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.

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[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

[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:

[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

[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.
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> 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?
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> 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.
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> 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.
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> 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]

<u>Subsequent developments</u>

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.
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> 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").