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Now it's goodbye, Mr. MIPS

A trust preferred issues ride into the sunset, 'real' preferred stocks return

By Robert N. Gordon

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In 2003, President George W. Bush substantially lowered the tax on dividends received by individual investors. That should have increased investor demand for preferred stock, but earlier tax policy — and Wall Street's creative solutions — dried up the pool of available preferred shares.

Here's the back story and the latest twist in the preferred saga.

In 1993, financial engineers at Goldman Sachs & Co. created monthly-Income preferred securities, which could be considered debt for tax purposes but treated as equity for capital purposes -- the very definition of the perfect security for corporations. Texaco issued the first MIPS.

Investors, however, likely were mislead by the name because MIPS pay interest, not dividends as might expected from a preferred stock. Payments are taxed at the maximum rate, not the favorable rate available to dividends from conventional preferred shares.

The issuance of MIPS and other trust preferreds, as the securities came to be known, really took off in late 1996 when the Federal Reserve ruled that the securities would constitute Tier 1 capital to bank holding companies. Between the ruling in mid-October and Dec. 31, 1996, some 40 banks issued $15 billion in trust preferreds.

In 1997, Enron Corp.'s vice president of finance was quoted as saying that he hoped its two recent MIPS issues would allow the company's rating "to be improved from BBB+ to A-." Enron alone issued $800 million in trust preferreds.

General Motors offered investors the opportunity to exchange their GM "real" preferreds for trust preferreds, as did United States Steel, McDonalds Corp., SunAmerica and RJR Nabisco. At least 29 companies issued trust preferreds specifically to redeem real preferreds.

By 2003, $211 billion of trust preferreds were outstanding, out of $250 billion in total preferred shares. And that total included real estate investment trust preferreds, whose dividends also which also don't enjoy the "real" dividend 15% rate. Today, there are only 100 issuers of old-fashioned preferred shares.

By way of background, preferred shares were invented by 19th-century financial engineers in Great Britain and were first issued to help complete that nation's canal system. In 1850, railroads became the first preferred issuers in the U.S. in response to government mandates that limited their borrowing capacity and because equity owners did not want more common stock issued that would cause dilution. Traditionally, preferred stocks stand below debt in the event of bankruptcy but are senior in payment to common stock.

DEDUCT BORROWING COSTS

Of course, companies do not get a deduction for payments of dividends on either common or preferred stock. A company that replaced preferred stock with trust preferred shares increased its borrowing cost a bit on a pre-tax basis but could deduct that cost, lowering the after-tax cost of the offering. At the same time, trust preferred shares are considered capital (at least for the moment).

For tax purposes, individual investors need to hold real preferred shares for a minimum of 61 days in order for the dividend to be “qualified” for the reduced tax rate. Individual investors who borrow to finance the purchase of preferreds are allowed to deduct any interest expense incurred to carry the preferreds. Interestingly, corporations cannot deduct interest used to carry dividend-paying stocks, which is similar to the prohibition on an investor’s ability to deduct interest incurred to carry tax-free muni bonds.

The leveraged purchase of a high-quality preferred stock paying a tax-favored stream of income financed by deductible-interest expense could offer an attractive after-tax return to individual investors.

The Dodd Frank legislation has effectively changed the landscape by phasing out the ability of companies to treat trust preferreds as good Tier 1 capital starting in 2013. These companies must find other ways to increase their regulatory capital base.

Huntington Bancshares Inc. recently offered to exchange its preferreds for real preferreds, reversing the process started in 1993. The money raised from these conventional preferred shares will constitute good capital under both Dodd Frank and Basel III. We hope this is the first of many exchange offers/refinancings. Ironically, the supply of preferreds might increase just when the Bush tax cuts expire and the tax on dividends skyrockets to 43.4% from 15%.

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