

**WRITTEN TESTIMONY OF THE STAFF OF THE
JOINT COMMITTEE ON TAXATION
ON THE REPORT OF INVESTIGATION OF
ENRON CORPORATION AND RELATED ENTITIES
REGARDING FEDERAL TAX AND COMPENSATION ISSUES,
AND POLICY RECOMMENDATIONS**

**Presented by
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**At a Hearing of the
SENATE COMMITTEE ON FINANCE
On February 13, 2003**



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INTRODUCTION

This document,¹ prepared by the staff of the Joint Committee on Taxation (“Joint Committee staff”), is the written testimony of Lindy L. Paull, Chief of Staff, Joint Committee on Taxation, at the hearing of the Senate Committee on Finance on February 13, 2003 relating to the Joint Committee on Taxation staff investigation relating to Enron Corporation and related entities. The testimony describes and summarizes the Joint Committee on Taxation staff's official report of the investigation (the "Report").² This investigation began in February 2002 at the request (by letter dated February 15, 2002) of Senator Max Baucus and Senator Charles E. Grassley of the Senate Committee on Finance.

¹ This document may be cited as follows: Joint Committee on Taxation, *Written Testimony of the Staff of the Joint Committee on Taxation on the Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCX-10-03), February, 13, 2003.

² Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003.

**WRITTEN TESTIMONY OF THE STAFF OF THE
JOINT COMMITTEE ON TAXATION
AT A HEARING OF
THE SENATE COMMITTEE ON FINANCE
ON FEBRUARY 13, 2003**

My name is Lindy L. Paull. As Chief of Staff of the Joint Committee on Taxation (“Joint Committee”), I am pleased to have the opportunity to appear before you today to transmit and summarize the Joint Committee staff’s official Report of its investigation of Enron Corporation and related entities (“Enron”).³

This Report, which was requested by Senator Max Baucus and Senator Charles E. Grassley, is the culmination of one year of extremely hard work of the Joint Committee staff. I would like to express my sincere appreciation for the herculean effort of our staff in conducting this investigation and writing the Report in a timely manner, while at the same time performing their normal legislative duties throughout the year. This was a massive project and I am grateful for the dedication of each member of the Joint Committee staff who worked on the investigation and the Report.

The Report consists of three volumes and is about 2,700 pages in length. Volume I (723 pages) contains the actual report of the investigation, which includes general observations, findings, and recommendations; a description of the methodology and scope of the investigation; a history of Enron; a detailed discussion of certain of Enron’s tax-motivated business transactions; and a detailed discussion of Enron’s pension plans and compensation arrangements.

Volumes II and III contain four Appendices to the Report, totaling 1,968 pages. The Appendices provide a variety of documents relating to the investigation, including detailed documentation relating to Enron’s tax-motivated transactions, copies of the tax opinion letters provided with respect to Enron’s tax-motivated transactions, and information relating to Enron’s pension plans and other compensation arrangements.

³ Except as otherwise indicated, all references to “Enron” refer to Enron Corporation and its affiliates, and all references to “Enron Corp.” refer specifically to the parent company.

I. GENERAL OVERVIEW OF THE INVESTIGATION

A. Scope and Methodology of the Investigation

This investigation was a rare opportunity to look inside of one of the ten largest corporations in the United States. Enron's size and broad range of businesses necessarily dictated that the topics to be reviewed would have to be selected carefully. As a result, the Joint Committee staff review focused on two principal areas: (1) Enron's use of tax shelter arrangements, off-shore entities, and special purpose entities, and (2) the compensation arrangements of Enron employees, including tax-qualified retirement plans, nonqualified deferred compensation arrangements, and other arrangements, in order to analyze the factors that may have contributed to the loss of benefits and the extent to which losses were experienced by different groups of employees.

Enron agreed to cooperate with the Joint Committee staff investigation.⁴ Enron complied with requests for information from the Joint Committee staff through the voluntary production of documents.

In conducting its investigation, the Joint Committee staff:

- Requested Enron's income tax returns since 1985;
- Reviewed more than 100 boxes of documents received from Enron in response to seven extensive document requests;
- Reviewed more than 40 boxes of documents from the Internal Revenue Service ("IRS") relating to Enron;
- Conducted 46 interviews of current and former Enron employees and other individuals with information relevant to the investigation;
- Made four trips to Houston, Texas, to review documents and conduct interviews;
- Reviewed publicly available information relating to Enron, including information made available by various Congressional committees, governmental agencies, the U.S. Bankruptcy Court for the Southern District of New York, and information contained in media reports; and
- Reviewed information provided by the Pension Benefit Guaranty Corporation, the Department of Labor, and the Senate Permanent Subcommittee on Investigations.

⁴ On March 6, 2002, a disclosure agreement was executed by representatives of Enron Corp., the Senate Finance Committee, and the Joint Committee staff. Under the terms of the disclosure agreement, Enron agreed to the disclosure of its tax returns and tax return information that would otherwise be confidential under the Federal tax laws. The Senate Finance Committee and Joint Committee staff agreed that any disclosure of information collected during the investigation would only be disclosed through official reports, meetings, or hearings of either Committee.

B. Summary of Income Tax Information and Tax-Motivated Structured Transactions

Enron is a Houston-based energy and commodities trading company currently under Federal bankruptcy reorganization protection. Prior to its bankruptcy, Enron conducted business through approximately 3,500 domestic and foreign subsidiaries and affiliates (though some of these entities were inactive), and operated in diverse markets and industries such as wholesale merchant and commodity market businesses, the management of retail customer energy services, the operation of gas transmission systems, and the management of energy-related assets and broadband services. Enron reported consolidated financial statement revenues of \$101 billion for 2000, and ranked seventh on the Fortune 500 list of the country's largest companies for 2001. As of December 31, 2000, Enron had approximately 59,000 shareholders of record with respect to its outstanding shares of common stock. At the time it filed for bankruptcy on December 2, 2001, Enron employed approximately 25,000 employees worldwide.

As of December 31, 2001, Enron's worldwide operations included roughly 250 foreign entities that were associated with ongoing businesses. Enron had a total of approximately 1,300 different foreign entities, including foreign corporations and partnerships that were controlled by Enron, as well as other entities in which Enron owned a significant stake. Approximately 80 percent of Enron's foreign entities were inactive shells that did not hold and were not engaged in or associated with any ongoing business.⁵

1. Summary of selected tax information

Federal income tax

Enron and certain of its subsidiaries and affiliates filed a consolidated Federal income tax return for each year from 1985 through 2001. Based on Enron's income tax returns without regard to audit adjustments, Enron paid approximately \$325 million in Federal income taxes for 1990 through 1995, paid no Federal income taxes for 1996 through 1999, and paid approximately \$63 million in Federal income tax for 2000 and 2001.

Table 1, below, lists Enron's Federal tax liability for its taxable years 1996 through 2001, as shown on Enron's Federal income tax returns.

⁵ Enron created many entities in jurisdictions that do not impose a tax on such entities. In particular, as of December 31, 2001, the Enron ownership structure included 441 entities formed in the Cayman Islands, a country that has never imposed a corporate income tax. Most of these entities were inactive shells not associated with any ongoing business and were largely irrelevant for tax purposes.

Table 1.—Enron’s Federal Tax Liability, 1996-2001
[millions of dollars]

Year	Regular Tax	Alternative Minimum Tax	Total Tax Per Return
1996	0	0	0
1997	0	0	0
1998	0	0	0
1999	0	0	0
2000	21.3	41.9	63.2
2001	0	0	0*
Totals	21.3	41.9	63.2

* Enron’s tax liability for taxable year 2001 as shown on its return was \$13,331.

The IRS uses a coordinated industry case program to coordinate the examination of large and highly diversified taxpayers. Enron has been in the coordinated industry case program since January 1989. The IRS has completed its examination of Enron’s tax returns through 1995 and is currently examining Enron’s 1996 through 2001 tax returns. The IRS adjustments to Enron’s taxable years 1988 through 1994 increased Enron’s taxable income by \$361 million, which, after taking into account net operating loss carryovers from earlier years, resulted in additional tax payments of \$4.3 million for 1988 through 1994.⁶ It is impossible to fully assess Enron’s ultimate tax liability until the IRS examination of Enron’s tax returns for 1996 through 2001 is completed and the bankruptcy court has reviewed the IRS proof of claim, which is expected to be filed by March 31, 2003.

Reconciliation of Enron’s financial statement net income and Federal taxable income

Enron reported financial statement net income of \$2.3 billion, but tax losses of \$3 billion, for 1996 through 1999. For year 2000, Enron reported financial statement net income of \$1.0 billion and taxable income of \$3.1 billion (before net operating loss carryovers from 1999).

Table 2, below, summarizes the significant adjustments from Enron’s Form 1120, Schedule M-1, Reconciliation of Financial Statement Income to Taxable Income, for years 1996 through 2000. These reconciliations use Enron’s financial statement and tax return information as reported or filed, without regard to restatements or audit adjustments. It should be noted that a complete analysis of Enron’s book to tax differences cannot be made prior to determination of Enron’s ultimate tax liability, which is under review by the bankruptcy court, and without a restatement of Enron’s financial statements for these periods to reflect generally accepted accounting principles.

⁶ Although the IRS examination of Enron’s Federal income tax return for 1995 is complete, the impact of any IRS adjustments for 1995 will not be known until the examination of 1996 through 2001 is complete.

Table 2.—Enron Corp. and Subsidiaries: Reconciliation of Financial Statement Income to Taxable Income 1996-2000
[millions of dollars]

	1996	1997	1998	1999	2000
Net Income Reported in Consolidated Financial Income Statement ¹	584	105	703	893	979
<u>Less Net Income from Entities not Included in Consolidated Tax Return</u>					
Domestic Corporations ²	-96	-189	-149	-152	-345
Foreign Corporations ³	-232	-44	-521	-1,110	-1,722
Partnerships ⁴	-145	-211	-319	-638	-6,899
	-473	-444	-989	-1,900	-8,966
<u>Plus Net Income from:</u>					
Intercompany Elimination Made for Books but not for Tax	1,322	1,300	1,884	3,997	13,625
Entities not Controlled for Financial Accounting Included for Tax ⁵	0	0	14	122	258
	1,322	1,300	1,898	4,119	13,883
 Book Income Reported on Consolidated Tax Return	 1,433	 961	 1,612	 3,112	 5,896
<u>Significant Book to Tax Adjustments⁶</u>					
Federal Income Taxes	159	-35	45	-128	193
Net Partnership Adjustments	-107	-122	-109	-338	-481
Net Mark to Market Adjustments	-118	118	-333	-906	-537
Constructive Sale (section 1259)	0	0	0	0	5,566
Structures Treated as Debt for Tax not for Book (e.g., equity or minority interest)	-2	-24	-3	-12	-149
Company Owned Life Insurance Adjustment	-19	-24	-27	-35	-20
Stock Options Deduction	-113	-9	-92	-382	-1,560
Depreciation Differences	-67	-65	-57	-124	-154
Equity Earnings Reversal Per Tax Return	-1,183	-1,023	-1,688	-2,868	-5,516
All Other Book to Tax Differences	-293	-281	-101	223	-137
 Taxable Income Reported on Consolidated Tax Return	 -310	 -504	 -753	 -1,458	 3,101

Notes:

(1) As originally reported. (2) Corporations not meeting 80 percent vote and value test (sec. 1504(a)(2)). The financial accounting to tax return reconciliation in Appendix A contains additional details of these amounts. (3) Foreign corporations are not eligible for inclusion in consolidated tax return (sec. 1504(b)(3)). (4) Partnerships are required to file separate Federal income tax returns. The financial accounting to tax return reconciliation in Appendix A contains additional details of these amounts. (5) Disregarded entities for Federal tax purposes (Treas. Reg. sec. 301.7701-3) not included in consolidated financial statements. The financial accounting to tax return reconciliation in Appendix A contains additional details of these amounts. (6) Amounts as reported in Enron presentation to the Joint Committee staff, June 7, 2002. Appendix B contains this presentation. In addition, Appendix A contains further details of Enron's book to tax adjustments as reported in the tax return.

2. Enron's development and use of tax-motivated structured transactions

In the mid-1990's, Enron's management began to view the role of its tax department as more than managing its Federal income tax liabilities. Rather, Enron's tax department became a source for financial statement earnings, thereby making it a profit center for the company. With an emphasis on short-term profitability and cash flow, Enron used various techniques to generate current financial statement net income, including tax planning by engaging in 12 large structured transactions during the period from 1995 until it filed for bankruptcy. At their core, Enron's structured transactions were designed to permit Enron to take the position that its long-term tax benefits could be converted to current or short-term financial statement net income. In most of the structured transactions discussed in the Report, the origin of the financial accounting benefits was the reduction in Federal income tax that the transaction was anticipated to provide either currently or in the future.

The Report tells the story of the development and implementation of each of the structured transactions. The transactions are classified into various categories: (1) structured transactions that raise corporate tax issues; (2) structured transactions that raise partnership tax issues; (3) other structured transactions which implicate international or certain financial products provisions; (4) corporate-owned and trust-owned life insurance arrangements; and (5) structured financings, including tiered preferred securities, investment unit securities, and commodity prepay transactions. Irrespective of the structure used, the structured transactions typically used one of two strategies to achieve their tax and financial statement benefits. Several of the structured transactions (i.e., Projects Tanya, Valor, Steele, and Cochise) were designed to duplicate losses (i.e., deduct the same loss twice) with respect to a single economic loss. The other dominant strategy (i.e., Projects Tomas, Condor, Teresa, Tammy I and Tammy II) was to shift tax basis from a nondepreciable asset to a depreciable asset with little or no economic outlay. Another transaction, Project Apache, was designed to generate tax deductions for what was, in essence, the repayment of principal on debt. In two transactions (Projects Renegade and Valhalla), Enron received a fee to serve as an accommodation party to another taxpayer who expected to derive tax or financial statement benefits from a structured transaction.

Most of the transactions relied on differences between the tax treatment and financial accounting treatment of various items so that the tax benefits could be used to generate financial statement income. For example, the transactions designed to duplicate losses (i.e., deduct the same tax loss twice) would be recorded on the financial statements as producing income (not loss). Similarly, the transactions designed to shift tax basis from a nondepreciable asset to a depreciable asset would be recorded on the financial statements as producing income.

Table 3, below, summarizes certain tax and accounting information regarding Enron's structured transactions. The table shows that the financial accounting benefits Enron expected to derive from the structured transactions were front loaded to provide immediate reporting of earnings for its financial statements, even though the bulk of the tax benefits would not be derived, if at all, until well into the future. The table lists the promoter of the transaction, the primary tax opinion provider, and project fees paid by Enron with respect to each transaction. The table tells a broader story as well -- from 1995 until Enron filed for bankruptcy, Enron achieved more than \$2 billion in tax and financial accounting benefits and paid approximately \$88 million in fees paid to advisors and promoters.

Table 3.—Benefits and Fees of Enron’s Various Structured Transactions (1995-2001)
[millions of dollars]

Project Name	Financial Accounting Income through 2001 ¹	Total Projected Financial Accounting Income ²	Federal Tax Savings through 2001 ³	Total Projected Federal Tax Savings ⁴	Promoter	Primary Tax Opinion Provider	Total Project Fees ⁶
Tanya (1995)	66	66	66	66	Arthur Andersen	Arthur Andersen	0.5
Valor (1996)	---	82	82	82	Arthur Andersen	Arthur Andersen	0.1
Steele (1997)	65	83	39	78	Bankers Trust	Akin, Gump, Strauss, Hauer & Feld	11
Teresa (1997)	226	257	(76)	263	Bankers Trust	King & Spalding	12
Cochise (1998)	101	143	---	141	Bankers Trust	McKee Nelson, Ernst & Young	16
Apache (1998)	51	167	51	167	Chase Manhattan	Shearman & Sterling	15
Tomas (1998)	37	113	95	109	Bankers Trust	Akin, Gump, Strauss, Hauer & Feld	14
Renegade (1998) ⁵	1	1	---	---	Bankers Trust	---	---
Condor (1999)	88	328	---	332	Deloitte & Touche	Vinson & Elkins	10
Valhalla (2000) ⁵	16	64	---	---	Deutsche Bank	Vinson & Elkins	---
Tammy I (2000)	---	406	---	414	Deloitte & Touche	Vinson & Elkins	9
Tammy II (2001)	---	369	---	370	---	---	---
Totals	651	2,079	257	2,022	N/A	N/A	87.6

Notes:

(1) Financial accounting income does not reflect the reversal of many of the reported income amounts due to Enron’s bankruptcy filing; (2) Source information for projected financial accounting income is the November Structured Transactions Group Summary of Project Earnings & Cash Flows, November 2001 contained in Appendix B to the Report, except Project Valor. Due to Enron’s bankruptcy filing, it is likely that many of the financial accounting benefits will not be realized; (3) Federal tax savings computed using a 35 percent tax rate. Because Enron had net operating losses for many of the years the benefits resulted in increased net operating losses rather than an immediate reduction in taxes; (4) Source information for projected Federal income tax savings is the November Structured Transactions Group Summary of Project Earnings & Cash Flows, November 2001 contained in Appendix B to the Report, except Project Valor; (5) Enron was an accommodation party to Bankers Trust and Deutsche Bank (the successor to Bankers Trust) in Projects Renegade and Valhalla, respectively. Enron was paid \$1.375 million for engaging in Project Renegade. Enron’s fee for participation in Project Valhalla was in the form of an interest-rate spread on the offsetting loans; and (6) Project fees are based on contractual agreements between Enron and the counterparty. Due to Enron’s bankruptcy filing, not all payments have been received by the counterparty to each agreement.

II. GENERAL OBSERVATIONS

Enron entered the 1990s as a rapidly growing company with an ambition to grow faster and larger and to change the nature of its business from an “old” economy energy company to a “new” economy firm with diverse interests and global reach. Enron’s desire to grow pushed Enron’s leaders to find ways to increase reported earnings and thereby drive up Enron’s stock price, which would fuel further growth. Ultimately, the reported picture of the company failed to comport with the underlying economic reality and Enron notoriously collapsed.

The Report’s detailed analysis of Enron’s structured transactions reveals a pattern of behavior showing that Enron deliberately and aggressively engaged in transactions that had little or no business purpose in order to obtain favorable tax and accounting treatment. For Enron’s leaders, financial statement income became paramount, and Enron announced to the world its target of \$1 billion in net income for year 2000.⁷ As Enron’s management realized that tax-motivated transactions could generate financial accounting benefits, Enron looked to its tax department to devise transactions that increased financial accounting income. In effect, the tax department was converted into an Enron business unit, complete with annual revenue targets. The tax department, in consultation with outside experts, then designed transactions to meet or approximate the technical requirements of tax provisions with the primary purpose of manufacturing financial statement income. The slogan “Show Me the Money!” exemplified this effort.⁸ However, a bona fide business purpose, that is, a purpose other than to secure favorable tax and accounting treatment, was either lacking or tenuous in many of the transactions and clearly was not the impetus for the transactions.⁹

Viewed in their entirety, Enron’s structured transactions not only pushed the concept of business purpose to the limit (and perhaps beyond) but also highlight several general issues about the nature of the tax system and a corporation’s attitude towards it. Enron’s behavior illustrates

⁷ According to Kenneth L. Lay: “Enron achieved its earnings and operational goals in 1996, the first year of our ENRON 2000 initiative to reach net income in excess of \$1 billion and achieve a minimum double digit growth in annual earnings per share.” Press Release, Enron Corp., Enron Reports 12 Percent Increase in 1996 Earnings Per Share, to \$2.31 Per Share (January 21, 1997), at <http://www.enron.com/corp/pressroom/releases/1997/12per.html> (last visited February 11, 2003). Enron’s reported net income in 2000 (before restatements) was \$979 million.

⁸ This is documented by Enron presentation materials titled “Show Me the Money! Project Steele Earning Benefits.” The expected pre-tax operating earnings from this transaction was approximately \$133 million. The Project Steele materials in Appendix B contain the document.

⁹ Nearly all of the reviewed transactions are vulnerable to attack under judicial or administrative anti-abuse and anti-avoidance doctrines. Many of the reviewed transactions shared common characteristics, such as claiming the same tax loss twice in order to generate a financial statement benefit, and the shifting of tax basis from a nondepreciable asset to a depreciable asset.

that a motivated corporation can manipulate highly technical provisions of the law to achieve significant unintended benefits. Remarkable in many respects was Enron's ability to parse the law to produce a result that was contrary to its spirit and not intended by Congress or the Treasury Department.

In transaction after transaction, Enron obtained sophisticated advice and in most instances received assurances that the proposed transaction "should" comply with technical tax law requirements. Often, these assurances were based on highly technical interpretations of the law even though the transaction produced surprising and questionable results. Many of the opinions hinged on a determination that the transaction had sufficient business purpose. Enron represented the business purpose of the transaction, and Enron's counsel did not bother to look beyond the representation. Troubling is the lack of responsibility or independent assessment that some advisors showed in evaluating Enron's stated business purpose.¹⁰ In one case, the advisors were involved in the promotion of the transaction and the creation of its ostensible "business purpose." It would not be surprising if this collusion also existed in other transactions.

For many transactions, Enron picked from the same small pool of outside advisors. In some cases, if one advisor from the pool was not advising Enron in a particular deal, that advisor advised the other party (the promoter) to the transaction. Thus did incestuous relationships evolve among the participants in many of the reviewed transactions, with the result that Enron even acted as an accommodation party to deals designed primarily by Enron's advisors to benefit others.

A critical component of many of Enron's structured transactions was the involvement of an accommodation party such as an Enron employee or the party promoting the transaction. Such parties were not related to Enron from an ownership standpoint, but their interests were aligned with Enron and they shared the same objectives as Enron for purposes of the transactions. The tax law generally assumes that unrelated parties to a transaction are independent and therefore will negotiate the terms of a deal consistent with their best (and selfish) interests. Typically, the tax law views parties as related by reference to entity ownership or family relationship. However, if nominally unrelated parties have the same interests and

¹⁰ The following statement by the managing partner of Enron's primary legal counsel, Vinson & Elkins, suggests that this minimal level of review perhaps was not unintentional.

With regard to the related party transactions, it is important to consider the role of legal counsel. If a transaction is not illegal and it has been approved by the appropriate levels of a corporation's management, lawyers, whether corporate counsel or with an outside firm, may appropriately provide the requisite legal advice and opinions about legal issues relevant to the transactions. In doing so, lawyers are not approving the business judgment of their clients. Likewise, lawyers are not responsible for the accounting treatment of the transactions.

Statement of Joseph C. Dilg, managing partner at Vinson & Elkins, in testimony before the House Committee on Energy and Commerce (March 14, 2002), available at <http://energycommerce.house.gov/107/hearings/03142002Hearing511/hearing.htm>.

objectives, the paradigm breaks down. Enron's activities show that, in general, when transactions can be structured by parties that have the shared goal of obtaining favorable tax treatment, the tax rules do not function as intended and may produce undesirable results.

In addition, rules that ordinarily produce sensible results generated a tax benefit for Enron because of the way Enron utilized its own stock in many transactions. Just as the tax law generally assumes that the interests of unrelated parties to a transaction will be adverse, the tax law also generally assumes that a corporation uses its stock as a source of capital. Enron, however, repeatedly used its stock in a way that yielded a financial statement benefit from a permanent tax savings.

Paradoxically, the legislative and regulatory systems permitted Enron to enter into transactions that policymakers either had prohibited by law or questioned by regulation. Congress abolished the tax advantages of certain types of transactions, but nevertheless permitted corporations such as Enron to take advantage of transitional rules to engage in the transactions despite the imminent change to the law. Enron also was free to ignore proposed Treasury Regulations (some of which were longstanding) that, if finalized by the Treasury, would have stripped Enron of some of its tax positions.

Enron also excelled at making complexity an ally. Many transactions used exceedingly complicated structures and were designed to provide tax benefits significantly into the future. For any person attempting to review the transaction, there would be no easy way to understand its terms or purpose. Rather, a reviewer would be required to parse details from a series of deal documents, make assumptions about the parties' intent in future years, and only then apply technical rules to the transaction to test for legitimacy. In short, Enron had the incentive and the ability to engage in unusually complicated transactions in order to preclude meaningful review.

Corporations like Enron have an inherent advantage over the IRS. Enron structured its deals with the advice of sophisticated and experienced lawyers, investment bankers, and accountants. Assertions of attorney-client privilege hinders the ability of the IRS to obtain many of the most instructive documents, which impedes the IRS's ability to audit the transaction. Some of the transactions resulted in the payment of some income tax in the early years, with significantly larger deductions to follow in later years. This pattern makes it less likely that the IRS will identify and challenge the transaction. Further, Enron's recent position as a company with significant net operating losses worked to its advantage in IRS examination. A company with significant losses generally is of less immediate concern to the IRS because the losses will offset any increased taxable income arising from the audit. Thus, the IRS has less incentive to investigate and devote resources to such examinations. Enron's activities show that the IRS cannot minimize the importance of loss companies on examination because to do so would ignore a breeding ground for tax-motivated transactions that also could be used by taxpaying companies.

Enron's aggressive interpretation of business purpose, the cooperation of accommodation parties, the protections provided by tax opinions, the complex design of transactions -- all were factors that encouraged Enron to engage in tax-motivated transactions. Thus, Enron places the spotlight once again on the general ineffectiveness of present law in regulating tax shelters. Tax shelters are in many ways a product of the ambiguity of complex provisions of law, lack of

administrative guidance, or inconsistent interpretations of the law by courts. Tax shelters often involve the juxtaposition of unrelated, incongruous Code provisions in a single transaction or a series of connected transactions. Taxpayers use the complexities of the system to their advantage and perform a clinical assessment of the risks and benefits of an action, often concluding that the low risk of effective enforcement (including the low risk of penalties) easily is outweighed by the promised benefits.¹¹ Until the costs of participating in tax-motivated transactions are substantially increased, corporations such as Enron will continue to engage in transactions that violate the letter or the spirit of the law.

¹¹ For detailed information of the present law rules and judicial doctrines applicable to tax-motivated transactions and related recommendations and developments, *see e.g.*, Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters* (JCX-19-02), March 19, 2002; Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including provisions relating to Corporate Tax Shelters)* (JCS-3-99), July 22, 1999; Temporary Treasury regulations (T.D. 9017) to section 6011 (October 22, 2002); Temporary Treasury regulations (T.D. 9018) to section 6012 (October 22, 2002); Joint Committee on Taxation, *Description of the "CARE Act of 2003,"* (JCX-04-03), February 3, 2003; Symposium: *Business Purpose, Economic Substance and Corporate Tax Shelters*, 54 SMU L. Rev. 1 (2001).

III. GENERAL FINDINGS AND RECOMMENDATIONS RELATING TO BUSINESS TAX MATTERS

A. General Findings Relating to Business Tax Matters

The Joint Committee staff believes that the transactions that are the subject of the Report demonstrate the need for strong anti-avoidance rules to combat transactions that might satisfy the technical requirements of the tax statutes and administrative rules, but that are conducted for little or no purpose other than to generate income tax or financial statement benefits. Accordingly, the Joint Committee staff makes the following findings and recommendations.

1. Cost-benefit analysis with respect to tax motivated transactions

The Joint Committee staff believes that stronger measures are necessary to discourage transactions that lack a non-tax business purpose or economic substance. Such measures, however designed, must significantly increase the economic risk to taxpayers of entering into tax-motivated transactions. Under the present system, the expected tax benefits from these transactions typically far outweigh the associated costs. Taxpayers will continue to engage in tax-motivated transactions unless and until there is a meaningful change in this cost-benefit analysis. At a minimum, taxpayers that engage in tax-motivated transactions should be subject to substantial penalties.

2. Business purpose

The Joint Committee staff believes that attainment of financial statement benefits based solely on Federal income tax savings is not a valid business purpose for purposes of evaluating a transaction or arrangement under Federal income tax laws.

3. Accommodation parties

The tax laws should not permit the use of accommodation parties such as employees, consultants, or advisors, to serve as a party in a transaction or arrangement to permit a taxpayer to achieve Federal income tax benefits. The Joint Committee staff recommends that severe penalties be imposed on the accommodation party and on the taxpayer who engages the accommodation party.

4. Tax advisors

The Joint Committee staff is concerned about the willingness of tax advisors to render opinions that rely on factual representations that the advisor knows, or has reason to believe, are incorrect, incomplete, or inconsistent with the facts. Many tax-motivated transactions cannot occur without the complicity of a tax advisor who is aware of all the relevant facts, yet chooses to ignore them and instead relies on the taxpayer's purported factual representations. The Treasury Department and IRS should have a broad array of sanctions to impose on advisors who render such opinions, and they should impose stiff sanctions on these advisors (and when appropriate, on the advisor's employer or partners). In addition, the relevant State licensing

authority should be notified when these sanctions are imposed, and the licensing authority also should discipline the advisor as appropriate.

5. Generally accepted accounting principles relating to accounting for Federal income taxes

The Joint Committee staff is concerned that businesses are engaging in tax-motivated transactions primarily to obtain financial accounting benefits. The accounting benefits result solely from the manipulation of the Federal income tax laws to create permanent book-tax differences. The Joint Committee staff further believes that this activity may be occurring because of certain aspects of the financial accounting rules governing accounting for income tax expense. Thus, the Joint Committee staff recommends that those responsible for promulgating the accounting standards evaluate whether changes are warranted to the rules governing accounting for income taxes.

6. Disclosure of tax-motivated transactions

The Joint Committee staff is concerned that the use of multiple entities in connection with tax-motivated transactions, coupled with the inherent complexity of these transactions and the delayed timing of the tax benefits, makes it exceedingly difficult for the Treasury Department and the IRS to timely identify and properly evaluate these transactions. The Joint Committee staff believes that taxpayers should be required to make a detailed disclosure of any tax-motivated transaction on a timely basis, irrespective of whether the transaction has immediate tax return effect.

7. Continued use of certain structured transactions

The Joint Committee staff is concerned that the publication of the Report may encourage taxpayers and promoters to engage in transactions similar to those described in the Report. The Joint Committee staff recommends that the Congress and Treasury Department take appropriate action as soon as practicable.

B. Recommendations Relating to Corporate Tax Issues

1. Curtail duplication of losses

General rule preventing duplication of losses¹²

A single economic loss should not be deducted more than once. The Joint Committee staff recommends limiting a corporation's basis in property acquired in a tax-free transfer (or reorganization) to its fair market value. Alternatively, the Joint Committee staff recommends expanding the sec. 358(h) basis reduction rule.

Specific rule preventing duplication of losses relating to real estate mortgage investment conduit residual interests¹³

Under the statutory rules regarding the taxation of a real estate mortgage investment conduit ("REMIC"), generally phantom income is allocated to REMIC residual interest holders. The phantom income allocation inevitably creates built-in losses to the holders of the REMIC residual interests, thus making such interests a natural component for transactions designed to duplicate a single economic loss. As such, the Joint Committee staff recommends that either a corporation's basis in REMIC residual interests acquired in a tax-free transfer (or reorganization) be limited to its fair market value or that a transferor's basis in the stock received in exchange for REMIC residual interests be limited to the fair market value of the REMIC residual interests.

2. Strengthen rules preventing acquisitions made to evade or avoid Federal income tax¹⁴

Section 269 disallows certain tax benefits if a taxpayer acquires direct or indirect control of a corporation for the principal purpose of Federal income tax evasion or avoidance. The Joint Committee staff recommends expanding section 269 to apply to acquisitions of equity interests in a corporation, without regard to whether such interests provide to the acquirer control of the corporation, if the principal purpose of the acquisition is the evasion or avoidance of Federal income tax.

The Joint Committee staff also recommends expanding section 269 to disallow tax benefits that can be obtained through either controlling or non-controlling interests in a corporation, if the principal purpose of the transaction in which the benefits are acquired is the evasion or avoidance of Federal income tax.

¹² Further discussion of this recommendation is provided in the descriptions of the transactions known as Project Tanya and Project Valor in Part Three of the Report.

¹³ Further discussion of this recommendation is provided in the descriptions of the transactions known as Project Steele and Project Cochise in Part Three of the Report.

¹⁴ Further discussion of this recommendation is provided in the description of the transaction known as Project Cochise in Part Three of the Report.

3. Strengthen the extraordinary dividend rules¹⁵

The extraordinary dividend rules were amended in 1997 to prevent a corporate shareholder from structuring a redemption transaction with a related party to take advantage of the dividends received deduction. The Joint Committee staff recommends that the extraordinary dividend rules should be further strengthened.

4. Provide guidance on the replication of earnings and profits in a consolidated group¹⁶

A distribution is treated as a dividend to the extent of a corporation's earnings and profits. The Joint Committee staff believes that guidance is needed to address situations in which a consolidated group attempts to create or replicate earnings and profits in a manner inconsistent with the purpose of the consolidated return rules.

¹⁵ Further discussion of this recommendation is provided in the description of the transaction known as Project Teresa in Part Three of the Report.

¹⁶ Further discussion of this recommendation is provided in the description of the transaction known as Project Teresa in Part Three of the Report.

C. Recommendations Relating to Partnership Tax Issues

1. Strengthen disclosure of disguised sales¹⁷

The Joint Committee staff recommends that the period for which disclosure is required under the disguised sale regulations should be extended beyond two years, and a more detailed disclosure of the source of permanent book-tax differences should be required. For example, extending the disclosure requirement to seven years, the period applicable to contributions and distributions under the pre-contribution gain rules, could make a facts and circumstances determination by the IRS both more likely to occur and easier for the IRS to administer.

2. Strengthen partnership allocation rules¹⁸

Partnership allocations between members of the same affiliated group (and, in general, related parties) may not have the same economic consequences as allocations between unrelated partners. As a result, related partners can use the partnership allocation rules inappropriately to shift basis among assets. The Joint Committee staff recommends strengthening of the anti-abuse rules relating to partnership allocations for property contributed to a partnership, especially in the case of partners that are members of the same consolidated group, to ensure that the allocation rules are not used to generate unwarranted tax benefits.

3. Provide guidance regarding transfers of partial partnership interests¹⁹

The transfer of partial partnership interests among related partners can result in inappropriate basis shifts among the partners. The Joint Committee staff believes that guidance is needed regarding the apportionment of tax basis upon the transfer of a partial partnership interest (particularly when the transfer involves related parties).

4. Provide rules for the appropriate interaction between partnership rules and corporate stock nonrecognition rules²⁰

The interaction of the partnership basis adjustment rules and the rules protecting a corporation from recognizing gain on its stock can give rise to unintended tax results. Transactions based on this interaction generally purport to increase the tax basis of depreciable assets and to decrease, by a corresponding amount, the tax basis of the stock of a partner.

¹⁷ Further discussion of this recommendation is provided in the description of the transaction known as Project Tomas in Part Three of the Report.

¹⁸ Further discussion of this recommendation is provided in the description of the transaction known as Project Condor in Part Three of the Report.

¹⁹ Further discussion of this recommendation is provided in the description of the transaction known as Projects Tammy I and Tammy II in Part Three of the Report.

²⁰ Further discussion of this recommendation is provided in the description of the transaction known as Project Condor in Part Three of the Report.

Because the tax rules protect a corporation from gain on the sale of its stock (including through a partnership), the transactions enable taxpayers to duplicate tax deductions at no economic cost. The Joint Committee staff recommends that either (1) the rules protecting a corporation from recognizing gain on its stock should be modified to limit the nonrecognition of any gain if the gain is attributable to a decrease in the tax basis of the stock resulting from the partnership basis adjustment rules, or (2) that the partnership basis adjustment rules should be altered to preclude an increase in the basis of an asset to the extent the offsetting basis reduction would be to stock of a partner (or related party).

In addition, the Joint Committee staff believes that the proposed regulations under section 337, relating to partnership acquisitions of stock of a corporate partner, would preclude taxpayers from engaging in these types of transactions. The Joint Committee staff recommends that final regulations on this subject should be issued expeditiously.

D. Recommendations Relating to International Tax Issues

1. Modify the rules for allocating subpart F income²¹

Treasury regulations contain highly mechanical rules for allocating the earnings and profits of a controlled foreign corporation for subpart F purposes. Special allocation abuses similar to those that have been encountered in the partnership taxation area also are possible in the context of controlled foreign corporations under these rules. In particular, a company may attempt to specially allocate subpart F income to tax-indifferent parties. The Joint Committee staff believes that this tactic is inconsistent with the purposes of subpart F and that the results that it purports to produce are inappropriate. The Joint Committee staff recommends adding an exception to the mechanical allocation method set forth in the regulations for cases involving allocations of earnings and profits to tax-indifferent shareholders made for tax-avoidance purposes.

2. Modify the interaction between the subpart F rules and the passive foreign investment company rules²²

In 1997, Congress enacted rules to mitigate the complexity and uncertainty that arose when a foreign corporation met the definitions of both the controlled foreign corporation rules of subpart F and the passive foreign investment company rules, thus requiring shareholders to negotiate two sets of anti-deferral rules in connection with the same investment. The 1997 legislation largely eliminated this overlap by providing that a controlled foreign corporation generally is not treated as a passive foreign investment company with respect to a “U.S. shareholder” of such controlled foreign corporation within the meaning of subpart F. Because this exception from the passive foreign investment company rules is based on a person’s status as a U.S. shareholder, as opposed to the person’s likely taxability under subpart F, situations may arise in which a U.S. shareholder of a controlled foreign corporation with mainly passive assets and passive income can take the position that no tax liability arises under either subpart F or the passive foreign investment company rules.

The Joint Committee staff believes that the exception to the passive foreign investment company rules for U.S. shareholders of controlled foreign corporations should be geared more closely to the U.S. shareholder’s potential taxability under subpart F, as opposed to mere status as a U.S. shareholder within the meaning of subpart F. Accordingly, the Joint Committee staff recommends adding an exception to the 1997 overlap-elimination rule for cases in which the likelihood that a U.S. shareholder would have to include income under subpart F is remote.

²¹ Further discussion of this recommendation is provided in the description of the transaction known as Project Apache in Part Three of the Report.

²² Further discussion of this recommendation is provided in the description of the transaction known as Project Apache in Part Three of the Report.

3. Strengthen the earnings stripping rules²³

The lack of final regulations under the earnings stripping tax rules has created a void in an area in which more definitive guidance is needed. Proposed regulations provide that entities or arrangements established with a principal purpose of avoiding the earnings stripping rules should be recharacterized or disregarded. The Joint Committee staff believes that this proposed anti-abuse rule would change a company's cost-benefit assessment of certain tax-motivated transactions, and thus recommends that the rule be finalized expeditiously.

4. Require annual information reporting with respect to disregarded entities²⁴

Present law requires no ongoing information reporting with respect to entities that are disregarded pursuant to a "check the box" entity classification election. Although the IRS is alerted of the existence and classification of each entity at the time the election is made, there is no regime of ongoing information reporting with respect to these entities. On the one hand, this lack of separate information reporting may be appropriate, given that the entities are supposed to be "disregarded" for Federal tax purposes pursuant to the election. Nevertheless, it is widely recognized that the application of the "check the box" regulations in the international setting raises a number of issues that the IRS is addressing through guidance and on audit.

The Joint Committee staff believes that a regime of annual information reporting with respect to entities disregarded pursuant to a "check the box" election would significantly enhance the IRS's ability to administer the international tax rules and to identify and address specific issues that arise in applying the "check the box" regulations in the international area.

²³ Further discussion of this recommendation is provided in the description of the transaction known as Project Apache in Part Three of the Report.

²⁴ Further discussion of this recommendation is provided in the description of Enron's use of foreign entities in Part Three of the Report.

E. Recommendation Relating to Financial Asset Securitization Investment Trusts²⁵

1. Repeal financial asset securitization investment trust rules

Recent commentary suggests that the financial asset securitization investment trust (“FASIT”) rules, which were first enacted in 1996, are not widely used in the manner envisioned by the Congress and thus have failed to further their intended purposes. The Joint Committee staff believes that the abuse potential inherent in the FASIT vehicle far outweighs any beneficial purpose that the FASIT rules may serve, and thus recommends that these rules be repealed.

²⁵ Further discussion of this recommendation is provided in the description of the transaction known as Project Apache in Part Three of the Report.

F. Recommendation Relating to Corporate-Owned and Trust-Owned Life Insurance²⁶

1. Repeal grandfather rules for pre-June 20, 1986 contracts

In light of the growth in interest incurred on debt under life insurance contracts that remains deductible due to a grandfather rule applicable to pre-June 20, 1986, corporate-owned and trust-owned life insurance contracts, the Joint Committee staff recommends termination of the grandfather rule for such contracts.

²⁶ Further discussion of this recommendation is provided in the description of Enron's corporate-owned and trust-owned life insurance contracts in Part Three of the Report.

G. Recommendations Relating to Structured Financing Transactions²⁷

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.

²⁷ Further discussion of these recommendations is provided in the description of Enron's structured financing transactions in Part Three of the Report.

IV. PENSION AND COMPENSATION ARRANGEMENTS

A. Overview of Pension and Compensation Arrangements

1. Overview

Enron's compensation arrangements received considerable media attention in the aftermath of the Enron bankruptcy. Some of this attention has focused on the broad-based retirement plans maintained by Enron that receive special tax benefits ("qualified retirement plans"). For many Enron employees, the benefits provided under these plans were the primary source of retirement income. Attention has also focused on the overall compensation arrangements of Enron, particularly the compensation provided to executives. The Report addresses both aspects of Enron's compensation arrangements.

2. Enron's qualified retirement plans

Overview of Enron qualified plans

Enron maintained three main qualified retirement plans: the Enron Employee Stock Ownership Plan ("ESOP"); the Enron Retirement Plan, which was modified and renamed the Enron Cash Balance Plan; and the Enron Savings Plan.

The Enron ESOP was invested primarily in Enron stock.

The Enron Retirement Plan provided a benefit based on a participant's compensation and years of service. The Enron ESOP and Enron Retirement Plan were designed as a floor-offset arrangement, under which benefits earned by a participant under the Enron Retirement Plan were reduced or "offset" by the benefits received by the participant under the Enron ESOP.

The floor-offset arrangement was frozen after 1994 and was phased out over the period 1996 through 2000. During that period, the value of the account balance in the ESOP was locked in, and an offset for benefits accrued under the Enron Retirement Plan during 1987 through 1994 was set permanently based on Enron stock prices at specified times. As a result of the locking in of the offset and the subsequent decline in the value of Enron stock, many plan participants did not receive the same level of benefits they would have received if the offset feature had remained unchanged. The locking in of the offset is currently under review by the IRS.

In 1996, the Enron Retirement Plan was renamed the Enron Cash Balance Plan and the traditional defined benefit plan formula was replaced with a cash balance formula. The Enron Cash Balance Plan has been under review by the IRS National Office since 2000, pursuant to a 1999 directive that all cash balance plan conversions be referred to the IRS National Office pending clarification of applicable rules.

The Enron Savings Plan is a 401(k) plan. Participants could make elective deferrals and after-tax contributions to the Enron Savings Plan, and had a range of investment choices available for their contributions, including Enron stock. In addition, Enron made matching

contributions based on employee elective deferrals. The matching contributions were invested in Enron stock pursuant to the plan terms; participants could elect to invest the matching contributions in another investment after attaining age 50.

Many Enron Savings Plan participants lost considerable amounts of retirement savings due to the high level of investment in Enron stock. Significant amounts of plan assets were invested in Enron stock even though the Enron Savings Plan offered approximately 20 investment options other than Enron stock, consisting of a broad range of alternatives offering various risk and return characteristics.

Employee investment in Enron stock was generally encouraged by Enron. Even as the price of Enron stock declined during 2001, management told employees of a bright future for Enron. For example, Kenneth L. Lay was consistently optimistic in his predictions for the future of Enron stock, even when an employee specifically asked about Enron stock in the context of the Enron Savings Plan.

The decline of Enron's stock price and Enron's subsequent bankruptcy has affected the benefits that Enron employees are or may be entitled to under the Enron qualified plans. Most of the media attention regarding the effect of the bankruptcy on employees' benefits related to the significant plan holdings in Enron stock, particularly in the Enron ESOP and the Enron Savings Plan.

Issues reviewed with respect to Enron qualified plans

The Joint Committee staff reviewed in detail certain issues relating to the Enron qualified plans, including: (1) the locking in of the value of the ESOP offset under the Enron Retirement Plan; (2) the conversion of the Enron Retirement Plan into the Enron Cash Balance Plan; (3) investment of the Enron ESOP in Enron stock; (4) a change in recordkeepers under the Enron Savings Plan that resulted in a "blackout" period in October and November 2001 during which plan participants could not make investment changes while the price of Enron stock was falling; (5) the reasons behind the level of investment of Enron Savings Plan assets in Enron stock; and (6) allegations made in early 2002 by Ms. Robin Hosea, a former Enron contract and full-time employee, that payments were made from Enron's employee benefit funds for purposes unrelated to employee benefits.

3. Other compensation arrangements

In general

In addition to the attention given to the Enron qualified retirement plan issues, attention has been focused on the various compensation arrangements of Enron, particularly those of officers and other executives. This focus has been both on the magnitude of compensation paid to certain executives and on the various forms of compensation used by Enron.

Enron had a pay-for-performance compensation philosophy. Employees who performed well were compensated well. Enron's compensation costs for all employees, and especially for executives, increased significantly over the years immediately preceding the bankruptcy.

Executives of Enron were extremely highly compensated. Table 4, below, shows information compiled by the IRS, which is based on information provided by Enron, on compensation of the top-200 highly compensated employees for 1998 through 2000. Compensation for the top-200 increased over recent years, particularly in the area of stock options.

Table 4.—Compensation Paid to the Top-Paid 200 Employees for 1998-2000²⁸

Year	Bonus	Stock Options	Restricted Stock	Wages	Total
1998	\$41,193,000	\$61,978,000	\$23,966,000	\$66,143,000	\$193,281,000
1999	\$51,195,000	\$244,579,000	\$21,943,000	\$84,145,000	\$401,863,000
2000	\$56,606,000	\$1,063,537,000	\$131,701,000	\$172,597,000	\$1,424,442,000

Overview of Enron’s executive compensation arrangements

Executive compensation at Enron was generally comprised of base salary, annual incentives, and long-term incentives. Enron’s long-term incentive program was designed to tie executive performance directly to the creation of shareholder wealth. The long-term incentive program provided for awards of nonqualified stock options and restricted stock. Certain executives were eligible to participate in nonqualified deferred compensation arrangements. Enron also had special compensation arrangements for certain individuals.

Nonqualified deferred compensation plans

Certain executives were given the opportunity to participate in nonqualified deferred compensation arrangements. Participants were eligible to defer all or a portion of salary, bonus, and long-term compensation into Enron-sponsored deferral plans. The plans provided an opportunity to delay payment of Federal and State income taxes and earn a tax-deferred return on deferrals. Many executives took advantage of the opportunity to defer amounts that would otherwise have been included in income currently.

Nonqualified deferred compensation was a major component of executive compensation for Enron. Documents provided by Enron show the approximate amounts deferred under all deferred compensation plans for the top-paid 200 employees for the years 1998-2001. Amounts deferred in these years are shown in the following table.

²⁸ The information provided by the IRS includes some inconsistencies. In reproducing the summary data, the Joint Committee staff attempted to reconcile inconsistencies and included the data that appears to be accurate. Amounts are approximates.

Table 5.—Amounts Deferred by Top-Paid 200 Employees 1998-2001

Year	Amounts Deferred Under All Deferred Compensation Plans for the Top-200 (millions of dollars)
1998	\$13.3
1999	19.7
2000	67.0 ²⁹
2001	54.4

In late 2001, prior to Enron's bankruptcy filing, early distributions were made to certain participants from two of Enron's nonqualified deferred compensation plans. These distributions totaled more than \$53 million.

Stock-based compensation

Enron used stock-based compensation as a principal form of compensation for executives. Enron's stock-based compensation programs included nonqualified stock options, restricted stock, and phantom stock. The amount of income attributable to stock options and restricted stock is shown in Table 4, above. Enron's deduction for compensation attributable to the exercise of nonqualified stock options increased by more than 1,000 percent from 1998 to 2000. Enron's directors were also compensated partially in Enron stock.

Pre-bankruptcy bonuses

In the weeks immediately preceding the bankruptcy, Enron implemented bonus programs: one for approximately 60 key traders and one for approximately 500 employees that Enron claimed were critical for maintaining and operating Enron going forward. In order to receive a bonus under one of these programs, the employee had to agree to repay the bonus, plus an additional 25 percent, if the employee did not remain with Enron for 90 days. The combined cost of the programs was approximately \$105 million.

Special compensation arrangements

Enron had certain compensation arrangements for limited groups of people or for specific individuals. For example, Enron had a Project Participation Plan for employees in its international business unit.

Enron also had arrangements for a small number of employees or in some cases just one employee. One executive, Mr. Lou Pai, received the use of a 1/8 fractional interest in a jet aircraft Hawker 800 as part of his compensation. A few employees received loans (or lines of credit) from Enron or split-dollar life insurance arrangements. Enron purchased two annuities from Mr. Lay and his wife as part of a compensation package for 2001. Certain executives were

²⁹ According to the documents provided by Enron, in 2000, Mr. Lay deferred \$32 million under the 1994 Deferral Plan in 2000.

allowed to exchange interests in plans for large cash payments or stock options and restricted stock grants.

Employee loans

From time to time, Enron extended loans to a few executives. Information provided to the Joint Committee staff indicates that loans were made to at least eight Enron employees, including Mr. Lay and Mr. Jeffrey Skilling. Mr. Lay was provided with a \$7.5 million line of credit with the company. The aggregate amount withdrawn pursuant to his line of credit from 1997 through 2001 was over \$106 million. In 2001 alone, Mr. Lay engaged in a series of 25 transactions involving withdrawals under the line of credit totaling \$77.5 million, of which all but \$7.5 million was repaid. Mr. Skilling was loaned \$4 million by Enron in 1997. Half of the loan was repaid in 1999 and the other half in 2001.

Purchase and reconveyance of Mr. Lay's annuity contracts

In September of 2001, the Compensation Committee of the Enron Board of Directors agreed to an "insurance swap transaction" under which Enron agreed to purchase two annuity contracts from Mr. and Mrs. Lay for \$10 million and also agreed to reconvey the annuity contracts back to Mr. Lay if he remained employed with Enron through December 31, 2005. If Mr. Lay left Enron prior to that date, the reconveyance would still take place in four events: (1) retirement with the consent of the Board; (2) disability; (3) involuntary termination (other than termination for cause); or (4) termination for "good reason." Mr. Lay's counsel indicated in a letter to the Joint Committee staff that they could not give a legal opinion about the current status of the annuity contracts and indicated their understanding that the characterization of Mr. Lay's termination with Enron for purposes of severance benefits was still under review.

Split-dollar life insurance arrangements

Enron entered into split-dollar life insurance arrangements with Mr. Lay (\$30 million and \$11.9 million), Mr. Skilling (\$8 million), and Mr. Clifford Baxter (\$5 million).

B. General Observations With Respect to Pensions and Compensation

Enron's stated philosophy was a pay for performance approach to compensation; those who performed well were paid well. Enron implemented this approach with a broad array of compensation arrangements for its executives that included base pay, bonuses, and long-term incentive payments. In 2000, total compensation for the 200 highest paid employees of Enron was \$1.4 billion dollars (\$1.2 billion of which was attributable to stock options and restricted stock). In the same year, Enron reported \$975 million of financial statement net earnings.

Enron's approval of compensation packages for its executives rested almost entirely with internal management. Although the Compensation Committee of the Board of Directors formally approved both the total amount of compensation paid to executives and the form of such compensation, the Compensation Committee's approval generally was a rubber stamp of recommendations made by Enron's management. Missing was an objective assessment of the value added by top executives; compensation was typically deemed to be justified if it appeared to be consistent with what other companies paid executives. Targets for compensation were sometimes set, but in practice the total amount paid frequently exceeded the targets. The Compensation Committee went through the motions of satisfying its role as objective evaluator of reasonable pay by commissioning "independent" studies with respect to Enron's compensation arrangements; in some cases, the studies appeared to be designed to justify whatever compensation arrangement management wanted to adopt.

The lack of scrutiny of compensation was particularly prevalent with respect to Enron's top executives, who essentially wrote their own compensation packages. In some cases, although going through the formalities of reviewing arrangements, the Compensation Committee merely rubber stamped what was presented. In other cases, the Compensation Committee either never reviewed certain arrangements for executives, or performed such a cursory review that they were not fully aware of what they were approving. For example, a former chairman of the Compensation Committee could not remember an arrangement under which an Enron executive was awarded a fractional interest in an airplane as a form of compensation.

There was no indication that Enron's Compensation Committee ever rejected a special executive compensation arrangement brought to them. Indeed, the Compensation Committee used studies, sometimes commissioned after the fact, to justify the compensation arrangements for top executives. As a result, Enron's top executives earned enormous amounts of money and even used the company as an unsecured lender. For example, from 1997 through 2001, Mr. Lay borrowed over \$106 million from Enron through a special unsecured line of credit with the company.

Enron did not appear to maintain consistent or centralized recordkeeping with respect to compensation arrangements in general and executive compensation in particular. Enron could not provide documentation relating to many of Enron's special compensation arrangements for its top executives. When asked about compensation arrangements in interviews, current and former Enron employees with responsibility for such matters had no knowledge of certain aspects of executives' compensation, particularly in the case of special arrangements. Although Enron represented that it properly reported income with respect to employee compensation arrangements, the lack of recordkeeping made it impossible to verify whether this was true.

Enron's heavy reliance on stock-based compensation, both with respect to executives and with respect to rank and file employees, caused significant financial loss when Enron's stock price collapsed. As part of a philosophy that a large portion of executive compensation should depend on shareholder return, Enron rewarded executives with huge amounts of stock options, restricted stock, and bonuses tied to financial earnings. In addition, a strong company culture encouraging stock ownership by all employees led to high investments in Enron stock by employees through the Enron Corp. Savings Plan (the "401(k)" plan). In the end, when Enron's stock price plummeted, Enron's employees and executives lost millions of dollars in retirement benefits under Enron's qualified plans and nonqualified deferred compensation arrangements and through the loss of value of stock that had been received as compensation for services. Although some executives suffered losses that appear stunning in amount, many executives also reaped substantial gains from their compensation arrangements. Enron's rank and file employees in many cases lost virtually all of their retirement savings because they believed statements made by Enron's top executives up to the very end that Enron was viable and that Enron's stock price would turn around.

C. Findings and Recommendations Relating to Pension and Compensation Arrangements

1. Cash balance plans

In converting the Enron Retirement Plan into a cash balance plan, Enron did not adopt many of the plan features that gained media attention in the 1990s when several large plans were converted to cash balance plans. Enron did not adopt a “wearaway” and took steps to protect the expectation interests of plan participants close to retirement under the old plan formula. The review of the plan has been pending in the IRS National Office for almost three years pursuant to a 1999 IRS moratorium on the issuance of determination letters for cash balance conversions pending clarification of applicable legal requirements. The Treasury Department has recently issued proposed regulations which, when finalized, would address many, but not all issues relating to cash balance plans.

The Joint Committee staff believes that the lack of clear guidance with respect to cash balance plan conversions and cash balance plans in general creates uncertainty for employers and employees. Thus, the Joint Committee staff recommends that clear rules with respect to such plans should be adopted in the near future.

2. Blackout periods under qualified plans

Enron implemented a change of recordkeepers under the Enron Savings Plan in October and November of 2001. As part of this change, plan participants experienced a “blackout” period of approximately two and one-half weeks during which investment changes could not be made. During this time, the price of Enron stock fell from \$15.40 to \$9.98.

Changes in plan recordkeepers or other third-party service providers is a normal part of qualified retirement plan operations. The Joint Committee staff review of the change in recordkeepers with respect to the Enron Savings Plan indicates that Enron had legitimate reasons for changing recordkeepers, and undertook an extensive search in order to find a new recordkeeper that would meet its needs.

The main issue raised with respect to the change in recordkeepers under the Enron Savings Plan is whether plan fiduciaries, including the Enron Savings Plan Administrative Committee, acted in accordance with their fiduciary obligations in implementing the blackout period or whether they should have stopped the blackout from occurring given the falling price of Enron stock and its financial circumstances. Members of the Administrative Committee interviewed by the Joint Committee staff indicated that they viewed their responsibilities as relatively narrow, and did not focus on the possible effects of the proposed blackout on plan participants until after the blackout had begun. Whether there was a breach of fiduciary responsibilities in this case will be resolved through litigation.

The blackout also raises questions regarding whether plan participants received notice of the blackout sufficient to allow them to make appropriate decisions in anticipation of the blackout. The information reviewed by the Joint Committee staff indicates that Enron provided a variety of advance notices to plan participants explaining the proposed blackout. The Joint Committee staff did not undertake to review whether all participants in fact received notice of

the blackout; however, the Joint Committee staff determined that not all participants received the same notices. In particular, certain active employees received additional reminders of the blackout that were not sent to other participants.

The Sarbanes-Oxley Act of 2002, enacted after the Enron bankruptcy, includes a notice requirement with respect to blackout periods under qualified plans. Thus, the Joint Committee staff does not recommend further legislative changes in this area at this time.

3. Investments under 401(k) plans

Many Enron Savings Plan participants lost considerable amounts of retirement savings due to a high level of investment in Enron stock. Plan design features which required Enron's matching contributions to be invested in Enron stock contributed to the significant investment in Enron stock. Other factors may also have played a role, including a lack of understanding of the importance of diversification and the actions (or inactions) of plan fiduciaries. The Joint Committee staff believes that an overwhelming factor was a corporate culture that actively promoted investment in Enron stock.

The Joint Committee staff believes that the importance of diversification of retirement savings cannot be overemphasized. The Joint Committee staff recommends that a variety of changes should be made to reduce the likelihood that participants in plans that allow participant directed investments will have high concentrations of assets in a single investment.

The Joint Committee staff recommends that plans should provide participants with investment education in a manner consistent with fiduciary standards. This should include periodic notices describing sound investment practices and individualized notices to plan participants whose plan investments are over concentrated in a single asset.

The Joint Committee staff recommends that plans should not be permitted to require that employee elective deferrals or after-tax contributions be invested in employer securities. In addition, plan participants should be given greater opportunity to diversify the investment of employer matching and certain other employer contributions made in the form of employer securities.

The Joint Committee staff recommends certain changes with respect to ERISA fiduciary rules. The experience at Enron points out the difficulties that may arise when individuals play more than one role, particularly roles as a fiduciary and as an executive of the employer. These two roles may conflict and cause confusion among plan participants. The experience at Enron demonstrates that plan fiduciaries may have difficulty determining what actions are consistent with their dual roles. The Joint Committee staff believes that fiduciary rules should apply to the statements of senior executives, whether or not they are otherwise plan fiduciaries, regarding qualified plans or plan investments. The Department of Labor should also take steps to educate plan fiduciaries regarding their fiduciary duties.

Because of the strong corporate culture that encouraged Enron stock ownership by Enron employees, it is not clear that the outcome would have been any different if these measures had been in place prior to the bankruptcy. Further, Enron is not alone in its high concentration of investment in employer stock. A recent study of 219 large 401(k) plans found 25 plans that had

over 60 percent of their assets invested in employer securities.³⁰ Given these factors, the Joint Committee staff is concerned that, absent legal restrictions on the amount of employer securities that can be held in defined contribution plans, situations such as Enron's may occur again. Such restrictions would involve a major policy change from present law.

4. Nonqualified deferred compensation

Through Enron's nonqualified deferred compensation programs, executives were able to defer more than \$150 million in compensation from 1998 through 2001. The key motivating factor in deferring compensation was the desire of Enron's employees to avoid current income inclusion with respect to their compensation. In the weeks preceding the bankruptcy, apparently in accordance with the terms of the deferred compensation arrangement, Enron paid executives \$53 million in accelerated distributions of nonqualified deferred compensation. In addition to the accelerated distributions, participants were able to direct investment of their accounts and to make subsequent elections to change the timing of distributions.

The nonqualified deferred compensation arrangements of Enron illustrate the common practice of allowing executives to defer tax on income, but also to maintain security and control over the amounts. Given the significant amounts of compensation deferred by Enron executives, it appears that the risks and restrictions associated with deferring compensation were not viewed as impediments to deferral.

Enron's deferred compensation plans allowed executives to receive benefits similar to those of qualified plans. To the extent that it is possible for executives to defer taxes and have security and flexibility through nonqualified arrangements, this undermines the qualified retirement plan system. If executives can obtain the result they desire through the use of nonqualified plans and arrangements, there will be less incentive for companies to maintain qualified plans, which will result in rank and file employees losing pension coverage.

Enron allowed its executives to defer significant amounts of compensation even though Enron had to forego a current deduction with respect to such amounts. The fact that Enron was apparently indifferent to the deferral of its deduction provides further support for the need for changes to the tax treatment of nonqualified deferred compensation. Changes to the present-law rules regarding the taxation of deferred compensation would reduce the amount of income deferred.

Rules should be developed to require current income inclusion in the case of plan features that give taxpayers effective control over amounts deferred. The Joint Committee staff believes that the existence of plan provisions that allow accelerated distributions, participant-directed investment, or subsequent elections should result in current income inclusion. In addition, the Joint Committee staff believes that consideration should be given to whether rabbi trusts are appropriate for deferred compensation and whether the rules relating to such arrangements

³⁰ See *Enron Debacle Will Force Clean Up of Company Stock Use in DC Plans*, DC Plan Investing (Institute of Management & Administration), at 1-2 (Dec. 11, 2001).

should be tightened. The use of programs such as Enron's deferral of stock options gains and restricted stock programs should not be allowed.

In addition, the Joint Committee staff believes that section 132 of the Revenue Act of 1978 should be repealed. This would allow the Treasury Department to issue much needed guidance in the nonqualified deferred compensation area. The lack of guidance over the last 25 years has given taxpayers latitude to use creative nonqualified deferred compensation arrangements that push the limit of what is allowed under the law.

The Joint Committee staff also believes that reporting of deferred amounts should be required to provide the IRS greater information regarding such arrangements.

5. Stock-based compensation

Enron utilized considerable amounts of stock-based compensation, including stock options, restricted stock, and phantom stock arrangements. The use of stock-based compensation was not limited to executives. Enron had all-employee stock option arrangements and, as described above, also facilitated the ownership of Enron stock through Enron's qualified plans. The use of stock-based compensation was part of Enron's overall compensation philosophy, and also reflected the views of the Compensation Committee that a significant amount of executive compensation should be dependent on shareholder return.

The amount of compensation generated from stock-based compensation arrangements was significant, and increased dramatically over the period 1998 through 2000. Over this period, Enron's deduction attributable to stock options increased by more than 1,000 percent; from \$125 million in 1998 to over \$1.5 billion in 2000. Income attributable to restricted stock for the top-200 most highly compensated employees rose from \$24 million in 1998 to \$132 million in 2000.

Although the intent of many of Enron's stock-based compensation programs was to align the interests of shareholders and executives, the Enron experience raises a potential conflict between short-term earnings from which executives can reap immediate rewards and longer-term interests of shareholders.

In addition, the use of stock options highlights the differences between the treatment of stock options for Federal income tax purposes and accounting purposes. The accounting rules and the income tax rules have different purposes, and therefore the two sets of rules may be necessary in order to accomplish their intended purposes.

In implementing its stock-based compensation programs, Enron appeared generally to follow IRS published guidance. Thus, no recommendations are made with respect to such programs.

6. Employee loans

While Enron did not have a formal policy regarding employee loans, it nevertheless made a variety of loans to certain executives, including top management. The loans raise Federal tax issues as well as corporate governance issues.

In some cases, loan agreements provided that the loan would be forgiven if the executive stayed with Enron for a certain period of time. For example, such an arrangement was provided for Mr. Skilling.³¹ While these arrangements were treated by Enron and the executives involved as loans, it is difficult to distinguish such arrangements factually from the pre-bankruptcy bonuses paid by Enron, which had to be repaid if the employee did not remain with Enron for a certain period of time and which were treated by Enron as taxable compensation. Loans of this type raise the question of whether the arrangement at the outset should have been treated as taxable compensation.

Other loans did not have a provision regarding forgiveness, but were forgiven by Enron. In such cases, the amount forgiven was treated as compensation to the executives.

The loan transactions raise corporate governance issues of whether corporate funds are in essence being used for personal purposes. A line of credit for Mr. Lay provides an example of the issues raised. Pursuant to his \$7.5 million line of credit, in a series of 25 transactions in 2001 alone, Mr. Lay withdrew a total of over \$77 million (all but \$7.5 million of which was repaid). The total amount withdrawn under the line of credit was over \$106 million; over \$94 million of this amount was repaid with Enron stock. Mr. Lay's attorneys have stated that the loan transactions related to Mr. Lay's personal investment.

The Sarbanes-Oxley Act of 2002 contains a prohibition on executive loans. Thus, the Joint Committee staff is not making any recommendation regarding loans at this time.

7. Split-dollar life insurance contracts

Enron had split-dollar life insurance contracts for three top executives, ranging from \$5 million to \$30 million of coverage. The Treasury Department has issued notices and proposed regulations offering more detailed guidance than was previously available with respect to split dollar life insurance. This guidance generally requires the inclusion in income of the value of the economic benefit received by the employee under the arrangement. This guidance provides clear rules and should be finalized expeditiously.

8. Limitation on deduction of compensation in excess of \$1 million

The \$1 million deduction limitation on the compensation of top executives did not appear to have a major effect on the overall structure of Enron's compensation arrangements or the total amount of compensation paid to Enron employees. For 1998 through 2000, total compensation for Enron's top executives was \$433.6 million. Although most of this compensation was treated by Enron as qualifying for the exception for performance-based compensation (86 percent), Enron paid a significant amount of nondeductible compensation during this period (\$48.5 million which was 11 percent of total compensation).³² Given Enron's net operating loss carryovers, the

³¹ Mr. Skilling did not remain with Enron for the period specified in his loan agreement, and he repaid the loan. According to Enron, some interest on the loan is still outstanding.

³² As explained in the Report, the compensation numbers presented here are approximate, due to inconsistencies in information obtained from Enron. These numbers are from information provided by Enron to the IRS.

nondeductibility of this compensation may not have had a significant impact on Enron's overall tax liability.

The \$1 million deduction limitation was designed to address corporate governance concerns that top executives were receiving excessive compensation. The experience with Enron indicates that the limitation is not effective in achieving its purposes. Taxpayers may choose to pay nondeductible compensation, and accept the potential adverse tax consequences. In the case of Enron, there may in fact be little adverse tax impact.

The Joint Committee staff recommends that the limitation be repealed, and that any concerns regarding the amount and types of compensation be addressed through laws other than the Federal income tax laws.