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# The Privatization and Project Finance Adventure: Acquiring a Colombian Public Utility Company

*Mario Andrade*

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## I. INTRODUCTION

It is a bright sunny summer day and you are sitting in your office wondering why you are not on the golf course or at home with your spouse and kids. Suddenly the telephone rings; it is a client with an urgent problem.

The client is considering bidding on a public utility privatization project in Colombia. The client's concerns run the gambit from privatization law questions to choosing local counsel. How do you effectively advise the client on the laws and business customs of an entirely foreign jurisdiction, while keeping in mind U.S. transactional consequences? The international project finance adventure has begun.

Colombia is an exciting new arena for the international practitioner structuring project finance and privatization transactions.<sup>1</sup> The sectors of

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Note: The views and opinions expressed in this article are solely those of the authors and do not reflect Deloitte Touche Tohmatsu's official position. Errors, omissions, and/or generalizations are attributable only to the authors. Additionally, because of the constant state of change in the Colombian law, laws and norms cited herein are controlling only as of August 1999.

the economy that are attractive targets for most multinationals (MNCs) entering Colombia are the energy, oil and gas, mining, water, and telecommunications sectors.<sup>2</sup>

In most cases, MNCs in these sectors consider investments in Colombia when the Colombian authorities announce a plan for the privatization or capitalization of state-run companies that have a monopoly on business.<sup>3</sup> Often the MNC becomes aware of the privatization, concession, or capitalization<sup>4</sup> project via an official announcement by the

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<sup>1</sup> Despite much internal political upheaval during the 1990s (in this context it is important to note that, for the past 35 to 40 years, Colombia has been experiencing an undeclared civil war), foreign investment in Colombia has increased steadily. At the end of 1992 foreign investment was registered at U.S.\$3 billion; a year later this figure increased by U.S.\$61.5 million and in 1994 it neared U.S.\$8 billion. Diego Herrera Caipa, *La Inversión Extranjera en Colombia Crece Como Espuma*, LA REPUBLICA, Aug. 12-18, 1997, at 6. According to a 1998 government report for the first trimester of the year, new foreign investment (composed of new capital, plus retained earnings, minus capital reimbursements) stood at U.S.\$1.1 billion. In terms of growth, from the 1997 first trimester to 1998 direct net foreign investment grew by 155 percent. INVERSIÓN EXTRANJERA EN COLOMBIA: INFORME DEL PRIMER TRIMESTRE DE 1998 (COINVERTIR) (Julio 1998). See COLOMBIA: INTERNATIONAL TAX AND BUSINESS GUIDE 2-4 (Deloitte Touche Tohmatsu eds. 1997) ("Foreign investment rose in 1996, as it had in previous years. According to statistics from the Central Bank, non-oil foreign direct investment increased from U.S.\$5.7 billion in December 1994 to U.S.\$9.4 billion in November 1996. According to the Foreign Investment Agency, foreign investment in the oil sector stood at U.S.\$1 billion in 1995"). See also GLOBALIZACIÓN DE LA ECONOMÍA Y COMERCIO EXTERIOR: INFORME DEL MINISTERIO DE COMERCIO EXTERIOR AL CONGRESO JUNIO 95-JUNIO 96 (Colombian government report on private and public sector foreign investment). But see Jacob M. Schlesinger, *La Inversión de Capital Privado hacia América Latina se Estabiliza*, in WALL ST. J. AMERICAS (included in EL TIEMPO, Sept. 12, 1997, at 2 B) (recent studies by international investment banks and funds indicate that private capital investments in Colombia are beginning to level off).

<sup>2</sup> The bulk of foreign investment during 1997 was directed toward the energy sector. *Inversión Extranjera hasta Mayo Creció 68 percent*, LA REPUBLICA, Sept. 17, 1997, at 1A, 10A.

<sup>3</sup> The decision to put a state owned company on the auction block is not so much a desire on the nation's part to embrace free market economics, but is rather an attempt to eliminate the mammoth-like debt of the state enterprise. See Tara K. Guinta, *Building Blocks to Forging a Robust Telecommunications Infrastructure*, 27 INT'L L. NEWS 1, 18 (Spring 1998) ("Inefficiencies run rampant in nationalized industries, which generate deficit which, in turn, prevent economic growth and prosperity for nations and their citizens."). This was the case in the decision to capitalize the Bogotá Energy Company in the summer of 1997. See Deyanira Tibana Muñoz, *Nuevos Socios Para Salvar Energía*, EL TIEMPO, Aug. 8, 1997, at 1D-2D (the financial demise of the Bogotá Energy Company was of such magnitude that failure to capitalize would lead to eventual bankruptcy). More recently, the decision to capitalize The Electric Company for the Atlantic Coast of Colombia (known as "CORELCA") during the summer of 1998 was driven by the fact that it have outside liabilities of close to U.S.\$1.2 billion, which it could not cover on its own. PROCESO DE REESTRUCTURACIÓN Y CAPITALIZACIÓN DE CORELCA Y LAS ELECTRIFICADORAS DE LA COSTA ATLÁNTICA/DOC. COMPES 3013 (Ministerio de Hacienda y Crédito Público, Ministerio de Minas y Energía, DNP: UINFE: DIMEN/ Departamento de Planeación Nacional de Colombia, Julio 14, 1998).

<sup>4</sup> Under the current Colombian political climate, privatization schemes are organized preferably under the rubric of capitalization processes, where foreign capital is brought in by

Colombian government calling for bids or an invitation informing the MNC that it is qualified for the particular project or a specific aspect of the project.

When a client is interested in participating in the bid process, it will most certainly, unless it has participated in other bids in Colombia, approach counsel and its other advisors with assumptions of how the bid should be structured, from both a Colombian and U.S. angle. In these instances, the only option for counsel and other advisors is to listen and take note. The following key questions must be considered under this scenario: what type of restrictions exist under current privatization laws; what form of business association should be used; what is the tax treatment regarding business associations, dividend treatment, technical services and assistance contracts, and repatriation of profits; do foreign exchange regulations hinder the availability of using inter-company loans and foreign currency operations; how should the due diligence review be performed; and how should local counsel be chosen?<sup>5</sup>

## II. ISSUES AND CONCERNS

### A. Colombian Privatization Law Issues

Compliance with Colombian privatization and related law is a must when crafting a public utility privatization or a capitalization transaction. In this regard, two pieces of legislation should be studied: Law 226/95 and Law 142/94.

#### 1. Law 226: Colombian Privatization Regulation

Law 226/95<sup>6</sup> regulates privatization in Colombia. The law provides a procedural map for privatization and capitalization transactions,<sup>7</sup> while

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an MNC or other foreign investor to purchase a significant share of the stock of the government entity's stock. See *Privatizaciones*, LA REPUBLICA, Sept. 2-8, 1997, at 6-7 ("The privatization model. . . that characterizes these processes in Colombia is private shareholder participation in traditionally state owned enterprises, a model of private sector participation in a mixed economy setting. . ."). Usually the foreign investor will purchase between 48 to 57 percent of the public entity's stock. *Id.* at 6. Public policy reasons for this strategy are twofold: (i) the public entity receives a fresh foreign capital injection to pay off existing debt and reorganize, and (ii) the government retains some control or semblance of it over the entity, even if only in the form of preferred non voting class stock. The latter is important from a political standpoint, given that it is in the government's best interest to preserve some appearance of sovereignty over its traditionally controlled operations.

<sup>5</sup> See THE INTERNATIONAL LAWYER'S DESKBOOK (Lucinda A. Low et al. eds., 1996) [hereinafter LAW. DESKBOOK] (setting out issues and concerns that must be considered when doing business in foreign jurisdictions); JAMES-OTIS RODNER S., LA INVERSIÓN INTERNACIONAL: EN PAÍSES EN DESARROLLO (1993) (legal and economic analysis of issues to be considered when conducting foreign investment in developing nations).

<sup>6</sup> Colombian Law 226/95 [hereinafter Law 226]. See *¡Energía!*, PODER & DINERO, Oct. 1997, at 220, 225-226 (illustrating the complexity of Law 226 application in the

setting out to democratize<sup>8</sup> the ownership and operation of state-run entities. Law 226 mandates that once a public service is privatized, necessary steps must be taken to guaranty that the service provided is continued throughout the newly privatized or capitalized entity's life.<sup>9</sup>

Democratization of ownership under Law 226 is the (initial) offering of public utility shares to the public utility's employees (in Spanish, *El Sector Solidario*).<sup>10</sup> The statutory language states, "Processes involving any disposition must be channeled through mechanisms guaranteeing adequate public notice and agreement and procedures promoting massive [public] participation in stock property."<sup>11</sup>

The Colombian Constitutional Court interprets this language to apply to the sale of state-owned assets, as well as to shares of stock.<sup>12</sup> The Court's interpretation is based on Article 60 of the Colombian Constitution. Article 60 provides that when the State sells or transfers its participation in a public entity it must, first, in the spirit of democratic processes offer its stake in the entity in the form of stock to the entity's employees.<sup>13</sup> This position, although highly debatable given the exact language of the law which talks of state-owned shares of stock, has not been challenged successfully to date,<sup>14</sup> due to its constitutional underpinnings.

Democratization under Law 226 is achieved once the labor sector has been offered a chance to participate in the ownership of state-owned assets. Typically, based on the capitalization process performed in the Bogotá Electric Company in September 1997, labor will only be allocated a one

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capitalization process of the Bogotá Electric Company (the largest Colombian utility company to ever be capitalized to date)).

<sup>7</sup> In some cases, Law 226 takes precedence over other Colombian administrative contract law principles. Law 226, art. 2.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.* at art. 5.

<sup>10</sup> *Id.* at art. 3.

<sup>11</sup> *Id.* at art. 2.

<sup>12</sup> *In re Unconstitutionality of Law 226/95, Articles 15 and 24*, Colom. Const. Ct., Op. C-343/96 (Aug. 5, 1996); *In re Unconstitutionality of Law 226/95, Article 20*, Colom. Const. Ct., Op. C-392/96 (Aug. 22, 1996).

<sup>13</sup> Colom. Const., art. 60.

<sup>14</sup> In the Colombian legal system, unlike the U.S. system, a party may bring an action challenging the constitutionality of a portion of a law without a specific case and controversy giving rise to judicial redress or relief. *Thompson v. Zurich Ins. Co.*, 309 F. Supp. 1178, 1181 (D.C. Minn.). Court holdings under a civil law paradigm, as in Colombia's case, serve only a persuasive and interpretive function in most cases. *In re Effect of Jurisprudence*, Council of State Op., Dec. 4, 1944 (appellate level administrative law court holding that laws are created only by the Colombian Congress and the administrative agencies empowered to do so); Colom. Civ. C., art. 17 (stating interpretive nature of court holdings under Colombian law). See generally RAYMOND GUILLIEN & JEAN VINCENT, 239 DICCIONARIO JURÍDICO (1995) (law in a civil jurisdiction is understood to be legislation, related administrative regulations, and the constitution). However, in the area of privatization and administrative law, Constitutional Court holdings are binding on agencies and entities managing and organizing privatization projects.

percent or nominal participation in the new entity.<sup>15</sup> As such, the foreign investor should not be scared off by the law's spirit.

Substantively, the scope of Law 226 covers total and partial sales to individuals of stocks or bonds obligatorily convertible into shares (BOCEAS),<sup>16</sup> belonging to the state and to any level of participation in the capital of any state entity.<sup>17</sup> Total or partial sales of state-owned stock or BOCEAS are conducted under the utmost scrutiny for public policy reasons.<sup>18</sup> This is because these assets are owned with public moneys.<sup>19</sup>

Procedurally, Law 226 transactions are structured in the following manner: first, the national government decrees that it will privatize or capitalize a state owned asset;<sup>20</sup> second, the appropriate ministries design a program for the privatization or capitalization process based on technical studies, directed by the Finance Ministry;<sup>21</sup> third, the process is approved by the government and public notice is affected (this notice may be given via tombstone advertisements), initially directed toward labor;<sup>22</sup> fourth, steps are taken to guarantee that the process is democratic, through limitations on the negotiability of shares and sanctions for transactions affected within set time frames.<sup>23</sup>

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<sup>15</sup> JONATHAN ARNOLD & STEPHEN EDKINS, EMERGING MARKETS EQUITY RESEARCH: COLOMBIA – ELECTRIC UTILITIES, COLOMBIA ELECTRICITY PRIMER – GET CONNECTED 24 (Santander Investment Securities Inc. 1997).

<sup>16</sup> BOCEAS are debt/equity instruments that may only be used by joint stock corporations. The use and issuance of this instrument is regulated by the Superintendency of Securities (the Colombian governmental agency regulating the securities markets) pursuant to Super. Sec. Res. 400/1995.

Additionally, Colombian commercial law establishes two forms of joint stock corporations. A joint stock corporation may be a generic corporation (*Sociedad Anónima*), see Colombian Commercial Code [hereinafter Colom. Com. Code], arts. 373-460, or a limited partnership issuing shares (*Sociedad en Comandita por acciones*), see Colom. Com. Code, arts. 343-352. See *Colombia Law Digest*, in MARTINDALE-HUBBELL INTERNATIONAL LAW DIGEST: ARGENTINA – VENEZUELA LAW DIGESTS, COL-9 (1995) (providing survey of Colombian business associations). The basics of these two business association forms are discussed in section B of this article.

<sup>17</sup> Law 226, art. 1.

<sup>18</sup> Transparency issues are a concern, given unfortunate trends of corruption associated with many governmental processes in Latin America. See John Otis & Jeb Blount, *Law & Order*, LATIN TRADE, June 1997, at 48-57 (survey of Latin American corruption and governmental efforts to curb it).

<sup>19</sup> Law 226, art. 1.

<sup>20</sup> *Id.* at art. 6.

<sup>21</sup> *Id.* at art. 7. The technical studies will include a valuation and appraisal of the shares of stock to be transacted (this phase will factor in the market value of assets and liabilities and asset profitability). *Id.*

<sup>22</sup> *Id.* at arts. 8-9.

<sup>23</sup> *Id.* at art. 14.

## 2. Law 142: Public Utility Regulation

Law 142 defines the scope of public utility regulation in Colombia. It also establishes rules for different agents operating in the sector. Fundamentally, the law establishes parameters for entities operating in the public utility sector.

First, the public utility sector comprises entities providing aqueduct, sewage, waste disposal, power, national and international long distance telephone, or gas distribution services.<sup>24</sup> If an entity does not render any of these services it will not qualify as a public utility service company.<sup>25</sup>

Second, public utility services may only be provided by corporations structured as Public Utility Companies (*Empresas de Servicios Públicos* or ESPs).<sup>26</sup> These entities are joint stock corporations.<sup>27</sup>

Third, ESP shareholders may be classified as private sector, public sector, or mixed economy entities.<sup>28</sup> ESP classification depends on capital participation. For example, a public sector ESP is one composed of 100 percent state stock ownership,<sup>29</sup> a private sector ESP is one in which private stock ownership exceeds 50 percent,<sup>30</sup> and a mixed economy ESP is one in which state participation equals 50 percent or more of the ownership.<sup>31</sup>

Fourth, an ESP may provide more than one public utility service.<sup>32</sup> Nonetheless, regulatory agencies in this sector may limit the ESP's business to only one service.<sup>33</sup> This restriction on the type of services that may be rendered by an individual ESP is done to provide for economies of scale and to prevent horizontal monopolization.<sup>34</sup>

Fifth, private, mixed economy and public sector ESPs are entitled, beginning in 1994, to a seven-year corporate and dividend income tax holiday. This tax holiday applies only to realized revenue that is capitalized or designated for special maintenance and system upkeep reserves for five years or more.<sup>35</sup> On July 2, 1998, the Colombian tax authorities issued DIAN Opinion 052058. This opinion, having the effect of a formal ruling, extends a current income tax holiday on revenues realized by electric and gas power generators to private sector holidays under Law 223, Article 97. Prior to DIAN Opinion 052058 Law 223,

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<sup>24</sup> Colombian Law 142/94 [hereinafter Law 142], arts. 14.18-14.28.

<sup>25</sup> *Id.* at art. 14.20.

<sup>26</sup> *Id.* at art. 15.1.

<sup>27</sup> *Id.* at art. 17.

<sup>28</sup> *Id.* at art. 14.5-14.7.

<sup>29</sup> *Id.* at art. 14.5.

<sup>30</sup> *Id.* at art. 14.7.

<sup>31</sup> *Id.* at art. 14.6.

<sup>32</sup> *Id.* at art. 18.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at art. 24.2; Colombian Tax Code [hereinafter CTC], art. 211 (modified by Law 223, art. 97).

Article 97, as discussed below, was interpreted according to its plain language to apply only to public and mixed economy entities engaged in electric power generation.

DIAN Opinion 052058 applies retroactively. As such, the interested taxpayer wishing to benefit from the tax holiday may use it in 1999 for the 1998 tax year and it may, where applicable, amend prior corporate income tax returns and petition the Colombian IRS for tax holiday treatment under Law 223, Article 97.

This tax holiday is a graduated one that began in 1996 with a 100 percent income tax, income tax on dividends, and remittance tax exemption that tapers down to a zero-percent exemption in the year 2003. More specifically, the tax holiday operates as follows:

Year	Percentage of Exemption
1996	100
1997	90
1998	80
1999	70
2000	60
2001	40
2002	20
2003 <i>et seq</i>	0

In order for a taxpayer to benefit from the electric generator tax holiday it must allocate profits to equipment and asset maintenance and overhauling reserves. These reserves should be kept intact for a period of five years or more, in order to avoid Colombian IRS scrutiny.

Law 223, Article 97, does not provide a time period within which the equipment and asset maintenance and overhauling reserves must be maintained. In effect, reserves act as reinvestment or capitalization reserves. However, the Colombian Tax Code in other instances provides this requirement for avoidance of profit remittance tax and offshore dividend payment income withholding tax applicability. Given that there is no case law on point, either in the form of tax court or Colombian IRS rulings, the taxpayer who intends to use the electric power generator tax holiday is advised to adopt this five year policy.

Another benefit under this tax holiday is that the taxpayer may enter into and leave the tax holiday period at will. For example, in 1996, Colombia Electric Power Generation Co. realized \$100 in power generation profits, of which all \$100 was paid offshore in the form of dividends and subject to appropriate income and dividend income withholding taxes, at the rate of 39.55 percent. In 1997, the same company realized \$150 in profits from its electric generation activities and it



allocated \$100 of these profits to a special equipment and asset maintenance and overhauling reserve. In this tax year the company pays \$50 of the \$150 in profits as dividends to its offshore shareholders and subjects that \$50 to income and dividend income withholding tax. The \$100 allocated to the special maintenance and overhauling reserve will be exempt from income tax within the 90 percent bracket established under the tax holiday. Therefore, \$90 is not subject to any taxation and \$10 would be subject to only a 35 percent corporate income tax (provided, however, that they are not paid offshore in the form of dividends, in which case they would then be subjected to a 7 percent dividend income withholding tax). In 1998, the same company realized \$200 in profits, all of which were distributed to its offshore shareholders in the form of dividend payments and were subject to appropriate corporate income tax and dividend income withholding taxes. The effect of Colombia Electric Power Generation Co.'s operations under the tax holiday for 1996 through 1998 is that the company bypasses favorable tax income tax and dividend income withholding tax treatment for 1996, takes the tax holiday in 1997, and elects not to take it in 1998. This illustrates how Law 223, Article 97, provides the taxpayer with flexibility as to how it implements its tax planning policy in this respect.

While the July 1998 Colombian Tax Authority ruling, discussed above, creates an added tax incentive for the client interested in entering into an energy project finance investment, it is important to note that the Colombian Constitutional Court on May 8, 1998, in *In re the Constitutionality of Law 233/95, Art. 97*<sup>36</sup> held that the tax holiday only applies to public and mixed economy companies. This confusion in the law is not uncommon in Colombia. The Colombian Congress is actively trying to resolve this current confusion by way of a 1998 Tax Reform Bill submitted for consideration in August and September 1998, wherein the energy generation tax holiday, if approved, will follow the Constitutional Court's holding and discard the Tax Authorities' interpretation. Intertwined with this tax holiday is an exemption granted to ESPs from the presumptive income tax or asset tax regime,<sup>37</sup> which is discussed below.

## B. Possible Colombian Business Association Forms

Once hurdles posed by Law 226 and Law 142 are understood and passed, the client must choose what type of business entity to establish for operating and bidding purposes. However, Law 142 limits the client to forming a joint stock corporation.<sup>38</sup>

Under Colombian commercial law the joint stock corporation may take one of two forms: (1) a basic corporation (In Spanish, *Sociedad*

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<sup>36</sup> *In re the Constitutionality of Law 233/95, Art. 97*, Colom. Const. Ct. Op. C-188/98 (M.P. Dr. Jose Gregorio Hernandez Galindo).

<sup>37</sup> Law 142, art. 24.3.

<sup>38</sup> *Id.* at art. 17.

*Anónima* or SA), or (2) a limited partnership issuing shares (In Spanish, *Sociedad en Comandita por Acciones* or LPIS). The basic elements of these two Colombian corporate forms follow.

### 1. *The SA*

SAs must comprise a minimum of five shareholders<sup>39</sup> and should be incorporated by a unanimous decision reached at the common fund meeting, held by the initial shareholders. At this meeting initial shareholders decide to incorporate and agree to be held liable up to respective capital contributions.<sup>40</sup>

The SA's capital is divided into shares of equal value.<sup>41</sup> Each share is be represented by a negotiable instrument.<sup>42</sup> Additionally, upon incorporation the company is to subscribe no less than 50 percent of its authorized capital and pay out no more than one-third of the value of each share of capital to be subscribed.<sup>43</sup> The SA must adhere to this proportion only at the moment of incorporation.<sup>44</sup>

Another key element of the SA is the compulsory legal reserve.<sup>45</sup> This reserve must be composed of at least 50 percent of the company's subscribed capital.<sup>46</sup> An SA's legal reserve is created by designating 10 percent of the annual profits to the reserve until the 50 percent requirement is met.<sup>47</sup> Once the legal reserve has adequate funds, the company need not continue to contribute to it, unless the company reduces the reserve at some point.<sup>48</sup>

### 2. *The LPIS*

The basic elements of the LPIS mirror those of the SA.<sup>49</sup> However, a difference between the SA and LPIS is that the latter will have at least one shareholder that will be subject to unlimited liability for the company's

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<sup>39</sup> Colom. Com. Code, art. 374. Colombian corporate law dictates that at no point in an SA's life may more than 95 percent of the company's subscribed shares be held by one shareholder, otherwise the SA will be deemed to be in technical dissolution. *Id.* at art. 457 (3).

<sup>40</sup> *Id.* at art. 373.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *Id.* at art. 376.

<sup>44</sup> Super. Corps., Op. OA-19573/Oct. 3, 1980.

<sup>45</sup> Colom. Com. Code, art. 452.

<sup>46</sup> *Id.*

<sup>47</sup> *Id.* The legal reserve may be funded in quotas of more than 10 percent of each year's profits. Super. Corps., Cir. D-001/Jan. 2, 1980.

<sup>48</sup> Colom. Com. Code, art. 452.

<sup>49</sup> *Id.* at arts. 343-352. See *In re LPIS Shareholder Requirements*, Colom. Sup. Ct., Civil Op. 20/97 (P.M. Rafael Romero Sierra) (holding that the LPIS must comply with the five or more shareholder rule).

business activities.<sup>50</sup> This shareholder is known in Spanish as the *socio gestor* or *socio colectivo*.

In order to effectively spread the risk of exposure across several levels, Colombian law permits the LPIS *socio gestor* to be a business entity.<sup>51</sup> In this regard, counsel may recommend the use of another LPIS, whereby one or more of the shareholders are SAs or other types of Colombian business associations.

Given the LPIS *socio gestor* requirement, why would a client opt for creating this type of entity? A client may want to elect an LPIS for U.S. tax purposes, given that U.S. tax law treats an LPIS as if it were a U.S. partnership or a pass through entity,<sup>52</sup> provided the taxpayer elects to be treated as such.<sup>53</sup>

### C. Tax Issues

Once the client decides which form of business association will be used as the vehicle for carrying forward the privatization process, counsel and other advisors must take into consideration the following Colombian tax law<sup>54</sup> rules for pro forma and planning purposes.

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<sup>50</sup> Colom. Com. Code, art. 323. The scope of this unlimited responsibility for LPIS business activities is akin to that of a general partner's liability under U.S. partnership law. Uniform Partnership Act, sec. 15.

<sup>51</sup> Super. Corps., Op. SL-MD-1034/Jan. 22, 1991.

<sup>52</sup> U.S. Internal Revenue Code [hereinafter "IRC"], sec. 701. See 1997 U.S. MASTER TAX GUIDE, par. 417, p. 131 (CCH eds. 1996) ("While a partnership is not subject to tax, its 'taxable income' is the key feature by which the partnership passes through its income or loss to partners. . . Each partner generally must account for his distributive share of partnership income, while the partner's basis generally decreases by the amount distributed to him by the partnership.").

<sup>53</sup> While U.S. tax law permits the taxpayer to elect whether the LPIS will be treated as a partnership or a branch, Treas. Reg. § 301.7701-3(a), under Colombian tax law, pass-through entities do not exist. See CTC, arts. 12 - 14 (Colombian tax law provisions indicating that business associations in Colombia, regardless of form, are taxed as entities). Note that U.S. tax law adopted the election rule via the "check-the-box" rules in December 1996, in Treas. Dec. 8697, 61 Fed. Reg. 66584-66593 (Dec. 18, 1996). See JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME 26:9-26:20 (2d ed. 1999) (providing overview of check-the-box rules); James H. Barret & William P. Ewing, *International Implications of Check - the - Box Regulations*, 72 FLA. B. J. 34 (May 1998) ("For over 30 years, the classification of entities as partnerships or corporations depended upon all the facts and circumstances concerning the entity pursuant to a test known as the "four factors test". On December 18, 1996, the IRS replaced the "four factors test" with regulations known as the "check - the - box" regulations that allow taxpayers to elect whether entities are to be taxable as corporations or partnerships."). Prior to this development U.S. tax law followed *Morrissey v. Commissioner*, 296 U.S. 344, 56 S.Ct. 289 (1935). The *Morrissey* court held that what an entity is called will not control how it should be treated for U.S. tax purposes. In essence substance should rule over form. See WILLIAM L. CARRY & MELVIN ARON EISENBERG, CORPORATIONS: CASES AND MATERIALS 96 (6th ed. 1988) (providing synopsis of *Morrissey v. Commissioner*).

<sup>54</sup> The client and U.S. counsel are well advised to seek specialized local tax counsel or advisors when preparing the pro forma for any privatization or capitalization operation in

## 1. Corporate Tax Issues

### (a) Income Tax

Income tax in Colombia is levied, as in most countries, when income is realized from the exploitation of tangible or intangible goods or when services are rendered in a permanent or transitory manner within the Colombian territory.<sup>55</sup> Income tax is also triggered by the general disposition of any tangible or intangible items, provided the item, such as stock, for example, was present in the Colombian territory at the time of the transaction.<sup>56</sup> Additionally, in Colombia all business entities are taxed on world-wide income, derived from profits and capital gains realized,<sup>57</sup> at a flat rate of 35 percent.<sup>58</sup> Income tax is calculated based on financial statements adjusted for inflation.<sup>59</sup>

Moreover, as indicated in the discussion of Law 142, ESPs are entitled to two income tax benefits. Private, mixed economy and public ESPs are entitled to a seven-year income tax holiday, and all ESPs are exempt from presumptive income tax (the Colombian asset tax).<sup>60</sup>

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Colombia, given that Colombian tax legislation is in a constant state of change and modification. For example, in 1997 the Colombian government passed two major tax reforms, Decree 80/97 and Law 383/97, and in late 1998 it promulgated Law 488/98.

Decree 80/97, known as the Economic Emergency Decree, was passed into law on January 13, 1997, by executive order and was the first 1997 tax reforms. However, this tax reform was judicially repealed by the Colombian Constitutional Court in *In re Economic Emergency*, Colom. Const. Ct., C-122, Mar. 12, 1997.

The second tax reform, which has not been challenged in court to date, is Law 383/97. This piece of legislation was passed into law in July 1997 by the Colombian Congress and is currently controlling. See Mario Andrade & Mario A. de Castro, *The 1997 Colombian Tax Reform in Retrospect: Issues and Concerns for Foreign Investors*, 16 TAX NOTES INT'L 1531 (May 11, 1998) (providing summary of Law 383/97).

The third and most recent tax reform, Law 488, which complements Law 383 in many ways, was passed into law on December 24, 1998, and became effective on January 1, 1999. At the date of this article's publication, Law 488 has not yet been challenged in court. See Mario Andrade & Mario A. de Castro, *Many Changes for Foreign Investors in Colombia's New Tax*, 7 LATIN AMER L & B REP. 11 (Jan. 31, 1999) (providing analysis of Law 488/98).

<sup>55</sup> CTC, art. 24, INC. 1.

<sup>56</sup> *Id.*

<sup>57</sup> *Id.* at arts. 12-14.

<sup>58</sup> *Id.* at art. 240. Colombian tax law has a system of alternative minimum income tax and asset tax provisions. The alternative minimum income tax is simply that tax credits taken for a particular tax year may not exceed the value of the basic income tax due. Moreover, income tax liability after taking into account tax credits may not be less than 75 percent of the tax liability calculated under the presumptive income tax system (asset tax), see *infra* note 60, before calculating in tax credits. Law 383/97, art 29.

<sup>59</sup> See *infra* sec. II(C)(1)(d)(vi). (discussing inflationary accounting).

<sup>60</sup> Law 142, arts. 24.2-24.3. The presumptive income tax regime is used to calculate income tax liability in circumstances where a taxpayer may be operating at a loss for a particular year. This system presumes that the taxpayer's taxable income is not less than the sum resulting between 5 percent of the taxpayer's net worth or 1.5 percent of its gross assets on the last day of the tax year.

(b) Remittance Tax

Remittance tax is levied when income or capital gains generated in Colombia by non-residents or branches of foreign companies are remitted abroad,<sup>61</sup> at a rate of 7 percent.<sup>62</sup> This tax, however, may be avoided if the investor reinvests<sup>63</sup> its profits in Colombia for five years or more.<sup>64</sup> If profits to be remitted abroad are reinvested for a period of less than five years, then remittance tax on such profits may be deferred until their remittance.<sup>65</sup>

(c) Dividend Income Tax

The dividend income tax is a withholding tax that applies to dividends paid offshore by Colombian entities.<sup>66</sup> This tax is set at a rate of 7 percent<sup>67</sup> and is applied in conjunction with income tax withholding at a rate of 35 percent, or an effective withholding tax at a rate of 39.55 percent.<sup>68</sup>

However, as with remittance tax, dividend income tax withholding may be avoided when dividends are capitalized for a period of five years or more.<sup>69</sup> Likewise, capitalization of dividends for a period of less than five years allows the taxpayer to defer the withholding of this tax.<sup>70</sup> At no point is income tax at 35 percent avoided.

2. *Other Taxes and Related Issues*

(a) Value Added Tax

Value added tax (VAT) is an issue for the investor at the most basic level. Most public utilities are excluded from VAT. As such, VATs paid to suppliers of goods and services cannot be offset against other VATs. The result in this instance is that VAT is assumed as a major value of goods and services, thus reducing net profits. However, VAT paid in the acquisition of capital assets may be taken as a tax deduction for corporate income tax purposes.<sup>71</sup>

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<sup>61</sup> CTC, art. 319. Foreign branches are presumed under the law to automatically remit abroad any profits realized in Colombia.

<sup>62</sup> *Id.* at art. 321.

<sup>63</sup> Reinvestment of profits in Colombia occurs when profits are simply commingled within a company's equity. Law 488/98, arts. 9-10.

<sup>64</sup> CTC, art. 319.

<sup>65</sup> *Id.*

<sup>66</sup> *Id.* at art. 245.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

<sup>69</sup> *Id.* See *supra* note 63 (reinvestment and capitalization of profits deemed to be effective commingling of these within Company equity).

<sup>70</sup> *Id.*

<sup>71</sup> Law 488/98, art. 18.

Additionally, VAT will be triggered at 16 percent (this rate will be reduced to 15% effective November 1999) on the rendering of consulting and advisory services and technical services and assistance, depending whether the service is performed in Colombia or offshore.<sup>72</sup> This will affect the investor interested in a privatization process in Colombia. This is because, as discussed below, these services may be used as a vehicle for profit repatriation and for creating costs and expenses for the newly privatized public utility company.

(b) Special Withholding Taxes: Technical Service & Assistance Contracts

Technical services and assistance contracts in Colombia play a special role in the privatization and foreign capital investment game. These contracts provide a means for importing know-how into the country via inter-company arrangements<sup>73</sup> and for repatriating profits offshore, as discussed below.

In Colombia, technical services and assistance agreements are given special treatment, depending on the circumstances and facts of the transaction. If these services are rendered offshore or in Colombia by non-Colombian residents or domiciliaries, then they are subject to a 10 percent income and remittance at-source withholding tax.<sup>74</sup>

The client's tax burden (although somewhat heightened), if it chooses this mechanism for profit repatriation, is offset via a complete income tax deduction for payments in Colombia, provided at-source withholding taxes are properly practiced<sup>75</sup> and the contract is registered with the Colombian importation authorities (known as INCOMEX).<sup>76</sup>

Technical services and assistance contracts may also be entered into between two Colombian entities. In this case the withholding tax for income tax purposes is set at 10 percent<sup>77</sup> for professional non-construction services. Why would a local technical services contract be needed?

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<sup>72</sup> Law 383/97, art. 33.

<sup>73</sup> Although beyond the substantive scope herein, the subject of inter-company arrangements and transfer pricing is relatively new in Colombia. Yet, transfer pricing issues should be considered by counsel once the client is successful with its privatization bid, given that the Colombian tax authorities (the "DIAN") are quickly moving into the direction of creating formal transfer pricing regulations. See Mario J. Andrade & Mario A. de Castro, *Colombian Transfer Pricing: A Statutory Analysis for International Practitioners*, 8 J. INT'L TAX 552 (Dec. 1997) (survey of interrelated legislation acting as country's main transfer pricing source law).

<sup>74</sup> Law 488/1998, art. 15. See Mario J. Andrade & Mario A. de Castro, *Colombia's Tax Reform Includes Benefits for Service Contract Payments*, 2 PRAC'L LATIN AMER. TAX STRAT. 15 (Feb. 1999) (discussion of service contracts under Colombian tax law).

<sup>75</sup> CTC, arts. 121, 124.

<sup>76</sup> Decree 259/92, arts. 1-3 (adopting guidelines set by Andean Pact Decision 291). INCOMEX registration is required for technical services and assistance contracts performed by offshore entities, whether the services are provided offshore or onshore, because these transactions are treated as if they were the importation of technology into Colombia.

<sup>77</sup> CTC, art. 392.

Local technical services and assistance contracts may be required in the event that technicians must be in Colombia providing services on an ongoing or long term basis (six months or more). In this circumstance it is best to establish a local branch or subsidiary in Colombia to perform the services that would ordinarily be provided directly under the auspices of an offshore entity. Failure to establish a Colombian entity when technicians and other related professionals are visiting the newly acquired company for long periods of time and possibly subcontracting out specific services to locals, will trigger permanent establishment problems under Colombian corporate law.<sup>78</sup>

(c) International Financial Leasing under Colombian Tax Law

International leasing operations are an attractive mechanism in privatization and project finance operations. They are effective methods of importing vital equipment into target countries, such as Colombia, and serve as a means of profit repatriation.

Under Colombian tax law, financial leasing operations come in three forms: (i) pure financial leases; (ii) financial operating leases; and (iii) infrastructure leases. Each form has specific tax law rules. Additionally, international lease payments are exempt from withholding taxes for income and remittance tax purposes when conducted for infrastructure projects.<sup>79</sup> An analysis of the various forms of Colombian financial leases follows.

i. The Financial Lease

The Colombian tax law mandates that, from December 31 of the prior tax year until the commencement of the lease agreement, lessees with gross equity of approximately U.S.\$6.84 million<sup>80</sup> must classify their lease operation for tax and accounting purposes as a financial lease.<sup>81</sup> For accounting and tax purposes, financial lease agreements have a treatment (set forth below) with which one should comply once the contract is established.

First, at the beginning of the contract, the lessee should register an asset and a liability for the total value of the leased asset.<sup>82</sup> This should be done for an amount equal to the present value of the lease payments and purchase options agreed to, calculated as of the date of the contract's start date and at the agreed interest rate.<sup>83</sup> The amount registered by the lessee

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<sup>78</sup> Colom. Com. Code, art. 474.

<sup>79</sup> CTC, art. 25 (c).

<sup>80</sup> This value is adjusted on a yearly basis. For example, in 1996 the gross equity cap was approximately U.S.\$5 million.

<sup>81</sup> CTC, art. 127-1, PAR.3.

<sup>82</sup> *Id.* at art. 127-1 (2) a.

<sup>83</sup> *Id.*

should coincide with the amount registered by the lessor as a monetary asset in the leased good's account.<sup>84</sup>

Second, the value registered as an asset by the lessee, except the portion corresponding to the VAT tax deduction, will be treated as a non-monetary asset.<sup>85</sup> A depreciable<sup>86</sup> or amortizable asset, under the law, registered as a non-monetary asset, shall be depreciated or amortized pursuant to the asset's useful life.<sup>87</sup> In the event the leased asset is not depreciable or amortizable, the lessee will not be allowed to do so in its accounting.<sup>88</sup>

Third, the lease payments for the lessee should be broken down to correspond to a capital advance and to the portion comprising interest or financial costs.<sup>89</sup> The part corresponding to a capital advance will be charged directly against the liability registered by the lessee for the lesser value of the liability.<sup>90</sup> The portion of the lease payments corresponding to interest or financial costs is a deductible expense for the lessee.<sup>91</sup> In this regard, the financial lease contract should stipulate the value of the asset at the moment of the lease's commencement, including VAT, as part of the agreed value of the periodic lease payments corresponding to financial and capital amortization.<sup>92</sup>

Fourth, upon exercising the purchase option, the asset value agreed to by the parties involved shall be registered against the lessee's liabilities, so as to clean out the account with zeros.<sup>93</sup> Any difference resulting from this exercise will be adjusted against the results of the operation. In the event the lessee does not exercise its option to purchase the lessee for tax accounting purposes will have to adjust its equity and income statements. This adjustment will result in the deduction of the total value of the balance to be depreciated for the non-monetary asset registered by the lessee in the

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<sup>84</sup> *Id.*

<sup>85</sup> *Id.* at art. 127-1 (2) b.

<sup>86</sup> CTC, art. 134, allows for depreciation to be conducted via the straight-line method. Colombian law also permits the use of declining-balance and sum-of-the-years digit methods.

Also, CTC, art. 140, indicates that depreciation may be accelerated method. This depreciation method may be implemented when an asset is used beyond usual work shifts, without altering the asset's useful life. The taxpayer may accelerate depreciation by 25 percent for each extra shift that the asset is used or in proportional fractions thereof. Minimum asset useful life schedules in Colombia are as follows: real Estate, 20 years; machinery and equipment, 10 years; vehicles and computers, 5 years. Decree 3019/89, art. 2.

<sup>87</sup> CTC, art. 127-1 (2)b.

<sup>88</sup> *Id.*

<sup>89</sup> *Id.* at art. 127-1 (2)c.

<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

<sup>93</sup> *Id.* at art. 127-1 (2)d.



corporate income tax return for the tax year in which the lease agreement is completed.<sup>94</sup>

Fifth, the amounts determined via the aforementioned process shall be used by the lessee to determine and declare the asset's equity value and realize the asset's depreciation calculation (when applicable) for: inflationary adjustment purposes; determining the liability's balance and its amortization; and calculating the amount of deductible financial costs.<sup>95</sup>

## ii. The Operating Leases

The rule for operating lease agreements, under Colombian tax law, is as follows:

Financial leasing contracts for immovable goods (real estate not including land) with a contract life equal to or greater than 60 months, machinery, equipment and office equipment with a contract life equal to or greater than 36 months, vehicles for productive use and computer equipment with a contract life equal to or greater than 24 months are deemed to be operating lease agreements. The aforementioned means that the lessee should register as a deductible expense the total sum of the lease contract's price, without registering in the asset or liability side of its books any amount for the leased good. . .

Only those leases listed in subpart 1 of this article which present as of December 31 of the prior tax year gross equity less than approximately U.S.\$4.5 million [for 1999, 8,012,300,000 Colombian Pesos] shall benefit from the treatment set forth in subpart 1. All others shall be treated under subpart 2 of this article.<sup>96</sup>

Furthermore, under an operating lease the holding gain for inflation is mitigated. This is because the interest and principal on the asset are fully deductible,<sup>97</sup> given that classification of the operation is based on lessee gross equity.<sup>98</sup>

## iii. Infrastructure Leasing

Leasing agreements with a life of 12 or more years intended for the development of infrastructure projects in the transportation, energy, telecommunications, potable water, or basic sanitary sectors shall enjoy operating lease treatment. Such treatment has the following accounting and tax consequences: the leasing payment may be registered as a complete deductible expense; neither an asset or liability has to be registered for the leased equipment, unless the purchase option is exercised; the leased equipment may not be amortized at a schedule less than what is indicated in the lease contract; and in concession agreements the lease term shall be

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<sup>94</sup> *Id.*

<sup>95</sup> CTC, art. 127-1 (2)e.

<sup>96</sup> CTC, art. 127-1 (1).

<sup>97</sup> *Id.*

<sup>98</sup> *Id.* at PAR. 3.

equal to that agreed to in the contract celebrated with the State for infrastructure projects.<sup>99</sup>

VAT needs to be contemplated when discussing financial lease structures, given that the operation encompasses the importation of a capital asset into Colombia, as is the case with infrastructure projects. The importation of the capital asset into Colombia takes the form of a temporary importation<sup>100</sup> that will be subject to VAT upon entering the Colombian territory. Colombian tax law allows the lessee to use VAT paid for capital and fixed assets throughout the life of the temporary importation to offset corporate income tax at the end of the term of the temporary import (through an income tax deduction), so long as the purchase option is exercised and the asset is nationalized into the Colombian territory.<sup>101</sup>

#### (d) Stamp Tax

Stamp tax is a document tax that must be considered and calculated into any pro forma created for any commercial activity to be developed in Colombia. This tax is levied on written contracts with a contract price exceeding approximately U.S.\$40,000, at a rate of 1.5 percent.<sup>102</sup>

#### (e) Registration Tax

Registration tax is paid at the departmental level over total gross revenues realized from operations that are registered with the Chamber of Commerce or with the local real estate registration office.<sup>103</sup> Rates vary between 0.3 percent and 1 percent. When documents are subject to registration tax, no stamp tax must be paid.<sup>104</sup>

#### (f) Monetary Correction

Clients need to be aware that Colombia's economy is an inflationary one. As such, inflationary adjustments (monetary correction) must be made to certain assets, pursuant to controlling tax law.<sup>105</sup> Investors often model elaborate financial structures only to find out before the closing of a deal that income statement and balance sheets are not reflective of the transaction's reality due to incorrect monetary correction.<sup>106</sup>

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<sup>99</sup> Law 223/95, art. 89.

<sup>100</sup> International lease operations may only be conducted under the rubric of temporary importations. Cen. Bank Ext. Res. 21/93, art. 12.

<sup>101</sup> DIAN Op. 087713, Nov. 13, 1996; DIAN Op. 090072, Nov. 26, 1996; Decree 2076/92, art. 5.

<sup>102</sup> Law 223/95, art. 519; Law 488/98, art. 116.

<sup>103</sup> Law 223/95, art. 226; Decree 650/96, art. 1.

<sup>104</sup> Law 223/95, art. 230.

<sup>105</sup> CTC, arts. 329-350; Decree 2075/92.

<sup>106</sup> See Erik Haindl et al., *Income Tax Issues*, in COMPREHENSIVE TAX REFORM: THE COLOMBIAN EXPERIENCE 17 (International Monetary Fund Publications, March 1995) (providing a general overview of Colombian monetary correction).

Colombian tax law dictates that inflationary adjustments should be conducted for the following:

- (1) Non-monetary assets held in foreign currency;
- (2) All other non-monetary assets;
- (3) Non-monetary liabilities; and
- (4) Net equity.<sup>107</sup>

Inflationary adjustments are calculated by taking the value of non-monetary assets and multiplying it by a percentage known as the percentage adjustment for the fiscal year (in Spanish, *Porcentaje de Ajuste del Año Gravable* or *PAAG*).<sup>108</sup> This percentage is calculated according to the increase registered by the Consumer Price Index.<sup>109</sup> The adjusted value of the non-monetary assets is recorded as a credit in the Monetary Correction Account (MCA) and as a debit in the non-monetary assets account.<sup>110</sup>

Accumulated depreciation corresponds to fixed assets in the prior year and must be adjusted by the PAAG.<sup>111</sup> It is a credit in the accumulated depreciation account balance and a debit in the MCA.

Non-monetary liabilities are adjusted by the PAAG.<sup>112</sup> This adjusted value is registered as a greater value of the non-monetary liability and as a debit in the P&L statement.

Foreign currency debt may lead to one of the following two situations:

(1) If there is revaluation of the Colombian peso versus the U.S. dollar, a profit should be registered as a result of the difference in exchange against a reduction in the liabilities account.

(2) If there is devaluation of the Colombian peso versus the U.S. dollar, then a cost or expense should be registered as a result of the difference in exchange against the increase in the liabilities accounts.

A company's net equity worth at the beginning of each tax year (January 1) must be adjusted by the PAAG.<sup>113</sup> The value of this adjustment is registered as a debit in the MCA and as a credit in an account known as, the Net Equity Worth Account.

The MCA will appear, as follows:

P&L Statement

*Monetary Correction Account*

<i>Debit</i>	<i>Credit</i>
adjusted Accumulated	adjusted

<sup>107</sup> Decree 2075/92, art. 5. Law 488 relaxed inflationary accounting rules by no longer mandating that profit and loss statements be adjusted for inflation. Law 488/98, art. 27.

<sup>108</sup> CTC, art. 331.

<sup>109</sup> *Id.*

<sup>110</sup> *Id.* at art. 339.

<sup>111</sup> Decree 2075/92, art. 5.

<sup>112</sup> *Id.*

<sup>113</sup> CTC, art. 345.

Depreciation adjusted net equity worth	non-monetary assets
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*P&L Statement*

<i>Debit</i>	<i>Credit</i>
adjusted non-monetary liabilities <sup>114</sup>	

If a credit is registered in the MCA due to a greater value of the non-monetary assets--in comparison with the non-monetary liabilities and the net equity worth--this credit balance will be considered a profit for tax and accounting purposes. As such, it results in greater income tax liability. This effect generates more profits, as well as dividends to be distributed to a client's shareholders.

The debit balance is considered a tax-deductible expense, if a debit balance is registered in the MCA due to a greater value of non-monetary liabilities and the net equity worth over the non-monetary assets. Therefore, total income tax liability, net profits, and dividend distribution is decreased.

Inflationary adjustments should be performed on a monthly basis, so long as the PAAG is correctly factored into the calculations conducted.

### III. INJECTING FINANCE INTO COLOMBIA AND PROFIT REPATRIATION

#### A. Injecting Finance Under Colombian Foreign Exchange Law

Once basic privatization, corporate, and tax concerns are understood, the next issue to consider is financing the project.<sup>115</sup> Infrastructure projects in Colombia are typically done via direct foreign investment, debt vehicles, and inter-company transactions.

Direct foreign investment is the most effective and permitted method<sup>116</sup> of injecting capital into Colombia. This method of injecting capital is subject to Colombian foreign exchange and investment controls. These controls consist of informing the Colombian Central Bank as to

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<sup>114</sup> Normally, adjustments to non-monetary foreign currency liabilities are registered as income (due to revaluation) or as an expense (due to devaluation in the P&L account).

<sup>115</sup> See PHILIP WOOD, 2A LAW AND PRACTICE OF INTERNATIONAL FINANCE 14-1 -14-22 (1984); RALPH H. FOLSOM ET AL., INTERNATIONAL BUSINESS TRANSACTIONS: A PROBLEM ORIENTED COURSE BOOK 738-850 (2<sup>nd</sup> ed. 1991); PAUL B. STEPHEN III. ET AL., INTERNATIONAL BUSINESS AND ECONOMICS: LAW AND POLICY 503-512 (1993); BEYOND SYNDICATED LOANS: SOURCES OF CREDIT FOR DEVELOPING COUNTRIES (John D. Shilling ed.) (World Bank Technical Paper No. 163, 1992) (sources providing general background into project finance operations and related issues, such as structuring privatizations). See also Guillermo Campos, *Piping Finance into Brazil*, INT'L TAX REV. (June 1997) (Authorized Reprint) (illustration of project finance methods).

<sup>116</sup> Conpes Res. 5/91, art.4.

when the investment is entered, modified, and repatriated via registration requirements.<sup>117</sup> If the investor does not comply with Central Bank registration requirements, the investor will not be legally permitted to bring in the capital or remit it abroad when desired.

Capital injections into Colombia under the rubric of direct foreign investment should not correspond to inter-company transactions with the offshore parent company. If a capital injection is understood by the Colombian authorities to be related to some type of *quid pro quo* with the parent company, the effective transfer of foreign currency into the target will not be permitted under Colombian law.<sup>118</sup>

Direct foreign investment under Colombian law is understood to be: the importation of capital assets into the territory,<sup>119</sup> the transferring of foreign exchange into the country that may be freely convertible into Colombian pesos,<sup>120</sup> in kind contributions in the form of technology or other intangibles,<sup>121</sup> resources in Colombian Pesos,<sup>122</sup> reinvested earnings,<sup>123</sup> and the transferring of foreign currency into Colombia destined for the purchase of real estate assets.<sup>124</sup>

Another acceptable method of pumping capital into Colombia is through the use of debt. Pumping money into an infrastructure project via debt vehicles is often preferred. Financing may be done with back-to-back loans, direct loans via syndication structures, sole lenders, multilateral organizations, and/or through a combination of all of these vehicles.

What level of debt a client should choose is, however, difficult to assess. Due to inflationary adjustments affecting actual capital, it is best to over leverage the purchase. Over leveraging the deal has great advantages.

A large amount of debt will enable the investor to remit payments out of the country via interest payments with no tax consequences attached. The investor will also be allowed a corporate income tax deduction for these payments. This is useful given that such payments may double as a profit repatriation tool within limited parameters.

Financing a project under current Colombian law is, however, limited. Foreign indebtedness transactions are limited to operations between foreign financial entities that are registered before the Central Bank.<sup>125</sup> This means that direct inter-company loans are forbidden. If an investor intends to finance the purchase of an asset in Colombia through inter-company loans with the holding company, then it will have to frame the transaction

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<sup>117</sup> Cen. Bank Ext. Res. 21/93, art. 37.

<sup>118</sup> *Id.* at art. 39; Conpes, Res. 5/91, art. 16.

<sup>119</sup> Conpes, Res. 5/91, art. 7(a).

<sup>120</sup> *Id.* at art. 7(b).

<sup>121</sup> *Id.* at art. 7(c).

<sup>122</sup> *Id.* at art. 7(d).

<sup>123</sup> *Id.* at art. 7(e).

<sup>124</sup> *Id.* at art. 7(h).

<sup>125</sup> Cen. Bank Ext. Res. 21/93, art. 28 (modified by Cen. Bank Ext. Res. 5/97, art. 1).

through a back-to-back loan mechanism. Often this tool will increment the cost of doing business by a substantial amount because the bank acting as intermediary for the transaction will charge a commission based on a spread of the total value of the operation.

Foreign indebtedness operations have similar Central Bank registration requirements to direct foreign investment strategies. Debt operations in Colombia are effectively registered with the Central Bank through a 10 percent deposit requirement that must be placed with the Central Bank.<sup>126</sup> The deposit is made on the initial loan draw-down and is placed by the borrower for a six-month period in Colombian pesos.<sup>127</sup> This deposit is interest-free. However, the deposit may be returned to the borrower via petition to the Central Bank before the end of the deposit period with a penalty charge. The penalty charge varies depending on the months remaining in the period.<sup>128</sup> Given devaluation of the Colombian peso, it is more cost effective to petition for the deposit refund shortly after placing it with the Central Bank.

Upstream inter-company charges are another effective method of bringing capital into the newly privatized entity. Under this method the Colombian entity charges an offshore affiliate for services rendered on latter's behalf. In order to support the transactions, the Colombian entity invoices the offshore affiliate. These transactions have a negative aspect.

The downside of upstream inter-company charges is that the Colombian entity may have to assume VAT liability. Additionally, payments made to it will constitute taxable income for Colombian purposes.

## B. Permitted Profit Repatriation Strategies under Colombian Law

Profit repatriation and privatization are almost synonymous concepts. The private foreign investor will want to maximize profits and repatriate<sup>129</sup> these quickly, in order to hedge foreign currency and economic volatility.

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<sup>126</sup> *Id.* at art. 30.

<sup>127</sup> *Id.*; Cen. Bank Reg. DCIN - 09/Feb. 3, 1998, at 3.1-3.2 (as modified).

<sup>128</sup> Cen. Bank Reg. DCIN - 09/Feb. 3, 1998, at 3.1-3.2 (as modified).

<sup>129</sup> In terms of where the profits are repatriated, Colombian law does not place any restrictions on foreign investors. Therefore, the client may be advised to pick anyone of the multiple tax havens located offshore, such as the Cayman Islands. *See generally*, Marylouise Dionne, *Tax Havens-An Introduction*, 17 TAX NOTES INT'L 430 (Aug. 17, 1998); Siraj Kkhan, *Malta: A Little-Known Tax Haven*, 17 TAX NOTES INT'L 432 (Aug. 17, 1998); Harold I. Steinbach & Heath A. Grayson, *Taxing Hardly: Locating a Business in a Tax - Free Jurisdiction*, 7 BUS. L. TODAY 32 (Sept.-Oct. 1997) (illustrating issues and concerns of picking an offshore jurisdiction to conduct international business); George C.J. Moore, *Selecting An Offshore Jurisdiction: Why Turks & Caicos*, 15 INT'L L. Q. (THE FLA. B.) 8 (Win. 1996) (presenting tips for picking offshore jurisdictions for conducting international business).

Furthermore, another key variable in this process is tax minimization within Colombia's tax paradigm.<sup>130</sup>

The perfect profit repatriation strategy encompasses efficiency and cost effectiveness values, from a country risk hedging and tax minimization perspective. Under controlling Colombian law, an effective profit repatriation strategy will be comprised of the following: (1) technical services and assistance agreements (offshore or onshore); (2) related company offshore management and administrative agreements; (3) back-to-back loans; (4) international lease agreements; (5) capital reductions; (6) upstream international loans; and (7) offshore dividend and royalty payments.

### *1. Technical Services and Assistance Contracts Performed by Offshore Entities*

Technical services and assistance contracts are effective profit repatriation tools, whether performed offshore or onshore. These contracts have a relatively low tax cost in comparison to other methods, especially if they are performed offshore, as seen above in the tax issues section of this article. Another attractive characteristic of these contracts is that they also function as effective know-how transferring vehicles.

### *2. Related Company Offshore Management and Assistance Contracts*

Related company offshore management and assistance contracts are very effective profit repatriation tools. They carry no income or remittance tax consequences, but there is no deductibility for payments on the Colombian end.<sup>131</sup> The only real tax cost of these contracts is that they are

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<sup>130</sup> Once the payments taking the form of any of the profit repatriation methods set forth herein arrive in whatever foreign jurisdiction chosen the client may face U.S. Subpart F Income issues, under I.R.C. §§ 951-964. The Subpart F rules apply only if a foreign corporation is a controlled foreign corporation ("CFC") (a CFC is an entity with at least 50 percent of its stock, by vote or by value, is owned by U.S. persons (both individual and corporate), counting only persons owning more than 10 percent of the voting stock). I.R.C. §§ 951, 957, 958. Subpart F rules, when triggered, tax U.S. shareholders on their ratable shares of several categories of corporate income, regardless of whether distributed or not. These categories of corporate income include (a) dividends, interest, royalties, and other passive income, (b) income from the sales of goods where the foreign corporation either buys from or sells to or on behalf of a related person, (c) income from services performed for or on behalf of related persons, and (d) income from shipping operations. See BORIS I. BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION 68-26 – 68-72 (1998-99 ed.) (providing detailed discussion of Subpart F rules and the changes in this area of the law over the past year and a half).

<sup>131</sup> The Colombian Constitutional Court held in *In re Payments and Related Deductions to Home Offices*, Const. Ct. Op. C-596, Nov. 6, 1996 (M.P. Dr. Hernando Herrera Vergara), that related company payments for offshore management and assistance services contracts are nondeductible, given that they are not deemed to be Colombian source income. See Andrade & de Castro, *supra* note 73, at 556 (discussing deductibility of intercompany payments under Colombian tax law).

subject to a VAT at 16 percent. Additionally, these contracts may be created via simple invoices. This invoicing method allows parties to avoid the stamp tax, otherwise triggered with the existence of a written contract.

The effectiveness of this profit repatriation method from an operation perspective is limited. This method may only be used for management and assistance services rendered offshore. If the services come onshore payments for them will be subject to harsh withholding taxes set at an effective rate of 39.55 percent, plus a VAT at 16 percent and local municipal taxes, wherever the service is rendered.

### *3. Back-to-Back Loans*

The back-to-back loan is an effective profit repatriation tool. However, it is subject to foreign exchange controls, as discussed above. From a tax perspective, the back-to-back loan represents a tax-free profit repatriation tool,<sup>132</sup> provided that the loan is deemed to be intended for activities in the interest of Colombia's economic and social development.

Consequently, given the special tax treatment that may be afforded to the back-to-back loan, it may be structured in a manner so that the interest rate set is slightly higher than usual. This will allow the client to include some profits mixed in with the interest payments.

Despite the effectiveness of this profit repatriation tool, it carries, added costs, such as a transaction fee that will be charged by the offshore correspondent bank acting as the operation's intermediary. Furthermore, this strategy should not be abused, given that unreasonable interest payments for the loan may trigger scrutiny from the Colombian tax authorities.

### *4. International Lease Arrangements*

The international lease arrangement is an interesting profit repatriation tool. It is a mechanism that allows the investor to bring in capital assets. As a profit repatriation vehicle the international lease agreement carries with it tax consequences, set forth in the tax issues section of this article.

This method is attractive for the same reasons as the back-to-back loan structure. As such, the interest component of the financing component may be grossed up in a reasonable manner to allow for some profit factor to be sent offshore virtually tax-free.

### *5. Capital Reductions*

Capital reduction as a profit repatriation strategy is efficient and conservative. This profit repatriation tool represents no tax consequences for the client, as a Colombian company. However, it is subject to Colombian corporate law limitations.

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<sup>132</sup> CTC, art. 25 (5).



The Superintendent of Corporations<sup>133</sup> must approve capital reductions under Colombian law. Approval for the capital reduction is granted if the entity requesting the reduction lacks outside liabilities, or if the reduction will not result in company assets representing less than an amount double its outside liabilities.<sup>134</sup> Additionally, if outside liabilities include outstanding labor obligations, then Labor Ministry must also approve the capital reduction.<sup>135</sup>

These government approvals are costly from a time-efficiency perspective. Informally, the Superintendent of Corporations indicates that if the basic criteria for capital reduction are met, then it will grant the request, typically within ten days. However, if Labor Ministry approval is also required and layoffs are eminent within the newly acquired public utility company, then the government most likely will not approve the request and it may not even respond to the request until after ten months of its filing.

#### *6. Upstream International Loans*

Upstream international loans are a method of profit repatriation, whereby a loan is made upstream to an offshore, unrelated party with profits realized in Colombia. This structure takes the form of a typical debt instrument and carries no tax consequences, as long as interest payments are not made. However, this tool is a short term one.

The client's principal corporate purpose in Colombia is to provide a public utility service and not to act as an international lender. It is prudent to use this tool on sporadic occasions, otherwise the client is surely to draw the attention of the Colombian regulatory authorities, thus increasing its exposure to unwanted and costly scrutiny.

#### *7. Offshore Dividend and Royalty Payments*

Offshore dividend and royalty payments are the most conservative method of profit repatriation. This method is also the most costly vehicle for getting profits out of Colombia. As discussed above in the tax section, offshore dividend and royalty payments are subject to a harsh effective withholding income and remittance tax rate of 39.55 percent. Nonetheless, this profit repatriation vehicle is a vital part of any repatriation strategy.

### **C. The Due Diligence Review**

The due diligence phase of the privatization or capitalization process is vital. It is in this phase that the client and its advisors become genuinely

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<sup>133</sup> Colom. Com. Code, art. 145. The Superintendent of Corporations is a regulatory agency in charge of regulating and supervising the activities of most business association forms allowed in Colombia.

<sup>134</sup> Colom. Com Code, art. 145.

<sup>135</sup> *Id.*

familiar with the entity they wish to acquire. The main purpose of the review should be to understand the legal, accounting, and financial state of affairs of the public utility company that is being acquired. As such, the most important function for the bidder's advisors is to coordinate with it in a timely manner and to communicate findings of unanticipated risks, liabilities, and other material matters that may affect the decision to bid.<sup>136</sup>

U.S. counsel and other advisors, however, must be sensitive to differences in cultural attitudes that may exist from country to country during this phase.<sup>137</sup> While Colombia's culture is a Western-oriented one, it is a Latin American culture with strong Mediterranean ties. This means that information and document gathering often proceeds at a slower and slightly more bureaucratic pace than what U.S. practitioners are accustomed to. For example, part of a due diligence review in Colombia should include verification with the government that the entity to be acquired does not have overwhelming labor litigation exposure. Attaining the appropriate Labor Ministry and Administrative Court documents could take more than just a couple of hours, even days. Overcoming such a problem is really a matter of patience and planning ahead for such delays, otherwise this and other similar problems will only frustrate counsel and its clients.

When undertaking a due diligence review in a Colombian privatization or capitalization bid the objectives should be the following:

(1) Identify, understand, and quantify risks and liabilities, such as discrepancies in accounting and financial reporting, outstanding tax liabilities and litigation with the tax authorities, improper monetary correction accounting, compliance levels with environmental protection regulations, labor issues (involving potential pension fraud and union problems),<sup>138</sup> and other potential matters that may lead to litigation (such as corruption issues, potential tort issues, and contractual matters).

(2) Verify the veracity and completeness of the government's representations and warranties in its role as the seller of the public utility, as set forth in the bid rules issued and other documents made available.

(3) Identify problem areas in the bid process and assist the client in making recommendations to the government entity and its advisors organizing the process that may be beneficial to the client in attaining a competitive edge in the competition. In making such recommendations,

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<sup>136</sup> Wilson Chu, *Cross-Border M&A*, 6 BUS. L. TODAY 8, 12 (Jan.-Feb. 1997).

<sup>137</sup> *Id.* at 9.

<sup>138</sup> Colombian labor issues should be studied carefully when conducting due diligence reviews. This is because most public utilities, if not all, are unionized in Colombia. Also, these unions often have strong ties to local and national government concerns. As such, if the client wins the privatization bid it may be difficult, if not impossible, to implement personnel lay-offs within the first months after winning the bid to streamline operations for efficiency purposes because labor ministry authorization will be required.

counsel and other advisors should craft these in a manner that will seem to benefit other bidders equally.<sup>139</sup>

Once these objectives are adequately and reasonably met, the next task is to draft the due diligence report for the client.<sup>140</sup> This report under the current business climate in Colombia should be as exhaustive as possible, keeping in mind time and cost constraints. The due diligence report should encompass all findings by counsel, as well as other advisors, in one document, if possible.

#### D. Picking Local Counsel

Another key ingredient of the project finance privatization and capitalization puzzle, is choosing local counsel. Every legal and otherwise related matter is unique, especially when dealing in the context of a jurisdiction with a different legal tradition.<sup>141</sup> Often U.S. counsel is not sensitive to these issues. The client is ultimately best served -- its expectations may even be exceeded -- if counsel becomes sensitive to foreign legal and related advisory matters.

With this in mind, U.S. counsel should seek local counsel and related advisors by outlining the client's needs before interviewing and selecting counsel and other advisors,<sup>142</sup> and identifying the type or types of lawyers and advisors the client will need, keeping in mind the following issues:

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<sup>139</sup> Remember that, although the bid process is competitive in most countries like Colombia, the underlying spirit of the competition is a democratic one. This democratic spirit must be fostered by all bidders, not just the organizers. This spirit is what ultimately precludes the process from being corrupted, at least in a perfect scenario.

<sup>140</sup> For literature on drafting reports and legal opinions on international transactions see LEGAL OPINIONS IN INTERNATIONAL TRANSACTIONS: FOREIGN LAWYER'S RESPONSE TO U.S. OPINION REQUESTS (Michael Gruson et al. eds.) (1989); Neil Flanagin, *Opinions on Foreign Law*, in NEGOTIATING AND STRUCTURING INTERNATIONAL COMMERCIAL TRANSACTIONS: LEGAL ANALYSIS WITH SAMPLE AGREEMENTS 95-108 (Shelly P. Bettram & David N. Goldsweig eds.) (1991) [hereinafter NEGOTIATING & STRUCTURING]; *Third Party Legal Opinion Report (including Legal Opinion Accord) of the Section of Bus. Law American Bar Association (1991)*, THE BUS. LAW. (1991).

<sup>141</sup> See Elliot R. Lewis, *Selecting and Working with Foreign Counsel*, in LAW. DESKBOOK, *supra* note 5, at 394-410 ("In these times of rapid movement toward a global economy, companies are expanding beyond traditional borders. Economic globalization is the result of significant legislative accomplishments and economic developments. . . With these developments comes the necessity for lawyers to be prepared for transactions and dealings worldwide."); James R. Silkenat, *The Need for Foreign Legal Counsel: Location, Selection and Evaluation*, in NEGOTIATING & STRUCTURING, *supra* note 140, at 81, 83 ("The laundry list of issues to spot in selecting foreign counsel is very long. . . [T]he following criteria are usually . . . relevant: 1. English language ability. . . ; 2. skill and integrity of the firm; 3. identity of the responsible foreign lawyer handling your matter; 4. contacts with government. . . ; 5. costs. . . ; 6. . . accessibility; 7. representation of other multinational corporations; 8. familiarity with the kind of. . . business transaction involved. . .").

<sup>142</sup> Lewis, *supra* note 5, at 394 ("[Y]ou may need. . . time to sketch out the parameters of your international matter."). As indicated herein, U.S. counsel should research in a preliminary matter the applicable law involved in an international project finance and privatization deal. This is true for jurisdictions like Colombia, where applicable laws may

Latin America continues to be very client-oriented in the manner in which business is conducted, even when getting questions answered from public sector entities on the privatization auction block; therefore it matters who you know. However, a word of caution: U.S. counsel and advisors should stay away from overzealous local advisors promising to get things done through favors and so-called "greasing the wheel" tactics, especially in light of U.S. Foreign Corrupt Practices Act restrictions.<sup>143</sup>

While it may be useful to know the Spanish language on a functionally literate level when communicating with local advisors, one must make sure that local advisors can communicate well in spoken and written English, for this will facilitate client and advisor meetings.

Generally, laws in Latin America, especially in Colombia, are in a constant state of change. Therefore, it is vital to have a solid team of technocrats on the local advisory team, that is, solid tax, customs, commercial, corporate, trade, and privatization attorneys and accountants. While this recommendation is obvious on its face, it is worth mentioning nonetheless. Oftentimes the technocrat is not as well-connected as the more gregarious advisor, but well-connected advisors in Latin America, as in other parts of the world, may not be the most competent associates.

Finally, if U.S. counsel and its client do not have contacts for local advisor purposes, in a jurisdiction such as Colombia, traditional international legal directories and listings are useful resources. Another valuable on-the-ground resource for local legal, financial, and accounting advisors may be a local branch or affiliate of the client's U.S. accounting and consulting firm. In this regard, U.S. counsel and its client should be aware that today's international professional services market is becoming a one-stop shop. Prestigious international accounting and consulting firms in

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change on a more than regular basis. While an exhaustive study of the foreign jurisdiction is not required, an overview of the controlling law is suggested. This task will enable information to be conveyed to the client in an optimal manner in order to assist it in its decision making.

<sup>143</sup> See Michael R. Geroe, *Complying with U.S. Antibribery Laws*, 31 THE INT'L LAW. 1037 (1997) ("The Foreign Corrupt Practices Act of 1977 (the FCPA), as amended, punishes U.S. businesses and businesspeople who provide any payment or promise to foreign officials in exchange for obtaining or retaining business."). FPCA issues should always be considered, not only when instructing local advisors, but also when the client is itself operating on the ground in a foreign jurisdiction, given the law's extraterritorial powers. *Id.* at 1038, n. 6 (citing Department of Justice statement on the antibribery provisions of the FCPA (Feb. 1992) (DOJ Statement)). See also, O. Thomas Johnson Jr., *The Foreign Corrupt Practices Act*, in LAW. DESKBOOK, *supra* note 5, at 224-236 ("The third element of the FCPA's antibribery provision is that there must be an 'offer, payment, gift or promise' of 'money or [a] thing of value'." This element presents no interpretative difficulty. Its intent is to sweep broadly to prohibit any offer or promise of a bribe and to make clear that the bribe itself can consist of 'anything of value'."); ELLEN S. PODGOR, WHITE COLLAR CRIME IN A NUTSHELL 133 (1993) (providing overview of FCPA). See generally, GUIDELINES: PROCUREMENT UNDER IBRD LOANS AND IDA CREDITS 1.15, at 7 (The World Bank Revised Sept. 1997) (providing general view of anti-corruption policy and World Bank bidding guidelines).

many parts of the world, such as Colombia, have competent legal practices.  
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SEC-restricted entity rules preclude accounting firms from providing large multinational clients<sup>145</sup> that are publicly traded on U.S. stock markets with legal advice, other than traditional tax and international tax consulting advice on both a domestic (U.S.) and international level. These firms may, however, through their legal practices in foreign jurisdictions, provide clients with a check as to traditional services by local counsel. This check is a value-added service to traditional tax consulting that often proves vital in furthering a client's interests.

#### IV. CONCLUSION

Taking on a privatization or capitalization project in Colombia is not simple, but the excitement of advising the client and being part of an infrastructure project in this country, as in any of the so-called emerging markets in today's global economy, surely makes missing a couple of months on the golf course worthwhile. While time with the family during the two to five months in preparation for the client's bid will not be recuperated, the experience will make for many war stories, and in fact, bid day may provide an occasion for including the family on a late-summer business trip.

On a less nostalgic note, the following should be kept in mind:

(1) The client will need a Colombian joint stock corporation, in this regard an LPIS is advisable, as it is very functional for Colombian and U.S. business and tax purposes.

(2) The LPIS will need 5 shareholders or more. In order to spread the risk of exposure, the shareholders should be made up of limited liability entities, whether located offshore or onshore.

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<sup>144</sup> See generally, John Gigeaut, *Squeeze Play*, ABA J., p. 42, Feb. 1998 ("[S]torm clouds have been gathering since the early 1990's, when the Big Six [now Big Five] accounting firms plunged into the practice of law in Europe. A more relaxed regulatory atmosphere there has allowed them to engage in all kinds of legal practice, either on their own or through affiliated law firms. The Big Six have gone beyond tax law and into contracts, mergers and acquisitions, and even into litigation.").

<sup>145</sup> The SEC-restricted entity rules exist in order to preserve the independence and objectivity of public accountancy firms when analyzing financial statements and conducting external audit processes. These rules exist to safeguard such processes from biases. This objective is best presented in sec. 602.02.e.ii. of the Codification of Financial Reporting Policies, as amended in Release No. FR-34, Mar. 2, 1989, 54 F.R. 9770, in SEC HANDBOOK: RULES AND FORMS FOR FINANCIAL STATEMENTS AND RELATED DISCLOSURES (AS OF NOVEMBER 1, 1995) (CHH Publishers, 1995), stating, "A legal counsel enters into a personal relationship with a client and is primarily concerned with the personal rights and interests of such client. An independent accountant is precluded from such a relationship under the Securities Acts because the role is inconsistent with the appearance of independence required of accountants in reporting to public investors."

(3) Make sure you, and especially local counsel and other advisors, understand privatization, capitalization, and public utility law issues.

(4) There are no pass-through entities under Colombian tax law; all entities are taxed at a rate of 35 percent and an income tax on dividends tax of 7 percent will be triggered when paying dividends offshore.

(5) The investment into Colombia may be done via a direct capital investment, debt vehicles, or inter-company transactions.

(6) The optimal profit repatriation strategy should include (a) technical services and assistance agreements (offshore or onshore) performed by offshore entities; (b) related company offshore management and administrative agreements; (c) back-to-back loans; (d) international lease agreements; (e) capital reductions; (f) upstream international loans; and (g) offshore dividend and royalty payments.

(7) The due diligence review and report should be as exhaustive as possible and all advisors should cooperate in order to give the client the best picture of what it might acquire.

(8) Pick local counsel carefully and if needed, use two groups of local counsel, a technical group for tax, foreign exchange and investment issues and a less technical, but strongly connected group, for assisting with needed information and contacts on the ground.