TRUST PREFERRED SECURITIES - ENRON CASE

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On April 1, 1998, Enron Corp. ("Enron") filed a petition in the United States Tax Court contesting the disallowance by the Internal Revenue Service ("IRS") of interest deductions taken by Enron in connection with two preferred securities transactions entered into in 1993 and 1994. The disallowance is surprising, particularly with respect to the 1994 preferred securities which are comparable to most of the approximately $150 billion of such securities issued in the last four years.

The terms of these securities, the detailed review by the IRS and its resulting pronouncements in 1994, and the history of failed legislative proposals all indicate that the IRS will ultimately fail in the disallowance of interest deductions on debt issued in the typical preferred securities transaction. Moreover, these types of securities, including the securities at issue in the Enron litigation, contain tax call provisions which may be activated by the Enron litigation or related developments. Accordingly, the IRS should immediately confirm the deductibility of interest paid on a typical preferred security so as to avoid turmoil in the marketplace and windfalls to issuers with hair trigger tax call provisions.

DESCRIPTION OF THE TRANSACTIONS

In 1993, Enron Capital LLC, a Turks and Caicos entity (the "LLC") issued 8% Cumulative Guaranteed Monthly Income Preferred Shares ("MIPS") to investors and a common interest to Enron. The LLC loaned the proceeds from the issuance to Enron in exchange for a loan that matured at the earlier of November 2043 or the date of certain events of dissolution or liquidation of Enron or the LLC. Under certain circumstances, upon repayment of the loan by Enron, the LLC could reloan the proceeds to Enron for an additional 50 years.

In 1994, Enron entered into a similar transaction by creating Enron Capital Resources, L.P., a Delaware limited partnership (the "L.P.") which issued 9% Cumulative Preferred Securities (the "Preferred Securities") representing limited partnership interests to investors and a general partnership interest to Enron. The L.P. loaned the proceeds from the issuance to Enron for a debt instrument with a thirty year maturity. Under certain circumstances, the proceeds received by the L.P. upon repayment of the loan could be reloaned to Enron for an additional 19 years.

IRS DETERMINATIONS/PETITION

The IRS determined that the interest payments made by Enron to both the LLC and the L.P. were not deductible for federal income tax purposes. Such determination was based on the following assertions by the IRS regarding the transactions: (a) both loans to Enron did not constitute indebtedness; (b) Enron and the LLC and Enron and the L.P. were not "sufficiently distinct" to be considered unrelated parties that could transact at arm's length; (c) there was no fixed and determinable obligation to pay a sum certain on any date other than at Enron's discretion; (d) the holders of the MIPS and the Preferred Securities did not have creditors' rights but rather had the rights of preferred shareholders; (e) Enron represented to federal agencies that the instruments viewed together were not debt; and (f) Enron characterized the payments on both loans as dividends on its financial statements and did not charge any interest expense with respect to the loans against its income.

In its petition, Enron challenged the accuracy of all of the IRS assertions. An answer to the petition is expected from the IRS by June 2, 1998.

DISCUSSION

While there are a number of variations in the terms of preferred securities, the essential element of these transactions is that a company issues debt to a flow-through entity (e.g., partnership or trust) that in turn issues interests in itself to third-party investors. Accounting rules treat the flow-through entity as a subsidiary of the company and, as a result, the debt is eliminated when consolidated financial statements are prepared. Certain rating agencies may give the company some degree of equity credit for the debt because interest payments can be extended for up to five years and because the debt is often subordinated to senior lenders. Except for the limited five-year deferral option on interest payments, the debt has provisions typically found in debt instruments (e.g., creditors' rights, an unconditional promise to pay a sum certain at a fixed maturity date and a maturity of less than fifty years).

These securities were considered in detail by the IRS at the end of 1993 and beginning of 1994 resulting in the issuance of Notice 94-47 which listed factors important to the determination of whether an instrument is debt or equity for federal income tax purposes. Notice 94-47 also provided that unreasonably long maturities coupled with significant equity characteristics were inconsistent with debt treatment for federal income tax purposes. The effect of Notice 94-47 was a general understanding that the IRS would not attack these securities as long as the debt had a maturity of between thirty and fifty years.

In 1996, the Clinton administration, as part of its revenue raising proposals, proposed equity treatment for these types of securities if the debt had a maturity of more than twenty years. In 1997, the Clinton administration included a similar proposal in its budget which would have treated debt with a maturity of more than fifteen years as equity. These proposals were rejected by Congress in both 1996 and 1997 and were not reproposed in 1998. Moreover in October 1996, the Federal Reserve Board designated preferred securities as eligible for Tier One capital treatment based on its understanding that such securities would entitle the issuing bank to an interest deduction.

Currently there are in excess of $150 billion of these securities in the market of which approximately $50 billion were accorded Tier One capital treatment for banks and other financial institutions.

As a result of this history of preferred securities, it is surprising that the IRS agent challenged the Enron MIPS and Preferred Securities transactions. Enron could have sought the advice of the National Office of the IRS through a request for technical advice which would have provided guidance. Instead, Enron chose to proceed directly to litigation in Tax Court. We continue to be of the view that the debt in a typical preferred securities transaction will be treated as indebtedness for federal income tax purposes. Guidance from the IRS confirming such treatment would help taxpayers who have these securities outstanding avoid needless litigation and would help avoid capital markets disruptions.

One issue raised by the Enron petition is the applicability of the "Tax Event" call provision that is generally contained in the terms of these securities. It does not appear that the tax call provisions in Enron have been triggered by the IRS determinations and Enron's subsequent petition. However, many Tax Event call provisions have hair triggers and the Enron litigation or other developments could, at some point, be interpreted as activating the tax call provisions. The effect of the tax call provisions to investors in the securities will, among other things, depend on whether the call is at par or whether it has a make-whole provision.

CONCLUSION

The IRS assertions are surprising and clarification by the National Office or the Treasury Department is necessary to avoid confusion in the marketplace.

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This memorandum is intended as merely an overview of the effect of the circumstances surrounding the Enron petition. If you have any questions about the impact on a specific preferred securities transaction, please contact Dickson G. Brown (212-455-2850), Karen S. Handler (212-455-2684), Peter F. Riley (212-455-3406) or any other member of our tax department.

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