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# PROJECT FINANCE NEWSWIRE™

*September 1998*

## US Court Hits Complicated Offshore Transaction

*by Keith Martin*

Merrill Lynch lost another round in the US courts within the past month in its effort to defend a complicated financial product that it sold to prominent US corporations to help the companies generate capital losses.

The decision is important for the project finance community because it shows the fragility of financial products that have little purpose other than generating tax results when tested in the US courts.

AlliedSignal was planning in 1990 to sell a subsidiary at a large capital gain.

An individual who sat on both the AlliedSignal and Merrill Lynch boards brought a new financial product that Merrill Lynch had developed to AlliedSignal's attention. The transaction involved a series of complicated offshore maneuvers at the end of which AlliedSignal would be able to claim a capital loss.

Briefly, the company set up an offshore partnership in April 1990. It had a 9% interest. Most of the remaining 91% of the partnership was owned by two Dutch Antilles subsidiaries of a foundation that was controlled by Dutch bank ABN-AMRO. The partners made capital contributions in their ownership percentages. ABN loaned the two Dutch Antilles companies the money they required to cover their capital contributions. The partnership then used $850 million of the capital to buy 5-year notes, called PPNs, from two Japanese banks. Less than a month later in May 1990, the partnership sold the PPNs for approximately $850 million to two other banks. The sales price was received partly in cash ($681 million) and partly in the form of notes with a market value of a little under $170 million payable over five years. The amount of each quarterly payment under the notes was uncertain because it varied with LIBOR. The partnership's tax year ended on May 31 shortly after the sale.

The partnership reported the disposition of the PPNs as an installment sale. It used the rules where

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### *In Other News*

**UNEXPECTED TAXES HIT WHEELING ARRANGEMENTS . . .** An Oregon court said last month that the state can tax a local generating cooperative that was using a federally-owned intertie to transmit power. The coop was one of nine companies that purchased a "capacity ownership share" on the line. The coop got the right to 50 megawatts of capacity, but had to submit power schedules in advance before using the intertie. The court said this was enough of an ownership interest in "property" to subject the coop to annual property taxes on part of the intertie's value.

*The case is a warning to factor state and local property taxes into wheeling costs or to take steps to draft wheeling agreements to avoid such taxes.*

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## Offshore Transaction

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the sales proceeds include "contingent debt" to report a large gain in its tax year when the sale occurred and to set up a largely matching loss in later years. The gain was allocated largely to the Dutch Antilles entities. They were not US taxpayers.

Three months later in August, AlliedSignal increased its interest in the partnership to 58%. The partnership distributed its assets to the partners in the August ownership ratio. The Dutch Antilles entities took cash. AlliedSignal got the LIBOR notes with the buult-in capital losses. AlliedSignal then sold the LIBOR notes and claimed net capital losses of $538 million.

The transactions cost AlliedSignal $11.3 to $12.6 million in transaction fees.

The US Tax Court cut through the transaction to conclude there was never any real partnership between AlliedSignal and the two Dutch Antilles companies.

The court ignored the existence of the two Dutch Antilles companies on grounds that they were thinly capitalized and "mere conduits" for participation by ABN. It said the relationship between ABN and AlliedSignal was one of lender-borrower rather than a partnership. The companies had divergent business goals. AlliedSignal entered into the venture for the sole purpose of generating capital losses. It ignored the transaction costs, profit potential and other fundamental business considerations. The AlliedSignal board focused only on the potential tax benefits when it approved the plan. Meanwhile, ABN entered into the venture for the sole purpose of receiving a debt return. This return was independent of the investment results of the venture. ABN had no profit potential beyond its specified return. The court said, quoting former US Supreme Court Justice Felix Frankfurter, if an arrangement does not put all parties "in the same business boat, then they cannot get into the same boat merely to seek . . . [tax] benefits."

Without a partnership, the tax results from the transaction collapsed.

The case is interesting for a number of reasons. First, it is an unusual case when courts ignore the separate existence of subsidiaries. Second, the fact that the court was unwilling to find a partnership may shed light on what parties should be careful to do when the shoe is on the other foot. US companies making outbound investments sometimes try to go in the opposite direction of claiming that a relationship is a joint venture, or partnership for US tax purposes, even though the contracts governing the relationship bear other names.

***If an arrangement does not put all parties in the same business boat, then they cannot get into the same boat merely to seek...[tax] benefits.***

Third, the case serves as a reminder: It was unhelpful to have the AlliedSignal board focusing only on tax benefits from the transaction. Fourth, it was equally unhelpful that ABN treated the transaction as a loan internally. The transaction went through normal credit committee procedures at ABN. An internal ABN memo described the transaction as, "AlliedSignal Inc. has a capital gain tax liability and this will cure their liability." No matter how careful the tax advisers may be for a company, there is no way to control what is said about the transaction by other participants. Such materials will come out in discovery.

This is the second loss for Merrill Lynch on its product. The US Tax Court ruled against Colgate-Palmolive on different grounds in a similar case last year called *ACM Partnership*. That case has attracted a lot of attention in the tax bar and is being appealed. The taxpayer hired the former top tax official in the Bush administration to handle the appeal. The IRS has challenged at least nine other Merrill Lynch customers on their use of the product. ■

# New Tax Credit Possible For Cogenerators

*by Keith Martin*

The Clinton administration released details in mid-September of a new energy tax credit it wants Congress to enact as part of a package of measures to deal with global warming.

Bills have been introduced in both the House and Senate to implement the proposal. They are unlikely to be acted on during the current Congress, but will be on the agenda for next year. Global warming is a high priority with Vice President Gore.

The new energy credit would work like the old investment tax credit. Taxpayers investing in a list of projects that the government wants to encourage would be given a tax credit for 10% of the cost in most cases. The list of projects that qualifies includes the following:

## Solar

Credits could be claimed on equipment that uses sunlight to generate electricity or heat or cool buildings or provide hot water. The credit would be set initially at 15% for projects that use photovoltaics or provide hot water. There would be an annual cap of $2,000 per "item of photovoltaic property" and $1,000 per "item of solar hot water property." There are no caps for other solar projects. The IRS has taken the position in the past that solar equipment that serves a dual role as part of the structure for a building does not qualify for energy credits. The bills make clear so-called dual-use property will qualify in future.

## Geothermal

Credits could be claimed on equipment that provides, distributes or uses energy from geothermal deposits, but only for the portion of a geothermal power plant up to the electrical transmission stage.

## Cogeneration

Equipment that is part of a "combined heat and power system" would qualify. However, at least 20% of the

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## In Other News *cont.*

**TREASURY TAKES AIM AT LILOs . . .** Philip West, the US international tax counsel, said at an American Bar Association meeting in August that the government has new regulations in the works that will prevent trafficking in tax benefits through cross-border leasing. West said the government is not concerned about cross-border leasing per se, but "the more egregious uses of leasing." He gave so-called lease-in-lease-out, or LILO transactions, as an example.

In a LILO, the owner of equipment – for example, a European utility – leases the equipment to a US lessee who then subleases it back to the utility. The rents under the head lease are largely prepaid. Head lease rents are allocated to different periods under the lease in a pattern that is front loaded. The utility receives the rent and then pays back sublease rents, but the sublease rents have a reverse pattern that starts low and goes high. The lease gives the US lessee net deductions for rent that are equivalent to a depreciation allowance on the equipment, except that the deductions are more accelerated.

LILOs were already hit by proposed regulations the IRS issued in June 1996 under section 467. These regulations limit the extent to which rents can fluctuate in leases. The market had already assumed LILOs would be impossible using the existing form once the section 467 regulations take effect. West said the new action is in addition to anything the government might do under section 467.

*The latest action may be good news? The leasing market has a history of building a better mousetrap each time the government moves to shut down one of its products.*

**INSTITUTIONAL EQUITY PARTICIPANTS FRET ABOUT** whether they give states a nexus to tax them by investing as a limited partner in a project.

The answer in Georgia at least is no. A Fulton County superior court said recently that two Tennessee residents did not become subject to income taxes by holding limited partner interests in a Georgia partnership. The court said the partnership was a separate entity from its partners. The partnership was formed to invest in securities traded on national stock markets. The general partners made all the investment decisions. The limited partners were barred from participating in management.

**SUPPORT IS BUILDING IN CONGRESS** for extending production tax credits.

The federal government offers a tax credit of 1.7 cents

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# Tax Credit

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output must be in the form of useful thermal energy. This compares to the 5% threshold to be a "qualifying facility" under the Public Utility Regulatory Policies Act, or PURPA. In addition, the project must have an energy conversion ratio greater than 70%, in the case of projects that exceed 50 megawatts, and 60% in smaller projects. The energy conversion ratio is the Btu content of the output divided by the Btu content of the fuel that went into the power plant.

## Circuit Breakers

Credits could be claimed for replacing any dual-pressure circuit breakers that went into service before 1986 and contain sulfur hexafloride (SF6). They must have a capacity of at least 115 kilovolts. The power company must certify that it promptly destroyed any circuit breakers that it replaced.

## Fuel Cells

Fuel cells that use an electrochemical process to generate heat and electricity would qualify for a 20% credit, but they must have an "electricity-only generation efficiency greater than 35%" and a minimum generating capacity of at least 50 kilowatts. Annual credits for fuel cells would be capped at $500 for each kw of capacity.

The administration is proposing that tax credits for cogeneration, replacing old circuit breakers and fuel cells last only five years through 2003. The solar and geothermal credits would be permanent.

Only new equipment would qualify. The bills would not allow credits to be transferred to another company through lease financing, at least as currently drafted. Any power company that is subject to rate of return regulation would not be able to claim the credits unless the regulators allow the credits to be retained by the power company rather than passed through to ratepayers.

The bills would require that cogeneration facilities that use biomass and waste fuels be depreciated over a longer period than under current law. ■

# Congress Weighs Changes in Foreign Corrupt Practices Act

*by Keith Martin and Heléna Klumpp*

The House is on the verge of amending the Foreign Corrupt Practices Act to make it illegal to offer anything of value to employees of the International Finance Corporation, Asian Development Bank and other "international public organizations."

The Foreign Corrupt Practices Act makes it a crime for US persons to offer anything of value to any foreign government official, candidate for office, or political party in an effort to win or retain business.

The Clinton administration asked Congress for a series of amendments to strengthen the government's hand in fighting corruption.

Three are significant. One would add employees of international public organizations to the list of persons whom it is illegal to bribe. Another would clarify that it is illegal not only to give things of value to government officials in an effort to win or retain business, but also for the purpose of "securing any improper advantage." Finally, the US government must prove currently that there was use of the US mails or any means or instrumentality of interstate commerce in order to establish a crime. This requirement would effectively be dropped from the statute.

The Senate approved the amendments in late July. A House vote in possible before Congress adjourns in early October. The statute was last amended in 1988. ■

# Lenders Seek Assurances About Year 2000 Problems

*by Keith Martin and Heléna Klumpp*

Most lenders are now requiring representations or covenants to ensure that borrowers will not have trouble repaying loans due to computer problems starting in the year 2000.

A recent survey found 84% of companies with fewer than 100 employees have done virtually nothing to ensure that their computer systems are prepared for the turn of the century. Other surveys indicate a similar level of inaction by larger companies.

Loan agreements are starting to address this problem in different ways. For example, a lender may ask a borrower for a representation that the borrower's computer systems are "year 2000 compliant." "Year 2000 compliant" is then defined broadly to mean that the systems will not be adversely affected by the date change to 2000. The following language is an example.

> "Borrower hereby represents and warrants, and at the request of Lender, shall provide assurance acceptable to Lender, that Borrower's computer based systems are Year 2000 Compliant. 'Year 2000 Compliant' shall mean that neither performance nor functionality of any computer hardware or software is affected by dates prior to, during, or after the Year 2000. In particular: (a) no value for current date will cause any interruption in operation; (b) Date-based functionality must behave consistently for dates prior to, during and after the Year 2000; (c) In all interfaces and data storage, the century in any date must be specified either explicitly or by unambiguous algorithms or interferencing rules; and (d) Year 2000 must be recognized as a leap year."

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## *In Other News* cont.

per kWh for producing electricity from wind or "closed-loop biomass." Credits may be claimed for 10 years after a project goes into service. However, projects must be in service by June 30, 1999 to qualify.

Support is building to extend the credit and perhaps also to broaden it. Rep. William Thomas (R.-Calif.) and 19 other members of the House tax-writing committee introduced a bill to allow another five years through June 2004 to place projects in service, but the bill would only apply to wind projects. Rep. Wally Herger (R.-Calif.) has a bill, with six tax-writing committee members as cosponsors, to extend the credit through June 2008 for all projects and allow credits for a broader class of biomass fuels. The Herger bill would cover waste fuels from farm, industrial and forest-related sources, but not garbage at municipal landfills.

*House action is unlikely until next year. However, Sen. William Roth (R.-Del.), chairman of the Senate Finance Committee, said on September 11 he would try to expand the list of eligible fuels to cover chicken litter and extend the credit for another five years in a tax bill this year.*

**SOME EXPATRIATES LIVING IN CHINA** would be wise to leave the country for at least 30 continuous days or a total of 90 days before the end of the year. Starting in 1999, expatriates who have lived in China for five consecutive years will become subject to Chinese income taxes on worldwide income. This result can be avoided by leaving the country for an extended period before the end of this year.

**THE AUSTRALIAN GOVERNMENT HAS PROPOSED A SERIES OF TAX REFORMS** that could hit US power companies with investments in the country.

Many inbound investments to date have been structured using trusts. The government proposes to eliminate the advantages by taxing trusts the same as companies commencing in July 2000. Transition rules would apply to existing investments.

Another proposal would eliminate the concept of "franked dividends," or distributions out of earnings that were already taxed at the company level. Franked dividends are not subject to further tax to the shareholder receiving them. This has given rise to "streaming" arrangements where franked income is steered to Australian shareholders and unfranked dividends go to shareholders who are outside the Australian tax net. Instead, companies will have to pay a top-up "equalization tax" when paying dividends to ensure

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## Y2K Problems

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The following is a more comprehensive representation in the same vein.

"The Company and its Subsidiaries have reviewed the areas within their business and operations that could be adversely affected by, and have developed or are developing a program to address on a timely basis, the 'Year 2000 Problem' (that is, the risk that computer applications used by the Company and its Subsidiaries may be unable to recognize and perform properly date-sensitive functions involving certain dates prior to and any date on or after December 31, 1999), and have made related appropriate inquiry of material suppliers and vendors. Based on such review and program, the Company believes that the 'Year 2000 Problem' will not have a Material Adverse Effect on the Company. From time to time, at the request of the Bank, the Company and its Subsidiaries shall provide to the Bank such updated information or documentation as is requested regarding the status of their efforts to address the 'Year 2000 Problem.'"

**A recent survey found 84% of companies with fewer than 100 employees have done virtually nothing to ensure that their computer systems are prepared for the turn of the century. Other surveys indicate a similar level of inaction by larger companies.**

A more moderate approach is to include a covenant that requires the borrower to provide an officer's certificate describing the status of its Y2K compliance efforts.

"Millennium Compliance: Within 120 days after December 31, 1998, the Borrower will cause an Officer to submit a certificate to the Agent that apprises the Agent of the Borrower's efforts with respect to (a) reprogramming any programs originally programmed by it, to the extent such programs are material to the conduct by the Borrower of its business, that must be reprogrammed to permit the proper functioning of such programs on or after January 1, 2000 and (b) seeking certifications from any vendors providing programs to it, to the extent such programs are material to the conduct by the Borrower of its business, in which such vendors certify that they are taking steps necessary to permit the proper functioning of such programs on or after January 1, 2000 or otherwise advise the Borrowers of the status of such efforts."

The British are known for succinct legal documents. The following is an example of a Year 2000 representation from a recent UK loan agreement:

"Millennium Compliance: The Borrower and each other member of the Group has reviewed its operations with a view to assessing whether, in the receipt, transmission, processing, storage, retransmission or other utilization of data there is a risk that computer hardware or software used in such operations will not, in the case of any date or time periods occurring on or after 1st January 2000, function in the same manner as in respect of any date or time periods occurring prior to this date (a "Millennium Fault"). Based upon such review, there is no risk that there will be an adverse change in the financial condition or business of the Borrower or any member of the Group by virtue of a Millennium Fault." ■

## *In Other News* cont.

all earnings have been subject to full corporate tax.

The government also proposes a rule where any distribution by a company would be treated as a dividend to the extent the company has profits. This will affect share buybacks, capital reductions and liquidations.

A general goods and services tax (GST) would be imposed by the federal government, probably at a 10% rate. The GST would replace the federal wholesale sales tax and certain state taxes, including most stamp duties.

The government also said it intends to talk to the business community about reducing the corporate tax rate to 30% (from the current 36%) in exchange for scaling back accelerated depreciation and possibly other concessions.

*The proposals will be included in the election manifesto of the ruling Liberal-National coalition for the next national election, currently expected in October. The government is currently trailing in the polls, but the main opposition party is backing most of the reforms.*

**RUSSIA SOURS ON CYPRUS TAX TREATY . . .** Foreign investment into Russia is often routed through Cyprus as a way of reducing withholding taxes on interest and dividends at the Russian border. The Russia-Cyprus treaty reduces these taxes to 0%. The Russian government has reportedly prepared draft legislation that would unilaterally renounce the treaty. The government should have given Cyprus notice by July 1 this year if it intended to renounce during 1998. This suggests the treaty will remain in effect at least until next year.

**INDONESIAN FALLOUT . . .** The Indonesian government is reviewing all tax breaks given to businesses in which Suharto cronies owned interests. Investment minister Hamzah Haz said a list of "transparent" requirements for foreign companies seeking tax incentives for investing in the country will be announced soon.

*Meanwhile, a new tax treaty took effect recently with Mauritius that reduces withholding taxes on dividends to 5% — the lowest under any treaty — but there are reports the Indonesian tax office wants to make revisions.*

**BRAZIL TAGS CAYMANS AS A TAX HAVEN . . .** The Brazilian tax authorities said they will subject all financial dealings and trade between Brazilian companies and entities in the Cayman Islands, British Virgin Islands and Netherlands Antilles to closer inspection to verify compliance with transfer pricing rules.

**TURKEY INCREASED ITS CORPORATE TAX RATE** from 25% to 30%.

It also eliminated withholding taxes on dividends in favor of a tax on the distributing corporation at the time it pays dividends. The rate for the distributions tax is expected to be 10%. A 10% corporate surtax will continue to apply.

Turkey may soon find itself in the same bind as India. India last year eliminated a requirement that Indian companies paying dividends to foreign shareholders must withhold income taxes on the shareholder. Instead, a tax is imposed on the distributing corporation directly. Some argue the move backfired because the typical power sales contract with a state electricity board allows a passthrough of taxes imposed on the project company. Thus, the government ends up bearing the new distributions tax.

**SPARE PARTS ARE PLACED IN SERVICE** when they are delivered to the taxpayer, even if he waits a while to put them to use.

Northern States Power Company won another round in a long-running battle with the IRS over when it can start depreciating nuclear fuel assemblies. The IRS argued the utility had to wait until the rods were installed in the reactor core. Equipment is considered in service when it is ready for the intended use. The US court of appeals for the 8th circuit said recently that this occurs in the case of nuclear fuel rods at delivery to the taxpayer. There is no need to wait for actual use.

**A GOOD IDEA IF IT WORKS . . .** Orbital Sciences Corporation expects to save $2 million on state sales taxes in Virginia by having the local industrial development authority in Loudon County act as its "general purchasing agent" in connection with a $50 million expansion in the county. State and local agencies are exempted from paying sales taxes. The Virginia Department of Taxation has yet to approve the arrangement.

**CHECK-THE-BOX** got a little easier last month.

US power companies investing offshore usually form an offshore holding company in a tax haven and then take steps to ensure that all entities below this holding company in the ownership chain are transparent for US tax purposes. This is usually a simple matter of filing a form with the IRS. However, IRS regulations require either that all shareholders in an offshore company must join in signing the form to treat the foreign company as transparent or else someone who is "authorized (under local law or the entity's organizational documents)" can sign for it.

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## In Other News *cont.*

A problem arises frequently in places like China. No Chinese joint venture participant wants to sign an IRS form, and joint venture contracts usually fail to authorize someone to file US tax forms on its behalf.

The IRS said in a new private ruling that a board resolution authorizing someone to sign counts as "authority under local law."

**SOME CHECK-THE-BOX DETAILS** still remain to be worked out.

The US allows taxpayers wide latitude to designate companies as corporations or partnerships or ignore them altogether. Companies in the last category are called "disregarded entities." There are still many unanswered questions, including whether mergers involving disregarded entities should be treated as tax-free mergers under the same rules that apply where all the entities involved in the merger are corporations. The New York State Bar Association sent Treasury a list of five fact patterns recently on which it asked for guidance.

**SOME STATES TAX "SUBPART F INCOME"** just like the federal government.

The federal government will look through offshore holding companies and tax any passive income it sees in the ownership chain. Examples of passive income are interest and dividends. Such income is called "subpart F income."

Nabisco argued in Illinois that it should not have to report subpart F income until the earnings are physically repatriated to the US. It lost recently before the Cook County circuit court. The court said the earnings have to be reported as part of the company's tax base in Illinois at the same time they become taxable at the federal level. Nabisco is headquartered in Illinois.

**NICE TRY . . .** PP&L lost an argument in a Pennsylvania court last month over whether it had to pay state gross receipts taxes on interest received from customers on late payments on utility bills. The state gross receipts tax applies only to revenue from "sales of electricity." The utility argued that interest is not technically electricity revenue. The state supreme court disagreed.

**"RIFLE SHOT" — NOT . . .** A "rifle shot" is a transition rule put in a tax bill to help a single taxpayer or a small group of taxpayers.

When Congress repealed the investment tax credit in the Tax Reform Act of 1986, it inserted language to let Merrill Lynch have more time to finish work on its "world headquarters" and still claim investment tax credits on the project. The special provision did not mention Merrill Lynch by name, but it described the particular facts of the Merrill Lynch project. Other taxpayers have tried to claim investment credits under the same provision. The US court of appeals for the 9th circuit upheld such a claim by Airborne Freight Corporation in late August.

*The decision is at odds with a ruling by the US court of appeals for the 7th circuit in Kjellstrom in November 1996 that relief under the transition rule is limited to Merrill Lynch.*

**LOONY TUNES . . .** The federal government offers a so-called section 29 tax credit as an inducement to look for fuel in unusual places. The credit is $1.052 per mmBtu for most qualifying fuels.

Two Pennsylvania gas producers claim they have "dual credit" gas. They argue they should be able to claim the credit twice on the same gas because the gas was certified by federal and state authorities as coming from both tight sands and Devonian shale. The case is before the US tax court.

**MINOR MEMOS:** Lee Sheppard argues that borrowers should not be allowed to deduct "interest" paid on DECS, TRUPS, PRIDES and QUIPPS in an article in *Tax Notes* magazine in early September. The magazine is widely read at the IRS and Treasury Departments . . . . The Edison Electric Institute and three other utility trade associations are lobbying Treasury to let utilities deduct the cost of removing old assets. The utility industry specialist at the IRS said he believes such costs should be treated as part of the cost of any replacement property and added to the tax basis of the replacement property . . . . The IRS recently released an old "field service memorandum" to its agents in the field advising that US companies may claim foreign tax credits for social contribution taxes paid in Brazil. ■

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