## III. STRUCTURED FINANCING TRANSACTIONS

### A. Background and Rationale

During the 1990s, Enron's rapid growth necessitated significant infusions of new capital. At tension with its capital requirements, however, was the need for Enron to maintain its credit rating, particularly as Enron's creditworthiness had a direct impact on its stock price. As a consequence of this circumstance, Enron raised nearly $10 billion through various structured financing transactions, including tiered preferred securities, investment unit securities, and commodity prepay transactions. The primary advantage to Enron from some of these transactions was its ability to raise capital without ostensibly incurring additional debt. Thus, such transactions enabled Enron to maintain its credit rating and, in turn, avoid the downward pressure on its market valuation that would likely result from additional leverage. In other transactions, the primary advantage to Enron was its ability to liquidate appreciated equity investments--and eliminate its risk of loss from future declines in the value of these investments--without actually disposing of the investments and incurring immediate recognition of gain for Federal income tax purposes.

In the case of the tiered preferred securities and investment unit securities, the favorable tax treatment accorded these transactions was a principal factor in Enron's decision to raise additional capital by issuing such securities. In the case of the commodity prepay transactions, Enron initially engaged in these transactions solely for tax purposes, but in later years used these transactions to manipulate its reported operating results. Throughout its participation in the commodity prepay transactions, Enron exercised a significant degree of selectivity in its tax treatment of these transactions, including the transactions that were carried out primarily for financial reporting purposes in later years.

## B. Discussion of Present Law Relating to Certain Structured Financing Transactions

### 1. Debt characterization

Whether a financial instrument is treated for tax purposes as debt, equity, or some other characterization is determined on the basis of the pertinent facts and circumstances. If an instrument qualifies as equity, the issuer generally does not receive a deduction for dividends paid and the holder generally includes such dividends in income (although corporate holders generally may obtain a dividends-received deduction of at least 70 percent of the amount of the dividend). If an instrument qualifies as debt, the issuer generally receives a deduction for accrued interest and the holder generally includes such interest in income, subject to certain limitations.

Under present law, the Treasury Department has the statutory authority to issue regulations classifying an interest in a corporation as debt or equity.[847] In 1989, the Treasury Department's authority to issue such regulations was expanded to include classification of an interest as part equity and part indebtedness.[848] In 1992, Congress enacted additional rules to require, in certain circumstances, that an issuer's characterization of an interest be binding on the issuer and the holders.[849] Although the Treasury Department published proposed and final regulations pursuant to its authority, these regulations have been withdrawn and there are no currently applicable regulations.

### 2. Constructive sales

For transactions entered into after June 8, 1997, taxpayers are required to recognize gain (but not loss) upon entering into a "constructive sale" of any appreciated position in stock, a partnership interest or certain debt instruments as if such position were sold, assigned or otherwise terminated at its fair market value on the date of the transaction.[850] If the requirements for a constructive sale are met, the taxpayer recognizes gain on a constructive sale as if the position were sold at its fair market value on the date of the transaction and immediately repurchased.[851]

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[847] Sec. 385, enacted in the Tax Reform Act of 1969, Pub. L. No. 91-172, sec. 415(a).

[848] Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, sec. 7208(a)(1).

[849] Sec. 385(c), enacted in the Energy Policy Act of 1992, Pub. L. No. 102-486, sec. 1936(a).

[850] Sec. 1259, enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1001(a). A "position" generally is defined as an interest, including a futures or forward contract, short sale, or option.

[851] Sec. 1259(a)(1).

In general, a taxpayer is treated as making a constructive sale of an appreciated position if and when the taxpayer (or, in certain circumstances, a person related to the taxpayer) does one of the following: (1) enters into a short sale of the same (or substantially identical) property; (2) enters into an offsetting notional principal contract with respect to the same (or substantially identical) property; or (3) enters into a futures or forward contract to deliver the same (or substantially identical) property.[852] In addition, in the case of an appreciated position that itself is a short sale, a notional principal contract, or a futures or forward contract, the holder is treated as making a constructive sale when it acquires the same (or substantially identical) property as the underlying property for the position.[853] Finally, to the extent provided in Treasury regulations, a taxpayer is treated as making a constructive sale when it enters into one or more other transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described.[854]

A forward contract results in a constructive sale of an appreciated position only if the forward contract provides for delivery, or for cash settlement, of a substantially fixed amount of property and a substantially fixed price.[855] Thus, a forward contract providing for delivery of property, such as shares of stock, the amount of which is subject to significant variation under the contract terms does not result in a constructive sale.[856]

**3. Disqualified indebtedness**

For most debt instruments issued after June 8, 1997, no deduction is allowed for interest or original issue discount ("OID") on a debt instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that is payable in stock of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), including a debt instrument a substantial portion of which is mandatorily convertible or convertible at the issuer's option into stock of the issuer or a related party.[857] In addition, a debt instrument is treated as payable in stock if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of stock of the

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[852] Sec. 1259(c)(1).

[853] *Id. See also* Rev. Rul. 2002-44, 2002-28 I.R.B. 84.

[854] Sec. 1259(c)(1)(E). Future Treasury regulations are anticipated to treat as constructive sales other financial transactions that, like those specified in section 1259, have the effect of eliminating substantially all of the taxpayer's risk of loss and opportunity for income and gain with respect to the appreciated position. H.R. Rep. No. 105-148, at 442-43 (1997).

[855] *See* section 1256(d)(1).

[856] H.R. Rep. No. 105-148, at 442 (1997). This treatment of forward contracts is consistent with the anticipated treatment of so-called "collar" transactions under regulations to be issued by the Treasury Department.

[857] Sec. 163(l), enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1005(a).

issuer or related party.[858] A debt instrument also is treated as payable in stock if it is part of an arrangement that is reasonably expected to result in the payment of the debt instrument with or by reference to such stock. For example, a debt instrument may be treated as payable in stock of the issuer or a related party in the case of a forward contract to sell such stock that is entered into in connection with the issuance of the debt.[859]

**4. Straddles**

A "straddle" generally refers to offsetting positions (sometimes referred to as "legs" of the straddle) with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property. A "position" is an interest (including a futures or forward contract or option) in personal property. When a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for any taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in the straddle.[860] Deferred losses are carried forward to the succeeding taxable year and are subject to the same limitation with respect to unrecognized gain in offsetting positions.

In addition to loss deferral, the straddle rules require taxpayers to capitalize certain otherwise deductible expenditures for personal property if such property is held as part or all of an offsetting position in a straddle.[861] This provision applies to certain specified carrying charges, as well as interest on indebtedness that is incurred or maintained in order to purchase or carry the personal property.[862] On January 18, 2001, the Treasury Department published proposed regulations that elaborate on the operation of the straddle capitalization rules.[863] In addition, the proposed regulations would "clarify" that the straddle rules can apply to a debt instrument that is an obligation of the taxpayer if the debt instrument provides for one or more payments that are linked to the value of personal property or a position with respect to personal property.

The straddle rules generally do not apply to positions in stock. However, the straddle rules apply if one of the positions is stock and at least one of the offsetting positions is: (1) an option with respect to the stock; (2) a securities futures contract (as defined in section 1234B) with respect to the stock; or (3) a position with respect to substantially similar or related property (other than stock) as defined in Treasury regulations. In addition, the straddle rules apply to

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[858] Sec. 163(l)(3)(B).

[859] Sec. 163(l)(3)(C).

[860] Sec. 1092.

[861] Sec. 263(g)(1).

[862] Sec. 263(g)(2).

[863] 66 Fed. Reg. 4746 (Jan. 18, 2001).

stock of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder.

**5. Prepayment transactions**

**Prepaid sales of goods**

A taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless the item properly is accounted for in a different period under the taxpayer's method of accounting.[864] In general, a taxpayer may adopt an accounting method that is different than the accounting method of an entity that is affiliated with the taxpayer.[865]

Under an accrual method of accounting, a taxpayer generally is required to include an item in income when all the events have occurred that fix the right to receive such income and the amount of the income can be determined with reasonable accuracy.[866] In general, the IRS has long taken the position that the right to receive income becomes fixed at the earliest of when: (1) the required performance occurs; (2) payment for such performance becomes due; or (3) such payment is made.[867]

Treasury regulations permit taxpayers to defer the recognition of taxable income in certain circumstances if the taxpayer receives an advance payment for the sale of goods that are to be delivered in a later taxable year.[868] In general, such advance payments may be recognized by the taxpayer as taxable income either: (1) in the taxable year of receipt; or (2) the earlier of (a) the taxable year in which the payments would otherwise be included in taxable income under the taxpayer's method of accounting (provided such method results in the inclusion of advance payments in taxable income no later than the time such payments are included in income for financial reporting purposes), or (b) the taxable year in which the payments are included in income for financial reporting purposes (provided the taxpayer's method of accounting for advance payments results in income inclusion earlier for financial reporting purposes than for tax purposes).[869]

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[864] Treas. Reg. sec. 1.451-1(a).

[865] *See* section 446(d); Treas. Reg. sec. 1.446-1(d).

[866] *Id.*

[867] Rev. Rul. 74-607, 1974-2 C.B. 149.

[868] Treas. Reg. sec. 1.451-5. For this purpose, an "advance payment" is defined as any amount which is received in a taxable year by the taxpayer using an accrual method of accounting for purchases and sales pursuant to an agreement for the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. Treas. Reg. sec. 1.451-5(a).

[869] Treas. Reg. sec. 1.451-5(b)(1).

With regard to the deferral of advance payments relating to the sale of inventoriable goods, Treasury regulations generally provide that, if the taxpayer has on hand (or has available through the taxpayer's normal source of supply) inventory in sufficient quantity to satisfy the contract, then all advance payments that the taxpayer has received for such property by the last day of the second taxable year following the year in which such substantial advance payments are received and not previously included in income according to the taxpayer's accrual method of accounting, must be included in taxable income of the taxpayer in that second taxable year.[870]

**Prepaid forward contracts**

The gain or loss on a forward contract typically cannot be determined until the settlement date of the contract (at which time the value of the cash payment or physical delivery of the underlying property is determined on the basis of the spot price of the underlying property).[871] Therefore, although there is a paucity of authority that addresses the basic tax consequences of forward contracts, it is generally understood that the common law tax treatment of a forward contract is governed by the "open transaction" doctrine, which provides that the recognition of gain or loss on a transaction is, in effect, "held open" until the transaction is closed and such gain or loss can be quantified.[872] Absent the application of the constructive sale rules described above, taxpayers generally take the view that the open transaction doctrine applies to forward contracts even if a prepayment is made.[873]

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[870] Treas. Reg. sec. 1.451-5(c)(1)(i).

[871] A forward contract is an executory contract that is privately negotiated directly between the parties (i.e., there is no market or exchange intermediation as with futures contracts), and generally provides for the delivery of a specified amount of commodities or other property at a specified price (i.e., the "forward price") and on a specified future date (i.e., the "settlement date"). Depending upon the terms agreed to by the parties, a forward contract may be settled by either physical delivery of the underlying property or by the payment of an amount of cash that is equal to the difference between the spot price (i.e., current price on the settlement date) of the underlying property and the forward price specified in the contract. A prepaid forward contract is a forward contract in which the forward price is payable (generally on a present valued basis) on a date earlier than the settlement date, typically the date that the contract is executed by the parties.

[872] *See* Warren, *Financial Contract Innovation and Income Tax Policy*, Harv. L. Rev. 460, 464 (1993).

[873] *Cf. Virginia Iron Coal & Coke Co.*, 37 B.T.A. 195 (1938), *aff'd.*, 99 F.2d 919 (4th Cir. 1938), *cert. denied*, 307 U.S. 630 (1939) (holding that option premiums are not earned and, thus, not taxable until the option lapses or is exercised because it is unknown at the time that the option premium is received whether the option premium will be taxed as ordinary income or capital gain).

### 6. Notional principal contracts

Pursuant to the statutory authority to prescribe methods of accounting that clearly reflect income,[874] Treasury regulations provide for the recognition of income and deductions with respect to payments that are made or received pursuant to a notional principal contract.[875] The term "notional principal contract" generally describes an agreement between two parties to exchange payments that are calculated by reference to a notional principal amount.[876] Notional principal contracts include interest rate swap agreements, commodity swap agreements, interest rate cap and floor agreements, currency swap agreements, and other similar contracts.[877]

In a typical interest rate swap agreement, one party agrees to make periodic payments based on a fixed rate while the counterparty agrees to make periodic payments based on a floating rate. Payments are calculated on the basis of an underlying hypothetical or "notional principal amount", and payment amounts are typically netted when payments are due on common dates. A commodity swap is similar to an interest rate swap except that a commodity price index is used instead of an interest rate index, and the notional principal amount is measured in units of a specified commodity, rather than in dollars.

The notional principal amount is not actually exchanged by the parties. Therefore, the payments due under a typical notional principal contract do not constitute compensation for the use or forbearance of money and therefore are not characterized as "interest." However, a lump-sum payment under one of these contracts may be economically identical to a loan and, thus, the party making the lump-sum payment receives a return, part of which is properly characterized as interest for tax purposes because it represents compensation for the use or forbearance of money.

The regulations define a notional principal contract as a financial instrument that provides for payments by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to

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[874] Sec. 446(b).

[875] Treas. Reg. sec. 1.446-3.

[876] *See* Treas. Reg. sec. 1.446-3(c)(1).

[877] These contracts are examples of a broader family of financial instruments known as "derivatives", which generally are defined as contracts or securities the value of which is derived from the price of an asset, a pool of assets, or (increasingly) anything that can be valued. Derivatives represent contractual relationships between parties to share the economic benefits and burdens of owning an asset (or pool of assets) without necessarily owning the asset itself (hence the "notional" characteristic of such contracts). Because there is no comprehensive statutory regime for the taxation of derivatives, the tax consequences of derivative contracts are governed in a piecemeal fashion by specific rules that are scattered throughout the Code. *See, e.g.*, secs. 1092 (straddles), 1234 (options), 1234A (payments to terminate certain derivatives), 1234B (securities futures contracts), 1256 (certain exchange-traded contracts), and 1259 (constructive sales). As applied to derivatives, these rules are incomplete and often inconsistent in specific situations.

pay similar amounts.[878] The term "specified index" is broadly defined to include almost any fixed rate or variable rate, price, index, or amount based on current, objectively determinable financial or economic information.[879] Thus, notional principal contracts governed by the regulations include interest rate swaps, basis swaps, interest rate caps and floors, commodity swaps, equity swaps, equity index swaps, and similar agreements. However, the regulations provide that certain contracts do not constitute notional principal contracts, including futures contracts, forward contracts, and options.[880]

The regulations generally provide that net income or deduction from a notional principal contract for a taxable year is included in or deducted from gross income for that taxable year. The net income or deduction from a notional principal contract for a taxable year equals the sum of all of the periodic payments that are recognized from that contract for the taxable year and all of the nonperiodic payments that are recognized from that contract for the taxable year.[881]

A periodic payment is defined as a payment that generally is payable at fixed periodic intervals of one year or less during the entire term of a notional principal contract. The ratable daily portions of periodic payments are included in income or deducted in the taxable year to which such portions relate.[882]

A nonperiodic payment is defined as any payment made or received pursuant to a notional principal contract that is not a periodic payment or a termination payment. Thus, a nonperiodic payment includes prepayments for all or one leg of a swap. The ratable daily portions of nonperiodic payments must be included in income or deducted in the taxable year to which such portions relate such that a nonperiodic payment is recognized over the life of the notional principal contract in a manner that reflects the economic substance of the payment. Thus, a nonperiodic payment for a swap generally must be recognized over the term of the contract by allocating it in accordance with the forward rates (or, in the case of a commodity, the forward prices) of a series of cash-settled forward contracts that reflect the specified index and the notional principal amount.[883]

A termination payment is defined as any payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under a notional principal contract. In general, a party to a notional principal contract must recognize a termination payment in the taxable year in which the contract is extinguished, assigned, or

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[878] Treas. Reg. sec. 1.446-3(c)(1)(i).

[879] Treas. Reg. sec. 1.446-3(c)(2).

[880] Treas. Reg. sec. 1.446-3(c)(1)(ii).

[881] Treas. Reg. sec. 1.446-3(d).

[882] Treas. Reg. sec. 1.446-3(e).

[883] Treas. Reg. sec. 1.446-3(f). The regulations provide alternative methods of recognizing nonperiodic payments that primarily affect the rate of amortization.

exchanged. The party also must recognize any other payments that have been made or received under the contract but have not yet been recognized.[884]

The regulations include a special rule with regard to swaps that provide for "significant" nonperiodic payments. Under this rule, a swap with significant nonperiodic payments is treated as two separate transactions, consisting of: (1) an at-the-market swap (i.e., no nonperiodic payments) with level payments; and (2) a loan. The parties to the contract must account for the deemed loan independently of the swap. The imputed interest component of the loan is accounted for as interest for all purposes of the Code.[885] The regulations do not define what amount of nonperiodic payments constitutes "significant", but examples in the regulations indicate that a nonperiodic payment that is less than 10 percent of total payments under a swap is not significant, while a nonperiodic payment that is 40 percent or more of total payments is significant.[886]

**7. Application of present law to Enron structured financing transactions**

Enron raised significant amounts of capital by issuing several different types of structured financial instruments that implicate a multitude of tax rules. Enron issued tiered preferred securities, the tax treatment of which primarily involved the application of the rules concerning debt characterization. Enron also issued investment unit securities, which involved debt characterization in general, as well as the constructive sale, disqualified indebtedness, and straddle rules. Enron entered into commodity prepay transactions, which involved debt characterization in general, as well as the tax treatment of prepayment transactions and notional principal contracts.

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[884] Treas. Reg. sec. 1.446-3(h).

[885] Treas. Reg. sec. 1.446-3(g)(4).

[886] Treas. Reg. sec. 1.446-3(g)(6), Examples 2 and 3.

## C. Tiered Preferred Securities

### 1. Brief overview

Between 1993 and 1997, Enron raised over $800 million through the issuance of hybrid financial instruments that combined characteristics of both indebtedness and equity ("tiered preferred securities"). By synthesizing these characteristics into a single financial instrument, Enron was able to report the financing as indebtedness for Federal income tax purposes, while reporting the same financing as a minority ownership interest on its financial statements. Consequently, these transactions enabled Enron to deduct the yield on its financings as interest expense for tax purposes without increasing the amount of liabilities reported in financial statements. Although the individual transactions varied in their details, they shared several common elements, primarily the issuance of securities by a special purpose entity to public or private investors and the transfer of the proceeds from such issuance to Enron in the form of a loan.

### 2. Background

**Reported tax and financial statement effects**

With regard to its tiered preferred securities, Enron took the position for Federal income tax purposes that it had issued a debt instrument to the special purpose entity, which Enron treated as a separate entity that was not part of the Enron consolidated group. Accordingly, Enron claimed interest expense deductions of the yield payments on the purported debt instrument.

For financial reporting purposes, Enron disregarded the purported debt instrument because the special purpose entity was consolidated with Enron on its financial statements.[887] Instead, Enron reported the preferred securities as though Enron had issued the preferred securities directly to the outside investors (rather than through the special purpose entity). These securities received equity credit from rating agencies because the borrowing by Enron from the special purpose entity that supported the preferred securities exhibited certain equity characteristics, including a long-term maturity, deep subordination, and an option for Enron to defer the payment of interest for the first several months (or years) that the borrowing was outstanding. Thus, Enron denominated the preferred securities as mezzanine equity, rather than indebtedness, on its balance sheet.[888] Enron reported yield payments to the holders of the preferred securities as "Dividends on Preferred Stock of Subsidiary".

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[887] As amended by Statement of Financial Accounting Standards No. 94, Accounting Research Bulletin No. 51, requires companies to consolidate majority owned subsidiaries unless control of the subsidiary is likely to be temporary, or the majority owner does not actually control the subsidiary. Because of the common ownership interest retained by the ultimate borrower, special purpose entities that issue tiered preferred securities generally satisfy the financial accounting requirements for consolidation with the borrower.

[888] Specifically, Enron's financial statement balance sheets referred to the tiered preferred securities as "Preferred Stock of Subsidiary" in 1993 and 1994, and thereafter have

**Development of tiered preferred securities**

In 1993, Goldman, Sachs & Co. began marketing a new financial instrument, dubbed monthly income preferred securities ("MIPS"), that was designed to be treated as a debt instrument (with deductible interest payments) for Federal income tax purposes, while simultaneously providing equity treatment for financial reporting and rating agency purposes.[889] Other investment banks subsequently marketed their own version of MIPS, such as trust originated preferred securities ("TOPrS") introduced by Merrill Lynch.[890] Whereas the special purpose entity involved in MIPS is characterized as a partnership for Federal income tax purposes, the special purpose entity involved in TOPrS is characterized as a grantor trust.[891] Regardless of the particular classification of the special purpose entity, the common feature of these transactions in this respect is that the special purpose entity is not classified as a taxable corporation under the entity classification rules.

In general, these financial instruments involve the creation of a special purpose entity by the ultimate borrower.[892] The special purpose entity is treated as a separate entity from the

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referred to the securities as "Company-Obligated Preferred Securities of Subsidiaries". This is consistent with the guidance provided in SEC Regulation S-X, Article 5, Rule 5-02.27.

[889] The issuance of debt instruments containing certain features that are characteristic of equity, such as subordination and deferred interest arrangements, allows borrowers to obtain capital with less impact on their credit rating than straight debt financing because such instruments receive "equity credit" from rating agencies. In addition, the Federal Reserve Board has stated that certain tiered preferred securities can qualify as Tier 1 equity capital for banks. *See* Federal Reserve Press Release, Oct. 21, 1996 ("To be eligible as Tier 1 capital, such instruments must provide for a minimum five-year consecutive deferral period on distributions to preferred shareholders. In addition, the intercompany loan must be subordinated to all subordinated debt and have the longest feasible maturity."); *Capital Briefs--Rule on Cumulative Preferred Stock Eased*, American Banker, Oct. 22, 1996; Padgett, *Surge of New Issues Seen as Fed Approves Use of Hybrid Security*, American Banker, Oct. 24, 1996.

[890] Goldman Sachs also began marketing a variation on MIPS, called quarterly income preferred securities ("QUIPS"), which differ materially from MIPS only in that payments on QUIPS are made quarterly instead of monthly. *See, e.g.*, BFGoodrich Capital 83% Cumulative Quarterly Income Preferred Securities (June 30, 1995).

[891] By using a grantor trust rather than a tax partnership as the special purpose entity, TOPrS significantly reduce the SEC reporting burdens associated with the securities. *See* John C. Reid, *MIPS Besieged--Solutions in Search of a Problem*, 76 Tax Notes 1057, 1058 (Dec. 1, 1997).

[892] Special purpose entities involved in earlier transactions usually were formed offshore. However, with the enactment of limited liability company laws in several States and the issuance by the SEC of "no action" letters exempting the entities from registration under the Investment Company Act of 1940, special purpose entities involved in more recent transactions have been formed as domestic pass-through entities.

borrower for tax purposes, but is not itself subject to tax. For financial reporting purposes, the special purpose entity is disregarded as separate from the borrower because it is consolidated with the borrower. In general, the special purpose entity issues its voting securities (with a nominal value) to the borrower, and issues nonvoting preferred securities to investors. The special purpose entity then lends the proceeds from the preferred securities issuance (along with any cash contributed by the borrower) to the borrower in exchange for a long-term (typically, 30-year) debt instrument. Distributions on the preferred securities closely correspond to the interest payments on the debt instrument issued to the entity by the borrower. When the loan from the special purpose entity to the borrower ultimately matures, the special purpose entity redeems the MIPS for cash.

For tax purposes, the debt instrument issued to the special purpose entity by the ultimate borrower is respected because the entity is treated as separate from the borrower. Thus, the borrower claims interest deductions on the debt instrument. For financial reporting purposes, the debt instrument is disregarded because the special purpose entity is not treated as separate from the borrower. Instead, the borrower is considered to have issued preferred securities directly to the investors. As mentioned earlier, these securities receive equity credit from rating agencies because the debt instrument issued by the borrower that supports the securities is long term, deeply subordinated, and provides the borrower an option to defer the payment of interest for an extended period of time (typically, the first five years) during which the debt instrument is outstanding. Thus, the preferred securities tend to be denominated as mezzanine equity, rather than indebtedness, on the financial statements of the borrower.

**Issuance of Enron tiered preferred securities**

As indicated, Enron raised over $800 million through several issuances of tiered preferred securities, including MIPS, TOPrS, and adjustable-rate trust securities ("ACTS").[893] In general, the ACTS were substantially similar to TOPrS, except that ACTS provided for a variable (rather than fixed) yield.

Table 2 on the next page summarizes the tiered preferred securities that Enron entered into between 1993 and 1997.

[893] *See, e.g.*, Minutes, Meeting of the Board of Directors, Enron Corp., December 10, 1996 at 5-6 (approving the 1996 Enron TOPrS issuance), EC 000045039 through EC 000045067; Minutes, Meeting of the Executive Committee of the Board of Directors, Enron Corp., December 18, 1996 (approving proposed resolution authorizing 1997 Enron TOPrS issuance), EC 000045073 through EC 000045079; Minutes, Meeting of the Executive Committee of the Board of Directors, Enron Corp., June 5, 1997 (approving proposed resolution authorizing 1997 ACTS issuance). EC 000045650 through EC 000045655. The structured financing materials in Appendix B contain these minutes.

## Table 2.–Enron Tiered Preferred Securities Issuances

| Issuance | Year of issuance | Proceeds of issuance (millions of dollars)[1] | Stated yield (percent) | Initial term to maturity[2] (years) | Extended term to maturity[3] (years) | Interest payment deferral period (months) |
|---|---|---|---|---|---|---|
| MIPS | 1993 | $200 | 8.00 | 50 | 50 | 18 |
| MIPS[4] | 1994 | 75 | 9.00 | 30 | 19 | 60 |
| TOPrS | 1996 | 200 | 8.30 | 20 | n/a | 18 |
| TOPrS | 1997 | 150 | 8.125 | 20 | n/a | 18 |
| ACTS | 1997 | 200 | Variable[5] | 49 | n/a | 60 |

**Notes**:

[1] Amount of proceeds is based upon the amount indicated in the prospectus of each issuance. Actual amount of proceeds from each issuance may differ somewhat from the amount indicated due to over-allotments.

[2] Based upon the loan from the special purpose entity (e.g., Enron Capital LLC) to Enron.

[3] Based upon the loan from the special purpose entity (e.g., Enron Capital LLC) to Enron, not including the initial term to maturity.

[4] This issuance was not formally an issuance of MIPS because the lead underwriter was Merrill Lynch & Co., not Goldman, Sachs & Co. However, this issuance was substantially similar to a MIPS issuance. Thus, this issuance is referred to as MIPS only for purposes of convenience.

[5] The ACTS issuance provided for yield payments at an initial rate of 5.813 percent through September 5, 1997, with subsequent quarterly resets of the yield based upon a Dutch auction process to obtain a yield reflective of current market conditions.

1993 Enron MIPS

On September 27, 1993, Enron convened a special meeting of its Board of Directors primarily for the purpose of hearing a management presentation concerning the issuance of perpetual preferred stock.[894] In its presentation, management stated that Enron would continue to require cash infusions because of its ongoing growth and expansion. However, management also indicated that maintaining Enron's credit quality was a high priority. Management then presented two options that had been proposed to Enron: (1) issuance of standard perpetual preferred stock underwritten by Merrill Lynch & Co.; and (2) issuance of tax deductible perpetual preferred stock underwritten by Goldman, Sachs & Co. According to management, Arthur Andersen & Co. had indicated to Enron that neither option would be treated as indebtedness for financial accounting purposes. In addition, the credit rating agencies had indicated that they would reach the same conclusion. Management also said that the law firm Sullivan & Cromwell had issued a letter confirming the tax deductibility of the option proposed by Goldman, Sachs & Co., but noting that future tax law changes could negate deductibility. Based upon the presentation by management, the Board adopted a resolution that authorized the registration, issuance and sale of up to $250 million of either standard or tax deductible perpetual preferred stock, and authorized the appointment of a special preferred stock committee to determine the terms of the issuance.

On October 12, 1993, the Finance Committee of the Enron Board of Directors met to discuss further the issuance of perpetual preferred stock by Enron.[895] At this meeting, management indicated to the committee that the "determination of the question of whether or not the preferred stock offering would be tax deductible was key to management's decision to proceed."[896] The committee concluded its consideration of perpetual preferred stock by agreeing to recommend that the Board restate its previous resolution and authorize the registration, issuance and sale of: (1) up to $575 million of perpetual preferred stock if the yield on the stock was determined to be tax deductible and the credit rating agencies would treat the stock as equity for debt rating purposes; or (2) up to $350 million of perpetual preferred stock if the yield on the stock was not determined to be tax deductible.[897]

On October 13, 1993, the Enron Board of Directors heard the recommendation of the Finance Committee and approved a resolution authorizing a shelf registration of fixed rate

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[894] Minutes, Special Meeting of the Board of Directors, Enron Corp., September 27, 1993 at 1. EC2 000055435 through EC2 000055450. The structured financing materials in Appendix B contain these minutes.

[895] Minutes, Meeting of the Finance Committee of the Board of Directors, Enron Corp., October 12, 1993. EC2 000055452 through EC2 000055456. The structured financing materials in Appendix B contain these minutes.

[896] *Id.* at 2.

[897] *Id.*

perpetual preferred stock in the amount of either $575 million (if tax deductible and rated as equity) or $350 million (if not tax deductible).[898]

Pursuant to the resolution, Enron formed Enron Capital LLC under the law of Turks and Caicos Islands for the sole purpose of issuing shares and lending the net proceeds to Enron.[899] Enron acquired the common shares of Enron Capital LLC for approximately $53.165 million.[900]

In November 1993, Enron Capital LLC authorized the issuance of $9.2 million shares of cumulative guaranteed MIPS with a cumulative preferred dividend rate of 8 percent ("1993 MIPS").[901] The MIPS became redeemable (at the option of Enron Capital LLC) on or after November 30, 1998, at a redemption price of $25.00 per share plus accumulated and unpaid dividends. Following the issuance of the shares and as part of the prearranged transaction, Enron Capital LLC loaned to Enron both the $53.165 million proceeds from the issuance of its common shares to Enron, and the $200 million proceeds from the sale of the MIPS, for an aggregate principal amount of $253.165 million.[902] The loan from Enron Capital LLC to Enron provided a stated interest rate of 8 percent until maturity, payable on the last day of each calendar month of each year beginning on November 30, 1993.[903]

Under the terms of the loan from Enron Capital LLC to Enron, Enron was permitted to defer payment of the monthly interest up to 18 months (provided Enron was not in default on the loan), during which time Enron would not be permitted to declare dividends on any of its capital stock. During any such period of interest payment deferment, Enron Capital LLC would continue to accrue the interest income being deferred, and the deferred interest income would be allocated (but not distributed) to the holders of the MIPS.[904]

The loan provided a maturity date of November 30, 2043 for repayment of the entire principal amount, together with any accrued and unpaid interest, or on any earlier date if Enron

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[898] Minutes, Meeting of the Board of Directors, Enron Corp., October 13, 1993. The structured financing materials in Appendix B contain these minutes.

[899] Prospectus Supplement, Enron Capital LLC 8% Cumulative Guaranteed Monthly Income Preferred Shares (Nov. 4, 1993) at S-6 [hereinafter "1993 Prospectus"].

[900] 1993 Prospectus at S-14.

[901] Terms of the 8% Cumulative Guaranteed Monthly Income Preferred Shares of Enron Capital LLC (Nov. 4, 1993) at 1. Of the total authorized MIPS, Enron Capital LLC issued 8,000,000 shares at $25.00 per share, for a total of $200 million. The remaining unissued 1,200,000 shares of MIPS were reserved for the underwriters' over-allotment option. 1993 Prospectus at S-6.

[902] 1993 Prospectus at S-14.

[903] 1993 Prospectus at S-15.

[904] 1993 Prospectus at S-20.

or Enron Capital LLC was dissolved, wound up or liquidated. The loan could not be prepaid prior to November 30, 1998. Upon repayment by Enron, the loan provided that the repaid principal could be reloaned to Enron under certain conditions, with a final maturity date of the new loan not later than the 100th anniversary of the issuance of the MIPS.[905] The loan was subordinate to all present and future senior indebtedness of Enron.

Enron guaranteed the payment of dividends by Enron Capital LLC to the holders of the MIPS. However, the guarantee agreement constituted an unsecured obligation of Enron and ranked: (1) subordinate and junior in right of payment to all liabilities of Enron; (2) *pari passu* with the most senior preferred or preference stock of Enron; and (3) senior to Enron's common stock. In the event of the bankruptcy of Enron (among other events), Enron Capital LLC automatically would dissolve and be liquidated.[906] In the event of the bankruptcy of Enron (among other events), the holders of a majority in liquidation preference of the outstanding MIPS were entitled to appoint and authorize a trustee to enforce the creditor rights of Enron Capital LLC against Enron, and to declare and pay dividends on the MIPS.[907]

Enron evidently used the loan proceeds to repay other indebtedness, and for general corporate purposes.[908] In its filings with the SEC, Enron stated that "the average cost of long-term debt declined to 8.2 percent at December 31, 1993 from 8.9 percent at December 31, 1992. The decline was accomplished primarily through the retirement of additional higher coupon long-term debt which was subject to call provisions during [1993]."[909]

**Role of outside advisers**

In the case of the 1993 MIPS, Goldman, Sachs & Co. was the lead underwriter, while Merrill Lynch & Co. was the lead underwriter for the 1994 Enron tiered preferred securities and the 1996 and 1997 TOPrS. The lead underwriter for the 1997 ACTS was Deutsche Morgan Grenfell.

For each transaction except the ACTS transaction, Vinson & Elkins LLP provided a tax opinion letter that analyzed the tax implications of the transaction. For the ACTS transaction, Skadden, Arps, Meagher & Flom LLP provided a tax opinion letter that analyzed the tax implications of the transaction.

With regard to the 1993 MIPS, Vinson & Elkins LLP concluded that:

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[905] 1993 Prospectus at S-7. The repaid principal may not be reloaned to Enron if (among other things) Enron is in bankruptcy.

[906] 1993 Prospectus at S-8.

[907] 1993 Prospectus at S-8 to S-9.

[908] 1993 Prospectus at S-5.

[909] 1993 Enron Form 10-K at 32.

(1) the proceeds received by Enron from Enron Capital LLC "should" be classified as loans for Federal income tax purposes;

(2) Enron Capital LLC "would" be treated as a partnership rather than a corporation or taxable mortgage pool for Federal income tax purposes; and

(3) interest paid by Enron on the proceeds received from Enron Capital LLC "would" qualify as portfolio interest within the meaning of section 1441(c)(9) and, thus, Enron "would" not be required to deduct and withhold tax with respect to such interest.[910]

Vinson & Elkins LLP subsequently issued a second tax opinion letter concerning the 1993 MIPS, in which the law firm concluded that:

(1) Enron "would" be liable for any tax that should have been withheld to the extent such tax is not paid by the holders of the Enron Capital LLC preferred shares;

(2) because of the "reasonable cause" exception, Enron "should not" be liable for penalties or additions to tax by reason of any failure to withhold in respect of a payment (of interest) on the proceeds received by Enron from Enron Capital LLC; and

(3) Enron "would" be liable for interest on any tax that should have been withheld during any calendar year, but that such interest "should not" start to accrue until March 15 of the following year and "should" cease to accrue upon payment of the tax against which such withholding tax may be credited by the holders of the preferred shares issued to investors by Enron Capital LLC (which may be as early as April 15 of such following year).[911]

Arthur Andersen provided an accounting opinion letter that analyzed the financial accounting implications of a hypothetical MIPS transaction and concluded that: (1) the special purpose entity issuing the securities (i.e., the MIPS) should be consolidated with the company that formed the entity; and (2) the securities should be reflected in the company's financial statements as minority interests.[912]

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[910] Vinson & Elkins LLP tax opinion letter to Enron, dated November 4, 1993. EC2 000036276 through EC2 000036289. The structured financing materials in Appendix B contain this opinion letter.

[911] Vinson & Elkins LLP tax opinion letter to Robert J. Hermann, Vice President - Tax, Enron, dated December 17, 1993. EC2 000036290 through EC2 000036302. The structured financing materials in Appendix B contain this opinion letter.

[912] Arthur Andersen opinion letter to Goldman Sachs & Co., dated September 13, 1993. With regard to the accounting treatment of the outside investors as minority interests, the opinion letter states that "[w]hile some may argue that where [sic] a subsidiary's only role is to loan funds to others in the consolidated group and the non affiliated stockholders of the subsidiary can

Table 3 summarizes that amounts of fees and expenses that Enron paid in connection with the tiered preferred share issuances:[913]

**Table 3.–Enron Tiered Preferred Securities Issuance Fees and Expenses**

| Issuance | Year of issuance | Lead underwriter | Lead underwriter fees | Other estimated expenses |
|---|---|---|---|---|
| MIPS | 1993 | Goldman, Sachs & Co. | $14,390,000 | $300,000 |
| MIPS | 1994 | Merrill Lynch & Co. | $11,800,000 | $400,000 |
| TOPrS | 1996 | Merrill Lynch & Co. | $37,500,000 | $400,000 |
| TOPrS | 1997 | Merrill Lynch & Co. | $22,000,000 | $400,000 |
| ACTS | 1997 | Deutsche Morgan Grenfell | Not available | $200,000 |

**IRS review of Enron tiered preferred shares**

Based upon its audit of Enron's tax returns for the 1993 and 1994 tax years, the IRS issued a statutory notice of deficiency, dated March 4, 1998, in which the IRS determined that Enron improperly deducted interest expense relating to the 1993 MIPS and the 1994 MIPS.[914] In response, Enron filed a petition with the Tax Court on April 1, 1998 contesting the deficiency.[915] Enron also requested consideration of the deficiency determination by the Appeals Division of the IRS, and the IRS assigned the case to the Appeals Division on June 17, 1998.

On May 6, 1998, IRS District Counsel (Midstates Region) sent a memorandum to the IRS National Office requesting technical assistance concerning the proper tax treatment of the 1993 MIPS and 1994 MIPS transactions. On August 12, 1998, the IRS National Office responded with a field service advice memorandum in which the National Office addressed three issues: (1) whether the MIPS securities constituted equity, rather than debt, for tax purposes; (2) whether

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gain control of [the company's] Board in the event of default on the loan [from the special purpose entity to the company], the non affiliate stockholders of the subsidiary should be treated as creditors in the consolidated financial statements of the [company], this is not practice." The structured financing materials in Appendix B contain this opinion letter.

[913] This information is based upon a review of the prospectus for each issuance and information provided to the Joint Committee staff by Enron. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003.

[914] The assessment disallowed interest expenses claimed by Enron in the amounts of: (1) $2,137,497 in 1993 with respect to the 1993 MIPS; (2) $21,645,569 in 1994 with respect to the 1993 MIPS; and (3) $3,512,658 in 1994 with respect to the 1994 MIPS.

[915] *Enron Corp. v. Commissioner*, Docket No. 6149-98. The petition also contested several other deficiencies asserted by the IRS for the 1992-1994 audit cycle, all of which were settled shortly after the filing of the petition.

the MIPS transactions overall lacked economic substance; and (3) whether the special purpose entities issuing the MIPS securities should be treated as taxable corporations, rather than partnerships, for tax purposes.[916]

With regard to whether the MIPS constituted debt or equity, the IRS National Office analyzed the issue by applying the debt-equity characterization factors listed in Notice 94-47[917] to the securities, and concluded that "we do not recommend recharacterizing the debt as equity." The National Office acknowledged that its analysis focused on the proper characterization of the loans from the special purpose entities to Enron, rather than the proper characterization of the MIPS securities themselves as debt or equity. However, the National Office stated that, even if the special purpose entities were not respected as partnerships for tax purposes, "the conclusions would not be different, and the [MIPS] instruments would still be properly characterized as debt."

In determining whether the MIPS transactions overall lacked economic substance, the IRS National Office noted that the transactions decreased the average cost of Enron's long-term debt and decreased Enron's debt-to-equity ratio from 1.2:1 to 1:1. Consequently, the National Office concluded that, "[i]n the balance, it appears from the available information that [Enron] entered into the transactions to obtain loans at lower interest rates and at lower costs generally and, therefore the underlying transactions possess economic substance. Thus, the interest deduction should not be disallowed."

With regard to whether the special purpose entities should be treated as taxable corporations, rather than partnerships, for tax purposes, the IRS National Office determined that the entities appeared to have a "reasonable basis" for their classification as partnerships under the entity classification regulations that were in place at the time of the transactions.[918] Therefore, IRS National Office concluded that the partnership treatment of the entities should be respected.

After receiving and reviewing the field service advice memorandum, the Appeals officer assigned to the case drafted an Appeals Transmittal and Case Memorandum. In the memorandum, the Appeals officer voiced strong disagreement with the analysis and conclusions set forth in the field service advice memorandum. Specifically, the Appeals officer indicated his view that the field service advice memorandum should have analyzed the proper characterization of the MIPS securities as debt or equity. In addition, the Appeals officer argued that the field service advice memorandum "addressed what Enron's business purpose (a partner) was for the MIPS transaction but fail[ed] to provide a business purpose for the partnership itself."

Contrary to the conclusion reached in the field service advice memorandum, the Appeals officer argued strenuously that the special purpose entities should not be respected as

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[916] The structured financing materials in Appendix B contain the field service advice that the IRS National Office provided to the IRS District Counsel in connection with the 1993 MIPS and 1994 MIPS issued by Enron.

[917] 1994-1 C.B. 357.

[918] *See* Treas. Reg. sec. 301.7701(f)(2).

partnerships on economic substance grounds, and that disregarding these entities as partnerships and treating the MIPS as having been issued directly by Enron would require the MIPS to be characterized as equity, rather than debt, for tax purposes. Finally, the Appeals officer raised a non-tax public policy concern that, in a more general context, would become central to Enron's bankruptcy a few years later:

> Here the taxpayer is admitting that they [sic] are skirting well regulated areas by designing a transaction to avoid the standard investor/creditors warning signals: Too much debt and dilution of their ownership rights.
>
> The taxpayer has designed a transaction that avoids both indicators by becoming debt that comes from equity. That is, this is in the bottom of the debt tier, but it takes its payment source from the top of the dividend class of securities. A bottom feeder if you will. Thus, there appears to be a public policy issue as to whether or not IRS should allow a deduction on a payment that is designed to frustrate some clear combination of GAAP, SEC regulations and regulators, and the regulated debt which is relied on by creditors in indicating too much debt.

Notwithstanding the conclusions reached by the National Office in the field service advice memorandum, the Appeals officer recommended litigating the validity of the interest deductions claimed by Enron in 1993 and 1994 with regard to the MIPS transactions.

On October 20, 1998, representatives from Enron and IRS Appeals met in a conference to discuss the MIPS issue. Notes of the conference taken by the Appeals officer indicate that Enron acknowledged "the MIPS were finely crafted to walk that fine line that does exist between debt and equity," but also argued that the mezzanine treatment of MIPS for financial reporting purposes allowed Enron to raise capital for expansion without eroding its credit rating (because the MIPS were not reported as indebtedness) or earnings per share (because the MIPS were not reported as shareholder equity). Thus, according to Enron, issuing the MIPS served a business purpose that was independent of tax considerations. In a revised version of his Appeals case memorandum, the Appeals officer responded to this point as follows:

> Should the IRS condone this treatment of debt to "fool" both GAAP and SEC reporting where both consider the MIPS as having substantial equity features?
>
> Look at it this way: No debt treatment fools creditors, [n]o equity treatment fools the market investors, the extendibility of the LLC and notes in the years at issue allow gradual conversion to actual equity (it seems to me), the continued drain on cash flow without disclosure to the public seems to set up, in [m]acroeconomic terms, a lot of corporations with debt/equity not displayed on they're [sic] books.
>
> If things turn south and payments are suspended:
>
> (1) A lot of investors will be unhappy
>
> (2) A lot of corporations may be required to make mandatory payments after 18 or so months (in the depths of a recession) which will endanger shareholders rights and

(3) If enough corporations are required to do this it could materially affect the nation[']s economy by reducing corporate capital available for operations.

This entire matter seems to be "leveraging" just like buying stocks on margin or leveraging your way to success... . [I]t works great in good times but in economic recessions it leads to bankruptcy. Potential non-tax shareholder derivative questions present in both years...should be considered in a public policy review by counsel. This is beyond IRS jurisdiction but important public policy implications may be present if the MIPS structure violates the [Enron] Board's duty to its shareholders to maximize shareholder value.

Nevertheless, Enron and the IRS subsequently reached a settlement of the issues concerning the 1993 and 1994 MIPS. In the settlement, the IRS conceded the deductibility of the stated interest payments made by Enron. Specifically, the IRS conceded that: (1) the loan from the special purpose entity to Enron in each transaction constituted indebtedness of Enron for Federal income tax purposes; (2) Enron was entitled to deduct stated interest accrued on such indebtedness; and (3) the special purpose entity was a valid entity that was separate and distinct from Enron for Federal income tax purposes.[919]

Because the settlement of the case (including settlement of the other asserted deficiencies) would result in refunds of overpaid taxes to Enron in excess of $1 million, the IRS referred the settlement to the Joint Committee on Taxation on July 26, 1999 for review as required under the Code.[920] On September 28, 1999, the Joint Committee staff reviewed the settlement and did not raise an objection to it.

The Tax Court approved the settlement on October 1, 1999.[921]

Subsequent developments

Although the offering materials for the tiered preferred securities issued by Enron provided for the dissolution and liquidation of the special purpose entity in the event of the bankruptcy of Enron, the tiered preferred securities remain outstanding except for the securities issued as part of the ACTS transaction.[922] However, the outstanding tiered preferred securities

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[919] First Supplemental Stipulation of Settled Issues, *Enron Corp. v. Commissioner*, Docket No. 6149-98, filed Dec. 24, 1998. *See also* Counsel Settlement Memorandum, MIPS Issues, In re: Enron Corporation & Consolidated Subsidiaries, Docket Number 6149-98, approved July 26, 1999. The structured financing materials in Appendix B contain the counsel settlement memorandum.

[920] Sec. 6405, as in effect at the time of the settlement.

[921] Decision, *Enron Corp. v. Commissioner*, Docket No. 6149-98, entered Oct. 1, 1999.

[922] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003. EC2 000055434.

currently trade over the counter for under $1 per share, down significantly from their $25 initial offering price and liquidation preference per share.

**3. Discussion**

**In general**

Under present law, taxpayers have significant flexibility in structuring a financial instrument as debt or equity. Frequently, taxpayers may characterize instruments with very similar economic terms selectively either as equity (for example, if the issuer intends to market them to corporate holders that would benefit from a dividends received deduction) or as debt (if the issuer intends to claim a corporate interest deduction or achieve certain other benefits of debt status).

In general, the characterization of a financial instrument as debt can be based on a number of factors, including the presence (or absence) of an enforceable and unconditional promise to pay a specified amount on a specified date,[923] and the length of the term to maturity of an instrument.[924]

**Tiered preferred securities**

Tiered preferred share transactions such as MIPS and TOPrS have their genesis in the fundamental principle that leverage generally is favored for tax purposes (because of the deductibility of interest and the non-deductibility of dividends) but disfavored for financial accounting purposes (because reported debt tends to depress marginal share price and credit ratings relative to outstanding equity). Thus, companies generally prefer to obtain equity financing for financial accounting purposes, but prefer to obtain debt financing for tax purposes. Because the financial accounting rules for characterizing financing as either debt or equity do not correspond with the tax rules for determining such characterization, companies have taken advantage of opportunities to arbitrage the financial accounting and tax rules in order to achieve

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[923] *See, e.g., John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972); *United States v. Title Guarantee & Trust Co.*, 133 F.2d 990 (6th Cir. 1943).

[924] *See, e.g., Reef Corp. v. Commissioner*, 24 T.C.M. 379 (1965), *aff'd*, 368 F.2d 125 (5th Cir. 1966); *United States v. Snyder Bros. Co.*, 367 F.2d 980 (5th Cir. 1966). Other factors may include (but are not limited to) a fixed maturity or mandatory redemption date, priority over general creditors of the issuer, rights to participate in the management of the issuer (including voting rights), the level of capitalization of the issuer, and the intent of the parties (although this last "factor" arguably is actually the fundamental question that the other factors attempt to answer as to the characterization of a financial instrument). However, the IRS has indicated that the right to receive a sum certain at maturity "is a *sine qua non* of debt treatment under the Code." Field Service Advice 199940007 (June 15, 1999). *See also Gilbert v. Commissioner*, 248 F.2d 399 (2nd Cir. 1957); *Johnson v. Commissioner*, 108 F.2d 104 (8th Cir. 1939). Section 385(b) provides a non-exclusive list of several traditional factors that Treasury regulations might take into account in determining the classification of an interest in a corporation.

an ideal objective--financing that can be reported on financial statements as equity and on tax returns as indebtedness. Tiered preferred shares are the financial instruments with which many companies have accomplished this result.[925]

Absent more definitive guidance concerning the characterization of the tiered preferred securities themselves, it generally has been believed that certain conditions must be satisfied in order for the tax benefits of tiered preferred share transactions to be realized by the ultimate borrower. Specifically, the special purpose entity that is used in such transactions must be respected for tax purposes as an entity separate from the borrower, and the debt instrument issued by the borrower to the entity in exchange for the proceeds from the issuance of preferred securities by the entity must be respected as indebtedness for tax purposes.

Because the special purpose entity issues two separate classes of securities to two different parties (i.e., the voting securities issued to the borrower and the nonvoting preferred securities to the investors), borrowers take the position that the entity cannot be disregarded as separate from the borrower for tax purposes. With regard to whether the debt instrument issued by the borrower to the special purpose entity should be respected as indebtedness for tax purposes, borrowers take the position that the debt characteristics (in particular, the repayment of a sum certain on a fixed maturity date) of the instrument outweighs its equity characteristics (i.e., long term to maturity, subordination, and the option to defer interest payments) and, thus, it should properly be characterized as indebtedness for tax purposes.

In response to the growth of hybrid financial instruments "that combine long maturities (greater than 50 years) with substantial equity characteristics" (including MIPS and other similar securities), the IRS issued Notice 94-47.[926] In the notice, the IRS listed eight factors to be taken into account in determining whether a security constitutes debt or equity for tax purposes:

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[925] The tax benefits of tiered preferred securities can permit companies to offer securities with a higher yield to investors than they might otherwise offer for comparable conventional preferred securities with non-deductible dividend yield payments. For example, General Motors Corporation ("GM") announced a tender offer in June 1997 to exchange certain classes of its outstanding preferred stock for a new issue of TOPrS. In exchange for an outstanding class of preferred stock that yielded a 7.92 percent dividend, GM issued a class of TOPrS that yielded 8.67 percent to tendering shareholders. In exchange for an outstanding class of preferred stock that yielded a 9.12 percent dividend, GM issued a class of TOPrS that yielded 9.87 percent to tendering shareholders. *See* General Motors Amendment No. 4 to Form S-4, filed June 2, 1997. Although the 75 basis point increase in the yield paid to the tendering shareholders of each class of preferred stock reportedly cost GM an additional $2.7 million per year before taxes, the deductibility of the TOPrS yield payments (as opposed to the nondeductible dividends paid on the tendered preferred stock) reportedly provided GM a tax savings of approximately $9 million per year. Interestingly, the rating agencies gave the GM TOPrS the same equity credit rating as they had given to the preferred stock that TOPrS replaced. *See* Lee A. Sheppard, *GM's Tax-Deductible Preferred Exchange Offer*, 75 Tax Notes 1458 (June 16, 1997).

[926] 1994-1 C.B. 357.

(1) whether there is an unconditional promise to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;

(2) whether holders of the securities possess the right to enforce the payment of principal and interest;

(3) whether the rights of the holders of the securities are subordinate to the rights of general creditors of the issuer;

(4) whether the securities give the holder the right to participate in the management of the issuer of the securities;

(5) whether the issuer of the securities is thinly capitalized;

(6) whether there is identity between holders of the securities and stockholders of the issuer;

(7) the labels placed on the securities by the parties; and

(8) whether the securities are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial purposes.

In the notice, the IRS warned that it "will scrutinize [instruments that combine both debt and equity characteristics] to determine if their purported status as debt for federal income tax purposes is appropriate." However, the notice did not specifically mention MIPS.

Notice 94-47 did not appear to have any discernible impact on the appetite of taxpayers to obtain financing through the issuance of MIPS. In response, the Treasury Department in 1996 proposed an amendment to section 385(c) that would have required an issuer to treat an instrument as equity if the instrument: (1) has a maximum term of more than 20 years; and (2) is not shown as indebtedness on the separate balance sheet of the issuer. In the case of an instrument with a maximum term of more than 20 years issued to a related party (other than a corporation) that is eliminated in a consolidated balance sheet that includes the issuer and the holder, the proposal would have treated the issuer as having characterized the instrument as equity if the holder or some other related party issues a related instrument that is not shown as indebtedness on the consolidated balance sheet. For this purpose, an instrument would not have been treated as shown as indebtedness on a balance sheet merely because it is described as such in financial statement footnotes or other such narrative disclosures. The proposal would have applied only to corporations that file annual financial statements (or are included in financial statements filed) with the SEC.[927] The proposal generally was interpreted as an effort by the Treasury Department to combat tiered preferred securities such as MIPS and TOPrS.

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[927] *See* Department of the Treasury, *General Explanations of the Administration's Revenue Proposals*, March 1996; Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1997: Analytical Perspectives*, H. Doc. 104-162/Vol. 3, at 35-48; Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 1997 Budget Proposal (Released March 19, 1996)* (JCS-2-96), March 27, 1996 at 65.

In 1997, the Treasury Department again proposed amending section 385(c) to foreclose debt characterization of tiered preferred securities.[928] The 1997 proposal was the same as the 1996 proposal, except that the 20 year term that would have triggered the application of the 1996 proposal was reduced to 15 years in the 1997 proposal. Proponents of this proposal took the view that corporations should not be permitted to characterize a financial instrument as indebtedness for tax purposes but not for financial reporting purposes. Furthermore, the extent to which tiered preferred securities such as MIPS and TOPrS have displaced preferred stock may suggest that the securities are viewed in the marketplace as having features closely similar to those of preferred stock.[929] However, others point out that financial statement characterization has not traditionally governed the characterization of items for tax purposes because the goals of generally accepted accounting principles and income tax rules are often different.[930] Indeed, many believe that the purported characterization of tiered preferred securities as indebtedness by the tax rules--not the characterization of such securities for financial statement purposes as equity--is the correct characterization.[931]

Congress did not enact either version of the Treasury proposal and, in fact, the IRS later issued a 1998 technical advice memorandum concluding that a taxpayer that issued tiered preferred securities (apparently, a MIPS transaction) was entitled to the interest deductions claimed in connection with the securities.[932] Specifically, the IRS applied the factors initially set forth in Notice 94-47 and ruled that: (1) loans made to the taxpayer by a foreign limited liability company ("LLC") that it formed constituted debt (rather than equity) for tax purposes; and (2) in any case, the preferred securities issued by the LLC to fund the loans constituted debt, even if the

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[928] *See* Department of the Treasury, *General Explanations of the Administration's Revenue Proposals*, February 1997; Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1998: Analytical Perspectives*, at 45-60.

[929] Joint Committee on Taxation, *Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal* (JCS-10-97), April 16, 1997 at 7.

[930] *Id.*

[931] *See, e.g.*, John C. Reid, *MIPS Besieged--Solutions in Search of a Problem*, 76 Tax Notes 1057, 1068 (Dec. 1, 1997) ("In an all-or-nothing world of the tax law, where an instrument must be debt or equity, MIPS must come down on the debt side of the scale. If an error has been committed in analyzing MIPS, it was committed by the rating agencies, not the tax lawyers."); Victor Fleischer, *Enron's Dirty Tax Secret: Waiting For the Other Shoe to Drop*, 94 Tax Notes 1045, 1046 (Feb. 25, 2002) ("It's never easy to draw a coherent line between debt and equity, but most people agree that the IRS was right to concede, and that MIPS should be treated as debt."). However, Mr. Fleischer also observes that, during the bankruptcy of Enron, the Enron MIPS have been trading significantly lower than Enron traditional debt. Consequently, "now that Enron is in trouble, the deep subordination of MIPS means that the market is treating MIPS more like common stock than debt." *Id.*

[932] Priv. Ltr. Rul. 199910046 (Nov. 16, 1998).

transaction was recast or the separate existence of the LLC was disregarded for tax purposes such that the preferred securities were treated as having been issued directly by the corporation.

The IRS also concluded that the LLC's issuance of the preferred securities and the subsequent loans to the corporation had economic substance because the transaction served non-tax business purposes, including: (1) the provision of funds for working capital and general corporate purposes, including the repayment of outstanding indebtedness; (2) a reduction in the corporation's overall cost of capital; and (3) a reduction in the corporation's debt/equity ratio. In spite of the statutory requirement that partnerships must be formed for the purpose of sharing business profits,[933] the tax transparency of the LLC (which the taxpayer treated as a partnership for tax purposes) apparently did not particularly concern the IRS, which stated:

> The fact that LLC earns no profit on the issuance of the Preferred Securities and the subsequent loans made to Corporation A does not imply the transactions lack economic substance. Although LLC is a "tax-transparent" investment vehicle that acts to pass through the interest earned on the loans to the Preferred Securities holders, the underlying transactions have economic substance.

The remarkable evolution in the reaction of the IRS and the Treasury Department to tiered preferred securities such as MIPS and TOPrS highlights the longstanding and pervasive tax policy dilemma of distinguishing between debt and equity--a problem that one Supreme Court justice presciently identified almost sixty years ago:

> Tax liability should depend upon the subtle refinement of corporate finance no more than it does upon the niceties of conveyancing. Sheer technicalities should have no more weight to control federal tax consequences in one instance than in the other. The taxing statute draws the line broadly between "interest" and "dividend". This requires one who would claim the interest deduction to bring himself clearly within the class for which it was intended. That is not done when the usual signposts between bonds and stock are so obliterated that they become invisible or point equally in both directions at the same time.
>
> Dividend" and "interest," "stock" and "bond," "debenture" or "note," are correlative and clearly identifiable conceptions in their simple and more traditional exemplifications. But their distinguishing features vanish when astute manipulations of the broad permissions of modern incorporation acts results in a "security device" which is in truth neither stock nor bond, but the half-breed offspring of both. At times only the label enables one to ascertain what the manipulator intended to bring forth. But intention clarified by label alone is not always legally effective for the purpose in mind. And there is scarcely any limit to the extent or variety to which this kind of intermingling of the traditional features of stock and bonds or other forms of debt may go, as the books abundantly testify. The taxpayer should show more than a label or a hybrid

[933] Sec. 761(a).

security to escape his liability. He should show at the least a substantial preponderance of facts pointing to "interest" rather than "dividends."[934]

The either/or approach taken by the present-law tax rules (i.e., a financial instrument generally must be characterized in its entirety as either equity or indebtedness) is a principal contributor to the difficulties that have long plagued the tax rules concerning the characterization of financial instruments.[935] This rigidity in the tax rules stands in contrast to the analysis of financial instruments undertaken by credit rating agencies, which employs a more flexible scaled approach that can accommodate and give recognition to the presence of both equity and debt characteristics in the same instrument.[936]

With regard to companies that choose to finance their activities with tiered preferred securities rather than traditional indebtedness (or, as in Enron's case, replace existing indebtedness with newly issued tiered preferred securities), it may be argued that such securities do not raise tax policy issues surrounding the distinction between debt and equity,[937] at least to the extent that questions of corporate governance do not fall within the purview of tax policy. On the other hand, it may be the case that companies more commonly have used tiered preferred securities to largely supplant preferred stock (rather than debt) financing, which more directly implicates tax policy concerns to the extent that the tax rules influence the behavior of corporate taxpayers and the financial markets.[938]

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[934] *John Kelley Co. v. Commissioner*, 326 U.S. 521, 534-35 (1945) (Rutledge, J., dissenting) (citations omitted).

[935] Although section 385(a) permits Treasury to issue regulations that characterize certain interests in a corporation as "in part stock and in part indebtedness," no such regulations exist currently.

[936] *See* John C. Reid, *MIPS Besieged--Solutions in Search of a Problem*, 76 Tax Notes 1057, 1065 n.70 (Dec. 1, 1997) ("[T]he tax administrators are making a binary inquiry; an instrument is either debt or it is equity. The rating agencies on the other hand, are placing the instruments somewhere in the range between pure debt and pure equity.").

[937] *Id.* at 1059 ("To the extent that corporations issue MIPS when they would otherwise issue debt, Treasury has no reason to be concerned with the tax treatment of MIPS because interest paid on conventional debt is deductible.").

[938] *See* Joint Committee on Taxation, *Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal* (JCS-10-97), April 16, 1997, at 6 (noting that tiered preferred securities such as MIPS and TOPrS "are reportedly largely replacing regular preferred stock issuances in today's market," and citing Bary, *Preferred Vehicle--How Goldman, Merrill Altered an Entire Market*, Barron's, August 21, 1995, at 13); Norris, *Bush's Plan Taxes Certain Dividends, Fine Print Reveals*, New York Times, January 9, 2003, at A1 (noting that 72 percent of existing preferred stock is actually comprised of hybrid securities that are treated as equity for financial statement purposes but as indebtedness for tax purposes, according to a Merrill Lynch analyst).

The hindsight that the Enron bankruptcy provides may be useful in further evaluating the role that the tax rules play in fostering the development and marketing of tiered preferred securities and other similar hybrid financial instruments that are treated as equity for financial reporting purposes but indebtedness for tax purposes. Consequently, Congress may wish to consider whether such a role raises policy concerns that should outweigh the supposed importance of ensuring that the tax rules in isolation provide the appropriate characterization of such instruments.

**4. Recommendations**

The proper characterization of financial instruments for Federal income tax purposes as either debt or equity has been a longstanding problem. This problem has been exacerbated in recent years by the escalation in the amount and variety of hybrid financial instruments that have characteristics of both debt and equity. Therefore, the Joint Committee staff recommends the rules concerning the Federal income tax characterization of financial instruments as either debt or equity should be reviewed in a comprehensive way. There are several possible alternative approaches that are available in considering such changes to present law, including:

(1) Conform the tax characterization of hybrid financial instruments to the characterization that is used for other reporting purposes, such as financial accounting, so that the non-tax characterization determines the tax characterization. This approach would largely eliminate opportunities to arbitrage the various tax and non-tax criteria for determining the character of hybrid financial instruments.

(2) Strengthen the requirements for debt characterization, similar to the approaches proposed by the Treasury Department in 1996 and 1997, which may include altering or more precisely articulating the debt-equity factors listed in section 385. This approach also could involve changing the manner in which such factors are applied so that certain financial instruments that exhibit (or lack) certain features are presumptively characterized as equity rather than indebtedness. While more definite debt-equity factors ideally would be self-executing (rather than executed through Treasury regulations), developing an appropriate statutory framework for the application of such factors may be exceedingly difficult.[939]

(3) Provide restrictions on the proportionate amount of yield payments on hybrid financial instruments that may be deducted as interest. The proportionate amount of deductible yield payments could be determined under such an approach by reference to one or more key factors (or some combination thereof), such as the length of the term to maturity of the instrument or the number of months that the issuer could defer yield payments. Similar to the approach used by credit rating agencies in evaluating hybrid financial instruments, this approach would provide

[939] In any event, section 385 should be amended to apply more broadly to interests in non-corporate entities, as well as corporations.

an alternative to the existing binary debt-equity characterization of financial instruments in appropriate circumstances.

(4) Reduce or eliminate the disparate taxation of interest and dividends (for both issuers and holders of financial instruments) that creates the market for hybrid financial instruments.[940] By providing more equivalence in the tax consequences of debt and equity, this approach would eliminate tax considerations from the process by which corporate taxpayers decide to obtain financing. This approach also recognizes the diminishing usefulness of the continuing debate among commentators concerning which regulatory or statutory regime provides the so-called "correct" characterization of financial instruments as debt or equity.

[940] In fact, it has been observed that tiered preferred securities may already achieve effective equivalence in the tax treatment of interest and dividends under present law, which may explain the apparent preference of issuers for such securities over conventional preferred stock. *See* Victor Fleischer, *Enron's Dirty Tax Secret: Waiting For the Other Shoe to Drop*, 94 Tax Notes 1045, 1046 (Feb. 25, 2002) (noting that "Enron has engaged in a sort of self-help corporate integration, getting the equivalent of a dividends-paid deduction, which some reformers would want to give out anyway").

## D. Investment Unit Securities

### 1. Brief overview

In 1995 and 1999, Enron raised over $470 million through the issuance of a different series of hybrid financial instruments. Whereas the tiered preferred securities combined features of both indebtedness and equity, these transactions combined characteristics of indebtedness and a forward contract for the sale of common stock in Enron Oil & Gas Company ("EOG"). By synthesizing these characteristics into a single financial instrument, Enron effectively was able to liquidate its investment in EOG common stock--and eliminate its risk of loss from future depreciation in the stock (along with reducing its opportunity for gain from future appreciation in the stock) -- without actually disposing of the stock.

### 2. Background

**Reported tax and financial statement effects**

For Federal income tax purposes, Enron treated the investment unit securities consistently with the terms of the indenture that was part of the securities offering. The indenture required Enron (as well as investors in the securities) to treat the investment unit securities as a combination of an undiscounted debt instrument with stated periodic interest and a forward purchase contract pursuant to which the holder was obligated to use the proceeds from the repayment of the debt instrument upon maturity to purchase EOG common stock based upon a specified exchange rate. Accordingly, Enron deducted the periodic yield payments on the investment unit securities as interest.

For financial accounting purposes, Enron reported the investment unit securities as long-term debt instruments. In addition, Enron reported as income or expense changes in the value of the investment unit securities based upon corresponding changes in the value of the underlying EOG common stock.[941]

As with several of the structured transactions entered into by Enron (e.g., Projects Teresa and Tomas), Enron reported the difference between the tax and financial statement effects of the investment unit securities as a component of its effective tax rate reconciliation under the caption "Asset[s] [or Basis] and Stock Sale Differences". Thus, when the 1995 investment unit securities issued by Enron matured in 1998, Enron reported an increase in financial statement

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[941] Specifically, increases in the value of the underlying EOG common stock would decrease the value of the investment unit securities (in particular, the imbedded forward contract on the EOG common stock) to Enron, and result in financial accounting expense. Conversely, decreases in the value of the underlying EOG common stock would increase the value of the investment unit securities to Enron, and result in financial accounting income. These adjustments produced differences between the financial reporting and tax reporting of the investment unit securities because the tax treatment of the securities did not take into account such changes in value until maturity.

earnings (i.e., earnings through a reduction in the provision for income tax expense) in the amount of $61 million.[942]

**Development of investment unit securities**

Over the past decade, several corporate taxpayers have issued certain financial instruments that are debt in form and provide regular, periodic payments of interest at a market rate. However, these instruments provide investors with a repayment at maturity that is not fixed in amount. Instead, the amount of the repayment at maturity varies based upon the value of stock other than stock of the issuing corporation (referred to as "reference stock"). Often, but not always, the issuing corporation owns the reference stock and issues the instrument in order to protect against a decline in the value of the reference stock.[943] In such cases, the financial instrument has the effect of monetizing the issuer's investment in the reference stock.[944]

In 1993, American Express Company issued the first such instruments, which are often referred to as debt exchangeable for common stock ("DECS").[945] In their original incarnation, DECS were structured as short-term or medium-term interest-bearing unitary debt instruments

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[942] Enron Corp. and Subs, 1998 Footnote, Detail of Assets and Stock Sales (Enron tax rate reconciliation workpaper). EC2 000036393.

[943] Typically, the issuing corporation issues one unit of the instrument for each unit of reference stock.

[944] More specifically, the investor bears the full risk of loss in the reference stock, but only limited opportunity for gain in such stock because the financial instrument typically provides that the investor is entitled to only a specified percentage of the appreciation in the stock upon maturity and only to the extent that the stock appreciation has exceeded a specified threshold amount. Because of this payout formula, some commentators have referred to these financial instruments as "kinky forward contracts". *See* Edward Kleinbard & Erika Nijenhuis, *Everything I Know About New Financial Products I Learned from DECS, reprinted in* 12 P.L.I. Tax Strategies 1171 (1999).

[945] American Express Company 6.25% exchangeable notes due October 15, 1996 (Oct. 7, 1993). The reference stock in the American Express DECS issuance was common stock of First Data Corporation. DECS is the service mark given these instruments by Salomon, Inc. (now Salomon Smith Barney, Inc.), which underwrote the American Express issuance. Similar instruments offered by other investment banks include yield enhanced equity linked debt securities ("YEELDS") offered by Lehman Brothers Holdings, Inc., stock appreciation income linked securities ("SAILS") offered by Credit Suisse First Boston Corporation, premium exchangeable participating shares ("PEPS") offered by Morgan Stanley & Co., Inc., provisionally redeemable income debt exchangeable for stock ("PRIDES") offered by Merrill Lynch & Co., and common-linked higher income participation securities ("CHIPS") offered by The Bear Stearns Companies, Inc. In general, the reference stock involved in DECS and their counterparts has been comprised of stock issued by a corporation in which the company issuing the DECS-type securities has only a so-called "portfolio", or non-controlling, ownership interest.

that the issuing corporation could repay either in cash (the amount of which was based upon the value of the reference stock) or by delivery of the reference stock itself. In general, DECS are offered at a price that is equal to the fair market value of the reference stock on the offering date.

Although DECS are offered as a single instrument, the economic substance of DECS is akin to a combination of a forward contract on the reference stock (i.e., a financial contract for the issuing corporation to sell the reference stock to the investor) and a conventional debt instrument.[946] However, these components are not independent as a practical matter because an investor in DECS is under an obligation to tender the securities in exchange for the reference stock (or its cash equivalent) upon maturity of the DECS. The tax treatment assigned to DECS by the market generally has been consistent with their substance -- a combination of a forward contract on the reference stock and a debt instrument.[947]

**1995 issuance of Enron investment unit securities**

In December 1995, Enron issued 10 million investment unit securities at an offering price of $21.75 each.[948] The Enron investment unit securities provided a stated interest rate of 6.25 percent payable quarterly. The stated maturity of the securities was December 13, 1998 and, upon maturity, the principal amount of the securities was to be mandatorily exchanged by Enron into common stock of EOG (or its cash equivalent) at a specified exchange rate.[949] Concurrently with the offering of the investment unit securities, Enron offered approximately 30 million shares of EOG common stock into the public U.S. and international stock markets in a separate public

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[946] In effect, an investor in DECS purchases a right to receive a series of noncontingent periodic payments (designated as stated interest under the terms of the DECS) and a "long" position in the reference stock, while the company issuing the DECS undertakes an obligation to make the periodic payments to the investor and acquires a "short" position in the reference stock.

[947] In the vernacular of a typical DECS prospectus or supplement tax disclosure, investors are "obligated (in the absence of contrary authority) to treat the DECS as a forward purchase contract that requires the holder to deposit the purchase price with the counterparty and to receive interest on that deposit."

[948] Enron Corp. 6.25 percent Exchangeable Notes due December 13, 1998 (December 8, 1995) [hereinafter "1995 Prospectus"]. The investment unit securities were approved for listing on the New York Stock Exchange under the symbol "EXG". 1995 Prospectus at 1. Enron referred internally to the 1995 investment unit securities as "ACES", presumably in reference to another structured finance product offered by Goldman, Sachs & Co. known as "automatic common exchange securities". In general, ACES are similar to DECS and the investment unit securities issued by Enron, except that the reference stock in ACES is the stock of the company issuing the securities rather than the stock of another company.

[949] The specified closing price of EOG common stock on the New York Stock Exchange at the time that Enron issued the investment unit securities was $21.75 per share, which also determined the $21.75 offering price of the investment units.

offering. This offering reduced Enron's stock ownership of EOG from 80 percent to approximately 54 percent.[950]

Typical of DECS offerings in general, the exchange rate specified by the Enron investment unit securities was equal to: (1) .8264 shares of EOG common stock (or the cash equivalent) per investment unit if the EOG common stock at maturity of the investment unit securities had appreciated to a value of $26.32 or more per share; (2) fractional shares of EOG common stock equal in value to $21.75 (or $21.75 in cash) per investment unit if the EOG common stock at maturity of the investment unit securities had appreciated up to $26.31 per share; or (3) one share of EOG common stock (or the cash equivalent) per investment unit if the EOG common stock had either not appreciated or had depreciated from a value of $21.75 per share.[951] Thus, whereas an actual purchaser of EOG common stock would bear the entire risk of loss and opportunity for gain, a purchaser of the Enron investment unit securities would bear the entire risk of loss but only a limited opportunity for gain from EOG common stock.[952] However, the 6.25 percent stated interest rate on the investment unit securities significantly exceeded the anticipated 0.6 percent anticipated dividend yield on the EOG common stock.[953]

The Enron investment unit securities were unsecured and ranked *pari passu* with all other unsecured and unsubordinated indebtedness of Enron. In addition, the securities did not restrict the ability of Enron to sell, pledge or otherwise dispose all or any portion of the EOG common held by it, and no shares of EOG common stock were pledged or otherwise held in escrow for use in satisfying Enron's obligations upon maturity of the investment unit securities. In the event of the bankruptcy of Enron, the investment unit securities provided for the acceleration of maturity upon the declaration of at least 25 percent of the holders of the securities.

The indenture for the Enron investment unit securities required both Enron and the holders of the securities to treat the securities as a combination of an undiscounted debt instrument with stated periodic interest and a forward purchase contract pursuant to which the holder agreed to use the proceeds from the repayment of the debt instrument upon maturity to purchase EOG common stock based upon the exchange rate described above.[954]

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[950] 1995 Prospectus at 1.

[951] 1995 Prospectus at 16. The price of the EOG common stock at maturity was based upon the average closing price per share of the stock for the 20 trading days immediately prior to (but not including) the maturity date. *Id.*

[952] To the extent that the closing price of the EOG common stock at maturity of the investment unit securities was $26.32 or more, the holders of the securities would be entitled to receive only 82.64 percent of the appreciation in the stock. 1995 Prospectus at 4.

[953] 1995 Prospectus at 4.

[954] 1995 Prospectus at 24.

Subsequent developments

Upon maturity of the 1995 Enron investment unit securities on December 13, 1998, the EOG common stock had depreciated to a price of 15.56 per share.[955] Pursuant to the terms of the securities and in accordance with the terms of the exchange rate specified by the securities, Enron retired the securities on December 14, 1998 by delivering one share of EOG common stock in exchange for each unit of the securities.

**1999 issuance of Enron investment unit securities**

In August 1999, Enron completed a new issuance of 10 million investment unit securities at an offering price of $22.25 each.[956] Structurally, these investment unit securities are similar to the 1995 Enron investment unit securities. The 1999 Enron investment unit securities provide a stated interest rate of seven percent payable quarterly. The stated maturity of the securities was July 31, 2002 and, upon maturity, the principal amount of the securities was to be mandatorily exchanged by Enron into common stock of EOG (or its cash equivalent) at a specified exchange rate.[957] Concurrently with the offering of the investment unit securities, Enron and EOG offered four million shares and 27 million shares, respectively, of EOG common stock in a separate public offering.[958] In conjunction with a separate split-off of a subsidiary of EOG to Enron occurring contemporaneously with the offering of the investment unit securities, this offering reduced Enron's stock ownership of EOG from approximately 53.5 percent (82.27 million shares) to approximately 9.7 percent (16 million shares).[959]

The exchange rate specified by the 1999 investment unit securities was equal to: (1) .8475 shares of EOG common stock (or the cash equivalent) per investment unit if the EOG common stock at maturity of the investment unit securities had appreciated to a value of more than $26.255 per share; (2) fractional shares of EOG common stock equal in value to $22.25 (or $22.25 in cash) per investment unit if the EOG common stock at maturity of the investment unit

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[955] As noted above, the price of the EOG common stock at maturity was based upon the average closing price per share of the stock for the twenty trading days immediately prior to (but not including) the maturity date.

[956] Enron Corp. 7 percent Exchangeable Notes due July 31, 2002 (Aug. 10, 1999) [hereinafter "1999 Prospectus"]. The investment unit securities were approved for listing on the New York Stock Exchange under the symbol "EXG." 1999 Prospectus at 1. As with its 1995 investment unit securities, Enron referred internally to the 1999 investment unit securities as "ACES."

[957] The specified closing price of EOG common stock at the time that Enron issued the 1999 investment unit securities was $22.25 per share, which also determined the $22.25 offering price of the investment units.

[958] In addition, the underwriters of the offering had an option to purchase from Enron up to an additional 4.5 million shares of EOG common stock solely to cover over-allotments.

[959] 1999 Prospectus at 5-6.

securities had appreciated up to $26.255 per share; or (3) one share of EOG common stock (or the cash equivalent) per investment unit if the EOG common stock had either not appreciated or had depreciated from a value of $22.25 per share.[960] Again, whereas an actual purchaser of EOG common stock would bear the entire risk of loss and opportunity for gain, a purchaser of the Enron investment unit securities would bear the entire risk of loss but only a limited opportunity for gain from EOG common stock.[961] However, the seven percent stated interest rate on the investment unit securities significantly exceeded the anticipated 0.5 percent anticipated dividend yield on the EOG common stock.[962]

Subsequent developments

Upon the original maturity of the 1999 Enron investment unit securities on July 31, 2002, the EOG common stock had appreciated to a price of $34.88 per share.[963] However, the securities remain outstanding and in default because of the bankruptcy of Enron,[964] with the holders of the securities representing unsecured creditors of the bankruptcy estate pursuant to the terms of the securities. The New York Stock Exchange suspended public trading of the 1999 investment unit securities on January 15, 2002, and moved to delist the securities from the exchange.[965]

**Role of outside advisers**

Goldman, Sachs & Co. was the lead underwriter for both the 1995 and 1999 issuances of the Enron investment unit securities. For each transaction, Vinson & Elkins LLP provided an analysis of the tax consequences of the transaction but, because of the absence of direct authority addressing the characterization of the investment unit securities and the resulting uncertainty concerning their tax treatment, stated that it could not provide an opinion with respect to the tax consequences of owning or disposing the securities.[966] However, in order to bolster the characterization of the 1999 investment unit securities as a combination of a debt instrument and

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[960] 1999 Prospectus at 4.

[961] To the extent that the closing price of the EOG common stock at maturity of the investment unit securities was more than $26.255, the holders of the securities would be entitled to receive only 84.75 percent of the appreciation in the stock. 1999 Prospectus at 5.

[962] 1999 Prospectus at 5.

[963] As with the 1995 issuance, the price of the EOG common stock at maturity of the 1999 issuance was based upon the average closing price per share of the stock for the 20 trading days immediately prior to (but not including) the maturity date.

[964] EC2 000055434.

[965] New York Stock Exchange, *NYSE Suspends Trading in Enron Corp. and Related Securities and Moves to Remove from the List*, press release dated January 15, 2002.

[966] 1995 Prospectus at 24; 1999 Prospectus at 28.

a forward contract on EOG common stock, the discussion of Federal income tax considerations also specified certain terms of the ostensible forward contract:

(1) At the time of issuance of the investment unit securities, the holder of the securities irrevocably deposited with Enron a fixed amount of cash equal to the initial price of the securities to assure the fulfillment of the holder's purchase obligation at maturity of the securities;

(2) until maturity of the investment unit securities, Enron was obligated to pay interest at seven percent as compensation to the holder of the securities for Enron's use of the cash deposit during the term of the securities; and

(3) at maturity of the investment unit securities, the cash deposit unconditionally and irrevocably would be applied by Enron in full satisfaction of the holder's obligation under the forward contract, and Enron would deliver to the holder the number of shares of EOG common stock that the holder is entitled to receive at maturity of the securities.[967]

In addition, the discussion stated that Enron would not segregate the cash proceeds of the investment unit securities offering during the term of the securities but, instead, would commingle the cash with its other assets for use in retiring existing short-term debt of Enron with a weighted average interest rate of 5.15 percent per year.[968]

In connection with its 1995 and 1999 issuances of the investment unit securities, Enron paid fees in the amounts of $6.6 million and $6.675 million, respectively, to Goldman, Sachs & Co. as lead underwriter in the transactions. Enron also paid expenses in the amount of $425,000 in connection with the 1995 issuance. The Joint Committee staff was unable to determine the actual amount of expenses paid by Enron in connection with the 1999 issuance.[969]

**3. Discussion**

**In general**

While the tax consequences of tiered preferred securities transactions depend primarily upon whether the loan by the special purpose entity to the taxpayer (or, in the alternative, the preferred securities issued to investors by the special purpose entity) is respected as indebtedness for tax purposes, the intended tax treatment of investment unit securities, such as those issued by Enron, fundamentally hinges upon whether the imbedded components of the transaction -- the

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[967] 1999 Prospectus at 29. It is important to note that these terms actually do not change the structure or the economic substance of the investment unit securities.

[968] 1999 Prospectus at 14 (use of proceeds) and 29.

[969] This information is based upon a review of the prospectus for each issuance and information provided to the Joint Committee staff by Enron. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003.

undiscounted conventional debt instrument and the forward contract for the purchase of stock held by the issuer -- are respected as having independent economic substance.

The discussion of Federal income tax considerations that was included as part of the offering materials for the 1999 issuance of investment unit securities by Enron demonstrated a attempt to cosmetically reinforce the independence of the purported components of the securities. In similar transactions by other companies, structural variations on the basic DECS transaction primarily have involved the addition of features that are designed to ensure this intended tax result by incrementally de-linking the forward contract component from the debt instrument component. Such features have included, for example, acceleration and cancellation rights pertaining to the forward contract component, as well as resets on the stated overall yield and separation between the maturity dates of the forward contract and the rest of the transaction.

Investment unit characterization

In the absence of any definitive guidance concerning the tax treatment of DECS and other similar investment unit securities such as those issued by Enron in 1995 and 1999, it generally is believed that there are three potential alternative tax characterizations of such securities: (1) unitary contingent payment debt instruments; (2) unitary prepaid forward contracts; or (3) investment units consisting of a non-prepaid forward contract and a conventional undiscounted debt instrument with periodic stated interest.[970] The first two options view the securities as single instruments rather than investment units comprised of multiple components, while the third option views the securities as consisting of a combination of a debt instrument component and a forward contract component, each with independent significance. In this regard, the characterization of these financial instruments is critical because the alternative characterizations can result in drastically different tax consequences to both the issuer and holder of the financial instruments. However, each alternative characterization has shortcomings that preclude any of them from being the obvious candidate for the proper characterization of this genre of financial instruments.[971]

For instance, the unitary contingent payment debt instrument characterization is inadequate because DECS and other similar securities lack the quintessential feature of a debt instrument--an unconditional promise to pay a sum certain upon maturity--and, thus, cannot properly be characterized as a contingent payment debt instrument.[972] The prepaid forward

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[970] *See* Garlock, Federal Income Taxation of Debt Instruments (2002) at sec. 9.09[A]; Schizer, *Debt Exchangeable for Common Stock: Electivity and the Tax Treatment of Issuers and Holders*, 13 J. Bank Tax'n 167 (Summer 2000).

[971] "The fact is that DECS simply do not fit as a whole into any of the traditional 'pigeonholes' of financial instruments, nor even into any of the modern categories that have been created to deal with more recent financial innovation (such as notional principal contracts)." Garlock, Federal Income Taxation of Debt Instruments (2002) at sec. 9.09[A].

[972] In two rulings concerning such financial instruments, the IRS has taken this view. Field Service Advice 199940007 (June 15, 1999); Field Service Advice 200131015 (May 2, 2001).

contract characterization is similarly deficient because, although it does not necessitate that such financial instruments be treated as indebtedness, it fails to account clearly for the periodic "interest" payments made to the holder by the issuer and the fact that (unlike true prepaid forward contracts) the initial investment by the holder is not discounted for present value to take into account the time value of money.[973] The investment unit characterization, although it perhaps most clearly reflects the underlying economics of the transaction and is the characterization that generally has been settled on by taxpayers, suffers from a general lack of authority for bifurcating a single financial instrument into its constituent components for tax purposes.[974]

**Constructive sale treatment**

Arguably, investment unit securities such as DECS and those issued by Enron properly should be treated as a taxable sale of the reference stock because the issuer of such securities has effectively liquidated or monetized its holdings in the reference stock and transferred substantial benefits and burdens of owning the reference stock to the holder of the securities.[975] In fact, the statutory constructive sale rules were enacted for the purpose of treating similar transactions as

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[973] "Were it not for the periodic payments, one might call the DECS a prepaid forward contract but, since the amount invested is not discounted to present value and the investor is paid a periodic return, the investor is clearly paying for something more than the right to receive the reference stock (or cash measured by the value of that stock)." Garlock, Federal Income Taxation of Debt Instruments (2002) at sec. 9.09[A]. However, it might be possible to view DECS as prepaid forward contracts by ignoring the specific cash flows and comparing the overall yield of an undiscounted prepayment with periodic payments over the term of the instrument to the overall yield of a discounted prepayment without such periodic payments.

[974] In discussing structural complexity relating to the taxation of financial products, the Joint Committee staff has stated that "[d]eveloping component-based rules would likely involve a considerable expansion of bifurcation principles that have previously been applied only in very narrow circumstances. *See, e.g.*, sec. 163(e)(5) (applicable high yield discount obligations); Treas. Reg. Sec. 1.1273-2(h) (investment units); *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (2d Cir. 1960) (debt instrument with equity rights); *Richmond, Fredericksburg & Potomac R.R. Co. v. Commissioner*, 529 F.2d 917 (4th Cir. 1975) ('guaranteed stock')." Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001 (vol. II at 338 n. 583).

[975] In fact, the 1995 and 1999 issuances of investment unit securities by Enron appear to have been part of an overall strategy to liquidate shares of EOG common stock. In late 1996, the Enron Board of Directors approved the monetization of 13 million shares of EOG common stock in a separate transaction involving an equity swap. Minutes, Meeting of the Board of Directors, Enron Corp., December 10, 1996, at 5-6 (approving "the monetization of [Enron's] ownership of [EOG] stock in the form of an economic equity swap which would entail [Enron's] sale of up to 13,000,000 shares of EOG"). EC 000045043 through EC 000045044.

taxable sales.[976] However, these rules only apply to forward contracts that provide for delivery (or cash settlement) of a substantially fixed amount of property and a substantially fixed price. The rules do not apply to forward contracts that provide for delivery of an amount of property that is subject to significant variation under the terms of the contract. Therefore, the payout pattern of a typical DECS transaction -- in which the amount of the repayment at maturity varies based upon the value of stock reference stock -- generally precludes such transactions from being treated as statutory constructive sales.

Nevertheless, the Treasury Department has the authority to define more precisely the circumstances under which a variable forward contract in general--and, thus, an issuance of investment unit securities such as DECS in particular--does result in a statutory constructive sale. Ideally, the Treasury Department will align the constructive sale treatment of investment unit securities with that of other transactions that transfer the economic risk of loss and opportunity for gain (such as collar transactions). However, the Treasury Department to date has not published such guidance.[977]

**Disqualified indebtedness treatment**

As noted above, treating investment unit securities such as DECS and those issued by Enron in 1995 and 1999 as unitary (contingent payment) debt instruments is probably inappropriate under general tax principles concerning the characterization of indebtedness because such securities lack the classic feature of a debt instrument -- an unconditional promise to pay a sum certain upon maturity. Consequently, taxpayers have taken the position that investment unit securities should not be subject to the interest disallowance rules for disqualified indebtedness because the securities, as a whole, do not constitute indebtedness and the debt instrument component (as opposed to the forward contract component) of such securities is not payable in equity. However, provided the issuer of investment unit securities owns more than 50 percent of the outstanding stock (in vote or value) that constitutes the reference stock, these interest disallowance rules can be applied to certain investment unit securities to the extent that the Treasury Department determines that the ostensibly imbedded debt instrument in such

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[976] Sec. 1259.

[977] In recent guidance relating to a particular taxpayer audit, the IRS National Office concluded that a transaction similar to DECS resulted in a constructive sale under common law tax ownership principles. However, the transaction at issue in the audit differed from DECS in that actual shares of the reference stock were pledged for delivery upon maturity of the instruments that the taxpayer issued in the transaction. Field Service Advice 200111011 (Dec. 6, 2000). In addition, the IRS recently issued generally applicable guidance in which it concluded that an unsecured prepaid forward sale of stock with a variable payout formula similar to DECS did not constitute either a common law constructive sale or a statutory constructive sale under section 1259. Rev. Rul. 2003-7, 2003-5 I.R.B. 1. However, while the ruling concluded that section 1259 did not apply because the number of shares to be delivered to close the transaction varied significantly, it did not provide a general framework for determining when a variable forward contract is subject to section 1259 by virtue of the amount payable at settlement not being subject to significant variation.

securities is part of an arrangement that is reasonably expected to result in the repayment of the debt instrument with or by reference to the reference stock underlying the accompanying forward contract.[978] To date, neither the Treasury Department nor the IRS has published guidance or rulings with precedent that would adopt this position.[979]

The 1995 issuance of investment unit securities by Enron predated the effective date of the disqualified indebtedness rules but, had these rules been in effect at the time of the issuance, it is possible that the issuance could have been considered an arrangement that was reasonably expected to result in the repayment of the securities with or by reference to the EOG common stock and, thus, treated as disqualified indebtedness.[980]

By contrast, the 1999 investment unit securities issued by Enron followed the effective date of the disqualified indebtedness rules. However, Enron apparently took into account the contemporaneous EOG subsidiary split-off transaction and/or the issuance of EOG common stock into the public stock markets, and thereby concluded that the disqualified indebtedness rules did not apply because Enron's stock ownership of EOG common stock had fallen below the 50-percent ownership threshold specified for Enron and EOG to be considered related parties under the disqualified indebtedness rules. Otherwise, it is possible that the 1999 issuance also could have been considered an arrangement that was reasonably expected to result in the repayment of the securities with or by reference to the EOG common stock and, thus, treated as disqualified indebtedness.

**Straddle treatment**

In recent years, it appears that the IRS position has been evolving toward a broader application of the straddle rules to investment unit securities such as DECS and those issued by Enron. In 1999, the IRS National Office issued guidance relating to an audit of a taxpayer that had issued equity-linked securities, and determined that the securities in question were not debt instruments but, rather, constituted a combination of put options and a call options (i.e., collars). Therefore, the National Office concluded that the taxpayer was subject to loss deferral under the straddle rules with regard to the reference stock underlying the securities because the issuance of

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[978] Sec. 163(l)(3)(C).

[979] As noted above, the reference stock involved in DECS and their counterparts generally has been comprised of stock issued by a corporation in which the company issuing the DECS-type securities has only a so-called "portfolio", or non-controlling, ownership interest. Therefore, the disqualified indebtedness rules do not apply to such transactions because the company and the corporation issuing the reference stock are not considered to be related parties under those rules.

[980] Even taking into account the concurrent issuance of EOG common stock into the public stock markets by Enron (which reduced Enron's stock ownership of EOG from 80 percent to approximately 54 percent), EOG would have been treated as a related party under the disqualified indebtedness rules because Enron would have held more than 50 percent of the outstanding stock of EOG.

the securities resulted in a substantial diminution of risk of loss attributable to the reference stock.[981] However, the National Office did not indicate in its guidance whether the taxpayer also was required to capitalize interest and carrying costs of the transaction under the straddle rules. Therefore, the guidance did not serve to either dispel or confirm the general view of taxpayers that the interest and carrying cost capitalization requirements of the straddle rules do not apply to payments of stated interest on DECS and similar securities because the debt component of such securities is not incurred to purchase or carry the reference stock.

With regard to applying the capitalization requirements of the straddle rules to DECS and similar securities, proposed regulations that the Treasury Department published in January 2001 would "clarify" its broad authority to require issuers of such securities to capitalize the stated interest payments that they make with respect to the securities. Under these rules, the IRS generally would have the authority to require issuers of DECS and similar financial instruments to capitalize (rather than deduct currently) the stated interest payments on the financial instruments.

Shortly after the publication of the proposed regulations, the IRS National Office provided guidance concerning a particular taxpayer audit that involved a financial instrument which appeared in all materials respects to be identical to DECS.[982] In this guidance, the National Office determined that the financial instrument in question did not provide for repayment of a sum certain upon maturity because the principal amount payable at maturity was contingent upon the value of the reference stock (as paid either in actual shares or their cash equivalent). Consequently, the National Office concluded that the financial instruments did not constitute indebtedness for tax purposes.[983] Instead, the National Office determined that the financial instruments constituted either: (1) a combination of put and call options comprising a "collar" on the reference stock; (2) a notional principal contract on the reference stock with the stated interest payments representing periodic payments; (3) a prepaid forward contract on the reference stock; or (4) a *sui generis* financial instrument subject to its own unique set of tax rules. In any case, the National Office concluded that the financial instruments in question were subject to the loss deferral provisions of the straddle rules because they provided the issuer with a substantial diminution in the risk of loss from holding an existing "long" position in the reference stock by reason of holding the "short" position in the reference stock through the issuance of the financial instruments in question.

In addition, the National Office concluded that, even though the issuer of the financial instruments did not actually pledge the reference stock to its obligation to deliver the reference stock (or its cash equivalent) to the investors upon maturity of the financial instruments, the issuer nevertheless intended to continue carrying (rather than actually disposing) the reference

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[981] Field Service Advice 199940007 (June 15, 1999).

[982] Field Service Advice 200131015 (May 2, 2001).

[983] The guidance stated that the taxpayer reported the financial instruments as a forward sale of the reference stock for (unspecified) regulatory purposes, but reported the instruments as indebtedness for financial accounting purposes.

stock by monetizing a significant portion of its economic interest in the reference stock through the issuance of instruments that included an obligation tied to the performance of the reference stock. Therefore, the National Office concluded that the financial instruments (and, in particular, the stated interest payments on the instruments) were subject to the capitalization requirements of the straddle rules.[984]

The recent guidance issued by the National Office suggests the IRS believes that, even if the deduction of stated interest payments on DECS and similar financial instruments is not disallowed altogether by the disqualified indebtedness rules (e.g., because the issuer does not have the requisite 50 percent stock ownership to be considered a "related party" to the issuer of the reference stock), such payments nevertheless must be capitalized under the present law straddle capitalization rules.

**4. Recommendations**

Unlike the constructive sale rules, the disqualified indebtedness rules apply to transactions involving stock in another corporation only if the taxpayer controls the other corporation by virtue of owning more than 50 percent (by vote or value) of the outstanding stock of such corporation.[985] It may be argued that the financing activities undertaken by Enron in 1995 and 1999 cast doubt upon the tax policy rationale for excluding from the application of these rules so-called "portfolio," or non-controlling, stock ownership interests of 50 percent or less. With regard to the investment unit securities issued by Enron during these years, the fact that Enron owned more than 50 percent of the EOG common stock at the time of the 1995 issuance but owned less than 50 percent of the EOG common stock at the time of the 1999 issuance (or shortly thereafter) had no discernible bearing on the intent or economic consequences of either transaction. In each instance, the securities had the purpose and effect of carrying out an equity transaction that involved the monetization of EOG common stock.

Therefore, the Joint Committee staff recommends that Congress eliminate the 50 percent related party threshold under the interest expense disallowance rules for disqualified indebtedness.

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[984] Because the straddle capitalization regulations remain in proposed form and, in any case, would not apply to straddles created prior to January 17, 2001 (such as the financial instruments apparently at issue in the guidance), the National Office reached its conclusion without actually applying the proposed regulations. However, the National Office did apply principles similar to those set forth in the proposed regulations, thus confirming the view of the National Office that the proposed regulations would merely "clarify" the present-law application of the straddle capitalization rules.

[985] In this regard, the disqualified indebtedness rules also stand in contrast to the rules under section 1032 (providing for the non-recognition of gain or loss by a corporation with respect to certain transactions involving its own stock), which only apply to the taxpayer's own stock and not to any stock held by the taxpayer.

## E. Commodity Prepay Transactions

### 1. Brief overview

Beginning in 1992, Enron entered into several structured financial transactions arranged by various financial institutions wherein Enron received upfront payments in exchange for the future delivery of a specified commodity such as crude oil or natural gas ("commodity prepay transactions").[986] Although such transactions are common in the energy industry in general, the Enron commodity prepay transactions were unique in that they involved a circular cash flow arrangement among Enron, the arranging financial institution, and a special purpose entity. The parties devised this circularity by engaging in multiple commodity transactions that involved a substantially identical amount of the underlying commodity. Upon termination of the overall transaction, no amount of the underlying commodity actually would be transferred. Rather, the initial cash flow to Enron that originated with the financial institution (or, in the case of some later transactions, outside investors) when the transaction was initiated essentially would be reversed when the transaction was terminated (i.e., Enron would return the funds to the financial institution or outside investors).

In general, the overall economic effect of the transactions was that Enron enjoyed the use of money provided to it during the pendency of the transactions, and returned the money (along with a premium) at the conclusion of the transactions. However, because of the way in which the transactions were structured, Enron portrayed its financial condition in a more favorable light -- from the standpoint of its credit rating and market valuation -- by reporting the transactions as part of its trading operations rather than as debt for financial accounting purposes.

The purposes for entering into most of these transactions apparently were twofold: (1) to accelerate the recognition of taxable income in order to utilize section 29 credits (relating to fuel production from nonconventional sources);[987] or (2) to generate cash flow, often immediately

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[986] September 22, 1999 memorandum from Morris R. Clark to Jordan Mintz, "Federal Income Tax Treatment of Prepayments" [hereinafter "Clark memorandum"]. EC2 000033005 through EC2 000033021. The structured financing materials in Appendix B contain the Clark memorandum. *See also The Role of the Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcommittee on Investigations of the Senate Comm. on Governmental Affairs* (July 23, 2002) (testimony of Robert Roach, Chief Investigator) [hereinafter "Roach testimony"].

[987] Clark memorandum (noting that Enron entered into three prepayment transactions in 1992 and 1993 "primarily as a means for generating taxable income in order to take advantage of [section] 29 credits generated by [Enron Oil and Gas] which, at that time, was part of Enron's consolidated group"). Section 29 credits may only be used against regular tax liability (secs. 29(b)(6)), and cannot be carried forward except as additional alternative minimum tax carryforward credits (sec. 53(d)(1)(B)). Consequently, Enron would not have been able to utilize its section 29 credits in 1992 and 1993 without the taxable income generated by the prepayment transactions because it otherwise would have been in an alternative minimum tax position.

preceding the close of a financial statement reporting period, that could be reported for financial accounting purposes as cash from trading operations rather than proceeds from debt financing.[988]

Enron entered into one or two commodity prepay transactions per year between 1992 and 1997, but entered into several more per year between 1998 and September 2001. Over this period of time, Enron entered at least 12 commodity prepay transactions with J.P. Morgan Chase & Co. ("J.P. Morgan"),[989] for an aggregate notional amount of approximately $3.7 billion, and at least 12 such transactions with Citigroup, Inc.,[990] for an aggregate notional amount of approximately $4.9 billion.[991]

**2. Background[992]**

**Reported tax and financial statement effects**

For financial accounting purposes, Enron treated the commodity prepay transactions as trading contracts.[993] Accordingly, Enron reported the proceeds from the transactions as cash flow from trading (or price risk management) operations and the obligation to close the

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[988] With regard to enhancing cash flow (as opposed to generating taxable income in order to utilize section 29 credits), the Roach testimony states that "Enron had two major reasons to reduce its balance sheet debt and increase cash flow from operations: 1) to improve Enron's credit rating and 2) to support and even boost Enron's share price." Roach testimony at A-2. Apparently, Enron entered into only one commodity prepay transaction for actual commercial purposes, which occurred in 1992 and involved a notional amount that was "considerably smaller than any of the other...prepayments." Clark memorandum.

[989] On December 31, 2000, The Chase Manhattan Corporation, the bank holding company of The Chase Manhattan Bank, N.A., merged with J.P. Morgan & Co., Inc. to become J.P. Morgan Chase & Co. All references herein to J.P. Morgan Chase & Co. include relevant constituent and predecessor firms.

[990] On October 8, 1998, Citicorp, the bank holding company of Citibank, N.A., merged with Traveler's Salomon-Smith Barney to become Citigroup. All references herein to Citigroup include relevant constituent and predecessor firms.

[991] Roach testimony at A-8. *See* Roach testimony at Appendix E for more details concerning the individual transactions (e.g., dates of the transactions, dollar amounts of the transactions, underlying commodities, and status at bankruptcy).

[992] The following description of the development and implementation of Enron's commodity prepay transactions is based in substantial part upon the Roach testimony, which provides a more comprehensive description and non-tax analysis of the transactions.

[993] Apparently, the commodity prepay contracts were treated in a similar fashion by the credit rating agencies. Clark memorandum ("The transaction is not treated as traditional debt for accounting and credit rating purposes, but rather, the prepayment is viewed as a part of Enron's overall price risk management activity.").

transactions as trading (or price risk management) liabilities.[994] In reporting its financial accounting income, Enron treated the proceeds from the transactions as deferred revenue, with income recognized over time as the underlying commodity was (or the cash proceeds from selling the commodity on behalf of the counterparty financial institution were) delivered by Enron pursuant to its obligations under the contract between Enron and the financial institution.

The Federal income tax treatment of the commodity prepay transactions by Enron depended upon Enron's objective for entering into the transaction. If Enron's objective was to generate immediate taxable income in order to utilize section 29 credits, Enron would treat the transaction as a sale of inventoriable goods under the applicable tax rules and would recognize the prepayment as taxable income in the year of receipt.[995] In order to characterize these transactions as a sale of goods for tax purposes, Enron structured the prepaid forward contracts to provide for settlement of the contracts by physical delivery of the underlying commodity (rather than non-physical cash settlement based upon the spot price of the underlying commodity on the settlement date of the contracts). However, because the counterparty financial institution presumably did not desire to take physical delivery of the underlying commodity, the parties structured the transactions to achieve the same practical effect as cash settlement by committing Enron to market or sell the underlying physical commodity at the spot price on behalf of the financial institution and remit the cash proceeds from such sale to the institution.[996]

By contrast, if Enron's intention was to generate cash flow for financial reporting purposes, but not recognize taxable income immediately, Enron initially relied upon the tax rules that provide for limited deferral of taxable income recognition with respect to inventoriable goods.[997] However, because such deferral constitutes a method of tax accounting, Enron had to

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[994] Roach testimony at A-2 to A-3; Clark memorandum. The decision by Enron to report these transactions as part of its trading activities, rather than as loan proceeds, has generated intense controversy and scrutiny. The Roach testimony concludes that "the basic transaction fails as a prepay and what remains is a loan to Enron using a bank and an obligation on Enron's part to repay the principal plus interest." Roach testimony at 1.

[995] Clark memorandum. Apparently, the need to utilize section 29 credits existed primarily during the time that Enron Oil & Gas was consolidated with Enron. *See The Role of the Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcommittee on Investigations of the Senate Comm. on Governmental Affairs* (July 23, 2002) (testimony of Jeffrey Dellapina, Managing Director, Credit and Rates Group, J.P. Morgan Chase & Co.: "Chase understood that the transactions originally had tax benefits to Enron. Later, Chase learned, Enron no longer received tax benefits from the transactions but chose to continue to engage in prepaid forward transactions for other corporation purposes."). However, consideration was given to using these transactions to generate immediate taxable income in order to absorb Enron's extensive and growing net operating losses. Clark memorandum.

[996] *Id.*

[997] Treas. Reg. sec. 1.451-5.

execute these transactions using entities that had not previously entered into transactions for the purpose of generating immediate taxable income to utilize section 29 credits.[998]

In later commodity prepay transactions, Enron structured the transactions with cash settled commodity contracts rather than physically settled contracts. Because Enron would market or sell the underlying commodity on behalf of the counterparty financial institution in the earlier transactions involving physical settlement, the use of cash settled contracts in the later transactions did not alter meaningfully the economic substance of the overall transaction. However, the change from physical settled contracts to cash settled contracts meant that the tax rules governing prepaid sales of goods no longer applied to the transactions. In addition, some of the commodity prepay transactions were funded by outside investors (rather than the financial institution arranging the transaction) through the issuance of so-called "credit-linked" notes. With regard to these transactions, Enron changed its characterization of the commodity prepay transactions for Federal income tax purposes and treated the transactions as loans for Federal income tax purposes, with the prepayment to Enron upon entering into the transaction treated as nontaxable loan proceeds and the termination of the transaction treated as a repayment of the loan.[999]

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[998] *Id.* The Enron entities that entered into the transactions for the purpose of generating immediate taxable income (and, thus, could not defer the recognition of taxable income from prepayments in subsequent transactions) included Enron Reserve Acquisition Corp., Enron Power Services, and EGS Hydrocarbon Corp. Enron Capital & Trade Resources Corp. ("ECT"), the predecessor to Enron North America, similarly was required to recognize immediate taxable income from these transactions because it had merged with some of the foregoing entities (and, thus, adopted their method of accounting for these transactions). Consequently, "although ECT may be the preferred entity to effectuate prepayment transactions from a commercial or legal perspective (since the counterparty may already have a master swap agreement in place with ECT or because the counterparty otherwise has familiarity with ECT from other commercial deals), ECT may not be the preferred entity from a tax perspective." *Id.* The Enron entities that entered into the transactions for the purpose of generating cash flow for financial reporting purposes without the immediate recognition of taxable income included Enron Hydrocarbons Marketing Corp., Enron Cushing Oil Marketing, Inc., and Enron Natural Gas Marketing. *Id.* Apparently, Enron formed a new entity every year from 1993 to 1996 in order execute new prepayment transactions that could achieve the desired tax results. *Id.*

[999] *Id.*; Roach testimony at 2; April 10, 2001 memorandum from AnnMarie Tiller and Brent Vasconcellos to Jim Sandt, "Enron Credit Linked Notes Due 2005" ("For book purposes, Enron will record the upfront payment under the Prepaid Swap in income and record Enron's obligation under the Prepaid Swap as a price risk management expense and liability. For tax purposes, these income and expense entries will be reversed with an M-1 adjustment.") [hereinafter "Tiller memorandum"]. EC 000850722 through EC 000850726. The structured financing materials in Appendix B contain this memorandum. The later commodity prepay transactions may have been restructured using cash settled contracts for tax purposes because it appears that the limited two-year deferral available for the recognition in taxable income of advance payments relating to inventoriable goods was considered insufficient for Enron's purposes inasmuch as the transactions (including the forward contracts) were structured to be

## Development and implementation of Enron commodity prepay transactions

### Basic structure

In general, these transactions involved a special purpose entity created by the financial institution that was arranging the transaction.[1000] The special purpose entity would enter into a prepaid forward contract with the financial institution providing for a cash payment by the financial institution to the special purpose entity in exchange for a promise by the special purpose entity to deliver to the financial institution a fixed quantity of a commodity (typically, crude oil or natural gas) on a specified future date.[1001] The amount of the cash payment made by the financial institution to the special purpose entity would equal the estimated future price ("forward price") of the reference commodity on the future delivery date.

Simultaneously, the special purpose entity would enter into an identical prepaid forward contract with Enron providing for a cash payment by the special purpose entity to Enron in exchange for a promise by Enron to deliver to the special purpose entity a fixed quantity of a commodity on a specified future date.[1002] The terms of this contract (e.g., the amount of the cash

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outstanding for three to six years. Clark memorandum ("[S]ince both natural gas and oil are carried in Enron's inventory, these prepayments fall under the inventoriable goods exception and, as such, gain recognition may only be deferred for a period of two years after the year of receipt.").

[1000] With regard to the transactions that Enron entered into with J.P. Morgan, the special purpose entity ("Mahonia Ltd.") was directly owned by the Eastmoss Charitable Trust, which J.P. Morgan formed in Jersey for the purpose of owning special purpose entities that J.P. Morgan would utilize in arranging financing transactions for its clients. Roach testimony at C-5. The Roach testimony concludes that, notwithstanding its formal ownership by a purportedly independent charitable trust, Mahonia Ltd. was controlled by J.P. Morgan to the point that it was "a non-substantive entity established for the benefit of [J.P. Morgan]." *Id.* at C-6. The Enron commodity prepay transactions that were arranged by Citigroup utilized a special purpose entity ("Delta Energy Corporation") that was incorporated in the Cayman Islands. *Id.* at D-6, fn. 9.

[1001] Although various media reports and congressional testimony have used the terms "forward contract" and "swap contract" somewhat interchangeably to describe Enron's commodity prepay transactions (perhaps to distinguish between physically and financially settled contracts), references herein to forward contracts refer only to contracts that do not provide for periodic payments, and references herein to swap contracts refer only to contracts that do provide for period payments.

[1002] Clark memorandum ("The [prepayment transactions intended to accelerate taxable income] were typically structured as forward oil sale contracts with a counterparty arranged by a financial institution (Chase Manhattan or Citibank), whereby the counterparty would make a significant upfront payment in exchange for Enron's obligation to deliver oil on a monthly basis over a 3 to 4 year period."), noting that the financial institution would not actually receive physical oil or gas from Enron pursuant to the transaction but, rather, Enron would sell the oil or gas on behalf of the financial institution and remit the proceeds from the sale to the institution.

payment by the special purpose entity to Enron, the quantity and type of the reference commodity, and the delivery date (and location) involved in the contract between the special purpose entity and Enron) all would mirror the terms of the contract between the special purpose entity and the financial institution.

Simultaneous with the execution of these prepaid forward contracts, Enron and the financial institution would enter into a commodity swap contract providing for the periodic payment of a fixed cash amount by Enron to the financial institution in exchange for the periodic payment of a variable, or floating, cash amount by the financial institution to Enron. The swap had the effect of eliminating the residual price risk that otherwise would be incurred by Enron from the transaction.

At the conclusion of the transaction, the special purpose entity would close the forward contract with Enron by taking delivery of the reference commodity from Enron, the financial institution would close the forward contract with the special purpose entity by taking delivery of the reference commodity from the special purpose entity (i.e., the same commodity delivered by Enron to the special purpose entity pursuant to their forward contract), and the financial institution would sell the commodity on the spot market (often to an Enron-affiliated entity).[1003] However, while some of the transactions provided for physical settlement through actual delivery of the reference commodity, many of the transactions provided for financial (or non-physical) settlement.[1004]

The diagram on the following page partially depicts a commodity prepay transaction that Enron entered into with Citigroup in August 2000 as an example of the basic structure of Enron's commodity prepay transactions.[1005]

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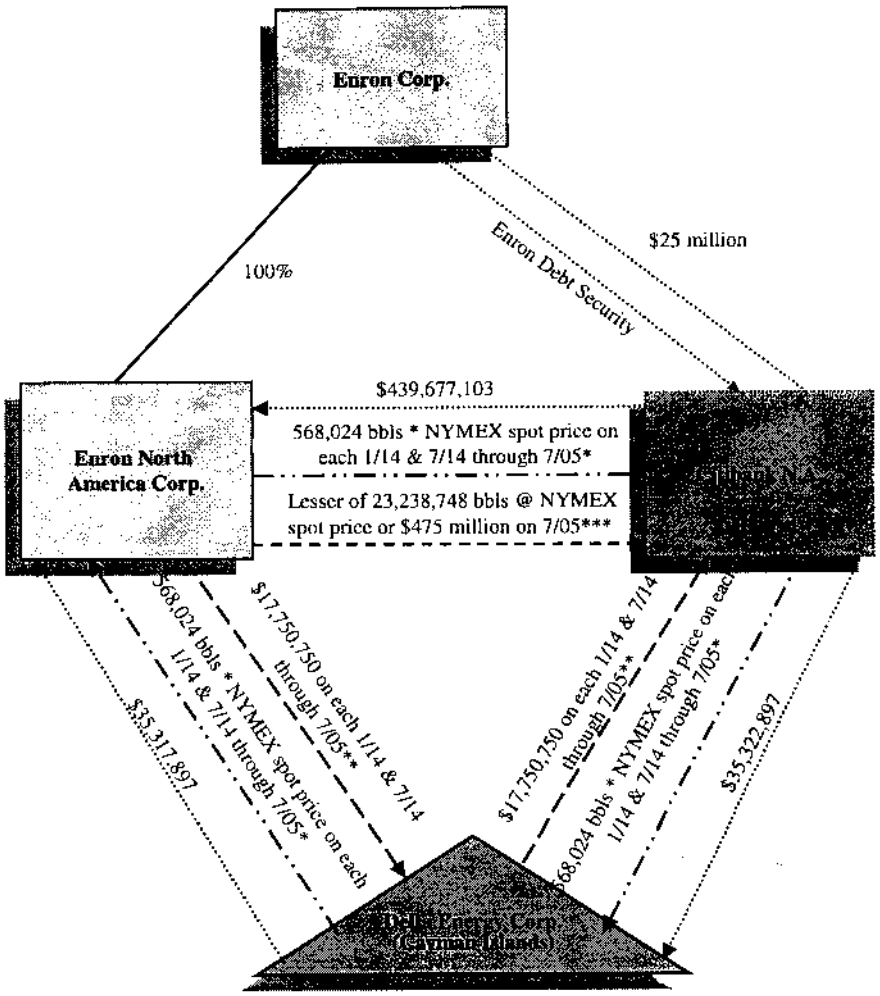
[1003] The particulars of the individual transactions often varied somewhat from the basic transactional structure. For example, prior to 1996 the special purpose entity and the financial institution would enter into a swap contract (rather than a forward contract), the special purpose entity (rather than the financial institution) would take ultimate delivery of the commodity pursuant to closing the forward contract with Enron and sell the commodity on the spot market, and the special purpose entity would hedge its price risk by entering into a futures contract. Roach testimony at C-3, fn. 3. In addition, the final commodity prepay transaction that Enron entered into involved three swaps rather than two prepaid forward contracts and one swap. *Id.* at C-9.

[1004] All but one of the transactions between Enron and J.P. Morgan involved physical settlement, while all but one of the transactions between Enron and Citigroup involved financial settlement. Roach testimony at A-8, fn. 33.

[1005] The diagram is only partial because it does not include the external financing obtained for this particular transaction from outside investors through the issuance of Enron credit-linked notes by an off-balance sheet trust (discussed below). *See* Diagram [2] below for a complete illustration of this particular transaction, including the issuance of Enron credit-linked notes.

# ENA $475 Million Prepay Transaction
# August 25, 2000
# (Partial Diagram)




U.S. GAAP/Tax Legend

- Enron GAAP Consolidated
- Third Parties
- Corporation
- Partnership

**Prepay Legend**

- **Initial Payments**
- **Periodic Floating Payments**
- **Periodic Fixed Payments**
- **Final Payment**

*As a result of the 8/25 closing date, the notional amount for the first periodic floating payment was 533,312 bbls

**As a result of the 8/25 closing date, the the first periodic fixed payment was $16,665,982

***Any shortfall below $475 million on the final payment to Citibank is made up through a final payment on the ENA/Delta Swap and Delta/Citibank Swap.

Credit-linked financial transactions

Whereas J.P. Morgan itself provided the funding for its commodity prepay transactions with Enron, several of the later commodity prepay transactions that Citigroup entered into with Enron were funded with the proceeds of notes that were issued through an off-balance sheet trust.[1006] Apparently, the financing of these transactions through the issuance of notes to investors who were otherwise external to the transaction was necessary because the internal credit policy of Citigroup precluded the extension of any additional credit to Enron.[1007] These transactions have become known publicly as the "Yosemite" transactions.

In the Citigroup transactions that involved external financing (i.e., the Yosemite transactions), the proceeds from the note issuances were loaned by the trust to the special purpose entity, which used the funds to make the prepayment as part of the prepaid forward contract entered into between the special purpose entity and Enron. The repayment of the notes by the trust was contingent upon (or "linked to") the credit rating of Enron.[1008] By issuing notes that were linked to Enron's creditworthiness, the exposure to a default by Enron on its

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[1006] Roach Testimony at D-1.

[1007] January 12, 2001 memorandum from AnnMarie Tiller to Dave Maxey, "Enron Credit Linked Notes Due 2005". EC 000850727 through EC 000850728. The structured financing materials in Appendix B contain this memorandum. According to an Enron internal communication, "Yosemite accomplished the following:

- Released bank capacity for future Enron deals by effectively refinancing the prepay structures into the bond market.
- Provided a longer-term financing option for our prepay structures (bond coupon could extend out to 10+ years)
- Provides for the ability to substitute transactions within Yosemite without having to prepay the bonds
- Provides for the ability to amend transactions within Yosemite through which is typically difficult in a bond transaction. Versus a bank deal, the Yosemite transaction allows for easier execution of an amendment because we only have to deal with Citibank versus a syndicate group.
- Retain the flexibility to sell Enron credit default swaps to the banks as an alternative method for freeing up their lending capacity."

Electronic mail message from Doug McDowell to Brent Vasconcellos, dated April 18, 2000. EC2 000033469.

[1008] These notes were designed to provide credit quality that was comparable to Enron senior unsecured obligations, and were referred to as Enron Linked Obligations ("LEOs"). Undated PowerPoint presentation, "Yosemite Securities Trust I: $750,000,000 Linked Enron Obligations (LEOs[SM])". EC2 000033095 through EC2 000033108.

obligations in the underlying commodity prepay transaction (i.e., the "credit risk") would be borne ultimately by the outside investors in the notes.[1009]

Yosemite transactions.–Between 1999 and 2001, Enron issued credit-linked notes for some of its commodity prepay transactions through four trusts known as Yosemite I, Yosemite II, Yosemite III, and Yosemite IV.[1010] In these transactions, Enron would enter into cash-settled commodity contracts (including the large initial premium payments to Enron) with Citigroup and a special purpose entity, similar to the basic commodity prepay transactions described above.[1011] In addition, Citigroup (through its special purpose entity) and the trust would enter into a credit default swap transaction whereby, in the absence of a credit event on the part of Enron (such as default of its obligations in the transaction or bankruptcy), the trust would make periodic (semi-annual) payments to Citigroup in an amount equal to the yield received by the trust on the loan to the special purpose entity that it made with the proceeds of credit-linked obligations that were issued by the trust to outside investors. In return, Citigroup would make periodic (semi-annual) payments sufficient for the trust to make yield payments on the credit-linked obligations and the trust certificates.

In the Yosemite transactions, the circular commodity prepay transactions among Enron, Citigroup, and the special purpose entity involved cash-settled commodity swaps, whereby Enron received an upfront payment from Citigroup (in the case of the swap between Enron and Citigroup) in exchange for an obligation to make periodic (semi-annual) floating payments (based upon the spot price for a notional amount of the underlying commodity) and a final payment at the end of the swap.[1012]

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[1009] January 12, 2001 memorandum from AnnMarie Tiller to Dave Maxey, "Enron Credit Linked Notes Due 2005". EC 000850727 through EC 00085078.

[1010] *Id.* In general, credit-linked financial transactions typically involve some form of derivative, such as a total return swap, default swap, credit risk option, or credit-linked notes. Credit-linked notes generally are comprised of fixed or variable interest rate debt instruments issued by a party that is unrelated to the issuer of the underlying obligation(s) the repayment of which determines the repayment of the credit-linked notes. If no default (or other specified similar credit event) occurs with regard to the underlying obligation(s), the credit-linked notes are repaid at maturity. However, if a default (or other specified similar credit event) does occur with regard to the underlying obligation(s), the maturity of the credit-linked notes is accelerated but no amount is required to be repaid or a reduced amount is repaid by reference to the fair market value of the underlying obligations. *See* Nirenberg and Kopp, *Credit derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes*, 87 J. Tax'n 82, 94 (August 1997).

[1011] March 27, 2001 Electronic mail message from AnnMarie Tiller to Ryan Siurek (describing Yosemite III commodity prepay transaction). EC2 000033031. The structured financing materials in Appendix B contain this electronic mail message.

[1012] Roach testimony at D-3; Tiller memorandum. Because the funding for the commodity prepay transactions was channeled from the trust to Citigroup through its special

Initially, Enron and Citigroup owned equal shares of the equity certificates in Yosemite I in order to avoid financial statement disclosure of the trust (and the debt issued by the trust) by Enron and Citigroup.[1013] After Enron determined that its percentage of equity ownership in the trust would exceed the amount permissible to avoid financial statement disclosure, Enron sold the necessary portion of its equity ownership through LJM2 to a related entity, Whitewing.[1014] Similar events occurred with regard to Yosemite II.[1015]

The following describes, in general, the cash flows involved in some of these transactions:[1016]

**Yosemite Trust Cash Flows**

- The Yosemite trust receives $X billion from offering credit-linked notes.
- The trust loans the offering proceeds to the special purpose entity (which, in turn, transfers the proceeds to Citigroup through a prepaid commodity swap).[1017]
- The Yosemite trust pays the interest on the credit-linked notes from the yield on the loans made by the trust to the special purpose entity and the premium received from Citigroup for entering into the credit default swap.
- The Yosemite trust repays principal on the credit-linked notes from the proceeds of the repayment upon maturity of the loans made by the trust to the special purpose entity.

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purpose entity, Enron entered into the commodity contract directly with Citigroup rather than through the special purpose entity.

[1013] Roach testimony at D-10, fn. 39.

[1014] *Id.*

[1015] *Id.* at D-11, fn. 41.

[1016] Citibank/Salomon Smith Barney presentation to Enron, "The 'Next' Yosemite," dated May 2, 2000. EC2 000033439 through EC2 000033468.

[1017] With regard to the Yosemite III and IV transactions, the trust used the proceeds of the offering to acquire Citigroup certificates of deposit from the special purpose entity (rather than loaning the proceeds to the special purpose entity) as collateral for the funding provided by Citigroup to Enron through the contract between Citigroup and Enron. Roach testimony at D-11, fn. 41. As part of the collateral arrangement, the trust and Citigroup entered into a credit default swap that effectively permitted Citigroup to repay the certificates of deposit by delivering to the trust so-called "Enron Deliverable Obligations" in the event that Enron defaulted on its contract with Citigroup or became insolvent or bankrupt. The Enron Deliverable Obligations would be senior unsecured obligations of Enron and any amounts recovered by the trust from these obligations would be used to repay principal on the credit-linked notes issued by the trust. Tiller memorandum.

## Credit Default Swap Cash Flows

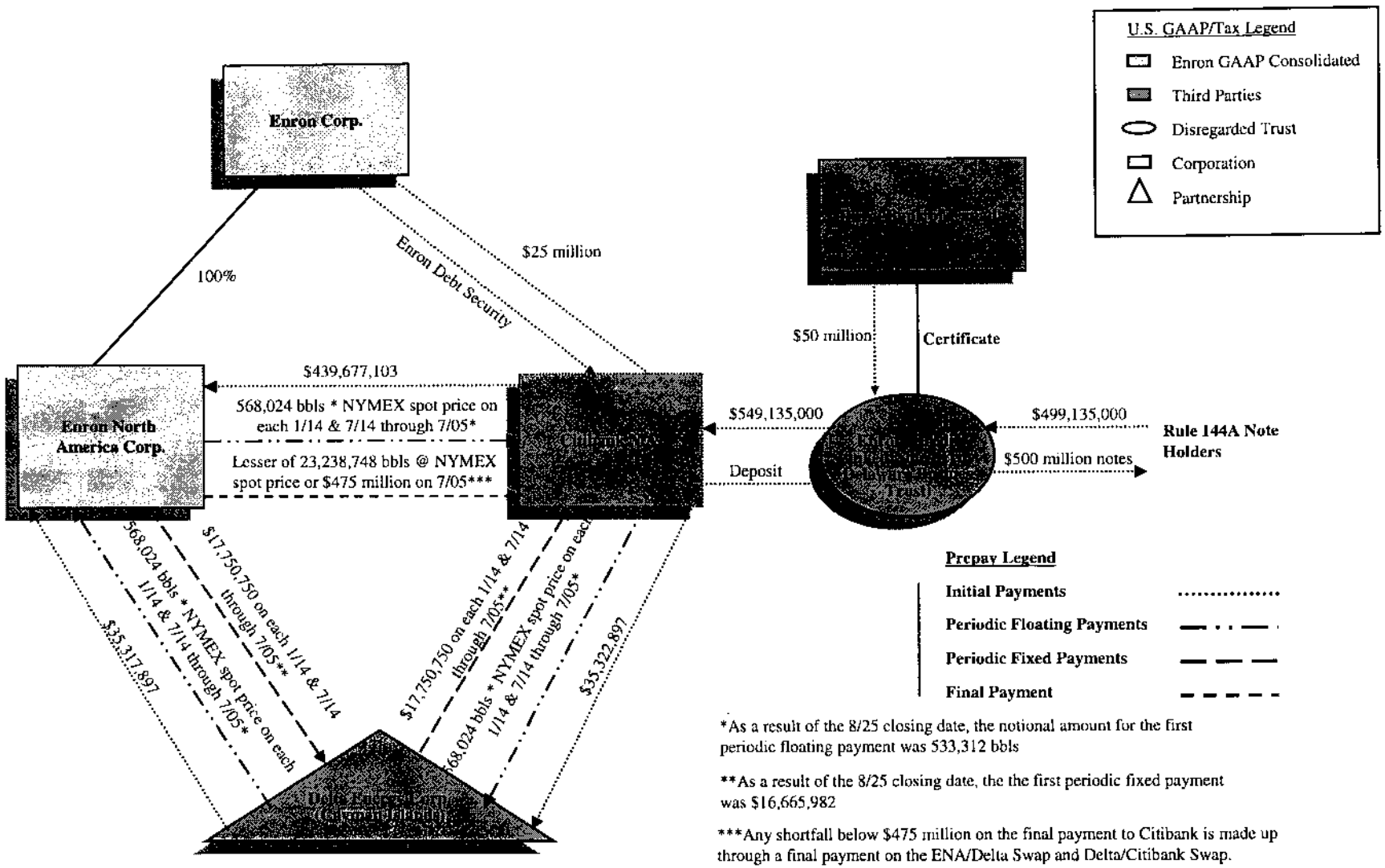
- The Yosemite trust receives a premium from entering into the credit default swap with Citigroup.
- If a credit event on the part of Enron occurs (such as default on its obligations in the transaction or bankruptcy), the Yosemite trust transfers to Citigroup the notes on the loans that it has made to the special purpose entity and, in exchange, receives senior, unsecured obligations of Enron; in turn, the trust repays the credit-linked notes out of any proceeds received by the trust from the sale or workout of the Enron obligations received from Citigroup.

## Enron Cash Flows

- Citigroup enters into a commodity swap contract with Enron that provides a prepayment by Citigroup to Enron in the amount of $\$X$ billion.
- Enron makes periodic (semi-annual) payments to Citigroup pursuant to the commodity swap contract.

The diagram on the following page depicts the commodity prepay transaction that Enron entered into with Citigroup in August 2000 as an example of an Enron commodity prepay transaction that included the issuance of credit-linked notes.

# ENA $475 Million Prepay Transaction
# August 25, 2000




*As a result of the 8/25 closing date, the notional amount for the first periodic floating payment was 533,312 bbls

**As a result of the 8/25 closing date, the the first periodic fixed payment was $16,665,982

***Any shortfall below $475 million on the final payment to Citibank is made up through a final payment on the ENA/Delta Swap and Delta/Citibank Swap.

**Role of outside advisors**

The roles of J.P. Morgan and Citigroup in these transactions have been chronicled extensively.[1018] In general, it appears that Enron compensated these financial institutions for their involvement in the transactions primarily through spreads built into the circular contracts that were used in the transactions (rather than through explicit fees). For example, in a commodity prepay transaction entered into with Citigroup in June 1999, Enron essentially received approximately $250 million in net up-front payments upon entering into the transaction, and paid approximately $253 million in net payments when the transaction closed.[1019] Similarly, the Yosemite III transaction provided for Enron to receive net up-front payments in the amount of approximately $483 million at the initiation of the transaction, and provided for Enron to make a payment of approximately $492 million when the transaction terminated, thus resulting in compensation to Citibank in the approximate amount of approximately $9 million.[1020]

Enron apparently did not receive tax opinion letters in connection with the basic commodity prepay transactions. Rather, it appears that Enron tax personnel primarily developed the tax analysis of these transactions with some legal assistance provided by Vinson & Elkins LLP.

**3. Discussion**

**In general**

The primary tax policy issue surrounding the basic structure of the Enron commodity prepay transactions involves the selectivity that Enron exercised in determining the tax consequences of substantially similar transactions based upon the underlying objectives of Enron in executing the transactions.[1021] In earlier commodity prepay transactions, Enron treated the transactions as prepaid sales of goods. Within the tax rules governing the treatment of prepaid

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[1018] *See, e.g., The Role of the Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcommittee on Investigations of the Senate Comm. on Governmental Affairs* (July 23, 2002); Peter Behr and Ben White, *J.P. Morgan Had Many Ties With Enron*, The Washington Post (Feb. 23, 2002) at E1; Kurt Eichenwald, *Questions Raised on Enron Offshore Gas Trades*, The New York Times (Feb. 19, 2002) at C1.

[1019] July 8, 1999 Memorandum from Michael L. Herman to R. Davis Maxey, "US$ 500 million Prepaid Forward and Swap Contracts with respect to Crude Oil, dated June 29, 1999". EC2 000033290 through EC2 000033294. Apparently, Enron also paid Citigroup a stated fee of $1 million in connection with the transaction. *Id.*

[1020] March 27, 2001 Electronic mail message from AnnMarie Tiller to Brent Vasconcellos (describing Yosemite III commodity prepay transaction). EC2 000033031.

[1021] For example, *see* RMTC Liquids (Prepay) 1999 and 2000 tax workpapers providing the tax return treatment of certain commodity prepay transactions entered into by Enron affiliate RMTC Liquids. EC2 000033554, EC2 000033529 and EC2 000033568. The structured financing materials in Appendix B contain these workpapers.

sales of goods, Enron essentially elected its tax treatment of these transactions (i.e., current recognition of prepayments from some transactions and limited deferral of prepayments from other transactions) by selecting the entity within the Enron consolidated group to execute the transaction based upon the entity's tax accounting method for prepaid sales of goods.

In later years, Enron exercised selectivity in the tax treatment of its commodity prepay transactions through the characterization of the transaction as a loan (resulting in no recognition of taxable income or subsequent offsetting deduction).[1022] Although these later transactions involved cash settled contracts (rather than physically settled contracts) and were funded by outside investors (rather than the arranging financial institution), they were no different economically from the earlier transactions in any material respect. However, their characterization as loans (specifically, loans from the Yosemite trusts to Enron) apparently provided certain timing and withholding tax advantages over alternative characterizations.[1023]

Because the commodity prepay transactions would generate an offsetting deduction when they closed (or would produce no deductions in the case of loan characterization), the transactions generally did not produce a permanent tax benefit. Rather, the selectivity that Enron exercised in the tax treatment of the transactions affected the timing of the recognition by Enron of taxable income.

**Yosemite transactions**

Enron's reliance upon credit-linked notes in the Yosemite transactions to effectively create credit capacity for additional commodity prepay transactions raises questions that are pertinent primarily to corporate governance and financial accounting. From the perspective of tax policy, the Yosemite transactions involve issues that are common to most credit-linked financial transactions. Because of their fairly recent advent, the overall tax treatment of the various types of credit-linked financial transactions remains uncertain. In substance, such transactions have been depicted in terms similar to the following description:

> In such transactions, a counterparty seeks to purchase protection against the default of a particular issuer. This protection can be most simply thought of as default insurance. This type of credit derivative is also most commonly thought

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[1022] Electronic mail message from AnnMarie Tiller to Jill Erwin, Danny Wilson, and Kerrie Smith, dated January 11, 2000 ("Although [Yosemite I's] current investments are a complicated set of interests in debt and swaps, we are taking the position for tax purposes (given [Yosemite I's] current investments, at least), that [Yosemite I] owns a debt instrument issued by Enron with terms that match the aggregate payments due to the [Yosemite I] Certificateholders and the holders of the [credit-linked] Notes"). EC2 000033045 through EC2 000033047.

[1023] January 14, 2000 memorandum from Brent Vasconcellos to AnnMarie Tiller, "Yosemite I Withholding". EC2 000033237 through EC2 000033244. The structured financing materials in Appendix B contain this memorandum. October 28, 1999 Yosemite Financing outline of various tax issues. EC 000850764 through EC 000850773. The structured financing materials in Appendix B contain this outline.

> of as a default or credit put option in which the holder of the put option holds the right to transfer obligations of the Reference Entity [i.e., the entity for which protection against default is being sought] to the credit derivative protection seller in exchange for either money or other value.[1024]

In effect, a credit-linked financial transaction brings together a party that desires to lend money without undertaking the associated credit risk and a counterparty that desires to undertake credit risk without lending money. Economically, these transactions can be described as synthetic loans in which the party that assumes the credit risk from the ostensible lender becomes the actual lender.

In characterizing a credit-linked note for Federal income tax purposes, it is not certain that repayment conditioned upon the non-occurrence of a credit event (such as default) constitutes the requisite promise to pay a specified amount at maturity that is necessary for a financial instrument to properly be characterized as indebtedness for Federal income tax purposes.[1025] In most transactions involving credit-linked notes, the classification of the notes as indebtedness for Federal income tax purposes can be critical because the loss of interest deductions that is occasioned by the loss of debt classification can destroy the economic rationale of the overall transaction.[1026]

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[1024] *The Role of the Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcommittee on Investigations of the Senate Comm. on Governmental Affairs* (July 23, 2002) (testimony of Ronald M. Barone, Managing Director, Standard & Poor's Ratings Services). Actual default is only one of a variety of types of events (e.g., changes in credit ratings) that can be incorporated as a triggering event into the terms of a credit-linked obligation. *See* Kayle, *Will the Real Lender Please Stand Up? The Federal Income Tax Treatment of Credit Derivative Transactions*, 50 Tax Lawyer 569, 577 (Spring 1997) (citing imposition of exchange controls by borrower's home country as another example of "quasi-credit risks" that can be embedded into a credit-linked obligation or other security) [hereinafter "Kayle"].

[1025] *But see* Nirenberg and Kopp, *Credit derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes*, 87 J. Tax'n 82, 95 (August 1997) (arguing that credit-linked notes can be treated as indebtedness for tax purposes). As with many types of financial instruments for which questions concerning the proper tax treatment remain largely unanswered, commentators generally have analyzed credit-linked notes by analogy to other types of transactions of which the tax treatment is more clear, particularly with regard to the fundamental tax issues of timing, character, and source of payments and receipts pursuant to a financial transaction. *See* Kayle, at 577-578 (noting the resemblance of credit-linked notes to guarantees and letters of credit).

[1026] To the extent that the credit-linked notes are marketed to foreign investors, the loss of debt classification could upend further the overall economics of the transaction because the interest income that generally otherwise would be exempt from U.S. withholding tax under the portfolio interest exemption would also be recharacterized (e.g., as dividends on an equity interest) in a manner that would result in the imposition of U.S. withholding tax.

Even if credit-linked notes appropriately can be classified as indebtedness to some extent for tax purposes, questions similar to those involving DECS can be raised concerning the precise nature of credit-linked notes as indebtedness. Some commentators believe that credit-linked notes, like DECS, can be viewed as a combination of a standard noncontingent debt instrument and a swap that provides for payments based upon the specified credit events underlying the credit-linked notes (e.g., a credit default swap).[1027] However, this analysis merely shifts the unanswered questions regarding appropriate tax treatment to those involving credit default swaps and, more generally, the ability to "componentize" a financial instrument for tax purposes.[1028] The unsatisfactory state of affairs discussed above with regard to the tax treatment of hybrid financial instruments in general is particularly detrimental with regard to credit-linked transactions, as one commentator has described:

> Credit derivatives have proven themselves in the marketplace to be powerful and versatile tools for market participants to manage credit risk. Like other powerful tools, they have their dangers. In no small part, those dangers relate to their tax consequences. The dangers...are those for potential users of credit derivatives, but there are dangers for the Treasury as well, as taxpayers may resolve doubts in their own favor using the benefit of hindsight. Thus, uncertainty surrounding the tax treatment of credit derivative transactions is in the interest neither of the Treasury nor the public.[1029]

In the case of the Yosemite transactions, Enron evidently employed an economic substance analysis to arrive at a conclusion that these transactions constituted lending transactions for tax purposes, rather than prepaid sales of goods (as in the previous commodity prepay transactions). Beyond the characterization of the transactions as loans, determining which party should be treated as the lender was crucial to the feasibility of these transactions. Enron was concerned that treating the off-shore special purpose entity in the Yosemite transactions as the lender could have given rise to tax withholding obligations that would have made the transactions uneconomic. Therefore, Enron took advantage of this aspect of uncertainty in the treatment of credit-linked notes and treated the Yosemite trusts as the lender in these transactions.

**Selective tax treatment of Enron commodity prepay transactions**

The questions surrounding the Enron commodity prepay transactions can be analogized to the problems discussed above with regard to DECS financing transactions. Specifically, drastically different tax consequences can arise on the basis of different characterization of the same or substantially similar economic transactions. The sole reason that such a circumstance -- and the characterization selectivity that stems from it -- is even possible can be attributed to the

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[1027] Kayle, at 609-611.

[1028] *Id.* at 591 ("[T]he credit default swap is in many respects the most difficult of the genre [of credit-linked financial transactions] to analyze.").

[1029] Kayle, at 613.

fact that the tax consequences of a financial transaction are dictated largely by tax rules that traditionally have assigned labels to transactions that may not reflect in all cases the underlying economics of the transaction in question.

The effort that has been expended to differentiate among various types of financial transactions, and the analytical techniques (such as analogy, integration and bifurcation) that have been employed in such efforts, suggests that any structural differences among these transactions have largely been eliminated through modern financial engineering. The convergence of financial transactions -- and even some transactions that traditionally have been thought of a non-financial, such as prepaid sales of goods--suggests that the tax consequences of such transactions no longer can be based upon their assigned labels.

**4. Recommendations**

The commodity prepay transactions entered into by Enron demonstrate the convergence of traditionally dissimilar transactions that has occurred in recent years through financial engineering. This convergence presents increasing challenges to the rationality of certain tax rules that have been developed on the basis of categorical distinctions that may no longer reflect meaningful economic distinctions. In general, the tax rules should endeavor to reduce or eliminate the extent to which the tax consequences of economically similar transactions are impacted by their characterization.

Given the inherent complexity and customization of structured financial transactions such as those in which Enron engaged, the opportunities for tax-advantaged characterization of such transactions are particularly great and, to a certain extent, unavoidable. Nevertheless, in developing any new rules concerning the tax treatment of financial transaction and products, careful attention should be given to the potential for unintentionally creating new opportunities for *de facto* taxpayer electivity that, once recognized, might be considered unwarranted.[1030] For example, notional principal contracts with significant upfront nonperiodic payments, prepaid forward contracts, and secured lending transactions should all have the same or similar tax consequences to the extent that they all yield the same or similar economic results.

Similarly, greater attention should be paid to coordinating the tax rules governing financial transactions with those governing what have traditionally been thought of as non-financial (or physical) transactions, so that financial transactions cannot be restructured as economically similar non-financial transactions (and vice versa) simply for the purpose of accessing more favorable tax rules. For example, prepaid sales of goods should have the same or similar tax consequences as prepaid forward contracts and secured lending transactions to the extent that they yield the same or similar economic results.

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[1030] *See* Notice 2001-44, 2001-30 I.R.B. 77 (noting that, "in the financial products area, it is particularly important to pay attention to the neutrality principle, i.e., consistent treatment of difference instruments with similar economic characteristics").