[4830-01-p] DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1 [REG-113526-98; REG-105369-00] RIN 1545-AW44; 1545-AY12

Arbitrage and Private Activity Restrictions Applicable to Taxexempt Bonds Issued by State and Local Governments; Investmenttype Property (prepayment); Private Loan (prepayment).

AGENCY: Internal Revenue Service (IRS), Treasury.

Withdrawal of previous notice of proposed rulemaking; ACTION: notice of proposed rulemaking and notice of public hearing. SUMMARY: This document contains proposed amendments to the final regulations on the arbitrage and private activity restrictions applicable to tax-exempt bonds issued by State and local governments. The proposed amendments affect issuers of taxexempt bonds and provide guidance on the definitions of investment-type property and private loan to help issuers comply with the arbitrage and private activity restrictions. This document also provides notice of a public hearing on these proposed regulations. The previous notice of proposed rulemaking (REG-113526-98), published on August 25, 1999, relating to arbitrage and related restrictions applicable to tax-exempt bonds issued by State and local governments, is withdrawn. DATES: Written or electronic comments must be received by July 16, 2002. Outlines of topics to be discussed at the public hearing scheduled for September 24, 2002, at 10 a.m., must be received by September 10, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG-105369-00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG-105369-00), courier's desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, submissions may be made electronically to the IRS Internet site at www.irs.gov/regs. The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Johanna Som de Cerff, (202) 622-3980; concerning submissions and the hearing, Sonya Cruse, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

#### Background

This document contains proposed amendments to 26 CFR part 1 (the proposed regulations). On August 25, 1999, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG-113526-98) (64 FR 46320) (the 1999 proposed regulations) proposing to modify §1.148-1(e) of the Income Tax Regulations to establish which prepayments for property or services give rise to investment-type property under section 148(b)(2)(D) of the Internal Revenue Code (Code). Numerous written comments responding to the 1999 proposed regulations were received, and a public hearing was held on January 12, 2000. In response to the extensive comments, particularly with regard to certain natural

gas prepayment transactions discussed below, the 1999 proposed regulations are withdrawn and amendments to §1.148-1(e) are proposed in accordance with this notice of proposed rulemaking. This notice of proposed rulemaking also proposes corresponding amendments to §1.141-5(c)(2) (relating to the private loan financing test).

# Explanation of Provisions

#### I. Existing Definition of Investment-type Property

With certain exceptions, section 148 prohibits the use of proceeds of a tax-exempt bond issue to acquire investment property with a yield that materially exceeds the yield on the issue. Section 148(b)(2)(D) provides that the term <u>investment</u> <u>property</u> includes <u>investment-type property</u>. Section 148(b)(2)(D) was added to the Code by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) (1986 Act). The Conference Committee Report states that the legislation "expands the types of investments of bond proceeds that are subject to the arbitrage restrictions to include all investment-type property (including other than customary prepayments)...." H.R. Conf. Rep. No. 99-841, pt. 2, at 745.

As an economic matter, prepayments for property or services generally contain a built-in investment return. That is, if a buyer of property or services makes a cash payment to the seller in advance of the seller's performance, the buyer may expect to receive an implicit investment return based on the time value of money. In the case of a prepayment financed with tax-exempt bond

proceeds, the presence of a built-in investment return raises the issue of whether the prepayment gives rise to investment-type property.

The existing regulations, at §1.148-1(e)(2), contain rules for determining when a prepayment for property or services results in investment-type property. Under that provision, a prepayment generally gives rise to investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. However, a prepayment does not give rise to investment-type property under the existing regulations if (1) it is made for a substantial business purpose other than investment return and the issuer has no commercially reasonable alternative to the prepayment (the business purpose exception); or (2) prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of taxexempt financing (the customary exception).

# II. <u>1999 Proposed Amendments to the Definition of Investment-</u> type Property

The 1999 proposed regulations proposed a modification to §1.148-1(e)(2) to establish that a prepayment of a contract for property or services that is made after the date that the contract is entered into can give rise to investment-type property. This modification was proposed in light of the opinion in <u>City of Columbus v. Commissioner</u>, 112 F.3d 1201 (D.C. Cir.

1997), which concluded that a 1994 prepayment by a city of its indebtedness to a state did not constitute a prepayment for property the city acquired in 1967. The proposed amendment to §1.148-1(e)(2) addressed only the narrow issue of whether a prepayment for property or services after the execution of a contract to buy the property or services can give rise to investment-type property.

Commentators generally agreed with the suggestion that a prepayment for property or services can occur after the date the purchase contract is executed. The proposed regulations retain the proposed change to §1.148-1(e)(2), with clarifying modifications that are consistent with this concept.

# III. <u>Definition of Investment-type Property in the Proposed</u> <u>Regulations</u>

Although commentators generally agreed with the 1999 proposed amendments to §1.148-1(e)(2), they requested additional clarification of other aspects of the definition of <u>investment-</u> <u>type property</u>. After considering all of the comments, Treasury and the IRS have determined that additional changes to the definition are needed to provide certainty to issuers and the IRS in a manner that is consistent with the broad scope of the investment-type property concept. To allow for public comment, these additional changes are issued in proposed form. Furthermore, to provide issuers with immediate certainty, issuers may rely on the proposed regulations to the extent specified below.

Commentators generally did not recommend modifying the basic framework for determining whether a prepayment gives rise to investment-type property under §1.148-1(e)(2). The proposed regulations retain this basic structure, but make certain modifications. In particular, the proposed regulations: (1) amend the business purpose exception; (2) retain the customary exception in its present form; (3) add an exception for certain prepayments by municipal utilities to acquire a supply of natural gas; and (4) add a <u>de minimis</u> exception for prepayments made within 90 days of delivery of the property or services. In addition, the proposed regulations state that the Commissioner may, by published guidance, set forth additional circumstances in which a prepayment does not give rise to investment-type property.

#### A. <u>Business purpose exception</u>

As indicated, the existing regulations provide that a prepayment does not give rise to investment-type property if it is made for a substantial business purpose other than investment return and the issuer has no commercially reasonable alternative to the prepayment. This provision, which was intended to be a narrow exception to the definition of investment-type property, has raised difficult interpretive questions. For example, in many instances it may be unclear whether the alternatives available to the issuer are "commercially reasonable."

Commentators suggested certain changes to the provision to clarify its application. For example, they suggested that a

prepayment should be considered made for a substantial business purpose other than investment return if the effect of the prepayment is (1) to fix the price of the property or service, (2) to assure a supply of the property or service, (3) to guarantee delivery of the property or service at a location favorable to the issuer, or (4) to enable the issuer to obtain a price discount that materially exceeds the investment return that could be earned between the time the prepayment is made and the time the property or services are delivered. Commentators suggested that an alternative should be viewed as "commercially reasonable" if it is reasonably available to the issuer, it would achieve the same substantial business purpose as the prepayment except that no investment return is received, and it is not more expensive by an amount that materially exceeds the investment return from the prepayment. Some commentators recommended that a safe harbor be added under which an alternative would not be considered commercially reasonable if the cost of the alternative exceeded the cost of the prepayment by a specified amount on a present value basis.

Treasury and the IRS have considered these suggested factors and have concluded that they do not, in and of themselves, represent administrable standards for distinguishing between prepayments that are made primarily for arbitrage purposes and those that are not. That is, a prepayment transaction may contain one or more of these features, even if it is primarily arbitrage-motivated. Therefore, the proposed regulations do not

adopt these suggested amendments. Nevertheless, as discussed below, these factors are taken into account, together with all the other facts and circumstances, in determining whether a prepayment satisfies the business purpose exception as revised by the proposed regulations.

In this regard, the proposed regulations amend the business purpose exception in order to clarify that it is to be applied narrowly in a manner that is consistent with the broad scope of the investment-type property concept. In particular, under the proposed regulations a prepayment meets the business purpose exception if the facts and circumstances clearly establish that the primary purpose for the prepayment is to accomplish one or more substantial business purposes that (1) are unrelated to any investment return based on the time value of money, and (2) cannot be accomplished without the prepayment. This exception is intended to be very narrow and to apply only in very unique circumstances, such as the situation illustrated by an example in the proposed regulations.

## B. <u>Customary exception</u>

As indicated, the existing regulations provide that a prepayment does not give rise to investment-type property if prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing. This provision implements the legislative history cited above

that indicates that customary prepayments should not result in investment-type property.

Commentators suggested that a safe harbor be added for determining a "substantial percentage" of similarly situated persons. However, Treasury and the IRS have concluded that the determination of whether a transaction is customary is appropriately made on a case-by-case basis, taking into account all the facts and circumstances, rather than by reference to a precise mathematical formula or predetermined percentage. Therefore, the proposed regulations do not adopt this suggested change.

Commentators also recommended that the "substantial percentage" requirement should be deemed satisfied if a substantial number of similarly situated persons who are not beneficiaries of tax-exempt financing make a similarly sized prepayment. The proposed regulations do not adopt this comment because the incidence of a particular number of transactions by similarly situated persons may not establish that the transaction is customary if those persons represent only a small percentage of all the similarly situated persons.

Finally, some commentators suggested that the customary exception should be automatically satisfied if the issuer and the supplier of the property or services certify reasonably and in good faith that its requirements are met. The proposed regulations do not adopt this comment because a certification by the parties to a transaction should not be sufficient to

establish the legal conclusion that the transaction meets the requirements of the exception.

# C. <u>Certain prepayments to acquire a supply of natural gas</u>

The preamble to the 1999 proposed regulations identified certain transactions involving the issuance of bonds to prepay for a supply of natural gas and the simultaneous execution by the issuer of a commodity swap under which the issuer receives fixed payments and makes variable payments based on an index. The 1999 preamble stated that Treasury and the IRS were concerned that the transactions create investment-type property and requested comments on the transactions.

Most, but not all, of the commentators disagreed with the suggestion that the identified transactions should result in investment-type property. They stated that deregulation of the natural gas industry has threatened the ability of municipal utilities to obtain a secure supply of natural gas on commercially reasonable terms. They stated that the natural gas prepayment transactions are necessary to obtain a guaranteed supply of natural gas on favorable terms in light of deregulation.

The proposed regulations add an exception to the definition of investment-type property for certain natural gas prepayments that are made by or for one or more utilities that are owned by a governmental person, as defined in §1.141-1(b) (for example, where a joint action agency acquires a natural gas supply for one or more municipal gas or electric utilities). The exception

applies only if at least 95 percent of the natural gas purchased with the prepayment is to be consumed by retail customers in the service area of a municipal gas utility, or used to produce electricity that will be furnished to retail customers that a municipal electric utility is obligated to serve under state or Federal law. For this purpose, the service area of a municipal gas utility is defined as (1) any area throughout which the municipal utility provided (at all times during the five-year period ending on the issue date) gas transmission or distribution service, and any area that is contiguous to such an area, or (2) any area where the municipal utility is obligated under state or Federal law to provide gas distribution services as provided in such law. Issuers may apply principles similar to the rules of §1.141-12 in order to cure a violation of this 95 percent requirement.

A transaction will not fail to qualify for this exception by reason of any commodity swap contract that may be entered into between the issuer and an unrelated party (other than the gas supplier), or between the gas supplier and an unrelated party (other than the issuer), so long as each swap contract is an independent contract. For this purpose, a swap contract is an independent contract if the obligation of each party to perform under the swap contract is not dependent on performance by any person (other than the other party to the swap contract) under another contract (for example, a gas supply contract or another swap contract).

Comments are requested on the exception for natural gas prepayments in the proposed regulations, including the definition of service area and the workability of the 95 percent test.

## D. <u>De minimis prepayments</u>

Commentators recommended adding to the regulations a <u>de</u> <u>minimis</u> exception under which prepayments that are made in small amounts or shortly before the property or services are delivered, would be disregarded. Treasury and the IRS recognize that prepayments made shortly before the property or services are delivered are unlikely to be arbitrage-motivated. Based on this consideration, and to provide administrative certainty, the proposed regulations add an exception for prepayments that are made within 90 days of the date of delivery of the property or services. However, the proposed regulations do not provide an exception for small prepayments because a prepayment may be made primarily for arbitrage purposes even if it is a small amount. E. <u>Timing mismatch between payment and delivery of property or</u>

The preamble to the 1999 proposed regulations requested comments regarding the proper treatment of contracts that provide for a timing mismatch between the buyer's cash payments and the seller's delivery of property or services.

Commentators generally expressed the view that, depending on the particular facts, payments made over time may give rise to investment-type property when the payment schedule does not match the schedule for the provision of property or services. The

commentators did not recommend any changes to the regulations on this issue. Treasury and the IRS have determined that §1.148-1(e)(2) appropriately addresses mismatches in payment and delivery obligations. Therefore, the proposed regulations do not propose any amendments in this regard.

# F. <u>Prepayments of capital charges</u>

Some commentators recommended that the regulations be modified to provide that a prepayment does not give rise to investment-type property if it is in substance a reimbursement to a seller of all or a portion of the seller's capital costs of a specific, tangible project through which the seller produces or delivers a service or commodity. The proposed regulations do not contain a specific exception for prepayments that reimburse a seller for its capital costs because a prepayment may be made primarily for arbitrage purposes even if it effectively reimburses the seller for capital costs. Nevertheless, this factor is taken into account, together with all the other facts and circumstances, in determining whether a prepayment meets the business purpose exception.

# IV. <u>Private Loans</u>

With certain exceptions, interest on an issue that meets the private loan financing test is not excluded from gross income. Under section 141(c), an issue generally meets the private loan financing test if more than the lesser of 5 percent or \$5 million of its proceeds are used to make loans to nongovernmental persons. Section 1.141-5(c)(1) states that, for purposes of the

private loan financing test, a loan may arise from the direct lending of bond proceeds or may arise from transactions in which indirect benefits that are the economic equivalent of a loan are conveyed. Thus, the determination of whether a loan is made depends on the substance of a transaction rather than its form. See also H.R. Conf. Rep. No. 99-841, pt. 2, at 692.

The existing regulations, at §1.141-5(c)(2)(ii), provide that a prepayment for property or services generally is treated as a loan for purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of taxexempt financing to the seller. However, under the existing regulations a prepayment is not treated as a loan for purposes of the private loan financing test if (1) it is made for a substantial business purpose other than providing a benefit of tax-exempt financing to the seller and the issuer has no commercially reasonable alternative to the prepayment; or (2) prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing. The proposed regulations amend the private loan provisions of §1.141-5(c)(2) to conform to the amendments to the definition of investment-type property in this notice of proposed rulemaking.

# Proposed Effective Date

The proposed regulations will apply to bonds sold on or after the date of publication of final regulations in the **Federal Register**. However, issuers may apply the proposed regulations in

whole, but not in part, to any issue that is sold on or after the date the proposed regulations are published in the **Federal Register** and before the effective date of the final regulations.

### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

## Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight copies) to the IRS. The Treasury Department and IRS specifically request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 24, 2002, at 10 a.m. in the Auditorium, Internal Revenue Building, 1111

Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the lobby more than 30 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments by July 16, 2002, and submit an outline of the topics to be discussed and the amount of time to be devoted to each topic by September 10, 2002.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### Drafting Information

The principal authors of these regulations are Rebecca L. Harrigal and Johanna Som de Cerff, Office of Chief Counsel (TE/GE), IRS, and Stephen J. Watson, Office of Tax Policy, Treasury Department. However, other personnel from the IRS and Treasury Department participated in their development.

## List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

#### Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. In §1.141-5, paragraph (c) is amended as follows:

1. Paragraph (c)(2)(ii) introductory text is revised.

2. Paragraph (c)(2)(ii)(A) is revised.

3. Paragraph (c)(2)(ii)(B) is amended by removing the period at the end of the paragraph and adding a semicolon in its place.

4. Paragraphs (c)(2)(ii)(C), (c)(2)(ii)(D), and (c)(2)(iii) are added.

The revisions and additions read as follows: <u>§1.141-5</u> Private loan financing test.

\* \* \* \* \*

(C) \* \* \*

(2) \* \* \*

(ii) <u>Certain prepayments treated as loans</u>. Except as otherwise provided, a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, is treated as a loan for purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller. A prepayment is not treated as a loan for purposes of the private loan financing test if-

(A) The primary purpose for the prepayment is to accomplish one or more substantial business purposes that--

 $(\underline{1})$  Are unrelated to providing any benefit of tax-exempt financing to the seller; and

(<u>2</u>) Cannot be accomplished without the prepayment; \* \* \* \* \*

(C) The prepayment is made within 90 days of the date of delivery to the issuer of all of the property or services for which the prepayment is made; or

(D) The prepayment meets the requirements of §1.148-1(e)(2)(ii) (relating to certain prepayments to acquire a supply of natural gas).

(iii) <u>Additional prepayments as permitted by the</u> <u>Commissioner</u>. The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment is not treated as a loan for purposes of the private loan financing test.

\* \* \* \* \*

Par. 3. In §1.148-1, paragraphs (e)(1) and (2) are revised to read as follows:

## <u>§1.148-1</u> Definitions and elections.

\* \* \* \* \*

(e) <u>Investment-type property</u>--(1) <u>In general</u>. Investmenttype property includes any property, other than property described in section 148(b)(2)(A), (B), (C) or (E), that is held principally as a passive vehicle for the production of income. For this purpose, production of income includes any benefit based on the time value of money.

(2) <u>Prepayments</u>--(i) <u>In general</u>. Except as otherwise provided in this paragraph (e)(2), a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, also gives rise to investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. A prepayment does not give rise to investment-type property if--

(A) The primary purpose for the prepayment is to accomplish one or more substantial business purposes that--

 $(\underline{1})$  Are unrelated to any investment return based on the time value of money; and

(2) Cannot be accomplished without the prepayment;

(B) Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing;

(C) The prepayment is made within 90 days of the date of delivery to the issuer of all of the property or services for which the prepayment is made; or

(D) The prepayment meets the requirements of paragraph(e)(2)(ii) of this section.

(ii) <u>Certain prepayments to acquire a supply of natural gas</u>
--(A) <u>In general</u>. A prepayment meets the requirements of this paragraph (e)(2)(ii) if--

(<u>1</u>) It is made by or for one or more utilities that are owned by a governmental person, as defined in §1.141-1(b) (<u>municipal utility</u>), to purchase a supply of natural gas; and

(2) At least 95 percent of the natural gas purchased with the prepayment is to be consumed by retail gas customers in the service area (as defined in paragraph (e)(2)(ii)(B) of this section) of a municipal utility, or used to produce electricity that will be furnished to retail electric customers that a municipal utility is obligated to serve under state or Federal law. An obligation that arises solely by reason of a contract is not an obligation to serve under state or Federal law.

(B) <u>Service area</u>. For purposes of paragraph
(e)(2)(ii)(A)(<u>2</u>) of this section, the service area of a municipal utility shall consist of--

(<u>1</u>) Any area throughout which the municipal utility provided (at all times during the 5-year period ending on the issue date) gas transmission or distribution service, and any area that is contiguous to such an area; or

(2) Any area where the municipal utility is obligated under state or Federal law to provide gas distribution services as provided in such law.

(C) <u>Commodity swaps</u>. A prepayment does not fail to meet the requirements of this paragraph (e)(2)(ii) by reason of any commodity swap contract that may be entered into between the issuer and an unrelated party (other than the gas supplier), or between the gas supplier and an unrelated party (other than the

issuer), so long as each swap contract is an independent contract. A swap contract is an independent contract if the obligation of each party to perform under the swap contract is not dependent on performance by any person (other than the other party to the swap contract) under another contract (for example, a gas supply contract or another swap contract).

(iii) <u>Additional prepayments as permitted by the</u> <u>Commissioner</u>. The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment does not give rise to investment-type property.

(iv) <u>Examples</u>. The following examples illustrate the application of this paragraph (e)(2):

Example 1. Prepayment after contract is executed. In 1998, City A enters into a ten-year contract with Company Y. Under the contract, Company Y is to provide services to City A over the term of the contract and in return City A will pay Company Y for its services as they are provided. In 2004, City A issues bonds to finance a lump sum payment to Company Y in satisfaction of City A's obligation to pay for Company Y's services to be provided over the remaining term of the contract. The use of bond proceeds to make the lump sum payment constitutes a prepayment for services under paragraph (e)(2)(i) of this section, even though the payment is made after the date that the contract is executed.

Example 2. Prepayment necessary to accomplish substantial business purpose. Authority is a governmental unit that furnishes electricity to the general public. In 1995, Authority enters into a 15-year agreement (the Agreement) with Power Company to obtain certain of its power requirements. In 2003, Authority enters into another contract (the Purchase Contract) with Power Company to obtain a specified amount of additional firm power through 2013. The rates paid by Authority under the Purchase Contract are based on a fixed capacity charge, which reflects Power Company's average cost of certain plants and equipment, and a variable energy charge, which reflects Power Company's average system energy costs to operate the utility, primarily fuel costs. Simultaneously with entering into the Purchase Contract, Authority issues a \$30 million issue with a 6

percent yield and uses the proceeds to make a lump sum payment to Power Company to prepay for the entire fixed capacity charge under the Purchase Contract. Authority pays the variable energy charges as energy is actually delivered. Power Company reports the lump sum payment for Federal tax purposes as income from the sale of capacity. Power Company also agrees to certain concessions under the Agreement, including the elimination of floors on capacity charges and a moratorium on capacity charge increases for five years. The discount rate used to compute the amount of the prepayment is 18 percent, compounded semi-annually. Power Company's taxable borrowing rate for a loan of a comparable size to the prepayment, with a term that coincides with the term of the Purchase Contract, is 8 percent, compounded semiannually. The prepayment allows Power Company to offer a low capacity charge to Authority, yet prevent other wholesale customers from taking advantage of the proposal. Under Federal rate-making quidelines, if Power Company had offered Authority a contract based on fixed periodic capacity charges, Power Company would have been obligated to offer the same capacity charges to its other wholesale customers (which would have been expected to accept the offer). Power Company is willing to offer Authority the lower capacity charge and to make the other concessions because it owns surplus generating capacity. Thus, it is important to Power Company to maintain its customer base. The loss of a significant customer such as Authority would require that Power Company either succeed in obtaining regulatory authorization to increase its rates charged to other customers or suffer a diminished return on capital. Power Company will not build additional generating facilities directly or indirectly by reason of its obligations under the Purchase Contract, and at the time it entered into the Purchase Contract, it had already incurred capital costs of facilities, which, if allocated to Authority's demands for energy under the Purchase Contract, would exceed the up-front capacity

charge. Under paragraph (e)(2)(i)(A) of this section, the prepayment does not give rise to investment-type property.

\* \* \* \* \*

Deputy Commissioner of Internal Revenue.