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Congress Votes Tax Changes Affecting Project Finance

by Keith Martin

Congress voted a number of tax law changes that affect segments of the project finance community shortly before adjourning for the November elections.

Tax-Exempt Bonds

It increased the so-called volume cap that limits the amount of tax-exempt bonds that state and local governments can issue each year to finance private projects.

The current limit is $150 million or $50 times the population of the state, whichever is greater. This would increase to the greater of $225 million or $75 times the population, whichever is greater. However, the new ceiling would be phased in over the period 2003 through 2007. Until then, it would remain at current levels.

Developers of independent power projects sometimes tap into the tax-exempt bond market for part of their financing. This gives them a lower borrowing rate. Tax-exempt financing is most common for power plants that use coal, waste coal, garbage and other forms of biomass as fuel. It is also sometimes used for hydroelectric facilities.

US Tax Deferral

US companies engaged in the "active conduct of a banking, financing or similar business" will find it easier to defer US taxes on earnings from offshore lending.

Since the US taxes US companies on worldwide income, but it does not tax foreign corporations on income from foreign operations, US companies typically set up offshore holding companies in tax havens like the Cayman Islands to receive and redeploy their earnings from foreign operations.

However, this strategy does not work to the extent the foreign operations throw off passive income like interest. The US will look through the Cayman holding company and tax the US owners

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CONTRACT BUYOUTS MADE CHEAPER . . . The IRS told a utility in a private ruling recently that the utility can deduct part of the amount it paid a "qualifying facility" to buy back two power contracts and take title to the generating equipment. The IRS let the utility deduct the amount the parties allocated to the contract buyback as opposed to the power plant. The more quickly a utility can deduct buyout payments, the less expensive the buyout will seem after taxes are taken into account.

In a related development, the IRS national office told an agent to give in on the issue whether the

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Tax Changes

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on any passive income. Tax lawyers refer to such passive income as "subpart F income." This reflects the US view that it will permit deferral only by active offshore businesses in order to prevent tax planning around where taxpayers want to record income from passive business that can be conducted just as easily from the US.

In late 1997, US banks and securities dealers succeeded in getting a special carveout for interest and other passive income from "active conduct of a banking, financing, or similar business." The banks argued that, even though the returns look passive, this is an active business for them. However, the carveout lasted only one year and was basically available only for income earned from financing transactions in the same country where the offshore business entity of the bank was located.

Congress just extended it for another year to the end of 1999, and also broadened the carveout to allow deferral for returns from cross-border financing transactions. The US Treasury resisted this feature because its view is that US tax deferral should be allowed only as long as US multinationals retain earnings in the country where they are earned. Most US multinationals currently lift foreign earnings to a tax haven and then redeploy them in other countries, to the consternation of the Treasury. The Treasury has now had to concede the issue — at least temporarily — to multinational banks.

Depreciation Study

Congress directed the Treasury to study current depreciation methods and recovery periods and report back to Congress by April 2000 on any changes it recommends. Most power plants are depreciated over 15 or 20 years. It is an interesting question whether the technology is changing so rapidly that this life no longer reflects the true economic life or, perhaps it reflects economic life but there is a more accelerated pattern to loss of value than is reflected in current write-down schedules.

There is little enthusiasm at Treasury for the assignment. Congress instructed Treasury to do essentially the same thing in 1986. Treasury devoted significant resources to the job and sent a number of reports to Congress, but the reports sat largely unread.

Section 29

The end-of-session tax bill may be more notable for what it did not do. Developers of projects to produce synthetic fuel from coal and steel coke had hoped for more time to place remaining projects in service to qualify for section 29 tax credits. The federal government offers a credit of $1.052 per mmBtu for producing unconventional fuels like landfill gas and syncoal. However, all remaining projects had to be in service by June 30, 1998 to qualify. Syncoal companies pushed hard for another eight months to the end of June 1999 and came extraordinarily close, but lost in the final negotiating round.

Section 45

In what may yet turn out to be good news, Congress did not extend a 1.7 cents per kWh tax credit for producing electricity from wind and "closed-loop biomass." The credit runs for 10 years. Projects must be in service by June next year to qualify.

The chairman of the Senate tax-writing committee, William Roth (R.-Del.), pushed to expand the credit to cover electricity generated from chicken droppings and extend the in-service deadline. Roth said the US produces eight billion chickens a year.

The landfill gas industry has been looking for a new tax credit to encourage landfill gas production now that section 29 credits are expiring. Congress's failure to extend the section 45 credit this year gives landfill gas producers another shot at hitching a ride on that credit. The House, which resisted doing anything about section 45 this year, has viewed it as an issue for next year. ■

Congress Orders Possible Sanctions Against More Countries

by Heléna Klumpp

Congress voted, shortly before adjourning for the November elections, to require US economic sanctions against countries that practice religious persecution. Congressional proponents said the bill could require sanctions against such countries as China, Pakistan, Egypt and Saudi Arabia. President Clinton said he will sign it.

Annual Reports

The new statute will require the US State Department to create an office on international religious freedom. This office will make annual reports to Congress describing the status of religious freedom in each country around the world and disclosing the nature and extent of any violations of such freedom. Countries that demonstrate significant improvement in the protection of religious rights will also be identified.

The first report is due next September.

The reports will also make recommendations in cases where sanctions should be imposed.

Sanctions

The president must take one of two actions where a foreign government "engages in or tolerates violations of religious freedom." He must either impose one or more sanctions from a list of 15, or persuade the foreign government to enter into a binding agreement to stop the persecution in question.

The president will have fewer options in cases where there are "particularly severe violations of religious freedom." In these cases, his choices for sanctions include the following:

- withdraw US foreign assistance;
- direct the US Exim Bank, OPIC and the Trade and Development Agency (formerly

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proceeds from sale of a QF contract to a utility produced long-term capital gain for the QF. The agent was arguing for ordinary income. The national office said he had a "colorable argument," but there were litigating hazards and it advised giving in, at least on a portion of the gain. The advice is in a 1992 "field service advice" that was just made public.

CONGRESS WILL LAUNCH HEARINGS NEXT YEAR ON REWRITING INTERNATIONAL TAX RULES, according to Senator Roth (R.-Del.). These rules date from the 1960's and are out of sync with the times. Roth is chairman of the Senate Finance Committee.

A key issue in the debate will be to what extent US tax rules should favor letting US companies compete on the same terms as the competition in foreign countries or to what extent the focus should be "tax neutrality," which is the idea that US companies should be subject to the same 35% tax on worldwide income whether they invest at home or abroad. Otherwise, they may have an incentive to invest abroad. Labor unions tend to worry about "runaway plants."

A UTILITY GROUP COMMENCES AN EFFORT to fix foreign tax credit problems in the power industry, but the fix would only help affiliates of regulated electric and gas utilities.

All US companies doing business overseas run quickly into a double taxation problem. The US claims the right to tax US companies on worldwide income. In theory, it lets anyone who has already paid taxes abroad on the same income claim a credit for these taxes in the US. However, the foreign tax credit rules are so full of fine print that few US power companies are able to claim such credits in practice.

The main problem is that interest paid on borrowing in the US is treated partly as a cost of foreign operations, even if the borrowed money was put to use solely in the US. This reduces earnings from overseas and reduces capacity to claim foreign tax credits, since the US only

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Congressional Sanctions

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AID) not to extend guarantees or insurance or make loans;

- direct US representatives on the boards of international financial institutions, like the International Finance Corporation and Asian Development Bank, to vote against financial assistance to the country;
- withhold US export licenses for goods destined for the country; and
- prohibit US banks from making loans or extending credit totaling more than $10 million in any year to the foreign government.

Sanctions will not apply to products or services that were covered by a binding contract before the sanctions were announced. Sanctions will also not be imposed against a country that is already feeling the full brunt of US economic sanctions — for example, Iran, Iraq and Sudan.

Waivers

The president will not be required to impose sanctions if he decides the sanctions would interfere with an "important national interest" or if a waiver would "further the purposes" of the sanctions statute. He may also waive if the foreign government has ceased the violations. The president must report to Congress on his reasons for any waivers.

Termination

The president decides how long sanctions will remain in effect in the first instance. There is a limit of two years. They can be renewed. He may terminate them sooner without the need for any action by Congress. ■

IRS Provides Roadmap for Hybrids

by Keith Martin

Foreign tax planning often consists of trying to exploit differences in definitions between the US and a foreign country.

For example, there are benefits to capitalizing a foreign subsidiary through hybrid instruments that look like debt to the local country but are equity for US tax purposes. (The benefit is one can reduce foreign taxes in the foreign country and, at the same time, defer taxes in the US.) However, this is not always easy to do. The US and the other country must define "debt" differently. There is also the problem what the instrument says. The US will usually hold a taxpayer to whatever form he chose for an instrument. Thus, if the instrument uses debt terminology, the taxpayer will have to have strong proof to overcome the presumption that he should be stuck with his own label.

Earlier this year, the IRS announced that it would no longer issue advance rulings in transactions where a company is claiming inconsistent tax treatment between the US and a foreign country with which the US has a tax treaty. Taxpayers will have to take their chances on audit.

With that background, it was surprising to see the IRS approve a hybrid transaction in a private ruling to a US manufacturing company recently. The IRS just made the ruling public. (A private ruling is not binding on the IRS except for the taxpayer to whom it was issued.)

The US manufacturing company has a subsidiary in country X. Country X gives tax credits to encourage foreign investment. The US manufacturer wants to count the retained earnings it leaves in the subsidiary as new investment in country X. Unfortunately, tax credits are not available unless the money leaves the country and is reinvested from offshore.

Consequently, the manufacturer entered into what the IRS said was a "binding commitment" with its subsidiary in which the manufacturer committed to vote all its shares at the next shareholder meeting to cause the subsidiary to pay out the retained earnings as a dividend, and it also committed to return the dividend, net of withholding taxes, to the subsidiary as an additional capital investment.

The manufacturing company went to the IRS just before carrying out the plan. The subsidiary planned to pay the dividend into a bank account in country X in the name of the US manufacturer. The bank would then transfer it to the bank account of the subsidiary per advance instruction. No additional shares would be issued by the subsidiary in exchange for the capital contribution.

The IRS said there will be no dividend in the US.

It essentially collapsed the steps and treated them as if nothing had happened.

The taxpayer got hybrid treatment — a dividend for foreign tax purposes but a nonevent in the US. The IRS was no doubt swayed by the fact that all the steps had been wired in advance.

Foreign tax planners have a certain number of tools in their tool boxes. The ruling serves as a reminder to consider pre-wiring and binding commitments to give a transaction or instrument a different look in the US. ■

Aggressive Tax Structure Loses Round Two

by Keith Martin

A US appeals court held in mid-October that the Internal Revenue Service was right to deny the benefit from a series of complicated offshore maneuvers Colgate-Palmolive undertook in 1989 and 1991 to generate $98

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allows credits for up to 35% of foreign earnings.

Senator Mack (R.-Fla.) introduced a bill on October 14 that would fix the problem only for companies that are consolidated for federal income tax purposes with a regulated electric or gas utility.

Mack is a member of the Senate tax-writing committee. The bill will feature in the international tax reform debate next year.

USE TAXES ON ELECTRICITY LOOK MORE AND MORE LIKELY as states look for ways to make up for loss of other tax revenue from deregulation.

The idea of imposing use taxes is often part of a plan to cut property taxes on regulated utilities and put them on an equal footing with independent generators. A Minnesota study last summer found that property taxes on just two utilities in 1995 would have dropped from $222 million to $35 million if utility property was assessed the same as other taxpayers. Ohio utilities proposed at the end of August to cut utility property taxes but make up the revenue by imposing an electricity use tax on a cents-per-kWh basis. The tax would be paid by consumers, but be collected by electric distribution companies.

LOOK FOR A SHOWDOWN NEXT YEAR BETWEEN IOUs AND MUNICIPAL UTILITIES over whether munis can serve customers outside municipal boundaries and still retain the tax exemption on their debt.

Municipal utilities expect to suffer erosion in their customer bases due to deregulation. This makes it hard to make debt service payments unless they try to replace the revenue from lost customers by expanding the areas they serve. Most municipal facilities are financed with tax-exempt debt. However, the tax exemption is threatened if they expand.

Senator Gorton (R.-Wash.) said September 30 that he will make a major push next year for a bill that has the backing of municipalities. The bill would allow expansion without the loss of tax exemption on

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Aggressive Tax Structure

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million in tax losses.

The case has attracted enormous attention in the tax community.

The transaction complied technically with US tax rules, but the court refused to honor the results on grounds that it had no credible business purpose. At least one commentator applauded the decision by the lower court last year — also in favor of the government — as a sign that the courts are beginning to hit back at aggressive tax schemes that work technically but defy common sense.

The case should disabuse any taxpayers who believe the sheer complexity of their transactions will make them impossible for the IRS to sort out.

The case is *ACM Partnership v. Commissioner*. Colgate-Palmolive sold a subsidiary in 1988 at a capital gain of $104.7 million. Merrill Lynch came to it late in the year with an idea for how to generate capital losses to offset the gain. It was late the following year when Colgate-Palmolive implemented the transaction.

Briefly, the company formed an offshore partnership in the Netherlands Antilles with subsidiaries of the Dutch bank ABN-Amro and Merrill Lynch as partners.

The three partners contributed $205 million to the offshore partnership. The partnership used the money the next day to buy short-term floating-rate notes from Citicorp. It sold the notes for roughly the original purchase price later the same month pursuant to terms that Merrill Lynch had negotiated around the time the notes were originally purchased.

The sale generated $140 million in cash for the offshore partnership and a promise from the buyers to pay the rest over time with interest tied to LIBOR.

Because of peculiarities in the US tax rules governing installment sales, the offshore partnership claimed a large gain on the sale of the Citicorp notes even though there was no gain in fact. Under the installment sale rules, the partnership was able to allocate its $205 million "basis" in the notes ratably over the four years that the balance of the purchase price was expected to be received from the buyers. This produced a large gain in the year of sale that was expected to be matched by equal losses in later years.

At the time of sale, ABN was an 82.6% partner, so most of the gain was allocated to it. Since ABN was not a US taxpayer, this gain escaped US tax.

By the time the offsetting losses were recorded, Colgate-Palmolive had increased its ownership of the partnership to 99.7%. Thus, the losses were claimed against the US tax base.

The appeals court disallowed almost all the losses. It applied two tests to the transaction. First, it did an objective analysis of the whether the transaction had any effect on Colgate's financial position or whether it was entirely a tax play. The transaction failed. The court said, "Tax losses such as these, which are purely an artifact of tax accounting methods and which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code . . . ."

Next, the court applied a subjective analysis of whether the transaction had any credible business purpose. Colgate argued that one purpose was to reduce the amount of the company's long-term debt without signalling that fact to the market. The company was a target in 1989 of unwelcome takeover speculation and any move

to reduce leverage might give hope to buyers wanting to do a leveraged buyout of the company. The offshore partnership used the $140 million in cash that it received from the sale of the Citicorp notes to buy Colgate debt. The fact that the offshore partnership now holding the Colgate debt was controlled by ABN meant the debt reduction did not have to reported on financial statements as Colgate buying back its own debt. Merrill Lynch originally brought the tax planning idea to Colgate in October 1988. Colgate made it go back and work debt management as another objective into the deal structure. Merrill Lynch returned with the revised proposal in August 1989.

The appeals court was not persuaded. The court said the timing of the debt acquisition strategy made no sense given that Colgate management was expecting interest rates to fall.

Colgate took a real loss of $5.8 million on the installment notes due to declining interest rates. The appeals court allowed this loss to be deducted, but not the rest. The IRS had argued that all losses associated with the transaction should be disallowed.

It was a divided decision. One of three judges dissented. He accused the majority of applying a smell test, and argued the IRS should complain to Congress or fix its own rules rather than rely on the courts.

The case suggests a number of lessons for multinational corporations engaged in foreign tax planning. First, a business purpose is essential, and it must be credible. Second, alarm bells should sound if the transaction has little real economic effect in relation to the large tax consequences claimed. The US government is currently attempting to apply this theory in other areas. For example, in Notice 98-5 earlier this year, the IRS said it would attack transactions that generate large foreign tax credits at the same time little taxable income is reported. Regulations to implement

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existing debt, as long as a utility foregoes the right to issue any additional bonds to finance generating plants. It could continue to finance its transmission and distribution lines, and certain pollution control equipment, in the tax-exempt market. The Clinton administration supports a version of the Gorton bill.

Meanwhile, IOU's are backing a bill by Senator Murkowski (R.-Alaska) that would let munis that expand keep existing tax-exempt debt, but only on two conditions. They would have to forego any future tax-exempt borrowing to finance generating plants. They would also have to repay their outstanding debt at the earliest redemption date allowed under the bonds. For bonds issued since November 1997, redemption would have to occur within 10 years at the latest.

Murkowski chairs the Senate Energy Committee. However, neither senator is on the tax-writing committee where the issue will ultimately be decided.

THE FIRST LILO WITH ULTIMATE US OWNERSHIP closed on the King's Lynn power plant in the UK as a bolt-on to a UK tax lease.

LILO's are a form of lease financing where the owner of a power plant leases his plant to a US equity, which subleases it back. Because of differences in the rent patterns under the head lease and the sublease, the US equity ends up with net rent deductions in the early years that look like accelerated depreciation. Meanwhile, the lessee is able to pocket a net upfront cash payment of as much as 8 or 9% of the asset cost.

Most LILO's involve assets owned by foreign governments or US municipalities. The problem with assets belonging to US private companies is the lessee cash benefit is treated as prepaid rent for US tax purposes and would be taxed immediately in the US.

This development is a huge potential breakthrough. However, US Treasury officials say long-anticipated final regulations under section 467 — which will require that the LILO product be

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Notice 98-5 are expected shortly.

The case should disabuse any taxpayers who believe the sheer complexity of their transactions will make them impossible for the IRS to sort out. The appeals court opinion takes the better part of a day to read properly. Senator John Breaux (D.-La.), a member of the Senate Finance Committee, once said committee staff should hand out headache tablets at any committee meeting to discuss taxes that runs over two hours.

Another lesson is to exercise care how a transaction is described, not only in internal memoranda, but also by outside participants. Colgate did not want the offshore partnership to report the cost of selling the Citicorp notes as a charge against income for financial purposes. An outside auditor discussed the issue in a memo to his supervisor. The memo described the transaction as "mainly tax driven" and said the problem with reporting the sale charge was the "inclusion might set the IRS on top of the reasons why the partnership was constructed in the first place." (Auditors' memos are not protected from disclosure to the IRS.) A note from ABN in Merrill Lynch's files said the Dutch bank would participate in the transaction only if all the steps were essentially wired and ABN was assured of being bought out at par less than a month after the partnership was formed. Internal computer runs by Colgate showed no interest in the rate of return from the transaction, particularly in relation to the large transaction costs the company would incur to implement it, when deciding whether to proceed. The Colgate board said all the right things in its resolution approving participation in the transaction, but the business purpose claimed was not credible in light of these other documents.

Another appeal is possible to the US Supreme Court. The case is significant enough that this will not be the last word. The IRS has challenged at least 10 other Merrill Lynch customers on their use of the product. One, AlliedSignal, lost in the US tax

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retooled — will be issued by year end.

THE NEW COLOMBIAN GOVERNMENT proposed a series of tax reforms that are expected to take effect next January 1, assuming they are approved by Congress in December.

Among the changes that would affect infrastructure investments in the country are the following. Colombia currently collects a 10% withholding tax on payments to foreigners for technical services performed offshore but 35% for such services performed in Colombia. The rate would be set at 10% for all technical services payments.

Dividends paid to foreigners are subject currently to withholding taxes at a 7% rate, but the tax is waived to the extent earnings are reinvested in Colombia for at least five years. The reforms would forego the need to pay a dividend and reinvest to qualify for this benefit. It would be enough if earnings are merely retained in a Colombian company.

The reforms would subject electricity to VAT. It is currently exempt. The general VAT rate would be set at 15% from November 1999.

Colombian companies would also be able to deduct interest paid to Colombian banks as the interest accrues rather than waiting until the interest is actually paid.

INSTITUTIONAL EQUITY PARTICIPANTS fret about whether they give states a nexus to subject them to income taxes by investing in a project company set up as a partnership or LLC.

A new survey suggests that most states say yes for partnerships and for LLCs treated as partnerships. However, a handful of states does not assert a nexus to tax for limited partners who lack full rights to participate in management. States in this category are New Jersey, Rhode Island, Tennessee, Kansas, New York and Virginia.

Almost all states assert a nexus to tax where the

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entity is an LLC that the owner has elected to treat as "disregarded" for federal income tax purposes. The survey also found states are less likely to assert a nexus for imposing net worth and franchise taxes than for income taxes.

US SATELLITE COMPANIES look for help from the US government to stop foreign countries from collecting withholding taxes on payments for use of transponders.

PanAmSat sent a letter to the US Treasury recently asking it to clarify in treaty negotiations with Italy and Korea that the payments for use of transponders are not "rent" or "royalties" that would be subject to withholding taxes.

Many US tax treaties allow withholding taxes on payments to US companies for the "use of, or the right to use, industrial, commercial or scientific equipment." The treaties limit the rate. However, the treaties bar taxes altogether on "business profits" of US companies unless the US company has extensive enough operations in the country to constitute a "permanent establishment."

PanAmSat has a network of 17 satellites and customers in over 20 countries. The company maintains that payments from its customers are its "business profits."

David Tillinghast of Chadbourne wrote Treasury, on PanAmSat's behalf, that the treaty clause allowing withholding taxes on rents or royalties was never meant to apply to active business operations of satellite companies, even if they involve an element of providing "use of equipment." Tillinghast suggested either dropping the "use of equipment" language from US treaties or altering the source rules employed in treaties so that income derived from activities in outer space cannot be taxed.

Tillinghast was US international tax counsel in the Kennedy and Johnson administrations.

LOOK FOR THE IRS TO PROVIDE A DEFINITION OF "TAX SHELTER" before the end of the year.

This will trigger reporting of all corporate tax shelters and also fill in gaps on when tax planning memos from accounting firms are privileged from discovery by the IRS during audits.

A 1997 law requires that corporate tax shelters be registered with the IRS, but the registration requirement does not take effect until the IRS provides a definition. The promoter of the idea must usually register it. However, in certain cases, companies to whom ideas are pitched must also register them. "Tax shelter" is defined broadly by statute to cover any plan or arrangement that has as "a significant purpose" avoiding or evading US taxes.

Communications with accountants have historically been subject to discovery by the IRS on audit. However, last summer, Congress extended a limited privilege for tax advice to accountants similar to the attorney-client privilege, but the new privilege does not cover advice concerning corporate tax shelters.

ANYONE WHO HAS TRIED TO CLAIM GRANDFATHER RIGHTS for tax benefits or SO_2 allowances knows to be careful not to alter his project or contract that was the basis for grandfather relief. Otherwise, the relief may be lost.

Steelcase, a US furniture manufacturer, built a new headquarters building that it said qualified for investment tax credits and ACRS depreciation, even though these benefits were repealed in 1986. The company started building a two-story L-shaped building for $35 million before the deadline. It ended up with a seven-story pyramid that cost approximately $100 million.

Nevertheless, a federal appeals court said last month the project remained grandfathered. Steelcase claimed that since the building was "self constructed," it should be tested under a more lax requirement that merely required that it start

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construction by a certain date even if it ended up with a different project.

The judge wasn't moved by the government's complaints about cost overruns. "If there is one party which we might be tempted to say ought not to be able to make this argument with a straight face, it is the federal government."

LETTING A FACILITY THAT WAS FINANCED WITH TAX-EXEMPT DEBT sit idle may cause loss of the tax exemption on the debt.

A cement company used tax-exempt financing for a recycling plant for disposing of waste paints and solvents. It eventually shut down the equipment because the plant was outmoded technologically. The company then worked out a remediation plan with the US Environmental Protection Agency that required demolishing the equipment altogether.

The IRS said in a private ruling recently that this was okay. The tax-exempt debt could remain outstanding. The ruling discussed whether there was a "change in use" of the plant much earlier when it shut down, but said there was not because the owner "kept the components in a condition so that they could be reactivated and used for the qualifying purpose for which the bonds were issued."

A change in use would have required that the bonds be repaid within 90 days (or the funds set aside in escrow).

THE IRS IS STUDYING WHEN IT WILL LET A COMPANY TRANSFER JUST PART OF ITS ASSETS to a new owner without triggering a tax on gain.

In 1997, Congress ruled out "tax-free spinoffs" of corporate assets to shareholders as part of a plan ultimately to transfer the assets to a new owner. In a spin-off, a company distributes part of its assets to its shareholders. Since 1997, the distribution will trigger a tax to the distributing corporation on any gain. This makes it more expensive to dispose of just part of a business.

The IRS is now wrestling with when it will link the two steps as a plan. James Sowell, a Treasury lawyer, suggested in mid-October that a plan will be found in most cases unless the company had no idea a suitor was lurking in the wings when it did the spinoff.

HONDURAS, INDONESIA, COLOMBIA, ECUADOR, VENEZUELA AND RUSSIA rank among the 10 most corrupt countries in the world, according to the latest listing by Transparency International.

The listing is a warning to US companies doing business in these countries to be on the lookout for payments to government officials. The US Foreign Corrupt Practices Act makes it a crime to give anything of value to a government official, political party or candidate for office in an effort to win or retain business. A US company will be held accountable for bribes that others pay on its behalf under a hindsight standard of whether the US company should have known part of its payments to a local consultant or joint venture partner would be passed along to a foreign official.

Scandanavian countries occupied the top three spots for "least corrupt." The US did not make the 10 least corrupt. Transparency International is based in Berlin.

THE SWEDISH CROSS-BORDER LEASE MARKET shut down after a decision this summer by the Regeringsrätten, or supreme court, that denied Swedish lessors depreciation on aircraft that they had leased cross border.

Bjorn Ohde, a tax lawyer with the prestigious firm Mannheimer Swartling Advocatbyra AB, said he and others are working on draft legislation with the aim of reopening the cross-border market sometime next year. Swedish leases offered a relatively low 3 to 4% net present value benefit for lessees, but they remained popular with Asian lessees because of their simplicity and perceived lack of tax aggression. US paper company

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Willamette Industries reportedly closed on a Swedish lease of paper machinery as recently as December.

Lessees under existing leases risk a possible early termination of their leases, according to Ohde, but there should be no other effect. In a typical lease, the lessor takes Swedish tax risk. In some leases, the lessor has a right to terminate the lease for increased costs.

The Japanese lease market also shut down in September. This is expected to mean more demand for US lease equity, with higher returns for US lessors.

INDIA ACKNOWLEDGED that a most-favored-nation clause in its tax treaty with Holland has the effect of reducing withholding taxes on interest, rents and royalties paid to companies in Holland to 10%.

In a related development, the Dutch finance ministry announced that it would not let Dutch companies claim credit against Dutch income taxes for the new tax India has imposed since June 1997 on distributed profits. India used to collect a withholding tax at the border on dividends paid to foreign shareholders. This tax was clearly creditable in Holland. India switched in June 1997 to a tax on distributed profits. The new tax is imposed on the Indian company paying the dividend.

OWNERS OF BUILD-OWN-TRANSFER PROJECTS IN VIETNAM will be subject to a flat 10% income tax rate, according to new regulations issued in mid-August. The projects will also qualify for a four-year tax holiday commencing in the first year a project turns a profit, and a 50% reduction in tax rate for the next four years.

POLAND IS EXPECTED TO REDUCE ITS CORPORATE TAX RATE from 36 to 32% effective January 1. At the same time, companies will no longer be able to claim a special tax deduction for 25% of an investment's value. The business community was disappointed that proposals for a corporate tax rate in the 22 to 26% range have been set aside for now.

HUNGARIAN PRIME MINISTER Viktor Orban promised "radical" tax reform by 2000 at a breakfast in Washington in October. The corporate tax rate was recently cut in half from 36 to 18%. Orban said the social security tax level would also be chopped in half during the next four years.

ROMANIA CUT WITHHOLDING TAXES in an effort to attract foreign investment. The new rates are 15% on royalties and payments for services and 10% on interest, except that interest received on deposits in Romanian banks is exempt. The government is also expected to eliminate a 1.5% charge on the price paid for securities in Romanian companies.

MINOR MEMOS . . . Gillette filed suit in federal court recently to fight the IRS over a claim that the company unwittingly triggered US "toll charges" twice on the same appreciation in value of its Mexican operations when the company restructured in Mexico. The US collects a 35% tax, or toll charge, when it sees appreciated assets leaving the US tax net . . . . A new coal audit guide the IRS distributed to its field agents last month lists 12 issues to be on the lookout for in audits of coal producers, including audits of power companies that recover coal from riverbeds or from culm or gob piles . . . . Congress will have to reopen the issue next year how to make up a shortfall in a benefits fund for retired coal miners and their families after the Supreme Court struck down a "reachback" tax that Congress imposed in 1992 to force companies that had any involvement with the industry going as far back as the 1950's to contribute to the fund . . . . The IRS said in two "field service advice" memos recently that income from contracts or options that a company enters into as a hedge have the same

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I just finished reading the article in the last issue of Project Finance NewsWire about covenants in loan agreements designed to protect project lenders from risks of computer failure associated with the "Y2K" problem.

We just drafted some Y2K provisions that I thought might interest you. In addition to the points mentioned in last month's article, here are a couple things to keep in mind:

- Covenants should also cover "firmware" (i.e., software that is imbedded into read-only memory) ; and
- They should also require that "compliance" last for the entire period of the concession. This provision is very important because Y2K problems, which are the result of using too few digits to refer to possible dates, will occur on many systems on dates other than 12/31/2000.

Subject: ***Mexican tax reforms***
To: ***Layda Carcamo in Mexico City***
layda@mpsnet.com.mx
From: ***Keith Martin***

Layda,

An article in the current issue of *International Tax Review* says,

"The Mexican government is planning to introduce an integral reform of the tax system. Details of the reform are likely to be released in September. The proposals are expected to include changes to the taxation of derivatives, tax haven regulations . . . and withholding tax on interest."

Have details been released? If yes, do any of the proposals affect foreign investment in infrastructure projects?

– REPLY –

Subject: ***RE: Mexican tax reforms***
From: ***Layda Carcamo***

No official proposals have been released yet. Usually, the proposed amendments to the tax laws are submitted to Congress sometime in November, and the approved document is issued by Congress at yearend (around December the 27-30th). However, we do know of some of the intended reforms

. . . . From what we have heard, most of the amendments would not affect infrastructure projects, but there may be important changes to accelerated depreciation and to withholding on interest that may possibly affect them.

Subject: ***China developments***
To: ***Yi Zhang in Hong Kong***
yi.zhang@chadbourne.com
From: ***Keith Martin***

Yi,

I read in the *Wall Street Journal* that the Chinese government published a circular declaring null and void local government guarantees on foreign debt. How will this affect infrastructure projects?

The *Journal* also reported that China recently "banned the import of small and midsize power plants — those under 600 megawatts — instructing its nominally independent power companies to buy local equipment." Can you give me more information about the ban?

– REPLY –

Subject: China Developments
From: ***Yi Zhang***

The State Council's circular basically clarifies that the government will strictly enforce existing rules against local government guarantees. Most big projects in China will not be affected by the circular because they correctly obtained guarantees from the central government instead of the local governments. Many smaller deals in China, however, have relied on various kinds of guarantees from different government entities, which have always been illegal.

Regarding your second question, we knew for a long time that there was an internal policy strongly favoring the use of domestic equipment for units of 300MW or smaller. The rationale is that China can make these generators pretty well and China needs to keep workers employed. The government is now attempting to make companies use Chinese-made 600MW units as well.

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