

May 3, 1996

IRS Battles Colgate Over Deal That It Calls a 'Subterfuge'

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Investment bankers from Merrill Lynch & Co. approached Colgate-Palmolive Co. with an intriguing proposal. If Colgate executed a series of transactions Merrill had devised, the company could reduce or eliminate its taxes on a \$105 million capital gain.

Merrill also stood to benefit nicely. It would share in fees for the complex deal that could total \$7.9 million.

Colgate took the advice and, in the fall of 1989, set up an exotic offshore partnership with a Dutch bank that generated \$98 million in paper losses.

Colgate says the partnership had a legitimate business purpose: providing a vehicle to buy back some of its own debt. But the Internal Revenue Service contends this was a "subterfuge" and the maneuvers were nothing more than "sham transactions" to evade taxes. Colgate now is fighting the IRS ruling in Tax Court in New York.

Thriving Business

Long after Congress drastically curtailed most tax shelters for individuals, such as commodity straddles and real-estate partnerships, corporate tax shelters flourish. The Colgate case is part of an IRS offensive against them. At stake are hundreds of millions in potential back taxes and penalties, as well as possible damage to a lucrative Wall Street business.

"The service has been worried about partnership abuses in the international area. The abuses are endemic," says Michael J. McIntyre, a professor at Wayne State law school in Detroit. When the Treasury Department proposed a plan to crack down on them in 1994, he adds, "it provoked a tremendous amount of anger from the tax-avoidance community."

Tax-avoidance community? "There's a very vibrant, active corporate tax-shelter market out there," says Ken Jones, a partner at accounting firm KPMG Peat Marwick. Lawyers, accountants and investment bankers mine the byzantine tax code, he says, for "hypertechnical interpretations of the tax law, tailored to the needs of corporate clients."

Naming Names

In a dramatic moment late in the trial of Colgate's case in a few weeks ago, E.S.P. Das, vice chairman of investment banking at Merrill, was forced to violate a Wall Street taboo and name clients for such deals. Asked for whom Merrill engineered deals similar to Colgate's, Mr. Das, in a barely audible voice, ticked off a blue-chip roster: AlliedSignal Inc., American Home Products Corp., Borden Inc., Brunswick Corp., Dun & Bradstreet Corp., Paramount Communications Inc. (now part of Viacom Inc.) and Schering-Plough Corp.

Most of the companies either express confidence in their tax accounting or won't comment, but it is known that at least a few face challenge by the IRS. The IRS rejected Borden's deal, and the company is appealing.

But such cases often escape notice. The designers of the tax deals keep them under wraps, showing them to corporate clients only under confidentiality agreements. The deals use obscure partnership names, such as ACM for Colgate or Zeelandia for Borden. Congress last year passed legislation requiring that such shelters be registered, but it was part of a larger bill that was vetoed.

Paper Losses

Merrill's plan put Colgate into a Bermuda-based investment partnership with Merrill and a Dutch bank, Algemene Bank Netherlands, or ABN, now a unit of ABN Amro Holding NV. Soon, shifts in the partnership's investments and ownership resulted in a paper profit for the Dutch bank in 1989, followed by a paper loss for Colgate two years later. As a non-U.S. taxpayer, the Dutch bank didn't owe federal taxes on its gain, but Colgate could apply its losses against the gain from the 1988 sale of its Kendall health-care division.

The sophisticated mechanics were built around a "contingent payment installment sale," under section 453 of the U.S. tax code. It covers the sale of assets that aren't publicly traded securities, for consideration whose ultimate amount may vary.

First the three partners invested \$205 million -- 82.6% of it coming from ABN, 17% from Colgate and 0.3% from Merrill. They named the partnership ACM. Within just a few weeks in late 1989, ACM invested the money in unregistered Citicorp notes, then sold \$175 million of them for \$140 million in cash and new five-year floating-rate notes.

This generated an immediate capital gain of \$110.7 million for ACM. How? The 453 rules let a seller calculate capital gains by deducting its cost over

the period in which payments are to be received, in this case six tax years. So while ACM received \$140 million in cash proceeds, its cost basis for the first tax year was only \$29.3 million, or one-sixth of \$175 million.

Because the Dutch bank owned most of the partnership, most of the gain wasn't subject to U.S. taxes. The Dutch bank used tax-exempt Netherlands Antilles foundations to invest in ACM.

Two years later, the Dutch bank exited ACM, leaving Colgate with a 99.5% stake. Then the partnership sold the remaining floating-rate notes, but it was able to count a huge part of the notes' purchase cost against the sale -- so much so that the result was an \$85 million capital loss. Colgate, by now the main owner of the partnership, harvested nearly all of this loss. In all, its paper losses totaled \$98 million.

Labeled 'Shams'

But the IRS -- which had cooled the traffic in this particular kind of deal with a warning in 1990 -- ruled in 1993 that the Dutch bank hadn't been a true partner in ACM, only a lender, and thus it couldn't be allotted the 1989 capital gain that was the flip side of Colgate's 1991 paper loss. It called the transactions "shams in that they were prearranged and predetermined." Colgate appealed.

In a federal-court skirmish, the IRS gained access to Merrill's files about the deals. As IRS investigators sifted through the partners' records, they found several bits of evidence that -- in the view of an economic consultant to the IRS, Irving Plotkin of Arthur D. Little Inc. -- pointed to ABN's playing the role of a lender rather than an investor.

One was that the Dutch bank had effectively hedged away much of its economic risk in the partnership via a series of Merrill-arranged "swaps." These were done outside the partnership and weren't immediately visible to the IRS.

Also, the bank had allowed Colgate to split voting control of the partnership even though Colgate put in only 17% of its funds. And the bank didn't pay any of the partnership's fees and transaction costs; Colgate did.

Peter de Beer, a lawyer for the Dutch bank, said it was trying to oblige Colgate in hopes of getting more of its financing business. "You were structuring the deal in a manner which you understood to be for tax purposes principally, is that right?" the Tax Court judge, David Laro, asked.

"Yes," Mr. de Beer replied.

"Did you ever really want to be a partner," the judge asked, "or were you doing it just to accommodate the form of the transaction that was being explained to you?"

"We were accommodating," said Mr. de Beer.

Step Program

As evidence of prearrangement, the IRS found a presentation by Merrill to Colgate dated Sept. 20, 1989, that laid out seven key steps eventually taken by the partnership, together with the tax consequences.

The IRS also said that in all the Colgate-style deals done for the eight Merrill clients, the foreign partners quickly cut their ownership stakes so the U.S. firms could harvest the losses. And it noted that Colgate's loss was timed to occur within three years of its 1988 gain, precisely the limit on how far back Colgate could carry the ACM loss to offset that gain.

Fees to be reaped by Merrill, which isn't a party to the case, were sketched in the court papers. Notes of one Merrill executive -- on stationery of the Southampton Princess Hotel, Golf, Beach and Tennis Club in Bermuda, where ACM held meetings -- suggest Merrill's fees would include \$1.75 million for designing the deal and a \$1.1 million commission on one note sale.

Buying Back Debt

A key issue at the trial was the deal's "business purpose." The partnership, besides buying and selling Citicorp notes to generate the Dutch bank's gain and Colgate's loss, bought \$155 million in Colgate debt. Colgate eventually ended up with that debt after it became the main owner of the partnership. It said this debt buyback was its chief business purpose.

But why such a roundabout method? Assistant treasurer Hans Polschroeder said one reason Colgate repurchased the debt through the partnership was to maintain anonymity, so traders wouldn't know Colgate was interested in buying. But IRS lawyer Jill Frisch noted that Colgate could have obtained nearly as much anonymity merely by placing an order for the debt with Merrill's trading desk.

At one point, Judge Laro asked Colgate's vice president of taxation, Steven Belasco: "Did you or any of your colleagues ... ever consider the fact that this was a very attractive transaction from a tax point of view, but it

wouldn't fly unless you dressed it up with some business purpose behind it?"

"Did anyone ever think that? Yes, of course," Mr. Belasco replied. "But the idea that we were going to go in and buy \$150 million of Colgate debt as window-dressing, to me is absurd."

Detailed Minutes

One of the IRS's expert witnesses was Paul Smith, a former chief financial officer of Eastman Kodak Co. In a written report he did at the IRS's behest, he said minutes of a Colgate board meeting Oct. 12, 1989, and a board finance-committee meeting 3 1/2 weeks later "seem very artfully crafted to try to describe a business purpose for the partnership transaction other than the capital gain tax avoidance on the Kendall sale." He said the finance-committee minutes reported events that hadn't actually occurred at that point, raising the possibility they had been "purposely and fraudulently created after the fact"

Colgate General Counsel Harold Obstler replied that errors occurred because, in preparing the minutes just before the next meeting, he would reconstruct what had happened at earlier meetings partly by questioning participants about what they had said.

Colgate argued that the Merrill deal provided a flexible tool for repurchasing its debt, and that the company was perfectly within its rights to take advantage of obscure tax rules. The IRS, Colgate lawyer Fred Goldberg said, can't "walk away from the implications of their own regulation." He added that "this case has been perhaps far too much characterized by questions of intent, questions of motive, questions of what people were thinking or feeling It's like performing a morality play of some sort. That's not the law."

Not Alone

Another line of Colgate's defense was that such deals had been blessed by some of the biggest names on Wall Street. "Is it possible the court would react to this case differently if the court knew that Goldman Sachs or Bankers Trust or Salomon Brothers had been involved in transactions of this sort," Mr. Goldberg asked, or "if it knew that four different Big Six accounting firms had concluded that it was appropriate?"

Mr. Smith, the former Kodak executive, testified that Salomon had made a similar proposal to Kodak in 1990, and Mr. Polschroeder said Colgate once received a proposal from Bankers Trust New York Corp. that would have put Colgate in partnership with a savings and loan whose past losses could

offset any gains. Mr. Das, the Merrill banker who named other clients, said the Paramount deal was brought to Merrill by Goldman.

Not every Wall Street firm participated. Two investment banks, J.P. Morgan & Co. and CS First Boston Inc., didn't recommend these deals to clients. And a partner at accounting firm Grant Thornton, Thomas Ochsenschlager, says the firm had calls in the late 1980s about such a deal, but "we felt it was too risky, that it was a sham transaction."

Awaiting a Ruling

Testimony in the Colgate trial ended March 18. Judge Laro isn't expected to rule for several months. After that, the loser can always try to persuade federal appeals-court judges to reconsider. But IRS officials seem dug in for a long fight.

Current IRS officials, that is. Among other things, the case offers an illustration of the revolving-door nature of tax practice.

James Fields, a lawyer who devised the Colgate deal while at Merrill, had earlier been assistant chief counsel at the IRS. Later he became the Treasury Department's tax legislative counsel and staff director of a presidential tax-reform commission. He is now back in the private sector.

Colgate lawyer Mr. Goldberg, of Skadden Arps Slate Meagher & Flom, headed the IRS itself from 1989 to 1992.

And Colgate put in evidence a 1989 memo from law firm Cleary Gottlieb Steen & Hamilton endorsing a similar shelter deal. The author? Leslie Samuels, now architect of the Treasury Department's drive against corporate tax-shelter abuses.

Updated May 3, 1996 12:41 a.m. EDT