D. Investment Unit Securities

1. Brief overview

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

2. Background

Reported tax and financial statement effects

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

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

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

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

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

Development of investment unit securities

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

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

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

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

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

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

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

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

1995 issuance of Enron investment unit securities

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

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

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

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

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

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

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

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

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

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[950] 1995 Prospectus at 1.

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

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

[953] 1995 Prospectus at 4.

[954] 1995 Prospectus at 24.

Subsequent developments

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

1999 issuance of Enron investment unit securities

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

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

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

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

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

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

[959] 1999 Prospectus at 5-6.

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

Subsequent developments

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

Role of outside advisers

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

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[960] 1999 Prospectus at 4.

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

[962] 1999 Prospectus at 5.

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

[964] EC2 000055434.

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

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

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

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

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

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

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

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

3. Discussion

<u>In general</u>

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

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

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

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

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

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

Investment unit characterization

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

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

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

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

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

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

Constructive sale treatment

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

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

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

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

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

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

Disqualified indebtedness treatment

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

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[976] Sec. 1259.

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

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

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

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

Straddle treatment

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

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

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

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

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

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

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

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

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

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

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

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

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

4. Recommendations

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

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

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

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