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US Congress Throws Tax Benefits At Project Finance Community

by Keith Martin, in Washington

Congress left Washington in early August after passing a $792 billion tax-cut bill with many provisions that are of interest to the project finance community. The bill faces a certain veto by President Clinton.

The real question is whether Republican Congressional leaders and the president will negotiate a smaller tax cut in the fall. If so, then the bill Congress passed will serve as a high-water mark for the negotiations. Here is what is in it that would affect companies involved in power, telecoms, toll roads and other infrastructure projects.

Section 45 credits

The bill extends a tax credit of 1.7 cents a kWh for generating electricity from wind and "closed-loop biomass" and adds 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. The credits run for 10 years after the project is put into service.

The bill extends this deadline for another four years through June 30, 2003.

Under current law, only the owner of the facility qualifies for credits. The bill would make an exception for power plants using poultry waste that are owned by a "governmental unit," like a municipal utility. In that case, a lessor of the power

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THE US TREASURY BELIEVES IT HAS AUTHORITY TO DISALLOW INTEREST DEDUCTIONS on new debt instruments like PHONES and DECS.

PHONES are a form of debt instrument a corporation might use to monetize shares it holds in another company. The acronym stands for "participating hybrid option note exchangeable securities." For example, COMCAST issued $718 million in PHONES in March this year tied to shares it owned in AT&T. The interest COMCAST paid on the PHONES was a function of the dividends it received from AT&T, and the PHONES converted at maturity into the full cash value of the underlying AT&T shares. DECS are a similar form of

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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.

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.

Foreign Tax Credits

The bill would make it easier for US companies to claim foreign tax credits starting in 2002.

This would help US businesses compete for projects in foreign countries since they would be less likely to face double taxes (same income taxed both by US and foreign country where it was earned). It would also help with a problem that many US multinationals have earnings trapped in offshore holding companies that they are loathe to bring back to the US for fear that repatriating the earnings will trigger taxes in the US.

The United States taxes American companies on worldwide income. It allows credit in theory to the extent the income was already taxed abroad, but almost no US power or telecoms company is able to claim foreign tax credits in practice.

The main problem is the interest allocation rules. The larger the percentage of a company's total income that comes from abroad, the more foreign tax credits it is allowed to claim. However, US rules require that a portion of the company's interest expense on borrowing to finance its operations in the United States be treated as a cost of its foreign operations. This interest is allocated between US and foreign operations in the same ratio as the company's assets are deployed at home and abroad. Thus, for example, if a US utility pays $600 million a year in interest on borrowing for its US operations and 6% of its total assets are abroad, then 6% times $600 million, or $36 million a year in costs must be allocated to its foreign operations. This reduces its foreign income in relation to its US income. The company may think it had $X in foreign earnings, but after subtracting allocated interest, the IRS will insist that really a much smaller portion of its income was from abroad. In fact, most US companies end up with a deficit in foreign earnings after this calculation that will take years to burn off. The result is no foreign tax credits.

Current US rules work on the theory that borrowed money is fungible. However, US multinationals complain that the principle ought to work both ways so that a portion of interest expense on foreign debt—for example, borrowing by a foreign subsidiary to finance a project in Brazil—is allocated away from foreign income and treated as a cost of its operations in the US. At first glance, it looks like Congress decided to let US companies allocate back to US operations part of the interest expense of some foreign subsidiaries. The foreign subsidiaries are ones in which the US company or

its US affiliates own more than 50% of the shares by either vote or value.

However, this is not quite what Congress did. No foreign interest expense will be charged to US operations. Instead, Congress set up a new formula that reduces the amount of domestic interest expense that will be allocated abroad starting in 2002. In many cases, it reduces it to zero.

The bill would also let US companies take some US debt out of the calculation altogether. A company would be able to elect to treat any domestic subsidiary in the US whose debts are not "guaranteed (or otherwise supported)" by a related company as essentially a standalone enterprise. However, there are two wrinkles. First, this election would have to be renewed every five years. Second, the subsidiary would be limited in the amount of dividends or other distributions it could make on its shares to its US parent each year. The limit is the average dividend it paid in each of the last five years or 25% of its average annual earnings during the last last five years, whichever is greater. Even though the foreign tax credit relief in the bill would not take effect until 2002, this limit on dividends applies immediately after the bill is enacted. If the limit is breached, the consequence is that the subsidiary will have to treat an amount of its debts equal to the excess dividend as regular debt subject to interest allocation.

Finally, the bill gives an additional boost to foreign tax credits, but not until 2006. (The Republicans in Congress were so eager to spend projected US budget surpluses that the bill is full of provisions that do not take effect until some time in the middle of next decade.) If, after interest allocation, a company shows a loss from its US operations—an "overall domestic loss"—then once it starts earning positive income again from US operations in future years, it will be allowed to change the label on some of those positive US earnings—relabel them as from foreign operations—until the overall domestic loss is burned off. This will help with

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debt instrument called "debt exchangeable into common shares."

Section 263(g) of the US tax code requires that interest paid on one leg of a "straddle" must be capitalized and treated as tax basis in the other leg.

Jeffrey Maddrey, an attorney-adviser at Treasury, said at an American Bar Association meeting in August that the government believes it can use section 263(g) to disallow interest deductions on PHONES. He made the same statement about DECS earlier in the summer.

Maddrey believes the IRS would have trouble applying section 263(g) retroactively and favors having the IRS clarify its regulations first and then apply the statute prospectively. The Clinton administration asked Congress in the last two budgets to "clarify" application of the straddle rules to structured financial transactions involving corporate stock. Congress did not act on the proposal.

PURPA CONTRACTS WON ANOTHER ROUND in court this summer.

A federal district court in Michigan ordered a reversal of orders the Michigan Public Service Commission had issued restructuring the state's electric utility industry to the extent the orders jeopardized the ability of Michigan utilities to recover above-market charges for electricity under power purchase agreements with independent power projects. The court said that the federal Public Utility Regulatory Policies Act, or PURPA, and the supremacy clause of the US constitution "preempted" the state public service commission from taking any action contrary to PURPA.

Chadbourne represented two plaintiffs in the case, Midland Cogeneration Venture and Central Wayne Energy Recovery Limited Partnership.

TAX HAVENS ARE EXPECTED TO COME UNDER FIRE next year in reports by the Organization for Economic Cooperation and Development (OECD) and a special tax force on money laundering of the G-7 countries. The OECD is working on a report, to be issued early next

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foreign tax credits since the more foreign-source income a company has, the more foreign tax credits it is allowed.

Tax-exempt Bonds

The bill increases "volume caps" on the amount of tax-exempt bonds that each state can issue each year to finance private projects. The current limit is $50 per person of population or $150 million, whichever is greater. The cap is already scheduled to increase over the period 2003 through 2007 to the greater of $75 per person of population or $225 million. The bill would speed this up so that the increase occurs over the period 2000 through 2004. (The cap next year would be $55 per person or $165 million.)

The bill authorizes up to $15 billion in tax-exempt financing for construction or reconstruction of as many as 15 private highway projects.

Highway Projects

The bill authorizes up to $15 billion in tax-exempt financing to be used for construction or reconstruction of as many as 15 private highway projects. The US Department of Transportation would allocate the borrowing authority. To qualify, a project would have to serve the general public and be located on "publicly-owned rights of way" in the United States, and it would either have to start out owned by a government or revert eventually to a government. The financing could not be used to acquire land.

Nuclear Power Plants

The bill will let utilities selling nuclear power plants transfer escrowed funds that have been set aside to pay the eventual decommissioning costs for the plants without triggering income taxes on the amount in the escrow account. The transfer would have to be after this year.

It also makes two other related changes. First, current law allows utilities to deduct annual contributions to nuclear decommissioning funds. The utility must get a private ruling from the IRS fixing the amount of its annual contributions. Its deduction is limited to the amount in the ruling or the amount its local public utility commission allows it to pass through to ratepayers as a cost of service, whichever is less. The bill drops the second part of the limit after this year. This was a response to electricity deregulation.

Second, some utilities have separate escrows for decommissioning funds that they were not allowed to deduct because their contributions exceeded the limits on deductions. The bill lets these utilities dump whatever they had in these "nonqualified" funds on December 31, 1998 into their regular decommissioning funds and deduct the nonqualified amounts ratably over the remaining useful life of the nuclear power plant starting in 2002. Anyone buying the power plant—and taking over the decommissioning fund—could continue with the deductions.

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 <u>not</u> 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.

Power Marketers

The bill clarifies 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.

Pipeline Projects

The bill makes it easier for large oil or gas companies like Enron to defer US taxes on income from foreign pipeline projects.

Even though the US taxes American companies on worldwide income, it is possible to structure offshore investments so that US taxes are deferred until the earnings are brought back to the United States. However, this works only where the US company will receive active income from the investment—not passive income like interest, dividends, rents or royalties. Transportation fees paid to the owner of an oil or gas pipeline are sometimes classified as passive income in cases where the owner is a large oil or gas company. The bill corrects this. However, the provision would not take effect until 2002.

Transmission Line Projects

The bill makes it easier to defer US taxes on income from providing services related to "the transmission of high voltage electricity" outside the US.

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year, on harmful tax competition. The French finance minister called over the summer for an "atomic bomb" approach to tax havens in which countries might "ban all financial transactions with these territories" on grounds that they are "black holes for internationally accepted regulations."

THE UNITED STATES TEMPORARILY SHELVED RULES THAT WOULD HAVE MADE IT HARDER FOR US MULTINATIONALS TO "STRIP EARNINGS" from other countries.

A multinational corporation can usually reduce its tax base in another country by having its subsidiary in that country pay out earnings in a deductible form. An example is where earnings are paid to the parent as interest or rents. The challenge for US multinationals is to do this and still be able to defer US taxes on the income. US tax deferral is possible only on "active" income and not "passive" income like dividends, interest or rents.

One way around this problem until recently was to make the subsidiary in the country into a "disregarded entity." The subsidiary is not considered to exist for US tax purposes. Therefore, a loan across the border to the company does not exist either. Neither do the interest payments on the loan.

The US Treasury issued proposed regulations in July to deny US tax deferral in such situations, but said the regulations would not be issued in final form before July 1, 2000 and would not be enforced for another five years after they become final.

The Treasury had planned a tougher approach but retreated under pressure from Congress. Treasury officials despair in private about ever being able to enforce the proposed rules.

COLOMBIA ruled that technical services that an offshore company performs for a Colombian company are not subject to value-added taxes if the services are performed offshore. The value-added tax is ordinarily 16%.

It would be a good idea to put these services in a separate contract to avoid confusion.

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The problem currently is that service fees are treated as passive income—making US tax deferral hard—if a service company is set up outside the United States to provide the services and it relies on "substantial assistance" from the US parent or other affiliates to provide the services. The bill creates a special exception for these service fees. The provision would not take effect until 2002.

Lobbyists had hoped to persuade Congress to broaden the fuels list for section 45 tax credits also to include wood and agricultural waste and landfill gas, but they were unsuccessful.

US Expatriates

US expatriates receive a so-called section 911 exclusion currently that spares them from having to pay US income taxes on their first $74,000 in wages. The exclusion is increasing at the rate of $2,000 a year and will hit $80,000 in 2002. Thereafter, current law requires it be adjusted each year by inflation. The bill provides for increases of $3,000 a year from 2003 through 2007, by when the exclusion would reach $95,000, and for inflation adjustments thereafter.

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 2004.

Sunset

The entire tax-cut bill expires on September 30, 2009, with a few exceptions where the provisions cease to have legal effect after December 31, 2008. This is a form of legerdemain to comply with budget targets. The business community has criticized Congress in the past for enacting temporary tax incentives and for making frequent changes in US tax laws because this makes it harder to plan. ■

NO_x Reduction Plans in Turmoil

by Roy S. Belden, in Washington

US efforts to reduce nitrogen oxide emissions from power plants and other facilities that burn fossil fuels in 22 states east of the Mississippi River are in turmoil after two recent court decisions.

The decisions have sent the federal government 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.

In the meantime, the Environmental Protection Agency is poised, in response to pressure from six

northeastern states, to take direct action against power plants and other NO_x sources in 12 states that are considered upwind from the northeast.

Background

The United States has had in place since the early 1970's a so-called 1-hour ozone standard that limits pollutants that contribute to smog. The standard limits the amounts of NO_x and volatile organic compounds, or VOCs, that can be emitted during each rolling 1-hour period to .12 parts per million.

In 1997, the Environmental Protection Agency issued a new 8-hour ozone standard limiting the same emissions to a total of .08 parts per million per hour on average during each rolling 8-hour period.

In 1998, EPA also issued regulations requiring 22 states east of the Mississippi to submit plans by the end of September 1999 to reduce NO_x emissions to levels significantly below 1990 emissions and to start implementing the plans by May 2003. Each state was assigned a target. This "NO_x SIP call rule"—or call for state implementation plans (or changes to existing plans where states already had them)—was based on a belief that the existing standards are inadequate by themselves to reduce smog to acceptable levels.

Court Actions

At the end of May this year, the federal appeals court for the District of Columbia issued a stay barring the federal government from enforcing the September 1999 deadline for states to submit their NO_x reduction plans. No new deadline has been set. The stay is temporary until the merits of the case can be heard—probably sometime early next year.

Also in May, and potentially more significant, the same appeals court sent the new 8-hour ozone standard—together with a standard on "fine" particulate emissions of 2.5 micrometers or less ($PM_{2.5}$)—back to the Environmental Protection Agency for further clarification of the legal and scientific bases for the standards. (The court also vacated a separate standard for "coarse" particu-

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THE US STATE DEPARTMENT IS UNDER PRESSURE TO IMPOSE SANCTIONS AGAINST A SPANISH HOTEL CHAIN that is developing hotels in Cuba.

The sanctions would bar executives and their families of the hotel chain from entry into the United States. The pressure is coming from Republicans in Congress. This would be the first time such sanctions were used against a company from a European Union country. They have been invoked only three times before against companies from Canada, Mexico and Israel.

The Spanish company, Grupo Sol Melia, is alleged to be building hotels on property that was confiscated from the Sanchez family when Fidel Castro took power in 1959. The family became US citizens in the 1970's.

The Helms-Burton Act gives US nationals with claims to property that was confiscated by the Castro government the right in theory to sue anyone trafficking in the property in the US courts. However, the Clinton administration has repeatedly suspended this right at six-month intervals—most recently on July 16. The Act also directs the State Department to deny entry visas to executives and controlling shareholders of companies that deal in such property after March 12, 1996.

PENNSYLVANIA enacted a new tax credit to encourage projects to make synthetic fuels from coal.

A synthetic fuel is a fuel that differs chemically from the underlying coal used as feedstock. The tax credit is 15% of the capital cost of the project. The credit is claimed when the project is placed in service and applies only to new projects and then only to equipment that is acquired or constructed during the period 2000 through 2012. Total credits for all projects under the program cannot exceed $18 million a year. The developer must sign a contract with the state promising to repay part of the subsidy over time.

THAILAND ANNOUNCED PLANS TO CUT CUSTOMS DUTIES ON 326 CAPITAL GOODS to 3% from current rates of from 5% to 20%. The government also said it would allow companies to use the double-declining

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NO_x Reduction

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late emissions of more than 2.5 micrometers up to 10 micrometers (PM_{10}).) The court said EPA's reason for selecting the levels of ozone and $PM_{2.5}$ standards was potentially unconstitutional because the agency failed to base its decision on an "intelligible principle" tied to ensuring the protection of public health. The court concluded that the government's approach violated a "nondelegation doctrine" of the US constitution that bars Congress from delegating legislative powers to an agency in the executive branch.

In an effort to salvage some of its NO_x reduction efforts, EPA is now moving to a backup plan to force NO_x reductions in 12 of the 22 states.

The appeals court decision throws the 8-hour ozone standard—which served as a key basis for the NO_x SIP call rule—into flux. EPA officials acknowledge that this is an additional barrier to their ability to implement the NO_x SIP call rule. The SIP call rule was based on a finding that NO_x emissions from upwind states contribute to violations by downwind states of both the old 1-hour and new 8-hour ozone standards.

Northeast Complaints

In an effort to salvage some of its NO_x reduction efforts, EPA is now moving to a backup plan to force NO_x reductions in 12 of the 22 states. The backup plan is a response to petitions from six states—Connecticut, Maine, Massachusetts, New Hampshire, New York and Pennsylvania—who complained that emissions from the other 12 states contribute to smog in the northeast. The government claims authority to act under section 126 of the Clean Air Act. EPA is expected to take final action on the backup plan this winter, but in the meantime, it has made a final finding that the petitioning states are correct that emissions have been moving downwind. Several midwestern utilities are tying to persuade Congress to block implementation of the backup plan in addition to challenging the plan in court.

The 12 states that would be affected are Delaware, Indiana, Kentucky, Maryland, Michigan, North Carolina, New Jersey, New York, Ohio, Pennsylvania, Virginia and West Virginia.

Under section 126, EPA has authority to implement NOx control reductions directly on specific sources that are alleged to contribute to downwind violations of the 1-hour ozone standard—without working indirectly through the states. NO_x emitters in other states have recently been targeted in three new section 126 petitions filed by Delaware, Maryland, and New Jersey, but EPA has not yet acted on them.

Outlook

The 8-hour ozone standard and the NOx SIP call rule are inextricably linked. If EPA is unable ultimately to save the 8-hour standard in court, then the agency will be left with only the old 1-hour standard. Most of the states are either now in compliance, or soon will be, with the 1-hour standard. EPA might be forced to scale back the NO_x SIP call rule substantially or even scrap it altogether.

However, EPA seems determined—regardless of what happens on the SIP call rule—to push through NO_x controls on sources in the 12 states that are considered upwind from the petitioning states. EPA may have a stronger hand in using its section 126 authority to implement such controls.

The bottom line is there will ultimately be additional NO_x reductions imposed on sources in at least the 12 states, but the mechanism remains unclear and the timing may slip from the May 2003 target date. ■

US Action Closer On Corporate Tax Shelters

by Keith Martin, in Washington

US companies with deals that might not close until very late this year should take into account the possibility that Congress might pass legislation this fall to penalize corporations and outside advisers involved in aggressive tax schemes that are later disallowed by the tax authorities.

A senior US Treasury official predicted at an American Bar Association meeting in August that such legislation would be enacted this fall. This may be optimistic. The chairmen of the tax-writing committees in Congress have only promised to hold hearings on the subject.

However, Congress released a set of staff recommendations in late July about what action should be taken. The staff proposals are in a 486-page paper released by the Joint Committee on Taxation. They would have the effect of increasing the level of tax opinion required in deals.

The main proposal is to collect a 40% penalty from any corporation that has tax benefits disallowed from a transaction the government considers a "corporate tax shelter."

The corporation could avoid the penalty only by doing three things. First, it would have to be "highly confident" of the tax results. This will usually mean getting an opinion from an outside tax adviser that there is at least a 75% likelihood of prevailing on the merits. The opinion must be credible. The tax adviser could not assume away inconvenient facts. Second, the corporation would have to have a "material," or credible, business purpose for the transaction other than reducing taxes. Third, it would have to disclose the details of the transaction to the Internal Revenue Service in a filing within 30 days after the transaction closes and again when its tax return is filed. The chief financial officer (or another senior corporate officer with knowledge of the facts) would have to certify,

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balance method to depreciate plant and machinery. The new depreciation only applies to assets purchased after the new law comes into effect. The announcement was made on August 10 only days after the World Bank told Thailand that it must reduce both import tariffs and corporate income taxes.

Meanwhile, the Board of Investment is working on revamping existing tax incentives for foreign investors. A new investment incentive package is expected in November.

BRAZIL TERMINATED ITS TAX TREATY WITH PORTUGAL, effective next January 1. The Brazilian revenue minister said that the treaty was being used to support tax evasion by routing investments into Brazil through Madeira island.

INDONESIA is expected in November to unveil a new set of tax incentives to lure foreign investors.

A DANGER IN COMPLICATED TAX STRUCTURES is that the IRS will invoke section 269 of the US tax code to deny benefits from the structure.

Section 269 gives the agency broad authority to deny tax benefits when a taxpayer acquires a corporation for the principal purpose of "evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit or other allowance which [the taxpayer] would not otherwise enjoy."

A European company restructured its operations in the United States by placing them under new US holding company with predominantly foreign assets. The idea was to enable the European parent to receive dividends from its US subsidiaries without any US withholding taxes. Dividends are normally subject to 30% withholding tax at the US border. However, US law exempts dividends from withholding tax when they are paid by a US company that receives at least 80% of its income from sources outside the United States.

The IRS issued a "field service advice" this summer urging the agent in the case to invoke section 269 to deny the withholding tax exemption.

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Tax Shelters

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under penalties of perjury, that the disclosure statements are true and complete.

Disclosure would be mandatory for all corporate tax shelters involving more than $1 million in tax benefits. There is an exception for leasing transactions that are "within the scope" of the IRS "true lease" guidelines in Revenue Procedure 75-21. The staff said, "The volume of such transactions would make 30-day disclosure [too] burdensome for the IRS."

The staff is also recommending an "aiding and abetting penalty" equal to the greater of $100,000 or half the person's fees from the transaction. This would be levied against outside advisers who assist in implementing a corporate tax shelter transaction that is later disallowed by the IRS. However, the penalty would apply only where

> "(1) the person to be penalized knew, or had reason to believe, that the corporate tax shelter (or any portion thereof) could result in an understatement of tax liability to the corporate participant; (2) the person opined, advised, represented, or otherwise indicated (whether express or implied) that, with respect to the tax treatment of the corporate tax shelter (or any potion thereof), there existed at least a 75-percent likelihood that its tax treatment would be sustained on its merits if challenged; and (3) a reasonable tax practitioner would not have believed that, with respect to the tax treatment of the corporate tax shelter (or any portion thereof), there existed at least a 75-percent likelihood that its tax treatment would be sustained on its merits if challenged."

An example in the staff paper makes clear that the penalty can be imposed on investment bankers. In the example, a "promoter" pitching the transaction to a potential equity participant is penalized for showing the potential equity a 75% opinion from an outside counsel that the transaction works.

This may lead to a change in the way investment banks promote deals. Investment banks will not want to make any representation about whether a transaction works, but rather encourage equity to rely on is own tax counsel. They will also want to be careful about what is said in internal memos, since these are usually not protected from disclosure to the IRS, and get a formal statement from the equity that no express or implied assurances have been made by the investment bank about tax results.

New rules on corporate tax shelters may lead to a change in the way investment banks promote deals.

"Corporate tax shelter" would be defined broadly as any arrangement, partnership or transaction where at least one of five factors is present. The five factors are as follows.

1. The expected pre-tax profit is insignificant in relation to the expected net tax benefits. The present value of benefit streams would be determined by using the short-term AFR (applicable federal rate) plus 1% as the discount rate. The short-term AFR was 5.43% in August (the figure with annual compounding). The staff recommends an "anti-stuffing rule" that would let the government look only at the legs of the transaction that contribute to the tax results. This would prevent corporations from "increasing the reasonably expected pre-tax profit by contributing income-producing assets that are not a necessary element of the arrangement."
2. The arrangement shifts tax burdens to a "tax-indifferent party" or shifts tax basis to the US participant. The staff paper gives as an example "certain" LILOs, or lease-in-lease-out transactions.

3. The transaction involves significant tax benefits, and the corporation receives a "tax indemnity or similar agreement." Certain "customary" indemnities would not count. The staff says these are indemnities tied to representations that all tax returns have been filed and taxes paid and about the tax audit history of a party to the transaction, about the tax-exempt status of bonds, about the seller's status as a "US real property holding corporation," and about tax-free reorganizations or spinoffs.
4. The transaction involves significant tax benefits, and it is expected to create a permanent difference between taxable income and US GAAP income.
5. The transaction involves significant tax benefits, and the corporation has "little (if any) additional economic risk" because of the way the transaction is structured. The staff suggested the following raise red flags: "use of nonrecourse financing, guarantees, stop loss agreements, recission clauses, unwind clauses, hedged positions, and other similar arrangements."

The government could still treat a transaction where none of the five factors is present as a corporate tax shelter if US tax avoidance or evasion is a "significant purpose" for the transaction. ■

"Lite Regulation" Is Not "Deregulation"

by Lynn Hargis, in Washington

Project developers and lenders should remember that the term "deregulation" is not completely accurate when applied to electric utility generation and sales.

For example, in some of the recent New York

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DEBT-EQUITY SWAPS in Latin American deals continue to face scrutiny from the IRS. However, the agency lost a case this summer in the US Tax Court.

A US auto-parts manufacturer, CMI International, planned to set up a manufacturing operation in Mexico. CMI bought Mexican government debt at a 51.5% discount from face value in the market. It then contributed the debt to its new Mexican subsidiary. The subsidiary cancelled the debt. The Mexican government then deposited an amount in pesos reflecting only a 15% discount from face value of the debt into the bank account of the new CMI subsidiary.

The IRS argued that CMI had income and that US income taxes were triggered under section 367(a) of the US tax code. That section requires that a "toll charge" be paid whenever a US company contributes appreciated property to an offshore company. However, the US Tax Court said there was no appreciation in the debt before it was contributed. CMI received back shares in its subsidiary that were equal to the value of the debt it contributed.

The IRS won a similar case called GM Trading in the Tax Court a few years ago (but lost on appeal).

BRIEFLY NOTED: President Clinton created an interagency panel in August to report back in eight months on how to increase use of biomass, including for generating electricity. The goal is to triple US use of bioenergy by 2010 . . . . The Senate Finance Committee voted in June to bar companies that use accrual accounting from reporting gain from installment sales of property ratably over the same period the installments are received. Rather, the entire gain would have to be reported immediately upon the sale. Installment reporting would only be allowed in future for companies that use cash accounting. The measure is part of a "Generalized System of Preferences Act" that may be taken up by the Senate this fall and then folded into an African trade bill that already passed the House. ■

— contributed by Keith Martin and Lynn Hargis in Washington

"Lite Regulation"

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state generation divestitures, the New York Public Service Commission refused to disclaim jurisdiction over the financing by the buyer of divested generation units. It approved the financing, but nonetheless retained jurisdiction over the assumption of liability by the divested generation facility owner.

Similarly, the Federal Energy Regulatory Commission has recently broadened its interpretation of its own jurisdiction, perhaps in light of what it perceives as lessening jurisdiction elsewhere, such as under the Public Utility Holding Company Act, or PUHCA. FERC has asserted jurisdiction in a variety of new areas, such as over holding company mergers, the Automated Power Exchange in California (that owns neither physical utility facilities nor sales contracts), over certain acquisitions (consolidations) of jurisdictional facilities (including wholesale contracts), and over foreign-domestic mergers. Moreover, the FERC recently withdrew waivers of filing requirements for long-term service contracts that it had previously granted to sellers with approval to sell at market-based rates.

It is generally better to assume that both state and federal agencies may assert jurisdiction over a transaction, and even to accede to it, in order not to delay financial closings.

Although both state and federal agencies are usually supportive of generation divestiture and competitive electric suppliers (and sometimes mandate them), regulatory agencies are nonetheless jealous of their jurisdiction ultimately to control electric utilities if competition does not appear to be working. Given the fact that almost all voters pay electric bills, this is unlikely to change.

For this reason, it is generally better to assume that both state and federal agencies may assert jurisdiction over a transaction, and even to accede to it, in order not to delay financial closings or other scheduled milestones. It is also important to remember that "lite" regulation still carries with it certain ongoing responsibilities, such as reporting requirements, including the reporting of interlocking directors, the payment of annual charges at the federal level, and various reporting requirements at the state level. ■

Ukraine To Sell Off Utility Assets

by Laura M. Brank and Shane R. DeBeer, in Moscow

Ukraine is expected to release details this fall for a planned selloff of 31 "voblast Energos," or regional electric utilities.

Ukrainian President Leonid Kuchma issued a decree (Decree No. 944/99) earlier this month directing four government bodies—the Ukrainian Property Fund, Securities Market Commission, Antimonopoly Committee and Ministry of Energy—to come up jointly by September 2 with rules for the tender, including the makeup of the tender committee. In the meantime, the European Bank for Reconstruction and Development, or EBRD, announced in mid-August that it had approved funding to engage an investment bank to advise on the tender.

Presidential elections are scheduled in the Ukraine for October. This has made some outside observers skeptical about whether the selloff will actually take place. However, President Kuchma is expected to be re-elected, and the opposition to these privatization measures is

not well organized, especially in view of Ukraine's growing budget deficit.

The presidential decree orders other actions in addition to the September 2 deadline for a procedure for carrying out the tender. By early October, the Ministry of Energy and the National Commission for the Regulation of Electric Energy are supposed to issue new regulations on licensing generation, transmission and sale of electric power, as well as strengthening general regulatory oversight. The Ukrainian cabinet of ministers is also charged with producing a proposal for gradual elimination of subsidies for electric power for certain categories of consumers and for deciding how existing debts of the 31 companies will be restructured before the tender.

Of the 31 utilities involved in the tender, majority interests—50% plus one share—will be offered in seven, including the utility that serves the suburbs of Kiev, the Ukrainian capital. Five utilities will remain in government control with at least 50% plus one share remaining in government hands. The smallest stake on offer is 26% (in 12 of the utilities).

A successful bidder must have a plan to make improvements in the utility he is purchasing.

The privatization of regional utilities has been under consideration in Ukraine for several years. It began with the sale of between 35% to 40% shares in five regional utilities in 1998. Private ownership of these utilities is probably much larger today than the 35% to 40% sold initially due to sales of shares that were originally set aside for employees and management.

The deadlines in the presidential decree are aggressive, and it remains to be seen whether the government can actually meet them. To the extent that the presidential decree is politically motivated, the tender rules may be hastily drafted (as has happened elsewhere in the former Soviet Union) with the potential for inconsistent interpretation of applicable laws. Nevertheless, given the scale and urgency of the privatization, significant opportunities may emerge for astute investors. ■

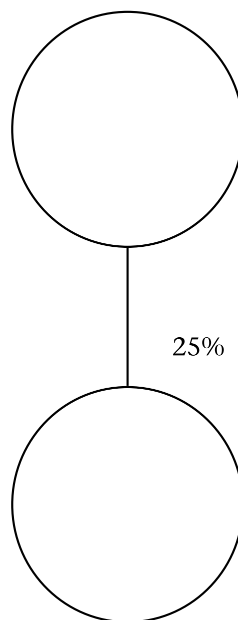
Latest Tax Angles For Latin American Projects

by Keith Martin, in Washington

Infrastructure projects have the potential to be very costly in terms of taxes. Latin America is no exception, especially with income tax rates generally increasing across the region.

This paper describes the main strategies that project developers are using to reduce the income tax burden on projects in Latin America and reports on recent developments in the region. The following diagram will help put the discussion into context.

The top circle represents the developer or investor in a project. The bottom circle represents the company formed in the project country to own the project.



The project company receives revenue from electricity sales.

The figures are tax rates. There are three places where taxes will be taken out of the revenue stream. There will be taxes in the project country—for example, the 45% shown next to the bottom circle—withholding taxes at the border when the developer or investor tries to repatriate earnings—for example, the 25% shown just above the bottom circle— and income taxes again on the earnings in his home country. It is easy to see the potential for a developer to have very little to show for his efforts at the end of the day. In practice, the combined taxes may range anywhere from 0% to 80% or more depending on the ownership and capital structure for the project.

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The key is to focus, when choosing an ownership structure and arranging financing, on what can be done at each level to reduce the tax burden.

US

Focus first on the potential for taxes in the United States. US participants in Latin American power deals will be subject to US income taxes on their earnings. The United States taxes American companies on worldwide income. In theory, the US gives credit for any foreign taxes paid, but the foreign tax credit rules are so full of fine print that few companies in the utility and telecoms industries are able to use foreign tax credits in practice. Therefore, one starts with taxes of 35% in the United States.

The most common strategy for reducing US taxes is to form an offshore holding company in a tax haven like the Cayman Islands, have the Cayman company, in turn, hold one's interest in the project company, and to make the project company a *limitada* or *comandita*—anything other than an SA (*sociedad anonime*). This will usually enable the developer or investor to defer US taxes until the earnings are physically repatriated to the United States. However, in order for this strategy to work, every entity below the Cayman holding company in the ownership chain must be "transparent" for US tax purposes. SA's cannot be transparent. Other kinds of entities can be.

The key is to focus, when choosing an ownership structure and arranging financing, on what can be done at each level to reduce the tax burden.

The problem in Latin America is that one often starts with an SA for the project company, especially in government privatizations.

There are at least ten strategies in use currently in Latin America when use of an SA is unavoidable.

1. Same-country exception: The most common approach is to put one's offshore holding company for the project in the same country as the project. However, the holding company must own more than 50% of the project company by vote or value in order for this to work. Ownership by vote is measured by the percentage of directors one is entitled to appoint. For example, one might own 50% of the shares but be entitled to appoint 75% of the board. This is 75% ownership by vote.

There are several techniques for getting over 50% by vote if one can at least get to 50%. The simplest is to acquire a few shares in another shareholder. A fraction of the other shareholder's voting rights can then be claimed under "attribution rules."

A frequent issue in deals is what to do when there are two US investors each of whom wants to defer US taxes on his earnings. Logically, both cannot own more than half the company. However, one solution is to put majority ownership by vote in one investor and majority ownership by value in the other. Another fix is to use stock options. An investor is treated as owning any shares that he has an option to purchase. US equity participants have sometimes resorted to "cross options" where each has an option to acquire enough of the other US participant's shares to put him over 50%. The US courts are split over whether the same shares can be counted more than once. Therefore, it is better to avoid direct cross options. The US participants could be given options to acquire shares from a third party or to acquire shares in entities at different tiers in the ownership chain.

The same-country exception works best in countries like Brazil or Argentina where there are opportunities to do more than one project. Earnings must usually be reinvested in other projects in the same country to preserve US tax deferral. Any dividend of the earnings out of the country will trigger US taxes. US developers sometimes plan to have the holding company in the project country *lend* its earnings to a

sister company in another country for redeployment elsewhere. This works, but it can be inefficient.

2. High-tax exception: If earnings are taxed in the project country at a rate higher than 31.5%, then US taxes can be deferred on earnings even though they leave the country. This is more complicated than it appears at first glance. One must restate the earnings using a US definition of taxable income — for example, by using slower *US* depreciation allowances — and then calculate what the actual taxes paid are as a percentage of this restated US taxable income. It rarely works, although some developers take the position currently that the high-tax exception can be used for investments in Argentina.

3. Conversion: A simple solution, if the other shareholders are willing, would be to convert the SA into a *limitada* or *comandita*. This is usually a problem where employees or the government hold shares in the SA. A conversion has the potential to trigger a US tax on any appreciation in asset value in the company and should be done before US participants formally take shares in the project company.

4. Dropdown: One way to get around a problem that the company cannot be converted is sometimes to have the SA remain in place but to have it either drop its assets or sell them to a *limitada* that is a subsidiary. US participants would be shareholders in the subsidiary. The employees would remain shareholders in the SA.

5. Sandwich: A problem with the same-country exception is that earnings usually must remain in the project country to maintain US tax deferral. There is a "same-country sandwich" structure that has sometimes been used. The US participant creates a holding company in the country, but then the holding company has a wholly-owned subsidiary in place like the Canary Islands or Madeira. The Canary or Madeira subsidiary owns the shares in the SA, and an election is filed with the US tax authorities to treat the Canary or Madeira subsidiary as a "disregarded entity." The subsidiary disappears for US tax purposes. That way, the earnings can be moved one tier up from the project company — and offshore — without breaking US tax deferral. Proposed IRS regulations would make the sandwich structure harder to use, but not impossible. The proposed regulations would not take effect before mid-2005 at the earliest. A downside is that earnings from any reinvesting done by the Canary or Madeira company must eventually pass through the holding company in the project country to reach the United States. It can be a challenge to avoid attracting tax in the project country when this occurs.

6. Domestication: An SA can be given dual status as both an SA and a Delaware limited liability company by "domesticating" the company in Delaware under section 18-212 of the Delaware LLC statute. This is a simple matter of filing forms in Delaware. Some people take the position that one can then elect to treat the entity as transparent for US tax purposes since a Delaware LLC can be transparent. This strategy has risk.

7. Deemed joint venture: A US participant might enter into an ambiguous contractual relationship with the SA that is viewed by the US tax authorities not as a shareholding in the SA but rather as a joint venture between the US participant and the SA. The US recognizes "deemed" joint ventures. Thus, the US participant will be viewed by the US as deriving his income from a transparent entity — the deemed joint venture — rather than from the SA directly. US tax deferral would then be possible on the earnings.

8. Deconsolidation: An alternative strategy is to give up on US tax deferral but to attack the problem from another angle. The reason US companies are driven to deferral strategies is the foreign tax credit rules don't work. A US participant can get around the foreign tax credit problem by investing in the project through a US subsidiary in which he owns no more than 79% of the stock. An unrelated party would have to own the other 21%. The "deconsolidated" US subsidiary would be subject to 35% US

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tax on its earnings from the project, but it would get full credit for any income taxes paid in the project country. The main problem with this approach is there is another 7% US income tax to pull earnings out of the "deconsolidated" subsidiary (since shareholders in the subsidiary must pay income taxes on any dividends they receive from it).

9. Stapled stock: A more aggressive form of deconsolidation is to use stapled stock. This has the virtue of letting a company create a deconsolidated subsidiary without having to find an unrelated party to own 21% of the shares. The concept is to "staple" the shares of a US subsidiary to a foreign subsidiary, meaning that shares in one company cannot be transferred without the other. Under Internal Revenue Service Notice 89-94, a US company whose shares are stapled to a foreign company is automatically deconsolidated. This strategy is complicated to implement in practice, and it is not without US tax risk. The same second-tier 7% US tax will be collected on dividends from the stapled subsidiary to the US parent.

10. 861 structures: An aggressive strategy for acquisitions where there will be a lot of debt is to loop the debt through a number of tiers of entities, starting in the US and then working offshore, before the cash ultimately reaches the holding company that will acquire the target. The debt passes down some legs of the structure as debt and down other legs as equity. Interest paid back up the chain counts several times over as "foreign source income" of the US parent — as many times as there are loops in the debt chain. The US parent has no real income from the interest payments in practice because the earnings are offset ultimately by deductions for interest paid to the lender. However, the more foreign source income a US company can claim, the greater its capacity to use foreign tax credits. These structures have been attacked obliquely in the tax trade papers, but the IRS has not yet done anything about them. In the meantime, they can put a US company in a position to use foreign tax credits in just a few months.

Project Country

The main strategy for reducing taxes in the project country is to have the project company distribute earnings in a form that it can deduct for local country tax purposes. This is called "earnings stripping." For example, the project company might pay out earnings to foreign shareholders in the form of "interest" on shareholder debt. Foreign shareholders might also pull out earnings as payments for services to the project company or as "rent" for leasing the project across the border to the project company.

Tax rates are high in Latin America and getting higher. Therefore, there is a strong incentive to do anything one can to reduce them, especially if one is deferring US taxes. Any reduction in effective tax rate in the project country adds directly to profit from the project.

When earnings cross the border, they usually attract a withholding tax. Earnings stripping is a way to push down the rate. For example, if earnings paid out as interest can be deducted by the project company against a tax rate of 33%, but they attract a 15% withholding tax, earnings stripping has had the effect of reducing the domestic tax rate from 33 to 15%.

Many countries either limit the amount of shareholder debt that one is allowed in the capital structure—these are called "thin capitalization" rules—or deny deductions for certain interest paid to related parties. This is the first of two obstacles to earnings stripping.

Argentina imposed limits on interest deductions in tax reforms that took effect last January 1. Forty percent of interest is deductible provided the debt does not run afoul of limits on borrowing from affiliates. However, the other 60% of interest can be deducted 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. In Brazil, there are no thin capitalization rules and no bar to deducting interest paid to affiliates. Mexico

does not have thin capitalization rules *per se*, but if there is a loan from a related party, the interest payment will be reclassified as a dividend (not deductible) in certain cases on related-party debt.

The second obstacle to earnings stripping has to do with the interplay between strategies for reducing US taxes versus project-country taxes. The goal is usually not only to pay out earnings in a deductible form, but also to defer US taxes. US taxes can only be deferred on active income—not passive income like interest or rents. (Service fees are tricky and are sometimes a problem and sometimes not.)

One way to thread the needle—or pay out earnings in a deductible form but not in a way that creates passive income—is to use a hybrid instrument. A shareholder lends money to the project company so that he can withdraw his earnings as interest. However, the instrument is drafted in such a way that, even though the tax inspector in the project country views it as a loan, the US sees it as just another class of equity investment. Hybrid instruments are tough to draft. However, they are possible in most Latin countries.

Another approach is to inject capital into the project company by means of a straight debt instrument but make the project company into a "disregarded entity" for US tax purposes. That way, earnings will be paid out as interest as far as the project country is concerned, but, from a US standpoint, there is no project company and no loan and, therefore, no passive income. SA's cannot be disregarded. Other types of Latin American business entities can be, but require some ingenuity to make work since US rules require that a disregarded entity have only one shareholder while local corporate law usually requires at least five. The key is to make all but one of the shareholders also disregarded.

At the Border

The next place to focus is on the taxes that must be paid at the border to move earnings out of the project country. Earnings are usually subject to a withholding tax at the border.

Look first at the list of withholding rates. Sometimes it makes a difference in what form money crosses the border. For example, the withholding rate in Brazil is 0% on dividends but 15% on interest. Try to pull money out in a form that qualifies for the lowest withholding rate. However, this avenue might be foreclosed by whatever strategy one has already adopted for deferring US taxes and reducing in-country taxes. For example, US taxes cannot be deferred on passive income.

Next, look at the list of tax treaties between the project jurisdiction and other countries. Treaties sometimes reduce withholding rates. This would require investing through a company in the treaty country. However, treaties are of limited value in Latin America. For example, Brazil has treaties with 24 countries, but only one—with Japan—reduces any withholding rate. Unfortunately, the treaty most likely to be of any value is the Caricom treaty among countries in the Caribbean basin. It eliminates withholding taxes on dividends. St. Lucia had been used as a staging post for Caribbean investment, but the government barred any further incorporations by foreign shareholders. Investment is now being run through Belize.

Latin American countries usually allow a reduced rate of withholding on interest paid by the project company to a financial institution. This has led to frequent use of back-to-back loans. For example, in Argentina, the withholding tax on interest paid to foreign lenders is 35%, but this drops to 15.05% if the lender is a financial institution. Back-to-back loans can take a number of forms. One common form is for one's offshore holding company to make a deposit in the Cayman branch of a bank. The bank then makes a loan to the project company. If one needs hybrid treatment for the debt for US tax reasons, then the documents must be drafted so that the bank's role can be characterized for US tax purposes as merely an agent collecting payments on the hybrid instrument for someone else.

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Brazil waives withholding taxes altogether on interest paid on commercial paper with a term of at least 96 months. Since many projects in Brazil start out with bridge debt that must be replaced after a short period of time, this had led to setting up a Cayman company as the borrower on the bridge loan. The Cayman company then onlends for at least a 96-month term to the project company. When the bridge debt is replaced, the Cayman company simply reborrows and uses the proceeds of the "permanent" debt to repay the bridge lender.

Other Ideas and Issues

Tax sparing: It may possible in some countries to take advantage of tax-sparing credits in treaties as a way of putting more juice into the ownership structure. A tax-sparing credit is the idea that another country—for example, Holland—will allow a Dutch company investing into Brazil to claim foreign tax credits against Dutch taxes at the highest Brazilian withholding rate even though withholding taxes were not in fact paid at this rate. This is a way to introduce more "juice" into the ownership structure. Conceptually, getting a reduction in Dutch taxes that one would otherwise pay is the same thing as reducing the project country taxes. It is also helpful to borrow from banks that can use tax-sparing credits to reduce the borrowing rate.

Cash traps: Most countries in the region bar project companies from paying dividends except out of book earnings. The combination of tax depreciation and the need to pay large amounts of interest initially on project debt usually mean that project companies have almost no book earnings during early years to distribute. Developers usually address this problem by capitalizing the project company with debt. Debt can be repaid without waiting for earnings. In some countries, it may also be possible to pay a "return of capital," although often not without notice to creditors and government approval.

TJLP: Brazil has a special provision allowing a project company to pay shareholders "interest" on their capital. The interest rate used is the long-term Brazilian rate for bonds (referred to as the TJLP). A company can distribute up to 50% of its profits or retained earnings in this form. The project company deducts the payments as interest, but collects a 15% withholding tax. There is no further tax to the recipient apart from a PIS-CUFINS tax of 3.65%. Therefore, it is usually in a company's interest to maximize these types of payments since they have the effect of pushing down the domestic tax rate.

Uruguayan holding companies: There is a great deal of interest in Uruguay as a possible place to put a regional holding company, possibly as a way of creating a currency (shares) that can be used for acquisitions, but there has been little real use so far in the power or telecoms sectors. Uruguay has a special type of entity for offshore investment called a *sociedad financiera de inversion*, or SAFI. Its principal activity must be to invest outside Uruguay in securities or subsidiaries for its own account. At least 51% of total assets must be invested abroad and more than 50% of total income must be from foreign sources. SAFI's are exempted from taxes in Uruguay, with the exception of a 0.3% annual tax on share capital, outstanding debentures and reserves.

Interest double-dips: Interest paid to lenders is deductible. Ordinarily, the borrowing should be slotted into the ownership structure at a level where interest deductions can be claimed against the highest tax rate. Thus, for example, one would ordinarily not put the project debt in the Cayman Islands (unless part of back-to-back lending) because the tax rate is 0%, and the interest deductions produce no value. It is better to put it at the level of the project company where there is a real tax rate.

It is not uncommon to see borrowing structured into Latin America designed to give the equity participants deductions for the same interest expense in both the project country and at home (for example, in the US). There are three basic double-dip structures in use in Latin America. In two of them, the US equity participants get the double dip in the US only by repaying the debt by injecting more equity over time into the deal. ■

E-mailbag

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power purchase agreement to see whether the imposition of sales tax on the sale of electricity is a passthrough item under the PPA.

Subject: ***CPMF tax in Brazil***
Author: ***Marcos Vinicius Zanlorenzi Pulino in São Paulo mpulino@levysalomao.com.br***

I was pleased to read your May issue of *Project Finance NewsWire*. On page 17, it said that "Brazil will resume collecting CPMF tax on financial transactions from June 17." Since June 17, a number of Brazilian companies and individuals initiated judicial proceedings claiming not to pay the CPMF on the grounds that said tax is illegal. Many of them have already been awarded preventive suspension of CPMF collection.

- REPLY -

Subject: ***CPMF tax in Brazil***
From: ***Keith Martin***

On what theory have the courts suspended the tax?

Is anyone paying CPMF?

What has been the government's response to these losses in the courts? For example, does it plan to replace the CPMF with another tax?

- REPLY -

Subject: ***CPMF tax in Brazil***
From: ***Marcos Vinicius Zanlorenzi Pulino in São Paulo***

Our arguments to suspend CPMF collection are

1. the Constitutional Amendment No. 21, dated March 18, 1999, did not follow the lawmaking process set forth in article 60 of the Brazilian Constitution, since it was amended by the House of Representatives and did not return to the Senate, and

2. even if valid, Constitutional Amendment No. 21 could not revive the laws instituting and regulating the CPMF that expired on January 23, 1999.

Besides developing these arguments, the legal actions against CPMF claim a provisional relief remedy suspending the tax, arguing that the taxpayer is in danger of suffering a patrimonial loss by being charged with an illegal tax.

Until now, court decisions on CPMF are coming mostly from lower courts and are limited to the provisional relief remedy. Under the Brazilian legal system, these rulings are not binding on other courts or on courts that issued them. A final decision on the merits from a high court, like the Brazilian Supreme Court, will probably take years to be issued and, if the final decision finds that the CPMF tax is valid, uncollected amounts will then be due with interest. However, it is a requirement to grant the provisional relief remedy that the court sees the arguments supporting it as "significantly strong." The first appellate courts that analyzed the matter have backed the provisional relief remedy or reversed lower court decisions that denied it.

To the best of our knowledge, the vast majority of Brazilians are currently paying the CPMF. This is probably due to lack of advice or fear of government retaliation, among other reasons.

There is no evidence of any government response to revenue losses caused by CPMF litigation, except for appeals to the superior courts. This is probably because such losses have not yet become critical.

However, if it deems necessary, in the near future, the government may raise the rates of other taxes, such as the IOF tax. IOF is a tax that falls on financial transactions as well, but assesses a smaller number of transactions. From the perspective of project finance parties, the CPMF's impact is stronger than the IOF's, because the first is levied not only on fund transfers related to debt repayment, securities issues, insurance policies and foreign exchange contracts but also on transfers of proceeds from purchase prices, fees and tolls paid to private concessionaires by consumers and users of goods and services such as electricity, gas, water, telecommunications, roads, railroads and others, as well as on fund transfers involved in payments from these concessionaires to their suppliers.

E-mailbag

Subject: ***Pakistan tax changes***
To: ***Kairas N. Kabraji in Karachi***
knk@digicom.net.pk
From: ***Keith Martin***

Electric Power Daily reports this morning, "Pakistan's federal cabinet on August 4 agreed in principle to impose a 15 percent general sales tax on the country's energy sector . . . [and] also proposed to remove up to 15% of the fuel surcharges on electricity . . . . The decision might be implemented in September." How certain are these changes to occur, and how would they affect private power projects in Pakistan?

- REPLY -

Subject: ***Pakistan tax changes***
From: ***Kairas N. Kabraji in Karachi***

The exemption from sales tax on "POL Products" and "Electrical Energy" has been withdrawn with effect from 16 August 1999. The IPPs and their fuel supplier, the Pakistan State Oil Company Limited, now must be registered as "registered persons" under the Sales Tax Act 1990.

[Editor's note: Mr. Kabraji's e-mail included some background information that has been omitted.]

The liability to pay the sales tax is, in the case of supply of goods in Pakistan, on the person makin the supply and, in the case of goods imported into Pakistan, on the person importing the goods. However, the federal government may, by notification in the official gazette, specify the goods in respect of which liability to pay the sales tax is on the person receiving the supply.

Consequently, sales tax at the rate of 15% of the value of the monthly consideration of the sale of electricity will be now be payable by the IPPs, unless the federal government, by a notification in the official gazette, shifts the liability to pay this tax on the "person receiving the supply," *i.e.*, WAPDA or KESC. As far as we are aware, no such notification has as yet been issued.

Sales tax at the rate of 15% of the value of POL products imported into Pakistan is now paid by the Pakistan State Oil Company as a customs duty. Additionally, the Pakistan State Oil Company is also liable to pay 15% sales tax on the price of the POL products sold or supplied to the IPPs. However, the price at which the Pakistan State Oil Company sells fuel is determined and notified by the Government of Pakistan (through the Ministry of Petroleum & Natural Resources). Therefore, the Government of Pakistan has to notify the levy of the sales tax on the fuel price. This has not been done as yet.

We understand that the incidence of the sales tax may be absorbed within the existing levy of "petroleum development surcharge" and, as such, there may not be any price increase on POL products on this account. However, one must wait and see the notification to be issued by the government. Until such time as the notification is issued, the Pakistan State Oil Company continues to invoice the IPPs at the existing determined price of fuel. If there is any change in price (which will be made effective from 16 August 1999), arrears may have to be paid.

Generally, most implementation agreements for private power projects provide that the full (or increased) amount of sales tax imposed on the sale of electricity, as of or after the execution of the respective implementation agreement, and which is payable by a power company, is a passthrough item (as defined in the power purchase agreement) under the power purchase agreement (which also contains provisions to that effect).

[Section 7 of the Sales Tax Act says that sales tax paid on inputs is subtracted from sales tax owed on outputs.]

Based on the method of determining tax liability under section 7 of the Act, it would appear that for a tax period the amount of the passthrough for an IPP would be the difference between its input tax, *i.e.* the amount of sales tax paid on the purchase of fuel (the sales tax will be built into the fuel price, any increase in the fuel price being a matter for indexation under the PPA) and the output tax. The output tax is the amount of sales tax paid on the sale of electricity to WAPDA or KESC. However, as stated above, until the government notifies the manner in which sales tax is to be levied on the fuel price, one cannot state with certainty the method of determining this passthrough item.

Additionally as a matter of prudence, each IPP should specifically examine its implementation agreement and

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