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Ideas for Responding to Global Climate Change

By Russell S. Frye and Roy S. Belden, in Washington

The "Framework Convention on Climate Change," adopted at the United Nations Earth Summit in 1992, envisions long-term solutions to a long-term problem. With the adoption of the "Kyoto Protocol" to the convention a year ago, and its signature by the United States in November, more specific deadlines and requirements are beginning to take shape. The Kyoto Protocol requires the so-called Annex I countries (basically, the OECD plus most of the Warsaw Pact) to reduce their greenhouse gas emissions by varying amounts, averaging 5.8%, below a 1990 baseline. Five-year average emissions in 2008-2012 are supposed to meet this target. While a 5.8% reduction may seem relatively insignificant, it will represent approximately 20-40% less than what those countries are projected to emit but for the Kyoto Protocol commitments.

This article highlights issues that anyone negotiating power purchase agreements or involved in financing projects or acquiring assets in the energy sector should keep in mind.

Although the United States has not yet ratified the Kyoto Protocol, many countries already have, and some have begun translating the commitments it contains into enforceable requirements. And regardless of whether the United States ever ratifies the Kyoto Protocol, at this point it is virtually certain that some measures to reduce greenhouse gas emissions will be required in the US.

1. Contracts being negotiated now should anticipate the likely increased costs associated with climate change mitigation measures

Power plant siting boards in the United States, New Zealand, and elsewhere have already demanded offsets for new projects (by

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POWER MARKETERS ARE UP IN ARMS about a January 1 letter from the deputy commissioner of taxes in New York.

The letter said fees paid to power marketers for delivery of electricity are subject to state sales tax. This reverses a position the state took in 1997.

New York subjects to sales tax "receipts from every sale...of gas, electricity, refrigeration and steam, and gas, electric, refrigeration and steam service of whatever nature." Sales for resale are exempted. The state ruled in 1985 that "contract carriage" of natural gas is not subject to sales tax.

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Global Climate Change

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reducing greenhouse gas emissions elsewhere or implementing greenhouse gas sequestration projects (mainly reforestation or forest preservation plans)). The countries that have agreed in the Kyoto Protocol to reduce greenhouse gas emissions over the next 10 years will have to impose emission reduction requirements on existing sources, in addition to requiring offsets for new sources.

Existing emissions of greenhouse gases now have value.... This means that at some point someone may be willing to pay for a facility to reduce its emissions.

A carbon tax is now being debated seriously in the European Union, is already imposed in a few countries, and has been discussed in the US. The tax could be on fuel consumed, gases emitted, or even fuel sold. The tax may be imposed on the person generating electricity, the person using electricity, or the person producing the fuel that is consumed. Some analysts have suggested it might be necessary to set the tax at somewhere in the $20-40 per ton of carbon range in order to get the reductions necessary to meet the Kyoto Protocol commitments for CO_2 emission reductions from the United States and some other countries. For a 300 megawatt plant, this could mean as much as $20 million a year in increased taxes. All of these future costs need to be considered in drafting long-term contracts for fuel supply or power sales.

2. Existing emissions of greenhouse gases now have value that should be accounted for.

Most of the likely scenarios for compliance programs involve the potential for one source to get credit for reducing greenhouse gas emissions at another source, either within the country or in some cases abroad. This means that at some point someone may be willing to pay for a facility to reduce its emissions (for example, by shutting down or improving efficiency). Existing sources of methane, such as landfills and coal mines, also now have value. (Since methane is 25 times more effective at trapping heat in the atmosphere than CO_2, capturing methane and burning it effects a reduction in greenhouse gases.)

The value of these existing emissions needs to be recognized and addressed in acquisitions, negotiations to sell power, and the like. Exiting emissions need to be documented, and reductions in emissions need to be documented, as do carbon sequestration projects. (In the United States, the Department of Energy has a mechanism for doing so under section 1605 of the Energy Policy Act of 1992.)

One example of how these issues may arise: If an independent power company contracts with a utility to supply electricity currently being generated by that utility, who gets the credit for the reduction in greenhouse gases emitted by the utility? Who gets the credit for the reduction in aggregate greenhouse gas emissions from both plants, achieved because the IPP is more efficient than the utility generator it replaced? Over the life of a power plant, resolution of these questions could involve hundreds of millions of dollars.

3. Companies in the power or fossil fuel business may want to begin developing hedging strategies, especially if they are relatively "long" on carbon compared with their competitors.

Due to differences in efficiency, fuel sources, raw materials, and processes, some companies will have much higher greenhouse gas emissions per unit of production than others. Such companies should be evaluating, and may want to begin executing, various types of hedging strategies, like purchasing options, swaps, bundling of

fuel with carbon dioxide emissions credits, voluntary early action agreements with the government, and so forth. The cost of hedging will undoubtedly go up as the 2008-2012 compliance period approaches. Millions of tons of CO_2 options have already been traded in private transactions.

4. Laws and procedures to implement the Kyoto Protocol greenhouse gas reduction commitments are beginning to be developed in many of the "Annex I countries" covered by those commitments.

The way those rules get written will have a big role in determining who are the winners and losers in the climate change "game." In particular, the new rules could present substantial barriers to independent power companies, who have little or no existing emissions that can be offset against emissions from their new facilities. A company investing tens of millions of dollars in development of a power project might be wise to invest some time and effort in assuring that it will not be impeded by new climate change requirements that may be adopted.

5. Companies that are publicly held or that make offerings of securities need to examine the reporting and disclosure obligations associated with climate change.

SEC regulations in the US require that anticipated material expenditures for environmental protection be specifically called out in registration statements and prospectuses. While it may be appropriate to say nothing or only make a general statement about facilities using fossil fuel in the United States, since the Kyoto Protocol has not yet been presented to the Senate for ratification, many other countries have already ratified the Kyoto Protocol, and some have begun imposing new requirements to implement their commitments for greenhouse gas reductions, so disclosure of the impact of such requirements, at a minimum, might be necessary. ■

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The contract carriage in the 1985 ruling was transportation by a pipeline company of natural gas owned by a consumer. The pipeline company never took title to the gas; it simply provided transportation services. Essentially the same ruling was issued for electricity in January 1997.

New York has now decided the electricity ruling was wrong. Steven U. Teiltelbaum, deputy commissioner of taxes, explained in a January 1 letter that electric utilities used to provide bundled services and collect sales tax on the entire charge to the consumer. The state does not see why the result should be different now that services are unbundled. The letter fails to explain why electricity transportation should be treated any differently than gas transportation has been historically.

The tax department is expected to issue a longer memorandum on the subject in the coming weeks. The change takes effect on April 1.

BRAZIL INCREASED SOME TAXES and is considering reforming others.

The Brazilian Senate voted on January 6 to extend a financial transactions tax, called CPMF, for three years and to increase the rate from the current 0.2% to 0.38% in 1999 and 0.3% in 2000 and 2001. The tax applies to all banking transactions. A second-round vote will be held in the Senate on January 19, after which the proposal will go to the Chamber of Deputies.

The rate for social security contributions by companies, known as COFINS, will increase from 2% to 3% on February 1. The rate is applied to gross receipts of a company. The extra 1% will be creditable against corporate income taxes, but the credit must be used in the same year. It cannot be carried forward. The increase has the effect of increasing tax collections from companies with tax losses.

Meanwhile, the government sent a broad tax

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Claiming R&D Tax Credits on Projects

By Keith Martin and Heléna Klumpp, in Washington

The Internal Revenue Service proposed in early December how to define "research" that qualifies for a 20% federal tax credit.

The definition is important to power, mining and telecoms companies experimenting with new technologies. The more tax benefits a company can build into its project, the less than project will cost at the end of the day.

The tax credit will be difficult to claim for most projects.

If a company qualifies for an R&D credit, then it can compute the credit in one of two ways. Under one approach, the credit is 20% of the amount by which the company increased its research spending.

In order to claim a credit, a company must show it spent money on experiments that have the aim of improving technology. The company will have to jump through four hoops to do this.

First, the aim must be to discover new information. The IRS gave the example of a manufacturing company that makes widgets, but wants to use a new material. The company lacks experience with the material, but how to use the material ***is within the common knowledge*** of other skilled professionals in the industry. This is not "research." However, where a company wants to build a bridge that can carry a higher volume of traffic than other bridges without deterioration, its work on the technology to build the bridge does qualify. The IRS said it does not matter if someone else has already built such a bridge if the technology is a closely-guarded secret.

Second, research is a process of experimentation. The company should have more than one hypothesis for how to achieve a result and be uncertain which is better. It should run tests to determine which hypothesis is better.

Third, the activity must precede commercial operation. Activity after a project is in commercial operation is not research. The IRS said tooling up for production, trial production runs and trouble shooting are not research. Thus, a power company could not claim the cost of a turbine as research on grounds that the turbine was the first of its kind off the production line. However, the turbine manufacturer might claim that it was still engaged in research if it ran a test model before the model was in production.

Fourth, it is not research simply to adapt an existing product or process to a company's needs. An example is customizing software so that a utility can use computers to dispatch electricity.

The cost of computer software developed for a company's own internal use qualifies for credits only if the software is innovative, it involves significant economic risk to develop, and it is not otherwise available. The IRS said it would not allow tax credits to be claimed for fixing year 2000 problems with computer software.

If a company qualifies for an R&D credit, then it can compute the credit 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. For example, if research spending in 1999 is $6 million, but the company's "base" spending on research was $4 million, then the credit is computed against the $2 million increase. The base is gross receipts for the year times the fraction of the company's gross receipts that it spent on research during a five-year period from 1984 through 1988. Companies that had no research during this period are arbitrarily assigned a base of 3% of annual gross receipts. Research spending must exceed this amount before there is any credit.

Calculations are done by treating all business entities that are more than 50% owned as a single taxpayer.

The government will not let a company treat more than half its research spending in a year as an increase in its research spending. For example, if research spending mushroomed one year, the government would limit the credit for that year to 20% of half the research spending that year.

The other way to compute credits is under a sliding formula. A company would have to spend more than 1% of its gross receipts in a year to get a credit. The credit would be 1.65% of research spending above 1% of gross receipts, 2.2% of such spending above 1.5% of gross receipts, and 2.75% of research spending above 2% of gross receipts.

The new definition of research is in proposed regulations the IRS published in the Federal Register on December 2. The agency is looking for comments.

The R&D tax credit expires on June 30, 1999, but Congress is expected to extend it. ■

Saudi Arabia Overhauls Electricity Supply

by Kevin Jordan and Stephanie Conaghan, in London

The Council of Ministers in Saudi Arabia approved proposals for a significant restructuring of its electricity sector on November 30. The changes are the result of almost two years of internal deliberation on how to meet the high projected growth levels in electricity consumption in the Kingdom for the next 20 years. The changes are also directed at better facilitating foreign investment in the power sector.

Reforms

The principal reforms are as follows:

- a decision has been made to merge all electricity companies into one joint stock

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reform plan to Congress in late November, its third since 1995. Under the plan, a value added tax would be levied at the federal level, with a uniform rate structure and base, in place of so-called ICMS taxes that are collected currently by states. A new federal excise tax would also be imposed on a limited number of products, including telecommunications, energy and fuel. The COFINS tax would be eliminated. The CPMF tax on financial transactions would be made permanent.

There is still no consensus among political leaders about the broad reforms. The finance minister said he hopes they will pass Congress during 1999 so that they can take effect on January 1, 2000. Congressional leaders expect a vote on the reform plan in June.

MCI FOUND A WAY TO ELIMINATE SALES AND USE TAXES on construction costs for a project.

The company is building a telecommunications switching station in Westchester County. The county industrial development authority will own the project and lease it to MCI with an option for MCI to buy the project at the end of the lease. In the meantime, MCI will act as the IDA's agent for purposes of arranging construction of the project. New York normally collects sales and use taxes on equipment purchased for use in the state. However, equipment purchases by governmental entities are exempted from tax. The exemption may be claimed by anyone acting as an agent for a governmental entity.

The New York Department of Taxation and Finance issued an "advisory opinion" to MCI recently confirming that no taxes need be paid on the project, including the rents and purchase option price that MCI will pay to the IDA under the lease.

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company, Saudi Electric Company (SEC), resulting in the dissolution of the General Electricity Organization (GEO) and the merger of the four Saudi Consolidated Electricity Companies and other smaller electricity companies in various provinces into the new SEC.

- New increased electricity tariffs will be effective a month after SEC is launched.

SEC will be able to establish and own subsidiary companies for electricity power generation and distribution. It is anticipated that the merger of the electricity companies will strengthen the sector and enable SEC to set up large generating plants and link different regions with a single power grid, while at the same time reducing the cost of production and distribution.

Background

Saudi Arabia needs approximately SR438 billion (US$116.2 billion) for electricity projects in the next 20 years. Annual growth of power demand in the Kingdom is estimated at 4.5 per cent. This will necessitate an increase to the country's power generating capacity from the current 21,000 megawatts to 70,000 megawatts by the year 2020.

Electricity in Saudi Arabia is currently produced and supplied to the central, eastern, western and southern regions by four vertically integrated Saudi Consolidated Electricity Companies (SCECOs). The northern region is supplied by the Electricity Corporation, except Tabuk, Haql, Tayma, Dawmat, Al Jandal, Rafha and Arar are supplied by six smaller electricity companies. SCECOs are joint-stock companies operating under the supervision of the Ministry of Industry and Electricity. The government owns 78% of the equity of all eleven companies; the remaining equity is owned by the private sector. Each region has its own electricity transmission grid. Only the central and eastern grids are linked together.

The four SCECO companies have been running at a deficit because of charges to consumers that are lower than production costs. Government subsidies to the four SCECO companies amounted to SR32 billion (US$8.5 billion) in 1997 while loans reached SR28.6 billion (US$7.5 billion).

A willingness to address … other concerns will determine whether Saudi Arabia is going to become a viable market in future for private investors interested in the project financing of power projects.

The proposed reforms are a clear acknowledgment by the government that the current system in which power generation and distribution is divided between four regional SCECOs and seven other regional companies is unsustainable. The SCECOs have been burdened with heavy losses for many years. Unable to sell power at cost, they have had to rely on unpredictable treasury subsidies to remain solvent. When times are hard (and the price of oil is the primary determinant of this) they have been the first to have their payments deferred by the government, leaving them short of capital and unable to plan effectively for the future.

Forces Prompting Change

Saudi Arabia's impressive developing industrial economy, together with its subsidized rates for electricity and high population growth, have created a demand for electricity that is far greater than existing capacity. Between 1985 and 1995 demand for electricity increased by over 300%. During the same 10-year period, however, the SCECOs increased their load capacity by only 50%. Recent dramatic falls in oil prices also galvanized the Council of Ministers into action. Other factors cited as the

reasons for the new policy include the need to attract private sector investment into new power projects, raise tariffs to permit gradual reduction in government subsidies, link the western and central electricity grids, and link up to a proposed regional grid serving members of the Gulf Cooperation Council.

Lingering Difficulties

Indecision on the part of the Saudi authorities administering power projects is one of the main criticisms cited by many developers with respect to their activities in the region.

The last couple of years have seen a reluctance on the part of the Saudi authorities to assist in providing the necessary elements to make classically-structured project financing viable. Projects have been funded either on a delayed payment basis (e.g., the 1,200 megawatt PP9 project north of Riyadh being built by GE) from funds contributed (through increased electricity tariffs) by wealthy domestic users to a fund set up by the Saudi authorities, or on the basis of corporate loans (e.g., the Ghazlan-2 expansion project). Neither of these methods of financing has proved particularly attractive to developers.

The difficulties in carrying out a privately-financed power project have been particularly evident in the recent process of awarding a contract to build the Shuaiba plant. More than five international consortia submitted bids to the Saudi Consolidated Electric Company for the western region in May 1997 to build the 1,750 megawatt plant on a build-own-operate (BOO) basis. One year later, the Saudi authorities decided not to proceed with the BOO option. A delayed payment scheme was then considered and dropped. It is still not certain what the structure will be.

Enough Reform?

Provided SEC is adequately capitalized, the

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THE IRS CRACKED DOWN ON "FAST-PAY STOCK."

This is stock that pays such large dividends that the dividends represent not only a return on the shareholder's investment, but also at least partly a return of that investment. An example is so-called step-down preferred shares that have an annual dividend rate of 11% of the issue price each year for the first 10 years, and then 3% thereafter. Another example is where the dividend rate remains 11% for as long as the shares remain outstanding, but the corporation has a right to redeem the shares for 40% of the issue price after 10 years. In each case, the dividend is at least partly a repayment of the issue price for the shares.

Fast-pay shares have features in common with debt. However, the company using them prefers to call its debt service "dividends." There may be tax benefits from doing this. For example, a real estate investment trust, or REIT, borrowing from a foreign lender can reduce the US tax hit on income used to repay principal. REITs are passthrough entities. Shareholders are taxed on their shares of the REIT's income like partners in a partnership. However, if principal paid to a foreign lender is called a "dividend," then the other shareholders are not taxed on this income. The foreign lender is exposed to a US withholding tax, but at only a 30% rate, and the rate may be reduced by tax treaty.

The IRS said in proposed regulations the first week in January that it will recharacterize all fast-pay arrangements involving REITs and regulated investment companies, or RICs. It may recharacterize them in other cases where "a principal purpose" of the arrangement is to reduce US taxes. The IRS action is retroactive to February 27, 1997, perhaps as a sign of growing IRS impatience with aggressive tax planning.

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announced changes will do much to allay existing private investor concerns about the credit worthiness of the SCECO companies. The revised tariff structure may also act as a significant impetus to private sector investment. While investors will no doubt welcome the changes which have been announced, the approach by the Kingdom to other important concerns that potential investors have often raised in the past will need to be considered seriously during implementation of the reforms. A willingness to address these other concerns will determine whether Saudi Arabia is going to become a viable market in future for private investors interested in the project financing of power projects.

Developers still have the following concerns:

- whether the regulatory system will be adequately clarified for private electric power producers;
- whether government support will be necessary or available for a power purchase agreement (PPA). The fundamental question is whether SEC will become a creditworthy purchaser or whether some government support will be necessary to ensure that it will have adequate funds to meet its obligations under any PPA;
- determining the precise role of the government as a shareholder and the extent of the control which it may wish to retain over any project;
- whether the fuel supply arrangements with Aramco, the government-owned oil and gas company, can be satisfactorily negotiated to meet foreign investors' expectations;
- whether an adequate security package over project assets will be available, allowing lenders to register mortgages and direct the sale of real property in the event of default;
- whether a percentage of the construction work for a project will have to be carried out by a Saudi entity;
- whether the rules for obtaining concession agreements, site leases and other permits from the government will be adequately clarified;
- whether foreign law and arbitration will be acceptable together with enforcement of foreign arbitral and judicial awards in the Kingdom; and
- whether private producers will be allowed to sell electricity directly to industrial end-users. ■

Trouble Getting Lender Liens Over Reserve Accounts

By Philip D. Beaumont, in Washington

Differences of opinion are cropping up in project financing deals where lenders seek security interests in collateral accounts set up to hold reserves to service debt, satisfy maintenance obligations and so forth. Most lenders and their lawyers are treating these cash collateral accounts as "securities accounts" governed by revised Article 8 under the Uniform Commercial Code, or UCC, but others are questioning the appropriateness of doing this.

How the accounts are treated is important, because it affects how lenders should perfect their security interests in the accounts.

Revisions to Article 8 have been adopted in all but two states (South Carolina and Rhode Island), with effective dates from 1995 to 1998. Prior to the revisions, cash collateral accounts were treated as "deposit accounts," and lenders in most states had to be sure they had "exclusive dominion and control" over the accounts in order to perfect their security interests. (Perfection is necessary to avoid the risk of losing priority to other creditors of the borrower.)

Even with this control, certainty that perfection had been achieved was not possible in many states, including New York, due to lack of clarity under case law.

The revisions to Article 8 clear up these perfection issues for "securities accounts." However, whether cash collateral accounts are "securities accounts" is not clear.

Arguments for "Securities Accounts"

Lenders and their lawyers arguing that cash collateral accounts are governed by Article 8 point to the definition of "securities account," which means an account to which a financial asset "is or may be credited." They argue, first, that cash can be a financial asset and, second, that even if it is not a financial asset, the account falls within the definition because it "may be" credited with a financial asset in the future.

In the securities account control agreement that is now commonly entered into to set up these accounts as Article 8 "securities accounts," the parties usually agree that cash is to be treated as a "financial asset," thus (the argument goes) satisfying the definition of "financial asset," i.e., "any property" if the institution maintaining the account (called a "securities intermediary") expressly agrees to treat it as such. The proponents also point to the official comment to section 9-115, which states that "a security interest in a securities account would include *credit balances* due to the debtor from the securities intermediary, whether or not they are proceeds of a security entitlement." (Emphasis added.)

Alternatively, as long as the funds in the account "may be" invested in securities, then the account satisfies the definition without regard to whether cash is a financial asset. There is no requirement that securities be credited to the account on day one, i.e., the moment the account is established; all that is needed is documentation that permits this to happen sometime

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Interestingly, the IRS seems concerned only about use of fast-pay stock to reduce US taxes. A fast-pay shareholder might still benefit in a foreign country from claiming payments are an equity return rather than a return on lending even where there is no US benefit.

SECTION 861 STRUCTURES COME UNDER FIRE . . . Lee Sheppard urged the government, in an article in late December in *Tax Notes* magazine, to attack so-called 861 structures that many US companies are using to burn off "overall foreign losses." The structures make the companies better able to use foreign tax credits. They involve debt loops where cash is circled among related parties. Sheppard argues that the government has authority to ignore the debt and to invoke partnership "anti-abuse regulations" to deny favorable US results from inserting partnerships in the ownership chain. *Tax Notes* is widely read at the IRS and by the staffs of the tax-writing committees in Congress. Sheppard is a contributing editor of the magazine.

THE UNITED STATES IS RETHINKING WHEN US MULTINATIONALS should be allowed to defer US taxes on foreign earnings.

The current rules date back to 1962. Donald C. Lubick, the assistant Treasury secretary for tax policy, told a tax audience in December that the government is in the initial stages of a comprehensive review. Many of the rules are out of date. Lubick said the review should be completed by summer, and everything is on the table.

Many US multinationals set up offshore holding companies in tax havens to receive earnings from foreign operations and redeploy them abroad. US taxes are deferred as long as the earnings remain offshore. However, this strategy works only to the extent the holding company

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in the future. And because the relevant credit documentation (usually) permits funds in the account to be invested in securities, this does, indeed, satisfy the definition of “securities account.”

Arguments for Something Else

The opposing voices argue that only incidental cash, such as occasional credit balances in an account that otherwise is actively invested in securities, was intended to be covered. Lawyers maintaining this position still insist on “exclusive dominion and control” language to establish a security interest in cash.

This position also has significant merit. The official comments to the UCC state that, in determining whether an account is a “securities account,” what matters most is whether the institution maintaining the account has undertaken to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the “financial assets” credited to the account. When one looks at these rights, they speak in terms of rights associated with holding securities, e.g., obtaining payments and distributions (section 8-505), exercising voting rights (section 8-506), and redeeming and transferring the underlying financial assets (section 8-507). These are not rights associated with holding cash. Furthermore, the definition of financial asset, although it does speak of “property,” was not intended to encompass cash. This strained construction also takes the official comment to section 9-115 out of context. The “credit balances” referred to are only incidental balances in an account otherwise actively invested in securities.

Investing in Time Deposits

The issue may be more important than it appears because, despite a broad array of governmental and corporate securities included in the typical definition of “permitted investments,” in practice many such accounts are invested only in time deposits. Time deposits often are treated under the UCC like a “deposit account” that is expressly excluded from coverage under Article 9 of the UCC in most states and cannot be a financial asset under Article 8. If time deposits are the equivalent of deposit accounts for purposes of Article 8, it may be that many of these accounts *never* get invested in *any* financial asset.

Covering All the Alternatives

How, then, should lenders perfect their security interest in these accounts and the underlying mixture of financial assets, cash and time deposits credited to the accounts? Probably the best approach is to cover all the alternatives. In the credit agreement (or in a separate securities account control agreement), the secured parties, the borrower and the securities intermediary would agree that the accounts will be treated as “securities accounts” under Article 8 and that cash and time deposits will be treated as financial assets for purposes of Article 8, but that, to the extent the accounts are not deemed to be securities accounts, or cash or time deposits therein are not deemed to be financial assets, the securities intermediary, as agent for the secured parties, shall have and will exercise exclusive dominion and control over them.

Proposed Article 9 Revisions Will Help

The effect of the distinction between “securities accounts” and “deposit accounts” will become less important after proposed revisions to UCC Article 9 are adopted, hopefully this year. Under the proposed revisions, it will be possible to perfect a security interest in deposit accounts under the UCC. This should eliminate the need to stretch to include cash collateral accounts as “securities accounts” under Article 8, while at the same time eliminating the need to rely on “exclusive dominion and control” concepts to establish security interests. ■

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receives "active" income, like revenue from electricity sales, rather than passive income, like interest or dividends. The companies take pains to ensure that all entities below the holding company are transparent for US tax purposes to preserve the character of income as active as it moves up the ownership chain.

Meanwhile, Stuart LeBlang suggests in a long article in *Tax Notes* magazine that there be some easing of current rules to make it easier to defer US taxes, but on condition that offshore holding companies be required to repatriate at least a minimum percentage of their earnings each year to the US where the earnings would become subject to tax. LaBlang worked until recently in the international tax policy office at Treasury.

THE IRS IS EXPECTED TO SHUT DOWN LILO TRANSACTIONS BY FEBRUARY . . . LILOs are a form of lease financing where a foreign company or US municipality leases rail cars or a power plant to a US equity and then subleases it back. The acronym stands for lease-in-lease-out. A senior Treasury official characterized the transactions in December as little more "than the US Treasury paying a foreign person a rebate on the price of some asset."

"CHECK-THE-BOX" rules will be tightened further.

These rules let US taxpayers classify foreign subsidiaries as corporations, partnerships or "disregarded entities" simply by mailing a form to the IRS. Donald C. Lubick, the assistant Treasury secretary for tax policy, said in December, "We are now considering a series of transactions facililtated by check-the-box that we never foresaw nor intended, and that may give rise to results inconsistent with the purposes of the statutes they seek to exploit. We are currently determining how best to address them."

MEXICO INCREASED TAXES after Congress approved the government's budget on New Year's Eve.

The corporate income tax rate increased from 34% to 35%. However, companies that reinvest profits can defer up to 3% of the tax, for a 32% rate this year. The deferred tax is paid at the time a dividend is paid to shareholders. Starting in 2000, companies reinvesting profits will be able to defer up to 5%. This will require maintaining a "reinvested profits account." When dividends are paid from the account, the deferred tax will be applied to the amount of the distribution multiplied by 1.5385. The gross-up is designed to account for the taxes already paid — in other words, it ensures that the deferred tax liability applies to the original amount of reinvested profits, not the lower, after-tax portion.

There is now also a 5% shareholder dividends tax. The company paying the dividends collects it by withholding. However, the free flow of dividends between Mexican companies has been maintained. Many companies made profit distributions at the end of 1998 to avoid the new tax.

Some benefits from consolidation have been eliminated. Starting this year, only 60% of the income or loss of a member of a consolidated group may actually be consolidated, regardless of the percentage ownership of the parent corporation. Thus, even if a parent corporation owns 100% of its subsidiary, it can only consolidate 60% of the subsidiary's profits and losses.

An immediate deduction for the cost of fixed assets has been repealed. The withholding tax on royalties that Mexican companies pay to foreigners has increased from 35% to 40%. Import tariffs have increased by 10% for products from countries with which Mexico does not have a free trade agreement.

The tax treatment of Associations of Partnerships, or AenP's, has changed. In the past, the active

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partner reported all the activity in the AenP in his tax return. Starting this year, the active partner must file a separate return for his share of the income, and passive partners will report their shares as dividends and be subject to the new dividends tax.

The Mexican Congress declined to enact a new 15% telephone service tax to be imposed on both residential and business customers. Talks on further tax reforms are expected to begin in February.

ARGENTINA ALSO INCREASED TAXES effective January 1, but there have been calls to overturn the changes when Congress reopens in March.

The corporate income tax rate increased from 33% to 35%. Argentina will impose a withholding tax for the first time on dividends. The rate is 35%. The tax applies only to the extent the dividends are paid out of income that went untaxed at the company level.

There are new restrictions on deducting interest on debt. Forty percent of interest will be deductible provided the debt does not run afoul of limits on borrowing from affiliates. However, the other 60% of interest will be deductible only if the debt-equity ratio of the company does not exceed 2.5 to 1 or the interest does not exceed 50% of adjusted net taxable income.

Finally, the withholding rate on interest paid to foreign lenders increased from 13.2% to 15.05%.

LOOK FOR GUIDANCE LATER THIS YEAR on the US tax treatment of international telecoms income. US Treasury officials are wrestling with a host of issues. A project is expected to appear on the IRS business plan for 1999.

"SOLID WASTE" may be redefined for tax purposes.

The definition is important because power plants that use solid waste for fuel qualify for tax-exempt financing and special depreciation allowances. "Solid waste" is defined currently as "useless, unused, unwanted, or discarded solid material which has no market or other value at the place where it is located."

The recycling industry is concerned that corrugated cardboard that recyclers purchase for different prices, depending on whether the cardboard is picked up at a loading dock or a collection system, may not qualify as waste. It wants the IRS to permit material to qualify as waste if its only value derives from demand for the material from recyclers or, alternatively, if it can be shown through general studies of the local waste stream that the material would otherwise end up in a landfill or incinerator.

Treasury officials have not decided yet whether to put the issue on the 1999 business plan.

LANDFILL GAS PRODUCERS want a tax credit for companies that consume landfill gas.

A lawyer for the Solid Waste Association of North America, or SWANA, sent the US treasury a draft bill in December to ask its support. The bill would allow a credit of 1.7¢ for each 12,159 Btus of landfill gas that a company consumes as fuel. The facility using the gas would have to be placed in service during a brief window period that ends in June 2004. Credits would run for 10 years from when the facility is placed in service.

MOST ECONOMIC SANCTIONS AGAINST INDIA AND PAKISTAN have been waived until October 21. The sanctions were imposed after both countries tested nuclear devices. President Clinton waived the sanctions temporarily by executive order. The waiver allows the US Export-Import Bank and Overseas Private Investment Corporation to resume activities in both countries, and it allows banks to makes loans to projects in which there is Indian or Pakistani government participation.

INDIA is expected to levy a new tax on electricity consumption, with 66% of the money to go to local

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governments to finance regional power projects.

The measure is espected to be in force by March 1999. The government is also expected to propose that the current policy of allowing a 10-year income tax holiday for private power projects be continued, but that a project have the ability to use the holiday at any time during the first 15 years after commercial operation.

Meanwhile, the Authority for Advance Rulings in New Delhi ruled recently that a Dutch company doing business in India was subject to minimum tax. The company had a "permanent establishment" in India in the form of a project office through which it executed several dredging contracts. India has a minimum tax that requires companies to pay income taxes based on 30% of "book income" in situations where taxable income would be less. The ruling settled a controversy whether the minimum tax applies only to domestic companies or also to foreign companies.

BULGARIA REDUCED ITS TAXES effective January 1 in the hope of spurring more investment.

The corporate tax rate has been reduced from 30% to 27%. A 5% investment tax credit has also been adopted to attract investments to municipalities where unemployment for the past five years exceeded 1.5 times the national unemployment rate.

Value added taxes have been reduced from 22% to 20% and made easier for big infrastructure projects to recover during construction. In the past, VAT on inputs could only be recovered against VAT on outputs after the company reached a high enough turnover rate to register as a tax collector. Effective January 1, companies with contributed capital of more than the equivalent of US$1 million will be allowed to register for up to a three-year period before turnover reaches the minimum required levels.

However, not all tax changes were for the better. Rules that prevent Bulgarian companies that are "thinly capitalized" from deducting interest payments have been extended to bank loans. A 50% income tax holiday for 10 years that was adopted in 1997 to encourage foreign investment has been repealed for new investments.

THE ROMANIAN PARLIAMENT voted in late November for a 10-year tax holiday on income from new investments exceeding the equivalent of US$50 million. Investments of between US$35 and US$50 million would qualify for a 75% exemption for seven years. The legislation also waives duties on imported technology.

RUSSIA RENEGOTIATED ITS TAX TREATY WITH CYPRUS after threatening last summer to cancel the treaty unilaterally.

Cyprus still remains the juridiction of choice from which to hold Russian investments. The treaty negotiations were concluded on December 5. The new treaty provides for 0% withholding tax on interest and royalty payments to tax residents of Cyprus. Dividends will be subject to 5% withholding tax, except for investments of the equivalent of US$100,000 or less, where the withholding tax will be 10%. Russia will not tax gain from the sale of shares by Cypriot shareholders in Russian companies. However, gain from the sale of any immovable property situated in Russia may be subject to Russian tax.

The new treaty will take effect on January 1 of the year following ratification by the Russian Duma and the Cypriot Council of Ministers. The existing treaty will continue to apply in the meantime.

INLAND REVENUE issued interim guidance in December for companies with global trading desks in London on how much income from trades should be allocated to the United Kingdom.

The guidance confirms that one way to keep such income outside the UK tax net is for a related party in another jurisdiction to supply the capital for the trades and assume the financial risk and pay a fee to the

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trading company for arranging trades. However, Inland Revenue said it would examine whether the person providing capital has a "permanent establishment" in the United Kingdom that would subject it to broader tax.

WATER UTILITIES CHARGE that the US government reneged on a deal involving tax treatment of water interties.

Homeowners require both a main water line and a wastewater line to connect to the utility. Real estate developers building new subdivisions usually reimburse the utility for the cost. The IRS is studying whether water utilities should report the payments as income. This is clearly the correct treatment for electric and gas interties. However, water utilities worked out a special deal with Congress in 1996 where they were supposed not to have to report certain amounts as income in exchange for less generous tax depreciation on their assets. There is disagreement over whether the deal covered these particular payments.

The National Association of Regulatory Utility Commissioners, or NARUC, sent a resolution to Treasury in mid-December endorsing the utility position.

BELL ATLANTIC lost a dispute in federal district court last month over investment tax credits.

Congress repealed the investment credit at the end of 1985. Many utilities have looked at whether they might still claim credits on equipment placed in service as late as 1990 under a transition rule that allowed credits on assets the utility needed to perform an existing "service or supply contract." The assets had to be "readily identifiable" in the contract. An example of readily identifiable assets is where an independent power company signed a power contract to sell electricity from a project the IPP planned to build.

Bell Atlantic argued that its franchise was such a contract because it had an obligation to serve customers. It also pointed to contracts with other telephone companies to interconnect.

The court disagreed. It said the franchises and agreements with other telephone companies were not the sort of contracts that Congress had in mind and, in any event, the equipment Bell Atlantic purchased was not "readily identifiable" in these documents. To allow such an expansive interpretation, the court said, would require the court to find that Congress "intended to permit every utility to claim the ITC for ... [its] routine business expenditures."

Bell Atlantic pointed to a statement by Senator Packwood — chairman of the Senate Finance Committee — during floor debate when the investment credit was repealed that cable television companies could qualify for relief based on their franchises. The court said this was different because "cable television providers are not regulated in the same manner as other utilities and Congress specifically chose to deal with [them] separately."

NEW JERSEY ENACTED LEGISLATION REQUIRING MUNICIPAL UTILITIES to pay corporate business tax if they make sales within a franchise area served by another electric utility.

Municipal utilities with eroding customer bases due to deregulation are under pressure to look outside city limits to ensure they retain a large enough revenue base to pay debt service on outstanding bonds. The debate has spilled over into Congress. Congress is expected to consider this year to what extent munis selling outside municipal boundaries should be forced to forfeit access to tax-exempt financing for their facilities.

AN EXECUTIVE WHO AGREES TO ACT AS THE "RESPONSIBLE PERSON" for payment of local taxes for his employer in a foreign country may be in for trouble.

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Carl Shen managed the branch office of Leo A. Daly Co. in Taiwan. He registered as the "responsible person" for payment of Taiwan taxes. Leo A. Daly Co. closed its Taiwan office in 1992 and terminated Shen. Shen remained in the country in an effort to start his own business. In 1995, Taiwan assessed Leo A. Daly Co. for back taxes for 1991 and 1992 and refused to let Shen leave the country until the taxes were paid. Shen eventually got an injunction in the US courts ordering Leo A. Daly Co. to pay the taxes, but it took over two years.

A federal district court ruled in Nebraska ruled last month on a series of cross motions in Shen's lawsuit against the company for breach of contract and "false imprisonment." The case is still pending.

US COMPANIES WITH OPERATIONS IN MEXICO may want to seek rulings on Mexican asset taxes.

Many countries in Latin America impose minimum taxes on asset value to ensure that some tax is paid even in cases where a company is otherwise reporting tax losses. The asset tax in Mexico is 1.8% of asset value. The value is generally gross value, without subtraction for debts. The Mexican Supreme Court ruled in a case recently involved Hyatt Regency Mexicana that this aspect of the asset tax is unconstitutional. The ruling is not binding precedent for other companies, but is expected to drive other capital intensive companies to seek similar rulings.

The case dealt with debts contracted through the Mexican financial system. It is unclear what the court would have said about ability to deduct debts with entities not residing in Mexico, such as debt owed to a US parent company.

PERUVIAN PRESIDENT ALBERTO FUJIMORI said recently that Peru will reduce its minimum tax from 0.5% to 0.2% of a company's assets.

INBOUND INVESTMENTS INTO CANADA should not be made with US LLCs, according to two Canadian lawyers.

The lawyers, with the firm Ladner Downs in Vancouver, write that Canada treats LLCs (limited liability companies) as corporations regardless of their US tax classification, and LLCs will not be considered residents for purposes of the US-Canadian tax treaty. The combination of these two factors means that business profits earned in Canada by a US LLC will not receive treaty protection and thus will be taxed fully in Canada, and payments of dividends, interest and royalties from Canada to a US LLC will be subject to full withholding tax of 25%.

ITALY ADOPTED CARBON TAXES in November in order to discourage use of fossil fuels other than natural gas. Similar measures are under consideration in the United Kingdom.

"FOREIGN SALES CORPORATIONS" are under attack before the World Trade Organization in Geneva. The US moved in December to dismiss the complaint on procedural grounds.

European countries complain that foreign sales corporations, or FSCs, are an illegal subsidy to promote US exports. FSCs are shell subsidiaries set up by US companies that export in order to reduce US income taxes on the export earnings. The FSC must be offshore. Many are formed in the US Virgin Islands or Bermuda. The US exempts as much as 30% of the export earnings on transactions run through FSCs. FSCs are also used in lease financings of US-made equipment that will be used offshore. US lessors pay reduced taxes on rents from FSC leases.

THE IRS SAID "STRONG PROOF" is not required to disavow the form of certain transactions between related parties.

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The government usually holds taxpayers to the form of a transaction when reporting tax results. An exception is where the company can produce "strong proof" that the transaction differs in substance from the labels used to describe it in legal documents.

Two sister companies had a common US parent. One sister company made a loan to the other. Later, they cancelled the loan and replaced it with a smaller amount of preferred stock. When a loan is cancelled, the borrower must ordinarily report "cancellation of indebtedness" income. However, in this case, the taxpayer argued that the cancelled debt was a constructive distribution to the common parent followed by a capital contribution by the parent to the borrower. An IRS agent questioned on audit whether the taxpayer should at least be required to provide "strong proof" of why it should be allowed to ignore its own form for the transaction. The IRS national office responded that transfers of excess consideration between sister companies are a special case where the tax treatment always follows the substance of the transaction regardless of its form. The statement is in a 1993 "field service advice" just made public.

US companies trying to strip earnings from foreign subsidiaries in a form that looks like an equity investment in the US but debt in the foreign country would still be well advised to use neutral terms in the legal papers so as not to have to overcome a "debt form."

TEXAS confirmed that manufacturing companies in the state do not have to pay sales taxes on natural gas they purchase to generate their own electricity. The advice came in a "taxability letter" the comptroller's office issued recently to a manufacturing company that makes plastic injection molding.

The state exempts from sales taxes natural gas and electricity "used in processing tangible personal property for sale as tangible personal property." In this case, the gas is effectively an input in manufacture of the plastic molding.

Texas told the owner of a petrochemicals refinery in a separate "taxability letter" that no sales taxes would be triggered by a sale-leaseback of the refinery because the transaction was really just a secured financing, even though it was set up as a sale-leaseback in form.

MINOR MEMOS: The Joint Tax Committee in Congress reported in December that 47.8 million Americans will escape income tax liability in 1998 due to deductions and credits. Most are in lower income brackets. The total number of taxpayers in the United States is 133.9 million . . . . Maine Yankee Atomic Power Company complained to the US Tax Court in a recent filing that the IRS will not let it deduct $4 million that it was assessed by Maine for construction of a low-level radioactive waste disposal facility. Maine Yankee insists that the payments are equivalent to taxes, while the IRS wants Maine Yankee to treat them as a cost of its nuclear power plant ...The US wants input from US businesses on whether it should renegotiate the current tax treaty with India . ...The IRS told a US company on audit that its foreign tax credits for Canadian taxes had to be reduced by the amount of investment credits and research credits that it used to reduce Canadian taxes. Only the net tax bill in Canada was creditable in the US. — *contributed by Keith Martin, Heléna Klumpp and Ken Hayduk.*

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