G. Recommendations Relating to Structured Financing Transactions[25]

1. Modify the rules relating to the characterization and treatment of debt and equity

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 that 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.

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

(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 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 under the terms of the financial instrument.

(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.

2. Modify the rules relating to disqualified indebtedness

The interest expense disallowance rules for disqualified indebtedness 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. The Joint Committee staff recommends that the 50-percent related party threshold under these rules should be eliminated.

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[25] Further discussion of these recommendations is provided in the description of Enron's structured financing transactions in Part Three of this Report.

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