock until the warrants are exercised. "With the exercise price of the warrants so high, they may never be exercised."

The IRS told the district counsel wondering whether to litigate the issue that he would need "further factual development" showing the investor merely facilitated the transfer of funds from the offshore subsidiary to the US parent because the terms of the warrants "were such that the investor would not have been able to involve an entity not related to US parent on the same terms and conditions."

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A COALITION OF COMPANIES IS LOBBYING TO ELIMINATE WITHHOLDING TAXES ON INTEREST BETWEEN THE US AND CANADA. The group sent US international tax counsel Philip West a report on April 14. The US and Canada are in discussions about negotiating a new protocol to amend an existing tax treaty. The group includes the Bank of Montreal, BP Amoco and GTE.

A US PARENT THAT MADE A LOAN TO A SUBSIDIARY DID NOT HAVE TO ACCRUE INTEREST because the subsidiary only had to the repay the loan out of positive cash flow, the IRS said.

The case opens the door to possible tax planning. The IRS concluded the loan was a "contingent debt" and, therefore, interest did not have to be reported as income by the parent until the contingencies arose requiring payment. The parent organized a special-purpose subsidiary to undertake a single real estate project. It advanced funds to the subsidiary as a loan at a stated interest rate. However, the loan agreement said the subsidiary had to make payments only out of "excess cash flow," and unpaid interest would be added to the unpaid principal amount.

No payments were made on the loan. An IRS agent thought on audit that the parent should have accrued interest under so-called OID, or original issue discount, rules. The IRS national office said no in a field service advice made public recently. It advised conceding the interest accrual issue on grounds that the loan was a contingent debt. However, it also advised not to enter into any written settlement that characterizes the instrument as debt or equity in order to preserve future litigating options.

UTILITIES CAN DEDUCT A PORTION OF THEIR RECEIVABLES EACH YEAR AS UNCOLLECTIBLE DEBTS by electing to be treated as "securities dealers" for US tax purposes.

The IRS said in an interesting field service advice recently that an owner of acute care hospitals and nursing homes could elect to be treated as a "securities dealer" because it regularly held securities — or debts — from customers. Under US tax laws, a company can take a deduction for worthless debts. It used to be able to deduct a percentage of the outstanding debts each year as an addition to a reserve for bad debts. However, in 1986, Congress changed the rules to require that a company wait until the year a debt actually becomes worthless before deducting it. The idea was to stop deductions based merely on additions to a reserve.

A company that elects treatment as a "securities dealer" marks its receivables to market at the end of each year. This has the same effect as taking deductions based on a reserve allowance.

The IRS remarked in the field service advice that "it has been suggested that [this] implicitly permits taxpayers to circumvent the prohibition against reserves for bad debt." However, it allowed just that for the nursing home owner.

BRAZIL WILL RESUME COLLECTING CPMF TAX ON FINANCIAL TRANSACTIONS FROM JUNE 17.

The tax lapsed at the end of last year, but Congress voted in March to extend it. The tax will be 0.38% for 12 months, after which it will drop to 0.30% for 24 months. Economists say the tax has the potential to increase consumer prices by 2.3% if it is passed through to consumers, but most expect the economy is soft enough that companies will be forced to absorb the tax rather than pass it through.

ECUADOR INCREASED TAXES IN MARCH. The tax increases came at the same time the country was

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negotiating for financial help from the International Monetary Fund. Ecuador restored its income tax that was scrapped in January. A 1% tax on financial transactions that was introduced to replace the income tax will remain in place. Most VAT exemptions have been eliminated.

A COMPANY COULD NOT CLAIM ATTORNEY-CLIENT PRIVILEGE FOR DOCUMENTS PREPARED BY ITS ACCOUNTANT WHO IS ALSO A LAWYER.

The documents were prepared in connection with work on the company's tax returns. A US appeals court held in late April that documents prepared by accountants are not privileged from disclosure if the IRS wants them on audit. It said the fact that the adviser was also a lawyer would not shield the documents if he was doing work normally done by accountants.

In 1998, Congress created a special statutory privilege for accountants, like the attorney-client privilege, but this new privilege does not apply to any advice accountants give relating to corporate tax shelters. The judge mentioned this provision, but said it would not have changed his analysis even if the documents in question had been prepared after July 21, 1998 when the new statutory privilege took effect. The case is *United States v. Richard A. Frederick*.

HUNGARY WILL PROBABLY NOT INTRODUCE MAJOR TAX REFORMS NEXT YEAR, despite past promises. The minister of economy, Attila Chikan, broke the news at a meeting of American business leaders in Washington in March.

THE US PLANS NO CHANGE IN ECONOMIC SANCTIONS AGAINST LIBYA, INDIA AND PAKISTAN.

US sanctions against Libya remain in place, despite a decision by the United Nations last month to lift UN sanctions. UN sanctions were lifted after Libya released two suspects to be tried in The Hague for the bombing of a Pan Am flight over Lockerbie, Scotland.

Meanwhile, the US has no plans to reimpose sanctions against India and Pakistan after both countries tested new missiles in April that can carry nuclear warheads. The US slapped economic sanctions on both countries last year after underground nuclear testing. Congress later gave President Clinton the authority to waive the sanctions "for a period not exceed one year," which Clinton used to suspend the sanctions last November 6. The missile launches have had the effect of derailing for now legislation that US Congressional leaders had planned to introduce to speed a further loosening of sanctions.

THE CZECH GOVERNMENT IS PROPOSING TO REDUCE THE CORPORATE TAX RATE from 35% to 33%. It would also reduce a withholding tax on dividends paid to both resident and nonresident companies from 25% to 20%. Both changes would be effective next year.

THE IRS ISSUED CONFLICTING RULINGS ON PAYMENTS TO TERMINATE INTEREST RATE SWAPS.

Both rulings were released in late April. One is an old field service advice that said a payment to terminate an interest-rate swap that a borrower entered into in order to hedge his exposure on a floating-rate loan is a capital loss. However, the IRS told the IRS agent asking the question to develop the facts of the case further. The agent claimed the swap was being used as a hedge. The borrower had a more complicated explanation.

In a more recent field service advice, the IRS appeared to change course by instructing an agent

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that a company should be allowed to deduct its swap termination payment as an ordinary loss. The swap was entered into as a hedge.

THE IRS ADJUSTED SECTION 29 AND 45 TAX CREDITS.

The section 29 tax credit was $1.055 an mmBtu during 1998. This represents only a tiny increase in the credit from the year before when it was $1.052. The IRS said there was not enough inflation to justify an increase in the section 45 credit. It remained at 1.7¢ a kWh during 1998. Credits for calendar year 1999 will not be announced until April next year.

The section 29 credit is an inducement to look in unusual places for fuel. A company can claim credits for producing gas from biomass, coal seams, tight sands, Devonian shale and geopressured brine, or synthetic fuels from coal. Credits run through 2002 or 2007 depending on when the project was placed in service. All qualifying projects must already be in service.

The section 45 credit rewards companies for producing electricity from wind or closed-loop biomass. The credit runs for 10 years from when a power plant commences operations. Projects must be in service by June 1999 to qualify.

A CALIFORNIA COALITION WANTS CONGRESS TO DENY SECTION 45 TAX CREDITS on electricity sold to utilities under power purchase agreements that were signed before 1987. It also supports extending the credit.

Only new power projects placed in service after June 1999 would be affected. However, there would be an exception. Credits could still be claimed if the power purchase agreement is amended to reset prices for both energy and capacity to a level no higher than avoided cost at time of delivery. The coalition seeking these changes includes the California Public Utilities Commission, Pacific Gas & Electric, Southern California Edison, the Independent Energy Producers, Enron Wind, and FPL Energy. PG&E and SoCal Edison said they still have a significant amount of megawatts under contract that have not been built out. The utilities and the CPUC worry about adding to stranded costs that would have to be recovered eventually from ratepayers.

The group claims California is the only state potentially affected by its proposal.

INDIANA EXPLAINS HOW TO APPORTION JOINT VENTURE INCOME BETWEEN INDIANA AND OTHER STATES.

Most states figure the income a company has from doing business in the state by applying a three-factor formula. They look at the percentages of the company's total sales, property and payroll that are in the state. It is this income that is then subject to state income tax.

However, when the income comes from a partnership in which a company doing business in the state is a partner, does one look at the sales, property and payroll of the *partnership* or the company that is a *partner* when deciding how to apportion income? The Indiana tax court addressed the issue in *Hunt Corp. v. Department of State Revenue* on April 20. It said to look at the three factors at the partner level. That's because the state treats partnerships as transparent.

However, the court said the rule was different before 1984. Before then, the state allocated income to Indiana by looking at the three factors at the level of the partnership because partnerships were treated as taxable entities.

NEW YORK POSTPONED COLLECTING SALES TAXES ON UNBUNDLED ELECTRICITY TRANSMISSION AND DISTRIBUTIONS SERVICES until June 1.

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The tax was to have applied from April 1. However, the state legislature has not yet enacted a "transition tax credit" that was supposed to ease the burden.

Meanwhile, a coalition of energy groups, including the Independent Power Producers of New York, called on New York state legislators on April 27 to enact a package of state tax reforms. The group said energy taxes are too high and need updating for a deregulated market. Among the changes the group wants is repeal of a 4.25% natural gas import tax.

DISCRIMINATORY TAXES AGAINST TELEPHONE COMPANIES WERE STRUCK DOWN IN TWO STATES.

The US Supreme struck down an Alabama tax in late March in the case *South Central Bell Telephone Co. v. Alabama*. Alabama collects franchise taxes from all companies doing business in the state, but the tax on domestic companies is tied to the par value of their shares, while the tax on foreign companies is tied to the value of the actual amount of capital they employ in the state. The court said this meant the average domestic corporation paid only one-fifth the franchise taxes paid by foreign companies. The tax was an unconstitutional infringement on interstate commerce.

In a separate case, the Iowa Supreme Court agreed with US West that a town had no right to levy a 3% "user fee" on gross revenues of any utility operating in town after the town decided to bounce US West as the telephone company and start its own rival service. The town argued the "tax" was rent for using public rights of way. The court said it was a tax that the town had no right under Iowa law to levy.

A GAS UTILITY HAD UNEXPECTED INCOME FROM DEMAND-SIDE MANAGEMENT PROGRAMS.

People's Gas System set up a number of energy conservation programs as required by Florida law with the aim of reducing electricity and oil consumption. For example, it paid builders to install gas appliances in new houses. It subsidized the purchase of new appliances that are more energy efficient than the ones they are replacing. The Florida Public Service Commission let the utility raise funds for the program by building an extra charge into utility rates. The utility was barred from separately stating the charge on customer bills. However, the utility collected the funds subject to a statutory obligation to spend them only for this purpose, and it was required to refund any money not used on the program to ratepayers. It kept separate records, but the funds were not physically segregated in separate bank accounts.

The utility argued it was merely a conduit for the receipts. The IRS said they were income. The US Tax Court agreed with the IRS in March.

The court said to avoid income, the utility would have had to put the money in a trust subject to a restriction that it be spent only for a particular purpose, and the utility would have had also to show that it did not profit, gain or benefit from the spending. People's Gas failed on both counts. There was no trust, and the utility benefited from the spending since the program tended to increase its rate base, number of customers and sales.

TWO TELEPHONE COMPANIES ARE ARGUING THEY WERE SHORTCHANGED ON DEPRECIATION.

MCI and Telecom*USA both qualified for investment tax credits in 1986. The credit was 10% of the cost of new equipment put into service that year. Each company had to reduce its tax basis for depreciation by an amount tied to the credit. However, neither was able to use its tax credit immediately and carried it forward to a later year. The credit was

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reduced to 6.5% for the year it was used. The two companies filed refund claims in 1994 seeking to recover the lost basis for depreciation. They lost in federal district court. The case is now before the US appeals court for the DC circuit.

ANOTHER COMPANY CLAIMED INVESTMENT CREDITS ON NEW EQUIPMENT AT ITS "WORLD HEADQUARTERS."

Scott Paper Company spent money in the late 1980's on improvements, equipment and furnishings at its headquarters in Philadelphia. In 1986, Congress repealed an investment tax credit for such spending on new equipment, but it added what it thought was a "rifle shot" transition rule to allow Merrill Lynch to complete work on its world headquarters and still claim investment credits after the repeal.

Unfortunately for Congress, the transition rule was vaguely worded. Other companies have claimed the same relief.

There is a split among US appeals courts about whether others can qualify. The 7th circuit court of appeals said in *Kjellstrom* that the transition rule covers only Merrill Lynch, notwithstanding the poor drafting. However, the 9th circuit court of appeals said in *Airborne* that the provision applies to anyone who can satisfy its terms.

A federal district court in Wisconsin said in March that Scott Paper qualifies potentially. The court denied a motion by the government for a judgment in its favor without the need to go to trial.

The case is interesting because the Wisconsin court is in the 7th circuit.

BRIEFLY NOTED: The US Treasury received a letter from Irvin N. Gleim of Gleim Publications, Inc. in Gainesville, Florida recently enclosing copies of newspaper articles describing a LILO, or lease-in-lease-out, arrangement that would produce $35 million in benefit to Gainesville Regional Utilities. Gleim condemned the arrangement as "nonsense." . . . . The town council in Gorham, Maine voted in late March to create a special tax district for an 825-mw merchant power plant proposed by American National Power. The move will give the project about a 30% reduction in local property taxes . . . . The US appeals court for the 2d circuit held in early April that a US mining company, Texasgulf, can claim foreign tax credits in the United States for a mining tax the company paid in Ontario, Canada. The case is interesting because foreign tax credits can only be claimed for foreign taxes on net income. Ontario based its tax on the appraised value of minerals less a fixed percentage for processing costs and profit. The court said this was close enough to net income. US rules treat a tax as one on net income as long as the tax base starts with gross receipts and allows recovery of costs "under a method that is likely to . . . approximate[]" or exceed actual costs . . . . The US Tax Court held in April that a partnership realized capital gains when it sold rights to draw water from the Colorado River back to the federal government. The partnership owned farmland. ■

— contributed by Keith Martin, Heléna Klumpp and Kristin Oelstrom in Washington

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