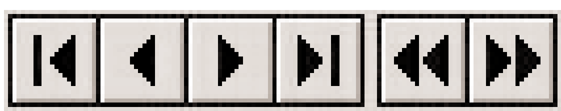
CHADBOURNE & PARKE LLP

PROJECT FINANCE NEWSWIRE

Navigation

There are several ways to navigate through the *NewsWire:*

- Click on the arrows at the top of the Adobe Acrobat™ Reader.



- Click on the *"continued on"* and *"continued from"* text, as well as the arrow symbol ➥, at the bottoms and tops of pages.

- Click on a title in the Table of Contents.

Go To Newswire ➥

CHADBOURNE & PARKE LLP

PROJECT FINANCE NEWSWIRE

December 1999

Older Power Plants Under Siege For Air Emissions

by Roy S. Belden, in Washington

A group of utilities failed in a last-minute bid in November to persuade Congress to freeze the penalties that they might be found to owe the federal government for violating federal Clean Air Act rules.

The utilities have been accused by the US Environmental Protection Agency, the New York attorney general, and environmentalists of modifying coal-fired power plants in the late 1970's and 1980's without going through required permitting reviews. The penalties to the federal government alone may potentially run at least $25,000 a day. The statute of limitations on federal enforcement actions in this area is typically five years, but the government takes the position that every day the power plants operate is a separate violation.

Since the government enforcement actions may drag on for several years, the utilities hoped to persuade Congress to freeze the damages they might owe. Congress adjourned for the year without acting on the utility proposal.

EPA Targets Utilities

Several of the power plants under investigation have either been sold in utility asset divestitures or are up for auction. The US Environmental Protection Agency has been collecting detailed information on coal-fired plants for the past two years. The agency is currently focusing on approximately 120 plants owned by many of the major utilities in the country.

The Department of Justice and the EPA announced on November 3 that they filed civil complaints targeting 17 coal-fired plants owned by seven utilities for alleged Clean Air Act violations. Another eight plants owned by these utilities were issued "notices of violation" for similar infractions.

continued on page 2

In Other News

A PLAN FOR REPATRIATING EARNINGS to the US failed in the US tax court.

Most US companies take care to structure foreign investments so that US taxes can be deferred on the earnings for as long as the earnings are kept offshore. Financial officers then press the tax directors for ways to bring the money back to the US without triggering taxes. US clothing retailer The Limited thought it had a way to do this. Its Hong Kong subsidiary had $179.5 million in earnings that it wanted to repatriate to the US. The Hong Kong subsidiary incorporated another company one

continued on page 3

Older Power Plants Under Siege

continued from page 1

EPA also issued an administrative order to the Tennessee Valley Authority ordering seven of its plants to install control technology to reduce sulfur dioxide and nitrogen oxide, or SO_2 and NO_x, emissions. The coordinated enforcement action is one of the largest in EPA history.

The power plants in question are exempted from EPA rules called "prevention of significant deterioration" and "new source review" because they were already in operation when the rules were adopted. However, they lose their exemptions if the plants undergo a "major modification." The federal government charges that all the plants underwent major modifications in the late 1970's and 1980's.

The case raises the issue how much a power plant can change before the changes are considered a "major modification."

The case raises the issue of how much a power plant can change before the changes are considered a "major modification." Routine repairs and maintenance are allowed. However, the owner of the power plant may go too far if he makes substantial physical changes that extend the life of equipment and lead to a significant increase in air emissions.

"Prevention of significant deterioration," or "PSD," is the standard for permitting review for power plants in so-called "attainment areas" — areas that have relatively little air pollution. "New source review," or "NSR," is generally referred to as the standard for issuing permits for power plants in "non-attainment areas" — areas that exceed permissible federal standards for air pollution. Understandably, the limits on new emissions are much more strict under an NSR review.

The federal government is seeking in the enforcement action to force the seven utilities to install appropriate pollution control technology at the targeted plants, and it may also require retroactive application of PSD or NSR review. The EPA said last year that it believes PSD and NSR violators should be forced to comply fully with current applicable permitting procedures, control technology requirements, air quality analysis, and emission offsets requirements, if applicable.

Others Also Sue

The New York attorney general joined the fray this fall by sending notice-of-intent-to-sue letters to owners of 17 utility plants in Ohio, Indiana, Virginia, West Virginia and Kentucky that allegedly contribute to unhealthy air in New York. Connecticut sent a similar letter targeting many of the same plants. Several environmental groups also recently sent a notice-of-intent-to-sue letter to American Electric Power Service Corp. alleging that 11 of its plants violated the federal Clean Air Act.

New York and Connecticut are focusing on several of the same plants involved in the federal action. On November 29, New York and Connecticut filed a "citizen suit" pursuant to the federal Clean Air Act against American Electric Power Service Corp. alleging that 10 AEP plants violated PSD/NSR requirements. The suit was filed in the U.S. District Court for the Southern District of Ohio. Five of the AEP plants were previously targeted in the federal government's lawsuit. New York and Connecticut are also seeking to intervene in the federal case. The environmental groups may also seek to join the litigation against AEP. New York and Connecticut also intend to file lawsuits in the near future against other utilities named in the notice letters.

The New York attorney general has also started investigating several power plants in New York that it thinks may have made major modifications. Eight plants received information request letters along the lines of the information requests that EPA sent earlier this year to coal-fired boiler manufacturers about the 120 plants the federal government has under investigation.

Congress Gets into the Act

A number of bills have been introduced in Congress to ratchet back air emissions from coal-fired power plants. Many of the bills target older plants built before the 1970's that are grandfathered from many key federal air regulations. Most of the bills take the approach of imposing emissions caps on SO_2, NO_x and other pollutants, with the intention of leveling the playing field among all electric generators.

Clean Air Act issues have also arisen in electricity restructuring legislation, with several members of Congress pushing for safeguards that will ensure that competitive electricity markets do not foster greater air pollution from older plants. This issue and others are currently bogging down the electricity restructuring bills.

There is not much chance of Congress rewriting the Clean Air Act before the elections next fall, but the bills could foreshadow the importance of the issue in the upcoming campaign.

State Activism

In addition, there is a growing activism in a number of states to roll back air emissions. For example, earlier this year, Texas stopped short of repealing grandfather status for older plants and opted instead for a voluntary program to encourage grandfathered plants to obtain air permits. This was a compromise after legislation that would have revoked grandfathered status was defeated.

In New York, Governor Pataki directed the Department of Environmental Conservation recently to issue regulations requiring electric generators to reduce SO_2 emissions by another 50% below federal standards. The governor also wants to impose stringent NO_x reduction requirements on a year-round basis, rather than just during the summertime ozone season. The new regulations would be phased in starting on January 1, 2003, with implementation completed by January 1, 2007. ■

In Other News *cont.*

tier below it in the Netherlands Antilles and then made a "capital contribution" of the $179.5 million. The Dutch Antilles company then loaned the money to the US parent. A loan of "earnings" back to the US would trigger income taxes on the earnings under section 956 of the US tax code. However, The Limited argued that the Dutch Antilles company making the loan had no earnings.

The tax court said the loan was essentially a dividend by the Hong Kong company. The IRS has reserved the right in regulations under section 956 to attribute such money transfers to the real party in interest.

US PLANS TO REDUCE NITROGEN OXIDE EMISSIONS from power plants and other facilities that burn fossil fuels in 22 states east of the Mississippi River took another beating in the federal courts in October.

A federal appeals court declined on October 29 to reconsider an earlier decision to send the Environmental Protection Agency back to the drawing board on efforts to force states to start implementing plans to reduce power plant NO_X emissions by an average of 60% to 75% from 1990 levels by May 2003. The court said last May that the rules the government has proposed in this area are unconstitutional.

The Environmental Protection Agency is expected to appeal to the US Supreme Court. Even if it wins on further appeal, the latest decision probably delays until 2005 at the earliest any implementation of the EPA rules.

RECYCLERS persuaded Congress to exempt them from environmental liabilities under the federal Superfund law. The President signed the measure into law on November 29.

Efforts to enact broader Superfund reforms failed. Congress is expected to consider broad-based reforms to the Superfund liability scheme

continued on page 5

US Tax Laws Change — Again

by Keith Martin, in Washington

Congress voted a number of tax law changes in late November that will affect the project finance community. Many of the same changes passed Congress in August, but were vetoed by President Clinton. Clinton is expected to sign the new measure.

Section 45 Credits

Congress extended a tax credit of 1.7 cents a kWh for generating electricity from wind and "closed-loop biomass" and added poultry waste to the list of eligible fuels. "Closed-loop biomass" consists of crops grown specifically to be used as fuel in a power plant. Lobbyists had hoped to persuade Congress to broaden the fuels list also to include wood and agricultural waste and landfill gas, but they were unsuccessful.

Existing law requires projects using eligible fuels be placed in service by June 30, 1999 to qualify for credits. Congress extended this deadline for another two years through December 2001.

The credits run for 10 years after a project is put into service.

Under current law, only the owner of the facility qualifies for credits. Congress made an exception for power plants using poultry waste that are owned by a "governmental unit," like a municipality. In that case, a lessee of the power plant or the operator could claim the credits.

The California utilities won a victory. Congress said tax credits cannot be claimed on electricity from new wind projects put into service after June 30 this year if the electricity is sold under a power sales agreement with a utility signed before 1987. The only exception is if the power contract is amended to limit the electricity that can be sold under the contract at above-market prices to no more than the average annual quantity of electricity supplied under the contract in the five years 1994 through 1998 or to the estimate the contract gave for annual electricity output. "Above market" means for more than the avoided cost of the electricity to the utility at time of delivery.

This is the first time the tax laws have been used to reform power contracts at independent power facilities. The utilities worry that there is the potential for a large number of new wind projects to be built under so-called "standard offer contracts" that they were forced by law to sign in the 1980's. If all these projects are built, they will add to the utilities' stranded costs.

Basis Shifts

A number of companies have found ways to exploit a loophole to create additional tax basis in assets inside partnerships. Congress closed the loophole for new partnerships, but left it open for another 19 months for existing partnerships.

"Basis" is the investment that a taxpayer has in an asset. He uses it to measure gain when the asset is sold.

In a basis-shift transaction, a partnership drops some of its assets with a high tax basis into a new subsidiary corporation and then distributes the shares in the subsidiary to one of the partners to liquidate his partnership interest. This causes four things to happen.

First, the new subsidiary corporation takes a "carryover basis" in the assets that the partnership drops into it. This means that it has the same

Congress closed a loophole for new partnerships, but left it open another 19 months for existing partnerships.

high basis in the assets that the partnership had in them.

Second, the distribution of shares in the subsidiary to the liquidating partner does not trigger any tax. The partner takes a “substituted basis” in the shares, meaning he has the same tax basis in the shares that he had previously in his partnership interest. In a basis-shift transaction, the partner starts with a lower basis in his partnership interest than the partnership has in the shares it distributes. Thus, the partner is forced to shed basis.

Third, the partnership makes a so-called section 754 election. This allows it to increase the basis in its remaining assets by the tax basis that the liquidating partner had to shed.

Fourth, the partner then liquidates the corporation whose shares he was distributed. The liquidation is tax-free. After the liquidation, the partner ends up owning the assets that the partnership dropped into the subsidiary corporation directly. His tax basis in the assets is a “carry-over basis,” meaning the basis that the partnership originally had in them.

The net effect is to increase the total basis in partnership assets. The transactions also produce other benefits.

Congress voted to require the subsidiary corporation to reduce its basis in its assets by the amount of the shed basis. This rule applies retroactively to distributions of corporate shares after last July 14. However, a transition rule allows another 19 months through June 30, 2001 for partnerships to do these transactions with persons who were their existing partners last July 14.

Installment Sales

Accrual taxpayers will no longer be able to use the “installment method” for reporting gain from the sale of assets. In the past, when an asset was sold for installment payments over time, the seller

continued on page 6

In Other News *cont.*

next year. However, Congress included an exemption for recyclers in an omnibus appropriations bill that it sent President Clinton shortly before adjourning for the year in late November. Clinton is expected to sign the measure.

The exemption would cover persons who recycle scrap paper, plastic, glass, textiles, rubber (other than whole tires) and scrap metal or batteries, but the sale of the recycled material would have to meet certain criteria. The exemption would not cover persons who burn the same types of materials as fuel in power plants or use them for energy recovery.

TURKEY imposed an additional 5% corporate tax on 1998 earnings to help pay for earthquake damage in a measure that cleared parliament on November 26. Companies in the quake region are exempted. The country is expected to take other steps soon to support its economic program for the period 2000 to 2002, including increasing indirect tax rates by one percentage point and raising value added taxes.

POLAND cut the corporate income tax rate from 34% to 22% by 2004. The new rates are 30% in 2000, 28% in 2001 and 2002, 24% in 2003 and 22% in 2004.

THE HOUSE WAYS AND MEANS COMMITTEE held a hearing on November 10 on corporate tax shelters.

Congress may take action next year, although the committee chairman, Rep. Bill Archer (R.-Texas), remains skeptical about the need for such action. Archer said at the hearing, “The IRS has won case after case in tax court using the very tools Congress already provided. Now, our challenge is to focus efforts on stopping abuses while properly restraining new blanket authorities for the IRS that might chill legitimate business transactions.”

At the hearing, the Joint Tax Committee staff repeated its list of recommendations from last

continued on page 7

US Tax Laws Change — Again

continued from page 5

could report his gain ratably over the same period. Congress robbed this benefit of much of its value in 1988 by imposing an interest charge on anyone taking advantage of the provision. The new tax bill repeals use of the installment method altogether for accrual taxpayers. The change takes effect for sales occurring on or after the day President Clinton signs the measure. Most large companies are accrual taxpayers.

Fuel Contracts

Current law is unclear about whether a payment to cancel a fuel supply contract is a "capital loss." Companies have a harder time deducting capital losses than ordinary losses. The bill makes clear that "supplies of a type regularly used or consumed by the taxpayer in the ordinary course of [his] trade or business" are *not* capital assets. This should have the effect of also clarifying that payments to cancel contracts to buy such supplies are not capital losses. The change applies to payments on or after President Clinton signs the bill.

Accrual taxpayers will no longer be able to use the "installment method" for reporting gain from the sale of assets.

Power Marketers

Congress clarified that trading in "commodities derivative financial instruments" produces ordinary income for power marketing companies — not capital gain. This should be helpful, since power marketers usually want to avoid mismatches in character between income and loss positions on contracts. (Most of their income is already ordinary income.) A "commodities derivative financial instrument" is a contract that is for, or an instrument that is tied to, a commodity like electricity and whose value is linked to an index. "Index" is defined broadly as "objectively determinable financial or economic information" that is not unique to the parties and not within their control.

The bill also clarifies that hedging transactions produce ordinary income and loss — not capital gain or loss — provided the hedge is "clearly identified as such before the close of the day on which it was . . . entered into." Both provisions apply to any instrument "held, acquired, or entered into," or "transaction entered into," from when President Clinton signs the bill.

Research Credit

The bill extends the so-called R&D tax credit through June 30, 2004. The credit expired at the end of last June. The bill also increases the amount of the credit. Companies that qualify for the credit currently can compute it in one of two ways. Under one approach, the credit is 20% of the amount by which the company increased its research spending above a base. The other way is to compute it under a sliding formula that rewards companies for spending more than 1% of their gross receipts on research. Effective next year, the credit under this alternative approach would be 2.65% of research spending above 1% of gross receipts, 3.2% of such spending above 1.5% of gross receipts, and 3.75% of research spending above 2% of gross receipts.

Foreign Lending

US banks, insurers and finance companies that make loans to foreign borrowers have a hard time deferring US taxes on the interest they earn on these loans. US taxes cannot be deferred on passive income. The banks argue that this is active income for them. Congress wrote a temporary "active financing exception" into the law in 1997. The bill extends it through 2001. ■

IRS Says Power Contracts Were "Involuntarily Converted"

by Keith Martin, in Washington

The Internal Revenue Service said in seven private letter rulings recently that independent power projects that accepted buyout payments from a utility had their power contracts "involuntarily converted."

This is important because it means the projects do not have to pay income taxes on the buyout payments, provided the money is reinvested within two years in property that is "similar or related in service or use."

The IRS also said the buyout payments will be long-term capital gain to the extent they are taxed.

The rulings do not identify the utility, but it is almost certainly Niagara Mohawk.

The utility had 175 contracts to buy electricity from independent power facilities at prices that were above market. It managed to buy out 20 of the 175 contracts and then entered into a five-year struggle that led to buyouts or buydowns of contracts with another 44 projects. During this period, the utility threatened to apply to the state public service commission for permission to seize independent power facilities by eminent domain and sell them at public auction. Also during the period, an administrative law judge recommended that utilities in the state be allowed to curtail purchases from independent power facilities, and the public service commission approved a curtailment order affecting certain projects, but the order was never formally issued.

The IRS said it is an "involuntary conversion" when a taxpayer has reasonable grounds to believe that steps will be taken to condemn his property if he does not agree to a voluntary sale.

Even though the eminent domain threat was against the power plant, the IRS said this would also be considered against the power contract since

continued on page 8

In Other News
cont.

summer. The staff wants tougher penalties, higher standards for tax opinions, and a shifting of penalties from the corporation to the tax adviser where a transaction is done with an opinion from the tax adviser that the transaction works. It also wants corporations to have to disclose the details of corporate tax shelter transactions to the IRS with perjury statements signed by the chief financial officer at the company.

Separately, the American Bar Association is urging the IRS to modify "Circular 230" to bar tax advisers from assuming key facts, including whether a transaction has a sufficient business purpose, when writing more-likely-than-not opinions in future. The ABA made the recommendation in a report in early November.

SAUDI ARABIA is considering allowing foreigners to own up to 75% of joint ventures and offering tax holidays and soft loans to attract more foreign investment, the Saudi industry and electricity minister said at a conference in early November. Current law limits foreign ownership of joint ventures to 49%. There is a 10-year income tax holiday, after which the income tax rate is 45%.

CHINA has extended a preferential 15% income tax rate to energy and transportation projects in the interior provinces. The reduced tax rate had been available previously to such projects in coastal cities and special economic zones.

INDEMNITY PAYMENTS may not be taxable income.

The IRS let a company deduct its environmental cleanup costs recently despite the fact that it was reimbursed for them under an indemnity agreement. The IRS national office said in a "field service advice" that the indemnity payments were really capital contributions to the company that had to do the cleanup.

continued on page 9

Contracts "Involuntarily Converted"

continued from page 7

the two assets are so closely linked that they are an "economic unit." It cited a US tax court case where a taxpayer was forced by condemnation of parking lots he owned across the street from his freight elevator also to sell the freight elevator.

According to the rulings, "The actions of the State PSC and [the utility] . . . provide . . . a reasonable basis for Taxpayer to conclude that [the utility] would pursue its threat to condemn Taxpayer's facility if Taxpayer did not renegotiate its PPA. Further, it is clear that [the utility] had the authority under [state law] to commence eminent domain proceedings against Taxpayer's facility."

It is an "involuntary conversion" when a taxpayer has reasonable grounds to believe that steps will be taken to condemn his property if he does not agree to a voluntary sale.

In five of the rulings, the independent power company later sold the power plant to a third party or abandoned it. The IRS said these power plants were also involuntarily converted.

The independent power companies reportedly asked the IRS to rule that the payments to buy out contracts will be considered reinvested in like property if the money is applied toward a greenfield power project in a different location. The rulings are silent on this issue, suggesting the IRS either would not rule or was "adverse." A taxpayer will usually withdraw part of his ruling request rather than receive an unfavorable ruling.

The seven projects received buyout payments in the form of cash or shares in the utility.

In two cases, the projects entered into new "swap" and "put" agreements with the utility to replace their power contracts. Under the swap contracts, the parties agreed that in months when the market price for electricity is below an agreed contract price, the utility will pay the difference times a notional quantity of electricity to the independent power producer. The independent power company will make differences payments to the utility in months when the market price is *above* the contract price. These payments will continue for 10 years.

Under the "put," the independent power producer has a right to sell the same quantity of electricity covered by the swap to the utility at the market price. The put has the same 10-year term. The market price is determined by a formula tied to the utility's short-term avoided energy and fixed costs in its tariff on file with the public service commission. However, once a power exchange starts functioning, then the actual market price quoted by the power exchange will be used in place of this formula.

The IRS said the swap and put are "similar or related in service or use" to the power contract so that replacing one with the other in an involuntary conversion does not trigger income taxes. ■

New Insurance For Capital Markets Financings

by Noam Ayali, in Washington

The Overseas Private Investment Corporation has introduced a new insurance policy aimed at protecting bondholders in capital markets financings from losses due to political risk. Other multilateral and private political risk insurers are expected to come to market shortly with similar products.

Political risk, or the risk that a commercial project will be adversely affected by politically-caused actions or circumstances over which an investor has little or no control, is a well-recognized risk in international project finance. To mitigate that risk, project developers and commercial bank lenders often seek political risk insurance policies from multilateral or bilateral agencies such as the Multilateral Investment Guarantee Agency (MIGA), the Overseas Private Investment Corporation (OPIC) or the US Export-Import Bank (US Exim), or from private market players such as American International Group (AIG), Zurich US or Lloyds, to name a few.

Until recently, however, political risk insurance was not available to one important and growing source of financing for emerging market projects: project bonds and bondholders.

That has now changed with OPIC's introduction of its new product: a political risk insurance policy specifically designed for the capital markets and investors in fixed-income securities. Officials from the Inter-American Development Bank and Zurich US said at a conference in late September that their own products in this area are imminent.

Traditional political risk insurance policies for equity participants and bank lenders generally cover three main categories of risk: expropriation, political violence, and inconvertibility of local currency. The new capital markets political risk insurance policies offered to date cover only one of these risk categories, namely inconvertibility of local currency. Inconvertibility can occur as a result of newly-imposed governmental restrictions or lack of sufficient foreign currency. Typical inconvertibility insurance also covers the inability to transfer converted funds overseas. It is important to emphasize that, although often referred to as insurance against "exchange risk," the new products do not cover devaluation risk, which continues to be borne by investors. None of the political risk insurance products — be they

continued on page 10

In Other News
cont.

Company A bought an oil company that owned refineries and pipelines and that had caused damage to the environment. The oil company had to spend money later on environmental cleanup. The seller of the oil company shares had given Company A an indemnity promising to reimburse it for the cleanup. An IRS agent in the field thought Company A — which, by then, was including the oil company in its consolidated tax return — should not be able to deduct the cleanup costs because it was reimbursed for them. However, the IRS national office disagreed. It said the indemnity payments were really capital contributions to the oil company, even though the seller no longer owned the oil company by the time the indemnity payments were made. It said the payments related back in time to just before the sale.

Indemnities given in connection with sale of a company should be drafted as an adjustment in purchase price or as retrospective capital contributions.

FOREIGN TAX CREDITS can be claimed in the US for "advance corporations taxes" paid to the United Kingdom, even though UK credits for the taxes were surrendered to a lower-tier subsidiary.

Until recently, the United Kingdom collected a "mainstream" corporate tax of 33% from UK companies and also required them, when paying dividends, to pay an advance corporations tax, or "ACT," on the dividend. The company was then given a credit for the ACT against its mainstream tax. If it could not use the credit, it could either carry it to another tax year or surrender it downstream for use by its UK subsidiaries.

Compaq-UK paid a dividend of £11.8 million to its US parent in 1992 and paid £3.9 million in ACT on the dividend. Compaq-UK could not use the ACT credit, so it surrendered the credit to its two UK subsidiaries, which used the credit with the result

continued on page 11

New Insurance

continued from page 9

the traditional political risk policies or the new capital markets product — covers project credit risk. (Partial credit guarantees are available for emerging markets projects through the World Bank and other multilateral institutions, and private monoline insurers also offer credit support products.)

The most important and attractive feature of the capital markets political risk insurance policy for project bonds issuers from emerging market jurisdictions is the possibility, in the case of an otherwise investment grade credit, to pierce the so-called sovereign ceiling and to achieve a foreign currency investment grade rating. In reviewing the new OPIC product, both Moody's Investors Service and Duff & Phelps Credit Rating Co. have indicated that the OPIC capital markets political risk insurance policy could be an effective means for certain projects to surpass the prevailing sovereign foreign currency rating and, in certain cases, may suffice to bring the foreign currency credit rating up to the level of the local currency rating.

The new insurance may enable a project to achieve an investment grade foreign currency rating.

Where this new product enables a project to achieve an investment grade foreign currency rating, the implication is clear. It opens the door for a large universe of institutional investors (such as insurance companies, pension funds, etc.) that would otherwise be prohibited from investing under their applicable investment policies and guidelines and potentially reduces the cost of borrowing significantly.

The capital markets political risk insurance product is not a risk panacea. It only covers one out of the three traditional political risks. In addition, the OPIC coverage also has specific conditions to payment and other requirements and limitations that should be carefully considered, both by developers contemplating using OPIC-insured project bonds as part of their financing plan and by potential investors considering an investment in OPIC-insured project bonds. While some of these are peculiar to OPIC as a creature of US law, it is almost certain that some of these conditions, requirements and limitations will also form part of the capital markets political risk insurance policies from other public and private providers of political risk insurance.

OPIC's coverage is limited up to an amount of US$200 million for any single project. In addition, OPIC's individual country exposure guidelines limit its exposure under each form of coverage to no more than 15% of its total exposure. As a result, in some cases, the amount of OPIC coverage may be less than the total amount of scheduled principal and interest payments on the project bonds. However, the possibilities for co-insurance and reinsurance arrangements should grow as additional public and private providers of political risk insurance join the market.

As with any insurance policy, there are certain exclusions to the new OPIC policy. Coverage is excluded in the case of pre-existing restrictions on convertibility, lack of due diligence by the insured to use all reasonable efforts to convert local currency into US dollars through all customary legal channels, and where the primary cause of the loss is unreasonable action attributable to the insured.

A key aspect of the OPIC capital markets insurance policy is the "eligibility" of the insured. This requirement comes directly from OPIC's governing statute, the Foreign Assistance Act of 1961. The statute provides that OPIC can issue insurance to "eligible investors," a term that the Act defines as US citizens, any US corporation, partnership or other association, or any foreign corporation, partnership, or association that is wholly-owned by a US entity. OPIC officials have indicated that, in order to accommodate the nature and dynamics of capital market transactions, OPIC will treat a "US trust structure" in which a trust is established in the US and in which a majority of the bondholders will be US persons as satisfying the eligibility requirement for purposes of the new OPIC policy.

Perhaps the most significant aspect of OPIC's capital markets political risk insurance policy from the perspective of developers and project sponsors, however, is OPIC's requirement that the project company or the issuer of the project bonds must enter into a "company support agreement" with OPIC. Under this agreement, the project company provides certain representations and warranties and undertakes certain covenants, breach of which could result in the denial of claims under the policy by OPIC or withdrawal and termination of the policy. The most important of these are the following:

1. anti-corruption representations and covenants to the effect that any project concessions, licenses, or other regulatory approvals were obtained in compliance with applicable anti-corruption legislation, specifically including the US Foreign Corrupt Practices Act, and that the project will continue to be operated in compliance with such laws,
2. environmental representations and covenants to the effect that the project is in compliance with applicable environmental laws and regulations, including applicable World Bank environmental guidelines, and that the project will continue to be operated in compliance with such laws, regulations and guidelines, and

continued on page 12

In Other News *cont.*

that neither subsidiary had to pay any mainstream corporate tax in 1992 and neither paid any dividends that year.

Ordinarily when a US company receives a dividend from a foreign subsidiary, it can claim a credit for taxes that were already paid on the earnings abroad. However, in this case, the IRS said no foreign tax credit was allowed in the United States because the ACT taxes were effectively paid by the two 2d-tier subsidiaries in the UK, and neither company paid a dividend. One needs a dividend from the company paying the taxes in order to release the foreign tax credits.

The US tax court disagreed. It said the ACT taxes were paid by Compaq-UK — not its subsidiaries. It said the only relevance of where the ACT credit gets used within a UK group is that it reduces the amount of that UK company's mainstream corporate tax that might eventually also be claimed as a credit. The case was decided in mid-November.

The UK stopped collecting ACT on dividends last April. The tax was repealed in the Finance Act, 1998.

A CONSENSUS BILL has emerged in Congress on how US states would be allowed to tax telephone company income from cellular phones.

Under the compromise, fees paid by cellular phone customers would be allocated to the state that is the "primary place of use." The bill, introduced by Senators Byron Dorgan (D.-N.Dakota) and Sam Brownback (R.-Kansas) in late October, has support from the National Governors' Association, National League of Cities, Multistate Tax Commission, and Federation of Tax Administrators, among others.

SHORT TAX YEARS are often overlooked in calculating depreciation.

For example, a new partnership formed to own a

continued on page 13

New Insurance

continued from page 11

3. a covenant that the project company will not take any action to prevent its employees from lawfully exercising their right to organize and bargain collectively.

In the event of misrepresentation or breach of any of the foregoing, OPIC may decline to pay a claim or withdraw and terminate the policy, irrespective of whether such violations brought about the loss. Consequently, "bad acts" of the borrower could result in loss of political risk insurance coverage for the bondholders.

For capital markets investors looking for a fixed income stream of payments, these potential "outs" are also a possible weakness of the OPIC capital market political risk insurance product.

Several potential "outs" are a possible weakness of the new OPIC insurance.

Both Moody's Investors Service and Duff & Phelps Credit Rating Co. have indicated that these are factors they will take into account in rating an OPIC-insured project bond issuance. However, both rating agencies appear to be taking comfort from OPIC's claims-paying track record to date — OPIC has denied only 26 of approximately 280 claims filed against the agency over its 28 years of operations. They also take comfort from its track record in handling the public policy aspects of its program — OPIC has only cancelled one policy for reasons relating to breach of environmental covenants.

One pioneering transaction with OPIC insurance already closed, and others are in the process of coming to market. There is no doubt that the capital markets political risk insurance policy will strengthen the nascent project bonds market as more developers, bankers and investors become familiar with the product. ■

Greenhouse Gas Credits May Prove A Source Of Financing

By Andrew Giaccia, in Washington

Two recent sales of greenhouse gas credits suggest that such credits might serve as a source of financing in future for projects that use landfill gas, manure and other forms of solid waste.

Until recently, the US government offered a subsidy for such projects through the US tax code. It allowed anyone producing "gas from biomass" to claim a so-called section 29 tax credit of 1.052¢ per mmBtu of gas produced. The gas producer had to sell the gas to a third party to qualify for credits. His equipment also had to be in operation by June 1998.

With expiration of section 29 tax credits, project developers have been looking for other enhancements to support financing.

One landfill gas company, Zahren Alternative Power Corp., said in late October that it sold 2.5 million metric tons of credits for reducing carbon dioxide, or CO_2, emissions to Ontario Power Generation Co. The two companies said this was the world's largest spot trade of greenhouse gas credits to date. Meanwhile, EPCOR Utilities reported the same week that it bought 18,000 tons of CO_2 credits from TransAlta Utilities through the commodity exchange in Calgary, Alberta.

The trades are noteworthy because no greenhouse gas credits exist yet under US law. The US

Department of Energy is simply keeping track of voluntary actions by US companies to reduce greenhouse gas emissions in case Congress decides to reward such actions in the future. This may explain why the trades to date have involved Canadian companies as purchasers of the credits.

The United States committed in the Kyoto protocol in December 1997 to reduce greenhouse gas emissions by at least 7% below 1990 levels by the period 2008 to 2012. The protocol faces stiff opposition in the US Senate, which would need to ratify it before it becomes a binding obligation.

A bill, called the "Credit for Voluntary Actions Act," that would provide credit for early actions to reduce greenhouse gas emissions has been introduced in both the House (H.R. 2520) and Senate (S. 547). Even though the bill has not been enacted, some investors anticipate that there will be a credit trading system — and they are looking to buy greenhouse gas reductions now for possible future use. In the absence of an existing program, the market is currently applying the basic criteria that govern most other types of saleable air emissions credits in the United States. Under these standards, the emissions reductions will have to be both verifiable and voluntary in the sense that they were not required by federal or state regulation or local law.

One concern with the availability of greenhouse gas credits from landfill projects is whether the reductions can be considered voluntary. The US Environmental Protection Agency issued new source performance standards and emissions guidelines for gas from landfills on March 12, 1996 and amended them on June 28, 1998. The new source performance standards affect "new" landfills that commenced construction, modification, or reconstruction on or after May 31, 1991. The emissions guidelines affect "existing" landfills that commenced construction, modification, or reconstruction on or before May 30, 1991. These rules force owners of landfills with capacity greater than 2.5 million cubic meters to operate gas flaring or

continued on page 14

In Other News *cont.*

power plant will have a "short" tax year when the power plant goes into operation. If the power plant begins operating in November, the partners will qualify the first year at most for only 2/12ths of the tax depreciation that they would have had if they owned the power plant directly. A new company is not allowed to calculate depreciation as if it had been in business all year.

However, the IRS said in a "technical advice memorandum" released in November that new corporations that join with other companies in filing a consolidated federal income tax return do *not* have short tax years. An existing company formed two special-purpose subsidiaries to acquire two television stations. Each subsidiary was formed late in the year. An IRS agent insisted on audit that the group overstated its tax depreciation the first year by failing to take into account that the subsidiaries had short tax years. The IRS national office disagreed. It said it treats all members of a consolidated group as if they were a single corporation that was in existence for the full year.

A "technical advice memorandum" is a ruling by the IRS national office to settle a dispute between a taxpayer and an IRS agent on audit.

PAKISTAN could come under additional US economic sanctions if the Clinton administration makes a formal finding that the government was overthrown in a military coup.

US law bars any US financial assistance to a country "whose duly elected head of government is deposed by a military coup." However, a source at the US Export-Import Bank said the finding would be of academic interest only since Pakistan is already closed for credit reasons and remains under sanctions for testing a nuclear device. The source said the administration does not appear eager to acknowledge that a military coup occurred and further burden Pakistan. On October 27, President

continued on page 15

Greenhouse Gas Credits

continued from page 13

energy recovery systems. Thus, there is some question whether the methane and CO_2 emissions that are eliminated as a result of these EPA-mandated systems can be considered "voluntary" for purposes of the early credit legislation. This will ultimately be an issue for Congress.

Landfills are particularly fertile environments for generating greenhouse gas credits. A landfill that has more than two million tons of municipal solid waste produces an average of 1.8 million cubic feet of landfill gas per day. Based on a typical composition of 50% methane and 45% CO_2, such a landfill could generate from 100,000 to 150,000 metric tons of CO_2-equivalent reductions. (Methane is 21 times more potent than CO_2 and, therefore, a ton of methane equals 21 tons of CO_2.) Even at current values ranging between \$0.50 and \$2.00 per ton, such credits could be worth from \$50,000 to \$400,000 per year for a project.

These values should improve after legislation is adopted. Such credits may become even more valuable if the US accedes to the demands of the international community that its Kyoto reductions be substantially derived from domestic projects, rather than relying heavily on international reduction trading. ■

US Courts Attack More Corporate Tax Shelters

by Keith Martin, in Washington

The US courts upped the ante this fall in corporate tax shelter cases by signalling that they are prepared to hit companies that engage in such transactions with large penalties.

In one case involving United Parcel Service, the company had to take a charge against 1999 earnings of \$1.786 billion, and it estimated in a Form 10-Q filing with the Securities and Exchange Commission that its liability could ultimately hit \$2.353 billion.

The case involved a tax plan that the company put in place in 1984. It was years later before the IRS challenged the plan on audit. The company has the same issue in all the intervening years.

The decisions are important because they show that the calculation many large US companies that adopt aggressive tax positions make may be flawed. The companies figure there is little chance of discovery on audit and, even if discovered, they will be able to settle for X cents on the dollar and still show a profit from implementing the tax plan. These calculations fail to take into account the potential for large penalties and also the risk that the company could be nearly bankrupted by the tax liability if the tax plan remains in effect for many years before the IRS challenges it.

The United Parcel Service case involved use of an offshore insurance subsidiary.

Two other cases — involving computer-maker Compaq and Iowa utility IES Industries — involved a "dividend stripping" transaction that was popular with large US corporations until Congress shut down the transactions in 1997.

Offshore Insurance

United Parcel Service protected customers against the full value of their packages if the packages are lost, but only up to \$100 in value. The customers had to pay an extra 25¢ per \$100 of value above this amount for additional protection. By 1981, these "excess value" premiums were a substantial source of income for UPS. It reported the net amount between the premiums it collected and the losses it had to pay each year as income. For example, in 1981, "excess value" premiums were \$67 million against only \$20 million in losses.

The company began investigating the possibility of setting up an offshore insurance subsidiary to receive the premium income.

It eventually formed such a subsidiary at the end of 1983 in Bermuda and distributed the shares in the Bermuda company to the 14,000 UPS shareholders as a dividend. UPS retained only 2.67% of the shares for itself.

At the same time, it entered into a "fronting" arrangement with a subsidiary of US insurance giant AIG. UPS insured against its excess value exposure with the AIG subsidiary. However, the AIG subsidiary then reinsured the same risk with the Bermuda company UPS had just formed. UPS continued to collect the premiums from its customers and handled the claims. All monies were deposited in its US bank account. Claims were paid from the same account. Each month, UPS paid the net premium income — above claims — to the AIG subsidiary. The AIG subsidiary deducted a commission of $1 million a year plus another 4.1% to cover taxes, board and bureau charges, and then paid the balance over to the Bermuda company.

The tax court said UPS shifted income improperly to a Bermuda insurance subsidiary.

UPS stopped reporting the net premiums as income in the United States. Rather, it took the position that they were income of the Bermuda company. The Bermuda company was not a US taxpayer. (The US would ordinarily have looked through the Bermuda company and taxed the US parent on the income under so-called subpart F

continued on page 16

In Other News
cont.

Clinton renewed a limited waiver of the nuclear-testing sanctions, but only for purposes of financial assistance by the US Department of Agriculture "to support the purchase of food" and for the "making of any loan or the providing of any credit to the Government of Pakistan by any US bank."

TAX DISCLOSURE in offering circulars came under scrutiny in a case in federal district court in California.

Heliotrope General purchased preferred shares in a subsidiary that Ford Motor Company set up to hold its insurance and financial services assets. Ford changed its tax strategy soon afterward and cashed out the preferred shareholders before they got the returns they were expecting. Heliotrope sued for its losses, alleging, among other things, that Ford had not made a full enough disclosure of its tax strategy in the offering circular.

Ford won. It was able to show, through contemporaneous news articles and financial analyst reports, that its tax strategy was well known even if it was not fully disclosed in the prospectus.

THE UNITED STATES is appealing an October ruling by the World Trade Organization that "foreign sales corporations" are an illegal export subsidy.

Many American companies reduce US taxes on their export earnings by 15 to 30% by running the exports through an offshore entity called a "foreign sales corporation," or "FSC." For example, cross-border leases of US-made equipment are sometimes set up as FSC leases to reduce taxes on the rental income to the US lessor. The World Trade Organization ruling calls on the United States to withdraw the FSC subsidy by October 1, 2000 at the latest.

Approximately one in every four dollars in US exports is run through a FSC.

INDONESIA said foreigners selling shares in Indone-

continued on page 17

Corporate Tax Shelters

continued from page 15

rules; however, the distribution of shares in the Bermuda company to the UPS shareholders had the effect of avoiding these rules.)

On audit, the IRS said the $99.8 million in net premium income that UPS claimed was income of the Bermuda company in 1984 was really its income.

The US tax court agreed. The court said the arrangement lacked any business purpose. UPS argued that it was prompted to act out of concern that it was offering insurance in the US without a license. However, its employees involved in implementing the plan never sought legal advice about whether its existing arrangements were illegal or whether the new arrangement addressed the concerns. The court said the Bermuda company did nothing to earn the income. All the work of collecting premiums and processing claims was still done by UPS employees in the United States. If this were real insurance, the court said, UPS could have bought the same coverage in the market for between 8¢ and 9.2¢ per $100 of value — not the 25¢ it purported to pay its affiliate.

The freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along.

The court also denied UPS a deduction for the commissions it paid AIG.

It also upheld a series of penalties. First, UPS was hit with a 5% penalty for "negligence or intentional disregard" of US tax rules. Second, it was ordered to pay an additional 25% penalty because it lacked "substantial authority" for its position. Third, it was assessed interest for the back taxes at 120% of the normal rate. This is a penalty interest rate that applies to "tax-motivated transactions." Fourth, it was assessed an additional 50% interest charge on top of the penalty interest because the court said the company lacked even a reasonable basis for its position.

UPS said in a Form 10-Q filing with the Securities and Exchange Commission in mid-October that the taxes at issue for 1984 were $31 million, but that when the penalties and interest were added, the sum comes to $246 million. It estimated that the total after-tax exposure for the tax years 1984 through 1999 could be as high as $2.353 billion. The company said it was still evaluating whether to appeal.

Dividend Stripping

In a separate case, the US tax court also upheld penalties against computer-maker Compaq for engaging in a "dividend stripping" transaction intended to generate a capital loss.

Compaq sold stock it owned in another computer company in July 1992 at a capital gain of $231.7 million. A broker at Twenty-First Securities learned of the capital gain and began pitching a dividend-stripping transaction in August. Compaq agreed to do the transaction after a meeting with the broker in mid-September. The transaction involved a series of trades that the broker arranged the next day.

Compaq bought 10 million American Depository Receipts, or ADRs, in Royal Dutch Petroleum Company in 23 cross trades with Arthur J. Gallagher & Co. — another customer of Twenty-First Securities — and immediately resold the ADRs back to Gallagher. All 23 cross trades were completed within an hour.

The ADRs were purchased "cum dividend" — with the expectation that Compaq would be entitled to a dividend about to be declared — and they were resold "ex-dividend." Compaq paid $887.6 million for the ADRs. It resold them for approximately $20 million less, or $868.4 million. The purchase leg of each cross trade settled on September 17, but the resale legs did not formally settle until September 21, thus entitling Compaq to the dividends that were declared two weeks later for persons who were shareholders of record on September 18.

Compaq paid Twenty-First Securities a commission of about $1 million.

Compaq claimed a capital loss of $20.7 million on its tax return. It also reported a dividend of $22.5 million, but claimed a foreign tax credit for the 15% withholding tax that was subtracted from the dividend in Holland.

The US tax court said the transaction lacked any business purpose other than tax planning. It quoted from an opinion by the 7th circuit court of appeals in another case: "The freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along." The court noted that Compaq did no market research before deciding to buy the ADRs and, about a year later, it shredded the spreadsheet that Twenty-First Securities had used in pitching the transaction.

The court upheld a 20% negligence penalty after concluding that Compaq could not show it had a reasonable basis for its position or that it acted in good faith.

An Iowa federal district court in September also disallowed $82.8 million in losses that Iowa utility IES Utilities claimed from dividend-stripping transactions in 1991 and 1992.

Congress closed the door on dividend-stripping transactions in 1997 by requiring that a company have held common stock for at least 16 days and preferred stock for at least 46 days before it will be entitled to foreign tax credits on dividends. ■

In Other News *cont.*

sian companies must pay income taxes of 5% of the gross sales proceeds.

Indonesia subjects persons selling shares in Indonesian companies to a 20% withholding tax on the profit — in theory. However, in practice, the tax applies to a "deemed" profit regardless of actual profit. The finance minister announced that 25% of gross proceeds from the sale of shares will be considered profit. A tax of 20% times 25% is equivalent to a tax of 5% of gross sales proceeds. Indonesian companies cannot register a change in shareholders without proof that the tax has been paid.

The tax can be avoided by owning shares through an offshore company and selling shares in the offshore company.

INDIA continued its assault on foreigners who invest in India via treaty countries. The Authority for Advance Rulings denied benefits under the tax treaty with Oman on grounds that Omani residents are not subject to income taxes in Oman. A person must be a "tax resident" of a treaty country in order to qualify for benefits.

In a separate action, the Indian government said it is reducing withholding taxes on dividends paid to Dutch residents from 15% to 10%. The change is retroactive to April 1, 1997. India was required to make the change because of a "most-favored-nation clause" in the Dutch tax treaty.

MASSACHUSETTS said a cogeneration facility whose contract to supply power to the local utility was bought out by the utility had a higher value for property tax purposes than the cogenerator claimed.

The cogenerator argued that the power plant had a low value because it had to operate on a merchant basis. Assessors for the town of Montague, where

continued on page 19

Third Parties Gain Right To Enforce Project Contracts

by Robin Mizrahi, in London

Third parties will have an easier time in the future asserting rights under project documents that are governed by English law as a result of a new law that took effect on November 11.

The new law partly abolishes the doctrine of "privity of contract" that, until now, has prevented any person from enforcing rights arising under a contract unless he is a direct party to the agreement. This was true regardless of how clear the actual parties to the contract were in expressing their intention to create a right in favor of the other person.

The new law — called the "Contracts (Rights of Third Parties) Act 1999" — gives more freedom to contracting parties by allowing them to create enforceable rights in favor of third parties. This development has the potential to obviate to a large extent the need for direct agreements. Enforceable rights could be given to the lenders in project agreements such as construction contracts, operation and maintenance contracts or concession agreements (although these are typically governed by the law of the country where the project will be built). However, it remains to be seen whether lenders will give up the comfort of a direct contractual relationship and rely solely on a statutory right.

In the US, where common law third-party beneficiary rights have existed for many years, project finance lenders still require that consents to assignment be executed even when the underlying agreement acknowledges certain rights to the lenders. It appears from the language of the act that it would be easier to assert third-party beneficiary rights in England than in the US, where there is a requirement to show the contracting parties' intention to create such rights.

Under the English act, if the term of the contract purports to create a third-party beneficiary right, then it is up to the contracting parties to prove that the contract, on a proper construction, does not show that they intended that term to be enforceable by the third party. In any case, the new contracts act should strengthen developers' hands in arguing that the sometimes costly direct agreements should not be required where the underlying agreement already grants the lenders adequate protections. In this respect, project finance transactions governed by English law could become simpler. The new contracts act has already provoked a serious debate within the English construction industry on the effect it will have on collateral warranties, a form of direct agreement widely used in real estate development deals.

However, because of the way it operates, the new law also has the potential to create new hazards. Presumably, a sweeping "no third party rights" clause specifically barring application of the bill would be sufficient to show that the parties had no intention to create such rights. However, things could get more complicated in cases where the parties to the contract want the contracts act to apply with respect to a specific right in favor of a specific third party. For example, the parties may desire to create third-party rights in favor of one type of lender to the project but not others. Simply stating that a clause is intended for the benefit of the lenders to the project would potentially create rights in favor of any lender to the project, whether senior or subordinated, secured or unsecured, who was aware of the clause granting third-party rights to lenders prior to entering into the relevant loan transaction. Because of the new law's limitations on amendments, a lack of caution could lead one to create rights inadvertently in favor of third parties without being able to do anything about it later.

The new contracts act does not apply to

contracts entered into fewer than six months after it took effect on November 11, although this restriction does not apply to contracts that are entered into on or after November 11 and expressly provide for its application. It is unclear under what circumstances amending a contract in future will bring it under the statute and, perhaps, create third-party rights inadvertently.

The new law states that "a person who is not party to a contract may in his own right enforce a term of the contract if the contract expressly provides that he may." In an effort to make things less technical by not requiring contracting parties to use any particular wording, the act provides that the third party may also enforce a term of the contract if "the term purports to confer a benefit on him" unless "on a proper construction of the contract it appears that the parties did not intend the term to be enforceable by the third party." The third party need not be identified by name if it is a member of a class or answers a particular description. Finally, unless they have expressly retained the right to do so in the contract, contracting parties that create a right to a third party may not rescind the contract or amend it in a way that alters that right if the third party has relied on the right and the party to the contract against whom the right would be enforceable knew of or should have reasonably foreseen such reliance. ■

Lack of caution could lead one to create rights inadvertently in favor of third parties without being able to do anything about it later.

In Other News *cont.*

the facility was located, said the cogenerator had to take into account the $9.9 million a year that it would receive in buyout payments from the utility through 2009.

The Massachusetts appellate tax board agreed with the assessor in a ruling on November 1. The board said the buyout payments were an intangible that added to the facility's value in the same way that government rent subsidies and accelerated depreciation add to value where the owner of an asset would qualify for them.

ALABAMA said that a local manufacturing company had to treat all of the dividends it received from two foreign subsidiaries as income from Alabama sources.

This meant the company had to pay income taxes on the dividends in Alabama. Most states require a company doing business in the state to allocate a share of its total income to the state based on the percentages of its total payroll, property and sales that are in the state.

In this case, QMS Inc. had its headquarters in Alabama. The company manufactured advanced printing systems. It had two wholly-owned foreign subsidiaries that did not do any business in Alabama, but the state said the subsidiaries were "integrally related" to the parent company. The parent pledged the shares of the subsidiaries as collateral for a loan. This triggered a "deemed" dividend under section 956 of the US tax code: the parent company was treated as having had the use of undistributed earnings in the foreign subsidiaries because it effectively borrowed against them in the United States.

The Alabama Department of Revenue said that the entire deemed dividend should be allocated to Alabama for state tax purposes. The decision was upheld this fall on appeal to an administrative law judge.

continued on page 20

In Other News
cont.

TAX DEPRECIATION for power plants should be shortened, the Edison Electric Institute urged the US Treasury.

Most coal- and gas-fired power plants are depreciated over 15 or 20 years. The trade association said in a letter to the Treasury in early November that the disparity between these lives and the 5-, 7- or 10-year tax depreciation allowed to most other industries has the effect of directing capital investment away from the utility sector. It pointed to a number of anomalies in the depreciation tables, including that a computer used to run a nuclear power plant must be depreciated over 20 years while the same computer used to run a cigarette factory or a textile mill can be depreciated over seven years. EEI did not recommend any particular lives. The Treasury Department is under orders from Congress to do a study of depreciable lives to determine whether they require changing.

The Treasury Department went through a similar exercise in the late 1980's, but Congress never acted on its report.

MCI AND TELECOM*USA lost a frustrating case on appeal over investment tax credits.

Congress repealed the investment tax credit at the end of 1985, but there were generous transition rules that allowed many companies still to qualify for credits for several more years. The credit allowed by these transition rules was 10% in 1986. It was 8.25% in 1987 and 6.5% from 1988 through 1990.

Meanwhile, a company had to reduce its depreciable basis by the full amount of the tax credit. MCI and Telecom*USA placed property in service in 1986 on which they were entitled to tax credits. However, they could not use the credits immediately and carried them forward to 1988. Under the rules, they could only claim a 6.5% credit. However, the IRS said each company had to reduce its depreciable basis by 10%. Both the US tax court and the US court of appeals for the DC circuit agreed with the IRS. The appeals court announced its decision in mid-October.

BRIEFLY NOTED: The airlines have been negotiating an industry-wide settlement with the US Treasury on the issue when costs of standard maintenance on aircraft engines must be "capitalized" and recovered over the remaining life of the engines. The airlines want to deduct the costs immediately like other repairs. Power companies have the same issue. In what may be a bad sign, United Airlines filed suit in the US tax court in October. The airline is contesting whether $118 million in maintenance costs in 1988 for so-called "heavy maintenance visits" or "mid-period visits" by its aircraft can be deducted . . . . Boston Edison argues in a suit it filed recently in US district court in Massachusetts that it was entitled to claim investment tax credits on additions to its Pilgrim nuclear power plant, in the late 1980's after the investment credit was repealed, under a transition rule for "service or supply contracts." The utility argued that it had to make the improvements to the nuclear plant because of contracts it had signed to supply power to local municipalities.

— contributed by Keith Martin, Heléna Klumpp and Roy Belden in Washington.

CHADBOURNE & PARKE LLP
30 Rockefeller Plaza • New York, NY 10112 • (212) 408-5100
1200 New Hampshire Avenue, N.W. • Washington, DC 20036 • (202) 974-5600
601 South Figueroa Street • Los Angeles, CA 90017 • (213) 892-1000
also in
London (Chadbourne & Parke, a multinational partnership), Moscow and Hong Kong

CHADBOURNE & PARKE LLP

PROJECT FINANCE NEWSWIRE EXTRA

December 1999

IRS Moves To Limit Certain Foreign Tax Planning

by Keith Martin, in Washington

The Internal Revenue Service proposed changes in its "check-the-box" regulations on November 26 that would rule out two foreign tax planning techniques that have been used by the project finance community.

The changes will not take effect in theory until the IRS republishes them in final form — perhaps in late 2000. However, the IRS said in a technical assistance memorandum in September that it does not believe one of the techniques works under existing law.

The "check-the-box" regulations are a set of rules that let US companies decide how they want their foreign subsidiaries classified for US tax purposes simply by checking a box on an IRS form. There are three choices: corporation, partnership or "disregarded entity," meaning the subsidiary does not exist at all for US tax purposes. US companies have had a much easier time —since the check-the-box rules took effect in January 1997 — structuring foreign investments so that US taxes on the earnings can be deferred. The earnings have to be retained offshore.

The IRS was uneasy from the start about what US companies and their tax advisers might be able to do. Soon after the rules were published, the IRS learned that US multinationals were using the ability to treat foreign subsidiaries as disregarded as a tool to "strip" earnings from foreign countries with little or no tax and, at the same time, defer US taxes on the earnings. The IRS tried in Notice 98-11 in early 1998 to put a stop to the practice. However, Congress forced the IRS to back down after heavy lobbying by US industry. Enforcement of the IRS rules on earnings stripping has now been delayed until July 1, 2005 at the earliest.

The IRS now wants to block two more tax planning techniques.

Sales of Shares

In one, a US company checks the box to cause a foreign subsidiary to disappear for US tax purposes shortly before shares in the subsidiary are sold. Gain from the sale of shares is "subpart F income," meaning income on which it is impossible to defer US taxes. Therefore, the US company files an election before the sale to treat the foreign subsidiary as disregarded. This means that the sale is treated as a sale of the foreign subsidiary's assets. Gain from the sale of assets ordinarily is *not* subpart F income.

The IRS said in a technical assistance memorandum released in September that a US company cannot avoid subpart F income on its gain by making a last-minute election. According to it, gain from the sale of assets escapes being labeled "subpart F income" only if the seller used the assets in its trade or business for more than half the period it held them. The IRS said that when a parent company becomes the owner of assets by checking the box on a subsidiary, it does so for the purpose of selling the assets and not using them in a trade or business. One commentator remarked wryly, "The Service would seem not to like its check-the-box regulations as they apparently might be used in certain situations."

The latest IRS action proposes to amend the check-the-box regulations.

Under the proposed rule, a US company would not be able to change the classification of any foreign subsidiary from corporation to disregarded entity within 12 months before a sale of 10% or more of the shares in the subsidiary.

Shelf Companies

The IRS also said it would not allow "shelf" companies to be used to get around this rule. It gave the following example. A parent company owns two foreign subsidiaries, FC1 and FC2. FC1 is a real company with real assets and is a corporation for US tax purposes. FC2 is a shelf company that was

continued on page 2

IRS Moves To Limit Certain Foreign Tax Planning

continued from page 1

formed two years ago, has no assets, and is treated as disregarded. The parent merges FC1 into FC2 with FC2 as the surviving company and then sells shares in FC2, hoping to treat a gain or loss from the sale of FC2 shares as from the sale of FC1 assets.

Under the proposed new rules, the IRS would reclassify FC2 as a corporation. It said it would do this whenever a disregarded foreign entity with few assets acquires the assets of another foreign entity in a transaction that is at least partly tax free and then, within 12 months, at least 10% of the shares in FC2 are sold.

What is a shelf company? The IRS proposes an 80% test. If the assets acquired by FC2 comprise more than 80% of FC2's assets after the acquisition or merger, then the proposed rule will come into play.

The IRS said it would apply an "anti-stuffing rule." It would not allow cash and marketable securities that "exceed the reasonable needs" of FC2 to be stuffed into FC2 to avoid characterization as a shelf company.

A problem with bright-line tests like these is they encourage more planning to get around them. If Congress would permit it, the IRS would be better off with a general statement of principles. US companies would be able to avoid the new rules by planning ahead in future. An election to treat a subsidiary as disregarded could be made at least 12 months before sale of the subsidiary. If a shelf company will be used, then one could plan ahead in the sense of having real assets other than cash or marketable securities in the shelf company before the merger.

"Grandfathered" Partnerships

The IRS also said it is offended by trafficking in foreign companies that were formed before the check-the-box regime took effect in January 1997 and that are classified under a "grandfather" rule as partnerships.

These entities have value because the IRS issued a list of *per se* corporations in January 1997. These are types of entities — generally one per country — that are treated automatically as corporations. US companies generally prefer not to have their foreign subsidiaries classified as corporations because this makes it harder to defer US taxes. Thus, for example, if a US company needed a subsidiary in Latin America and is required to use a *sociedad anonime*, or "SA" — which is a *per se* corporation — it might acquire an SA from someone else that was classified as a partnership for US tax purposes before January 1997. Such an SA can continue to be classified as a partnership under a grandfather rule.

The IRS proposes to revoke the grandfathered status of such entities if there is at least a 50% change in ownership after November 29, 1999.

The entity would already lose its grandfathered status under the existing IRS regulations if there is a "sale or exchange" of at least a 50% interest in the entity's capital *and* profits within any 12-month period. The new proposal is aimed at preventing tax planning around this rule.

Per Se List

The IRS also finalized some changes to the *per se* corporations list on November 26. These changes had been proposed earlier.

The main changes are clarifications that a *sociedad anonime de capital variable*, or an SA de CV, formed in Mexico is a *per se* corporation and that companies "limited by shares" or "limited by guarantee" are considered "limited companies" in countries where a "limited company" is a *per se* corporation. These changes are retroactive to January 1, 1997. The IRS also made minor changes to the companies listed for Canada, Cyprus, Finland, Hong Kong, Jamaica, Malta, Norway and Trinidad and Tobago. ■

CHADBOURNE & PARKE LLP
30 Rockefeller Plaza • New York, NY 10112 • (212) 408-5100
1200 New Hampshire Avenue, N.W. • Washington, DC 20036 • (202) 974-5600
601 South Figueroa Street • Los Angeles, CA 90017 • (213) 892-1000
also in
London (Chadbourne & Parke, a multinational partnership), Moscow and Hong Kong