

## **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.<sup>847</sup> 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.<sup>848</sup> 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.<sup>849</sup> 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the Treasury Department published proposed and final regulations pursuant to its authority, these regulations have been withdrawn and there are no currently applicable regulations.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.<sup>850</sup> 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.<sup>851</sup>

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

<sup>848</sup> Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, sec. 7208(a)(1).

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

<sup>850</sup> 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.

<sup>851</sup> 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.<sup>852</sup> 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.<sup>853</sup> 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.<sup>854</sup>

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.<sup>855</sup> 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.<sup>856</sup>

### 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.<sup>857</sup> 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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<sup>852</sup> Sec. 1259(c)(1).

<sup>853</sup> *Id.* See also Rev. Rul. 2002-44, 2002-28 I.R.B. 84.

<sup>854</sup> 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).

<sup>855</sup> See section 1256(d)(1).

<sup>856</sup> 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.

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

issuer or related party.<sup>858</sup> 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.<sup>859</sup>

#### 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.<sup>860</sup> 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.<sup>861</sup> 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.<sup>862</sup> On January 18, 2001, the Treasury Department published proposed regulations that elaborate on the operation of the straddle capitalization rules.<sup>863</sup> 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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<sup>858</sup> Sec. 163(l)(3)(B).

<sup>859</sup> Sec. 163(l)(3)(C).

<sup>860</sup> Sec. 1092.

<sup>861</sup> Sec. 263(g)(1).

<sup>862</sup> Sec. 263(g)(2).

<sup>863</sup> 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.<sup>864</sup> 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.<sup>865</sup>

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.<sup>866</sup> 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.<sup>867</sup>

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.<sup>868</sup> 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).<sup>869</sup>

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<sup>864</sup> Treas. Reg. sec. 1.451-1(a).

<sup>865</sup> See section 446(d); Treas. Reg. sec. 1.446-1(d).

<sup>866</sup> *Id.*

<sup>867</sup> Rev. Rul. 74-607, 1974-2 C.B. 149.

<sup>868</sup> 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).

<sup>869</sup> Treas. Reg. sec. 1.451-5(b)(1).

With regard to the deferral of advance payments relating to the sale of inventorable 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.<sup>870</sup>

### **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).<sup>871</sup> 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.<sup>872</sup> 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.<sup>873</sup>

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<sup>870</sup> Treas. Reg. sec. 1.451-5(c)(1)(i).

<sup>871</sup> 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.

<sup>872</sup> See Warren, *Financial Contract Innovation and Income Tax Policy*, Harv. L. Rev. 460, 464 (1993).

<sup>873</sup> 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,<sup>874</sup> 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.<sup>875</sup> 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.<sup>876</sup> Notional principal contracts include interest rate swap agreements, commodity swap agreements, interest rate cap and floor agreements, currency swap agreements, and other similar contracts.<sup>877</sup>

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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<sup>874</sup> Sec. 446(b).

<sup>875</sup> Treas. Reg. sec. 1.446-3.

<sup>876</sup> See Treas. Reg. sec. 1.446-3(c)(1).

<sup>877</sup> 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.<sup>878</sup> 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.<sup>879</sup> 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.<sup>880</sup>

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.<sup>881</sup>

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.<sup>882</sup>

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.<sup>883</sup>

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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<sup>878</sup> Treas. Reg. sec. 1.446-3(c)(1)(i).

<sup>879</sup> Treas. Reg. sec. 1.446-3(c)(2).

<sup>880</sup> Treas. Reg. sec. 1.446-3(c)(1)(ii).

<sup>881</sup> Treas. Reg. sec. 1.446-3(d).

<sup>882</sup> Treas. Reg. sec. 1.446-3(e).

<sup>883</sup> 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.<sup>884</sup>

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.<sup>885</sup> 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.<sup>886</sup>

## **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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<sup>884</sup> Treas. Reg. sec. 1.446-3(h).

<sup>885</sup> Treas. Reg. sec. 1.446-3(g)(4).

<sup>886</sup> Treas. Reg. sec. 1.446-3(g)(6), Examples 2 and 3.