SPECIAL UPDATE

CHADBOURNE & PARKE LLP

Tax Issues In Project Sales

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Merchant power companies will remain under pressure for the next couple years to shed assets in order to raise cash to pay down debt. Private equity funds are continuing to circle the industry like scavengers hoping to buy assets at distressed prices. Sales have been slow because the banks are in no rush to force asset sales at the bottom of the business cycle at prices that would require they take a loss on their loans.

For those sales that do occur, one challenge is how to structure the sale so that the seller does not face an immediate tax on gain. The seller wants to take away as much cash as possible after the sale to pay down debts.

Buyers face their own challenges. A frequent issue in sales is "-6 liability" — or the problem that any buyer purchasing a project company whose tax results were reported on a consolidated tax return with other companies remains liable potentially for any underpayment of taxes by the entire group of companies for the period the project company was included in the group return. The problem has killed more than one deal.

This paper addresses tax issues for both sellers and buyers.

Form of Sale

The starting point for any sale is to decide what is being sold — the project directly or the company that owns it?

It is easiest for everyone concerned to sell the company because a direct sale of assets would require getting consents to the assignment of contracts and permits that are held in the project company. Each one of these assets would have to be transferred separately. In some cases, a seller might also prefer to sell the company if it has a higher "tax basis" in its ownership interest in the project company. Assets are depreciated over time, meaning that the older the project, the lower the tax basis that the project company will have in the project itself. These reductions in asset basis may or may not be reflected in the tax basis that the seller has in his ownership interest in the project company. If not, then the seller will be better off selling the project company. The higher his tax basis, the less gain he has to report — or the larger the loss he can claim — from the sale. A sale of membership interests or shares in a project company usually also avoids state and local sales taxes that would be triggered by a direct sale of the project.

Buyers tend to prefer to buy assets. For one thing, buyers worry about inheriting a company with existing liabilities that may be hard to uncover fully on due diligence. Moreover, a buyer usually wants to make sure the price he pays for the project is reflected fully in his tax basis in the assets so that it can be recovered through tax depreciation. Shares in a project company cannot be depreciated. Only assets can.

The buyer's objectives are often best served by buying the project company, but treating the transaction as an asset purchase for tax purposes.

This occurs automatically in cases where the project company is a "disregarded entity" for tax purposes. An example of a "disregarded entity" is a limited liability company, or LLC, that has only one owner. Otherwise, an election would have to be made by the parties under either section 338 — in cases where a corporation is being sold — or under section 754 — in cases where the sale is of a partnership interest. These are sections in the US tax code. The election is made by filing a form with the Internal Revenue Service.

Another benefit from selling the project company but treating the transaction as a sale of assets is this avoids state and local sales taxes. Sales taxes are usually triggered by a sale of "tangible personal property." In some states, an existing power plant may be considered "real property" — and, therefore, not be subject to sales taxes. There may be real property transfer taxes, although usually at a lower rate. Be aware that in California — and perhaps some other states — it is not a good idea to say in the transaction documents that the project is personal property for bankruptcy purposes. California courts have held the parties to this designation for sales tax purposes. Be aware that in some states sale of a project company may trigger state transfer or gains taxes if the project company is considered a real property holding company.

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There are two kinds of section 338 elections. Section 338(g) elections are rarely made. A section 338(h)(10) election can only be made where the seller is selling a subsidiary corporation with which it files a consolidated return. The subsidiary is treated as if it sold its assets to the buyer. The seller ends up having to bear any tax triggered by this deemed asset sale. Both parties must join in making a section 338(h)(10) election.

Understand the state income tax consequences of making a section 338 election. Not all states recognize such elections. The state income taxes on the sale and going forward need to be factored into the sales price.

If the project company is a corporation and is included in the seller's consolidated federal income tax return, then the seller will usually be indifferent for tax purposes whether it sells the project company or the assets. Its tax basis in each of them should be the same. It should be willing to make a section 338(h)(10) election to allow the buyer to step up the asset basis. (An exception is where the seller acquired the project company from someone else earlier without making a section 338 election.)

In other situations where the project company is a corporation, but is *not* included on the seller's consolidated return, giving the buyer a stepup in asset basis is a zero-sum game — or worse. The buyer can only get a stepup in asset basis if the project corporation will pay tax immediately on gain. This is not a good exchange. The project corporation has immediate income. The buyer will have matching deductions, but over time through depreciation. The present value of the buyer's tax savings from the additional depreciation is less than the additional tax that must be paid on the sale.

Beware of the "loss disallowance rule." The seller may not be able to claim a loss on sales of shares in a subsidiary with which it files a consolidated income tax return.

Beware of the "consistency rule." The buyer will not be able to "step up" its tax basis in the assets if it buys some assets from a corporation directly and then also buys the shares in the corporation without making an election under section 338 to treat the purchase of shares as an asset purchase.

Buyer Strategies

Are there any strategies that a savvy buyer might use to win bids?

The best strategy is to be aware of what the seller needs to get out of the transaction and to try to present a structure that accommodates its needs.

There may also be peculiarities about the project or the bidder that can be factored into a bid. For example, it may be possible to qualify for some form of tax subsidy by switching fuels. The Senate voted in May to allow section 45 tax credits of 1.5¢ a kWh to be claimed by owners of existing coal-fired power plants for co-firing with "closed-loop" biomass. It may be that the buyer can qualify for a 50% "depreciation bonus" on the project even though the seller would not. A buyer planning to sell the output to a municipal utility may be able to tap into the tax-exempt bond market for at least part of the purchase price. It may be that a particular buyer has an advantage over other bidders because it would be able to defer taxes in its home country on its future earnings from the project while other bidders would not. The buyer may be able to arrange financing from a Canadian income fund; such financing brings a tax advantage that should enable the buyer to pay at least 27% more than competing bidders. In bids for foreign projects, buyers sometimes present purchase structures that produce hidden benefits. An example is a so-called section 861 structure that allows a US bidder to treat future project earnings that go to pay interest on the acquisition debt as if they were a source of repatriated earnings to the US, but to do so in a way that does not create any taxable income in the United States and that puts the buyer in a better position to claim foreign tax credits from its other foreign projects. Another example is a structure that allows the interest on the acquisition debt to be deducted twice — once in the project country and again in the US or someplace else.

Seller Strategies

Many sellers in the current market are having to sell their projects at a loss.

Any seller expecting a loss will want to structure the sale so that it produces an "ordinary" loss rather than a "capital" loss. The problem with capital losses is corporations can only use them to offset capital gains. Corporations can carry unused capital losses back three years and forward five years. It makes no difference how long the asset being sold was held: there is no difference for corporations between short- and long-term losses.

The key for projects that are already in */ continued page 3*

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service is to sell the assets — or sell the project company but in a manner that is treated as a sale of the assets for income tax purposes. Shares and partnership interests are capital assets, and their sale produces a capital loss. Depreciable property that a company is using in its trade or business is not a capital asset.

It is less clear that a seller can claim an ordinary loss when selling a project that is merely under development. The problem in that case is that the US tax code defines "capital asset" as all property other than certain categories of assets. The category into which the project would have to fall to avoid being labeled a capital asset is "property, used in [the seller's] trade or business, of a character which is subject to the allowance for depreciation . . . or real property used in [the seller's] trade or business." The IRS has ruled privately that property that is not yet in service is not yet of a "character which is subject to . . . depreciation," and it is unclear whether a project under development is real property for this purpose. There are arguments back and forth.

Any seller expecting a *gain* on the sale will want to try to sell in a manner that defers the tax on gain. Here are seven ideas for how to defer taxes on gain.

1. *Like-kind exchange*. The US tax laws do not require a company to pay tax immediately on gain when it is merely exchanging one asset for another asset of a "like kind." The company takes the same tax basis in the new asset that it had in the old one. The tax on gain on the old asset is merely deferred. It will be taxed in the future when the *new* asset is sold.

This approach offers little to a company that must shed assets to pay down debt. However, it should be considered when a company plans to reinvest the sales proceeds in another project. The old property can be sold for cash and the new asset purchased later. The company must identify the replacement property within 45 days after the old property is sold. The cash must be spent on the replacement property within 180 days. Most power plants are considered "real property." This is determined under local law where the power plant is located. In cases where "real property" is being exchanged, the replacement property does not have to be fully built. Thus, a company could take the sales proceeds and apply them against the cost of a project that is still under construction. Transactions that involve a sale of the old property for cash must be run through a "qualified intermediary," or broker.

2. *Hybrid lease*. The seller might avoid tax on gain by entering into a long-term lease of the asset to the "buyer." The buyer would prepay the rents. The seller would invoke special rules in section 467 of the US tax code to report the rents over the term of the lease, notwithstanding that the seller was paid virtually the entire rent at the start.

The lease must be structured so that it is a "true lease" for tax purposes. This means that the lease term could not run longer than 80% of the remaining expected useful life of the project or beyond the period when more than 80% of its value has been used. The seller might also want to structure the lease as a "capital lease" for book purposes. This would allow it to book its gain from the sale. Treatment as a capital lease requires either that the lease have a term at least 75% of the remaining expected useful life of the project or the rents have a present value of at least 90% of the fair market value of the project.

In such transactions, the "seller" will eventually get back the project at the end of the lease term. The "buyer" could always negotiate in the future to buy the residual interest (after the lease ends) for its market value.

3. *Installment sale*. Taxes on gain can always be deferred by providing for payment of the purchase price over time. In that case, the gain is reported as a fraction of each installment payment of purchase price — and the taxes are paid on each installment. A lot of the benefit of reporting a sale this way was taken away by Congress in 1987 when it required that interest be paid on the "deferred" taxes. Merchant power companies with junk ratings may find this a cheaper way to borrow. The current interest charge on the deferred tax liability is 5%. On the other hand, this offers little to such a company that is desperate for cash, since taxes are paid on gain at the same rate as the installment payments of purchase price are received over time. Beware that if the installment note is pledged as security for borrowing, then tax on the entire gain will come due.

4. *Leveraged partnership*. Several sellers have explored the following. At least two transactions have closed. The buyer and seller form a partnership. The seller contributes the project to the partnership. The buyer contributes assets that generate cash and have a value equal to the purchase price. The partnership borrows against the value of the cash-generating assets and uses the

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borrowed funds to redeem all but 10% of the seller's partnership interest. The seller guarantees repayment of the partnership debt. If it works, the transaction has the effect of giving the seller installment sale treatment, but without the interest charge and with all the cash received up front. The seller's tax on gain is deferred until the partnership debt is paid down. An internal IRS memorandum made public in November 2002 suggests a number of ways the tax authorities might try to attack the transaction.

5. *Mixing bowl*. Partnership mixing bowls are a way to avoid tax on gain altogether, but they are hard to use. They work as follows. S contributes property it wants to sell to a new partnership that S forms with B. B contributes cash, marketable securities or other property that S wants. The partnership agreement gives S management rights over the asset that B contributed, and vice versa. There are "tracking allocations" where S gets 75% or 80% of the income or loss — and cash flow — from the property that B contributed, and vice versa. The problem with mixing bowls is the seller and buyer must remain joined at the hip and the seller does not get cash out immediately with which to pay down debt. The partnership must normally remain in place for seven years. There remains a risk — as in the leveraged partnership transaction — that the IRS will say that the seller made a "disguised sale" of the project.

6. *Tax-free reorganization*. If the project is held in a corporation and the seller is willing to take back stock in the buyer, then it may be possible to do a tax-free reorganization. There would be no tax to the seller upon receipt of the new shares. The seller could spread the tax hit by staggering the sale of the shares over time.

7. *Foreign projects*. A seller might avoid immediate US tax on gain from the sale of a foreign project by structuring the transaction as a sale of assets (or of a project company that is treated as a "disregarded entity" for US tax purposes). US tax cannot be avoided if what is sold is a partnership interest or shares in a corporation. The IRS is challenging transactions on audit where the seller made a sale of the project company and took steps shortly before the sale to turn the project company into a "disregarded entity."

Indemnity Issues

A number of recurring issues come up when trying to negotiate tax indemnities in project sales.

One big concern of buyers who end up owning a project company that is a corporation and was included in the consolidated return of the seller is "-6 liability." The IRS can go after such a project company for any taxes that the seller consolidated group failed to pay during the period the project company was part of the seller group (assuming the statute of limitations has not run). The project company is "severally" liable for all the taxes of the seller consolidated group. This is referred to as "-6 liability" because the rules are found in the IRS regulations at section 1.1502-6. The IRS regulations go on to say that the IRS *may* limit any claim against the project company to its share of the tax deficiency rather than hold it accountable for taxes owed by the entire group. There is not much that a seller can do to protect itself in practice other than get an indemnity from a creditworthy entity and do due diligence. It may be impossible to get a creditworthy indemnity in cases where the seller is in financial distress. On the other hand, the seller group may have had such large operating losses in recent years that it did not owe any taxes.

It is "market" for the seller to indemnify the buyer against any taxes for the period through closing and for the buyer to indemnify the seller against post-closing taxes.

Most parties agree in the indemnity to take the position that any indemnity payment is an adjustment to the purchase price. This is another way of saying that they will not report the indemnity as taxable income. However, there may be situations where the payment must be reported. In such cases, the indemnity payment should be "grossed up" for the taxes the indemnitee must pay on the indemnity payment. Without such a grossup, the indemnitee will not truly be made whole for its loss. By the same token, any *benefit* that the indemnitee gets from being able to deduct taxes that triggered the indemnity payment should be taken into account in calculating the amount of the payment. The indemnity should address how grossup situations are identified. For example, the indemnitee might produce an opinion from outside tax counsel that it is "more likely than not" the payment must be reported as income.

The buyer will want the ability to participate in tax audits of the seller group in cases where what is decided on audit might affect the project company's tax position going forward. Sellers resist. Buyers are often given the right to participate if the issues can be isolated

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and handled in separate meetings with IRS agents. The parties argue about whether the seller can settle the issues without consent from the buyer. No seller wants the closing of a tax audit of its consolidated return to be held hostage to a small issue. There is no one "market" approach for the settling this.

Other Tax Issues

Here are other tax issues that make an appearance in many project sales.

In cases where the project company is a partnership, the parties will often go to great lengths to avoid terminating the project company for tax purposes. The main problem with a termination is the partnership must start over depreciating its remaining tax basis in the project. This has a present-value cost. A termination can also cause loss of "grandfather" rights to certain tax benefits. A partnership terminates if there is a sale of 50% or more of the profits *and* capital interests in the partnership during a 12-month period. The easiest way to avoid a termination is to stop short of selling 50%. It is enough to stop short of selling a 50% capital interest. The buyer can buy a much larger profits interest. His "capital interest" is the amount the buyer would receive if the partnership liquidated. It is popular lore that the buyer can agree at closing to buy an X% interest today and bind himself to purchase another Y% interest to take him up to 50% a year and a day later. However, there is not much authority for this. It would be better not to have a legal commitment to buy the second increment. Asset consistency rules in the section 338 regulations are a trap for parties trying to avoid a termination by having the buyer purchase less than a 50% partnership interest directly and buy the rest indirectly by purchasing shares in a corporation that is a partner.

A question often asked is whether any part of the purchase price must be allocated to a power sales contract — for example, where the project has a long-term contract to sell electricity to a utility at above-market prices. The issue is whether the power contract merely adds value to the power plant or is a separate asset. The answer may have an effect on how quickly the buyer can recover its purchase price through tax depreciation or amortization. There is no clear answer. The law is clear that one ignores the market value of a lease in valuing a power plant — for example, where a lessor has leased the power plant to a utility at above-market rents. The rents are taken into account in valuing the power plant. The IRS takes the position that favorable financing terms to which an asset is subject are not a separate asset since "it is illogical to suggest that an obligation to pay money is an asset." However, the US Tax Court suggested in September 2003 in a case involving the Federal Home Loan Mortgage Corporation — known as Freddie Mac — that anyone acquiring another company with outstanding debt that is today at below-market rates can allocate part of the purchase price to the favorable financing terms.

Sellers sometimes sell for a price that is partly contingent on future events. For example, a project under development might be sold for $X plus another $Y if the project reaches financial closing so that it can start construction. IRS regulations suggest the seller must take into account as income at closing the expected value of the principal amount of the contingent payment (as opposed to the embedded interest). In cases where the seller is selling at a loss, the fact that part of the purchase price is contingent does not prevent the seller from claiming a loss. If a different amount than the expected value is received later, then the seller reports the additional income or loss in that later year.

The purchase agreement will often hold the seller accountable for any sales taxes. However, beware that sales tax liability might follow the assets that were sold unless the buyer gets a certificate from the state tax authorities that the taxes were paid — at least that was the outcome in an appeals court case in California in late 2002. The case is a warning to buyers to insist on a tax certificate at closing.

Projects that were financed with tax-exempt bonds are often sold subject to the outstanding bonds — but not always. A project can be sold without the buyer assuming the obligation to repay the bonds. The bonds will not lose their tax exemption. However, this creates risk for the seller. If the buyer changes the use of the project — for example, if the buyer later permanently shuts down the project or the reason tax-exempt bonds could be used is the project used "culm" or "gob" as fuel and the buyer switches to run-of-mine coal as fuel — then money must be set aside immediately in escrow to repay the bonds at the first date on which the bonds are callable.

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The IRS made clear in regulations in September 2003 that a purchaser of a project that is still under development or under construction can qualify for a "depreciation bonus" on the project even though the seller would not have qualified. An economic stimulus bill in 2002 authorized companies making new investments during a window period that runs from September 11, 2001 through 2004 or 2005, depending on the project, to deduct 30% of the cost of the project in the first year. Congress increased the amount of the bonus to 50%, but only for projects on which construction started after May 5, 2003. The Joint Tax Committee staff expressed the view in a "blue book" in late January 2003 that the buyer will qualify for whatever bonus applies at the time of purchase, as long as he does not acquire the project in a "churning" transaction. A churning transaction is a sale-leaseback or other arrangement where the seller continues to use the project after the sale. There had been a debate about whether the buyer would qualify for a bonus on both its purchase price to acquire the existing work in the ground and also on its spending to complete the project. The blue book suggests a bonus can be claimed on the full amount. IRS confirmed this in regulations on the depreciation bonus last September. ◎

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