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Enron's Dirty Little Secret: Waiting for the Other Shoe to Drop

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Enron's Dirty Little Secret: Waiting for the Other Shoe to Drop

By Victor Fleischer

Victor Fleischer, Columbia University, looks at the Enron scandal and concludes that Enron didn't pay income tax in the last four years because it didn't have much income during that time.
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Does Enron have a tax skeleton hiding in the closet? Smart money is betting that they don't -- not a big one, anyway. The evidence so far suggests that the tax lawyers got it basically right; it's the accountants that got it wrong.

A student recently asked me the following question: How could Enron, one of the 10 largest companies in the country, not pay income tax for four out of the last five years? [1] In my mind the answer is simple: Enron didn't pay a whole lot of income tax because it didn't have a whole lot of income. Whatever the financial statements may have said, the sad truth is that the earnings reported on the income statement were largely illusory, and a lot of the debt -- some of which still generated interest deductions for tax purposes -- was hidden from the balance sheet. Put the two together and you have a formula for inflating earnings-per- share while keeping tax payments down. We're still waiting for more dirt to be uncovered by government investigators, journalists, and plaintiffs' lawyers, but early signs suggest that almost all of the Enron gamesmanship was accounting-driven, not tax-driven.

Enron had its grubby fingers in a lot of different pies, from oil pipelines and energy trading to transportation, broadband, and Internet investments. As the bubble economy was expanding, Enron moved some of its speculative investments off balance sheet, "monetizing" those assets at an artificially high valuation and booking a permanent gain for accounting purposes. [2] Our tax system, on the other hand, is based on the realization requirement, which takes a wait-and-see approach. Although, over the years, tax lawyers have been justly criticized for abusing the realization requirement through constructive sales and the like, Enron's byzantine transactions also highlight the upside of having a realization-based system: avoiding the tricky valuation questions that invite abuse.

Raptor, Jedi, Chewco, and Other Scary Names

Take, for example, the frightfully named off-balance sheet partnerships we've read so much about. [3] In simplified form, Enron takes an asset of uncertain value and contributes it to a partnership, taking back 97 percent of the partnership interests in return. The partnership then

borrows from outside lenders and feeds cash back to Enron. The partnership loan is secured by the partnership assets, but Enron also guarantees the loan with Enron stock. What result?

For tax purposes, it's basically a non-event. [4] As well it should be. From an economic perspective, Enron's position has changed very little regarding the asset -- it still carries virtually all of the opportunity for gain and risk of loss. So the tax system concludes that we should wait and see what the asset is really worth before requiring payment of the tax. If and when the partners exit the investment by selling to a third party, *that's* when the tax system recognizes a true event, the income flows through to the partners and the partners pay the tax.

It's the accounting treatment that poses a problem. For accounting purposes, Enron has "monetized" the asset, notwithstanding the fact that Enron is still economically on the hook. The core problem here is valuation. The willingness of the outside lenders to put in money is no comfort, since Enron is guaranteeing the loan with its own stock. I'll confess to not knowing exactly how the accounting system should treat the transaction, and I expect we will hear a range of possible solutions to this sort of problem in the weeks and months to come. But if nothing else, I would think that Enron's downside exposure should be clearly explained in the financials.

MIPS

There has been some talk about the Enron MIPS transaction -- a "dubious security," as *The Wall Street Journal* called it. [5] MIPS -- Monthly Income Preferred Securities -- is a relatively simple financial instrument that allows an issuer to raise money from the public and take an interest deduction on its periodic payments while still getting some equity credit from the accountants and rating agencies. In 1993, Enron issued $214 million in MIPS, creating a special purpose entity (SPE) called Enron Capital LLC to issue the "preferred shares" to the public. The MIPS paid an 8 percent annual dividend, paid in monthly installments. Enron then borrowed the money from the SPE, and as Enron paid interest on the SPE loan, the SPE paid the interest through to the MIPS holders. This allowed Enron to take a tax deduction on its interest payments but still receive some equity credit from the finance people. [6]

Abusive tax scheme? Again, I think it's the accountants and rating agencies who are on the wrong side. The IRS challenged the interest deduction, arguing that the MIPS really resembles nondeductible preferred stock. In an odd turnaround, the IRS then conceded the issue when it issued TAM 199910046, *Doc 1999-9636 (44 original pages), 1999 TNT 4-15* /taxbase/archive/tnt1999.nsf/86255f19006ce90385255b580068db3a/7151be4522835bbd85256a400055ecbe?OpenDocument /taxbase/archive/tnt1999.nsf/86255f19006ce90385255b580068db3a/7151be4522835bbd85256a400055ecbe?OpenDocument, blessing a MIPS structure with debt classification. 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.

Hindsight does give some new support to the MIPS critics: As of February 8, 2002, the MIPS were trading at about 50 cents per share, down about 98 percent from an issue price of $25. Enron's corporate debt, battered as it is, trades significantly higher: about 20 cents on the dollar, off 80 percent. In other words, now that Enron is in trouble, the deep subordination of

MIPS means that the market is treating MIPS more like common stock than debt. [7] But my point is that if MIPS is as bad as it gets, the tax bar will slip through the Enron hurricane with its hair only slightly tousled.

The academic community is still waiting to see if government investigators and journalists turn up anything more. Perhaps Enron has taken advantage of tax shelters that we don't yet know about. A recent article in *The Wall Street Journal* hinted at Enron's abuse of international tax treaties. [8] And it may be that the worst accounting vs. tax "abuse" is hiding in plain sight -- Enron's tax deductions for stock options exercised by management weren't reported in the body of the income statement as a current compensation expense. In any event I think that the real story -- the one that history books will tell in 20 years -- is where we began. Enron's dirty secret is that it didn't have any income, not that it had income but didn't pay any income tax.

The Sound of the Other Shoe Dropping

While the tax bar may get lucky here, it is only a matter of time before Main Street forces Wall Street tax lawyers to face up to their contribution to the lack of transparency in the financial statements of America's largest corporations. Tax lawyers surely share in the blame for helping engineer complex financial instruments that game the system in myriad ways: exploiting the differences between accounting treatment and tax treatment, abusing the deferral advantages of a realization-based tax system, and most disturbingly, contributing to the proliferation of tax shelters bereft of any real economic substance. Granted, the tax bar is hardly a lone wolf, and recent court decisions like the *Compaq* case will only make it more difficult for reform-minded tax lawyers to discourage greedy clients. But it is only a matter of time before the other shoe drops and Congress imposes its own reforms. If the tax bar does not step forward first with effective self-regulation -- something the accounting industry never did -- the tax bar will be joining the accountants at the mercy of the political system.

FOOTNOTES

[1] *See* Citizens for Tax Justice, "Less Than Zero: Enron's Corporate Tax Payments 1996-2000," Jan. 17, 2002, available at http://www.ctj.org/pdf/enron.pdf; David Cay Johnston, "Enron's Collapse: The Havens; Enron Avoided Income Taxes in 4 of 5 Years," *The New York Times,* Jan. 17, 2002, p. A1.

[2] *See, e.g.,* Enron 2000 Annual Report at 25 ("Gross margin [from Enron's Broadband Services] included earnings from sales of excess fiber capacity, a significant increase in the market value of Broadband Services' merchant investments and the monetization of a portion of Enron's broadband content delivery platform.").

[3] *See, e.g.,* John R. Emshwiller and Rebecca Smith, "Murky Waters: A Primer on the Enron Partnerships," *Wall St. J.,* Jan. 21, 2002, p. C1.

[4] Although technically the contribution is a realization event, section 721 makes a partner's contribution of property to a partnership in exchange for a partnership interest a nonrecognition event.

[5] John D. McKinnon and Greg Hitt, "How the Treasury Department Lost a Battle Against a Dubious Security," *Wall St. J.,* Feb. 4, 2002, p. A1. If the *Journal* calls it dubious, I shudder to think what Lee Sheppard will call it. *Cf.* Lee Sheppard, "IRS Attacks Enron MIPS," *Tax Notes,* June 1, 1998, p. 1089 ("The interest deferral on the MIPS, combined with the long maturity and deep subordination, add up to what the rating agencies think MIPS are: equity."). I note that Ms. Sheppard has been one of the few clear voices calling for closer scrutiny of financial intermediaries like Enron. *See, e.g.,* Lee Sheppard, "Gremlins in the Global Dealing Regulations," *Tax Notes,* Jan. 21, 2002, p. 270; Lee Sheppard, "ABA Tax Section: Financial Transactions Committee Considers Shelters, Straddles," *Tax Notes,* May 22, 2000, p. 1046.

[6] Enron repeated the transaction several times using very similar structures that use a trust instead of an LLC as the wrapper around the Enron debt. The Enron 2000 Annual Report refers to the interest payments to the MIPS vehicles as "Dividends on company-obligated preferred securities of subsidiaries." *Id.* at 31.

[7] At worst, 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. *But see, e.g.,* Herwig J. Schlunk, "The Zen of Corporate Capital Structure Neutrality," 99 *Mich. L. Rev.* 410 (2000) (describing problems with dividend-paid-deduction approach to integration). Among other things, the presence of foreign and tax- exempt investors on the interest/dividend-receiving end of the MIPS means that neither a corporate-level nor individual-level tax is paid.

[8] Glenn R. Simpson, "As Tax Haven, Enron Found a Dutch Treat," *Wall St. J.,* Feb. 7, 2002, p. A2 (describing Enron's use of Dutch subsidiaries as intermediaries for an investment in third countries to take advantage of Holland's favorable and extensive treaty agreements).

END OF FOOTNOTES