



Internal office  
Memorandum

To: Ann Marie Tiller  
From: Brent Vasconcellos  
Subject: Yosemite I Withholding

Department: Tax Planning  
Date: January 14, 2000

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Pursuant to your request, I have prepared the following analysis of U.S. federal withholding tax considerations related to payments made by Enron North America ("ENA") to Delta Energy Corp. ("Delta"), a Cayman Islands exempt LLC, as part of the Yosemite structured finance transaction.

**Background**

On November 18, 1999, Yosemite Securities Trust I ("Yosemite"), a Delaware statutory business trust, issued \$750 million in senior unsecured notes (the "Notes"). The beneficial ownership interests of Yosemite are evidenced by \$75 million of certificates held by Enron Corp. ("Enron") and Long Lane Master Trust IV ("Long Lane"), a Delaware statutory business trust.<sup>1</sup> Yosemite is treated as a partnership for tax purposes, and the trust certificates held by Enron and Long Lane are treated as partnership interests for tax purposes. Currently, Yosemite's sole asset is an \$800 million debt obligation of Delta (the "Delta Note").<sup>2</sup> The Delta Note originally bore interest at a rate of 6.3% payable semi-annually, although it was amended on December 22, 1999 (as discussed below) to, among other things, increase the rate to 7.25%.

Delta is checked open as a partnership and is capitalized with nominal equity held by a Cayman Islands charitable trust (the "Trust") and \$800 million in proceeds, nominally in the form of a loan, from the issuance of the Delta Note to Yosemite.<sup>3</sup> Delta plans to take certain precautionary measures in order to assure itself of favorable tax treatment for withholding purposes by filing a Form 926 (Form 8865 which is not yet in final form) and has also included tax characterization language in the Delta Note.<sup>4</sup>

The \$800-million proceeds received by Delta were used as a prepayment of Delta's obligation under a cash-settled swap with ENA on the price of crude oil (the "Prepay").<sup>5</sup> As part of a pre-arranged integrated transaction, ENA entered into a cash-settled commodity swap with

<sup>1</sup> Enron and Long Lane each own \$37.5 million of the certificates. Long Lane is an accommodation party for Citibank through the total return swap in place between Long Lane and Salomon Smith Barney, a Citibank affiliate.

<sup>2</sup> Yosemite is also a swap counterparty to a credit default swap with Citibank, N.A. and has entered into a guarantee arrangement, nominally characterized as a loan, with Enron in which Enron effectively guarantees the interest payable on the Notes (although Enron's obligation is not in the nature of a traditional guarantee because it is not dependent on a payment default by Delta). Neither transaction is relevant for purposes of this discussion.

<sup>3</sup> The use of Delta came at the insistence of Enron Global Finance due to accounting concerns over the Yosemite investing entity's status as a special purpose vehicle (SPV). Characterization of an alternative Delta-like entity as an SPV for financial accounting purposes would have jeopardized the accounting treatment of the debt issuance by Yosemite as an off-balance sheet financing. The decision to use Delta apparently reduced such concerns based, at least in part, on ENA's prior dealings with Delta in similar swap transactions.

<sup>4</sup> These precautionary measures relate to withholding in calendar years 2001-2004. See discussion *infra*.

<sup>5</sup> The use of a prepaid swap was not motivated by tax considerations but instead was necessary in order to report the transaction as part of ENA's price risk management activities rather than debt for financial accounting purposes.

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Citibank and Citibank entered into a cash-settled commodity swap with Delta. Citibank and Delta hold floors and ENA holds a cap on the price of crude oil at the swap's maturity. All three swaps are based on an identical notional amount. Further, the caps and floors are identically priced and have the effect of creating a hedge to all three parties. After canceling all of the redundant terms to the three swaps, ENA receives \$800 million and Delta receives 6.3% interest payable semi-annually. Delta uses the interest received from the Swaps to make identical semi-annual interest payments to Yosemite on the Delta Note. Yosemite uses the interest earned on the Delta Note to satisfy the semi-annual interest payments due on the Notes and the semi-annual yield payments due on the Certificates.<sup>5</sup>

Due to commercial uncertainty caused by a last-minute change to a provision in the Swaps, Enron decided to shorten the tenor of the Swaps to two and a half months with a maturity date of January 31, 2000. The tenor of the Delta Note was also shortened to reflect an identical maturity date. Enron terminated the original Swaps and executed new Swaps on December 22, 1999 that reflect the originally contemplated maturity date of October 26, 2004. The Delta Note was also amended to reflect a similar maturity date. The terms under the new Swaps and the Delta Note remained substantially unchanged with the exception of the maturity date and a new interest rate of 7.25%. In connection with the termination of the original Swaps and execution of the new Swaps, Yosemite will execute a consent to these changes in order avoid a mandatory repayment of the Delta Note as required under its terms.<sup>7</sup>

**Issues**

1. In calendar year 2000, what basis does ENA have for making payments to Delta under the Prepay without reduction for U.S. federal income tax withholding under I.R.C. § 1441 and the regulations thereunder?
2. In calendar years 2001 through 2004, what basis does ENA have for making payments to Delta under the Prepay without reduction for U.S. federal income tax withholding under I.R.C. § 1441 and the regulations thereunder?

**Executive Summary**

1. For calendar year 2000, ENA can forego withholding on payments made to Delta under the original Prepay by relying on the short-term OID exception contained in I.R.C. § 871. ENA can also forego withholding on payments made to Delta under the new Prepay in calendar year 2000 by relying on the "portfolio interest" exemption.
2. The regulations promulgated under I.R.C. § 1441, effective January 1, 2001, would not require ENA to withhold on any payments made to Delta under the new Prepay for calendar years 2001 through 2004 on the basis that the beneficial owner of the income received by Delta is a U.S. person.

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<sup>5</sup> These cash flows only partially satisfy the Notes and certificates. The "Magic Note" was put in place to make up the shortfall amount.  
<sup>7</sup> For purposes of this discussion, the term "original Swaps" refers to the two-and-a-half-month Swaps that mature on January 31, 1999 and the "new" Swaps refers to the Swaps executed on December 22, 1999 that mature on October 26, 2004. Any reference to the "Prepay" or the "Swaps" also refers to the new Prepay/Swaps.

**Confidential: Attorney-Client Privilege****Discussion****§ 1441 Withholding in Calendar Year 2000****Tax Characterization of the Prepay**

The tax characterization of the Prepay is an integral part of the withholding analysis for calendar year 2000 because it allows ENA to identify alternative reporting positions based on the availability of withholding exemptions. Once the tax characterization of the underlying transaction is determined, the most advantageous reporting position for withholding purposes can be determined.

As noted above, the net result of the Swaps was that ENA received \$800 million in exchange for interest payable semi-annually at 7.25%. Based on the economic substance of the Swaps, the Service could potentially view the Prepay as a 7.25%, \$800 million loan by Delta to ENA and view the ENA/Citibank swap and the Citibank/Delta swap as swaps for tax purposes. Therefore, under this characterization, any payments made by ENA to Delta under the Prepay would be characterized as interest.<sup>8</sup>

**Current § 1441 Regulations**

The current version of the regulations promulgated under I.R.C. § 1441 are effective until December 31, 2000.<sup>9</sup> Those regulations generally provide that payments made by U.S. persons to foreign persons that constitute gross income from sources within the U.S. are subject to withholding tax at a rate of 30% unless an exemption applies.<sup>10</sup> Here, ENA is expected to make semi-annual payments to Delta under the Prepay that are likely characterized as interest. Therefore, in order for ENA to avoid the withholding obligation under § 1441, it must show either that:

- ◆ The payments constitute non-U.S. source income as:
  - ◆ Interest paid to by an 80/20 company<sup>11</sup>; or
  - ◆ Income from a notional principal contract

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- OR -

- ◆ The payments are U.S. source income, but an exemption from withholding applies:

<sup>8</sup> ENA intends to report the payments under the Swaps according to their form but acknowledges that the economic substance of the Swaps for withholding purposes is a loan by Delta to ENA. ENA will obtain the appropriate withholding certificates from Delta in accordance with its acknowledgement that the Prepay is a loan for tax purposes. See § 1441 Documentation discussion *infra*.

<sup>9</sup> See I.R.S. Notice 99-25, 1999-20 I.R.B. 75. This notice was the second postponement of the effective date for the new withholding regulations. See I.R.S. Notice 98-16, 1998-15 I.R.B. 12 (moving the effective date from 1/1/99 to 1/1/2000).

<sup>10</sup> See Treas. Reg. § 1.1441-1.

<sup>11</sup> Under Treas. Reg. § 1441-3(a), payments that represent income from sources without the U.S. are not subject to tax and withholding. I.R.C. § 861(a)(1)(A) excludes from the definition of income from sources within the U.S. interest received by a foreign taxpayer from an "80/20 company." Thus, if the provision applies, any interest paid to a foreign taxpayer would be deemed non-U.S. source income and thus not subject to withholding. An "80/20 company" is a domestic corporation that, for the three-year period ending on the close of the taxable year preceding the interest payment, derived at least 80% of its income from all sources as "active foreign business income." "Active foreign business income" is income derived from outside of the U.S. and is attributable to the active conduct of a trade of business in a foreign country. Here, ENA does not derive 80% of its income from all sources as "active foreign business income" and thus would not qualify as an "80/20 company" under §

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- Income tax treaty<sup>12</sup>; or
- Short-term OID exception; or
- The portfolio interest exemption

Non-U.S. Source Income*Income from a Notional Principal Contract*

Under § 1441, a payer is only required to withhold on payments to foreign persons that constitute income from sources within the U.S.<sup>13</sup> Payments that constitute income from sources outside of the U.S. are not subject to § 1441 withholding. Under Treas. Reg. § 1.863-7(b)(1), the source of notional principal contract income is determined by reference to the residence of the taxpayer. Here, Delta is a Cayman Islands resident and thus under § 1.863-7, any income earned by it from a notional principal contract would be foreign source income. Therefore, if the payments made by ENA to Delta under the Prepay are characterized as payments made under a notional principal contract pursuant to § 1.446-3, no withholding would be required under § 1441 because the payments would not constitute U.S. source income to Delta.

Here, however the Service would likely take the position that the economic substance of the Prepay supports a loan characterization rather than a notional principal contract characterization. The \$800 million prepayment by Delta would be treated as the advanced principal and the semi-annual barrel payments by ENA would be treated as interest payable to Delta on that principal. However, the payments under ENA/Citibank swap and the Citibank/Delta swap would be treated as payments under a notional principal contract. Another position the Service could take is that § 1.446-3(g)(4) applies to the Prepay. This provision generally provides that a swap that contains significant non-periodic payments is treated as two separate transactions consisting of a loan and a swap.<sup>14</sup> As such, all of the payments made by ENA to Delta under the Prepay would be characterized as interest rather than periodic swap payments under § 1.446-3, thus requiring ENA to identify another withholding exemption.

Exemptions from Withholding<sup>15</sup>*(i) Short-term OID Exception*

The § 1441 regulations generally impose a withholding obligation on payments representing original issue discount under I.R.C. § 871(a)(1)(C). However, an amount representing original issue discount that is payable less than 183 days from an obligation's date of issuance is not subject to the tax imposed under § 871(a)(1)(C) and thus is not subject to withholding under § 1441.<sup>16</sup> Here, the original Swaps executed on November 18, 1999 provided for a maturity of January 31, 2000 and did not provide for any payments to be made during this

<sup>12</sup> Under Treas. Reg. § 1.1441-6(a), a foreign taxpayer may claim a reduced rate of withholding or complete exemption from withholding pursuant to an income tax treaty between the U.S. and the taxpayer's home country. The U.S. and Cayman Islands do not currently have a negotiated tax treaty in place and therefore this withholding exemption would not be available to Delta for the payments it receives from ENA.

<sup>13</sup> See Treas. Reg. § 1.1441-1. For purposes of this discussion, the term "payer" is synonymous with the term "withholding agent" under § 1441 and the regulations thereunder.

<sup>14</sup> See also Treas. Reg. § 1.446-3(g)(6) example 3. It is not entirely clear how this provision would apply to the Prepay. However, the potential does exist that the Service could apply this provision in an attempt to recharacterize the transaction.

<sup>15</sup> The exemptions discussed below are dependent on a characterization of the Swaps as a loan for § 1441 withholding purposes.

<sup>16</sup> See I.R.C. § 871(g)(1)(B)(i).

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period.<sup>17</sup> Therefore, any interest component of the termination payment made by ENA to Delta is not subject to withholding since the payment contains OID payable less than 183 days from the Swaps' execution date.

*(ii) The Portfolio Interest Exemption*

Payments to foreign persons that constitute "portfolio interest" are generally not subject to withholding.<sup>18</sup> "Portfolio interest" includes interest paid on certain registered debt issued to unrelated non-bank persons. In order to be unrelated for purposes of the "portfolio interest" exemption, the foreign person may not own, either directly or indirectly, through application of the § 318 stock attribution rules, 10 percent or more of a corporate debt issuer's total combined voting power of all classes of stock entitled to vote. I.R.C. § 871(h)(3)(C) modifies the § 318 stock attribution rules by eliminating the 50-percent limitation.<sup>19</sup>

It is not entirely clear whether a withholding agent is required to look beyond the form of a transaction to reasonably rely on a foreign payee's claim of exemption from withholding. Here, the Service could potentially argue that ENA is required to acknowledge the economic substance of the transactions in the Yosemite structure for purposes of determining its withholding obligations under § 1441. This argument would effectively require that ENA, as a "withholding agent" under § 1441, determine the tax characterization of any transaction that ultimately determines whether it has an obligation to withhold on payments to foreign persons. In the context of payments made by ENA to Delta that constitute "portfolio interest", the Service's argument would require that ENA determine the tax character of the Delta Note held by Yosemite in order to determine whether Delta is a 10% or more shareholder in ENA under § 871(h)(3). Thus, the potential exists that the Service would disallow use of the "portfolio interest" exemption by asserting that Delta is a 10% or more shareholder in ENA.

If the Service were to attack ENA's reliance on the "portfolio interest" exemption, ENA should argue that Delta is merely an accommodation party used solely for accounting purposes and that the ultimate recipient and beneficiary of all payments made by ENA is Yosemite, who is a U.S. person. This argument should be at least somewhat persuasive because it serves as the foundation for the new but not yet effective § 1441 regulations. The new § 1441 regulations recognize that the status of the ultimate beneficiary of income should determine (as discussed further below) whether withholding is appropriate.

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<sup>17</sup> The Swaps, as drafted, retained provisions that provided for interest payments beyond the maturity date of the Swaps, effectively creating OID. This was done in anticipation of the early termination and issuance of new Swaps with similar terms and a maturity of October 26, 2004.

<sup>18</sup> See I.R.C. § 1441(c)(9).

<sup>19</sup> The § 318 stock attribution rules, as modified by § 871(h)(3)(C), could potentially apply to Delta as follows:

1. Yosemite's constructive ownership of the ENA stock owned by Enron
  - § 318(a)(3)(A), as modified by § 871(h)(3)(C), provides that stock (the ENA stock) owned by a partner (Enron) shall be considered as owned by the partnership (Yosemite).
  - Thus, through application of this provision, Yosemite is deemed to constructively own the ENA stock.
2. Reattribution of the constructively owned ENA stock by Yosemite to Delta
  - § 318(a)(5)(A) provides that the entity (Yosemite) deemed to "constructively" own stock (the ENA stock) from the first application of § 318 is deemed to "actually" own the stock (ENA stock) for purposes of applying the attribution rules a second time (i.e., continuing ENA stock attribution down the chain of ownership to Delta).
3. Delta's constructive ownership of the ENA stock "actually" owned by Yosemite for the purposes of § 318
  - § 318(a)(3)(A), as modified by § 871(h)(3)(C), provides that stock (the ENA stock) owned by a partner (Yosemite) shall be considered as owned by the partnership (Delta).

**Confidential: Attorney-Client Privilege****Reporting Position for Year 2000 Payments to Delta**Loan Characterization

Given the economic substance underlying the Swaps, the most advantageous position for ENA to take is that the Prepay is a loan for tax purposes but that § 1441 withholding should not apply based on the following arguments:

1. The Swaps possess a five-year tenor that straddles the effective date of the new § 1441 regulations. The transaction should be treated consistently over its outstanding life and since four of five years' payments under the Prepay will not be subject to withholding under the new § 1441 regulations, the first year payments under the Prepay should be treated similarly.
2. By promulgating the new § 1441 regulations, Treasury recognized that the aggregate theory of partnerships was appropriate for § 1441 withholding purposes in contrast to the entity theory utilized by the current § 1441 regulations. Since Yosemite is a U.S. partner in Delta for tax purposes and is allocated all of the income of Delta, payments made by ENA to Delta should not be subject to withholding by virtue of Yosemite's status as a U.S. person under the approach embodied by the new § 1441 regulations.
3. By giving effect to the new withholding certificates, the Service implicitly authorized the use of the new regulations since the new withholding certificates were created for use under the new withholding regulations.
4. The new regulations were originally expected to take effect on January 1, 1999, but were delayed for two years and therefore ENA should be allowed to informally adopt the new § 1441 regulations.

Even if the Service were to ignore all of the preceding arguments regarding the inapplicability of § 1441 withholding to payments made by ENA to Delta in calendar year 2000, ENA should argue that once the tax is paid it is abated and therefore ENA is only potentially liable for interest and penalties.<sup>20</sup>

**§ 1441 Withholding in Calendar Years 2001-2004**New § 1441 Regulations

As discussed above, effective January 1, 2001, the withholding rules promulgated under § 1441 will change.<sup>21</sup> One of the major changes under the new regulations is the addition of the partnership look-through rules which recognize that payments made to partnerships generally flow through the partnership to its partners whom are the beneficial owners of income.<sup>22</sup> Thus, if a payment is made to a foreign partnership in which only U.S. persons are partners, the payment would not be subject to withholding because it would be considered a payment by a U.S. person to a U.S. person under the new regulations.

<sup>20</sup> See I.R.C. § 1463.

<sup>21</sup> See note 5, *supra*.

<sup>22</sup> See generally Treas. Reg. § 1.1441-5

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The new § 1441 regulations also contemplate payments to partnerships where another partnership is a partner.<sup>23</sup> In such a case, the regulations require that the payer look through only the partnerships that are foreign until it can identify a U.S. person, if any.<sup>24</sup> For purposes of the new § 1441 regulations, language was included in the Delta Note that acknowledges its treatment as a partnership for tax purposes. Therefore, Yosemite and the Trust would be treated as partners in Delta. Yosemite is a U.S. person and the Trust is a foreign person for tax purposes. Since Yosemite is allocated all of the income of Delta under the terms of the Delta Note, any payments made by ENA to Delta after the year 2000 would not be subject to withholding under the new § 1441 regulations since they would be considered made between ENA and Yosemite rather than between ENA and Delta.

**§ 1441 Documentation**

In 1998, the Service announced that it would be implementing the use of new withholding certificates in connection with the new § 1441 regulations that were finalized in 1997.<sup>25</sup> However, the Service announced that the new certificates would be valid under the current withholding regime.<sup>26</sup> Generally, a U.S. taxpayer must request the appropriate withholding certificate from a foreign payee in order to meet the reliance standard under § 1441 and the regulations thereunder. (See Attachment A for a summary of the required withholding certificates and other tax forms discussed below).

**Portfolio Interest Exemption**

A foreign payee claiming the "portfolio interest" exemption from withholding under § 1441 should provide the payer with Form W-8BEN. The purpose of the form is to establish that the payee is a foreign person and that it is the beneficial owner of the income. The payer reports the payment to a foreign person on Form 1042-S and claims an exemption from withholding as portfolio interest. If ENA relies upon the "portfolio interest" exemption Delta should provide ENA with Form W-8BEN to claim its status as a foreign person and beneficial owner of the income it receives.

**The Look-through Rules under the New § 1441 Regulations**

Under the look-through rules of the new § 1441 regulations, a foreign partnership that claims it is not subject to withholding must provide the payer with Form W-8IMY that indicates its status as a foreign partnership. In order for the payer to rely on the foreign partnership's claim of exemption from withholding, the partnership must also provide the payer with the withholding certificates of its beneficial owners evidencing each owner's distributive share and the owner's status for withholding purposes (e.g., U.S. person, foreign person, income effectively connected with a U.S. trade or business). For purposes of the new § 1441 withholding regulations, Delta is a foreign partnership and Delta's partners are Yosemite, a Delaware statutory business trust, and the Trust, a Cayman Islands exempt LLC. Yosemite should provide Delta with Form W-9 to

<sup>23</sup> See Treas. Reg. § 1.1441-5(c).

<sup>24</sup> See parenthetical in Treas. Reg. § 1.1441-5(c)(1)(i). The documentation requirements for a withholding agent's reliance on a partner's U.S. or foreign status is discussed *infra*.

<sup>25</sup> See Announcement 98-15, 1998-10 I.R.B. 36, T.D. 8734, 1997-44 I.R.B. 5.

<sup>26</sup> See Notice 98-16, 1998-15 I.R.B. 12. The withholding certificates discussed herein refer to the new certificates

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claim its status as a U.S. person. Delta should provide ENA with its Form W-8IMY and attach Yosemite's Form W-9 in order to satisfy the requirements under Treas. Reg. § 1.1441-5(c).<sup>27</sup>

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<sup>27</sup> As a precautionary measure, ENA should obtain these forms during calendar year 2000 based on the discussion, *supra*, regarding year 2000 reporting. The Trust need not provide a withholding certificate since none of the money paid by ENA under the Swaps will be allocated to the Trust. The Trust's "accommodation fee" will be deducted from the initial prepayment made by Delta to ENA under the Prepay.