

**REPORT OF INVESTIGATION OF  
ENRON CORPORATION AND RELATED ENTITIES  
REGARDING FEDERAL TAX AND COMPENSATION ISSUES,  
AND POLICY RECOMMENDATIONS**

**VOLUME I: REPORT**

**Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION**

**At the Request of  
Senator Max Baucus  
and  
Senator Charles E. Grassley  
of the  
SENATE COMMITTEE ON FINANCE**



February 2003

JCS-3-03

**JOINT COMMITTEE ON TAXATION**

**108TH CONGRESS, 1ST SESSION**

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## TRANSMITTAL LETTER

Senator Max Baucus  
Senator Charles E. Grassley  
Senate Committee on Finance  
Washington, DC 20510

Dear Senators Baucus and Grassley:

By this letter, I am hereby transmitting to you an official report of the investigation of the staff of the Joint Committee on Taxation relating to Enron Corporation and related entities, which was prepared pursuant to your request dated February 15, 2002. This investigation took nearly a year to complete. The Joint Committee staff spent countless hours reviewing documents and other information, interviewing individuals relevant to the investigation, and preparing this Report, while at the same time continuing to perform the normal legislative duties with which the Joint Committee staff is charged.

Each member of the Joint Committee staff contributed to the investigation. However, special recognition must be given to certain members of the Joint Committee staff who devoted much of their time during the last year to the investigation. Mary Schmitt, Sam Olchyk, and Carolyn Smith coordinated all aspects of the Joint Committee staff work on the investigation and were each primarily responsible for certain aspects of the investigation. Other Joint Committee professional staff members who also had primary responsibility for the investigation include E. Ray Beeman, Nikole Clark, Robert Gotwald, Brian Meighan, David Noren, Cecily Rock, Carol Sayegh, Ron Schultz, and Allison Wielobob. Other professional staff members who contributed to the investigation include Roger Colinvaux, Patrick Driessen, Deirdre James, Laurie Matthews, Patricia McDermott, Pamela Moomau, John Navratil, Oren Penn, and Tara Zimmerman. Recognition is provided to the administrative and support staff who assisted with the investigation, including Jean Best, John Bloyer, Sean Corcoran, Kathleen Dorn, Jayne Gribbin, Debra McMullen, Neval McMullen, Kristine Means, Tracy Nadel, Melissa O'Brien, Lucia Rogers, and Patricia Smith. A special thanks goes to Christine Simmons, whose skill at pulling together an enormous document made the Joint Committee staff's work much easier.

The Joint Committee staff gratefully acknowledges the contribution of Christopher Hanna, Professor of Law, Southern Methodist University, who contributed to the Joint Committee staff investigation as a consultant and was particularly helpful in assisting the Joint Committee staff understand Enron's complex tax transactions. In addition, Claire Merkin who was with the Joint Committee staff for six months under a special fellowship program with the New York University School of Law, also assisted in the investigation.

Sincerely,

Lindy L. Paull  
Chief of Staff

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## INTRODUCTION

This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation (“Joint Committee staff”), is an official report of the Joint Committee staff investigation relating to Enron Corporation and related entities. 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.

The Joint Committee staff is publishing this Report in three volumes. Volume I contains the Joint Committee staff report of investigation. Volume I is divided into Four Parts: Part One is the general observations, findings, and recommendations; Part Two contains general background information including the methodology and scope of the Joint Committee staff investigation and a history of the company; Part Three provides a detailed discussion of certain of Enron’s tax-motivated business transactions and other business tax issues; and Part Four provides a detailed discussion of Enron’s pension plans and compensation practices.

Volumes II and III contain four Appendices to this Report. Appendix A (general information relating to investigation) and Appendix B (information relating to Enron’s tax-motivated transactions) are contained in Volume II. Appendix C (tax opinion letters with respect to Enron’s tax-motivated transactions) and Appendix D (pension and compensation-related materials) are contained in Volume III.

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<sup>1</sup> This document may be cited as follows: 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.

## EXECUTIVE SUMMARY

### A. General Overview of the Investigation

#### 1. Scope of Report

In February 2002, at the direction of Senator Max Baucus and Senator Charles E. Grassley of the Senate Committee on Finance (“Senate Finance Committee”), the staff of the Joint Committee on Taxation (“Joint Committee staff”) began its review of Enron Corporation and related entities (“Enron”).<sup>2</sup> The 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. This Report transmits the findings and recommendations of the Joint Committee staff with respect to its review of these areas.

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.

#### 2. Methodology and scope of Joint Committee staff investigation

Enron agreed to cooperate with the Joint Committee staff investigation. 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 tax returns since 1985;<sup>3</sup>
- Reviewed more than 100 boxes of documents received from Enron in response to seven extensive document requests;

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<sup>2</sup> Except as otherwise indicated, all references to “Enron” in this Report refer to Enron Corporation and its affiliates, and all references to “Enron Corp.” refer specifically to the parent company.

<sup>3</sup> Each tax return was thousands of pages in length.



- 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.

The Joint Committee staff faced several limitations in conducting the investigation. The Joint Committee staff had to rely on Enron’s cooperation to make available relevant documents and employees. In many cases, current Enron management could not locate the requested documentation or were unable to answer questions posed by the Joint Committee staff. The individuals interviewed by the Joint Committee staff were not under oath, nor were individuals relevant to the investigation compelled to appear. Many Enron employees who had participated in the transactions or activities reviewed by the Joint Committee staff have since left Enron and, in some cases, could not be located for an interview. Other individuals stated that they recalled little of the specific events or transactions. The Joint Committee staff cannot represent that this Report identifies all relevant facts or analyzes all transactions in which Enron engaged that might be of interest to policymakers or government agencies.

Despite these limitations, the Joint Committee staff believes that its investigation provides valuable analysis of Enron’s structured transactions and compensation structures and provides important recommendations and findings for improvements to the Federal tax system. More generally, the Joint Committee staff believes the Report provides significant insights into a corporation’s tax and compensation activities that typically are unavailable to those outside the company.

The Report identifies financial accounting benefits that Enron claimed in connection with certain tax-motivated transactions, but it was beyond the scope of the investigation to evaluate the validity of these claimed financing accounting benefits. Therefore, the financial accounting benefits are reported as claimed.

This Report is presented in three volumes. Volume I contains the Joint Committee staff report of investigation. Volume I is divided into Four Parts: Part One is the general observations, findings, and recommendations of the Joint Committee staff investigation; Part Two contains general background information, including the methodology and scope of the Joint Committee staff investigation and a history of the company; Part Three provides a detailed discussion of certain of Enron’s tax-motivated business transactions; and Part Four provides a detailed discussion of Enron’s pension plans and compensation practices.

Volumes II and III contain four Appendices to this Report. Volume II contains Appendices A and B. Appendix A contains copies of certain general information relating to investigation, including the letter to the Joint Committee staff from Senators Baucus and

Grassley and the disclosure agreement among Enron, the Senate Finance Committee, and the Joint Committee staff. Appendix B provides detailed documentation relating to Enron's tax-motivated transactions. Volume III contains Appendices C and D. Appendix C reprints copies of the tax opinion letters provided with respect to Enron's tax-motivated transactions. Appendix D contains information relating to Enron's pension plans and other compensation-related materials.

## B. Enron's Business Operations and Tax-Motivated 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, the company 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.

### 1. Summary of selected tax information

#### Federal taxable income

Enron and its affiliates filed a consolidated Federal income tax return for each year from 1985 through 2001. Based on Enron's tax returns without regard to audit adjustments, Enron paid approximately \$325 million in Federal income taxes between the years 1990 and 1995.

Enron paid no Federal income tax for taxable years 1996 through 1999, and reported a net operating loss carryover of \$3.1 billion from 1999 to 2000. Enron reported that it fully utilized its net operating loss carryover in 2000 and paid \$63.2 million of Federal income tax for its 2000 taxable year. Enron filed its 2001 Federal income tax return on September 13, 2002, and reported a net operating loss of \$4.6 billion for its 2001 taxable year.

Table 1, below, lists Enron's Federal tax liability for its taxable years 1996 through 2001.

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

<b>Year</b>	<b>Regular Tax</b>	<b>Alternative Minimum Tax</b>	<b>Total Tax Per Return</b>
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*
<b>Totals</b>	21.3	41.9	63.2

Source: Enron's Federal income tax returns

\* 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.<sup>4</sup>

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 the period 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.

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<sup>4</sup> The IRS examination of Enron's tax return for 1995 is complete. The impact of any IRS adjustments to Enron's 1995 tax return 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]

	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>
Net Income Reported in Consolidated Financial Income Statement <sup>1</sup>	584	105	703	893	979
<u>Less Net Income from Entities not Included in Consolidated Tax Return</u>					
Domestic Corporations <sup>2</sup>	-96	-189	-149	-152	-345
Foreign Corporations <sup>3</sup>	-232	-44	-521	-1,110	-1,722
Partnerships <sup>4</sup>	-145	-211	-319	-638	-6,899
	<b>-473</b>	<b>-444</b>	<b>-989</b>	<b>-1,900</b>	<b>-8,966</b>
<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 <sup>5</sup>	0	0	14	122	258
	<b>1,322</b>	<b>1,300</b>	<b>1,898</b>	<b>4,119</b>	<b>13,883</b>
Book Income Reported on Consolidated Tax Return	<b>1,433</b>	<b>961</b>	<b>1,612</b>	<b>3,112</b>	<b>5,896</b>
<u>Significant Book to Tax Adjustments<sup>6</sup></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	<b>-310</b>	<b>-504</b>	<b>-753</b>	<b>-1,458</b>	<b>3,101</b>

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**

As Enron's management came to realize that tax-motivated transactions could generate financial accounting benefits, Enron looked to its tax department to devise large transactions that would increase its financial accounting income. Enron came 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 and increase cash flows. Enron also used techniques with respect to its 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 this 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.

This Report classifies Enron's business transactions 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. One exception was Project Apache, which was designed to generate tax deductions for what was, in essence, the repayment of principal. In two 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)

<b>Project Name</b>	<b>Financial Accounting Income through 2001<sup>1</sup></b>	<b>Total Projected Financial Accounting Income<sup>2</sup></b>	<b>Federal Tax Savings through 2001<sup>3</sup></b>	<b>Total Projected Federal Tax Savings<sup>4</sup></b>	<b>Promoter</b>	<b>Primary Tax Opinion Provider</b>	<b>Total Project Fees<sup>6</sup></b>
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) <sup>5</sup>	1	1	---	---	Bankers Trust	---	---
Condor (1999)	88	328	---	332	Deloitte & Touche	Vinson & Elkins	10
Valhalla (2000) <sup>5</sup>	16	64	---	---	Deutsche Bank	Vinson & Elkins	---
Tammy I (2000)	---	406	---	414	Deloitte & Touche	Vinson & Elkins	9
Tammy II (2001)	---	369	---	370	---	---	---
<b>Totals</b>	<b>651</b>	<b>2,079</b>	<b>257</b>	<b>2,022</b>	<b>N/A</b>	<b>N/A</b>	<b>87.6</b>

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 this 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 this 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.



### **3. Enron's foreign subsidiaries and other entities**

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 and that were therefore largely irrelevant for tax purposes.

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.

## **C. 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. The Report also discusses the issue of whether plan fiduciaries of the Enron ESOP should have acted to remove Enron stock as an investment under the ESOP, despite plan provisions directing such investment.

### **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.

Enron's executives were paid substantial amounts. In 2000, total compensation for the 200 highest paid employees of Enron was \$1.4 billion. This consisted of \$56.6 million of

bonuses, \$1.06 billion attributable to stock options, \$131.7 million attributable to restricted stock, and \$172.6 million of other income, including base salary.

### **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.

### **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. In 1998, the 200 highest paid employees at Enron employees deferred \$13.3 million. By 2000, that amount had risen to \$70 million. For the years 1998 through 2001, a total of \$154 million in compensation was deferred. According to documents provided by Enron, Mr. Lay deferred \$32 million under one of Enron's nonqualified deferred compensation plans.

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. 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 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 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).

## **D. Summary of General Observations**

This 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.

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. 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 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 outcomes. 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.

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 transactions, with the result that Enron even acted as an accommodation party to deals designed primarily by Enron's advisors to benefit others.

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. A reviewer of the transaction 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. 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 relied on advice from 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. Enron's activities shows 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, advantages over the IRS -- all were factors that contributed to Enron's ability to engage in tax-motivated transactions. 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.

## **E. Summary of Findings and Recommendations**

### **1. General findings relating to business tax matters**

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

- Stronger measures (e.g., the imposition of substantial, punitive penalties) are necessary to increase the costs to taxpayers of engaging in transactions that lack a non-tax business purpose or economic substance;
- Attainment of financial statement benefits based solely on Federal income tax savings is not a valid business purpose for Federal income tax purposes;
- The tax laws should impose severe penalties on the use of accommodation parties such as employees, consultants, or advisors, as parties in a transaction or arrangement to permit a taxpayer to achieve Federal income tax benefits;
- The Treasury Department and IRS should have a broad array of sanctions to impose on advisors who render opinions that rely on representations that the advisor knows, or has reason to believe, are incorrect, incomplete, or inconsistent with the facts; State licensing authorities should be notified when these sanctions are imposed, and the licensing authorities should discipline the advisor as appropriate;
- Many taxpayers are engaging in transactions primarily to obtain financial accounting benefits and those responsible for promulgating the accounting standards should evaluate whether changes to the rules governing accounting for income taxes should be made; and
- The use of multiple entities in connection with tax-motivated transactions, coupled with the inherent complexity of these transactions and the delayed realization of the tax benefits, makes it exceedingly difficult for the IRS to timely identify and properly evaluate these transactions; thus, 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.

## **2. Specific recommendations relating to business tax issues**

In addition to the general recommendations and findings relating to tax-motivated transactions, the Joint Committee staff makes the following specific recommendations:

- The duplication of losses should be curtailed so that a single economic loss is not deducted more than once;
- The rules that prevent corporate acquisitions made to evade or avoid Federal income tax should be strengthened;
- The extraordinary dividend rules should be strengthened;
- Guidance should be provided on the replication of earnings and profits in a consolidated group;
- There should be greater disclosure of partnership disguised sales;
- The partnership allocation anti-abuse rules should be strengthened;
- Guidance should be provided regarding the transfer of partial partnership interests;
- Rules are needed to address the appropriate interaction between the partnership basis rules and the corporate stock nonrecognition rules;
- The rules for allocating subpart F income should include an anti-abuse provision;
- The exception to the passive foreign investment company rules for U.S. shareholders of controlled foreign corporations should relate more closely to the U.S. shareholder's potential taxability under subpart F;
- The earnings stripping rules should be strengthened;
- Annual information reporting should be required with respect to entities that are disregarded pursuant to a check-the-box election;
- The financial asset securitization investment trust provisions should be repealed;
- The pre-June 20, 1986, grandfather rule for certain corporate-owned life insurance contracts should be repealed;



- The rules relating to the characterization and treatment of debt and equity should be modified; and
- The 50-percent related party threshold under the interest expense disallowance rules for disqualified indebtedness should be eliminated.

### **3. General findings relating to pensions and compensation**

This Report's detailed review of Enron's compensation programs reveals a process which rested approval of executive compensation packages 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 Committee's approval generally was a rubber stamp of recommendations made by Enron's management.

Underlying Enron's compensation programs was an apparent lack of 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. 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. 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.

### **4. Findings and recommendations relating to pensions and compensation**

Some of the issues examined by the Joint Committee staff with respect to Enron's retirement plans and compensation arrangements raise nontax issues, such as issues of corporate governance and fiduciary responsibility. The Joint Committee staff finds it appropriate to make the following recommendations with respect to these plans and arrangements:

- Clear rules should be adopted with respect to the operations of cash balance plans and the conversion of traditional defined benefit plans into cash balance plans;
- To better protect retirement benefits, legislative changes should be made to reduce the likelihood that defined contribution plan participants will have high concentrations of assets in a single investment, such as employer securities. Such changes include allowing participants greater opportunities to move plan assets out of employer securities and into more diversified investments, and requiring plans to provide notices regarding investment principles. In addition, plan participants should receive investment education consistent with fiduciary rules;

- To help prevent plan participants from being misled with respect to investments in employer securities, fiduciary rules should apply to statements made by company executives regarding investments under participant-directed defined contributions plans, regardless of whether such officials are otherwise plan fiduciaries. The Department of Labor should also make additional efforts to educate plan fiduciaries and company executives regarding fiduciary obligations;
- Changes should be made to the rules relating to nonqualified deferred compensation arrangements to curb current practices that allow for the deferral of tax on compensation income while providing executives with inappropriate levels of security, control, and flexibility with respect to deferred compensation. These changes include repealing the prohibition on the issuance of related Treasury guidance, and providing that certain plan features result in current taxation, including the ability to obtain accelerated distributions, participant directed investments, and subsequent elections.
- Guidance relating to split-dollar life insurance should be finalized; and
- The limitation on the deduction for compensation in excess of \$1 million should be repealed.

## **PART ONE: GENERAL OBSERVATIONS, RECOMMENDATIONS, AND FINDINGS**

### **I. 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.

This 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.<sup>5</sup> 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.<sup>6</sup> 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.<sup>7</sup>

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<sup>5</sup> 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.

<sup>6</sup> 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. EC2 000038546.

<sup>7</sup> 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.

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 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.<sup>8</sup> 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

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<sup>8</sup> 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>.

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 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.<sup>9</sup> 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.

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<sup>9</sup> 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).

## **II. 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 this 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 this 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 losses**<sup>10</sup>

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 interests**<sup>11</sup>

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 tax**<sup>12</sup>

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.

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<sup>10</sup> Further discussion of this recommendation is provided in the descriptions of the transactions known as Project Tanya and Project Valor in Part Three of this Report.

<sup>11</sup> Further discussion of this recommendation is provided in the descriptions of the transactions known as Project Steele and Project Cochise in Part Three of this Report.

<sup>12</sup> Further discussion of this recommendation is provided in the description of the transaction known as Project Cochise in Part Three of this Report.

### **3. Strengthen the extraordinary dividend rules<sup>13</sup>**

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 group<sup>14</sup>**

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.

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<sup>13</sup> Further discussion of this recommendation is provided in the description of the transaction known as Project Teresa in Part Three of this Report.

<sup>14</sup> Further discussion of this recommendation is provided in the description of the transaction known as Project Teresa in Part Three of this Report.

## **C. Recommendations Relating to Partnership Tax Issues**

### **1. Strengthen disclosure of disguised sales<sup>15</sup>**

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 rules<sup>16</sup>**

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 interests<sup>17</sup>**

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 rules<sup>18</sup>**

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.

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<sup>15</sup> Further discussion of this recommendation is provided in the description of the transaction known as Project Tomas in Part Three of this Report.

<sup>16</sup> Further discussion of this recommendation is provided in the description of the transaction known as Project Condor in Part Three of this Report.

<sup>17</sup> 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 this Report.

<sup>18</sup> Further discussion of this recommendation is provided in the description of the transaction known as Project Condor in Part Three of this 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 income<sup>19</sup>**

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 rules<sup>20</sup>**

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.

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<sup>19</sup> Further discussion of this recommendation is provided in the description of the transaction known as Project Apache in Part Three of this Report.

<sup>20</sup> Further discussion of this recommendation is provided in the description of the transaction known as Project Apache in Part Three of this Report.

### **3. Strengthen the earnings stripping rules<sup>21</sup>**

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 entities<sup>22</sup>**

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.

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

<sup>22</sup> Further discussion of this recommendation is provided in the description of Enron's use of foreign entities in Part Three of this Report.

## **E. Recommendation Relating to Financial Asset Securitization Investment Trusts<sup>23</sup>**

### **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.

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

## **F. Recommendation Relating to Corporate-Owned and Trust-Owned Life Insurance<sup>24</sup>**

### **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.

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<sup>24</sup> 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 this Report.



## **G. Recommendations Relating to Structured Financing Transactions<sup>25</sup>**

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

The proper characterization of financial instruments for Federal income tax purposes as either debt or equity has been a longstanding problem. This problem has been exacerbated in recent years by the escalation in the amount and variety of hybrid financial instruments that have characteristics of both debt and equity. Therefore, the Joint Committee staff recommends that the rules concerning the Federal income tax characterization of financial instruments as either debt or equity should be reviewed in a comprehensive way. There are several possible alternative approaches that are available in considering such changes to present law, including:

- (1) Conform the tax characterization of hybrid financial instruments to the characterization that is used for other reporting purposes, such as financial accounting, so that the non-tax characterization determines the tax characterization.
- (2) Strengthen the requirements for debt characterization, similar to the approaches proposed by the Treasury Department in 1996 and 1997, which may include altering or more precisely articulating the debt-equity factors listed in section 385. This approach also could involve changing the manner in which such factors are applied so that certain financial instruments that exhibit (or lack) certain features are presumptively characterized as equity rather than indebtedness. In any event, section 385 should be amended to apply more broadly to interests in non-corporate entities, as well as corporations.
- (3) Provide restrictions on the proportionate amount of yield payments on hybrid financial instruments that may be deducted as interest. The proportionate amount of deductible yield payments could be determined under such an approach by reference to one or more factors (or some combination thereof), such as the length of the term to maturity of the instrument or the number of months that the issuer could defer yield payments under the terms of the financial instrument.
- (4) Reduce or eliminate the disparate taxation of interest and dividends (for both issuers and holders of financial instruments) that creates the market for hybrid financial instruments.

### **2. Modify the rules relating to disqualified indebtedness**

The interest expense disallowance rules for disqualified indebtedness apply to transactions involving stock in another corporation only if the taxpayer controls the other corporation by virtue of owning more than 50 percent (by vote or value) of the outstanding stock of such corporation. The Joint Committee staff recommends that the 50-percent related party threshold under these rules should be eliminated.

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<sup>25</sup> Further discussion of these recommendations is provided in the description of Enron's structured financing transactions in Part Three of this Report.

### **III. PENSION AND COMPENSATION OBSERVATIONS, FINDINGS, AND RECOMMENDATIONS**

#### **A. 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 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 made 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.

## **B. Findings and Recommendations Relating to Pension and Compensation Arrangements**

### **1. Cash balance plan**

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 the Enron Savings Plan**

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.<sup>26</sup> 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

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<sup>26</sup> 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.<sup>27</sup> 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 of 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 affect 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).<sup>28</sup> Given Enron's net operating loss carryovers, the

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<sup>27</sup> 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.

<sup>28</sup> As explained in this 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.

## **PART TWO: GENERAL BACKGROUND INFORMATION**

### **I. BACKGROUND AND METHODOLOGY**

#### **A. Background Information Relating to Joint Committee on Taxation Staff Investigation of Enron**

##### **Letter to Joint Committee on Taxation staff directing investigation of Enron**

On February 15, 2002, Senators Max Baucus and Charles E. Grassley, then Chairman and Ranking Member of the Senate Committee on Finance (“Senate Finance Committee”), directed the staff of the Joint Committee on Taxation (“Joint Committee staff”) to undertake a review of Enron’s Federal tax returns, tax information, and any other information deemed relevant by the Joint Committee staff to assist the Senate Finance Committee in evaluating whether the Federal tax laws facilitated any of the events or transactions that preceded Enron’s bankruptcy. The letter indicated that press reports had raised troubling questions about Enron, including the use of entities in tax haven countries, other special purpose entities, and questionable tax shelter arrangements. The letter stated that the Joint Committee staff should, as part of the review, examine the adequacy of present tax law, particularly in the areas of tax shelters and offshore entities.

The letter also directed the Joint Committee staff to include a review of the compensation arrangements of Enron employees, including tax-qualified retirement plans, nonqualified deferred compensation arrangements, and other arrangements, and to analyze the factors that may have contributed to any loss of benefits and the extent to which losses were experienced by different categories of employees. A copy of the letter from Senators Baucus and Grassley to Ms. Lindy L. Paull, Chief of Staff of the Joint Committee, is included in Appendix A to this Report.

Senators Baucus and Grassley directed that the Joint Committee staff conduct the Enron investigation pursuant to the authority provided to the Joint Committee under section 8022 of the Internal Revenue Code.<sup>29</sup> They asked that the Joint Committee staff transmit its findings and recommendations as soon as practicable.

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<sup>29</sup> Section 8022(1)(C) of the Internal Revenue Code of 1986 (the “Code”) provides that the Joint Committee will conduct such investigations with respect to the Federal tax system as the Joint Committee may deem necessary. Code section 8021 authorizes the Joint Committee to obtain and inspect tax returns and return information (as specified in sec. 6103(f)). In addition, section 8023 authorizes the Joint Committee (or the Chief of Staff of the Joint Committee), upon approval of the Chairman or Vice-Chairman, to secure tax returns, tax return information, or data directly from the Internal Revenue Service or any other executive agency for the purpose of making investigations, reports, and studies relating to internal revenue tax matters, including investigations of the Internal Revenue Service’s administration of the tax laws.

## **Disclosure agreement**

On January 30, 2002, staff of the Senate Finance Committee, Joint Committee staff, and lawyers from Skadden, Arps, Slate, Meagher & Flom LLP (“Skadden Arps”)<sup>30</sup> met to discuss whether Enron would consent to the public disclosure of its tax returns and return information in connection with a Congressional review of the role that Federal taxes may have played in the Enron bankruptcy. This meeting set in motion a series of interactions, during February of 2002, among the staff of the Senate Finance Committee, the Chief of Staff of the Joint Committee, and Skadden Arps to negotiate a disclosure agreement relating to the Joint Committee staff investigation. A representative from the Office of the Senate Legal Counsel also participated in the negotiations. The disclosure agreement was executed on March 6, 2002, by Mr. Raymond M. Bowen, Jr., Executive Vice President and Chief Financial Officer of Enron Corp., Senator Baucus, Senator Grassley, and Ms. Paull.<sup>31</sup>

Under the terms of the disclosure agreement, Enron agreed to provide upon request to the Senate Finance Committee and the Joint Committee copies of all Federal tax returns and related information of Enron and of affiliated and related entities not included in Enron’s consolidated returns. Enron retained the right under the disclosure agreement to elect to assert any applicable privilege or legal objection provided that such assertion would be accompanied by a document-by-document index sufficiently detailed to enable the Senate Finance Committee and the Joint Committee to evaluate the assertion.<sup>32</sup>

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<sup>30</sup> Skadden, Arps, Slate, Meagher & Flom LLP (“Skadden Arps”) represents Enron in connection with Congressional investigations and other matters.

<sup>31</sup> A copy of the disclosure agreement is included in Appendix A to this Report.

<sup>32</sup> During the course of the Joint Committee staff investigation, Enron (through its counsel Skadden Arps) did not generally raise an issue of privilege or legal objection with respect to any document requested by the Joint Committee staff. Enron made the following statement in each of the letters addressed to the Joint Committee staff: “The enclosed documents are being provided to you in accordance with the terms of the Disclosure Agreement entered into by and among the Senate Committee on Finance, the Joint Committee on Taxation and the Company as of March 7, 2002. With this production, the Company does not intend to provide a general waiver of the attorney-client, attorney work product or other applicable privileges, and does not waive those privileges as to other documents not produced here.” Enron did assert privilege in a letter to Senate Finance Committee staff dated May 8, 2002, with respect to certain matters contained in minutes of the Board of Directors from August 2001 through January 2002. Enron asserted its privilege by redacting certain portions of the minutes that Enron asserted related to (1) communications with counsel or among counsel, or involving work product of counsel, relating to discussions or handling of government and congressional investigations; and (2) communications with counsel or among counsel, or involving work product of counsel, relating to discussions or handling of litigation. In the letter, Enron stated “Other privileged material, outside these two narrow exceptions, has not been redacted in keeping with the Company’s past practice in this matter.”

The disclosure agreement required the Senate Finance Committee and the Joint Committee to seek tax returns and return information for years after 1995 from the Internal Revenue Service (“IRS”) and to request such information from Enron only to the extent either Committee was unable to obtain the information expeditiously from the IRS.

The disclosure agreement set forth the terms and conditions under which Enron agreed to the public disclosure of information collected by the Senate Finance Committee and the Joint Committee. The first part of the disclosure agreement related to Enron’s tax returns and return information.<sup>33</sup> In the case of Enron’s tax returns and return information, obtained by the Finance Committee or Joint Committee pursuant to section 6103,<sup>34</sup> Enron consented to disclosure only through official reports, meetings, or hearings of either the Senate Finance Committee or the Joint Committee. Any other disclosure of such information is prohibited and would violate section 6103 because it would constitute a disclosure outside the agreement. In the case of tax returns and return information of Enron for years after 1995, the Senate Finance Committee and Joint Committee further agreed to make no public disclosure before June 10, 2002.

The second part of the disclosure agreement related to all other documents and information (other than tax returns and return information obtained from the IRS). Under the disclosure agreement, the Senate Finance Committee and Joint Committee agreed that they would not disclose other nonpublic documents or information obtained from Enron, except through official reports, meetings, or hearings. In addition, the Senate Finance Committee and Joint Committee agreed that neither Committee would disclose before June 10, 2002, any such nonpublic information for years after 1995, which would be return information if it were in the possession of the IRS.

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<sup>33</sup> Under sec. 6103 of the Internal Revenue Code of 1986 (the “Code”), the returns and return information of a taxpayer are confidential. However, a taxpayer can consent to the disclosure of information that otherwise would be subject to sec. 6103.

<sup>34</sup> Sec. 6103 only applies to returns and return information obtained from the IRS. Information provided directly by Enron, including tax returns, is not subject to sec. 6103. As noted above, the Senate Finance Committee and the Joint Committee agreed that they would first attempt to obtain tax returns and return information for years after 1995 from the IRS.

## **B. Methodology and Scope of Joint Committee Staff Investigation**

### **In general**

This section outlines the methodology and scope of the Joint Committee staff investigation of Enron. This Report attempts to describe the events that occurred over time at Enron both with respect to its Federal tax situation and with respect to its compensation arrangements. To understand the information and analysis that is provided in this Report, it is useful to understand the way in which the investigation was conducted.

The Joint Committee staff did not follow the Federal rules of evidence that would apply in a court proceeding in conducting its investigation. Thus, documents provided to, and reviewed by, the Joint Committee staff would not necessarily be admissible in a court of law. Similarly, with respect to interviews conducted by the Joint Committee staff, the individuals interviewed were not under oath at the time of their interviews. In some instances, the individuals made statements that would constitute hearsay in a court of law.

Enron agreed to cooperate with the Joint Committee staff investigation. Enron complied with requests for information from the Joint Committee staff through the voluntary production of documents.<sup>35</sup> The Joint Committee staff cannot represent that it was able to review all documents relating to a transaction in which Enron engaged or all information relating to other aspects of the Joint Committee investigation. During the course of the Joint Committee staff investigation, Enron was complying with document requests relating to its bankruptcy filing and other Federal investigations; thus, the company was responding to numerous document requests at the same time. In some instances, particularly with respect to executive compensation matters, Enron's recordkeeping was either abysmal or company representatives who compiled the information failed to provide relevant documentation.

Throughout this Report, specific information is provided as it was contained in documents provided by Enron or the IRS.<sup>36</sup> In many instances, the documents provided to the Joint Committee staff contained data and other information as of the time at which a transaction occurred. The Joint Committee staff could not independently verify the accuracy of this information in all cases; for purposes of this Report, the Joint Committee staff has used the information as it was provided. Furthermore, in many cases, information that may have been

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<sup>35</sup> Throughout this Report, information contained in documents provided by Enron is referred to with a Bates-stamp numbering system (e.g., EC 00001234) used by Enron to identify the documents. Certain of these documents have also been included in the Appendices to this Report, as noted throughout the Report. It should be noted that Enron's counsel Skadden Arps responded to requests for information on behalf of Enron.

<sup>36</sup> Certain documents received by the Joint Committee staff in connection with the investigation are included in Appendices to this Report. Handwritten notes on these documents are not those of Joint Committee staff; in most cases, the author of the handwritten notes is not identified.

accurate when included in a document may subsequently have become inaccurate due to subsequent events such as Enron's restatement of its earnings.

Despite these limitations, the Joint Committee staff believes that its investigation provides a useful in-depth examination of some of the transactions into which Enron entered, as well as an in-depth examination of Enron's compensation structures. The information gathered enabled the Joint Committee staff to prepare a detailed discussion of specific transactions and issues to provide an insight into how large corporations might manage their tax liabilities (see Part Three of this Report, below). The discussion outlines the methods and some of the complex transactions that Enron used to manage its Federal income tax liabilities. The transactions that were reviewed by the Joint Committee staff were identified from a variety of sources, including interviews with current and former Enron employees, meetings with the IRS, and published reports relating to Enron. However, the Joint Committee staff cannot represent that this Report identifies and analyzes all transactions in which Enron engaged that might be of interest to policymakers or the IRS. The sheer volume of information relating to Enron made available to the Joint Committee staff, the fact that the issues associated with a company the size of Enron are so broad, and the difficulty faced in attempting to identify specific transactions from the face of a tax return as complex as Enron's necessarily limits the ability to identify all of the transactions in which Enron engaged.<sup>37</sup>

It should be noted that this Report identifies financial accounting benefits that Enron claimed in connection with certain of its tax-motivated transactions. It was beyond the scope of the Joint Committee staff investigation to evaluate the validity of any of the claimed financial accounting benefits. Therefore, the financial benefits are presented as claimed.

The review also led the Joint Committee staff to make certain general observations about Enron that are contained in Part One of this Report, above; while these observations relate specifically to Enron, they highlight some of the systemic issues and problems facing policymakers and the IRS, especially with respect to large corporations.

The following discussion details the work done by the Joint Committee staff in connection with this investigation.

### **Overview of chronology of Joint Committee staff investigation**

The Joint Committee staff began its investigation of Enron in February 2002, prior to execution of the disclosure agreement with Enron. On February 25, 2002, the Joint Committee staff made an initial document request to the IRS. In the letter to the IRS, the Joint Committee staff requested copies of all Federal tax returns (including amended returns) for Enron and other entities in which Enron had an equity interest for tax years from 1985 to the present, including supporting workpapers, and other information in the IRS' possession including, but not limited to, IRS master file information from 1985 to the present, information concerning Enron's

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<sup>37</sup> In some cases, documents reviewed by the Joint Committee staff provided inconsistent information relating to certain transactions. In such cases, the Joint Committee staff attempted to develop the most reasonable description of the transaction.

involvement in tax shelter transactions, Federal tax litigation in which Enron has been involved, and information relating to Enron's involvement with specific transactions and entities. In addition, the letter requested information relating to the qualified retirement plans and compensation arrangements of Enron including, but not limited to, copies of all annual returns relating to the qualified retirement plans, copies of any IRS information relating to such plans, and information relating to nonqualified deferred compensation programs.

On February 27, 2002, the Joint Committee staff was briefed in Washington, D.C., on the history of IRS involvement with Enron by IRS personnel from the IRS National Office in Washington, D.C., and IRS personnel from Houston who were involved in the examinations of Enron's tax returns. At the same time, IRS personnel briefed Joint Committee staff on specific information contained in the Joint Committee's first document request and the logistics of transmitting this information to the IRS National Office.

The Joint Committee staff made an initial document request to Enron on March 12, 2002. This document request related to Enron's Federal tax returns and business operations and did not request information relating to the qualified pension plan and other compensation arrangements of Enron. Pursuant to the terms of the disclosure agreement, the letter requested copies of Enron's Federal tax returns for the 1985-1995 period,<sup>38</sup> as well as other information relating to Enron's business operations.

Pursuant to a request made by Enron, the Joint Committee staff met on April 23, 2002, in Washington, DC, with representatives from Skadden Arps and two employees of Enron<sup>39</sup> to discuss the Joint Committee staff's first document request and the parameters of the Joint Committee staff investigation. Enron's employees indicated that full compliance with the first Joint Committee document request would produce 3,500 to 5,000 boxes of information for the period requested. Much of the material requested was located at an off-site storage location in Houston, Texas, with a third-party contractor. The Enron employees argued that it would be too costly to produce the documentation requested by the Joint Committee staff. As a result of this meeting, the Joint Committee staff agreed to narrow the first document request in order to produce a manageable request for documentation relating to business operations of Enron relevant to the Joint Committee investigation.

On April 25, 2002, the Joint Committee staff made a first document request to Enron relating to qualified plans and compensation arrangements.

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<sup>38</sup> As mentioned above, the disclosure agreement required the Joint Committee staff to attempt to secure Enron's tax returns for years after 1995 from the IRS.

<sup>39</sup> Enron employees in attendance at the meeting were Mr. Jordan H. Mintz and Mr. Edward R. Coats.

On June 7, 2002, at Enron's request, lawyers from Skadden Arps and Enron employees<sup>40</sup> met with Joint Committee staff to make a presentation concerning information requested by the Joint Committee staff and information on certain structured transactions and other significant transactions in which Enron engaged.<sup>41</sup> During this presentation, the Enron employees provided an oral description, with accompanying written material, of the structured transactions that are addressed in depth in Part Three, below, of this Report.

During May, June, and July of 2002, the Joint Committee staff conducted an extensive review of documents provided by Enron and the IRS in response to the Joint Committee staff document requests.

On July 16, 2002, the Joint Committee staff interviewed Mr. Robert J. Hermann, Former Vice President and Director of Taxes, for Enron Corp.<sup>42</sup>

During August through November of 2002, the Joint Committee staff conducted interviews in Houston, Texas, and Washington, D.C., of current and former Enron employees, certain members of Enron's Board of Directors, and certain outside counsel to Enron. Also during this time frame, the Joint Committee staff continued to review documents received from Enron, the IRS, the Department of Labor, the Pension Benefit Guaranty Corporation, and others in connection with the investigation.

In the course of its investigation, the Joint Committee staff received periodic briefings from the IRS with respect to the status of the IRS review of Enron's 1996 to 2001 tax returns for purposes of filing a proof of claim with the bankruptcy court.<sup>43</sup> The Joint Committee staff also received periodic briefings from the Pension Benefit Guaranty Corporation and the Department of Labor with respect to Enron's pension plans.

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<sup>40</sup> In attendance at the meeting were Enron employees Jordan Mintz, Edward Coats, and James Ginty, lawyers from Enron's counsel (Skadden Arps and Weil Gotschal & Manges LLP), lawyers from Alston & Bird LLP (counsel for the Enron Examiner).

<sup>41</sup> The company presentation and appendix thereto are contained in Appendix A to this Report.

<sup>42</sup> The Joint Committee staff contacted Mr. Hermann after his name appeared in a May 22, 2002, Washington Post article that discussed the structured transactions in which Enron engaged. April Witt and Peter Behr, *Enron's Other Strategy: Taxes; Internal Papers Reveal How Complex Deals Boosted Profits by \$1 Billion*, The Washington Post (May 22, 2002) at A-1. The article and the interview with Mr. Hermann provided useful information for this Report. A follow-up telephone interview of Mr. Hermann took place on December 4, 2002.

<sup>43</sup> The IRS' deadline for filing a proof of claim regarding Enron's tax liabilities with the bankruptcy court is March 31, 2003. The Joint Committee staff has, in some cases, chosen not to describe or discuss certain aspects of the investigation if the staff determined that doing so could jeopardize the IRS' interests in Enron's pending bankruptcy proceedings.



### **Review of Enron's tax returns**

The Joint Committee staff requested Enron's consolidated Federal tax returns for all years since 1985. Each of these tax returns contains thousands of pages of schedules and attachments. As noted in Table 4, below, since 1997, Enron Corp. prepared more than 1,000 Federal tax returns each year with respect to affiliated and other entities in which Enron held an interest.

**Table 4. –Enron’s Federal Tax Returns\***

	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>
Total number of returns prepared for Enron consolidated tax return	274	333	502	713
Total number of returns prepared for entities filed outside of the Enron consolidated tax return**	58	164	178	190
Total number of entities/branches included in foreign information returns	628	842	1,048	1,485
Total number of entities/branches included in partnership returns	42	66	94	98
<b>Total Number of Federal Tax Returns</b>	<b>1,002</b>	<b>1,405</b>	<b>1,822</b>	<b>2,486</b>

Source: Enron presentation to Joint Committee staff, June 7, 2002, included in Appendix B to this Report.

\* Includes pro-forma returns for check-the-box, accounting, and legal branches.

\*\* Approximately 15-20 separate company or consolidated returns.

In addition, the Joint Committee staff was provided access by the IRS to returns of partnerships and other entities that were not legally related to Enron, but with which Enron had significant relationships. For example, in some instances, Enron may not have held an interest in a partnership engaged in a transaction with Enron; however, partners in the partnership were high-ranking Enron employees.

The proliferation of Federal tax returns prepared by Enron (note, for example, the 36 percent increase in returns from 1999 to 2000) is consistent with trends the Joint Committee staff observed with respect to the operations of the company. See, for example, the discussion in Part Three, V., below, about the increases in the numbers of off-shore entities utilized by Enron.

As Table 4, above, demonstrates, the scope of Enron’s activities, and the number of entities associated with Enron Corp., was quite large in the period before it sought bankruptcy protection. Enron Corp. and members of its consolidated group<sup>44</sup> also held interests in hundreds of other entities that were not themselves included in the consolidated return. For example, in Enron’s international operations, approximately 1,300 foreign entities were established, a majority of which were inactive.<sup>45</sup> In addition, Enron and its numerous corporate subsidiaries entered into transactions for which special-purpose entities were formed. The structured tax-motivated transactions and structured financing transactions in which Enron affiliates engaged involved the use of dozens of legal entities.<sup>46</sup> As a result of the broad scope of Enron’s group

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<sup>44</sup> An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. An affiliated group means one or more chains of included corporations connected with a common parent, if stock ownership rules requiring 80-percent voting and value are met. Includible corporations do not include foreign corporations; partnerships are not included in a consolidated return. Secs. 1501 and 1504.

<sup>45</sup> “Enron Corp. Presentation to the Joint Committee on Taxation, June 7, 2002,” at 42.

<sup>46</sup> These transactions, and the entities involved in them, are described (with diagrams) in Part Three of this Report.

and the numerous consolidated and nonconsolidated entities in which Enron had an interest, the Joint Committee staff took the broad approach of examining transactions and patterns of compensatory arrangements in which Enron engaged, rather than examining Enron's structure or tax posture on an entity-by-entity basis.

In conducting its review, the Joint Committee staff did not conduct the equivalent of an IRS examination of Enron's tax returns. Rather, the staff examined certain tax-driven transactions of Enron that raised issues of tax policy and interpretation of the tax law. The staff focused on these types of transactions rather than attempting generally to examine the activities of Enron. An attempt to duplicate the type of work that the IRS performs when examining a tax return for a corporation as large and complex as Enron would have required staffing, time, and examination expertise well beyond that available to the Joint Committee staff.

The Joint Committee staff used Enron's Federal tax returns as a resource to verify information provided by the IRS and Enron. For example, the Joint Committee staff has provided a book-to-tax reconciliation for certain years, the information for which was obtained from Enron's Federal tax returns. This book-to-tax reconciliation shows how Enron's book income was translated to taxable income on its Federal tax returns.

### **Document requests**

The Joint Committee staff made seven written document requests (including requests for information contained on other forms of media (e.g., videotapes and CD-ROMs)) to Enron during the course of its investigation. Enron responded in 16 separate letters prepared by its counsel, Skadden Arps. The document production from Enron totaled more than 100 boxes of information.

The Joint Committee staff requested documents and information from the IRS on at least six occasions. The IRS responses to these requests totaled more than 40 boxes of information.

On March 6, 2002, the Joint Committee staff requested documents and other information from the Department of Labor relating to Enron's qualified plans and other compensation arrangements within the Department of Labor's jurisdiction. Certain materials were provided to the Joint Committee staff by the Department of Labor during the summer of 2002. On October 1, 2002, a follow-up letter was sent to the Department of Labor. On October 11, 2002, the Department of Labor provided additional documents in response to the Joint Committee staff's requests.

On June 6, 2002, the Joint Committee staff met with staff of the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs with respect to the Subcommittee's investigation relating to Enron. The Joint Committee staff was afforded the opportunity to review documents the Subcommittee had collected that might be relevant to the Joint Committee staff investigation.

### **Interviews of individuals relevant to the Enron investigation**

The Joint Committee staff considered interviews with current and former Enron employees and other individuals with connections to Enron to be an important element of its

investigation. Between July 16, 2002, and January 23, 2003, the Joint Committee staff conducted 46 interviews of individuals with information relevant to the Joint Committee staff investigation.<sup>47</sup> Generally, each interviewee was asked a standard set of questions based upon the individual's particular knowledge of Enron. Some of the interviews were conducted by telephone, but many were conducted in person in Houston, Texas, and Washington, D.C.

In some cases, individuals who the Joint Committee staff requested to interview were not available. Some individuals refused to cooperate with the Joint Committee staff investigation. Some individuals did not respond to repeated requests for an interview.

The Joint Committee staff who conducted the interviews took notes, but generally did not record the interviews. After each interview, the Joint Committee staff compiled their notes into a single interview record. These interview records have been used extensively in this Report to detail the activities of Enron and, in some cases, the motivation or purpose for Enron's activities.

It is important to note that the individuals interviewed by the Joint Committee staff were not under oath. To the extent individuals made statements that were inconsistent with statements made by others or with documents provided by Enron or other sources, the Joint Committee staff attempted to resolve the inconsistency through follow-up interviews or further document review. In some unresolved cases, the Joint Committee ultimately had to use its best judgment to resolve inconsistencies.

Appendix A to this Report contains a list of individuals the Joint Committee staff interviewed and their relationship to Enron. The document in Appendix A also contains a listing of certain individuals who did not agree to the Joint Committee staff's request for an interview.

### **Joint Committee staff travel**

Joint Committee staff made four trips to Houston, Texas in connection with its investigation (during March, August, and September of 2002). During these trips, the Joint Committee staff met with IRS personnel from Houston and Dallas and interviewed current and former Enron employees.

### **Other investigations and sources of information**

The Joint Committee staff reviewed publicly available information relating to Enron, including information made available by the Securities and Exchange Commission; the Department of Labor; the Pension Benefit Guaranty Corporation; the Senate Committee on Health, Education, Labor, and Pensions; the Senate Committee on Governmental Affairs; the Senate Committee on Energy and Commerce; the Senate Committee on Commerce, Science and Transportation; the Senate Committee on Banking, Housing, and Urban Affairs; the House Committee on Financial Services; the House Committee on Energy and Commerce; the House Committee on Education and the Workforce; and the U.S. Bankruptcy Court for the Southern District of New York.

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<sup>47</sup> The Joint Committee staff sent more than 48 letters to potential interviewees and their counsel and made numerous telephone calls in its attempts to schedule interviews.

The Joint Committee staff reviewed media reports relating to Enron's activities for information relevant to the Joint Committee staff investigation.

### **Outside advisors**

The Joint Committee staff reviewed tax opinions and other documentation regarding the tax advice provided by Enron's outside advisors with respect to many of the transactions within the scope of the investigation.<sup>48</sup> Although the Joint Committee staff reviewed such opinions and advice for purposes of analyzing the transactions, the Joint Committee staff did not examine the propriety of this advice under present standards of professional conduct or similar rules relating to Federal tax practice, or for purposes of determining whether there may have been violations of tax statutes relating to tax return preparers or tax advisors.

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<sup>48</sup> Many of the tax opinion letters reviewed by the Joint Committee staff are included in Appendix C to this Report.

## II. HISTORY OF THE COMPANY

### A. Background

Enron Corp. is a Houston-based energy and commodities trading holding company currently under Federal bankruptcy reorganization protection.<sup>49</sup> Through approximately 3,500 domestic and foreign subsidiaries and affiliates, Enron conducted business in diverse markets and industries, including wholesale merchant and commodity market businesses, the

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<sup>49</sup> Enron Corp., an Oregon corporation, and thirteen of its affiliates filed voluntary petitions for Chapter 11 bankruptcy reorganization protection on December 2, 2001, in the United States Bankruptcy Court, Southern District of New York. Simultaneously with the filings, the companies collectively filed a motion requesting entry of an order jointly administering and consolidating for administrative purposes only these Chapter 11 cases. Additional affiliated entities were consolidated with the proceeding subsequent to the original filings.

As of February 8, 2003, Enron reported that the following 79 Enron companies have filed voluntary petitions for Chapter 11 reorganization: Artemis Associates, LLC; BAM Leasing Company; Clinton Energy Management Services, Inc.; EBF LLC; Calypso Pipeline, LLC; EES Service Holdings, Inc.; EESO Merchant Investments, Inc.; EFS Construction Management Services, Inc.; ENA Asset Holdings, L.P.; ENA Upstream Company LLC; Enron Broadband Services, Inc.; Enron Broadband Services, L.P.; Enron Capital & Trade Resources International Corp.; Enron Communications Leasing Corp.; Enron Corp.; Enron Energy Information Solutions, Inc.; Enron Energy Marketing Corp.; Enron Energy Services Inc.; Enron Energy Services L.L.C.; Enron Energy Services North America, Inc.; Enron Energy Services Operations, Inc.; Enron Engineering & Construction Company; Enron Engineering & Operational Services Company; Enron Expat Services, Inc.; Enron Federal Solutions, Inc.; Enron Freight Markets Corp.; Enron Fuels International, Inc.; Enron Gas Liquids, Inc.; Enron Global LNG LLC; Enron Global Markets LLC; Enron India Holdings Ltd.; Enron Industrial Markets LLC; Enron International Fuel Management Company; Enron Liquid Fuels, Inc.; Enron LNG Marketing LLC; Enron LNG Shipping Company; Enron Management, Inc.; Enron Mauritius Company; Enron Metals & Commodity Corp.; Enron Methanol Company; Enron Natural Gas Marketing Corp.; Enron Net Works L.L.C.; Enron North America Corp.; Enron Power & Industrial Construction Company; Enron Power Marketing, Inc.; Enron Processing Properties, Inc.; Enron Property & Services Corp.; Enron Reserve Acquisition Corp.; Enron Transportation Services Company; Enron Ventures Corp.; Enron Wind Constructors Corp.; Enron Wind Corp.; Enron Wind Development LLC; Enron Wind Energy Systems Corp.; Enron Wind Maintenance Corp.; Enron Wind Systems, Inc.; E Power Holdings Corp.; EREC Subsidiary I, LLC; EREC Subsidiary II, LLC; EREC Subsidiary III, LLC; EREC Subsidiary IV, LLC; EREC Subsidiary V, LLC; Garden State Paper Company, LLC; Intratex Gas Company; LINGTEC Constructors, L.P.; National Energy Production Corporation; NEPCO Power Procurement Company; NEPCO Services International, Inc.; Offshore Power Production CV; Operation Energy Corp.; PBOG Corp.; Palm Beach Development Company, L.L.C.; San Juan Gas Company, Inc.; Smith Street Land Company; Tenant Services, Inc.; The New Energy Trading Company; Zond Minnesota Construction Company LLC; Zond Pacific, LLC; and ZWHC LLC.

management of retail customer (end-use) energy services, the operation of gas transmission systems, and the management of energy-related assets and broadband services.

Enron's roots can be traced to a domestic natural gas pipeline company formed in 1930. For the next 30 years, the company remained a domestic natural gas pipeline company. In the 1960s, Enron began a series of changes that diversified the company into other energy markets. Major expansion of the company's operations occurred in the late 1980s and early 1990s as the company moved from being a domestic company to a global provider of energy products. In the mid and late 1990s, further expansion of Enron's activities continued, including a shift from a company based in physical energy assets to a provider of broader services, such as risk management, communications, and financial services.

By the time it filed for bankruptcy protection, Enron had been transformed from a domestic natural gas pipeline company into a global provider and trader of: (1) energy resources and commodities (including electricity, crude oil, physical natural gas, liquefied natural gas, wind power, and air emissions credits); (2) financial and risk management services (including hedging, weather, energy price, and foreign exchange risk management); and (3) electronic commerce (including trading in bandwidth capacity, operating a global Internet-based transaction system for trading in wholesale and retail energy and other commodities, and providing movies and other entertainment on demand). Enron also expanded into non-energy resource businesses such as global metals trading and water resources. Much of Enron's business strategy attempted to take advantage of market opportunities in increasingly deregulated energy markets, including natural gas and electricity, or in lesser regulated markets, such as energy commodities trading and electronic commerce.

Enron has been recognized as a leading innovator<sup>50</sup> and employer.<sup>51</sup> Enron's market capitalization reportedly increased from approximately \$2 billion in the mid-1980s to

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<sup>50</sup> Enron was named the "Most Innovative Company in America" for six consecutive years by Fortune magazine, and also ranked among the top five companies in Fortune's categories of quality of management, quality of products and services, and employee talent in the 2001 rankings. Press Release, Enron Corp., Enron Named Most Innovative for Sixth Year (February 6, 2001), at <http://www.enron.com/corp/pressroom/releases/2001/ene/15-MostInnovative-02-06-01-LTR.html> (last visited January 22, 2003).

<sup>51</sup> At the time it filed for bankruptcy, Enron employed approximately 25,000 employees worldwide. Affidavit of Jeffrey McMahan Pursuant to Local Bankruptcy Rule 1007-2 at 5, In re Enron Corp., et. al., Debtors (No. 01-16034 (Docket Entry No. 3)), available at <http://www.elaw4enron.com/default.asp> (last visited January 27, 2003). Enron was named to Fortune magazine's list of "100 Best Companies to Work For in America" for 1998 (73<sup>rd</sup>), 1999 (24<sup>th</sup>), and 2000 (22<sup>nd</sup>). Press Release, Enron Corp., Enron Named #22 of "100 Best Companies to Work for in America" (December 18, 2000), at <http://www.enron.com/corp/pressroom/releases/2000/ene/111-FortuneBestCo.html> (last visited January 22, 2003); Press Release, Enron Corp., Enron Named One of "100 Best Companies to Work for in America" (December 21, 1999), at <http://www.enron.com/corp/pressroom/releases/1999/ene/fortune.html> (last visited January 22, 2003).

approximately \$70 billion in early 2001.<sup>52</sup> Enron reported consolidated revenues of \$101 billion for 2000, and ranked seventh on the Fortune 500 list of the country's largest companies for 2001.<sup>53</sup> As of December 31, 2000, the company had approximately 58,920 shareholders of record with respect to its outstanding shares of common stock.<sup>54</sup> Enron's bankruptcy filing was the largest corporate bankruptcy in U.S. history prior to the July 21, 2002, filing by Worldcom, Inc.<sup>55</sup>

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<sup>52</sup> Enron reported in 2001 that during the 15-year period that Mr. Kenneth L. Lay was Chief Executive Officer of the company (1986 to 2001), its market capitalization increased from \$2 billion to \$70 billion. Press Release, Enron Corp., Enron Announces Skilling Resignation; Lay Assumes President and CEO Duties (August 14, 2001), at <http://enron.com/corp/pressroom/releases/2001/ene/58-ENE-SkillingResignation-08-14-01-LTR.html> (last visited January 22, 2003).

<sup>53</sup> <http://www.fortune.com/fortune/fortune500> (last visited January 22, 2003). Enron moved up to fifth place on the Fortune 500 list for 2002, and was sixth on Fortune's 2002 Global 500, which lists the world's largest corporations. *Id.*

<sup>54</sup> Affidavit of Jeffrey McMahon Pursuant to Local Bankruptcy Rule 1007-2 at 6, In re Enron Corp., et. al., Debtors (No. 01-16034 (Docket Entry No. 3)), at <http://www.elaw4enron.com/default.asp> (last visited January 27, 2003).

<sup>55</sup> [http://www.bankruptcydata.com/Research/15\\_Largest.htm](http://www.bankruptcydata.com/Research/15_Largest.htm) (last visited January 22, 2003).



## **B. History of Business Operations**

### **1. Formative years and the 1985 acquisition of Houston Natural Gas**

The company that became Enron Corp. was incorporated as Northern Natural Gas Company, a Delaware corporation, on April 25, 1930. The company changed its name to InterNorth, Inc. (“InterNorth”) in 1980, and then to Enron Corp. in April 1986.<sup>56</sup>

During the company’s first thirty years of existence its only business was transporting and marketing natural gas. During the 1960s, it diversified its operations to include natural gas liquids, petrochemicals, and exploration and production of natural gas and oils. Its revenues and assets increased steadily during the 1970s and early 1980s. The company underwent major expansion in the 1980s when it acquired Belco Petroleum Company (an oil and gas exploration and production company) in 1983, Chemplex Company (a manufacturer of olefins, high- and low-density polyethylene and adhesives) in 1984, and Houston Natural Gas Corporation (“HNG”) on July 1, 1985. The HNG acquisition was a major contributing factor to the company’s ultimate transformation from a regional natural gas pipeline to a global provider and trader of energy and other products.

At the time of the 1985 acquisition of HNG, InterNorth was a publicly traded regional interstate natural gas pipeline company based in Omaha, Nebraska. As of December 31, 1984, InterNorth had approximately 35,000 miles of natural gas pipeline, \$6.1 billion of total assets, 10,551 employees, and \$7.5 billion of revenues during fiscal year 1984.<sup>57</sup> Its natural gas operations were sold to purchasers at various points in the upper Midwest, as well as in the production area States of Texas, New Mexico, Louisiana, Oklahoma, Kansas, Colorado, Montana, and Wyoming. Following the Federal deregulation of natural gas markets commenced by the Federal Energy Regulatory Commission (“FERC”) in 1985,<sup>58</sup> InterNorth sought to expand its presence in the domestic natural gas industry by acquiring HNG. HNG was a publicly traded intrastate natural gas pipeline company that had three large but separate pipeline systems based in Texas, Florida, and California.<sup>59</sup> HNG had approximately 14,000 miles of natural gas pipeline, 3,100 employees, and \$3.9 billion of assets as of December 31, 1984. InterNorth and

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<sup>56</sup> Enron Corp. reincorporated as an Oregon corporation in 1997.

<sup>57</sup> InterNorth’s operating revenues were derived from the transmission and distribution of natural gas at wholesale and retail (38 percent); the acquisition, production, transportation, and marketing of natural gas liquids and petroleum products (52 percent); the exploration and production of natural gas and oil (5 percent); and the production and marketing of plastic resins and films, petrochemicals, and antifreeze (5 percent).

<sup>58</sup> Various FERC orders mandated a fundamental restructuring of interstate pipeline sales and transportation services, and further enhanced competition in the natural gas industry by assuring comparability of pipeline sales and services offered by competitors.

<sup>59</sup> HNG had been an intrastate natural gas pipeline company operating primarily in Texas until 1984 when it acquired interstate pipeline systems based in Florida and California.

HNG reported market capitalization of \$2.1 billion and \$1.4 billion, respectively, as of March 1985.

InterNorth acquired HNG pursuant to a stock acquisition in which InterNorth paid HNG shareholders \$2.4 billion cash for all of HNG's stock. For financial reporting purposes, the InterNorth/HNG transaction was reported as the acquisition by InterNorth of HNG, effective June 1, 1985, under the purchase method of accounting. For Federal income tax purposes, the transaction was reported as a taxable purchase by InterNorth of HNG's stock, and HNG and its affiliates were included in InterNorth's consolidated Federal income tax return beginning in calendar year 1985.

The combination of InterNorth's and HNG's pipeline systems formed the largest natural gas pipeline system in the United States, approximately 37,000 miles in length, and the first nationwide natural gas pipeline network in the United States. HNG's Houston pipeline served as the hub of the company's network and major interstate pipelines, and created a pipeline system that extended from the borders of Mexico to Canada, and from Florida to the Arizona-California border. The combined company's major businesses included: (1) gathering and wholesale marketing of natural gas through its pipeline system (approximately 63 percent of the company's assets); (2) exploration and production of natural gas and crude oil (approximately 25 percent of the company's assets); (3) production, purchase, transportation, marketing and trading of natural gas liquids, crude oil, and refined petroleum products (approximately five percent of the company's assets); and (4) the manufacture and marketing of polyolefin plastic resins and related products (approximately five percent of the company's assets).<sup>60</sup>

Although HNG was the smaller of the two combined companies, its officers and directors took over management control soon after the acquisition.<sup>61</sup> The combined company first operated under the name HNG InterNorth. HNG's Chairman and Chief Executive Officer, Mr. Kenneth Lay, became the Chairman of the Board and Chief Executive Officer of HNG InterNorth in February 1986.<sup>62</sup> By the end of 1986, a majority of Enron Corp.'s officers and directors were former officers and directors of HNG, the acquired company.

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<sup>60</sup> At the time of the HNG acquisition, InterNorth was the eighth largest producer of polyolefin resins in the world.

<sup>61</sup> This was contemplated in the agreement between InterNorth and HNG. Pursuant to section 6.12 of the Agreement and Plan of Merger between the companies, InterNorth agreed and covenanted to cause its Chairman and Chief Executive Officer to remain in those positions until January 1, 1987, at which time Mr. Lay would assume those positions, and increase the InterNorth board size to permit ten directors to be selected by HNG's board or by Mr. Lay. The Chairman and Chief Executive Officer of InterNorth at the time of the acquisition left the company in November 1985.

<sup>62</sup> Mr. Lay became Chairman and Chief Executive Officer of HNG in June 1984. He served in these capacities with HNG InterNorth and Enron Corp. until February 2001, at which time Mr. Jeffrey K. Skilling was promoted to Chief Executive Officer of the company. Mr. Skilling resigned from Enron in August 2001, and Mr. Lay once again became Chief Executive

## 2. Transition from natural gas company to diversified energy company: 1986-1995

During 1986 to 1995, Enron began its transformation from a domestic natural gas company to a global provider of energy products. Immediately following the HNG acquisition, Enron implemented a program of selective asset divestitures. Asset dispositions included certain pipelines that were required to be sold as a condition to regulatory approval of the HNG acquisition, retail natural gas operations, the petrochemicals business segment, and other smaller operations.<sup>63</sup>

At the end of 1986, Enron was predominantly a domestic business, with the company's foreign assets and foreign operating revenues comprising 10 percent and eight percent, respectively, of the company's worldwide totals.<sup>64</sup> The company had oil and gas reserves in the United States and Canada, most of which were held in its subsidiary, Enron Oil & Gas Company ("EOG").<sup>65</sup>

By the late 1980s, however, Enron's business began to change. Enron became involved in buying and selling energy commodities, as well as exploring, developing, and transmitting natural gas and liquid energy products. During 1987, Enron discontinued its speculative oil and petroleum products trading operations conducted by Enron Oil Corp. in New York due to losses incurred as a result of unauthorized trading activities. In 1989, Enron began entering into long-term fixed priced energy contracts, and trading natural gas commodities through the use of forward contracts and other instruments.

As recently as 1990, Enron viewed itself as a natural gas company. In its Annual Report released in early 1990, Enron stated, "Enron enters the 1990s with a focused business strategy, a strong set of values and a vision to become the premier integrated natural gas company in the world. Enron's business is natural gas, from the reservoir to the burner tip ..."<sup>66</sup>

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Officer. Mr. Lay remained Enron's Chairman of the Board and Chief Executive Officer until he resigned from those positions in January 2002. Mr. Lay resigned as an Enron director in February 2002.

<sup>63</sup> The divestitures and associated layoffs of employees reduced the company's total workforce from 8,800 employees in 1985 to 7,200 employees at the end of 1986.

<sup>64</sup> See Table 5, Miscellaneous Foreign and Domestic Financial Information for Enron, 1991 to 2000.

<sup>65</sup> As of December 31, 1989, EOG's reserves were 91 percent natural gas and predominantly domestic (91 percent located in the United States and nine percent located in Canada).

<sup>66</sup> Enron Corp., 1989 Annual Report, at 6 (1990). For the year ended December 31, 1989, Enron's consolidated group of companies derived approximately 35 percent of its revenues from natural gas operations, 63 percent from liquid fuels operations (including liquid natural gas, gas liquids, and crude oil), and 2 percent from exploration and production. *Id.* at 1.

In the early 1990s, Enron increased its natural gas trading and financing activities through its subsidiaries, Enron Gas Marketing, Inc., Enron Finance Corp., and Enron Gas Services.<sup>67</sup> During the period 1992-1994, Enron disposed of a substantial portion of its liquid pipeline assets, including the Northern Border Pipeline in 1993, and its substantial Enron Oil Trading & Transportation Company (“EOTT”) crude oil and trading operations in 1994, by transferring those assets to unconsolidated partnerships such as Enron Liquid Pipelines, LP, Northern Border Partners, LP, and EOTT Energy Partners, LP.<sup>68</sup> Enron’s disposition of EOTT was so significant that it caused Enron to restate certain of its financial statements, beginning with those included in its 1993 Annual Report.<sup>69</sup>

In 1994, Enron began purchasing and selling electricity after Enron’s power marketing subsidiary obtained a no-action letter from the Securities and Exchange Commission exempting its power marketing activities from regulation as an electric utility under the Public Utility Holding Company Act.<sup>70</sup>

In the 5-year period, 1991 through 1995, Enron’s annual revenues (restated after taking into account the divestiture of EOTT) increased from \$5.7 billion to \$9.2 billion. Enron’s total assets were \$13.2 billion as of December 31, 1995.

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<sup>67</sup> In 1992, Enron adopted the mark-to-market method of accounting for financial statement purposes for its trading operations. *See* Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation (June 7, 2002).

<sup>68</sup> Enron Liquid Pipelines, LP, Northern Border Partners, LP, and EOTT Energy L.P. were classified as master limited partnerships. Enron reported to the Joint Committee staff that the master limited partnership prospectus informed investors of the intent to register the aforementioned as tax shelters under sec. 6111(c). *See* Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation (June 7, 2002).

<sup>69</sup> EOTT’s operations had accounted for revenues of \$8.2 billion, \$7.7 billion, and \$6.4 billion of Enron’s consolidated revenues for 1991, 1992, and 1993, respectively. Enron Corp., Form 10-K for Fiscal Year Ended December 31, 1993 (note 3 to the consolidated income statement). Enron’s reported revenues decreased from \$13.5 billion in 1991 to \$6.3 billion in 1992, with revenues from liquid fuels (including EOTT) decreasing from \$9.9 billion to \$2.0 billion for those years. Enron Corp., Form 10-K for Fiscal Year Ended December 31, 1991 (1992), at 23-24; Enron Corp., Form 10-K for Fiscal Year Ended December 31, 1992 (1993), at 20-21. Based on these reported amounts, the EOTT divestiture decreased Enron’s reported consolidated revenues by approximately 55 percent and 44 percent for 1992 and 1993, respectively. *Id.* *See also* Enron Corp., 1992 Annual Report (1993), at 42, 51 (disclosing proposed spinoff of EOTT and reporting EOTT’s activities as discontinued operations).

<sup>70</sup> Congressional Research Service, Financial Oversight of Enron: *The SEC and Private-Sector Watchdogs, Report of the Staff to the Senate Committee on Governmental Affairs*, at 47-51 (October 8, 2002).

During the early 1990s, Enron also increased its foreign presence principally through the development, acquisition, promotion, and operation of natural gas and power projects and the marketing of natural gas liquids. A consortium that included Enron acquired a southern Argentina pipeline system in 1992 to establish Enron's first presence in South America. In April 1993, Enron made its first substantial investment in the European energy markets when it began its Teesside operations, a combined cycle gas turbine power plant in the United Kingdom. In 1994, Enron formed Enron Global Power and Pipelines to develop energy projects in developing nations. By 1995, Enron's international activities included power plants or projects in Germany, Guatemala, and the Philippines, its pipeline system in Argentina, retail gas and propane sales in the Caribbean basin, and natural gas liquids processing at Teesside. By the close of 1995, Enron's foreign assets and revenues accounted for approximately 14 percent and 11 percent of total worldwide assets and revenues, respectively.

### **3. Transformation to a marketing and logistics company: 1996-2001**

The period 1996-2001 involved four significant company-wide themes: (1) expansion into increasingly deregulated domestic energy markets such as natural gas and electricity; (2) movement into global markets such as power plants, water, and metals; (3) transformation from a physical assets company to a provider of risk management, communications, financial, and energy services; and (4) a focus on attaining financial and operational objectives established in January 1996. Enron promoted itself as an innovator and a company for the changing economy, describing itself as having "metamorphosed from an asset-based pipeline and power generating company to a marketing and logistics company whose biggest assets are its well-established business approach and its innovative people."<sup>71</sup> The company's Chief Executive Officers during this period, Messrs. Lay and Skilling, oversaw the company's transformation.

In 1996, Enron introduced "Enron 2000," a plan that represented the company's commitment to achieving three specific financial objectives: (1) \$1 billion of net income by the year 2000; (2) 15 percent average compound annual growth; and (3) double-digit growth in each individual fiscal year.<sup>72</sup> Enron 2000 was introduced and described in the company's year-end earnings release issued to analysts, media, shareholders, and employees, and was communicated to stock analysts and management personnel at separate meetings.<sup>73</sup> In announcing Enron's 1996 earnings per share, Mr. Lay, chairman and chief executive officer of Enron, was quoted in an Enron press release as saying, "Enron achieved its earnings and operational goals in 1996, the

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<sup>71</sup> Enron Corp., 2000 Annual Report, at 9 (2001).

<sup>72</sup> Presentation to Enron Corp. Board of Directors' Meeting, December 9, 1997 (describing the history regarding introduction of Enron 2000 and its importance as the standard against which the company's actual financial performance was to be measured). EC 000046072.

<sup>73</sup> Enron Corp., 1996 Performance Review (January 17, 1997). EC 000103501.

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."<sup>74</sup>

Enron restructured its worldwide operations in January 1997. The restructured company: (1) consolidated its international activities into Enron International (consisting of Enron Development Corporation, Enron Joint Venture Management, Enron Americas, and Enron Global Power and Pipelines); (2) established the Enron Gas Pipeline Group, which was responsible for all of Enron's North American pipeline companies; (3) established Enron Ventures Corp. to manage its international and domestic engineering and construction activities; (4) formed Enron Renewable Energy Corp. to conduct wind energy projects; (5) formed Enron Capital Management to encompass Enron's treasury and corporate risk management functions; and (6) continued Enron Capital & Trade Resources, which was later renamed Enron North America Corp.

Enron's shift during this period from physical assets to services businesses was evidenced by its growth in reported risk management assets (from \$0.5 billion in 1992 to \$21 billion in 2000) relative to net plant, property, and equipment (from \$6.5 billion to \$11.7 billion during the same period). By March 2000, Enron was the sixth largest energy company in the world, with its businesses divided into three core areas: (1) wholesale services, including the marketing and delivery of physical commodities and financial risk management services; (2) retail energy services business, including providing integrated energy and facility management outsourcing solutions to commercial and industrial consumers worldwide; and (3) global services, including asset-based businesses such as pipelines, engineering businesses, and international power, pipeline, and distribution operations. Enron entered into contracts for physical delivery of energy products, as well as financial contracts related to trading its wholesale commodity products, including commodities contracts, forward contracts, swap agreements, securities contracts, caps, floors, collars, futures contracts, repurchase agreements, and options.

Enron's reported consolidated revenues increased from \$13 billion in 1996 to \$101 billion in 2000. During the same period, Enron's reported total assets increased from \$16.1 billion to \$65.5 billion.<sup>75</sup>

### **Natural gas and electricity in the United States**

At the beginning of 1996, Enron operated the second largest natural gas transmission system in the world. Throughout the 1990s Enron also increased its power marketing activities, which consisted of selling power at market-based rates. Shortly after announcing its January 1997 worldwide restructuring, Enron formed Risk Management & Trading Corp. to "manage trading books" for various Enron entities. Soon thereafter, Enron formed Enron Energy Services

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<sup>74</sup> 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 January 26, 2003).

<sup>75</sup> The asset and revenue figures were reported in the company's financial statements prior to charges and restatements announced and made in October and November 2001.

to sell energy and advisory services, such as long-term energy management, to large consumers.<sup>76</sup>

In early 1997, Enron took steps to increase its electricity development and production in the northwestern United States when it announced a strategic energy alliance with Northern California Power Agency, pursuant to which Enron would provide a comprehensive package of services, including the sale of natural gas and financial and risk management products. This event reportedly marked the first alliance of its kind following California's deregulation of the electric power industry. In July 1997, Enron acquired Portland General Corporation ("PGC"), an electric utility holding company, and Portland General Electric ("PGE"), its affiliated electric utility with approximately 685,000 residential and commercial retail customers in Oregon. Enron's acquisition of PGE and PGC was effected by a \$1.9 billion stock swap in which Enron issued 50.5 million shares of Enron stock to PGC shareholders in exchange for 49.6 million shares of PGC stock. Enron also consolidated \$1.1 billion of PGE's debt, making the total acquisition price approximately \$3 billion.<sup>77</sup> Enron considered PGE to be its platform to enter the deregulated California electricity market.<sup>78</sup> In October 1997, Enron entered the California electricity market by offering consumers two weeks of free electricity and utility rates guaranteed for at least two years.

Enron's acquisition of PGE raised certain regulatory issues under the Public Utility Holding Company Act that caused Enron to change its corporate domicile from Delaware to Oregon. When Enron acquired ownership of all of the outstanding voting securities of PGE, an Oregon public utility, Enron became a public utility holding company within the meaning of the Public Utility Holding Company Act. The Public Utility Holding Company Act provided a limited "intrastate exemption" from certain regulatory provisions if the holding company (Enron Corp.) and its subsidiary utility (PGE) were domiciled within the same State. Concomitant with the PGE acquisition, Enron Corp. reincorporated in Oregon, reissued its capital stock without par

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<sup>76</sup> As identified in Enron press releases, these long-term energy management customers ultimately included, among others: The Chase Manhattan Corporation, IBM, Quebecor, Starwood Hotels and Resorts, Compaq, Simon Properties, Sonoco, Owens-Illinois, Quaker Oats, Eli Lilly, JCPenney, and Saks Incorporated. *See* Press Release, Enron Corp., Enron and Chase Manhattan Bank Sign Long-Term Energy Management Agreement (February 2, 2000), at <http://www.enron.com/corp/pressroom/releases/2000/ene/chase.html> (last visited February 11, 2003); and Press Release, Enron Corp., Enron Reports Record First Quarter Recurring Earnings of \$0.47 per Diluted Share; Increases Earnings Expectations for 2001 (April 17, 2001), at <http://www.enron.com/corp/pressroom/releases/2001/ene/ENE-Q1-01-LTR.html> (last visited February 11, 2003).

<sup>77</sup> The PGE acquisition was reported under the purchase method of accounting for financial reporting purposes. For Federal income tax purposes, Enron treated the acquisition of the stock of PGE and its affiliates as a tax-free reorganization pursuant to section 368(a)(1)(A) when PGC was merged with and into Enron.

<sup>78</sup> Enron Corp., Form U-1, Application-Declaration Under The Public Utility Holding Company Act of 1935, filed with the Securities and Exchange Commission (February 28, 2002).

value, and ceased to be a Delaware corporation, in order to place Enron Corp. and PGE within this intrastate exemption.

By 1999, Enron had become the largest merchant of power and gas in North America. Enron's gas pipeline group owned interests in four interstate pipelines, operated 32,000 miles of pipelines in 21 states, and transported approximately 15 percent of the U.S. natural gas demand.

### **Foreign markets**

During 1996 to 1998, Enron commenced marketing electricity and natural gas, delivering energy and other physical commodities, and providing financial and risk management services around the world. Construction of the combined cycle power plant project in Dabhol, India began in 1996.<sup>79</sup> Years 1998 and 1999 brought further expansion into foreign markets, with Enron making a substantial equity investment in Elektro, a Brazilian electricity transmission system. In total, Enron's foreign net proved reserves of natural gas and liquids had increased as a portion of worldwide net proved reserves from four percent and 13 percent, respectively, at the end of 1985, to 45 percent and 65 percent, respectively, at the end of 1998.<sup>80</sup> Enron entered the water business in July 1998 when it acquired Wessex Water Plc, a major U.K. water company. The 1998 acquisition of Wessex Water for \$2.2 billion, and the formation of a new water company, Azurix Corp. ("Azurix"), was effected to allow Enron to own and operate strategic water and wastewater assets, such as local distribution systems and treatment facilities, and to develop related infrastructure. Azurix pursued water projects in Europe, Latin America, and Asia.

During 2000, Enron opened a Tokyo office to pursue opportunities in Japan's energy, commodity, and financial sectors, with an initial focus on activities such as risk management, multi-commodity market making, electronic commerce, and merchant asset development. In May 2000, Enron entered the metals markets by acquiring MG plc, an independent international metals market-making business, for approximately \$2 billion.

Enron's total international investment ultimately exceeded \$7 billion, including more than \$3 billion in Latin America, \$1 billion in India, and \$2.9 billion in Britain. It owned or operated electric power plants or transmission systems in the United Kingdom, Germany, Turkey, Guatemala, the Philippines, the Dominican Republic, and off the coast of China, and operated one or more of its businesses in approximately 20 countries and territories, including Central America and the Caribbean (Panama, Guatemala, Nicaragua, Puerto Rico, the Dominican Republic, and Jamaica), South America (Colombia, Venezuela, Argentina, Brazil, and Bolivia),

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<sup>79</sup> The Dabhol project became the subject of extensive litigation between Enron and the State of Maharashtra, India, regarding energy prices charged by Enron.

<sup>80</sup> "Net proved reserves" is a measure of energy reserves that have been proved to a high degree of certainty, based on studies performed by engineers.



Europe (Poland, Italy, and Turkey), and Asia Pacific (People's Republic of China, Guam, and the Phillipines).<sup>81</sup>

Enron used foreign subsidiaries and offshore entities to hold its investments throughout the world. Enron located more than 140 subsidiaries in the Netherlands alone, including subsidiaries for its broadband and wind energy units, and formed numerous subsidiaries in low-tax jurisdictions such as the Cayman Islands and Bermuda.<sup>82</sup> By the end of 2001, Enron's worldwide ownership structure included approximately 1,300 different foreign entities, with over 400 entities formed in the Cayman Islands.<sup>83</sup> Much of Enron's reported foreign earnings remained offshore, as Enron's reported undistributed earnings from foreign subsidiaries increased from \$185 million in 1993 to \$1.8 billion in 2000.

By the end of 2000, Enron was reported to be the sixth largest energy company in the world, with its foreign revenues accounting for approximately 23 percent of its total reported worldwide revenues.

### **Communications businesses**

Much of Enron's activity during the late 1990s involved expansion into the communications and financial services businesses by taking advantage of emerging technologies such as the Internet and other forms of electronic commerce.<sup>84</sup> Enron formed businesses designed to facilitate the trading and transacting of business by others, and to sell technological and communications capacity as a commodity.

One of Enron's major business strategies during the late 1990s was the creation of an online energy trading business that bought and sold contracts to deliver energy products such as natural gas, oil, and electricity. In November 1999, Enron created EnronOnline, a global Internet-based transaction system for wholesale energy and other commodities. EnronOnline allowed participants to view commodity prices in real time and directly transact with Enron over

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<sup>81</sup> See Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, (June 7, 2002). The assets held in the various international investments ranged from pipelines, power plants, electricity, gas processing, gas compressions, and gas distributions. *Id.* See also Enron website, factsheet Enron Global Services - International. See <http://www.enron.com/corp/pressroom/factsheets/egs/egsi.html>.

<sup>82</sup> For example, Enron Oil & Gas India, Ltd., which conducted upstream oil and gas activities in India, was a Cayman Islands corporation with a registered office in Grand Cayman.

<sup>83</sup> See Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, (June 7, 2002). Approximately 250 entities were associated with active operations. *Id.* See Part Three of this Report for a detailed discussion of Enron's use of foreign entities.

<sup>84</sup> See, e.g., Enron Corp., 1998 Annual Report, at 21 (1999); Enron Corp., 2000 Annual Report, at 3 (2001).

the Internet free of commission.<sup>85</sup> In May 2000, together with IBM and America Online, Enron formed New Power Company to market power and natural gas over the Internet to homes and businesses. In May 2001, Enron reported that approximately 60 percent of all Enron transactions were being conducted online, with a 75 percent reduction in the cost of processing transactions.

Another significant event during this period was the creation of Enron Broadband Services, the purpose of which was to buy and sell Internet access as a commodity.<sup>86</sup> As part of this effort, Enron launched broadband steering media services and the trading of bandwidth as a commodity,<sup>87</sup> and built what Enron called the first all-Internet Protocol backbone in the United States (named the Enron Intelligent Network, or EIN). Enron also invested \$10 million to acquire 5.4 million shares of Rhythms NetConnections, Inc. (“Rhythms Net”), a privately-held Internet service provider for businesses using digital subscriber line technology.<sup>88</sup> Enron later extended its Enron Intelligent Network broadband business to Europe through an agreement with British Telecommunications PLC.

Enron also entered various other financial and services markets through a variety of venues, including: (1) Enroncredit.Com, a real-time credit department for business-to-business

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<sup>85</sup> Enron Online commenced trading in November 1999. It reportedly generated transactions involving \$857 million of notional dollar value in its first two weeks, \$336 billion of notional value through 548,000 executed transactions during 2000, and \$590 billion of notional value by the time EnronOnline reported its one millionth transaction on May 23, 2001. 1999 Performance Review, EC 000101574; Enron Corp., 2000 Annual Report, at 3 (2001); Press Release, Enron Corp., Enron Completes One Million Transactions on EnronOnline (May 23, 2001), at <http://www.enron.com/corp/pressroom/releases/001/ene/45-MillionthTransaction-LTR-5-23-01.html> (last visited January 22, 2003).

<sup>86</sup> This opportunity stemmed from the PGE acquisition. Enron acquired PGE’s communications business, which Enron reported to be the basis for Enron Broadband Services, in the PGE merger. Enron Corp., 1999 Annual Report, at 23 (2000).

<sup>87</sup> This was accomplished through an Enron subsidiary, Enron Communications, Inc., which announced its first forward trade of bandwidth on December 2, 1999. The seller in the transaction was Global Crossing Services. Press Release, Enron Corp., Enron Communications Announces First Commodity Bandwidth Trade (December 2, 1999), at <http://www.enron.com/corp/pressroom/releases/1999/ene/bandwidth.html> (last visited January 22, 2003).

<sup>88</sup> Enron’s initial Rhythms Net investment of \$10 million reportedly grew to approximately \$300 million, though Enron was prohibited from selling any of the shares before the end of 1999 because of a lock-up commitment it undertook when it acquired the shares. Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp., dated February 1, 2002 (“Powers Report”), at 77. As described below, Enron entered into a purported hedging transaction with a newly formed special purpose entity in an attempt to hedge against a decrease in Rhythms Net stock values while Enron was required to hold the shares.

customers;<sup>89</sup> (2) a 20-year exclusive relationship with Blockbuster Inc. to provide movies on demand to households via the Internet;<sup>90</sup> (3) commodity transactions involving weather derivative products; and (4) online emissions allowance auctions.<sup>91</sup>

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<sup>89</sup> EnronCredit.com was described by Enron as being the first global online credit department to provide live credit prices and information regarding hedging credit exposure instantly over the Internet, and allowed customers to transact in bankruptcy swaps via EnronOnline.

<sup>90</sup> The Enron/Blockbuster movie-on-demand relationship, announced in July 2000, was terminated in March 2001.

<sup>91</sup> Enron's first online emissions allowance auction was conducted March 2000 and involved sulfur dioxide.

## C. Recent Financial History

### 1. Use of off-balance sheet entities to enhance financial performance measures<sup>92</sup>

#### Financial objectives

By the late 1990s, Enron had amassed substantial debt relating to its capital expenditures and investments in power plants, pipelines, electronic commerce, water, metals, and broadband services. Many of Enron's growth businesses required substantial upfront capital investments long before positive cash flows and earnings reasonably could be expected from those investments. These circumstances placed enormous pressure on the company's Enron 2000 financial objectives of: (1) \$1 billion of net income by the year 2000; (2) 15 percent average compound annual growth; and (3) double-digit growth in each individual fiscal year. Further, the company needed cash to service its increasing debt load.

Enron's evolving business approach also required the company to access increased lines of credit to ensure that the company had sufficient funds to settle energy contracts being traded on its online trading system. Enron experienced large fluctuations of short-term debt from quarter to quarter. These fluctuations potentially affected Enron's credit rating, which in turn affected Enron's ability to obtain low-cost financing and to attract investment. In response to this, Enron emphasized increasing its cash flow, lowering its debt, and smoothing its reported earnings to satisfy the criteria set out by credit and rating agencies.

The company developed or used a number of financing, operational, and accounting strategies to accomplish its financial objectives. These included: (1) using energy contracts called "prepays," which provided Enron a large advance payment to deliver natural gas or other energy products; (2) designing hedges to reduce the risk of long-term energy delivery products; (3) pooling energy contracts and securitizing them through bonds or other financial instruments sold to investors; and (4) making the company "asset light" by disposing of capital-intensive energy projects, such as power plants, that were traditionally associated with low returns and persistent debt on the company's books. Certain of Enron's strategies, such as its use of "accounting hedges," reportedly were designed to reduce the effect of investment value declines on Enron's financial statements, without effectively changing the economic risks relating to the asset.

Many of these strategies used special purpose entities ("SPEs") formed by Enron or Enron employees to conduct transactions with Enron and its affiliates. Instead of selling assets to, or transacting hedging transactions with, independent third parties, Enron engaged in transactions with unconsolidated, or "off-balance-sheet," SPEs that Enron did not include in its financial accounting statements.<sup>93</sup> Enron used SPEs in synthetic lease transactions (sale to an

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<sup>92</sup> The Powers Report serves as a source of information regarding the off-balance sheet transactions. See Part Three, below, for a more in-depth description of off-balance sheet entities.

<sup>93</sup> By October 2000, Enron had a total of approximately \$60 billion in assets, of which approximately \$27 billion were in Enron's unconsolidated affiliates. Use of unconsolidated entities allowed Enron to include its share of the affiliates' revenues in its income statement

SPE of an asset and a lease back of that asset); “sales” to SPEs of business assets with prearranged commitments to repurchase the assets at a specified future date; and “sales” to “hedging SPEs” of Enron stock and stock rights to provide credit support for hedging transactions.<sup>94</sup>

Enron reported for financial statement purposes gains or losses on portfolio investments on a mark-to-market basis, meaning that increases or decreases in the market value of Enron’s portfolio investments increased or decreased Enron’s financial statement earnings. Decreases in portfolio investment values adversely affected Enron’s financial statement earnings. Enron used purported hedging structures in an attempt to offset its portfolio investment losses by taking the position that the underlying portfolio investments were hedged, with Enron reporting offsetting gains on the purported hedging positions.<sup>95</sup>

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while excluding related debt from its consolidated financial statements, thereby enhancing its return on investment and certain other financial performance measures.

<sup>94</sup> Powers Report at 37. These off-balance structures and transactions were widely reported in the press and have become an issue in Enron’s bankruptcy proceedings. Enron’s unsecured creditors have attempted to obtain documents and testimony regarding 52 of Enron’s off-balance sheet affiliates: Rawhide Investors LLC; Ponderosa Assets LP; Sundance Assets LP; Zephyrus; Choctaw; Hawaii 125-0; Cerebus; Cornhusker; Nikita/EOTT; ETOL; Motown; Riverside; Service Co.; Slapshot; Marlin Water Trust; Atlantic Water Trust; Osprey Trust; Whitewing Associates LP; Whitewing Associates LLC; LJM Cayman LP; LJM2 Co-Investment LP; Condor; Raptor I; Raptor II; Raptor III; Raptor IV; Joint Energy Development Investments Limited Partnership; Osprey, Inc.; Big Doe, LLC; Braveheart; Chewco Investments, LP; Firefly; Yosemite; Big River Funding, LLC; Little River Funding, LLC; SONR #1, LLC; SONR #1 LP; SONR #2, LLC; LJM Partners, LLC; LJM Partners, LP; LJM SwapCo; LJM Swap Sub, LP; Talon, LLC; Harrier; Timberwolf; Pro[n]ghorn; Porcupine; Bobcat; Southampton Place, LP; Southampton, LP; LJM2 Capital Management, LP; and LJM2 Capital Management, LLC. Motion of Official Committee of Unsecured Creditors For Order, Under 11 U.S.C. Section 1103(c) and Fed. R. Bankr. P. 2004, For Production of Documents and Examination of Witnesses Regarding Debtors’ Off-Balance Sheet Assets and Liabilities, filed by the Official Committee of Unsecured Creditors of Enron Corp., *et. al.*, In re Enron Corp., *et. al.*, Debtor at 6 (01-16034) (Docket Entry No. 1352), available at <http://www.elaw4enron.com/default.asp> (last visited February 4, 2003).

<sup>95</sup> The U.S. Government has alleged that Enron used off-balance structures for other purposes, including to receive beneficial regulatory treatment of its California wind farms under the Public Utility Holding Company Act, following Enron’s purchase of PGE. Criminal Complaint, *United States of America v. Andrew S. Fastow*, at 7 (alleging improper use of RADR special purpose entities to disguise Enron’s interests in wind farms); Complaint, *United States Securities and Exchange Commission v. Andrew S. Fastow*, at 3-5 (alleging improper use of RADR special purposes entities to achieve favorable financial benefits).

Three of Enron's off-balance sheet structures that received significant attention included the Chewco, LJM1, and LJM2 partnerships.

### **Chewco and JEDI**

In 1993, Enron and California Public Employees Retirement System ("CalPERS") entered into a joint venture investment partnership called Joint Energy Development Investments Limited Partnership ("JEDI I"), whereby each partner owned 50 percent of the venture. JEDI I was an unconsolidated entity, which meant that Enron did not include JEDI I's assets or debt in Enron's balance sheet.<sup>96</sup> JEDI I made numerous energy-related investments during the period 1993 to 1997. In late 1997, Enron wanted to approach CalPERS for a substantial cash investment in a second investment partnership to be called JEDI II. Concerned that CalPERS would not invest simultaneously in both JEDIs, Enron sought a buyer for CalPERS' interest in JEDI I. After no third party expressed interest, certain Enron employees, with the assistance of Enron, formed Chewco Investments, LP ("Chewco"), a Delaware limited partnership, to acquire and own the JEDI I interest held by CalPERS. Enron ultimately reached an agreement with CalPERS for JEDI I to redeem CalPERS' interest as a limited partner of JEDI I for \$383 million. The parties closed the transaction in November 1997 and Chewco replaced CalPERS as JEDI I's limited partner. Enron intended that Chewco be structured as an unconsolidated affiliate to achieve off-balance sheet treatment for Chewco and JEDI I following CalPERS' exit from the joint venture.<sup>97</sup>

After CalPERS ceased to be a partner of JEDI I, Enron used JEDI I as an unconsolidated affiliate to enhance or accelerate Enron's reported financial statement earnings through transactions paying Enron management fees and guaranty fees, and through JEDI I's ownership of Enron's stock or stock rights. By treating JEDI I and Chewco as unconsolidated entities after CalPERS departed from the venture, Enron reported increased net income of \$45 million (out of \$105 million total reported net income) in 1997, \$107 million (out of \$703 million reported total net income) in 1998, \$153 million (out of \$893 million reported total net income) in 1999, and \$91 million (out of \$979 million reported total net income) in 2000.<sup>98</sup>

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<sup>96</sup> Enron's investments in JEDI I were accounted for under the equity method of accounting, which meant that Enron included its net ownership interest in JEDI I in Enron's balance sheet. Enron Corp., 2000 Annual Report (2001), at 42.

<sup>97</sup> The Powers Report stated that under then applicable generally accepted accounting principles ("GAAP"), Chewco was required to satisfy two requirements for non-consolidation: (1) any control of Chewco by Enron or an Enron affiliate as a general partner had to be limited; and (2) Chewco had to have a minimum of three percent outside equity at risk. Financial Accounting Standards Board, Emerging Issues Task Force, No. 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions* (nullified by Financial Accounting Standards Board Interpretation No. 46, *Consolidation of Variable Interest Entities*, an Interpretation of ARB No. 51, at Appendix D1).

<sup>98</sup> Enron Corp., Form 8-K filed with the Securities and Exchange Commission (November 8, 2001).

## **LJM1, LJM2, and the Raptors**

LJM Cayman, LP (“LJM1”) and LJM2 Co-Investment, LP (“LJM2”) (collectively the “LJM Partnerships”) were established by Enron employees to function as off-balance-sheet SPEs intended to transact business with Enron to improve Enron’s financial statements. The LJM transactions had the effect of boosting Enron’s reported earnings through the use of purported hedging transactions and asset transfers.

From June 1999 to June 2001, Enron entered into approximately 20 distinct purported asset sales or hedging transactions with the LJM partnerships.<sup>99</sup> In the asset sales category, Enron transferred assets to the LJM entity to remove the asset from Enron’s books. The effect in some of the transactions was that no associated risk passed from Enron, because transactions of this type generally require that the benefits and burdens of ownership pass from the transferor to the transferee.<sup>100</sup> The LJM hedges were intended to be accounting hedges, not economic hedges, designed to permit Enron to record gains on hedging positions to offset investment losses in the value of underlying portfolio investments on Enron’s financial statements.

LJM1 was organized as a limited partnership in the Cayman Islands. The first LJM1 transaction involved stock issued by Rhythms Net that Enron had purchased at the initial public offering for \$10 million and which later increased in value to over \$300 million. Enron reported the appreciation in the investment’s stock price as earnings on its financial statements, but wanted to protect its income statements from any loss if the stock price declined. In order to achieve this protection, Enron devised a strategy whereby LJM1 purportedly could provide a hedge on the Rhythms Net stock. In 1999, Enron recognized after-tax income of \$95 million from the Rhythms Net investment.

In October 1999, LJM2 was formed as a Delaware limited partnership. The first seven LJM2 transactions consisted of Enron purportedly selling poorly performing assets to LJM2, which enabled Enron to move debt off of its balance sheet and report additional earnings and cash flow from asset sales on its financial statements. One stated purpose of LJM2 was to provide a “source of private equity for Enron to manage its investment portfolio risk, funds flow,

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<sup>99</sup> The definition of a hedging transaction varies widely depending upon the purpose for which the term is used. For example, a hedging transaction for Federal income tax purposes is defined as any transaction that is entered into in the normal course of a trade or business that is properly identified as managing the risk of price changes, currency fluctuations, interest rate changes, or any other risk prescribed in regulations with respect to ordinary property or borrowings. Sec. 1221(b)(2). By contrast, a hedging transaction for financial accounting purposes is defined as a derivative that is designated as a hedge, but only to the extent that the changes in the value of the derivative are effective in offsetting changes in the fair value or cash flow of an exposure or changes in the value of net investment in a foreign operation. See Financial Accounting Standards Board Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

<sup>100</sup> Powers Report at 11-12.

and financial flexibility.”<sup>101</sup> The transactions between Enron and LJM2 that had the greatest impact on Enron’s financial statements, however, increased Enron’s earnings through the use of purported hedges. These involved four SPEs known as the “Raptors,” a series of complex transactions that began in mid-2000 and terminated in 2001.<sup>102</sup> The Raptors hedges were used by Enron to offset mounting mark-to-market losses attributable to investments otherwise reportable on Enron’s income statement.

In three of the four Raptors, an SPE was established and LJM2 provided the SPE with a \$30 million investment. LJM2’s ability to provide the hedge to Enron was created by Enron transferring its own stock or stock rights to the Raptors entity at a substantially discounted price. In these cases, Enron’s stock price needed to remain high in order for LJM2 and the Raptor entity to be able to honor the Raptors entity’s commitment to Enron pursuant to the hedge. The first Raptor (Raptor I) was formed in April 2000 and involved an SPE named Talon I, LLC (“Talon”). Enron and LJM2 established two additional Raptor structures, Raptor II and Raptor IV, that did not materially differ in structure from Raptor I.<sup>103</sup> Enron reportedly provided assurances to LJM2 that LJM2 would recoup its \$30 million investment plus an additional \$10 million profit within six months of each SPE’s establishment. The Raptors hedging transactions purportedly transferred Enron’s risk to an SPE holding Enron’s own stock and stock contracts and, therefore, did not transfer meaningful risk to an unrelated third party.<sup>104</sup>

Raptor III differed from the other Raptors in that it was intended to hedge a single Enron investment, The New Power Company (“TNPC”), rather than Enron’s investments in unaffiliated companies. Unlike the other Raptors, Raptor III held the stock of TNPC, the company whose stock it was intended to hedge, rather than Enron stock.

Throughout 2000 and into 2001, the assets of the Raptor SPEs declined in value as the value of Enron stock and stock contracts and the TNPC stock supporting the Raptor SPEs’ creditworthiness declined. By the end of December 2000, the asset and collateral values declined to the point that the Raptor SPEs had virtually no assets or capital to support their hedge obligations to Enron. In response to this, Enron structured several complex financial transactions in an attempt to provide further credit support to the Raptors entities.<sup>105</sup>

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<sup>101</sup> LJM2 Summary, materials provided by Enron. EC 000052043-44.

<sup>102</sup> Enron disclosed the first Raptor in the Form 10-Q that it filed with the Securities and Exchange Commission for the second quarter of 2000, and provided more detailed disclosures for all four Raptors in the Form 10-Q that it filed for the third quarter of 2000 and in its 2000 Form 10-K.

<sup>103</sup> Raptor II was formed in June 2000 and Raptor IV was formed in August 2000.

<sup>104</sup> Powers Report at 97-98.

<sup>105</sup> These financial arrangements included placing a “collar” (i.e., purchasing a put option at a strike price below the current market price of the security and selling a call option at a price above the current market price of the security) on the Raptor hedges in October 2000, creating a 45-day guarantee arrangement to support all four Raptor transactions in December 2000, and



In the last two quarters of 2000, Enron reported revenues of approximately \$500 million on derivative transactions with Raptor entities, which offset mark-to-market losses attributable to Enron's merchant investments, and recognized pre-tax earnings of \$532 million (including net interest income).<sup>106</sup> Enron's reported pre-tax earnings for the last two quarters of 2000 totaled \$650 million. Reported earnings from the Raptors accounted for approximately 80 percent of that total. In total, Enron reportedly used the Raptors structures to offset Enron investment losses totaling approximately \$1 billion.<sup>107</sup>

## 2. Financial performance and liquidity issues<sup>108</sup>

Enron's investment in its growing broadband business and foreign operations adversely affected Enron's liquidity position in the late 1990s and thereafter. Capital expenditures for its broadband business were expected to reach an estimated \$1.1 billion for 2000 and 2001, with broadband capital expenditures comprising 47 percent of the company's estimated 2001 total capital expenditures.<sup>109</sup> Although the Dabhol power project in India was expected to be a strong contributor to Enron's earnings, after reportedly investing \$3 billion in Dabhol, the plant was shut down in 2001. The Azurix and Wessex Water projects in the United Kingdom also faced financial and operational difficulties.<sup>110</sup> Enron's earnings performance was further adversely affected by start-up losses in its broadband business and the California energy crisis. Enron

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restructuring the Raptors in March 2001 by placing additional Enron shares at risk to support them. Report Prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs U.S. Senate, *The Role of the Board of Directors in Enron's Collapse*, Report 107-70 (July 8, 2002) at 117.

<sup>106</sup> Powers Report at 119, 128.

<sup>107</sup> Powers Report at 132.

<sup>108</sup> For a listing of selected historical Enron financial information, see Table 3, below, Miscellaneous Financial Information, 1985-2000.

<sup>109</sup> Enron Corp., Form 10-K filed with the Securities and Exchange Commission (April 2, 2001). Enron reported a gross margin of \$318 million from broadband services, with a \$60 million loss before interest, minority interests, and taxes, for its 2000 year. *Id.*

<sup>110</sup> Enron reported a \$326 million charge to earnings in its 2000 financial statements, reflecting Enron's portion of impairments recorded by Azurix related to assets in Argentina, and a \$287 million write-off of Azurix asset impairments in its third quarter 2001 financial statements. Enron Corp., 2000 Annual Report (2001), at 42; Press Release, Enron Corp., Enron Reports Recurring Third Quarter Earnings of \$0.43 Per Diluted Share; Reports Non-Recurring Charges of \$1.01 Billion After-Tax; Reaffirms Recurring Earnings Estimates of \$1.80 for 2001 and \$2.15 for 2002; and Expands Financial Reporting (October 16, 2001), at <http://www.enron.com/corp/pressroom/releases/2001/ene/68-3QearningsLtr.html> (last visited January 27, 2003).

reportedly incurred in excess of \$500 million in trading losses in the California markets over the summer of 2000.

As part of its strategic plan, Enron made efforts to raise cash by selling large holdings in various businesses. In 1999, Enron Corp. and EOG established the latter as a public company independent of Enron. The 1999 EOG transaction involved the exchange by Enron of approximately 76 percent of its stock ownership of EOG for EOG's China and India operations, and generated a pre-tax financial reporting gain of \$454 million (\$345 million after-tax).<sup>111</sup> Approximately \$600 million of cash was transferred by EOG to EOGI-India, Inc., an Indian subsidiary acquired by Enron Corp. to be used by Enron to finance international activities. Also during 1999, Enron attempted to sell PGE. Enron reached agreement with Sierra Pacific Resources ("Sierra") to sell PGE to Sierra for approximately \$3 billion in cash, but the parties terminated the agreement in April 2001.<sup>112</sup>

Enron attempted to sell a large portion of its foreign assets during 2000, but these attempts also failed. One example, called Project Summer, involved Enron's attempt to sell approximately 80 percent of its non-European international businesses for \$6.08 billion in cash.<sup>113</sup> Enron believed that if consummated, Project Summer would have allowed Enron to reduce its annual dividends to be paid on its common stock, one of its financial strategies to reduce cash outflows, without raising investor concerns that the dividend cut was driven by a lack of cash.<sup>114</sup>

Investor concerns regarding Enron's financial condition began to appear in late 2000. To address these concerns, Enron President and Chief Operating Officer Jeff Skilling issued a press release on November 24, 2000, stating that "rumors of a potential profit warning are not true." On January 25, 2001, and on March 22, 2001, the company issued press releases reaffirming its confidence in "strong business prospects for 2001" and stating it was "comfortable" with estimates and previously announced targets for 2001. Enron restructured a portion of its debt in

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<sup>111</sup> Enron treated the EOG exchange transaction as a tax-free split-off under section 355 for Federal income tax purposes. *See* Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation (June 7, 2002).

<sup>112</sup> Enron's disposition of PGE's assets, which was part of its 1998-2000 strategic plan, had been under consideration since 1997. *See* 1998-2000 Operating & Strategic Plan, Presentation to Board of Directors (December 9, 1997). EC 000046107. Enron expected to use the PGE sales proceeds to reduce debt and fund higher growth opportunities. Board Presentation: Project Granite (November 5, 1999). EC 000052176. After the aborted sale of PGE to Sierra, Enron reached agreement with Northwest Natural Gas in October 2001 to sell PGE for \$1.8 billion, including \$1.55 billion in cash, but these negotiations terminated in May 2002.

<sup>113</sup> Handout for Project Summer, Meeting of the Enron Corp. Board of Directors', August 1, 2000. EC 000043574 et. seq.

<sup>114</sup> *Id.*

February 2001 and issued \$1.9 billion face value of 20-year zero coupon notes that yielded \$1.25 billion in proceeds, most of which were used to refinance existing debt.<sup>115</sup> On April 17, 2001, Enron announced an increase in its earnings expectations for 2001. On June 19, 2001, Chief Executive Officer Skilling announced the company remained “very confident” that it would meet its previously-announced increased earnings expectations for 2001. On July 12, 2001, Mr. Skilling announced renewed confidence in achieving the 2001 earnings expectations and new increased earnings guidance for 2002.<sup>116</sup>

In general, the financial markets did not react favorably to Enron’s performance or earnings announcements during the first nine months of 2001. Enron’s stock price, which had peaked at \$90.75 per share in August 2000 and opened 2001 at \$83.13 per share, declined throughout 2001. Enron’s stock closed at \$58.10 and \$49.10 per share on March 30, 2001, and June 29, 2001, respectively. By September 28, 2001, the end of the third quarter, Enron’s stock was trading at \$27.23 per share.

At this point in time, Enron had reported financial information to the public that had portrayed Enron as a company that was increasing its revenues, net income, assets, and market capitalization. To the public, Enron appeared to have achieved the financial goals established in 1996 with its implementation of Enron 2000.

Table 5, below, provides information that illustrates Enron’s growth for the years 1985 through 2000, including its attainment of \$1 billion of net income.

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<sup>115</sup> The \$1,000 zero coupon notes were offered at an issue price of \$655.24, which represented an annual yield to maturity of 2.125 percent. The notes were convertible into Enron common stock, upon certain contingencies being satisfied, at a conversion premium. Enron was not obligated to make interest or principal payments with respect to the notes prior to their scheduled maturity of February 2021.

<sup>116</sup> The following month, in August 2001, Mr. Skilling resigned his position with Enron Corp.

**Table 5.—Miscellaneous Financial Information, 1985 to 2000**

<b>Year</b>	<b>Revenues [billions of dollars]</b>	<b>Operating income [millions of dollars]</b>	<b>Net income per books [millions of dollars]</b>	<b>Total assets [billions of dollars]</b>	<b>Year-end common stock price per share (split- adjusted)<sup>1</sup></b>	<b>Market capitalization [billions of dollars]<sup>2</sup></b>
<b>1985</b>	\$16.4	\$234	\$-79	\$12.1	\$5.63	\$2.0
<b>1986</b>	9.3	-158	557	10.1	4.94	1.8
<b>1987</b>	8.5	330	-29	9.4	4.89	1.8
<b>1988</b>	8.3	295	109	8.7	4.58	1.7
<b>1989</b>	9.8	337	226	9.1	7.20	2.9
<b>1990</b>	5.3 <sup>3</sup>	434	202	9.8	6.84	2.8
<b>1991</b>	5.7	498	232	10.1	8.75	3.5
<b>1992</b>	6.4	614	306	10.3	11.59	6.1
<b>1993</b>	8.0	631	333	11.5	14.50	8.5
<b>1994</b>	9.0	716	453	12.0	15.25	7.6
<b>1995</b>	9.2	618	520	13.2	19.06	9.6
<b>1996</b>	13.3	690	584	16.1	21.56	11.3
<b>1997</b>	20.3	15	105 <sup>4</sup>	22.6	20.78	12.9
<b>1998</b>	31.3	1,378	703	29.4	28.53	18.9
<b>1999</b>	40.1	802	893	33.4	44.38	33.4
<b>2000</b>	100.8	1,953	979	65.5	83.13	62.5

Notes: (1) This column shows Enron's stock price on a split-adjusted basis, not on an historical actual price basis. For example, Enron's per share actual stock price on December 31, 1985, was \$45.00, which converts to a \$5.63 split-adjusted price to account for the three 2-1 stock splits since then. Enron Corp. did a 2-for-1 stock split during each of 1991, 1993, and 1999; (2) The figures for 1985 through 1992 are based on end of year market prices and outstanding share information. The figures for 1993 through 2000 are as reported in the company's Form 10-K filings for the relevant year, which reflect market price and outstanding shares at a point in between the relevant year end and the date the Form 10-K was filed. These figures do not take into account the value of preferred stock issued and outstanding during these periods; (3) The revenue figures for 1990 and subsequent years reflect the 1993 divestiture of EOTT, which caused the company's revenues to be restated downward for 1990 and thereafter; (4) After a \$463 million non-recurring charge relating to J-block gas contracts.

Source: Compiled by the Joint Committee staff from Enron's annual reports and Forms 10-K filed with the Securities and Exchange Commission. Split-adjusted stock prices are as reported in the Historical Market Data Center™ from Dow Jones & Company, Inc.

### 3. Accounting irregularities, adjustments, and non-recurring charges to earnings for financial reporting periods 1997 to 2001

Certain of the company's accounting practices came under scrutiny when an Enron employee warned Enron management "that we will implode in a wave of accounting scandals."<sup>117</sup> In August 2001, Ms. Sherron Watkins, Vice President for Corporate Development, sent a memorandum to Mr. Lay raising numerous areas of concern regarding accounting issues with respect to the Raptor, LJM, and Condor transactions,<sup>118</sup> including the disclosure of related party transactions and equity derivative transactions. The memorandum also outlined some solutions, including retaining the services of a law firm (other than Enron's general counsel, Vinson & Elkins) to investigate these transactions, and retaining the services of an accounting firm (other than Enron's auditors, Arthur Andersen).

In October 2001, at Enron's request, Vinson & Elkins conducted an investigation into the issues presented in Ms. Watkins' memo by addressing the following areas of concern: (1) the apparent conflict of interest involving Mr. Fastow's ownership in the LJM partnerships; (2) the accounting treatment accorded the Condor and Raptor structures in Enron's financial statements; (3) the adequacy of public disclosures of the Condor and Raptor transactions; and (4) the potential impact on Enron's financial statements of the Condor/Whitewing and Raptor vehicles. Each issue was given separate consideration and Vinson & Elkins' findings were consistent with the company's overall approach. Vinson & Elkins concluded that "facts disclosed through our preliminary investigation do not, in our judgment, warrant a further widespread investigation by independent counsel and auditors."<sup>119</sup>

On October 16, 2001, Enron announced its first quarterly loss in four years when it reported a net loss of \$618 million for the quarter ended September 30, 2001, after taking into account after-tax non-recurring charges of \$1.01 billion.<sup>120</sup> The non-recurring charges consisted of a \$287 million write-off of asset impairments relating to Azurix Corp., Enron's U.K. water company, for its planned dispositions of its North American and certain South American service-

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<sup>117</sup> Ms. Watkins memo to Mr. Lay (August 2001). See <http://www.news.findlaw.com/hdocs/docs/enron/empltr2lay82001.pdf>.

<sup>118</sup> The Raptor, LJM, and Condor transactions are discussed in greater detail in Part Three of this Report.

<sup>119</sup> Letter from Mr. Max Hendrick II of Vinson & Elkins to Mr. James V. Derrick, Jr. of Enron Corp., dated October 15, 2001. E68562. <http://news.findlaw.com/hdocs/docs/enron/veeron101051ltr.pdf> As discussed in Part Three of the Report, Vinson & Elkins also participated as an advisor in the Condor structured transaction.

<sup>120</sup> The Form 10-Q filed by the company with the Securities and Exchange Commission reported the loss at \$644 million. Previously, Enron had not reported a net loss since the second quarter of 1997.

related businesses;<sup>121</sup> a \$180 million charge associated with the restructuring of Enron's broadband businesses; and a \$544 million loss principally relating to "Enron's interest in The New Power Company, broadband and technology investments, and early termination during the third quarter of certain structured finance arrangements with a previously disclosed entity."<sup>122</sup> At the same time, Enron announced that it was making a \$1.2 billion reduction to shareholders' equity. Information disclosed in the company's Securities and Exchange Commission filings explained that the \$544 million charge related in large part to a pre-tax charge of \$710 million associated with the termination of the Raptors special purpose entities, and that the \$1.2 billion equity reduction was required to correct Enron's improperly recording an investment in the Raptors partnerships as an asset rather than as a reduction to equity.<sup>123</sup>

Enron's liquidity position deteriorated as it attempted to deal with the fallout from its adverse earnings announcements. On October 25, 2001, Enron drew down on approximately \$3 billion of its available bank lines to repay outstanding and expiring commercial paper obligations and provide immediate cash liquidity. Just a few days later, on October 31, 2001, Enron announced its Board of Directors had appointed a special investigative committee to be chaired by Mr. William C. Powers, Dean of the University of Texas Law School, to examine and take actions with respect to the off-balance sheet transactions between Enron and related parties, including, as appropriate, making reports to the Securities and Exchange Commission.<sup>124</sup>

The financial markets continued to react negatively to Enron's situation, and Enron's stock dropped to \$13.90 per share on October 31, 2001. On November 8, 2001, Enron announced that it was restating its financial statements for the periods 1997 through 2000 and the

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<sup>121</sup> This was in addition to a \$326 million charge reflecting Enron's portion of impairments recorded by Azurix related to assets in Argentina that was reflected in Enron's 2000 financial statements.

<sup>122</sup> Press Release, Enron Corp., Enron Reports Recurring Third Quarter Earnings of \$0.43 Per Diluted Share; Reports Non-Recurring Charges of \$1.01 Billion After-Tax; Reaffirms Recurring Earnings Estimates of \$1.80 for 2001 and \$2.15 for 2002; and Expands Financial Reporting (October 16, 2001), available at <http://www.enron.com/corp/pressroom/releases/2001/enc/68-3QearningsLtr.html> (last visited October 28, 2002).

<sup>123</sup> The explanatory information was contained in a Form 8-K filed on November 8, 2001, and in the company's third quarter 2001 Form 10-Q filed on November 19, 2001. The accounting errors pertaining to the \$1.2 billion restatement of equity were made in the second quarter of 2000 and in the first quarter of 2001.

<sup>124</sup> The three-month investigation culminated in the February 2002 release of the Powers Report. According to Mr. Powers' testimony before the House Committee on Finance Services, the report would be a "helpful starting point for the necessary further investigations by Congressional Committees, by the Securities and Exchange Commission, and by the Department of Justice." See Testimony of William C. Powers, Jr., Chairman of the Special Investigative Committee of the Board of Directors of Enron Corporation, Before the House Committee on Financial Services (February 4, 2002).

first two quarters of 2001 to reflect the retroactive consolidation of certain investments that Enron previously had reported as off-balance sheet entities. These entities included: (1) JEDI I and Chewco, each of which should have been consolidated beginning in November 1997; and (2) a wholly-owned subsidiary of LJM1 that engaged in the Rhythms Net hedging transactions that should have been consolidated beginning in 1999. Enron announced that earnings for the periods 1997 through the second quarter of 2001 were adjusted downward by a total of \$569 million, with \$396 million attributable to JEDI I and Chewco, and \$103 million attributable to the LJM1 subsidiary.<sup>125</sup> Enron filed a Form 10-Q quarterly report with the Securities and Exchange Commission on November 19, 2001, that included detailed information regarding these restatements. The Form 10-Q restatements varied slightly from those announced earlier by Enron in the November 8, 2001, press release.

Table 6, below, summarizes the restatements as set forth in Enron's November 19, 2001, Form 10-Q.

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<sup>125</sup> Enron reported these adjustments in a Form 8-K filed with the Securities and Exchange Commission on November 8, 2001. Enron also decreased its third quarter 2001 earnings by \$17 million at the same time.

**Table 6.—November 19, 2001, Form 10-Q Accounting Restatements for Enron**  
**[Millions of Dollars]**

<b>Accounting period</b>	<b>Net income as initially reported</b>	<b>Net income as restated</b>	<b>Adjustment to net income</b>	<b>Chewco and JEDI I portion</b>	<b>LJM1 portion</b>	<b>Other</b>	<b>Raptors equity adjustment (non-P&amp;L)</b>
<b>1997</b>	\$105	\$26	\$-79	\$-28	\$0	\$-51	\$0
<b>1998</b>	703	564	-139	-133	0	-6	0
<b>1999</b>	893	635	-258	-153	-95	-10	0
<b>2000</b>	979	842	-137	-91	-8	-38	-172
<b>1Q 2001</b>	425	460	35	6	0	29	-1000
<b>2Q 2001</b>	404	409	5	0	0	5	-1000
<b>Totals</b>	3,509	2,936	-573	-399	-103	-71	N/A

Note: N/A = not applicable.

Source: Compiled by the Joint Committee staff from Enron's Form 10-Q filed with the Securities and Exchange Commission on November 19, 2001.



Prior to Enron's October and November announcements of its third quarter earnings loss and its earnings restatements, Enron had reported shareholders' equity of \$11.7 billion as of June 30, 2001, in its second quarter 2001 Form 10-Q filed with the Securities and Exchange Commission on August 14, 2001. The aggregate effect of the charges to third quarter 2001 earnings and equity adjustments reported on October 16, 2001, and the restatements announced in November 2001, was a decrease in Enron's net income for the periods 1997 through 2001 of approximately \$1.7 billion. This included \$399 million relating to JEDI I and Chewco, \$103 million relating to LJM1, \$710 million relating to LJM2 and the Raptors entities, \$287 million relating to Azurix, and \$180 million relating to the broadband businesses.<sup>126</sup> Enron's equity diminished from the \$11.7 billion it had reported as of June 30, 2001, to \$9.6 billion it reported as of September 30, 2001.<sup>127</sup>

Enron's stock price, which had moved slightly upward in early October 2001, plummeted during the weeks following its announcement of its third quarter loss on October 16, 2001. Its per share price dropped from \$34.30 on October 16 to \$13.90 at the close of trading on October 31, 2001.

#### **4. Illiquidity and failed merger attempts during November 2001**

Enron's stock continued its downward slide during early November, closing at \$8.41 per share on November 8, 2001, the day it announced its earnings restatements for 1997 through 2001. The company's debt structure had become increasingly difficult to support as the company's weakening credit ratings and declining stock price triggered defaults under various debt covenants. Enron debt coming due in the fourth quarter of 2001 reportedly had increased from less than \$1 billion dollars to \$2.8 billion, as Enron's cash on hand reportedly had decreased from \$3 billion dollars to \$1.2 billion.<sup>128</sup>

On November 9, 2001, Enron announced that it had reached agreement to be acquired by Dynegy, Inc. ("Dynegy"), a global provider of energy and communications services, in a \$9 billion stock-for-stock acquisition.<sup>129</sup> As part of the negotiations, Dynegy (through Chevron

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<sup>126</sup> The \$1.2 billion Raptors equity adjustment made during third quarter 2001 did not involve an earnings restatement because the prior erroneous entries had not been reflected in the company's income statements.

<sup>127</sup> Enron Corp., Form 10-Q for the Fiscal Quarter Ended September 30, 2001 filed with the Securities and Exchange Commission, at 6 (November 19, 2001).

<sup>128</sup> Wendy Zellner & Stephanie Anderson Forest, *The Fall of Enron*, Business Week (December 17, 2001).

<sup>129</sup> Enron later reported in its bankruptcy filings that Dynegy had agreed to pay approximately \$9 billion in Dynegy stock and assume approximately \$13 billion in Enron debt. Motion Of The Debtors Pursuant To Rule 1015(B) Of The Federal Rules Of Bankruptcy Procedure For Joint Administration Of Cases, In re Enron Corp. et.al., Debtors (No. 01-16034) Docket Entry No. 2), at 6, at <http://www.elaw4enron.com/default.asp> (last visited February 5, 2003).

Texaco Corporation, which owned approximately 27 percent of the combined common stock of Dynegy), provided Enron a \$1.5 billion cash infusion in exchange for a preferred stock interest in Enron's subsidiary, Northern Natural Gas Company, and certain option rights to acquire Northern Natural Gas Company in the event the merger terminated.<sup>130</sup>

Enron's announcement of the ongoing Dynegy merger negotiations temporarily bolstered Enron's stock price. Enron's stock price increased slightly to \$9.06 per share by the close of business on November 19, 2001, the day Enron provided detailed information to the Securities and Exchange Commission regarding its 1997 through 2001 earnings restatements. On November 20, 2001, however, Enron warned that continuing credit worries, reduced asset values, and reduced trading activity could weaken fourth quarter 2001 earnings. Enron's stock price fell to \$6.99 that day, and to \$4.11 by the close of trading on November 27, 2001.

Enron's financial condition continued to deteriorate, and the Dynegy merger agreement unraveled on November 28, 2001. That same day, Enron shut down EnronOnline, and various ratings agencies downgraded Enron's long-term debt to "below investment grade" (i.e., junk bond) status. Enron announced it had temporarily suspended all payments other than those necessary to maintain its core operations, and that it was evaluating and exploring options to protect its core energy businesses. Enron's stock fell from \$4.11 to \$0.61 per share on November 28, and closed at \$0.26 per share on November 30, 2001. Enron was on the brink of bankruptcy.

## **5. Bankruptcy reorganization and present condition**

Enron Corp. and thirteen of its affiliates filed voluntary petitions for Chapter 11 bankruptcy reorganization protection on December 2, 2001.<sup>131</sup> On the same date, Enron filed suit against Dynegy, alleging Dynegy had wrongfully terminated its proposed merger with Enron and sought damages of at least \$10 billion.<sup>132</sup> Within the next several days, numerous other

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<sup>130</sup> Dynegy exercised its option rights to acquire Northern Natural Gas Company when the merger negotiations terminated. Enron Corp., Form 8-K, filed with the Securities and Exchange Commission (August 19, 2002), at Exhibit 99.1.

<sup>131</sup> The affiliates included, among others, Enron North America Corp., the wholesale energy trading business; Enron Energy Services, Inc., the retail energy marketing operations; Enron Transportation Services Company, the holding company for pipeline operations; and Enron Broadband Services, Inc., the bandwidth trading operation. Excluded from the bankruptcy filing were Northern Natural Gas Pipeline, Transwestern Pipeline, Florida Gas Transmission, EOTT, PGE, and numerous Enron International entities. Press Release, Enron Corp., Enron Files Voluntary Petitions for Chapter 11 Reorganization; Sues Dynegy for Breach of Contract, Seeking Damages of at Least \$10 Billion (December 2, 2001), at <http://www.enron.com/corp/pressroom/releases/2001/ene/PressRelease11-12-02-01letterhead.html> (last visited October 28, 2002).

<sup>132</sup> Press Release, Enron Corp., Enron Files Voluntary Petitions for Chapter 11 Reorganization; Sues Dynegy for Breach of Contract, Seeking Damages of at Least \$10 Billion

Enron affiliates filed petitions to be included in the consolidated bankruptcy proceeding.<sup>133</sup> In its bankruptcy filing, Enron Corp. (separately, not including any affiliates) listed its assets at \$24.8 billion and liabilities at \$13.1 billion.<sup>134</sup> The combined listed assets of Enron Corp. and its thirteen affiliates that initially filed for reorganization protection totalled \$63.4 billion. Enron and certain of its consolidated debtors continue to operate businesses and manage properties as debtors in possession pursuant to the Federal Bankruptcy Code.<sup>135</sup>

On January 15, 2002, the New York Stock Exchange suspended trading of Enron stock and moved to delist the company's shares from the exchange.<sup>136</sup> On January 17, 2002, Enron discharged Arthur Andersen, its auditor. On February 2, 2002, the Powers Report was delivered to the Enron Corp. Board of Directors. On February 12, 2002, the company announced that the total claims of its creditors exceeded the fair market value of its assets and that it did not expect equity interest holders to receive any interest in the reorganized company.<sup>137</sup> In March 2002, the U.S. Trustee in the bankruptcy proceeding appointed an Employment-Related Issues Committee to investigate issues relating to current and former employees of Enron. On May 24, 2002, the bankruptcy court for the Southern District of New York approved the appointment of Neal Batson, as the Examiner for Enron Corp.

While under bankruptcy reorganization protection, the company has attempted to sell its non-core assets (primarily global assets and broadband services segments), restructure to protect its core businesses (wholesale gas and power, coal, retail businesses in North America and Europe, and natural gas pipeline businesses), and settle litigation and other claims.

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(December 2, 2001), at <http://www.enron.com/corp/pressroom/releases/2001/ene/PressRelease11-12-02-01letterhead.html> (last visited January 22, 2003).

<sup>133</sup> In November 2001, Enron Europe, the company's European energy-trading arm, filed for creditor protection under the laws of the United Kingdom.

<sup>134</sup> The company reported that this total debts figure, as reported in the corporation's voluntary petition for bankruptcy reorganization, did not reflect off-balance sheet and contingent obligations.

<sup>135</sup> A total of 75 Enron companies are reported as Enron bankruptcy debtors in the most recent Monthly Operating Report filed with the Securities and Exchange Commission and the bankruptcy court. Enron Corp., Form 8-K filed with the Securities and Exchange Commission, at 4-9 (January 9, 2003). As of February 8, 2003, Enron reported that 79 Enron companies have filed voluntary petitions for Chapter 11 reorganization.

<sup>136</sup> Enron's stock fell to \$0.26 per share on November 30, 2001, just prior to its bankruptcy filing.

<sup>137</sup> In Forms 8-K filed by the company with the Securities and Exchange Commission on and after February 12, 2002, the company has stated it "believes the existing equity of the company has and will have no value and that any plan ... confirmed by the bankruptcy court will not provide the company's existing equity holders with any recovery."

Major business asset dispositions completed during Enron's bankruptcy reorganization include: (1) the February 2002 sale and licensing of certain North American gas and electric power trading assets, including EnronOnline; (2) the sale of Enron Oil & Gas India, Ltd.; (3) the sale of various wind energy assets and holdings; (4) the sale of its domestic and European metals businesses; and (5) the May 2002 sale by Azurix Corp. of Wessex Water Ltd. On August 27, 2002, Enron commenced its auction of 12 major assets, including PGE,<sup>138</sup> several power plants, and its interests in the Transwestern, Florida Gas Transmission, and Northern Plains pipelines. On October 10, 2002, the bankruptcy court approved the sale of the newly constructed headquarters building, Enron Center South.<sup>139</sup>

On August 15, 2002, Enron and Dynegy announced settlement of their dispute regarding the termination of merger discussions in late 2001. Pursuant to the settlement, Enron received \$25 million cash and agreed to forego claims regarding Dynegy's exercise of its option to acquire Northern Natural Gas Company relating to Dynegy's \$1.5 billion equity infusion made during November 2001.

Enron filed with the bankruptcy court its Statement of Financial Affairs ("Statement"), which provides certain financial and other information regarding the company as of the bankruptcy filing date. Among other things, the Statement reported that Enron and its affiliates paid senior management \$309.9 million in salary, bonuses, long-term incentives, deferred payments, loan advances, expense reimbursements, director's fees, and other payments during the year preceding the bankruptcy filing.<sup>140</sup> The company has filed Monthly Operating Statements for the periods of December 2001 through October 2002 with the bankruptcy court, and with the Securities and Exchange Commission as attachments to Form 8-K filings. These statements are unaudited and do not contain a balance sheet. The company has certified to the Securities and Exchange Commission that it does not have an independent auditor, it believes that retention of an independent auditor is not feasible, and it does not intend to provide audited financial statements for the fiscal year ended December 31, 2001, or any subsequent unaudited quarterly financial statements.<sup>141</sup>

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<sup>138</sup> Enron's earlier agreement to sell PGE to Northwest Natural Gas Company terminated in May 2002.

<sup>139</sup> Enron had commenced construction of this structure, a 40-story, 1.2 million square feet office headquarters in downtown Houston, Texas, in 1999.

<sup>140</sup> Statement of Financial Affairs, Exhibit 3b.2 (list of all insider payments made within one year immediately preceding the commencement of the bankruptcy case). These same insiders also received \$434.5 million of compensatory stock value during this period relating to exercised Enron stock options and Enron restricted stock, measured at the time of the exercise of the option or the lapsing of the stock's restrictions.

<sup>141</sup> Enron Corp., Form 8-K filed with the Securities and Exchange Commission (August 13, 2002). The company has stated, however, that if a comprehensive review of accounting adjustments, including asset impairments and writedowns, related to previously reported financial information, were conducted, and a consolidated balance sheet as of December 31,

Enron now describes itself as being “in the midst of restructuring its business with the hope of emerging from bankruptcy as a strong and viable, albeit smaller, company.”<sup>142</sup> Enron presently reports assets of \$47.3 billion, including 9,000 miles of pipeline, and 14,000 employees.<sup>143</sup>

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2001, were prepared in accordance with GAAP, an estimated \$14 billion writedown of assets would be required. Monthly Operating Statement for the Period December 2 to 31, 2001, filed with the Securities and Exchange Commission on April 22, 2002. The same report stated an additional downward adjustment of \$8 billion to \$10 billion relating to price risk management assets as of December 31, 2001, could also be required in such a case.

<sup>142</sup> <http://www.enron.com/corp/> (last visited January 22, 2003).

<sup>143</sup> <http://www.enron.com/corp/pressroom/factsheets/company.html> (last visited February 8, 2003).

## D. Enron's Federal Income Tax Position

### 1. Enron's consolidated Federal income tax filings

Enron Corp. is a calendar year taxpayer that uses the accrual basis method of accounting for Federal income tax purposes. Enron Corp. files consolidated Federal income tax returns in which it reports the consolidated taxable income of its affiliated group within the meaning of section 1504(a).<sup>144</sup> Enron reported 346 entities as members of its affiliated group in its 2000 tax return.<sup>145</sup> Enron's consolidated group also includes numerous single member limited liability companies that Enron treats as disregarded entities for Federal income tax purposes.<sup>146</sup>

The IRS master file account information pertaining to Enron Corp. as of January 8, 2003, shows that Enron filed Federal income tax returns for each of its taxable years from 1988 through 2001. Enron filed its Federal income tax return for its 2001 taxable year in September 2002.<sup>147</sup> Enron's tax return for calendar year 2002 is not due until March 17, 2003.

Mr. Robert J. Hermann signed Enron's Federal income tax returns for the years 1985 through 2000 in his capacity as an officer of the company.<sup>148</sup> Mr. Jordan H. Mintz signed

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<sup>144</sup> In general, an affiliated group is defined for this purpose to mean one or more chains of corporations connected through stock ownership with a common parent if the common parent owns, directly or indirectly, at least 80 percent of the total voting power and value of the stock of such corporations. Certain corporations, including tax-exempt corporations, life insurance companies, foreign corporations, section 936 corporations (regarding the Puerto Rico and possessions tax credit), regulated investment companies, real estate investment trusts, domestic international sales corporations, and S corporations, generally are not eligible to be included in an affiliated group. Sec. 1504(b).

<sup>145</sup> Form 1120, Enron Corp., 2000 (Form 851 Affiliations Schedule).

<sup>146</sup> Enron North America, Corp. (a subsidiary of Enron Corp.) alone reported in excess of 100 such entities. *See* Diagram of Enron North America - Disregarded entities. EC2 000025345. Under the Treasury Department's "check-the-box" entity classification regulations issued in December 1996, a domestic entity (other than a corporation and certain other ineligible entities) with a single owner is disregarded as an entity separate from its owner for Federal income tax purposes unless such entity elects to be treated as an association taxable as a corporation. Treas. Reg. secs. 301.7701-3(b)(1)(ii) and 301.7701-2(c)(2). Such a disregarded entity is treated as a branch or division of its sole owner for Federal income tax purposes.

<sup>147</sup> Enron filed documents with the Federal bankruptcy court which state that PGE has ceased to join in the filing of Enron's consolidated Federal income tax returns as a result of a May 7, 2001, transaction that caused PGE to cease to qualify as a member of Enron's affiliated group. Docket No. 8232, paragraph 27.

<sup>148</sup> Mr. Hermann signed the returns as "Vice-President, Tax" for the tax years through 1995, as "VP & General Tax Counsel" for the tax years 1996 through 1998, and as "Managing Director and General Tax Counsel" for the tax years 1999 and 2000.

Enron's Federal income tax return for the 2001 taxable year as Enron's Managing Director and General Tax Counsel.

Table 7, below, provides a reconciliation of Enron's consolidated financial statement net income and Enron's consolidated taxable income for 1996 through 2000. The information contained in the table is based on Enron's tax returns as filed without regard to audit adjustments.<sup>149</sup> In addition, the information contained in the table is based on Enron's financial statements as initially reported, without regard to earnings restatements as announced on November 19, 2001.<sup>150</sup>

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<sup>149</sup> The IRS examination of tax years 1996 through 2000 is ongoing.

<sup>150</sup> See Table 6, above, November 19, 2001, Form 10-Q Accounting Restatements for Enron, for a detailed listing of Enron's restatements. It is impossible to fully assess Enron's book to tax differences 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.

**Table 7.—Enron Corp. and Subsidiaries: Reconciliation of Financial Statement Income to Taxable Income 1996-2000**  
[millions of dollars]

	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>
Net Income Reported in Consolidated Financial Income Statement <sup>1</sup>	584	105	703	893	979
<u>Less Net Income from Entities not Included in Consolidated Tax Return</u>					
Domestic Corporations <sup>2</sup>	-96	-189	-149	-152	-345
Foreign Corporations <sup>3</sup>	-232	-44	-521	-1,110	-1,722
Partnerships <sup>4</sup>	-145	-211	-319	-638	-6,899
	<b>-473</b>	<b>-444</b>	<b>-989</b>	<b>-1,900</b>	<b>-8,966</b>
<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 <sup>5</sup>	0	0	14	122	258
	<b>1,322</b>	<b>1,300</b>	<b>1,898</b>	<b>4,119</b>	<b>13,883</b>
Book Income Reported on Consolidated Tax Return	<b>1,433</b>	<b>961</b>	<b>1,612</b>	<b>3,112</b>	<b>5,896</b>
<u>Significant Book to Tax Adjustments<sup>6</sup></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	<b>-310</b>	<b>-504</b>	<b>-753</b>	<b>-1,458</b>	<b>3,101</b>

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 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. Interaction between Enron and the Internal Revenue Service

### Selected information regarding Enron's tax department

Prior to the 1985 acquisition of HNG by InterNorth, HNG had a tax department with 24 employees, and InterNorth had approximately 55 tax department members. The 1985 HNG/InterNorth combination created a combined tax department with approximately 80 employees, led by Mr. Hermann, who had served as HNG's Vice President of Corporate Taxes.<sup>151</sup> The size of the Enron tax department decreased in the late 1980s as a result of recommendations by external management consultants that the company's tax department should be reduced to about 40 employees.

Enron's tax department went through significant expansion and reorganization during the 1990s. Beginning in 1989 or 1990, when Enron's business was moving beyond physical assets into financial products, Enron's tax department began "managing" Enron's tax liability, rather than merely preparing a tax return to report income resulting from Enron's operations. During the late 1980s Enron had been reporting net operating losses for Federal income tax purposes, resulting in a cumulative reported net operating loss carryover of approximately \$404 million available from its 1990 taxable year.<sup>152</sup> Enron had "tight sands" tax credits, however, that Enron could utilize only if it had taxable income that generated a Federal income tax liability. It became advantageous for Enron to begin reporting positive taxable income for Federal income tax purposes, rather than net operating losses, to ensure full utilization of the tight sands tax credits. In its 1990 annual report letter to its shareholders and customers, Enron reported that the tight sands tax credits, combined with a Texas severance tax exemption, could be worth more than \$100 million to Enron on a present value basis.<sup>153</sup> For 1991, Enron reported Federal taxable income of \$167.5 million after fully utilizing its \$404 million net operating loss carryover from 1990.<sup>154</sup> Enron also reported that its tight sands tax credits amounted to \$17 million in 1991 and could exceed \$40 million in 1992.<sup>155</sup> By this time, Enron recognized the importance of Federal income tax benefits, such as the tight sands tax credits, as a means of favorably affecting income

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<sup>151</sup> The information regarding Enron's tax department was obtained during the course of interviews conducted by the Joint Committee staff.

<sup>152</sup> Enron reported a consolidated net operating loss carryover of \$403 million, available until 2003, in its notes to its 1990 annual report. Enron Corp., 1990 Annual Report, at 47 (1991). The actual amount of the carryover reported on Enron's 1991 tax return was \$404 million.

<sup>153</sup> Enron Corp., 1990 Annual Report, at 6 (1991). The letter stated the successful move to longer term contracts and "the supportive role Enron Oil & Gas played in the passage of tight sands legislation were significant accomplishments in 1990." *Id.*

<sup>154</sup> Enron Corp., 1991 Annual Report, at 43 (1992).

<sup>155</sup> *Id.* at 3. Enron stated that the "positive impact of the tight gas sand tax credit, continued emphasis on cost control and net revenue from other marketing activities should allow EOG earnings to continue to improve despite low natural gas prices." *Id.*

for financial reporting purposes.<sup>156</sup> From the period 1991 through 1995, Enron claimed tight sands tax credits of approximately \$150 million.<sup>157</sup>

In 1991, Enron also started expanding into international business ventures. In order to win bids on international ventures, the tax department provided tax planning methods involving the establishment of offshore companies to reduce U.S. tax on income from the ventures.<sup>158</sup> This led to staffing increases in the international tax area in Enron's tax department personnel and in other areas as well, causing the staff to approximately double in size from the late 1980s to 1996. Enron's tax department grew from a staff of 83 in 1996 to 253 in 2000.<sup>159</sup> The majority of these employees were located in Houston, although a few were in Portland, Oregon, and others were in Enron's office in London, England. By the end of 2001, however, the tax department had decreased to 183 employees. By 2002, the Enron tax department had further declined to 117 employees.

During the second half of the 1990s, the Enron tax department was divided into 12 separate and distinct functions. These functions included: Managing Director/General Tax Counsel; Planning; Reporting & Analysis; Tax Systems; Structured Transactions; Audits; Sales and Use Tax; Ad Valorem Tax; Administrative; Azurix; PGE - Portland; and London.<sup>160</sup> At the beginning of 2001, Enron's tax department was organized into several groups, generally with a vice president in charge who reported to Mr. Hermann. These groups included: Corporate Reporting and Analysis; Corporate – International; Corporate - Tax Planning; Enron North

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<sup>156</sup> Enron was able to reduce its income tax expense (and increase its financial statement net income) by the amount of its tight sands tax credits. *See e.g.*, Enron Corp., 1993 Annual Report (1994), at 52, n.3. Enron reported that it utilized tight sand tax credits of approximately \$42.5 million in 1992, and that it expected to utilize approximately \$50 million of the credit in 1993. Enron Corp., 1992 Annual Report, at 31 (1993). Enron reported it would continue to support a possible extension of the credit qualification period beyond 1992, and that it would continue to benefit from the credit after 1992 because it applied to previously qualified production through 2002. Enron Corp., 1992 Annual Report 31 (1993).

<sup>157</sup> *See* Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, (June 7, 2002).

<sup>158</sup> These offshore structures are discussed in more detail in Part Five.C., below, of this Report.

<sup>159</sup> *See* Appendix B, Enron Corp. Tax Department Summary Headcount Analysis, Enron Corp. Presentation to the Joint Committee on Taxation (June 7, 2002), at 8.

<sup>160</sup> *See* Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, (June 7, 2002).

America; Enron Energy Services; Europe; Enron Broadband Services; Gas Pipeline Group; Audits; and Structured Transactions.<sup>161</sup>

Enron's tax department was proactive. Over time the tax department generated benefits for Enron that equaled, or eventually far outstripped, the budgeted cost of the tax department itself. The benefits generated by Enron's tax department included financial earnings as well as tax savings.<sup>162</sup>

Enron's tax department obtained the services of external tax advisors for general tax advice that included: tax return preparation, transfer pricing documentation, State tax issues, tax audit support, and Federal tax consulting.<sup>163</sup> Enron estimated that it paid \$14 million in external U.S. tax advisor fees in connection with such advice during the late 1990s.<sup>164</sup>

During the period 1997 through 2000, Enron prepared more than 1,000 Federal tax returns for each year with respect to its affiliated and related entities.<sup>165</sup> From 1997 to 2000, the total number of Federal tax returns prepared by the department increased from 1,002 to 2,486.<sup>166</sup> Similarly, the total number of State income and franchise tax returns prepared by the department increased during this period from 622 to 1,422.<sup>167</sup>

Enron's tax department prepared an annual report measuring the total tax savings generated by the department. The tax department transmitted the report to Enron's Board of Directors each December, before the Board approved the bonus pool for employees. In the late 1990s, the pay and bonuses of the tax department personnel were determined, like those of other Enron employees, on a ranking system with different levels. The base pay and bonus for any particular individual in the tax department were not specifically dependent on the tax savings

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<sup>161</sup> Appendix B, Tax Department Organization As Of January 1, 2001, Enron Corp. Presentation to the Joint Committee on Taxation (June 7, 2002), at 7; a description of the Structured Transactions Group is included in Part Three. A of this Report.

<sup>162</sup> These benefits are described in more detail with respect to the structured transactions described in Part Three.A., below, of this Report.

<sup>163</sup> See Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, (June 7, 2002).

<sup>164</sup> *Id.* These estimates do not include external tax advisor fees paid with respect to Enron's structured transactions.

<sup>165</sup> See Part Two, Background and Methodology. See also Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, (June 7, 2002).

<sup>166</sup> *Id.*

<sup>167</sup> See Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, (June 7, 2002).

generated by that individual. A general discussion of Enron employee compensation is described in more detail in Part Four of this Report.

### **IRS examination of Enron tax returns**

From 1990 to the present, the IRS conducted four examinations of Enron's Federal income tax returns. The examinations were divided into four audit cycles as follows: (1) taxable years 1983 through 1987; (2) taxable years 1988 through 1991; (3) taxable years 1992 through 1994; and (4) taxable years 1995 through 2001. The first three audit cycles were closed by the IRS in 1993, 1996, and 1998, respectively.<sup>168</sup> The net agreed deficiencies with respect to these examination cycles totaled \$4.3 million. The audit cycle for 1995 through 2001 is currently under examination by the IRS.<sup>169</sup>

Each of the IRS's examinations of Enron's tax returns was coordinated through a team manager and a team coordinator. The IRS team generally included revenue agents, economists, engineers, and specialists in financial products, international examinations, and computer audits.<sup>170</sup> Each IRS team that examined Enron's 1985 through 1987 and 1988 through 1991 audit cycles consisted of 11 individuals. The IRS team size increased to 13 individuals for the 1992 through 1994 audit cycle, and to 27 individuals for the 1995 through 2001 audit cycle. The team manager for the last three audit cycles was the same IRS employee. The IRS assigned a different revenue agent as the team coordinator for each of the four audit cycles.

The IRS reported certain audit adjustment information to the Joint Committee staff. According to those reports, the adjustments to taxable income made by the IRS audit teams for Enron's taxable years 1988 through 1995 were as follows: -\$18.8 million for 1988, -\$27.3 million for 1989, -\$11.7 million for 1990, \$19.7 million for 1991, \$101.6 million for 1992, \$85.9 million for 1993, and \$211.8 million for 1994. The total net adjustments made by the IRS audit teams for taxable years 1988 through 1994 increased Enron's taxable income by \$361.2 million.

For the 1995 through 1999, the IRS issued 854 information document requests to Enron through March 5, 2002. Some of the information or materials requested included or involved: planning materials, partnership filings and returns, phantom stock deductions, other deductions, balance sheets, reorganization materials, affiliates' receivables, commodity derivatives and commodity physical positions, employee status, company policies, and general information. As of March 5, 2002, Enron had completed its responses to 830 requests. The outstanding requests involved related party transactions, potentially abusive tax shelters, development costs,

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<sup>168</sup> Internal Enron management documents reported that Enron had "successfully concluded the audit of the 1989-1991 tax returns, sustaining the deductibility of Net Operating Loss carry forward, which allowed recognition of \$10 MM in tax benefit during third quarter 1995." 1995 Performance Review. EC 000102767.

<sup>169</sup> The Joint Committee staff understands that the IRS examination of Enron's 1995 taxable year is complete and that proposed adjustments have been made with respect to 1995.

<sup>170</sup> The IRS team for the 1995 through 2001 audit cycle also included specialists in employee plans and a specialist in excise taxes.

partnership income/loss, trading in the context of financial deals, capital gains, political contributions, and certain self-audit adjustments. The IRS expects to propose or make adjustments to one or more of the years in the open audit cycle, which could affect Enron's tax liability for such years.

Enron's overall working relationship with the IRS was described by Mr. Hermann as "professional" and "good" from the mid-1980s through the mid-1990s.<sup>171</sup> Mr. Hermann reported that Enron's expansion into international markets in the mid-1990s complicated the IRS's development of an audit plan and audit team to examine the tax implications of this growth, resulted in the IRS exploring irrelevant issues, and caused the working relationship between the IRS and Enron to deteriorate.<sup>172</sup> During IRS briefings, the Joint Committee staff was told that the relationship between Enron and the IRS became strained in the later years.

### **Enron's involvement in the coordinated industry case program**

The IRS uses a coordinated industry case program<sup>173</sup> ("CIP") to coordinate the examination of large and highly diversified taxpayers. Pursuant to the CIP, over 1,600 of the largest corporate taxpayers are audited on an ongoing basis for a period of one or more years. If a taxpayer is chosen for the CIP, the taxpayer and all of their effectively controlled entities are included in the case. Unrelated entities may also be included in the case if they are associated

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<sup>171</sup> Joint Committee staff interview.

<sup>172</sup> *Id.*

<sup>173</sup> The CIP was created to centralize control of large cases and obtain uniformity and consistency in management. *See* Internal Revenue Manual Ch. 4.45.3.1 (Primary Control—Overview). CIP cases generally are selected based on factors that potentially indicate a high level of tax complexity. Such factors include the taxpayer's gross assets (usually starting at \$500 million), gross receipts (usually starting at \$1 billion), the number of entities involved, the number of separate and distinct major industries the taxpayer is involved in, and the specialized staff-related resources required to conduct the audit. Each of these factors is considered for a specific taxpayer and if certain thresholds are met the case qualifies as a CIP case. Usually, once a corporation qualifies as a CIP case it will remain in the program even if there may be a change in its circumstances. *See* Internal Revenue Manual Ch. 4.45.2.1 (Case Selection--Identification of Cases). Irrespective of whether a case exceeds the required threshold, a case may be included in the program if it is determined to be sufficiently complex and would likely benefit from using the team approach of the CIP. Likewise, cases meeting the thresholds may be excluded from the examination under the CIP. *See* Internal Revenue Manual Exhibit 4.45.2-1 (Criteria for the identification of Coordinated Industry Program cases).

Audit-related work in CIP cases is carried out by a team of revenue agents and other specialist members (such as international tax specialists, employment and excise tax specialists, economists, and engineers) who are responsible for reviewing and analyzing the tax liabilities of the corporate taxpayer in their respective area of specialization over a period of approximately 26 months. *See* Internal Revenue Manual Ch. 4.45.7.1 (Examination Cycle).

with the taxpayer in activities that have significant tax consequences. In 2001, over 400 cases and 3,700 returns were closed after being examined under the CIP.<sup>174</sup> Enron has been a CIP program participant since January 1989.

### 3. Enron's Federal income tax payments

Enron filed Federal income tax returns for 1996 through 2001 that reported a tax liability (before payments and credits) only for its 2000 and 2001 taxable years. These returns report that Enron paid no Federal income taxes with respect to taxable years 1996 through 1999.<sup>175</sup> Enron's taxable year 2000 Federal income tax return reported a tax liability of \$63.2 million, tax payments and other credits of \$70.1 million, and an overpayment of \$6.9 million. Enron's taxable year 2001 Federal income tax return reported a total tax of \$13,331, but a refund due to Enron of \$20,428.<sup>176</sup>

Table 8, below, contains selected information regarding the company's taxable years 1986 through 2001, based on Enron's consolidated Federal income tax returns as filed without regard to audit adjustments.<sup>177</sup>

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<sup>174</sup> These returns related to a number of different taxable years. See Department of Treasury, Program Performance Report for FY2001, at <http://www.ustreas.gov/gpra/2001rpt.pdf>.

<sup>175</sup> This is consistent with the IRS master file account information pertaining to Enron Corp. as of January 8, 2003.

There have been conflicting accounts regarding whether Enron paid Federal income taxes during its profitable years. For example, a January 17, 2002, analysis of Enron's financial documents by Citizens for Tax Justice concluded that Enron received a net tax rebate of \$381 million for the five-year period 1996 to 2000, even though it had U.S. profits before Federal income taxes of \$1.785 billion for the same period. <http://www.ctj.org/html/enron.htm>. The Congressional Research Service, however, concluded that Enron paid U.S. Federal taxes during 1996 through 2000. Congressional Research Service, Report for Congress: *Enron and Taxes*, No. RS21149 (February 12, 2002).

<sup>176</sup> Although Enron made no Federal income tax payments with respect to its 2001 taxable year, Enron's 2001 return reported a credit for Federal tax on fuels of \$33,759, which exceeded the reported tax due of \$13,331 and created the reported refund of \$20,428.

<sup>177</sup> These figures do not include taxes paid by related entities that were not included in Enron's consolidated group. For example, EOG was not included in Enron's consolidated Federal income tax return for those periods in which Enron owned less than 80 percent of EOG, and the figures do not include any taxes paid by EOG during such period. See Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, (June 7, 2002).

**Table 8.—Selected Information Relating to Enron’s U.S. Federal Taxes for 1986-2001,  
Per Original or Amended Returns  
[millions of dollars]**

<b>Year</b>	<b>Regular income tax</b>	<b>Alternative minimum tax</b>	<b>Other taxes</b>	<b>Nonrefundable credits</b>	<b>Total tax</b>	<b>Tax payments</b>	<b>Refundable credits</b>	<b>Tax due or overpaid</b>
<b>1986</b>	0	0	1.4	0	1.4	1.3	0	0.1
<b>1987</b>	0	0	0.6	0	0.6	0.6	0	0
<b>1988</b>	0	0	0	0	0	11.0	0	-11.0
<b>1989</b>	0	1.2	0.1	0	1.3	2.0	0	-0.7
<b>1990</b>	0	31.4	0.4	0	31.8	41.4	0	-9.6
<b>1991</b>	56.9	90.4	0.8	-30.1	118.0	124.0	0	-6.0
<b>1992</b>	68.2	0	0.3	-12.4	56.1	60.0	0	-3.9
<b>1993</b>	78.7	0	0.3	-29.2	49.8	56.0	0	-6.2
<b>1994</b>	62.5	0	0.2	-23.7	39.0	44.0	0	-5.0
<b>1995</b>	56.7	0	0.2	-26.5	30.4	21.6	0	8.8
<b>1996</b>	0	0	0	0	0	0	0	0
<b>1997</b>	0	0	0	0	0	0	0.1	-0.1
<b>1998</b>	0	0	0	0	0	0	0	0
<b>1999</b>	0	0	0	0	0	0	0	0
<b>2000</b>	21.3	41.9	0	0	63.2	70.0	0.1	-6.9
<b>2001</b>	0	0	0	0	0 <sup>1</sup>	0	0	0
<b>Totals</b>	344.3	164.9	4.3	-121.9	391.6	431.9	0.2	-40.5

Notes: (1) Enron reported tax for 2001 of \$13,331, tax credits of \$33,759, with a refund due of \$20,428.

Source: Forms 1120, Enron Corp., 1986-2001.

#### **4. Enron's reported present Federal income tax position**

Enron reported net operating losses (before net operating loss carryovers) for each of its taxable years 1996 through 1999. Enron did not seek to carry back those net operating losses to receive a refund of income taxes paid in earlier years. Instead, Enron carried forward these net operating losses (\$3.1 billion) into 2000.<sup>178</sup> The net operating losses for 1996 through 1999 prevented Enron from obtaining closure for Federal income tax audit purposes with respect to those years.<sup>179</sup> As a result, Enron adopted a strategy to pay tax for 2000 to close out the audit for 1996 through 1999. Late in 2000, Enron entered into a number of transactions intended to generate taxable income in 2000 that would absorb the entire \$3.1 billion net operating loss carryover to that year.<sup>180</sup> In its 2000 Federal income tax return, Enron reported \$3.1 billion of taxable income (before its net operating loss deduction), which Enron offset with its reported net operating loss carryover from 1999 to 2000 of approximately the same amount. The following year, 2001, Enron recognized losses from closing out the transactions that had generated taxable income in 2000. This resulted in a net operating loss of \$4.6 billion on Enron's 2001 Federal income tax return.<sup>181</sup>

#### **5. Federal income tax claims in Enron's bankruptcy proceeding**

Enron Corp. and each of its affiliates included in the consolidated bankruptcy proceeding that filed a Statement of Financial Affairs with the bankruptcy court (except one company, Enron LNG Shipping Company) listed the IRS as a creditor holding an unsecured claim, with the total

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<sup>178</sup> The \$3.1 billion net operating loss carryover (as reported in Enron's 1999 return) consisted of \$337.5 million from 1996, \$503.5 million from 1997, \$752.8 million from 1998, and \$1.4 million from 1999. The 1996 loss amount of \$337.5 million differs slightly from the \$310.2 million reported on Enron's 1996 return. Enron reported its consolidated alternative minimum tax net operating loss carryover from 1999 to 2000 as \$2.9 billion.

<sup>179</sup> A net operating loss carryover from a year closed under the generally applicable limitations provisions of Section 6501 may be examined for purposes of adjusting the net operating loss deduction allowable in a subsequent open year. Rev. Rul. 56-285, 1956-1 C.B. 134; Rev. Rul. 65-96, 1965-1 C.B. 126. This rule has the effect of keeping open Enron's taxable years for which it had reported unexpired net operating losses (1996 through 1999), for these limited purposes, beyond the generally applicable limitations periods.

<sup>180</sup> These transactions were part of the Project NOLy transaction that is described in Part Three of this Report, which by itself generated \$5.5 billion of the taxable income that Enron reported in its 2000 tax return. A member of Enron's tax department described the transactions "as generating income [to] close tax years". In that person's words, "we needed a statute and so in the year 2000 we managed our taxable income to pay \$60 million in tax so that we'd have a statute and use up the \$3 billion NOL we had." Joint Committee staff interview.

<sup>181</sup> The intent of Project NOLy was to generate sufficient income in taxable year 2000 to use the company's \$3.1 billion net operating loss carryover, and reverse the income recognized by Enron the following year (in 2001).



amount of the claim being unknown. Enron Corp. listed as an asset a Federal income tax refund of \$63.2 million in its Statement of Financial Affairs, Schedule B, filed with the bankruptcy court on June 17, 2002. On August 1, 2002, the bankruptcy court ordered that the IRS has until March 31, 2003, to file proofs of claim or interests against any of the Enron entities that are part of the consolidated bankruptcy proceeding. Under that order, the IRS may seek an extension of the deadline for filing its proof of claim beyond March 31, 2003.

### **PART THREE: DISCUSSION OF SELECTED TAX MOTIVATED TRANSACTIONS AND BUSINESS ARRANGEMENTS USED BY ENRON**

This Part Three of the Report addresses Enron's participation in arrangements that were designed to achieve significant tax and financial accounting benefits. As early as the late 1980s, Enron recognized the importance of managing its Federal income tax liability by generating taxable income to absorb certain temporary energy credits. In the 1990s, Enron began to engage in structured transactions that were motivated largely, if not entirely, to achieve certain desired tax benefits. These tax-motivated transactions, referred to in this Report as "Projects," initially were done to shelter capital gain that Enron realized from its sales of subsidiary stock. As Enron began reporting net operating losses for Federal income tax purposes, its need for tax savings diminished. Around the same time, however, the importance to Enron of reporting of financial statement earnings increased dramatically.<sup>182</sup> In essence, Enron's tax department was given a new responsibility -- to contribute to Enron's bottom line earnings, much like Enron's operating business units. To achieve this objective, the tax department, in consultation with outside experts, 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.<sup>183</sup>

Along with the change in responsibility came an organizational change to Enron Corp.'s tax department. In 1998, Enron segregated the personnel responsible for the Projects into a separate group within Enron's corporate tax department. Known as the structured transactions group, the employees in this group handled all aspects of the Projects.

This Part of the Report analyzes in detail the Projects that were done by Enron's structured transactions group. Each analysis has been written to "tell the story" of the Project, beginning with a brief overview of the Project, followed by the relevant background information, how the Project was implemented, a diagram that depicts the Project structure, the role of outside advisors, and any significant event that occurred subsequent to the Project. Each analysis then discusses the significant tax issues raised by the Project and concludes with specific recommendations (if appropriate). In order to provide a brief discussion of the relevant present-law tax laws that are implicated by the Projects, each Project has been classified into one of the following categories: (1) structured transactions that raise corporate tax issues; (2) structured

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<sup>182</sup> For example, as part of its "Enron 2000" plan, Enron announced its commitment to achieving \$1 billion of net income by the year 2000. *See* Presentation to Enron Corp. Board of Directors, December 9, 1997 (describing the history regarding introduction of Enron 2000 and its importance as the standard against which the company's actual financial performance was to be measured. EC000046072.

<sup>183</sup> 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. EC2 000038546.

transactions that raise partnership tax issues; (3) other structured transactions; and (4) transactions in which Enron served as an accommodation party.

This Part of the Report also analyzes Enron's use of corporate-owned and trust-owned life insurance arrangements, structured financings arrangements, and offshore entities. This Part of the Report concludes with a general discussion of certain of Enron's off-balance sheet partnership arrangements that were motivated by financial reporting objectives.

## I. STRUCTURED TAX MOTIVATED TRANSACTIONS

### A. Background and Rationale

In the early 1990s, Enron engaged in several structured financing transactions in which Enron received upfront payments in exchange for the future delivery of a specified commodity such as crude oil or natural gas (“commodity prepay transactions”).<sup>184</sup> The commodity prepay transactions originally were entered into in order to generate current taxable income to use tax credits generated by Enron Oil and Gas that would have otherwise expired. In the mid-1990s, Enron continued its use of structured financing transactions and used other structured transactions to shelter capital gain income on the sale of Enron Oil and Gas stock.<sup>185</sup>

Although providing financial accounting benefits, the early structured transactions, including the commodity prepay transactions, were primarily engaged in for Federal income tax benefits. However, as Enron began to report losses for Federal income tax purposes, the importance of immediate tax deductions declined. At the same time, the importance of financial accounting income to Enron increased. As a result, Enron’s focus shifted from structured transactions that could shelter specific tax items to transactions that could generate financial accounting benefits.

Arguably, the primary reason for engaging in most of the subsequent structured transactions after 1996 was for the financial accounting benefits they generated rather than the Federal income tax benefits.<sup>186</sup> Indeed, many of the structured transactions were designed to permit Enron to begin reporting the financial accounting benefits of a transaction immediately even though the Federal income tax benefits (which generated the financial accounting benefit) would not occur until significantly into the future.<sup>187</sup> In some of the structured transactions,

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<sup>184</sup> The commodity prepay transactions are discussed in more detail later in this Part of the Report.

<sup>185</sup> For example, Enron issued investment unit securities (discussed later in this Part of the Report) to monetize part of its investment in Enron Oil and Gas common stock. In addition, Project Tanya and Project Valor were structured transactions that Enron engaged in to shelter taxable income on capital gain on the sale of Enron Oil and Gas stock.

<sup>186</sup> In all of the structured transactions discussed in this Report, except two structured transactions in which Enron was an accommodation party, 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.

<sup>187</sup> Statement of Financial Accounting Standards 109 (“SFAS 109”), Accounting for Income Taxes, generally provides that assets and liabilities that are recorded at different amounts for financial reporting purposes and income tax purposes create differences for which a deferred tax asset or liability generally must be reported in the financial statements. However, certain basis differences may not result in taxable or deductible amounts in future years when the related asset is recovered or settled because the tax law provides a means for the taxpayer to recover the asset in a tax-free transaction. In such situations, if management reasonably represents that,

specific attributes intentionally were incorporated to accelerate the recognition of the associated financial accounting income and enable the income to be reported as operating income in lieu of a reduction in income tax expense. In general, operating earnings are more valuable to a business than a reduction in income tax expense because many stock analysts and valuation specialists utilize operating earnings when analyzing the appropriate value and stock price for a business.<sup>188</sup> In addition, because the relevant accounting standard does not use present value concepts, in many cases the reported financial accounting income significantly exceeded the present value of the anticipated Federal income tax benefits.<sup>189</sup>

### **Organization of the structured transactions group**

The general tax-planning group within Enron's corporate tax department initially was responsible for implementing the structured transactions. However, in June of 1998, Mr. Hermann segregated the personnel responsible for the structured transactions into a separate

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without incurring significant cost, the company will use a tax planning action that permits the asset to be recovered in a tax-free transaction, then no deferred taxes are reported in the financial statements. Because no deferred tax asset or liability is reported, such difference will increase or decrease income reported in the financial statements in the year the basis difference arises, irrespective that such tax planning action may not be undertaken for until a later year. In many of the structured transactions, Enron represented that it would use tax-planning actions in the future to recover a basis difference in a tax-free manner and, consequently, did not report deferred taxes on such basis differences (i.e., increased financial accounting income). The Joint Committee staff has not addressed whether the financial accounting treatment reported by Enron is appropriate as it is beyond the scope of the Report.

<sup>188</sup> Commonly, stock analysts and valuation specialists use earnings before income, taxes, and depreciation and amortization ("EBITDA") to value a company. Using EBITDA, stock analysts and valuation specialist ignore the tax expense line in an income statement (among others). Accordingly, because the compensation of a business entity's executive officers often is tied to the market or trading value of the entity, some executives place much greater priority on increasing operating income and are generally less concerned about the entity's net income. For example, an increase in operating earnings of \$10 for a company trading at a multiple of fifteen times EBITDA would be expected to increase the market value of a company by \$150. From 1997-2001, two Enron structured transactions enabled Enron to increase operating income by a total of approximately \$260 million (and to increase net income by approximately \$170 million).

<sup>189</sup> The difference between the reported financial accounting income and the present value of the Federal income tax benefits can be significant because, unlike some financial accounting rules, SFAS 109 does not determine deferred tax assets and liabilities on a present value or discounted basis. Enron and its advisors used this rule to devise transactions that could report financial statement benefits that were significantly in excess of the anticipated present value of the Federal income tax benefits. Although not discounting income taxes for financial reporting can result in anomalies, as highlighted by some of the structured transactions, the conceptual and implementation issues with discounting income taxes for financial reporting are numerous and complex.

“structured transactions” group within Enron’s corporate tax department.<sup>190</sup> The group apparently was separated due to the increase in the number of structured transactions, the ongoing responsibilities associated with implementing and administering existing structured transactions, and the time expended to review proposed structured transactions. The structured transactions group was modeled after similar groups established by a select group of corporations and financial institutions. Mr. Maxey headed the structured transactions group, which had (at its peak) over twenty-five attorneys and accountants.

The structured transactions group’s focus was to synthesize tax, finance, legal, and accounting principles to enhance economic returns to Enron. The structured transactions group effectively was responsible for managing a structured transaction from its inception to final execution. The group handled all aspects of the entities involved in a structured transaction, including the bookkeeping, financial reporting, tax reporting, investor reporting, dividend payments, and corporate governance responsibilities. Although many of these formalities were not tax-related, they were centralized in the structured transactions group as well, because other corporate departments were not always responsive to requests to perform the additional functions required to demonstrate the substance of entities that otherwise generally were ignored for financial accounting purposes and overall corporate management. Effectively, the group operated substantially independent of the remaining tax professionals and, to some extent, operated as a standalone business unit.<sup>191</sup>

### **Operation of the structured transactions group**

The structured transactions group completed 11 large structured transactions over seven years. One additional structured transaction was approved but never implemented because of Enron’s bankruptcy. The ideas for the structured transactions primarily were brought to the attention of Enron’s corporate tax department via referrals from Enron’s finance department or direct calls to Mr. Hermann or Mr. Maxey. The promoters of the transactions comprised a select group of investment banks, law firms, and accounting firms.

In general, Enron would listen to a “pitch” and then evaluate the idea.<sup>192</sup> The structured transactions group used a multistage process to evaluate the ideas. The first part of this process was to determine whether the transaction was technically sound. Enron generally reviewed a

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<sup>190</sup> Although those responsible for the structured transactions were part of the planning group until 1998, for purposes of this Report they are referred to as part of the structured transactions group.

<sup>191</sup> In many cases, Enron tax personnel outside of the structured transactions group had limited knowledge of the transactions being undertaken by the group even when they were responsible for tax matters affecting a business unit that was a party to a transaction.

<sup>192</sup> In addition, Enron tax personnel periodically traveled to New York, Washington D.C., and other locations to seek out tax advantageous transactions.

general tax opinion provided by the promoter<sup>193</sup> and would raise concerns and issues specific to Enron's organization and tax situation. In addition to structured transactions personnel, other senior level tax personnel reviewed aspects of a proposed structured transaction based on their specific technical expertise. For a structured transaction to proceed, Mr. Hermann required counsel to indicate that it could provide a "should" level opinion.<sup>194</sup>

The second part of the process was to fit the structured transaction into Enron's business strategy. Effectively, the structured transaction would need to be attached to an existing transaction that the company was contemplating to provide a purported business purpose for the transaction. Finding a business purpose for a structured transaction was the most important and the most difficult aspect of the development of a structured transaction. For example, an Arthur Andersen memorandum discussing a structured transaction stated "the biggest issue to be resolved [is the] business purpose."<sup>195</sup> The difficulty of obtaining reasonable operational purposes for entering into some of the structured transactions resulted in Enron representing that its business purpose for some structured transactions was the financial accounting benefits obtained.<sup>196</sup> Other structured transactions were able to fit into to an existing business transaction; however, based on the documents reviewed by the Joint Committee staff, their stated business purposes for the structured transactions were lacking or tenuous and, in general, unrelated to underlying business transaction.

If an idea satisfied the technical and business strategy requirements, accounting, finance, legal, and other relevant personnel would become involved in further vetting the idea. If a transaction appeared to satisfy all parties, the transaction generally would be sent to Mr. Causey, Chief Accounting and Information Officer, for approval. Whether additional approvals were

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<sup>193</sup> Generally, the promoters provided a general explanation of the expected accounting treatment for an idea. In some cases, they provided internal opinions or opinions written by accounting firms based upon a hypothetical transaction that effectively mirrored the idea being promoted.

<sup>194</sup> The "should" level requirement was added after the first two structured transactions. Those transactions received "more likely than not" tax opinions.

<sup>195</sup> Memo from Robert P. Palmquist of Arthur Andersen to Robert J. Hermann dated October 27, 1995, item # 4, EC2 000037798, attached in Project Tanya materials in Appendix B.

<sup>196</sup> Projects Steele, Cochise, and Teresa all relied heavily on this "business purpose." However, claiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) in these transactions and significantly diminishes the purpose for having a substantial non-tax purpose requirement. See, e.g., *American Electric Power, Inc. v. U.S.*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'" citing *Winn-Dixie v. Commissioner*, 113 T.C. 254, 287 (1999)).

needed depended upon the general Enron corporate approval guidelines for engaging in a transaction. In many cases, the Board of Directors or one of its committees approved the structured transactions.

Once a structured transaction was approved, Enron would enter into an agreement with the promoter detailing the responsibilities of each party and setting forth the compensation to be paid. In general, the engagement letters reviewed by the Joint Committee staff indicate that Enron would pay a fee of approximately \$8 to \$15 million to the “idea provider” selling the specific transaction and would incur approximately \$800,000 to \$1.2 million for the legal work including the tax opinion for a transaction.<sup>197</sup>

Besides engaging in structured transactions for its own tax and financial accounting benefits, Enron also acted as an accommodation party, for a fee, in two structured transactions with Bankers Trust. In addition, it appeared that the structured transactions group viewed this role as a new source of value to Enron. Highlighting the transformation of the tax department, Mr. Maxey stated that because of the group’s successful completion of structured transactions, “the relationships developed by group members with outside parties have grown, enabling the group to act as facilitator for other entities or to joint venture with other entities to provide similar services to other companies in addition to Enron. In effect, we have created a business segment for Enron that generates earnings and interacts with other entities for profit.”<sup>198</sup>

Table 1, below summarizes certain tax and accounting information regarding 12 of Enron’s structured transactions. The table shows that Enron’s financial accounting benefits that it 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 also lists the promoter of the transaction, the primary tax opinion provider, and project fees paid by Enron with respect to each transaction.

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<sup>197</sup> Two exceptions to the general range of fees paid for the idea were the fees paid to Arthur Andersen for Projects Tanya and Valor. Arthur Andersen was paid \$500,000 and \$100,000, respectively, for the idea and the tax opinion on these transactions. The General Background Materials in Appendix B contain the Estimated Project Fees schedule (6/4/01) for certain structured transactions. EC2 000036379.

<sup>198</sup> Interoffice memorandum dated October 2, 2000 to Richard J. Causey from R. Davis Maxey. EC2 000038284 - EC2 000038285.



**Table 1.—Benefits and Fees of Enron’s Structured Transactions (1995-2001)**  
[millions of dollars]

<b>Project Name</b>	<b>Financial Accounting Income through 2001</b>	<b>Total Projected Financial Accounting Income</b>	<b>Federal Tax Savings through 2001</b>	<b>Total Projected Federal Tax Savings</b>	<b>Promoter</b>	<b>Primary Tax Opinion Provider</b>	<b>Total Project Fees</b>
Tanya (1995)	66	66	66	66	Arthur Andersen	Arthur Anderson	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)	1	1	0	0	Bankers Trust	---	---
Condor (1999)	88	328	0	332	Deloitte & Touche	Vinson & Elkins	10
Valhalla (2000)	16	64	0	0	Deutsche Bank	Vinson & Elkins	---
Tammy I (2000)	---	406	0	414	Deloitte & Touche	Vinson & Elkins	9
Tammy II (2001)	---	369	0	370	---	---	---
<b>Totals</b>	<b>651</b>	<b>2,079</b>	<b>257</b>	<b>2,022</b>	<b>N/A</b>	<b>N/A</b>	<b>87.6</b>

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, in Appendix B. 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, in Appendix B; (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.

**Reporting of activities to management**

As the number of transactions entered into by Enron increased, the structured transactions group began preparing reports for Mr. Causey and senior tax personnel summarizing the executed transactions, the cash flow savings by year, the financial statement earnings impact, and new transactions under consideration by the group. This report was updated fairly frequently and was conveyed to appropriate personnel. Appendix B contains the Structured Transactions Group Summaries of Project Earnings & Cash Flows November 2001 report, as well as other reports prepared by the group regarding its activities.

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The following discussion provides an overview of selected tax motivated structured transactions into which Enron entered. The discussion includes information on the development and implementation of each transaction, the reported financial accounting and tax implications, the role of outside advisors in the transaction, a discussion of the relevant tax authorities, and recommendations by the Joint Committee staff.

## **B. Transactions That Raise Corporate Tax Issues**

Beginning in 1995, Enron, in consultation with outside tax advisors, engaged in a series of structured transactions that were designed to satisfy the literal requirements of the corporate tax laws, yet produce results that were not contemplated by Congress and not warranted from a tax policy perspective. Several of the projects were structured to duplicate and accelerate tax deductions. The reported tax benefits (and corresponding financial statement benefits) were predicated on the interaction of the corporate tax-free transfer rules and the basis rules that apply to such transfers. For example, Projects Tanya (done in 1995) and Valor (done in 1996) relied on these rules, along with the rules regarding the treatment of contingent liabilities, to duplicate losses in connection with a widely-marketed transaction known as the “contingent liability” tax shelter. Projects Steele (done in 1997) and Cochise (done in 1999) also relied on these rules to duplicate losses in connection with certain built-in loss assets owned by Bankers Trust.

Project Teresa (done in 1997) relied on the interplay between the corporate redemption and dividends received deduction rules (while avoiding the extraordinary dividend rules), in concert with the partnership basis rules, to purportedly increase Enron’s tax basis in its building by approximately \$1 billion.

This section of the Report begins with a brief discussion of relevant corporate tax rules and then describes in detail Projects Tanya, Valor, Steele, Cochise, and Teresa.<sup>199</sup>

### **1. Discussion of relevant corporate tax laws**

In general, the Federal income tax laws treat a corporation as a separate entity apart from its shareholders. Corporations and shareholders generally are each subject to tax on distributed corporate income. A corporation pays income tax on its income (regardless of whether such income is distributed to its shareholders), while its shareholders include in their income amounts that the corporation distributes to them.

#### **Tax-free transfers to controlled corporations**

A transferor that transfers appreciated (or depreciated) property to a corporation in exchange for stock in the corporation, and immediately after the transfer is in “control” of the corporation, generally does not recognize gain (or loss) on the exchange.<sup>200</sup> However, a transferor does recognize gain to the extent the transferor receives money or other property as part of the exchange.<sup>201</sup>

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<sup>199</sup> The next section of this Report discusses the general partnership tax rules (which is relevant to Project Teresa).

<sup>200</sup> Sec. 351(a). For this purpose, section 368(c) defines “control” as the ownership of stock possessing at least 80 percent of the combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

<sup>201</sup> Sec. 351(b)(1).

If an exchange satisfies the requirements of a tax-free transfer, then the transferor's basis in the stock received in the exchange is the same as the transferor's basis in the property transferred, decreased by (1) the amount of any money or other property received by the transferor and (2) any loss recognized by the taxpayer on the exchange, and increased by the amount of gain (or dividend) recognized by the transferor on the exchange.<sup>202</sup> The transferee corporation's basis in the property received in the exchange generally equals the transferor's basis in such property, increased by any gain recognized by the transferor on the exchange.<sup>203</sup>

### **Assumption of liabilities**

A corporation's assumption of a liability in connection with a transfer of property does not prevent a transaction from qualifying for tax-free treatment, nor is such assumption generally treated as a receipt of money by a transferor.<sup>204</sup> The assumption of a liability does reduce the transferor's basis in the stock received in the exchange,<sup>205</sup> and it may result in the recognition of gain by the transferor to the extent the liabilities assumed exceed the total amount of the adjusted basis of the property transferred.<sup>206</sup> In addition, if it appears that the principal purpose of the transferor with respect to the assumption of the liability was to avoid Federal income tax (or was not a bona fide business purpose), then the assumption is considered to be money received by the transferor on the exchange.<sup>207</sup>

#### Treatment of certain contingent liabilities

An exception to the basis reduction and gain recognition requirements applies with respect to a liability, the payment of which would give rise to a deduction (and that has not resulted in the creation or increase of basis of any property). A liability that falls within this exception is not treated as money received by the transferor and does not reduce the transferor's basis in the stock received in the exchange.<sup>208</sup> This exception was enacted in 1978 to protect a cash basis taxpayer from having to recognize gain on the transfer of its accounts payable on the incorporation of a going business concern.<sup>209</sup> Although this rule was enacted primarily with cash

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<sup>202</sup> Sec. 358(a).

<sup>203</sup> Sec. 362(a).

<sup>204</sup> Sec. 357(a).

<sup>205</sup> Sec. 358(d)(1).

<sup>206</sup> Sec. 357(c)(1).

<sup>207</sup> Sec. 357(b)(1).

<sup>208</sup> Secs. 357(c)(3)(A) and 358(d)(2).

<sup>209</sup> S. Rep. No. 95-1263, 95<sup>th</sup> Cong., 2d Sess. 184, *reprinted in* 1978-3 C.B. 482 (1978).

method taxpayers in mind,<sup>210</sup> accrual method taxpayers also have properly relied on the exception. In some cases, however, taxpayers have utilized the exception to achieve tax benefits not envisioned by Congress. Eventually, Congress revisited the tax treatment of assumed liabilities and enacted section 358(h) in 2000.<sup>211</sup> This provision reduces the basis in stock received by a transferor in connection with a tax-free transfer (but not below its fair market value) by the amount of any liability that is assumed in the exchange if such liability was not treated as money received by the taxpayer.<sup>212</sup> For this purpose the term “liability” includes any fixed or contingent obligation, without regard to whether the obligation is otherwise taken into account for tax purposes.

### **Deduction of liabilities by transferee corporation**

In general, a transferee corporation may be entitled to a deduction of an assumed liability as appropriate under its method of accounting.<sup>213</sup> In this regard, the IRS has ruled that a transferee corporation may deduct certain environmental liabilities assumed in a tax-free transaction.<sup>214</sup>

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<sup>210</sup> The reasons for change states that “[t]he committee therefore believes that it is appropriate to resolve the ambiguity as to whether for purposes of sections 357(c) and 358(d) the term liabilities includes deductible liabilities of a cash basis taxpayer.”

As part of the Technical Corrections Act of 1979, Congress changed the requirement that only cash basis taxpayers could exclude certain liabilities for purposes of sections 357(c) and 358(d). *See* S. Rep. No. 96-498, 96<sup>th</sup> Cong., 1<sup>st</sup> Sess. 62 (1979).

<sup>211</sup> Section 358(h), added by The Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, sec. 1(a)(7) (Dec. 21, 2000).

<sup>212</sup> Sec. 358(h)(1). This rule does not apply to any liability if (1) the trade or business with which the liability is associated is transferred to the person assuming the liability, or (2) substantially all of the assets with which the liability is associated are transferred to the person assuming the liability. Sec. 358(h)(2).

<sup>213</sup> This has not always been the government’s position. *See, e.g., Holdcroft Transp. Co. v. Commissioner*, 153 F.2d 323 (8<sup>th</sup> Cir. 1948) (in a transfer to which the predecessor of section 351 applied, the transferee corporation could not deduct payments made in satisfaction of tort claims even though the transferor would have been entitled to the deductions if it had made the payments). Over the years, however, the IRS generally has refrained from asserting a *Holdcroft*-type argument.

<sup>214</sup> Rev. Rul. 95-74, 1995-2 C.B. 36. In the ruling, an accrual-basis taxpayer (“P”) operated a manufacturing plant on land it owned. When P purchased the land, it was not contaminated by any hazardous waste (but the land became contaminated as a result of P’s operations). P transferred all of the assets of the manufacturing business (including the plant and the land) to a newly-formed subsidiary (“S”) in exchange for stock. S also assumed the liabilities of the business (including the environmental liabilities) as part of the exchange. Two years later, S began soil and groundwater remediation efforts.

### **Acquisitions made to avoid income taxes**

If a taxpayer engages in certain transactions for the principal purpose of evading or avoiding Federal income tax by securing the benefit of a deduction, credit, or other allowance that would not otherwise have been available, the Secretary of the Treasury (the “Secretary”) has the authority to disallow the resulting benefits.<sup>215</sup> The Secretary may only exercise this special authority with respect to three defined transactions: (1) if any person or persons acquire, directly or indirectly, control (defined as at least 50 percent of vote or value) of a corporation; (2) if a corporation acquires, directly or indirectly, property of another corporation (not controlled, directly or indirectly, by the acquiring corporation or its stockholders) where the basis of the property is determined by reference to the basis in the hands of the transferor corporation; or (3) if a corporation acquires at least 80 percent control (measured by both vote and value, but excluding certain nonvoting preferred stock) of another corporation, an election pursuant to section 338 is not made, and the acquired corporation is liquidated pursuant to a plan of liquidation adopted within two years after the acquisition date.

### **Redemptions between related corporations**

If one or more persons are in control<sup>216</sup> of each of two corporations, and one corporation (“acquiring corporation”) acquires stock of another corporation (“issuing corporation”) in exchange for property, then the transaction is treated as a distribution in redemption of the stock of the acquiring corporation.<sup>217</sup> In determining whether the acquisition is to be treated as a distribution in part or full payment in exchange for the stock, reference is made to the stock of the issuing corporation.<sup>218</sup>

If the distribution is treated as a dividend distribution, the transferor and the acquiring corporation are treated in the same manner as if the transferor had transferred the stock so

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The IRS concluded that the contingent environmental liabilities assumed by S were not included in determining P’s basis in S stock. In addition, the contingent environmental liabilities were not treated as money received by P. The IRS also concluded that the contingent environmental liabilities were deductible by S or capitalized as appropriate under its method of accounting. The IRS analogized the fact pattern to that in Rev. Rul. 80-198, 1980-2 C.B. 113 (transfer of trade accounts receivable in connection with the incorporation of a sole proprietorship). The IRS stated that, for business reasons, P transferred substantially all of the assets and liabilities of the manufacturing business to S, and P intended to remain in control of S. P would have been able to deduct/capitalize the remediation costs had P incurred the costs.

<sup>215</sup> Sec. 269.

<sup>216</sup> For this purpose, “control” means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock. Sec. 304(c).

<sup>217</sup> Sec. 304(a)(1).

<sup>218</sup> Sec. 304(b)(1).

acquired to the acquiring corporation in exchange for stock of the acquiring corporation in a section 351 exchange, and then the acquiring corporation redeemed the stock it was treated as issuing in the transaction.<sup>219</sup> The determination of the amount that is a dividend is made as if the property were distributed by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits.<sup>220</sup>

### **Dividends received deduction**

In general, a corporation is entitled to a deduction for a percentage of the amount received as dividends from a domestic corporation that is subject to taxation under Chapter 1 of the Code.<sup>221</sup> The amount of the dividends received deduction generally depends on the corporate shareholder's ownership of the distributing corporation. If the shareholder is a member of the same affiliated group as the distributing corporation (generally 80 percent vote and value), then the dividends may be "qualifying dividends" and a 100 percent dividends received deduction applies.<sup>222</sup> An 80 percent dividends received deduction applies if the corporate shareholder owns 20 percent or more of the vote and value of the stock of the distributing corporation;<sup>223</sup> in other cases, a 70 percent dividends received deduction generally applies.<sup>224</sup> If a corporation is a partner in a partnership that receives a dividend, the corporate partner may be entitled to a dividends received deduction. Little guidance exists in applying the various ownership thresholds under the dividends received deduction to a corporate partner receiving dividends through a partnership.<sup>225</sup>

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<sup>219</sup> Sec. 304(a)(1) last sentence. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, section 1013(a) (August 5, 1997) (change to section 304(a)(1) last sentence). Prior to this change (which took effect on June 9, 1997), the stock that was acquired was treated as having been received by the acquiring corporation as a capital contribution.

<sup>220</sup> Sec. 304(b)(2).

<sup>221</sup> Sec. 243(a).

<sup>222</sup> Sec. 243(a)(3) and (b).

<sup>223</sup> Sec. 243(c).

<sup>224</sup> Sec. 243(a).

<sup>225</sup> In a somewhat analogous situation, the IRS held that two unrelated domestic corporations that form a partnership, each corporation being a 50 percent partner in the partnership, are each treated as owning 50 percent of all of the assets of the partnership. As a result, the partnership's ownership of 40 percent of the stock of a foreign corporation will be treated as owned 20 percent by each corporate partner for purposes of the deemed paid foreign tax credit. Rev. Rul. 71-141, 1971-1 C.B. 211.

## **Extraordinary dividends**

Generally, if a corporation receives an extraordinary dividend with respect to stock and the corporation has not held the stock for more than two years after the dividend announcement date, then the basis of such corporation in the stock is reduced (but not below zero) by the non-taxed portion of the dividends.<sup>226</sup> The non-taxed portion of the dividend is generally the amount of the dividends received deduction with respect to the dividend.<sup>227</sup> An extraordinary dividend means any dividend if the amount of such dividend equals or exceeds ten percent (five percent in the case of preferred stock) of the taxpayer's adjusted basis in such share of stock.<sup>228</sup>

In 1997, Congress amended the extraordinary dividend rules in connection with redemptions between related corporations.<sup>229</sup> In the case of any stock redemption that would not have been treated (in whole or in part) as a dividend if the related corporate redemption rules had not applied, then any amount treated as a dividend with respect to such redemption is treated as an extraordinary dividend without regard to the holding period.<sup>230</sup> In other words, such dividends are per se extraordinary dividends. In addition, only the basis in the stock redeemed in the related corporate redemption transaction (i.e., the hypothetically issued acquiring corporation stock) is subject to the general basis reduction rule.<sup>231</sup>

The Treasury Department has applied the extraordinary dividend rules in the partnership setting pursuant to a Congressional grant of authority.<sup>232</sup>

## **Earnings and profits in a consolidated group**

A corporation that is a member of a consolidated group must compute its earnings and profits so as to reflect the earnings and profits of any subsidiary of that particular member.<sup>233</sup>

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<sup>226</sup> Sec. 1059(a)(1). If the non-taxed portion of the dividends exceeds the corporation's basis in the stock, then the excess is treated as gain for the taxable year in which the extraordinary dividend is received. Sec. 1059(a)(2).

<sup>227</sup> Sec. 1059(b).

<sup>228</sup> Sec. 1059(c).

<sup>229</sup> Taxpayer Relief Act of 1997, Pub. L. No. 105-34, section 1013(b) (August 5, 1997) (effective for distributions and acquisitions after June 8, 1997).

<sup>230</sup> Sec. 1059(e)(1)(A)(iii)(II).

<sup>231</sup> Sec. 1059(e)(1)(A) (last sentence).

<sup>232</sup> Sec. 1059(g); Treas. Reg. sec. 1.701-2(f) example 2. In the example, a partnership composed of two corporate partners received an extraordinary dividend. The partnership was treated as an aggregate of its partners for purposes of section 1059. As a result, the partnership had to make appropriate adjustments to the basis of the stock it owned, and the corporate partners had to make appropriate adjustments to the basis in their partnership interests.



This rule is designed to treat the two entities as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the consolidated group's earnings and profits in the common parent.<sup>234</sup> If the location of a member within a consolidated group changes, then appropriate adjustments must be made to the members to prevent earnings and profits from being eliminated.<sup>235</sup>

### **Real estate mortgage investment conduits**<sup>236</sup>

In general, a real estate mortgage investment conduit ("REMIC") is a self-liquidating vehicle that holds a fixed pool of mortgages and issues multiple classes of investor interests. A REMIC is not treated as a separate taxable entity. Rather, the income of the REMIC is allocated to, and taken into account by, the holders of the interests in the REMIC under detailed rules.<sup>237</sup> In order to qualify as a REMIC, all of the interests in the REMIC must consist of one or more classes of regular interests and a single class of residual interests. A regular interest is an interest in a REMIC that is issued with a fixed term, designated as a regular interest, and unconditionally entitles the holder to receive a specified principal amount (or other similar amount) with interest payments that are either based on a fixed rate (or to the extent provided in regulations, at a variable rate) or consist of a specified portion of the interest payments on qualified mortgages that does not vary during the period such interest is outstanding. The holder of a regular interest generally recognizes income in an amount equal to the taxable income that would be recognized by an accrual method holder of a debt instrument that has the same terms as the regular interest.

In general, a residual interest is any interest in the REMIC other than a regular interest, and which is so designated by the REMIC, provided that there is only one class of such interest and that all distributions (if any) with respect to such interests are pro rata. Holders of residual REMIC interests are subject to tax on the portion of the income of the REMIC that is not allocated to the regular interest holders. Specifically, the holder of a residual interest takes into account the holder's daily portion of the taxable income or net loss of the REMIC for each day during the holder's taxable year in which such holder held such interest. The amount so taken

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<sup>233</sup> Treas. Reg. sec. 1.1502-33.

<sup>234</sup> Treas. Reg. sec. 1.1502-33(a)(1).

<sup>235</sup> Treas. Reg. sec. 1.1502-33(f)(2). For example, if P transfers all of S's stock to another member in a section 351 transaction (and Treas. Reg. sec. 1.1502-13 applies), the transferee's earnings and profits are adjusted immediately after the transfer to reflect S's earnings and profits immediately before the transfer from consolidated return years. Also, if the transferee purchases S's stock from P, then the transferee's earnings and profits are not adjusted. The regulation also provides for an anti-avoidance rule warning that adjustments must be made as necessary to carry out the purpose of the section.

<sup>236</sup> Although unrelated to the general corporate tax laws, a general discussion of the rules relating to REMICs has been included in this section because REMICs were used in connection with Projects Steele and Cochise.

<sup>237</sup> See sections 860A through 860G.

into account is treated as ordinary income or loss. The daily portion is determined by allocating to each day in any calendar quarter, a ratable portion of the taxable income or net loss of the REMIC for such quarter, and by allocating the amount so allocated to any day among the holders (on such day) of residual interests in proportion to their respective holdings on such day.

A holder's basis in a residual interest is increased by the amount of taxable income of the REMIC that is taken into account by the holder. The basis of such an interest is decreased (but not below zero) by the amount of any distributions received from the REMIC and by the amount of any net loss of the REMIC that is taken into account by the holder.

Because of the interest income and deduction accrual rules pertaining to REMIC residual interests, such interests typically produce non-cash "phantom" interest income accruals that cannot be offset by net operating losses or negated by the tax-exempt status of a REMIC residual interest holder.<sup>238</sup> Unlike non-statutory securitization structures, the holder of the residual interest in a REMIC is not required to demonstrate any degree of equity substantiality through a minimum threshold of cash return entitlement, which makes the REMIC a highly efficient securitization structure. Therefore, REMIC residual interests typically have little or no fair market value because they have nominal (if any) entitlement to cash distributions from the REMIC. In fact, REMIC residual interests often have a negative fair market value because, although the non-cash "phantom" interest income accruals are reversed by non-cash "phantom" interest deductions, such deductions may accrue only years after the income inclusions, and REMIC residual interest values reflect the time value of money relating to this timing mismatch. The magnitude of these timing differences depends (among other things) upon the structure of the REMIC regular interest tranches and, in particular, their interest rates and terms to maturity in relation to each other and to the REMIC assets.<sup>239</sup>

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<sup>238</sup> Primarily because of the REMIC excess inclusion rules that require this result, REMIC residual interests have been described as "intensely regulated by arcane and complicated tax rules that are designed principally to maximize a holder's tax liability." Kirk Van Brunt, *Tax Aspects of REMIC Residual Interests*, 2 Fla. Tax Rev. 149, 152 (1994). However, others point out that the excess inclusion rules "tend to reduce the excessive differences in after-tax yields for high and low marginal rate taxpayers," in part because excess inclusion income may not be offset by net operating losses or negated by the tax-exempt status of the holder of a REMIC residual interest. Bruce Kayle, *Where Has All the Income Gone? The Mysterious Relocation of Interest and Principal in Coupon Stripping and Related Transactions*, 7 Va. Tax Rev. 303, 351 (1987).

<sup>239</sup> "Income and deductions created by timing differences will ultimately offset each other and net to zero. However, timing is everything and the pain of a substantial tax liability on phantom income in one year is only partially eased by the prospect of offsetting phantom losses in a later year." Kirk Van Brunt, *Tax Aspects of REMIC Residual Interests*, 2 Fla. Tax Rev. 149, 156 (1994).

## Lease versus financing<sup>240</sup>

The IRS has issued a number of revenue rulings and revenue procedures addressing the issue of whether an agreement is a lease or a conditional sales contract (i.e., a financing arrangement).<sup>241</sup> A synthetic lease transaction is a transaction that is structured as an operating

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<sup>240</sup> Although unrelated to corporate tax laws, a general discussion of synthetic lease arrangements is included in this section because Project Teresa involved such an arrangement (though this Report does not focus on issues raised by the synthetic lease arrangement).

<sup>241</sup> In Rev. Rul. 55-540, 1955-2 C.B. 39, the IRS stated that whether an agreement, which is in form a lease, is in substance a conditional sales contract depends upon the intent of the parties as evidenced by the terms of the agreement and the facts and circumstances existing at the time of the execution of the agreement. The IRS subsequently issued a number of rulings in distinguishing a lease from a conditional sales contract. *See, e.g.*, Rev. Rul. 55-541, 1955-2 C.B. 19 (sale rather than a lease), Rev. Rul. 55-542, 1955-2 C.B. 59 (sale rather than a lease), Rev. Rul. 60-122, 1960-1 C.B. 56 (two transactions, one considered a lease and the other considered a sale), and Rev. Rul. 72-408, 1972-2 C.B. 86 (sale rather than a lease).

In Rev. Proc. 75-21, 1975-1 C.B. 715, the IRS set forth guidelines that it would use for ruling purposes in determining whether certain transactions purporting to be leases are, in fact, leases for Federal income tax purposes. On May 7, 2001, the IRS published Rev. Proc. 2001-28, 2001-19 I.R.B. 1156, which modifies and supersedes Rev. Proc. 75-21. The new revenue procedure, like its predecessor, applies to leveraged lease transactions.

The leading case in determining the tax ownership of leased property in a sale-leaseback transaction is *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978). In *Lyon*, Worthen Bank & Trust Company (“Worthen”) constructed a bank building and sold it to Frank Lyon Company (“Lyon”) for approximately \$7.64 million. Lyon invested \$500,000 of its own funds and financed the remaining purchase price with a mortgage from New York Life Insurance Company payable over 25 years. Lyon then leased the bank building to Worthen for 25 years (equal to the term of the mortgage). The rental payments under the lease also matched in time and amounts the payments due under the mortgage. Under the lease, Worthen had the option after 11 years, 15 years, 20 years, and 25 years, to repurchase the building at a price equal to: (1) the outstanding balance on the mortgage and (2) \$500,000 plus six percent compound interest over the lease term. If Worthen did not exercise its option to repurchase the building, it could renew the lease for eight additional five-year terms. The rents under the renewal were calculated to return Lyon’s investment plus six percent compound interest. Worthen was responsible for all expenses associated with the maintenance of the building (a “net lease” arrangement).

The Supreme Court respected the form of the transaction and held for the taxpayer. The Court wrote:

In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-

lease for financial accounting purposes but a financing arrangement for tax purposes. The primary benefit is that the lessee does not record the debt incurred to finance the property acquisition or the rent obligation to the lessor as a liability on its balance sheet. For income tax purposes, the transaction is structured so that the lessee (and not the lessor) is treated as the owner of the property. As a result, for tax purposes, the lessee is entitled to the depreciation and interest deductions.<sup>242</sup>

## **2. Projects Tanya and Valor**

### **Brief overview**

Projects Tanya and Valor were structured to accelerate and duplicate certain deductions within the Enron consolidated group. Each transaction involved a tax-free transfer of assets and unrelated contingent liabilities by Enron to an Enron subsidiary in exchange for stock in the subsidiary. The transferred assets had a value that only slightly exceeded the projected amount of the contingent liabilities.<sup>243</sup> The transferred assets had a tax basis that significantly exceeded the net value of the stock received in the exchange. Therefore, a sale by Enron of the subsidiary stock would result in a significant capital loss (i.e., an acceleration of a future loss). In addition, the contingent liabilities would give rise to a future tax deduction when paid by the subsidiary (resulting in a duplication of the loss).

### **Project Tanya – background**<sup>244</sup>

#### Reported tax and financial statement effects

In connection with Project Tanya, Enron reported a short-term capital loss of \$188.515 million on its 1995 return. Enron also deducted a total of \$76.68 million in connection with the assumed liabilities in its 1996 through 2000 tax returns.

The \$188.515 million loss that Enron reported on its tax return did not result in a corresponding loss for financial statement purposes. Thus, the tax savings associated with the

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avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. *Id.* at 583-84.

<sup>242</sup> The IRS has issued agency decisions addressing synthetic lease arrangements. For example, in 1998 FSA LEXIS 413 (February 26, 1998), the IRS concluded that a transaction structured as a synthetic lease was a lease for Federal income tax purposes and not a financing arrangement. The IRS reached a contrary result in FSA 19992003 (January 12, 1999).

<sup>243</sup> Project Tanya involved the assumption of liabilities relating to deferred compensation and post-retirement medical, life insurance, and executive death benefit obligations. Project Valor involved the assumption of certain risks associated with third-party commodity contracts.

<sup>244</sup> The information regarding Project Tanya was obtained from Joint Committee staff interviews of Robert J. Hermann, Robert D. Maxey, Greek L. Rice, and Mary K. Joyce, as well as from documents and information provided by Enron and the IRS.

loss resulted in an increase in financial statement earnings (i.e., earnings through a reduction in the provision for income tax expense) of \$65.8 million.<sup>245</sup> Enron reported \$46.5 million of the earnings in 1995 and the remaining \$19.3 million in 1999 (upon the IRS's completion of its review of the stock sale that generated the capital loss).<sup>246</sup>

### Development of Project Tanya

Arthur Andersen, Enron's outside auditor, brought the idea for Project Tanya to Enron in August 1995.<sup>247</sup> Robert J. Hermann, Managing Director and General Tax Counsel of Enron Corp., named the transaction after a hurricane.<sup>248</sup> Arthur Andersen, aware that Enron had significant capital gain in 1995 from the sale of stock in Enron Oil & Gas, proposed the transaction as a means to offset a portion of the capital gain. Originally, the transaction contemplated the assumption of potential environmental liabilities; however, Enron did not have such liabilities. So the transaction was customized to involve the assumption of deferred compensation and post-retirement benefit obligations. The transaction had to be completed in December 1995 (presumably to offset the capital gain that was recognized in the same year).

The Finance Committee of Enron Corp.'s Board of Directors approved the transaction on December 11, 1995.<sup>249</sup> The next day, Richard D. Kinder, a member of the Enron Corp. Board of Directors, presented the details of the transaction at a meeting of the Board of Directors. At that meeting, the Board of Directors approved and ratified the transaction.<sup>250</sup>

Implementing the transaction was a time-consuming process, but the Enron tax group received help from different parts of the company for document production. The Enron tax group also depended heavily on Arthur Andersen in implementing the transaction. Enron's Human Resources Department did the modeling for the transaction.

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<sup>245</sup> The calculation is 35 percent (i.e., the statutory Federal corporate income tax rate) of \$188.515 million.

<sup>246</sup> The General Background Materials in Appendix B contain the Structured Transactions Group, Summary of Project Earnings & Cash Flows, November 2001. The IRS review of Project Tanya is discussed in greater detail below.

<sup>247</sup> ERMI Structure Presentation by Arthur Andersen, dated August 14, 1995, EC2 000037817-37827.

<sup>248</sup> This tax Project was named for the Atlantic tropical storm, as listed by the World Meteorological Organization, that began with the letter "T" in the year the project was commenced. Projects Teresa, Tomas, and Tammy I and II were also named using this convention.

<sup>249</sup> Agenda item #3 of the Meeting of the Finance Committee of the Enron Corp. Board of Directors, December 11, 1995, EC2 000037848.

<sup>250</sup> Minutes of the Meeting of the Board of Directors of Enron Corp., December 12, 1995, EC2 000037855-56.

The purported business purpose of the transaction was to provide an incentive for human resource personnel to manage the deferred compensation and post-retirement benefit obligations by allowing the employees to share in the successes that may result from their management efforts. According to an Arthur Andersen memo, “the biggest issue to be resolved [is the] business purpose for [the subsidiary’s] managing these items.”<sup>251</sup>

### Implementation of Project Tanya

In December 1995, Enron Corp. transferred two intercompany promissory notes to Enron Management, Inc.<sup>252</sup> (1) a 20-year promissory note with a tax basis of \$120.84 million, and (2) a 10-year promissory note with a tax basis of \$67.7 million. As part of the transfer, Enron Management, Inc. also assumed certain contingent liabilities of Enron Corp. -- a contractual assumption of Enron Corp.’s deferred compensation obligations of approximately \$67.7 million, and a contractual assumption of post-retirement medical, life insurance, and executive death benefit obligations of approximately \$120.8 million. Enron Management, Inc. also assumed responsibility for administering Enron Corp.’s other compensation and benefit plans. These employee benefit liabilities were segregated from the employee benefit liabilities that were not involved in the transfer.

In exchange for the two promissory notes (and the assumption of the contingent liabilities), Enron Corp. received 20 shares (i.e., all of the issued shares) of a newly created class of voting preferred stock in Enron Management, Inc. The preferred stock had a reported tax basis of \$188.555 million.<sup>253</sup> The preferred stock provided for a nine percent annual dividend and represented \$40,000 of Enron Management, Inc.’s existing net equity. In addition, the class of preferred stock was entitled to three percent of any increase in Enron Management, Inc.’s net equity up to a maximum redemption value of \$340,000.

On December 28, 1995, Enron Corp. sold the 20 shares of Enron Management preferred stock to Patricia L. Edwards and Mary K. Joyce (10 shares to each), both of whom were officers in Enron Corp.’s Human Resources Department and were involved in the management of deferred compensation and post-retirement benefit obligations.<sup>254</sup> The sales price of the stock

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<sup>251</sup> The Project Tanya materials in Appendix B contain a Memo from Robert P. Palmquist of Arthur Andersen to Robert J. Hermann dated October 27, 1995, item # 4, EC2 000037798.

<sup>252</sup> Enron Management, Inc. was a wholly-owned subsidiary of Enron Corp. and a member of the Enron consolidated group.

<sup>253</sup> The tax basis equaled the tax basis of the promissory notes Enron Corp. contributed to Enron Management, Inc.

<sup>254</sup> According to current Enron management, the shares were offered to Ms. Joyce and Ms. Edwards because of their cost-management knowledge and expertise regarding the various pension and deferred compensation liabilities contributed to Enron Management, Inc. Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Chief of Staff of the Joint Committee on Taxation, dated January 13, 2003, answer 5.

was \$40,000,<sup>255</sup> and Enron Corp. reported a capital loss from the stock sale of \$188.515 million (\$40,000 amount realized less a tax basis of \$188.555 million).

The terms of the Enron Management preferred stock, as contained in a Stock Sale and Purchase Agreement, included a put option after five years for the shareholders and a call option after six years. The holders of the preferred stock had the right to elect one of the six directors of Enron Management, Inc.<sup>256</sup>

It was anticipated that in 2002, Enron Management, Inc. would be liquidated into Enron Corp., and Enron Corp. would assume the deferred compensation and post-retirement benefit obligations that Enron Management, Inc. had assumed from Enron Corp. in 1995.<sup>257</sup>

The diagram on the next page depicts the general structure of Project Tanya.

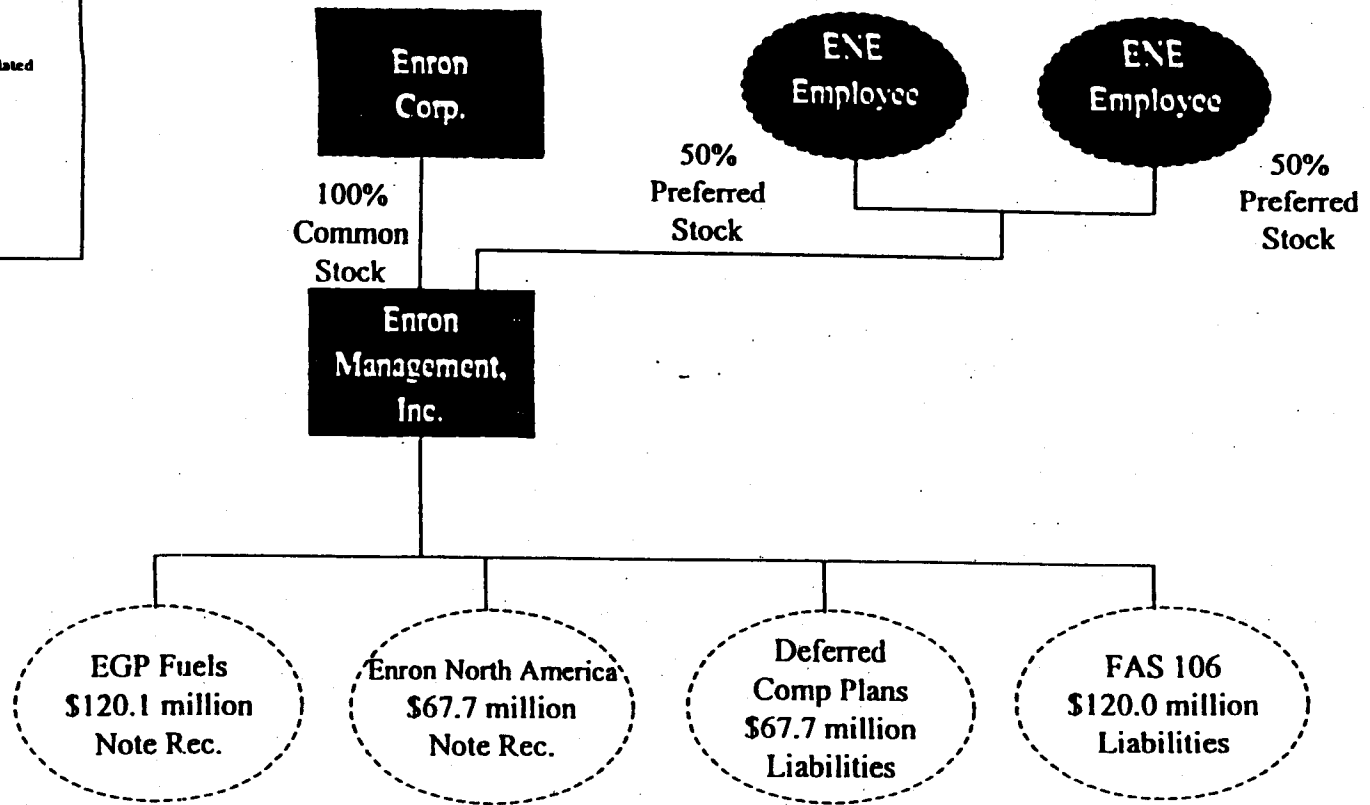
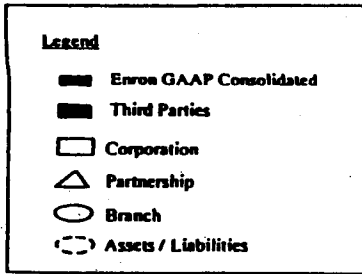
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<sup>255</sup> Current Enron management is not aware of any investment information or advice provided to either Ms. Joyce or Ms. Edwards in connection with the investment. In addition, current Enron management is not aware of any payments that were made to Ms. Joyce or Ms. Edwards regarding the economic outlay for the Enron Management, Inc. preferred stock. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Chief of Staff of the Joint Committee on Taxation, dated January 13, 2003, answers 6 and 8.

<sup>256</sup> Current Enron management is not aware of any promises or commitments made by Enron to Ms. Joyce or Ms. Edwards regarding a return of their investments. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Chief of Staff of the Joint Committee on Taxation, dated January 13, 2003, answer 9.

<sup>257</sup> Project Tanya Structure Overview, EC2 000038324.

# Transaction Structure



Time to execute	2 months
Closing date	December 1995
Total earnings	\$66 million



### Role of outside advisors

Arthur Andersen promoted the transaction to Enron. In connection with Project Tanya, Arthur Andersen provided a tax opinion which concluded that the overall tax result of the transaction, “more likely than not,” is the recognition of a capital loss by Enron on the sale of the Enron Management, Inc. preferred stock. The specific tax issues discussed in the opinion were: (1) the qualification of the transfer of the intercompany promissory notes to Enron Management, Inc., subject to the contractual assumption of the contingent liabilities, as a tax-free contribution; (2) Enron Corp.’s tax basis in the Enron Management, Inc. preferred stock not being reduced by the deferred compensation and post-retirement benefit liabilities; (3) Enron Corp.’s loss on the sale of the Enron Management, Inc. preferred stock not being a duplicated loss (and thus a disallowed loss) under the Treasury consolidated return regulations; and (4) the contribution of the assets in exchange for the Enron Management, Inc. preferred stock not being considered an acquisition made to evade or avoid income taxes.

Arthur Andersen’s fee in connection with Project Tanya was approximately \$500,000.<sup>258</sup>

Appendix C, Part I to this Report contains the tax opinion Enron received in connection with Project Tanya.

### Subsequent developments

In the years following the transaction, Enron Management, Inc. claimed the following deductions in connection with the assumed employee benefit obligations: \$16.977 million on its 1996 return; \$16.217 million on its 1997 return; \$13.682 million on its 1998 return; \$14.7 million on its 1999 return; and \$15.103 million on its 2000 return.

In July 1998, Ms. Edwards left Enron and sold her 10 shares to Ms. Joyce for \$85,000. In 2001, Enron notified Ms. Joyce that it intended to exercise the call option pursuant to the Stock Sale and Purchase Agreement and purchase the 20 shares of Enron Management, Inc. preferred stock. The purchase price was \$440,000 (i.e., \$22,000 per share).<sup>259</sup> The stock purchase occurred in year 2000.

The IRS reviewed the transaction and ultimately allowed the \$188.515 million short-term capital loss to Enron in its audit of Enron’s 1995 consolidated tax return.<sup>260</sup> The IRS is in the process of auditing Enron’s tax returns for years 1996 through 2001.

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<sup>258</sup> Letter from Enron’s counsel (Skadden Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 7; confirmed by information obtained from interviews.

<sup>259</sup> According to current Enron management, the price was the result of negotiations between Ms. Joyce, Mr. Richard A. Causey and other personnel who are no longer at Enron. Letter from Enron’s counsel (Skadden Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 31, 2003, answer 1.

<sup>260</sup> There were disagreements within the IRS regarding the proper tax treatment of the transaction. The IRS Houston field office (including the audit team responsible for the Enron

## Project Valor – background<sup>261</sup>

### Reported tax and financial statement effects

In connection with Project Valor, Enron reported a short-term capital loss of \$235.327 million on its 1996 tax return. Enron also deducted \$181.73 million in connection with the assumed liabilities in its 1997 tax return, and a total of \$88.56 million in connection with the assumed liabilities in its 1998 through 2001 tax returns.

The \$235.327 million loss Enron reported on its tax return resulted in an increase in financial statement earnings (i.e., earnings through a reduction in the provision for income tax expense) of \$82.38 million.<sup>262</sup> However, it appears that Enron never recorded any benefits from Project Valor in its financial statements.<sup>263</sup>

### Development of Project Valor

Project Valor was patterned after Project Tanya, though Project Valor involved different types of contingent liabilities. Project Valor was designed to generate a capital loss that could be used to offset capital gain realized by Enron from the sale of additional stock in Enron Oil & Gas.

It appears that Ben F. Glisan, Jr., recruited from Arthur Andersen in 1996 to be a Director at Enron Capital Trade & Resources Corp. (“Enron Capital Trade”),<sup>264</sup> led the effort to

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audit) believed that the capital loss should be disallowed. The IRS Houston field office forwarded to IRS District Counsel Office a proposed notice of deficiency that would have disallowed the loss on the grounds that the transaction lacked economic substance, or alternatively, that it lacked business purpose. The IRS District Counsel Office, in consultation with the Corporate Division of the Office of Chief Counsel, declined to support the audit team’s position. As a result, the issue was not included in the Revenue Agent Report for Enron’s 1995 tax year. The Project Tanya materials in Appendix B contain a Memo dated August 16, 1999, from IRS District Counsel, Houston District to Chief, Quality Measurement Staff, Houston District, regarding this matter.

<sup>261</sup> The information regarding Project Valor was obtained from Joint Committee staff interviews of Robert J. Hermann, Jordan H. Mintz, Robert D. Maxey, and Greek L. Rice, as well as from documents and information provided by Enron and the IRS.

<sup>262</sup> The calculation is 35 percent (i.e., the statutory Federal income tax rate) of \$235.327 million.

<sup>263</sup> Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 12; confirmed by information obtained from interviews.

<sup>264</sup> Enron Capital Trade is a wholly-owned subsidiary of Enron Corp. and a member of the Enron consolidated group.

implement Project Valor. Sometime in September 1996, Mr. Glisan began assembling a team to restructure certain commodity contracts used by Enron in its commodity business. Mr. Glisan was considered the team leader of Project Valor, and he reported to Andrew Fastow (who was Managing Director of Enron Capital Trade). In early December 1996, Mr. Hermann asked Jordan H. Mintz (who had recently been hired by Enron Capital Trade as its Vice President of Taxes) to assist in the project, which Mr. Hermann wanted completed before December 31, 1996. Mr. Mintz became the tax representative of the team.<sup>265</sup> Other significant participants in Project Valor included Richard Kieval (who was selected to manage the risk management liabilities), Bill Bradford (who was selected to manage the credit risk liabilities), Debra Culver (internal counsel representative on the team), and Paige Grumulaitis (Assistant Business Unit Coordinator).<sup>266</sup>

Unlike Project Tanya, Project Valor apparently was not presented to Enron Corp. management for formal approval.<sup>267</sup> Rather, Mr. Glisan informally presented an overview of the concept to Mr. Fastow, and Mr. Fastow gave Mr. Glisan an informal approval to proceed. To account for control policies, Ms. Culver (from internal counsel) was included on the team.<sup>268</sup>

The purported business purpose of the transaction was to provide an incentive for employees responsible for managing Enron's potential credit risk obligations and fixed price and risk management contract liabilities to manage effectively such liabilities by allowing the employees to share in the successes that may result from their management efforts.

#### Implementation of Project Valor

Enron Capital Trade was a purchaser and marketer of natural gas and wholesale electricity. In addition, it managed a portfolio of contracts offering physical and financial energy products and services. In support of its business activities, Enron Capital Trade would enter into various swaps, options, and forward contracts with unrelated parties, including numerous fixed price and risk management contracts ("FPRM contracts"). Due to changes in commodity prices and interest rates, some FPRM contracts were liabilities to Enron Capital Trade (because it would owe a payment to the counterparty pursuant to the contract). Enron Capital Trade also had certain credit risks that were characterized as liabilities in its financial records.

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<sup>265</sup> The project was approximately 25 to 50 percent complete when Mr. Mintz became involved.

<sup>266</sup> IRS compilation of interviews with Ben Glisan, Paige Grumulaitis, Bill Bradford, Jordan Mintz, Richard Kieval, and Debra Culver.

<sup>267</sup> However, current Enron management understands that Project Valor was presented to and approved by the Board of Directors of Enron Capital Trade. Letter from Enron's counsel (Skadden, Arps), to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 17.

<sup>268</sup> IRS compilation of interview with Mr. Glisan.

On December 20, 1996, Enron Capital Trade transferred to Enron Capital Trade Strategic Value Corp. (“ECT Strategic”)<sup>269</sup> two intercompany promissory notes: (1) a 10-year promissory note with a tax basis of \$217 million, and (2) a 10-year promissory note with a tax basis of \$50.32 million. As part of the transfer, ECT Strategic assumed certain contingent liabilities of Enron Capital Trade -- a contractual assumption of \$5.01 million of Enron Capital Trade’s credit reserve obligations and a deemed assumption of \$262.27 million of Enron Capital Trade’s FPRM contract liabilities.<sup>270</sup> Pursuant to a Liability Management Agreement between Enron Capital Trade and ECT Strategic dated December 20, 1996, ECT Strategic assumed responsibility for managing the FPRM contract liabilities and the credit reserves, but any restructuring of the FPRM contracts or the credit reserves required prior approval by Enron Capital Trade. Employees who were responsible for the management of these liabilities, including Richard Kieval and Bill Bradford, were transferred to ECT Strategic.

In exchange for the promissory notes (and the assumption of the contingent liabilities), Enron Capital Trade received 40 shares (i.e., all of the issued shares) of a new class of ECT Strategic voting participating preferred stock. The preferred stock had a reported tax basis of \$235.367 million.<sup>271</sup> The preferred stock paid a nine percent annual dividend and represented in the aggregate, \$40,000 of ECT Strategic’s net equity. In addition, the class of preferred stock was entitled to four percent of any increase in ECT Strategic’s net equity up to a maximum redemption value of \$2 million.

On December 27, 1996, Enron Capital Trade sold the 40 shares of ECT Strategic preferred stock to three employees involved in the monitoring of the commodity trading activities – Mr. Kieval (who purchased 30 shares for \$30,000), Mr. Bradford (who purchased five shares for \$5,000) and Mr. Glisan (who purchased five shares for \$5,000).<sup>272</sup> Thus, the aggregate sales price of the stock was \$40,000, and Enron reported a capital loss from the stock sale of \$235.327 million (\$40,000 amount realized less a tax basis of \$235.367 million).

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<sup>269</sup> ECT Strategic, formerly known as Enron Gas Gathering Inc., was formed in March 1985, to manage various gathering assets of Enron. In connection with Project Valor, its name was changed to ECT Strategic, and its purpose was altered to undertake responsibilities associated with credit reserve obligations and FPRM contract liabilities.

<sup>270</sup> In order to avoid a breach of the terms of the FPRM contracts (which required consent for any assignment), Enron Capital Trade and ECT Strategic entered into a Master Swap Agreement and a Liability Management Agreement. These agreements replicated the economics that would have resulted from an actual transfer of the FPRM contracts to ECT Strategic.

<sup>271</sup> This amount equals the aggregate basis in the promissory notes of \$267.37 million less approximately \$32 million of premiums on unrealized liabilities that were assumed by ECT Strategic in connection with the transfer.

<sup>272</sup> Current Enron management is not aware of any payments that were made to Messrs. Kieval, Bradford, or Glisan specifically to cover the economic outlay for the ECT Strategic preferred stock. Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 15.

The terms of the ECT Strategic preferred stock included a put option exercisable by the shareholders (requiring ECT Strategic to redeem its shares) after five years<sup>273</sup> and a call option exercisable by ECT Strategic (requiring the preferred shareholder to sell the stock to ECT Strategic) after six years.<sup>274</sup> The holders of the ECT Strategic preferred stock had the right to elect one of the six directors of ECT Strategic.

#### Role of outside advisors

In connection with Project Valor, Arthur Andersen provided a tax opinion, dated December 27, 1996, which concluded that the overall tax result of the transaction, “more likely than not,” is the recognition of a capital loss by Enron Capital Trade on the sale of the voting participating preferred stock of ECT Strategic. The specific tax issues discussed in the opinion were: (1) the qualification of the transfer of the intercompany promissory notes to ECT Strategic, subject to the contractual assumption of the contingent liabilities, as a tax-free contribution; (2) Enron Capital Trade’s tax basis in the ECT Strategic preferred stock not being reduced by the amount of the credit reserve obligations and FPRM contract liabilities assumed by ECT Strategic; (3) Enron Capital Trade’s loss on the sale of the ECT Strategic preferred stock not being a duplicated loss (and thus a disallowed loss) under the Treasury consolidated return regulations; and (4) the contribution of the assets for ECT Strategic stock not being considered an acquisition made to evade or avoid income taxes.

Arthur Andersen’s fee in connection with Project Valor was approximately \$100,000.<sup>275</sup>

Appendix C, Part II to this Report contains the tax opinion Enron received in connection with Project Valor.

#### Subsequent developments

In the years following the transaction, ECT Strategic claimed the following deductions in connection with the assumed credit risk and risk management liabilities; \$181.729 million on its 1997 return; \$49.099 million on its 1998 return; \$26.064 million on its 1999 return; \$10.317 million on its 2000 return; and \$3.085 million on its 2001 return.<sup>276</sup>

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<sup>273</sup> The price at which the preferred stock could be put to the company would be equal to four percent of any increase in ECT Strategic’s net equity up to a maximum redemption value of \$2 million.

<sup>274</sup> The right to call the preferred stock had a maximum redemption value of \$2 million.

<sup>275</sup> Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 22.

<sup>276</sup> Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 18. The total of these losses exceeds the amount of the loss reported in 1996 in connection with the sale of the ECT Strategic preferred stock.

Around March 30, 1999, Mr. Kieval left Enron. Immediately prior to his departure, ECT Strategic redeemed the 30 shares of preferred stock owned by Mr. Kieval for \$30,000 (i.e., the initial investment). The 30 shares were resold to Messrs. Bradford and Glisan, effective March 30, 1999, in the amount of \$15,000 per each investor. According to current Enron management, Enron included amounts equal to the purchase price of the additional 15 shares each of the ECT Strategic preferred stock in Messrs. Bradford's and Glisan's 1999 bonuses (paid in February 2000).<sup>277</sup> Messrs. Bradford and Glisan apparently continue to hold their ECT Strategic preferred stock.

The IRS is in the process of auditing Enron's tax returns for years 1996 through 2001.

## **Discussion**

In Projects Tanya and Valor, Enron sought to both duplicate and accelerate certain deductions with respect to contingent liabilities assumed by the respective Enron subsidiaries. Enron claimed a loss with respect to the contingent liabilities when Enron sold the preferred stock, and a second deduction in subsequent years as the liabilities were paid.<sup>278</sup>

A determination of whether Enron should be entitled to a capital loss on the sale of the preferred stock and on the subsequent accrual of the contingent liabilities necessarily involves an analysis regarding Enron's satisfaction of the literal requirements of the corporate tax rules as well as the rules and judicial doctrines (such as business purpose and economic substance) that are often applied to evaluate claimed tax benefits in tax-motivated transactions.<sup>279</sup>

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<sup>277</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 15.

<sup>278</sup> The transfer of swap liabilities raises an issue that is unique to Project Valor. By independent operation of the Treasury regulations concerning the tax treatment of notional principal contracts with significant nonperiodic payments, Treas. Reg. sec. 1.446-3(g)(4), the manner in which the promissory notes and swap liabilities were transferred to ECT Strategic could have caused the transfer (at least to the extent of the swap liabilities and a corresponding amount of the promissory notes) to be recharacterized instead as a deemed contribution of on-market swaps and a loan by Enron Capital Trade to ECT Strategic (with the amount of the deemed loan being equal to the actual liabilities associated with the individual swaps). In such a case, the basis in the ECT Strategic preferred stock received by Enron Capital Trade in the exchange would be reduced by the amount of the deemed loan to ECT Strategic.

<sup>279</sup> 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

From a policy perspective, there is little question that, assuming Enron remains responsible for the liabilities, Enron should be entitled to a deduction when the liabilities are paid or accrued. Had Enron not engaged in Projects Tanya and Valor, it would have been entitled to a deduction with respect to the liabilities when the liabilities are taken into account under Enron's method of accounting. By the same token, however, there is no policy justification for allowing a single taxpayer multiple deductions with respect to the same liabilities.<sup>280</sup>

In Projects Tanya and Valor, Enron remained accountable for the liabilities both before and after the transactions. Also in each project, the same employees remained responsible for monitoring and managing the liabilities both before and after the transactions. Thus, apart from the tax benefits, there appeared to be little justification for participating in Projects Tanya and Valor. The purported rationale -- to provide an incentive for employees responsible for managing these liabilities to share in the success of their efforts -- is dubious. The maximum value of the preferred stock (whose value was dependent upon the successful management of the liabilities) was capped and subject to a call option, which had the effect of limiting the employee incentives. Enron could have provided similar incentives (without engaging in a complex and costly restructuring of its liabilities) through employment contracts. Indeed, Arthur Andersen noted that "the biggest issue to be resolved [is the] business purpose for [the subsidiary's] managing these items."<sup>281</sup>

If the non-tax business purpose of a transaction is not self-evident -- or stated another way, if a taxpayer and its tax advisor have to develop or devise a justification for the taxpayer's involvement in a particular transaction -- then the transaction in all likelihood lacks a non-tax

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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).

<sup>280</sup> Cf. *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), *reh'g denied*, 2001 U.S. App. LEXIS 23207 (Oct. 3, 2001), where the Circuit Court of Appeals for the Federal Circuit invalidated a provision in the consolidated return regulations that prevented the taxpayer from claiming a loss on the sale of stock of a subsidiary to the extent the subsidiary had assets that had a built-in loss, or had a net operating loss, that could be recognized or used by another taxpayer. Subsequent to the *Rite Aid* decision, the IRS issued Notice 2002-18, 2002 I.R.B. 644, in which the Treasury Department reiterated its belief that "a consolidated group should not be able to benefit more than once from one economic loss," and indicated its intent to issue regulations that will prevent a consolidated group from claiming multiple losses with respect to one economic loss. In October 2002, the Treasury Department proposed regulations under section 1502 that redetermine the basis of the stock of a subsidiary member of a consolidated group immediately prior to dispositions and deconsolidations of the stock. The proposed regulations also suspend certain losses recognized on the disposition of such stock. See REG-131478-02, 67 FR 65060 (Oct. 23, 2002).

<sup>281</sup> The Project Tanya materials in Appendix B contain a Memo from Robert P. Palmquist of Arthur Andersen to Robert J. Hermann dated October 27, 1995, item # 4, EC2 000037798.

business purpose and should be challenged accordingly. In Project Tanya, Enron and Arthur Andersen shared the responsibility of developing a business purpose for the transaction.<sup>282</sup> The fact that Enron's tax advisor, who promoted the transaction and assisted in its implementation, actually shared in the responsibility for developing the business purpose for Project Tanya should be *prima facie* evidence that Enron lacked a non-tax business purpose for the transaction.

Related to the concept of a non-tax business purpose is section 269. This provision grants the IRS the authority to disallow benefits if a taxpayer acquires control (defined as at least 50 percent of vote or value) of a corporation, and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax.<sup>283</sup> In Projects Tanya and Valor, the Arthur Andersen tax opinions concluded that section 269 was not implicated because Enron Management, Inc. and ECT Strategic were preexisting entities (and the acquisition occurred when Enron acquired the common stock, not the preferred stock, of these subsidiaries). Furthermore, even if control were measured at the time the preferred stock was acquired, the opinion letters rely on Enron's representations regarding its business purpose to conclude that the principal purpose was not the evasion or avoidance of income tax.<sup>284</sup> Given that Arthur Andersen shared in the responsibility for devising a business purpose for the transactions, its reliance on Enron's representations is difficult to justify. Similarly, if called upon, Enron should have a difficult time asserting that its reliance on the tax opinion constitutes reasonable cause and good faith.<sup>285</sup>

As to the economic substance of the transactions, even the most optimistic projections regarding the expected additional savings resulting from the transaction would be miniscule

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<sup>282</sup> The Project Tanya materials in Appendix B contain a facsimile that Enron Corp. received from Arthur Andersen of a "To Do List" dated November 9, 1995, EC2 000037845-37847, which states (action step #7) that Arthur Andersen and Enron shared the responsibility of developing a business purpose for Project Tanya.

<sup>283</sup> Sec. 269(a)(1).

<sup>284</sup> Appendix C, Part I to this Report contains the tax opinion Enron received in connection with Project Tanya (with the section 269 analysis in appendix E of the tax opinion). Appendix C, Part II to this Report contains the tax opinion Enron received in connection with Project Valor (with the section 269 analysis in appendix E of the tax opinion).

<sup>285</sup> An accuracy-related penalty is not imposed with respect to any portion of any underpayment if the taxpayer can show that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion. Section 6664(c)(1). Reliance on a tax opinion constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. This standard is not satisfied if the advice or opinion is based on unreasonable factual or legal assumptions. "For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner." Treas. Reg. sec. 1.6664-4(c)(1)(ii).



when compared to the \$423.8 million in additional tax deductions claimed by Enron (i.e., the aggregate loss from the sale of the Enron Management preferred stock and ECT Strategic preferred stock).

Another troubling aspect of Projects Tanya and Valor was Enron's use of an accommodation party -- its employees. While these shareholders were not "related" to Enron as the term is generally used under the tax laws, their interests were aligned with Enron and they shared the same objectives as Enron for purposes of the transactions. In these situations, the tax rules oftentimes do not function as intended and may produce undesirable results.

### Subsequent legislation

Congress enacted legislation in 2000 out of concern that taxpayers were accelerating and potentially duplicating deductions involving contingent liabilities -- precisely what Projects Tanya and Valor were designed to accomplish.<sup>286</sup> The provision applies if, after application of the other transferor basis rules, the basis of property permitted to be received without the recognition of gain or loss exceeds its fair market value. In such a case, the basis of the property is reduced (but not below its fair market value) by the amount of any liability that is assumed in exchange for such property if the liability was not treated as money received by the taxpayer in the exchange.<sup>287</sup> Had section 358(h) been in effect at the time that Projects Tanya and Valor were undertaken, the provision would have reduced Enron's aggregate tax basis in its Enron Management and ECT Strategic preferred stock from \$423.8 million to \$80,000.

### Administrative guidance

The IRS also has made several administrative pronouncements with respect to contingent liability transactions. On February 26, 2001, the IRS released a notice on the contingent liability tax shelter.<sup>288</sup> The notice describes the transaction and states that the IRS was "not aware of any case in which a taxpayer has shown a legitimate non-tax business reason to carry out the combination of steps... ." In addition, "any business purposes taxpayers may assert for certain aspects of these transactions are outweighed by the purposes to generate deductible losses... ." The notice states that the IRS will disallow any loss from the sale of the stock.<sup>289</sup> The IRS also

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<sup>286</sup> The Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, sec. 1(a)(7) (Dec. 21, 2000). See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 106<sup>th</sup> Congress* (JCS-2-01), April 19, 2001, at 154.

<sup>287</sup> Sec. 358(h)(1).

<sup>288</sup> Notice 2001-17, 2001-09 I.R.B. 730. The notice identifies the contingent liability tax shelter (and transactions similar to it) as a "listed transaction."

<sup>289</sup> For transfers after October 18, 1999, the losses are disallowed by reason of section 358(h). For transfers on or before October 18, 1999 (and for transfers not subject to section 358(h)), the IRS stated that it would disallow such losses under several different legal theories, including: (1) the purported section 351 exchange lacks a sufficient business purpose; (2) the transfer of the asset to the transferee corporation is in substance an agency arrangement or a payment to the transferee corporation for its assumption of a liability; (3) the purported section

noted that any deduction claimed by the transferee corporation for payments on the assumed liability may be subject to disallowance on one or more of several possible grounds, including that the payments are not for ordinary and necessary business expenses of the transferee corporation.<sup>290</sup> The IRS also has issued notices to assist Chief Counsel attorneys in advising field personnel in the development of cases involving these (or similar) transactions.<sup>291</sup>

#### Tax shelter resolution initiative program

On October 4, 2002, the government announced a tax shelter resolution initiative<sup>292</sup> under which it will agree to enter into settlement agreements with taxpayers involved in three abusive tax-avoidance transactions (including the contingent liability transactions). With respect to the contingent liability transaction, the settlement initiative provides for two resolution methodologies that an eligible taxpayer can elect.<sup>293</sup> A taxpayer that wishes to participate in the program must notify the IRS by a written application before March 5, 2003.<sup>294</sup>

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351 exchange is disallowed under section 269(a); (4) the principal purpose of the transferee's assumption of the liability was to avoid federal income tax or was not a bona fide business purpose under section 357(b)(1) and therefore the assumption of the liability should be treated as money received by the transferor; (5) the purported loss on the sale of stock of the transferee corporation is disallowed or limited by the loss disallowance rules of Treas. Reg. sec. 1.1502-20; (6) the purported loss on the sale of stock of the transferee corporation is not a bona fide loss under section 165; and (7) the transaction lacks sufficient economic substance.

<sup>290</sup> The IRS distinguished Rev. Rul. 95-74 by noting that in the ruling, the transferee corporation assumed the liabilities in connection with the transfer of substantially all the assets associated with the operation of a manufacturing business.

<sup>291</sup> See, CC-2001-033 (June 22, 2001) and CC-2001-033a (revised) (June 28, 2001). The IRS has released a number of agency decisions in which it has cited Notice 2001-17. See, e.g., FSA 200121013 (February 12, 2001) (transaction involving nonqualified deferred compensation liabilities in a consolidated return context); FSA 200122022 (February 23, 2001) (transaction involving swap liabilities and credit reserves in a consolidated return context); CCA (chief counsel advice) 200117039 (March 13, 2001) (transaction involving an obligation to pay rent under a leasehold position following a lease stripping transaction); FSA 200134008 (May 15, 2001) (transaction involving employee benefits); and FSA 200146025 (August 2, 2001) (in determining whether a loss is a bona fide loss in an equity stripping transaction).

<sup>292</sup> IR-2002-105 (Oct. 4, 2002).

<sup>293</sup> Under one methodology -- the "fixed concession procedure" -- an eligible taxpayer is permitted a capital loss deduction equal to 25 percent of the amount of the capital loss reported for the sale of the transferee stock received in the contingent liability transaction. To prevent a duplication of the tax benefits, the taxpayer must include an amount equal to the permitted capital loss as income in equal annual amounts over a 15-year period. Under the second methodology -- the "fast track dispute resolution procedure" -- the taxpayer must concede between 50 and 90 percent of the amount of the capital loss reported for the sale of stock (with a

## **Recommendations**

The legislation enacted in 2000 makes it more difficult for taxpayers to achieve the duplication of losses sought by Enron in Projects Tanya and Valor. The IRS and Treasury Department also have taken measures to address the specific transaction. Therefore, with respect to the specific transaction, a recommendation is not necessary at this time.

The linchpin to the contingent liability transaction is the interactive effect of the corporate tax-free transfer rules and the tax basis rules,<sup>295</sup> which results in a duplication of losses for the transferor and transferee. Equally as important to the transaction is the use of a liability that is not taken into account for Federal income tax purposes.<sup>296</sup> While section 358(h) was an appropriate response to the transaction at issue, there are instances in which it falls short of addressing other transactions that raise similar concerns. For example, the provision does not apply to situations in which the duplication of loss is achieved via a transfer of built-in loss assets without an assumption of liabilities.<sup>297</sup>

The duplication of gains and losses is one of the fundamental underpinnings of subchapter C. Some commentators have said that duplication of gain and loss is the price a transferor pays in order to achieve deferral of gain and loss.<sup>298</sup> Such a rationale, however, does

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binding arbitration procedure if the taxpayer and IRS cannot agree on the amount of the disallowed loss). The details of the settlement offer in connection with the contingent liability transaction are described in Rev. Proc. 2002-67, 2002-43 I.R.B. 733 (Oct. 28, 2002).

<sup>294</sup> In Announcement 2002-110, 2002-50 I.R.B. 1, the IRS announced it was extending the deadline for participating in the resolution program from January 2 to March 5.

<sup>295</sup> Secs. 351, 358 and 362.

<sup>296</sup> For a general discussion of the treatment of liabilities, *see generally*, Lee Sheppard, *What is a Liability*, 89 Tax Notes 1513 (2000).

<sup>297</sup> Bank of America used a similar section 351 loss duplication strategy in connection with certain problem loans to increase its 2001 fourth-quarter earnings by \$418 million (i.e., earnings through a permanent reduction in its income tax liability). *See* Bank of America News Release dated January 22, 2002 (“During the year, the company realigned operations that manage distressed assets to make them more effective. The establishment of this new unit and the disposal of distressed assets generated a \$418 million tax benefit which resulted in a 17 percent [effective] tax rate for the company.”). *See also*, Carry Mollenkamp, *Rare Use of Tax Law Helps Lift Bank of America to Hefty Profit*, Wall St. Journal, p. A-2 (Jan. 24, 2002); Lee Sheppard, *Bank of America’s Tax Plan for Bad Loans*, Tax Notes Today, 2002 TNT 38-5 (Feb. 26, 2002). *See also*, the following discussions of Projects Steele and Cochise in this Report.

<sup>298</sup> *See, e.g.*, Boris Bittker & James Eustice, *Federal Income Taxation of Corporations and Shareholders*, par. 3.01 at 3-8 (7<sup>th</sup> ed. 2002) (“In short, the cost of deferral under sec. 351 is that gain or loss accruing during the individual transferor’s ownership is escalated from the one-tier tax treatment of individual to the two-tier corporate regime. This is one of the features

not justify permitting a transaction whose primary purpose is to duplicate losses, particularly in light of the degree of tax planning flexibility that taxpayers enjoy with respect to tax-free transfers.

A single economic loss should not be deducted more than once. If the loss duplication issue is to be addressed, a question arises as to which party should be entitled to the deduction. One theory is that the transferor bore the economic consequences of the loss and therefore should be entitled to the deduction. If this theory is followed, 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.<sup>299</sup> An alternative view is that the loss is a tax attribute that is inherent in the property, and therefore it should remain with the property. The depreciation recapture rules reflect this concept -- if depreciable property is transferred to a corporation in a tax-free transaction, the recharacterized gain element remains with the asset (as opposed to tainting the stock received in the exchange).<sup>300</sup> If this theory is followed, the Joint Committee staff recommends expanding the sec. 358(h) basis reduction rule.

In addition to the above specific recommendations, Projects Tanya and Valor highlight the need for stronger measures 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. A number of recommendations and proposals have been made in recent years to curtail the use of tax-motivated transactions (including by the Joint Committee staff).<sup>301</sup>

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making life in the subchapter C lobster pot confining, complicated, and costly, even though entry, thanks to sec. 351, is usually simple and painless.”) (citations omitted).

<sup>299</sup> For example, section 301 of H.R. 2520, the “Abusive Tax Shelter Shutdown Act of 2001,” would reduce a transferee corporation's basis under section 362 with respect to loss property the corporation receives from a foreign transferor in a tax-free transaction. Such a proposal would raise several related issues, most notably whether the basis limitation rule should apply to aggregate asset transfers or to individual assets.

<sup>300</sup> Sec. 1245(b)(3).

<sup>301</sup> 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* (JCS-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

The Joint Committee staff recommendations regarding Project Cochise<sup>302</sup> include recommendations to expand section 269. These recommendations also are appropriate for consideration with respect to Projects Tanya and Valor.

### 3. Project Steele

#### Brief overview

Project Steele was structured to generate approximately \$130 million of pre-tax financial statement operating income<sup>303</sup> while, conversely, generating significant Federal income tax deductions for Enron. Project Steele involved a tax-free transfer of (1) cash and leased assets by Enron, and (2) cash and assets<sup>304</sup> with tax basis significantly in excess of their fair market value by Bankers Trust Company, a New York banking corporation (“Bankers Trust”),<sup>305</sup> to a newly formed corporation in return for common and preferred stock. Because Enron received more than 80 percent of the vote and value of the corporation, the corporation’s income and loss was included in Enron’s consolidated tax return. Therefore, the ensuing tax losses from the built-in loss assets contributed by Bankers Trust are generally available to offset taxable income of Enron.

Additionally, because Bankers Trust’s tax basis in the stock received is determined by reference to the built-in loss assets contributed, Bankers Trust’s tax basis in the stock significantly exceeds its fair market value. Thus, the transaction effectively duplicates the built-in loss in the contributed assets (i.e., Bankers Trust and Enron both seek to shelter taxable income as a result of the built-in-loss on the contributed assets). In order to provide substance to the transaction, Bankers Trust anticipated holding the stock received until at least 2002. In order to compensate Bankers Trust for delaying the realization of its tax loss for a number of years, Bankers Trust requested Enron pay Bankers Trust the present value cost of delaying such losses.

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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).

<sup>302</sup> Project Cochise is discussed in this corporate section of the Report (following Project Steele).

<sup>303</sup> This amount was obtained from an Enron presentation material titled “Show Me the Money! Project Steele Earnings Benefits.” The after-tax amount was anticipated to be approximately \$83.5 million. The Project Steele materials in Appendix B contain the document. EC2 000038546.

<sup>304</sup> The assets contributed by Bankers Trust entities were Real Estate Mortgage Investment Conduit residual interests (hereinafter “REMIC residual interests”).

<sup>305</sup> The assets were contributed by Bankers Trust (Delaware) and Bankers Trust. On or about June 4, 1999, all of the outstanding stock of Bankers Trust Corp., a New York corporation and the holding company parent of Bankers Trust, was acquired by Deutsche Bank.

This was described in correspondence between Bankers Trust and Enron that quantified the present value cost to Bankers Trust of entering into Project Steele.<sup>306</sup>

## **Background**<sup>307</sup>

### Reported tax and financial statement effects

Project Steele generated approximately \$112 million of net Federal income tax deductions from 1997 through 2001.<sup>308</sup> In addition, Project Steele generated approximately \$65 million in net earnings for financial reporting purposes from 1997 through 2001.<sup>309</sup>

### Development of Project Steele

Bankers Trust promoted the concept of Project Steele to Enron in April of 1997.<sup>310</sup> The transaction was presented to Enron as a mechanism to generate financial statement income while providing significant Federal income tax deductions. A memorandum prepared by Bankers Trust provided an analysis of the financial accounting and Federal income tax treatment of three alternative structures that could be used to undertake the proposed transaction.<sup>311</sup> The memorandum states that in Bankers Trust's professional opinion that it would not receive much, if any, fee solely for the tax benefits (alternative structure one), but if the transaction were

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<sup>306</sup> Letter from Thomas Finley of Bankers Trust to Mr. Maxey dated August 11, 1997. The Project Steele materials in Appendix B contain the letter. EC00003795-96.

<sup>307</sup> The information regarding Project Steele was obtained from Joint Committee staff interviews of Robert J. Hermann and R. Davis Maxey, as well as from documents and information provided by Enron Corp. and the Internal Revenue Service.

<sup>308</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 31, 2003, answer 4.

<sup>309</sup> Enron stated that no opinion or memoranda was obtained from Arthur Andersen regarding the financial accounting treatment of Project Steele. However, Enron provided documentation from Bankers Trust regarding the accounting treatment of Project Steele. The Project Steele materials in Appendix B contain the letter. EC2 000037573 - EC2 000037592. The financial statement net earnings source documentation is a letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13 and January 31, 2003, answers 32 and 4, respectively.

<sup>310</sup> Project Steele Overview contained in a document titled Enron Structured Transactions Group Summaries of Project Earnings and Cash Flows dated November 2001. See also letter from Mr. Finley of Bankers Trust to Mr. Maxey dated June 17, 1997. The Project Steele materials in Appendix B contain the letter. EC2 00037571 - EC2 000037572.

<sup>311</sup> Letter and attachment from William B. Boyle of Bankers Trust to William McKee of King & Spalding, dated June 2, 1997. The Project Steele materials in Appendix B contain the letter and attachment. EC2 000037574- EC2 000037592.

redesigned to provide for financial accounting benefits, as well, then corporate clients would be extremely interested and would pay a substantial fee (alternative structures two and three).<sup>312</sup>

On June 17, 1997, Bankers Trust provided an engagement letter to Enron indicating that Bankers Trust agreed to provide Enron with all information regarding the proposed transaction, including all analyses and documents prepared by Bankers Trust or any of its advisors, and, in consideration thereof, Enron agreed to employ Bankers Trust as its exclusive financial advisor in connection with the consummation of one of the alternative structures.<sup>313</sup>

During the summer and early fall of 1997, the alternatives were evaluated and various details of the transaction were agreed to by Enron and Bankers Trust. On October 28, 1997, Enron and Bankers Trust entered into an agreement: (1) providing that Enron would enter into the proposed transaction with Bankers Trust; (2) providing that Enron would engage Bankers Trust to act as its financial advisor in connection with such transaction; and (3) detailing the compensation to be paid by Enron to Bankers Trust and to Akin, Gump, Stauss, Hauer & Feld, LLP (hereinafter “Akin, Gump”) by Enron.<sup>314</sup> The transaction was subsequently completed on October 31, 1997.

It is unclear from the documents which corporate officers, other than Mr. Causey, approved the transaction prior to its completion. However, on March 4, 1998, Kenneth L. Lay, Chairman and Chief Executive Officer of Enron Corp. thanked Mr. Hermann and Mr. Maxey for their good job on the transaction.<sup>315</sup> In addition, Enron’s Board of Directors was made aware of the completion of Project Steele at the December 9, 1997 meeting.<sup>316</sup>

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<sup>312</sup> *Id.* at EC2 0000375092. The letter also states that “other less expensive alternatives exist to generate equivalent tax benefits.” EC2 000037592 and EC2 000037573.

<sup>313</sup> Letter from Mr. Finley of Bankers Trust to Mr. Maxey, dated June 17, 1997. Although the letter limits disclosure of the information, it does not explicitly require confidentiality; however, it states “[i]f any law enacted after the date of this letter shall require that the Transaction be registered as a ‘tax shelter’... then this letter shall be null and void...including without limitation any payment obligations or any requirements of confidentiality or exclusivity.” The Project Steele materials in Appendix B contain the letter. EC2 00037571 - EC2 000037572.

<sup>314</sup> Letter from Mr. Finley of Bankers Trust to Richard A. Causey, dated October 28, 1997. Although Akin, Gump was not a party to the agreement, the agreement specifically references fees to be paid to Akin, Gump, an unrelated and otherwise unnamed third party. Enron stated it was not aware why Akin, Gump was included in the agreement.

<sup>315</sup> Mr. Lay relayed his comments to Mr. Hermann and Mr. Maxey by forwarding a letter from Frank N. Newman, Chairman of the Board and Chief Executive Officer of Bankers Trust, in which Mr. Newman congratulates Mr. Lay on the successful completion of Project Steele. Mr. Newman wrote that Bankers Trust “is extremely pleased to have worked with your company as both financial advisor and principal on this transaction to collaboratively meet Enron’s financial objectives. Moreover, we view this transaction as a solid platform for

Enron's purported principal business purpose for the transaction was to generate financial accounting income. Other business purposes stated were (1) that the transaction is expected to reduce Federal income taxes owed by Enron, (2) that the transaction is expected to generate investment profits, and (3) that the transaction provides access to Bankers Trust investment expertise.<sup>317</sup>

### Implementation of Project Steele

On October 27, 1997, Enron Corp., indirectly through three wholly owned subsidiaries ("the Enron Subsidiaries"), formed ECT Investing Partners, LP ("ECT Partners").<sup>318</sup> Although legally a limited partnership, ECT Partners elected under the "check the box" regulations to be treated as a corporation for Federal income tax purposes.<sup>319</sup>

On October 29, 1997, ECT Partners borrowed on a short-term basis \$51.2 million from Enron North America, Inc.<sup>320</sup> The next day, ECT Partners used the entire proceeds to purchase corporate bonds from Bankers Trust.<sup>321</sup> The purchased bonds were high-grade corporate bonds

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continuing to explore innovative solutions that are tailored to your needs." It is unclear if Mr. Newman's reference to "financial objectives" was to the stated business purpose of generating financial accounting income. The Project Steele materials in Appendix B contain the letter. EC2 000037643. In addition, subsequent to the completion of Project Steele, Bankers Trust invited Mr. Maxey to the Potomac Capital Investment Corporation Conference on February 8, 1998 through February 11, 1998. The Project Steele materials in Appendix B contain the letter. EC2 000037639-EC2 000037642.

<sup>316</sup> Enron 1998 - 2000 Operating & Strategic Plan for Enron mentioned that Project Steele, a tax strategy, will contribute pre-tax earnings of about \$20 million per year in 1998-2000. EC 000046108 and EC 000046154.

<sup>317</sup> Federal tax opinion letter from Akin, Gump to Mr. Maxey dated December 16, 1997 at EC2 000033872. Appendix C, Part III to this Report contains the tax opinion letter.

<sup>318</sup> The Enron Subsidiaries received general and limited partnership interests in return for their contributions. The contributing subsidiaries were ECT Investing Corp., ECT Investments Holding Corp., and Enron Pipeline Company.

<sup>319</sup> Treas. Reg. sec. 301.7701-3.

<sup>320</sup> At the time of the loan, Enron North America, Inc. was known as Enron Capital & Trade Resources Corp. Enron North America, Inc. (a wholly owned subsidiary of Enron) is a parent corporation of two of the ECT Partners.

<sup>321</sup> The bonds were subsequently transferred to ECT Diversified Investments, LLC, a wholly owned subsidiary of ECT Partners. ECT Diversified Investments, LLC elected to be treated as a disregarded entity for Federal income tax purposes.



of various energy companies.<sup>322</sup> On October 30, 1997, and October 31, 1997, the three Enron owners contributed approximately \$48 million of cash, \$93.5 million of preferred stock of Enron Liquids Holding Corporation,<sup>323</sup> and a beneficial interest in certain leased aircraft with a fair market value of \$42.6 million and a tax basis of zero to ECT Partners. The leased aircraft interest was contributed subject to \$42.6 million of debt. In exchange for such property, Enron received approximately 95 percent ownership in ECT Partners. Also on October 31, 1997, ECT Partners repaid \$50.5 million to Enron North America, Inc. in satisfaction of all but \$700,000 of ECT Partner's borrowing from Enron North America, Inc.

On October 31, 1997, Bankers Trust, through two entities, contributed to ECT Partners \$4.4 million of cash and REMIC residual interests with an approximate fair market value of \$7.6 million and a tax basis of \$233.8 million. In return, the Bankers Trust entities received approximately a five percent preferred ownership interest in ECT Partners and \$4.5 million of ECT Partners debt securities. Bankers Trust also purchased from Enron Corp. two puts for \$1,000 (\$500 per option). The puts permits Bankers Trust to put its interest in ECT Partners to Enron at specified times (2 years and 6 ½ years after a recapitalization of ECT Partners).<sup>324</sup>

As a result of these steps, the Enron Subsidiaries received common and preferred shares in ECT Partners representing approximately 95 percent of the total vote and value of ECT Partners's shares. Bankers Trust's received preferred shares representing approximately 5 percent of the total vote and value of ECT Partners and \$4.5 million of ECT Partners debt securities. After the contribution of property, ECT Partners owned REMIC residual interests with a fair market value of approximately \$7.5 million and a tax basis of \$234 million. The partnership also owned \$51.2 million of corporate bonds, \$2 million cash, and \$42.6 million in leased assets (with a zero tax basis) subject to debt in an equal amount, and 100 percent of the

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<sup>322</sup> The companies included Mobil Oil, Texaco Capital, Pacificorp, Alabama Power, Florida Power and Light, Imperial Oil, and Northern States Power. Ecx000003222.

<sup>323</sup> ECT Partners subsequently contributed the Enron Liquids Holding Corporation preferred stock to Enron Equity Corporation in return for a preferred interest in such entity. Enron North America contributed a \$110 million intercompany note receivable from Enron Reserve Acquisition Corporation for the common interest in Enron Equity Corporation. Enron Equity Corporation immediately sold the Enron Liquids Holding Corporation preferred stock to Enron Corp. in exchange for a \$93.5 million intercompany note receivable from Houston Pipeline Company, another wholly owned subsidiary of Enron Corp. Enron stated that it is not aware of any non-tax business reasons for the issuance of the \$110 million intercompany note receivable from Enron Reserve Acquisition Corporation or the \$93.5 million of Enron Liquids Holding Corporation preferred stock.

<sup>324</sup> At any time after five years, any equity owner of ECT Partners could cause a recapitalization of ECT Partners pursuant to which preferred shares and debt securities held by Bankers Trust would be exchanged for new debt securities of ECT Partners with a current cash pay London Interbank Offering Rate based rate of return.

preferred stock of ECT Equity Corp. which owned \$203.5 million of intercompany notes of Enron affiliates.<sup>325</sup>

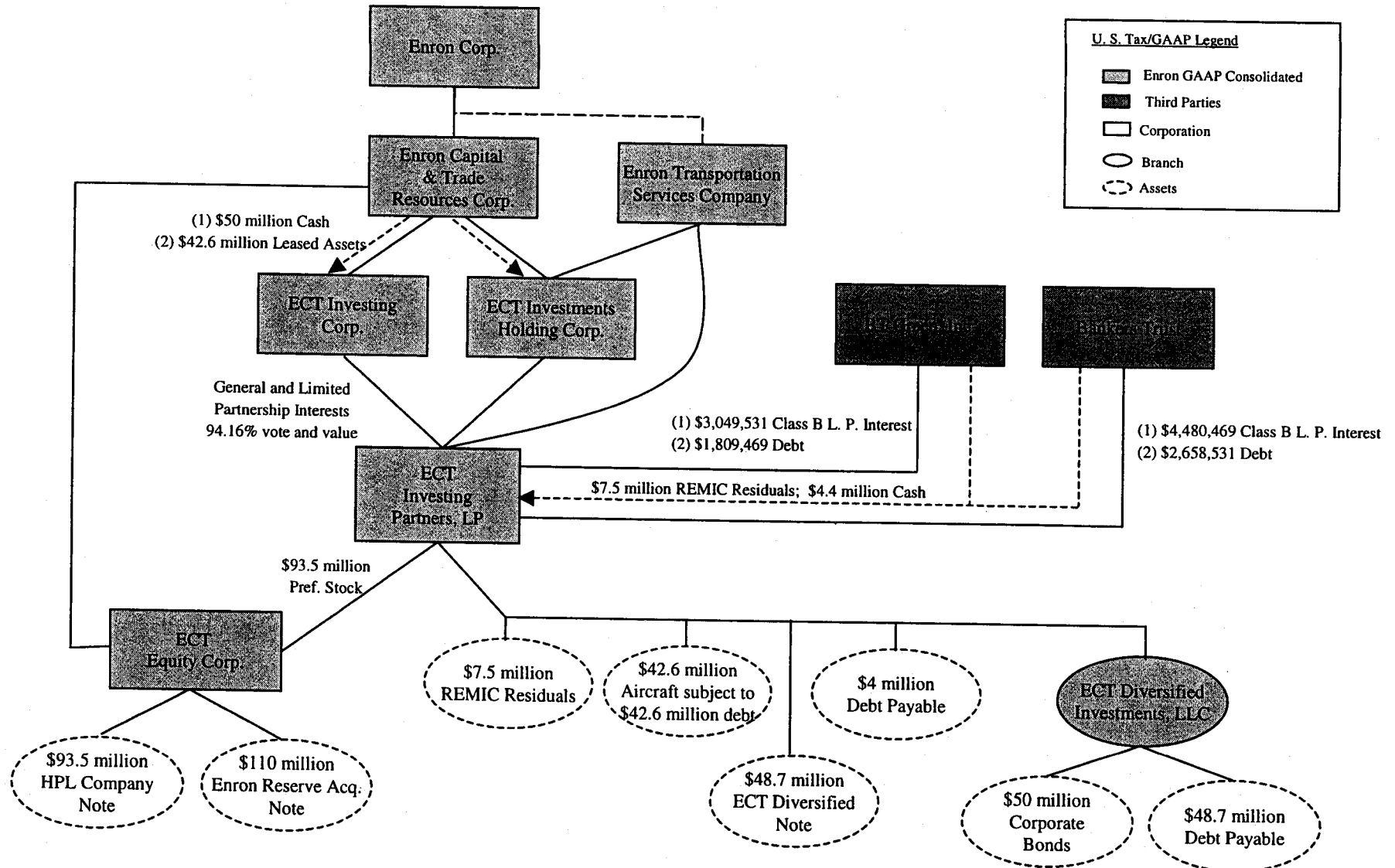
The diagram on the next page depicts the Project Steele structure.

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<sup>325</sup> ECT Equity Corp. held a \$93.5 million note receivable from Houston Pipeline Company and a \$110 million note receivable from Enron Acquisition Corporation. Enron North America, Inc. owned 100 percent of the common shares of ECT Equity Corp.

# Project Steele Structure as of October 31, 1997

Confidential



### Role of outside advisors

As noted above, Bankers Trust promoted and was the exclusive financial advisor on the transaction to Enron; in addition, Bankers Trust was the only legally unrelated counterparty to the transaction. Enron's outside counsel for Project Steele was Akin, Gump. In connection with Project Steele, Akin, Gump provided two tax opinion letters. The first opinion analyzed the tax implications of the transaction and concluded that (1) the contribution of property and assets by the Enron Subsidiaries and Bankers Trust should constitute nontaxable transfers of property under section 351; (2) the tax basis of the contributed property to the corporation should equal the tax basis of such assets in the hands of the contributor; (3) the losses attributable to the REMIC residual interests should not be disallowed, whether by the business purpose doctrine, section 269, the step transaction doctrine, or Treas. Reg. sec. 1.1502-13(h); (4) losses attributable to the REMIC residual interests recognized during the five-year period after the closing of the transaction more likely than not will be subject to limitation under the SRLY rules of the consolidated return regulations; and (5) ECT Partners should be eligible to join the consolidated group of Enron.<sup>326</sup> The second tax opinion analyzed the potential accuracy-related penalties (under section 6662) and tax shelter disclosure requirements (under section 6111). The opinion concluded that (1) the accuracy-related penalty should not apply in the event the deductions attributable to the REMIC residual interests are disallowed, and (2) no person principally responsible for, or participating in, the organization and management of ECT Partners should be required to register ECT Partners as a tax-shelter.<sup>327</sup> In addition, Arthur Andersen was engaged to do a tax basis study on the REMIC residual interests contributed by Bankers Trust.

Bankers Trust was paid \$8.65 million for its services.<sup>328</sup> Akin, Gump was paid \$1 million for the tax opinion letters and Arthur Andersen was paid \$49,600 for its services.<sup>329</sup>

### **Discussion**

Project Steele was designed to provide Enron with the tax benefits associated with built-in losses in the REMIC residual assets at a cost significantly less than the amount of the tax benefit. A determination of whether Enron should be entitled to deduct the built-in losses in the REMIC residual assets necessarily involves an analysis regarding Enron's satisfaction of the

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<sup>326</sup> Federal tax opinion letter from Akin, Gump to Mr. Maxey dated December 16, 1997. Appendix C, Part III to this Report contains the tax opinion letter Enron received in connection with Project Steele. EC 000033867-EC 000033903.

<sup>327</sup> Akin, Gump tax opinion letter to Mr. Maxey dated December 16, 1997. EC 000033905-EC 000033916. Appendix C, Part III to this Report contains the tax opinion letter Enron received in connection with Project Steele.

<sup>328</sup> The contractual fee was \$10 million. Enron is still obligated on the final three installments of \$450,000.

<sup>329</sup> The General Background Materials in Appendix B contain the Estimated Project Fees schedule (6/4/01). The fees were determined from a table summarizing fees paid on structured transactions. EC2 000036379.

literal requirements of the applicable statutory requirements as well as the rules and judicial doctrines (such as business purpose and economic substance) that are often applied to evaluate the purported tax benefits in tax-avoidance transactions.<sup>330</sup>

The Code and Treasury regulations recognize the potential for abusive activity and contain provisions intended to limit the benefits of arrangements that, although satisfying the literal requirements of a provision, are used to distort, pervert, and defeat the basic purpose of the underlying statute.<sup>331</sup> These provisions address such policy concerns by limiting the benefit of the underlying statute through the use of general disallowance if (1) specific factual tests are met or (2) if the principal purpose of the transaction is to evade or avoid income tax.

#### Acquisitions made to evade or avoid income tax

If a taxpayer acquires control (defined as at least 50 percent of vote or value) of a corporation, and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax, the deductions or other tax benefits may be disallowed.<sup>332</sup> In Project Steele, the formation of ECT Partners by the Enron Subsidiaries and Bankers Trust was the acquisition of control. Thus, in order to avoid the disallowance of the tax benefits from Project Steele, Enron had to have a principal purpose other than the avoidance or evasion of Federal income tax.

In determining Enron's motives for engaging in Project Steele, Akin, Gump relied heavily upon Enron's representation that its principal purpose for entering into the transaction

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<sup>330</sup> For detailed information of the present law rules and judicial doctrines applicable to tax avoidance 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).

<sup>331</sup> *See, e.g.*, sec. 269 (acquisitions made to evade or avoid income tax), sec. 362(d) (limitation on basis increase attributable to assumption of liability), sec. 358(h) (reduction to basis of assets in connection with transfers of liabilities that give rise to a deduction), Treas. Reg. sec. 1.701-2 (partnerships formed or availed of in connection with a transaction with a principal purpose of reducing tax), and sec. 732(f) (adjustment to basis of assets of a distributed corporation controlled by a corporate partner). *See also* proposed regulations to prevent a consolidated group from obtaining more than one tax benefit from a single economic loss (IRS Proposed Rules and Public Hearing Notice (Reg-131478-02) On Suspension of Losses on Certain Stock Dispositions Federal Register October 23, 2002).

<sup>332</sup> Sec. 269(a)(1).

was to generate financial accounting benefits and that it would not have entered into the transaction in the absence of the accounting benefits. In addition, Akin, Gump relied on Enron's representation that it would have entered into the transaction even if no net cash benefit was anticipated to arise as a result of an excess of net present value tax savings over the transaction costs. Based on these representations, Akin, Gump concluded that section 269 would not disallow the benefits obtained from Project Steele.<sup>333</sup>

Akin, Gump's conclusion is disturbing in two respects. First, concluding that a non-tax business purpose exists based on the accounting benefits of Project Steele fails to consider the origin of the accounting benefit (i.e., solely reduction of taxes). Such an analysis significantly diminishes the purpose for having a substantial non-tax business purpose.<sup>334</sup> Second, Akin, Gump's reliance on Enron's representation that Enron would have engaged in the transaction even if there were no present value tax benefits after transaction costs fails to recognize that Project Steele under all circumstances, absent an extraordinary fee to the promoter, would have significant present value tax benefits. Reliance on answers given to unimaginable hypothetical transactions, especially when evaluating a taxpayer's non-tax business purposes, may call into question the reasonableness and objectivity of the advice given, especially for purposes of the accuracy related penalty.<sup>335</sup>

### Section 351

The Code and Treasury regulations also contain specific provisions intended to limit a taxpayer's ability to transfer tax attributes, such as net operating losses, built-in-losses, and

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<sup>333</sup> Appendix C, Part III to this Report contains the Akin, Gump tax opinion.

<sup>334</sup> See, e.g., *American Electric Power, Inc. v. U.S.*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'" citing *Winn-Dixie v. Commissioner*, 113 T.C. 254, 287 (1999)).

<sup>335</sup> An accuracy-related penalty is not imposed with respect to any portion of any underpayment if the taxpayer can show that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion. Sec. 6664(c)(1). Reliance on a tax opinion constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. This standard is not satisfied if the advice or opinion is based on unreasonable factual or legal assumptions. "For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner." Treas. Reg. sec. 1.6664-4(c)(1)(ii).

various credit items.<sup>336</sup> The general purpose of these provisions is to limit the ability of such tax benefits by a taxpayer who did not suffer the economic loss that gave rise to the tax benefit.

Project Steele purported to use the tax-free incorporation rules and resulting carryover basis rules to transfer losses and duplicate a single economic loss. The ability to transfer losses and duplicate a single economic loss through section 351 has been, and continues to be, a concern in the administration of tax policy.<sup>337</sup> In order for Project Steele to achieve the desired tax results (and the corresponding financial accounting benefits), the transfer of the REMIC residual interests by Bankers Trust had to occur in a tax-free incorporation such that the REMIC residual interests tax basis would carry over to ECT Partners.

It may be argued that the application of section 351(a) is predicated upon a valid non-tax business purpose and that the transfer by Bankers Trust did not have the requisite business purpose.<sup>338</sup> Documents exchanged between Bankers Trust and Enron clearly reflect that one of the considerations in the transaction was the fee paid to Bankers Trust for the delay the structure imposed on Bankers Trust's ability to deduct the losses. Bankers Trust provided schedules to Enron detailing the net present value cost of delaying their tax benefits until the recapitalization was permitted.<sup>339</sup> The documentation reviewed by the Joint Committee staff demonstrated no

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<sup>336</sup> See, e.g., sec. 382 (limitation on net operating loss carryforwards and certain built-in-losses following ownership changes, sec. 383 (special limitations on certain excess credits, etc.), and Treas. Reg. sec. 1.1502-15 (SRLY limitation on built-in-losses).

<sup>337</sup> For example, in the year 2000, Congress enacted rules requiring a reduction in basis of assets in connection with transfers of certain liabilities in order to stop transactions that duplicated a single economic loss. See, the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, sec. 1(a)(7) (Dec. 21, 2000). See Staff of the Joint Committee on Taxation, *General Explanation of Tax Enacted in the 106<sup>th</sup> Congress* (JCS-2-01), April 19, 2001, at 154. In addition, President Clinton's Fiscal Year 2001 Budget Proposals contained a proposal that was aimed at limiting the ability of taxpayers to transfer built-in losses into the U.S. tax system by requiring marking to fair market value such assets when such assets become "relevant" for U.S. tax purposes (See Office of Management and Budget, *Budget of the United States Government, Fiscal 2001: Analytical Perspectives* (H.Doc. 106-162, Vol. III). See also Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal* (JCS-2-00), March 6, 2000.) Most recently, the Treasury Department issued proposed regulations to prevent a consolidated group from obtaining more than one tax benefit from a single economic loss (IRS Proposed Rules and Public Hearing Notice (Reg-131478-02) On Suspension of Losses on Certain Stock Dispositions Federal Register October 23, 2002).

<sup>338</sup> An analysis of the non-tax business purpose is also relevant for the application of the judicial doctrines referred to above.

<sup>339</sup> Letter from Mr. Finley of Bankers Trust to Mr. Maxey dated August 11, 1997. The Project Steele materials in Appendix B contain the letter. EC2 000037595 - EC2 000037596. King & Spalding was counsel to Bankers Trust on Project Steele.

purpose for the transaction other than to facilitate the transfer of Federal income tax benefits, and the resulting financial accounting benefits to Enron.

Bankers Trust's reason for engaging in the transaction can be gleaned from a letter to King & Spalding.<sup>340</sup> Bankers Trust provided a detailed analysis of how the "base case" duplication of losses from the REMIC residual interests could be enhanced by inserting a recapitalization feature and having a corporation (in this case Enron) transfer additional unrelated assets into the structure.<sup>341</sup> By inserting these features, Bankers Trust concluded that significant financial accounting benefits inure to a participant, including reflecting the tax benefits in operating income rather than as reduction to tax expense.<sup>342</sup> Most importantly to Bankers Trust, though, was its conclusion that by inserting the recapitalization feature into the structure, it could earn a modest fee, but with both features inserted, it could obtain a substantial fee from its corporate clients.

### **Recommendations**

The Joint Committee staff recommendations regarding Projects Tanya and Valor<sup>343</sup> include recommendations to limit the duplication of a single economic loss. These recommendations also are appropriate for consideration with respect to Project Steele.

Irrespective of whether an overall change is made to limit the duplication of a single economic loss under subchapter C generally, the Joint Committee staff believes it is appropriate to limit the ability to transfer REMIC residual interests in a carryover basis transaction. Under the statutory rules regarding the taxation of REMICS, 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.<sup>344</sup>

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<sup>340</sup> See letter and attachment from William B. Boyle of Bankers Trust to William McKee of King & Spalding dated June 2, 1997. The Project Steele materials in Appendix B contain the letter. EC2 000037574 - EC2 000037592.

<sup>341</sup> Both of these features were included in Project Steele.

<sup>342</sup> A short explanation of why operating earnings are considered more beneficial than a reduction in income tax expense is contained in Background and Rationale of this Part of the Report.

<sup>343</sup> Projects Tanya and Valor are discussed in this section of the Report immediately preceding Project Steele.

<sup>344</sup> See recommendations for Projects Tanya and Valor for a discussion of general issues with respect to this type of proposal.



## 4. Project Cochise

### Brief overview

Project Cochise was a variation on Project Steele and, like Project Steele, was designed to produce operating income on Enron's financial statements, while also providing Enron with significant Federal income tax deductions. Thus, the prearranged transaction was intended to yield Enron a combination of both income for financial statement purposes and deductions for Federal income tax purposes.

In general, Project Cochise involved tax-free transfers by Enron of assets with a steady income stream (i.e., REMIC regular interests)--along with tax-free transfers by the London branch of Bankers Trust of assets with a tax basis significantly in excess of fair market value (i.e., residual interests in the same portfolio of REMICs)--to an existing wholly-owned subsidiary of Enron. The subsidiary subsequently elected to be treated as a real estate investment trust ("REIT") for Federal income tax purposes. Based upon the differences between the financial accounting and Federal income tax treatment of the REMIC residual interests that were transferred to the subsidiary by Bankers Trust, Project Cochise produced for Enron a substantial amount of financial accounting income through the immediate creation of a deferred but undiscounted tax asset.<sup>345</sup>

Because the subsidiary would no longer be part of Enron's consolidated group (as a result of its REIT status election) and Bankers Trust would own all of the common stock of the subsidiary following the transfers, all of the remaining so-called "phantom" (i.e., non-cash) income from the REMIC residual interests would be distributed to Bankers Trust through the declaration of consent dividends on the common stock in the subsidiary held by Bankers Trust. Furthermore, it was anticipated that Enron would recognize in later years the tax deductions resulting from the reversal of the earlier REMIC non-cash "phantom" income, after the subsidiary was recapitalized and rejoined the Enron consolidated group in 2004. Based upon the special deconsolidated treatment of the subsidiary as a REIT and the anticipated future reconsolidation of the subsidiary with the Enron consolidated group, Project Cochise was intended to redirect the REMIC non-cash "phantom" income and the subsequent offsetting deductions so that Enron could claim the deductions on its Federal income tax return after 2003 without having recognized the associated income in earlier tax years.

As with Project Steele, Project Cochise also produced a duplication of the loss that was built into the REMIC residual interests transferred by Bankers Trust to the subsidiary. Specifically, the tax basis of the subsidiary stock received by Bankers Trust in exchange for the REMIC residual interests significantly exceeded its fair market value because the tax basis in the stock was determined by reference to the built-in loss assets (i.e., the REMIC residual interests) contributed by Bankers Trust to the subsidiary. Consequently, Project Cochise enabled both Enron and Bankers Trust to shelter other taxable income with the losses that were built into the

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<sup>345</sup> The financial accounting benefits of Project Cochise also were facilitated by the acquisition by Enron from Bankers Trust of two leased aircraft and the associated leases.

REMIC residual interests, either directly with future deductions generated by the REMIC residual interests (in the case of Enron) or indirectly through the disposition of stock in the subsidiary that mirrored the built-in loss in the interests (in the case of Bankers Trust).

## **Background**<sup>346</sup>

### Reported tax and financial statement effects

Although Project Cochise did not (and was not intended to) generate any material net tax deductions during the period 1999 through 2001 (out of a projected total of approximately \$388 million beginning after 2004), it did generate approximately \$100 million (out of a projected total of approximately \$140 million) in reported net earnings for financial reporting purposes through the third quarter of 2001.<sup>347</sup>

### Development of Project Cochise

The development of Project Cochise began as early as July of 1998 and, on December 18, 1998, the executive committee of Enron's Board of Directors approved for recommendation to the full Board a resolution authorizing Enron to undertake the transactions involved in Project Cochise.

On January 28, 1999, Bankers Trust provided an engagement letter to Enron indicating that Bankers Trust agreed to act as the exclusive financial advisor to Enron in connection with assisting in the implementation of Project Cochise. The engagement letter provided that Enron would pay Bankers Trust \$15 million in consideration of the services provided by Bankers Trust pursuant to the engagement letter, with an initial payment of \$5,250,000 on September 1, 1999 and quarterly installments of \$750,000 beginning on December 1, 1999 and ending on December 1, 2002.<sup>348</sup>

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<sup>346</sup> The information regarding Project Cochise was obtained from Joint Committee staff interviews of Robert J. Hermann, Robert Davis Maxey, David Williams, and Alicia Goodrow, as well as from documents and information provided by Enron Corp. and the IRS.

<sup>347</sup> The General Background materials in Appendix B contain the Structured Transactions Group Summary of Project Earnings & Cash Flows (Nov. 2001). In response to questions from the Joint Committee staff, Enron has indicated that it recorded financial statement benefits from Project Cochise as follows: (1) \$27.7 million in 1999; (2) \$50.3 million in 2000; and (3) \$23.2 million in 2001. However, Enron also has indicated that it recorded a financial statement valuation reserve in December 2001 with regard to Project Cochise in the amount of \$73.5 million. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003.

<sup>348</sup> Bankers Trust letter from Brian J. McGuire to Richard A. Causey, dated January 28, 1999. EC2 000037417 through EC2 000037421. The Project Cochise materials in Appendix B contain this letter. Although the contractual fee was \$15 million, it appears that Enron has not paid the final five installments of \$750,000. Thus, the fees paid to date by Enron to Bankers

On January 28, 1999, the primary initial transactions involved in Project Cochise (e.g., transfers of assets to Enron subsidiary) were executed, as described below.

On January 28, 1999, Potter Anderson & Corroon LLP provided an opinion to Enron relating to the application of Delaware law to the transactions involved in Project Cochise.

On February 8, 1999, the Enron Board of Directors approved the board resolution relating to Project Cochise.<sup>349</sup>

On May 26, 1999, Arthur Andersen provided a SAS 50 opinion to Bankers Trust relating to the appropriate financial accounting treatment of the transactions involved in Project Cochise.<sup>350</sup>

On March 21, 2001, McKee Nelson, Ernst & Young LLP provided an opinion to Enron relating to the Federal income tax consequences of the transactions involved in Project Cochise.<sup>351</sup>

On May 14, 2001, King & Spalding provided an opinion to Enron relating to the REIT qualification of the Enron subsidiary involved in Project Cochise for Federal income tax purposes.<sup>352</sup>

The principal tax personnel involved in executing the transaction for Enron were Mr. Hermann and Mr. Maxey.

Enron's purported principal business purposes for the transaction were to: (1) invest in REMIC regular and residual interests; (2) invest in leased aircraft; and (3) increase the pre-tax financial accounting income and net earnings of Enron.<sup>353</sup>

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Trust with regard to Project Cochise equal \$11,250,000. The General Background materials in Appendix B contain the Estimated Project Fees schedule (June 4, 2001).

<sup>349</sup> The Project Cochise materials in Appendix B contain the minutes of the February 8, 1999 meeting of the Enron Board of Directors at which the Board discussed and approved Project Cochise and the associated resolution.

<sup>350</sup> Arthur Andersen letter to Bankers Trust Company, dated May 26, 1999. EC2 000037349 through EC2 000037367. The Project Cochise materials in Appendix B contain this letter.

<sup>351</sup> McKee Nelson, Ernst & Young LLP letter from William S. McKee and James D. Bridgeman to R. Davis Maxey, dated March 21, 2001. EC2 000033988 through EC2 000034072. Appendix C, Part IV of this Report contains the tax opinion letter Enron received from McKee Nelson, Ernst & Young LLP in connection with Project Cochise.

<sup>352</sup> King & Spalding letter to Enron, dated May 14, 2001. EC2 000033980 through EC2 000033983. Appendix C, Part IV of this Report contains the tax opinion letter Enron received from King & Spalding in connection with Project Cochise.

### Implementation of Project Cochise

Prior to the execution of Project Cochise, Enron owned all of the outstanding stock (1,000 shares of common stock) of Maliseet Properties, Inc. (“Maliseet”), a Delaware corporation that was formed on April 16, 1985.<sup>354</sup>

On January 28, 1999, the following events occurred contemporaneously and as part of a prearranged plan in the implementation of Project Cochise.<sup>355</sup>

- (1) BT Green, Inc., a New York corporation and member of the Bankers Trust consolidated group (“BT Green”), sold undivided interests in REMIC regular interests to Bankers Trust for approximately \$2.7 million;
- (2) BT Green sold to Enron its remaining undivided interests in the REMIC regular interests for \$24.8 million;
- (3) Enron contributed the REMIC regular interests that it purchased from BT Green to Maliseet in exchange for 39,000 shares of Maliseet Series A preferred stock and 572 shares of Maliseet Series B preferred stock;<sup>356</sup>
- (4) Enron sold all of its Maliseet common stock to Bankers Trust for \$100;

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<sup>353</sup> “Representations and Assumptions” described in the McKee Nelson, Ernst & Young LLP Federal income tax opinion letter from William S. McKee and James D. Bridgeman to R. Davis Maxey, dated March 21, 2001, at 12-13. EC2 000033999.

<sup>354</sup> Maliseet was the result of the recapitalization and renaming of Enron Interstate Pipeline Company by Enron in January 1999. “Structured Transactions Group: Business Review”, dated October 2001. EC2 000038350. The Project Cochise materials in Appendix B contain this document.

<sup>355</sup> “Statement of Facts” described in the McKee Nelson, Ernst & Young LLP Federal income tax opinion letter from William S. McKee and James D. Bridgeman to R. Davis Maxey, dated March 21, 2001, at 4-12. EC2 000033991 through EC2 000033999.

<sup>356</sup> In general, the Series A preferred stock were junior to the Series B preferred stock and provided for cumulative quarterly dividends to be accrued at an initial annual rate of 5.06788 percent of the stated liquidation preference with respect to the stock. The Series B preferred stock were senior to the Series A preferred stock and provided for cumulative quarterly dividends to be accrued at an annual rate of 15 percent of the stated liquidation preference with respect to the stock. The Series A preferred stock provided voting rights, but the Series B stock did not. The Series A and Series B preferred stock each were immediately redeemable upon an affirmative vote of at least 80 percent of both the holders of the preferred stock to be redeemed and the common stockholders. In addition, the Maliseet Board of Directors could compel a redemption of the Series B preferred stock at any time on or after January 28, 2004 upon an affirmative vote of at least 80 percent of both the holders of the Series A preferred stock and the common stockholders.

- (5) Bankers Trust contributed the REMIC regular interests that it purchased from BT Green and REMIC residual interests to Maliseet in exchange for 1,000 shares of the common stock of Maliseet worth approximately \$1.25 million and a 20-year zero coupon debt instrument issued by Maliseet with a stated principal amount of approximately \$5.4 million and a stipulated fair market value of approximately \$1.6 million;<sup>357</sup>
- (6) Enron and Bankers Trust executed a shareholders agreement whereby (a) either Enron or Bankers Trust could compel the recapitalization of Maliseet, which would redeem all of the Series B preferred stock on or after January 28, 2004, exchange the common stock and the debt instrument issued by Maliseet to Bankers Trust for 10-year notes of equal value that pay current interest, and exchange the Series A preferred stock issued by Maliseet to Enron for common stock of Maliseet, (b) Enron would ensure that Maliseet elected REIT status and qualified as a REIT at all times from January 1, 1999 to January 1, 2004, and (c) Bankers Trust agreed to treat Maliseet as having paid to Bankers Trust “consent dividends” (as defined in section 565) and to be treated for Federal income tax purposes as having received an actual cash dividend from Maliseet at the end of each taxable year in an amount equal to the consent dividend for such year;
- (7) Bankers Trust purchased from Enron for \$1,000 two put options that permitted Bankers Trust to require Enron to purchase from Bankers Trust any of the 10-year notes received by Bankers Trust in a recapitalization of Maliseet at any time on or after two years (in the case of one put option) or 78 months (in the case of the other put option) following such recapitalization;
- (8) Enron and Bankers Trust entered into put and call options that permitted Bankers Trust to purchase (in the case of the call option) or Enron to require Bankers Trust to purchase (in the case of the put option) at a stipulated fair market value the Maliseet preferred stock held by Enron upon a change in law that prevented Maliseet from qualifying as a REIT, holding REMIC residual interests, or declaring consent dividends; and
- (9) BT Ever, Inc., a New York corporation and member of the Bankers Trust consolidated group (“BT Ever”),<sup>358</sup> sold two aircraft, and leases to which they

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<sup>357</sup> The Bankers Trust London branch previously had purchased the REMIC residual interests in two packages--one package in September 1997 and the other package in December 1997. The REMIC residual interests currently generate phantom income and are not expected to generate phantom deductions until after January 1, 2004.

<sup>358</sup> Bankers Trust, as well as three of its affiliates and an affiliate of Potomac Capital Investment Corp. (a taxable subsidiary of Potomac Electric Power Co. and also a minority investor in Project Teresa), own non-voting participating preferred stock in BT Ever. EC2 000037412.

were subject, to an Enron subsidiary (ECT Investments Holding Corp., a Delaware Corporation) for \$44,046,885.85.

On or before February 15, 1999, six directors of Maliseet each contributed \$1,000 to Maliseet in exchange for one share of Series B preferred stock,<sup>359</sup> and 98 other investors each contributed \$1,000 to Maliseet in exchange for one share of Series B preferred stock.<sup>360</sup>

After the contributions to Maliseet, Enron owned approximately 95 percent of the total combined voting power of all classes of stock of Maliseet that were entitled to vote and approximately 95 percent of the total value of shares of all classes of stock of Maliseet. Bankers Trust owned approximately five percent of the total combined voting power of all classes of stock of Maliseet that were entitled to vote and approximately five percent of the total value of shares of all classes of stock of Maliseet.

Because of the creation of non-cash phantom income on REMIC residual interests for Federal income tax purposes, the REMIC residual interests that Bankers Trust contributed to Maliseet had an aggregate adjusted tax basis (\$120 million) significantly in excess of their aggregate fair market value (\$165,000). Furthermore, the adjusted basis in the REMIC residual interests was expected to increase by approximately \$268 million over the life of these interests because of such treatment.

In June 2000, ECT Investments Holding Corp. sold the aircraft and associated leases that it had acquired from BT Ever for approximately \$36 million.

The diagram on the next page depicts the structure of Project Cochise at formation.

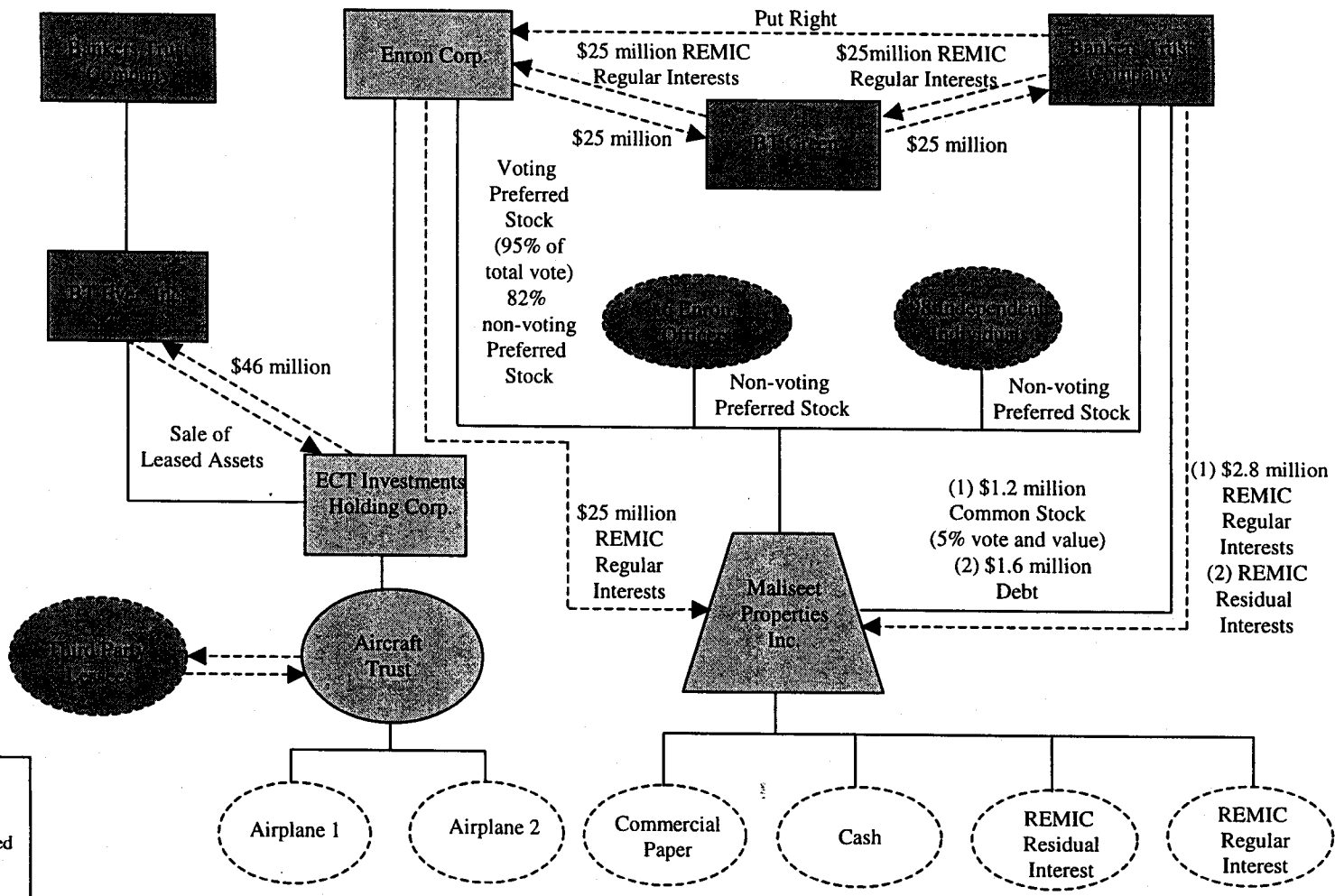
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<sup>359</sup> The Maliseet directors who received shares were Jeffrey McMahon, James V. Derrick, Jr., Richard A. Causey, Robert H. Butts, Mr. Hermann, and Andrew S. Fastow. The stock subscription agreements with these directors were executed on behalf of Maliseet by Mr. Maxey as vice president of Maliseet. Maliseet stock subscription agreements dated February 12, 1999. EC2 000036853 through EC2 000036908.

<sup>360</sup> According to interviews with Enron tax department personnel, Enron utilized the services of a firm called REIT Funding, Inc. to assist in placing the Maliseet shares with the other 98 investors. Joint Committee staff interview with Alicia Lynn Lockheed Goodrow, September 23, 2002. Most of these investors were residents of the Atlanta, Georgia, metropolitan area, and all of the investors were residents of Georgia, Tennessee, North Carolina, or Florida. Maliseet stock subscription agreements, EC2 000054439 through EC2 000054738. At some point during the development of Project Cochise, consideration apparently was given to using partners of the law firm Akin, Gump, Strauss, Hauer & Feld as the outside investors in Maliseet. The Project Cochise materials in Appendix B contain a preliminary diagram of Project Cochise indicating that Series B preferred stock would be transferred to at least 99 partners of Akin, Gump, Strauss, Hauer & Feld “in satisfaction of legal services provided on matters unrelated to [Maliseet].”

# Project Cochise Structure as of January 1999

Confidential



Following the implementation of Project Cochise, it was intended that Maliseet would distribute current cash dividend payments on the Series A and Series B preferred stock, and would distribute any remaining taxable income through cash and consent dividends to Bankers Trust as holder of the Maliseet common stock.

Pursuant to the terms of the shareholders agreement between Enron and Bankers Trust, it was anticipated that either Enron or Bankers Trust would prompt the recapitalization of Maliseet after five years (i.e., on or after January 28, 2004), which would redeem all of the Series B preferred stock, exchange the common stock and the debt instrument issued by Maliseet to Bankers Trust for 10-year notes of equal value that pay current interest, and exchange the Series A preferred stock issued by Maliseet to Enron for common stock of Maliseet.<sup>361</sup> By then (or shortly thereafter), the REMIC residual interests would begin to generate tax deductions to reverse the previous REMIC non-cash phantom income that was distributed exclusively to Bankers Trust (primarily through consent dividends) as holder of the Maliseet common stock. Accordingly, it was expected that Maliseet would intentionally lose its REIT status (either through a revocation of its REIT election or by failing to qualify as a REIT) and would rejoin the Enron consolidated group, which would then take into account the tax deductions generated by the REMIC residual interests held by Maliseet.

#### Role of outside advisors

According to interviews with Enron tax department personnel, Bankers Trust promoted Project Cochise to Enron.<sup>362</sup> As noted above, Bankers Trust also was the exclusive financial advisor to Enron with respect to Project Cochise. Bankers Trust was the sole financial advisor for Enron irrespective that Bankers Trust was the only unrelated counterparty to the transaction (other than the handful of individual investors in Maliseet).

The documentation for Project Cochise indicates that William S. McKee and James D. Bridgeman of McKee Nelson, Ernst & Young LLP were the primary counsel responsible for the development and implementation of Project Cochise, with King & Spalding providing counsel on the more limited issue of REIT status qualification for Maliseet.<sup>363</sup> In connection with Project Cochise, McKee Nelson, Ernst & Young LLP provided a tax opinion letter that analyzed the tax implications of the transaction and concluded that:

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<sup>361</sup> The tax deductions included in Enron's projections with respect to Project Cochise would become available to Enron only upon the recapitalization of Maliseet. The Project Cochise materials in Appendix B contain projections and diagrams in connection with Project Cochise indicating that the recapitalization of Maliseet was a prearranged step in the implementation of Project Cochise.

<sup>362</sup> Interview with Mr. Maxey, August 6, 2002.

<sup>363</sup> Appendix C, Part IV of this Report contains the tax opinion letters Enron received from McKee Nelson, Ernst & Young LLP and King & Spalding in connection with Project Cochise.



- (1) the contributions to Maliseet of REMIC regular interests by Enron and REMIC regular and residual interests by Bankers Trust “should” constitute non-taxable transfers of property under section 351;<sup>364</sup>
- (2) the tax basis of the REMIC residual interests contributed to Maliseet by Bankers Trust “should” equal the tax basis of such interests in the hands of Bankers Trust immediately before the contributions;
- (3) Enron “will” be treated as the owner of the Series A and Series B preferred stock received from Maliseet,<sup>365</sup> and “will” be treated as the owner of the two aircraft and leases to which they were subject;<sup>366</sup>
- (4) section 269 “should not” apply to disallow any tax deductions generated by the reversal of earlier non-cash phantom income on the REMIC residual interests in the hands of Maliseet;<sup>367</sup>
- (5) Maliseet’s use of any tax deductions generated by the reversal of earlier non-cash phantom income on the REMIC residual interests “should not” be subject to limitation under section 382 solely as a result of either the contributions of the REMIC residual interests by Bankers Trust to Maliseet or the acquisition of Bankers Trust Corp. by Deutsche Bank;
- (6) “it is more likely than not” that neither Maliseet, the REMIC residual interests, nor the transactions involved in Project Cochise are required to be registered as a tax shelter under section 6111;

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<sup>364</sup> Included in this opinion was the conclusion that Enron and the Bankers Trust London Branch were in “control” of Maliseet (within the meaning of section 368(c)) immediately after the exchange notwithstanding the 2004 recapitalization provisions in the shareholders agreement between Enron and Bankers Trust.

<sup>365</sup> Employing an economic substance analysis, this opinion was based upon representations from Enron that it would earn annual pre-tax profits of at least five percent with regard to its investment in the Series A preferred stock and 15 percent with regard to its investment in the Series B preferred stock, exclusive of finance costs and the time value of money.

<sup>366</sup> Employing an economic substance analysis, this opinion was based upon representations from Enron that it would earn an annual pre-tax profit of at least 4.12 percent with regard to its investment in the aircraft and leases, exclusive of finance costs and the time value of money.

<sup>367</sup> Included in this opinion was the conclusion that neither Enron nor the Bankers Trust London Branch “acquired” control of Maliseet in the transaction because Enron owned 100 percent of the vote and value of Maliseet before the transaction and owned 95 percent of the vote and value of Maliseet after the transaction.

- (7) Enron “should not” be subject to penalties under section 6707 for failing to register Maliseet, the REMIC residual interests, or the transactions involved in Project Cochise as a tax shelter under 6111 prior to January 28, 1999;
- (8) Maliseet “should” be entitled to a deduction for dividends paid under section 857(b)(2)(B), provided (a) Bankers Trust (the sole owner of the Maliseet common stock) properly consents to be treated as having received the consent dividends, (b) Maliseet timely files such consent with its Federal income tax returns, and (c) there are no arrearages of any accrued dividends on the Series A and Series B preferred stock as of December 31 of each taxable year; and
- (9) for purposes of sections 6662 and 6664, there is “substantial authority” for the tax treatment of the transactions involved in Project Cochise and there is a “greater than 50 percent likelihood” that the tax treatment of such transactions will be upheld in litigation if challenged by the IRS.

To date, Enron has paid \$1,022,774 in fees to McKee Nelson, Ernst & Young LLP in connection with Project Cochise.<sup>368</sup>

In addition, King & Spalding provided a tax opinion letter that analyzed the tax implications of the transaction and concluded that Maliseet “should” qualify as a REIT for Federal income tax purposes for its taxable year ended December 31, 1999, and that the organization and proposed method of operation of Maliseet “should” enable it to continue to satisfy the requirements for qualification and Federal income taxation as a REIT for its taxable year ended December 31, 2000 and subsequent taxable years.

As indicated above, Arthur Andersen provided a hypothetical accounting opinion letter to Bankers Trust that analyzed the financial accounting treatment of a hypothetical transaction that was substantially identical to Project Cochise. Based upon the Arthur Andersen opinion, Enron took various favorable financial accounting positions. For purposes of producing accounting income on its financial statements, Enron took the position that Project Cochise generated a deferred tax asset that was not discounted to take into account the time value of money.<sup>369</sup> In

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<sup>368</sup> The General Background materials in Appendix B contain the Estimated Project Fees schedule (June 4, 2001). Enron was unable to provide to the Joint Committee staff a copy of any engagement letter between Enron and McKee Nelson, Ernst & Young LLP with respect to Project Cochise, and was unable to provide information concerning the entire fee arrangement between Enron and McKee Nelson, Ernst & Young LLP with regard to Project Cochise. Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003. It is unclear from a review of documents provided by Enron whether these fees actually were paid to McKee Nelson, Ernst & Young LLP (Mr. McKee’s current firm) or King & Spalding (Mr. McKee’s previous firm).

<sup>369</sup> According to internal Enron documents, the transaction would enable Enron “to record deferred tax assets at gross amounts well in excess of their present value.” The Project Cochise materials in Appendix B contain an executive summary describing the accounting benefits of Project Cochise. EC2 000037381.

essence, this deferred tax asset purportedly arose because of the prearranged confluence of several factors, including:

- (1) the treatment of the contribution of the REMIC residual interests to Maliseet as a purchase of the interests by Maliseet for financial accounting purposes (in contrast to the treatment of the contribution as a tax-free, carryover basis transaction for Federal income tax purposes);
- (2) the disparity between the \$120 million aggregate adjusted tax basis in the REMIC residual interests (which carried over to Maliseet for Federal income tax purposes) and the \$165,000 aggregate fair market value of the assets;
- (3) the fact that the taxable non-cash phantom income generated by the REMIC residual interests would be distributed to Bankers Trust through consent dividends on the Maliseet common stock held by Bankers Trust;
- (4) the fact that such phantom income would reverse in later years and generate deductions for Enron after Maliseet relinquishes its REIT status and becomes reconsolidated with Enron for Federal income tax purposes; and
- (5) the fact that FAS 109 provides for the recording of an undiscounted deferred tax asset that does not take into account the time value of money.

Apparently, no tax basis study was performed for Enron with regard to the REMIC residual interests that were transferred to Maliseet. However, Deutsche Bank and Morgan Stanley & Co., Inc. provided historical basis information concerning the REMIC regular and residual interests transferred to Maliseet.<sup>370</sup>

#### Subsequent developments

Project Cochise remains in place pursuant to the original plan and, with the assistance of PricewaterhouseCoopers, Enron continues to monitor Maliseet to ensure that it maintains its status as a REIT for Federal income tax purposes. Maliseet is not a debtor in the Enron bankruptcy.

#### IRS examination of Project Cochise

As with Project Steele, the IRS examination team undertook an expedited review of Project Cochise that was limited to examining whether Maliseet satisfied the REIT qualification requirements. Having determined that Maliseet was properly formed as a REIT, and did properly operate as a REIT, for the tax years under review, the IRS examination team stated that they would not review Project Cochise any further and would propose no tax liability adjustments relating to Project Cochise.<sup>371</sup>

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<sup>370</sup> EC2 000054739 through EC2 000054743.

<sup>371</sup> Interview with IRS examination team, August 8, 2002.

## Discussion

### In general

Like Project Steele, Project Cochise was designed to provide Enron financial accounting benefits from the acquisition of future tax deductions through REMIC residual interests, and at a cost that was significantly less than the acquired tax benefits. Determining whether Enron should be entitled to deduct the future tax deductions inherent in the REMIC residual interests necessarily involves an analysis regarding Enron's satisfaction of the literal requirements of the applicable statutory requirements as well as the rules and judicial doctrines (such as business purpose and economic substance) that are often applied to evaluate the purported tax benefits in tax-motivated transactions.<sup>372</sup>

A number of Code provisions are specifically designed to remove tax impediments from bona fide business transactions. In developing these provisions, the basic policies contemplate the bona fide conduct of business in the ordinary course. However, these provisions potentially can be utilized to effectuate unintended tax benefits. The Code and Treasury regulations recognize the potential for abusive activity and contain provisions intended to limit the benefits of arrangements that, although satisfying the literal requirements of a provision, are used to distort or defeat the basic purpose of the underlying statute.<sup>373</sup> These provisions address such policy concerns by limiting the benefit of the underlying statute through the use of general disallowance if specific factual tests are met, or if the principal purpose of the transaction is to evade or avoid income tax.

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<sup>372</sup> For detailed information concerning 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).

<sup>373</sup> *See, e.g.*, sec. 269 (acquisitions made to evade or avoid income tax), sec. 362(d) (limitation on basis increase attributable to assumption of liability), sec. 358(h) (reduction to basis of assets in connection with transfers of liabilities that give rise to a deduction), Treas. Reg. sec. 1.701-2 (partnerships formed or availed of in connection with a transaction with a principal purpose of reducing tax), and sec. 732(f) (adjustment to basis of assets of a distributed corporation controlled by a corporate partner). *See also* proposed regulations to prevent a consolidated group from obtaining more than one tax benefit from a single economic loss (IRS Proposed Rules and Public Hearing Notice (Reg-131478-02) On Suspension of Losses on Certain Stock Dispositions Federal Register October 23, 2002).

### Carryover basis of REMIC residual interests transferred to Maliseet

The Code and Treasury regulations also contain specific provisions intended to limit a taxpayer's ability to transfer tax attributes, such as net operating losses, built-in-losses, and various credit items.<sup>374</sup> The general purpose of these provisions is to limit the ability of such tax benefits by a taxpayer who did not suffer the economic loss that gave rise to the tax benefit.

Project Cochise purported to use the tax-free incorporation rules and resulting carryover basis rules to transfer losses and duplicate a single economic loss. The ability to transfer losses and duplicate a single economic loss through section 351 has been, and continues to be, a concern in the administration of tax policy.<sup>375</sup> In order for Project Cochise to achieve the desired tax result (and the corresponding financial accounting benefits), the transfer of the REMIC residual interests by Bankers Trust had to occur in a tax-free manner such that the REMIC residual interests tax basis would carry over to Maliseet.

It may be argued that the application of section 351(a) is predicated upon a valid non-tax business purpose and that the transfer by Bankers Trust to Maliseet did not have the requisite business purpose. Although it is unclear under present law whether section 351(a) does require a valid business purpose and, if so, how it is to be applied in the specific context of purported transfers under section 351(a), the tax opinion letter provided to Enron by McKee Nelson, Ernst & Young LLP includes no discussion of this issue in its analysis of the application of section 351 to Project Cochise. Moreover, the documentation of Project Cochise reviewed by the Joint Committee staff demonstrated no purpose for the transaction other than facilitating the generation of financial statement and tax benefits to Enron, as well as the duplication of losses built into the REMIC residual interests that Bankers Trust transferred to Maliseet.

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<sup>374</sup> See, e.g., sec. 382 (limitation on net operating loss carryforwards and certain built-in-losses following ownership changes, sec. 383 (special limitations on certain excess credits, etc.), and Treas. Reg. sec. 1.1502-15 (SRLY limitation on built-in-losses).

<sup>375</sup> For example, in the year 2000, Congress enacted rules requiring a reduction in basis of assets in connection with transfers of certain liabilities in order to stop transactions that duplicated a single economic loss. See, the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, sec. 1(a)(7) (Dec. 21, 2000). See Staff of the Joint Committee on Taxation, *General Explanation of Tax Enacted in the 106<sup>th</sup> Congress* (JCS-2-01), April 19, 2001, at 154. In addition, President Clinton's Fiscal Year 2001 Budget Proposals contained a proposal that was aimed at limiting the ability of taxpayers to transfer built-in losses into the U.S. tax system by requiring marking to fair market value such assets when such assets become "relevant" for U.S. tax purposes (See Office of Management and Budget, *Budget of the United States Government, Fiscal 2001: Analytical Perspectives* (H. Doc. 106-162, Vol. III). See also Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal* (JCS-2-00), March 6, 2000.) Most recently, the Treasury Department issued proposed regulations to prevent a consolidated group from obtaining more than one tax benefit from a single economic loss (IRS Proposed Rules and Public Hearing Notice (Reg-131478-02) On Suspension of Losses on Certain Stock Dispositions Federal Register October 23, 2002).

In analyzing whether Project Cochise had a non-tax business purpose, McKee Nelson, Ernst & Young LLP placed significant weight in its tax opinion letter on the fact that the financial accounting benefits overshadowed the Federal income tax benefits of Project Cochise. As in Project Steele, a conclusion that a non-tax business purpose exists based on the accounting benefits of Project Cochise fails to consider the origin of the accounting benefit (i.e., solely reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement.<sup>376</sup>

#### Application of section 269 to transfer

The tax opinion letter provided to Enron by McKee Nelson, Ernst & Young LLP concerning Project Cochise contains a lengthy discussion and analysis of section 269, and concludes that the provision “should not” apply to disallow any tax deductions generated by the reversal of earlier non-cash phantom income on the REMIC residual interests in the hands of Maliseet. The tax opinion letter points out that Enron did not relinquish, and Bankers Trust did not acquire, control of Maliseet as a result of the transfers to Maliseet. Even if Enron had obtained control of Maliseet in the transaction, the tax opinion letter argues further that the application of section 269 to acquisitions of control<sup>377</sup> is limited to transactions securing the types of tax benefits that can be obtained only through the acquisition of control. In addition, the tax opinion letter argues that, although Maliseet acquired the REMIC regular and residual interests in a purported carryover basis transaction to which section 269 also could apply,<sup>378</sup> Project Cochise was not motivated by the tax avoidance or evasion purposes contemplated by section 269.

Acquisition of control.—With regard to acquisitions of control, the tax opinion letter concludes that section 269 applies only to the types of tax benefits that can be secured only through the acquisition of control by relying upon case law for the proposition that “section 269 does not apply to a case where the taxpayer would have obtained the tax benefit regardless of whether the taxpayer acquired control in the acquisition in question.” Specifically, the tax opinion letter cites *Commodores Point Terminal Corp. v. Commissioner*,<sup>379</sup> in which the Tax Court interpreted the phrase in section 269 “which such person [or corporation] would not

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<sup>376</sup> See, e.g., *American Electric Power, Inc. v. U.S.*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) (“AEP’s intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings ‘were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,’” citing *Winn-Dixie v. Commissioner*, 113 T.C. 254, 287 (1999)).

<sup>377</sup> Sec. 269(a)(1).

<sup>378</sup> Sec. 269(a)(2).

<sup>379</sup> 11 T.C. 411 (1948), *acq.* 1949-1 C.B. 1.

otherwise enjoy” as conditional language that limits the denial of tax benefits under section 269 to those benefits that can be obtained only through the acquisition of control.<sup>380</sup>

The tax opinion letter also cites subsequent decisions in *Coastal Oil Storage Co. v. Commissioner*<sup>381</sup> and *Cromwell Corp. v. Commissioner*,<sup>382</sup> in which the Tax Court appeared to follow its earlier interpretation of section 269 in the *Commodores Point* case. In *Coastal Oil Storage*, the Fourth Circuit Court of Appeals reversed the Tax Court, in part based upon its apparent conclusion that section 269 can disallow tax benefits without regard to whether such benefits can be obtained only through the acquisition of control. However, the tax opinion letter discounts the Fourth Circuit decision in *Coastal Oil Storage* as deficient because, in contrast to the Tax Court decisions upon which the tax opinion letter does rely, the Fourth Circuit did not sufficiently take into account legislative history supporting the analysis adopted by the Tax Court.<sup>383</sup> Finally, the tax opinion letter cites several administrative rulings issued during the 1990s by the IRS National Office in which the National Office interpreted the scope of section 269 consistent with the interpretation adopted by the Tax Court.

Proscribed tax evasion or avoidance purpose.—The tax opinion letter concludes that Project Cochise was not imbued with the Federal income tax evasion or avoidance purpose proscribed by section 269 primarily on the basis that Maliseet would have obtained most of the future phantom deductions from the REMIC residual interests without regard to whether Maliseet received the interests with a high carryover basis (as opposed to a nominal fair market value basis). In particular, the tax opinion letter argues that the remaining future phantom income inclusions from the interests would increase Maliseet’s basis in the interests by a greater amount than the initial carryover basis in the interests. Therefore, according to the tax opinion letter, the tax motivation for transferring the REMIC residual interests to Maliseet in a carryover basis transaction was quantitatively outweighed by the basis increases from the phantom income inclusions that would occur without regard to whether the transfer of the interests occurred in a manner that carried over the basis of the interests.

In addition, the tax opinion letter contends that the transfer of future phantom deductions imbedded in the REMIC residual interests by the taxpayer that has already recognized the associated initial phantom income inclusions does not distort the tax liabilities associated with a REMIC residual interest over the life of the interest. The tax opinion letter recognizes several

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<sup>380</sup> See 11 T.C. at 415-417 (stating that “[t]he word ‘otherwise’ can only be interpreted to mean that the deduction, credit, or allowance, if it is to be disallowed, must stem from the acquisition of control”).

<sup>381</sup> 25 T.C. 1304 (1956), *aff’d in part and rev’d in part*, 242 F.2d 396 (4th Cir. 1957).

<sup>382</sup> 43 T.C. 313 (1964).

<sup>383</sup> The tax opinion letter also notes that the Fourth Circuit decision in *Coastal Oil Storage* would not be binding upon the Tax Court if it were to consider the application of section 269 to Project Cochise because an appeal of a Tax Court decision with regard to Project Cochise would lie in the Fifth Circuit.

unique tax rules associated with REMIC residual interests that are intended to ensure that the initial phantom income inclusions are taxed in light of the subsequent offsetting phantom deductions, but argues that none of these or the other tax rules relating to REMIC residual interests evidence a legislative plan or intent that the same taxpayer should recognize both the phantom income inclusions and the subsequent phantom deductions.

In its only acknowledgement that Project Cochise results in a duplication of the future phantom deductions to be produced by the REMIC residual interests transferred to Maliseet, the tax opinion letter states in a brief footnote that the transfer of the interests in a carryover basis transaction duplicates the future deductions through a difference between the low value and high basis of the common stock received by Bankers Trust from Maliseet in exchange for the REMIC residual interests. However, the tax opinion letter concludes that this duplication should not be taken into account for purposes of determining whether the requisite tax evasion or avoidance purpose under section 269 is present with regard to Project Cochise because section 269 only takes into account the tax motivation of Maliseet as the actual acquirer of the interests. According to the tax opinion letter, the potential benefits to Bankers Trust of duplicating the future phantom deductions is not pertinent in evaluating the tax motivation of Project Cochise under section 269.

Even if such duplication should be considered in examining the application of section 269 to Project Cochise, the tax opinion letter suggests that Bankers Trust would not have had a principal tax motivation for its participation in the transaction, as measured by the likelihood that Bankers Trust would trigger its recognition of the duplicated losses through a compelled recapitalization of Maliseet, followed by an exercise of the put option that it purchased from Enron as part of the transaction. In discussing the application of the section 351(a) control requirement to the transfers of REMIC regular and residual interests by Bankers Trust to Maliseet, the tax opinion letter states the following:

[At the time of the transfers by Enron and Bankers Trust to Maliseet], the London Branch had no plan or intention of transferring, disposing of, or exchanging any of the Common Stock, other than possibly pursuant to a Recapitalization. In any event, however, a Recapitalization will not occur before January 1, 2004. Accordingly, because Enron and the London Branch together owned 100 percent of the outstanding stock of Maliseet immediately after the transfers of the [REMIC regular and residual interests] to Maliseet and had no plan or intention of disposing of such stock until possibly on or after January 1, 2004, Enron and the London Branch should be treated as satisfying the Control Requirement in connection with such transfers.

This statement may not be patently false but, at minimum, it understates the clear intention of Bankers Trust to activate the recapitalization provisions of the shareholders agreement and exercise its option to sell to Enron the notes that Bankers Trust would receive in the recapitalization. Internal company documents describing Project Cochise and quantifying the overall tax consequences of the transactions unambiguously demonstrate that the parties structured the transaction with every intention that Maliseet would be recapitalized at the earliest possible opportunity and Bankers Trust would exercise its put option, thus recognizing the duplicated loss. Taking into account the duplicated loss and the inevitability of its recognition in



2004 would cast substantial doubt as to whether Project Cochise was undertaken for the principal purpose of evading or avoiding Federal income tax under section 269 through the duplication of the loss that was built into the REMIC residual interests transferred to Maliseet.

## **Recommendations**

### Carryover basis of REMIC residual interests transferred to Maliseet

The Joint Committee staff recommendations regarding Projects Tanya and Valor include recommendations to limit the duplication of a single economic loss. These recommendations also are appropriate for consideration with respect to Project Cochise.<sup>384</sup>

Irrespective of whether an overall change is made to limit the duplication of a single economic loss under subchapter C generally, the Joint Committee staff believes it is appropriate to limit the ability to transfer REMIC residual interests in a carryover basis transaction. Under the statutory rules regarding the taxation of REMICS, 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.<sup>385</sup>

### Acquisitions made to evade or avoid Federal income tax

Project Cochise highlights the limited reach of section 269 as it applies to acquisitions of corporate equity interests for the principal purpose of obtaining tax benefits. Tax avoidance transactions involving the acquisition of a non-controlling interest in a corporation are no less pernicious (and actually may be more prevalent) than similarly motivated transactions involving the acquisition of a controlling interest in a corporation. Therefore, the Joint Committee staff recommends that Congress expand 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.<sup>386</sup>

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<sup>384</sup> Projects Tanya and Valor are discussed elsewhere in this section of the Report.

<sup>385</sup> See recommendations for Projects Tanya and Valor for a discussion of general issues with respect to this type of proposal.

<sup>386</sup> This recommendation is not limited to acquisitions in which the ownership percentage of a pre-existing interest in a corporation is increased. Accordingly, this recommendation also includes acquisitions involving a change to the capital structure of a pre-existing corporation (e.g., an existing shareholder relinquishes common stock and obtains preferred stock in the transaction), without regard to whether the change results in an increase in the percentage (by vote or value) of a pre-existing ownership interest.

With regard to acquisitions of corporate interests, present-law section 269 also is circumscribed by the judicial interpretation that the provision applies only to the types of tax benefits that can be obtained only through the acquisition of control of a corporation. Project Cochise demonstrates that tax motivated transactions can generate significant tax benefits that can be obtained through a non-controlling interest in a corporation. Regardless of whether the application of section 269 is limited to acquisitions of controlling interests in a corporation, the tax policy rationale is unclear for insulating from the application of section 269 tax benefits that can be obtained through either controlling or non-controlling corporate interests. Therefore, the Joint Committee staff also recommends that Congress expand 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.

Because the application of section 269 to a particular transaction is conditioned upon the tax evasion or avoidance purpose for the transaction, the Joint Committee staff acknowledges that implementation of these recommendations would not necessarily eradicate transactions such as Project Cochise. Nevertheless, the Joint Committee staff believes that these recommendations would make section 269 generally more effective in deterring tax motivated transactions that involve the acquisition of an equity interest in a corporation.

## 5. Project Teresa

### Brief overview

Project Teresa<sup>387</sup> was a synthetic lease arrangement designed to result in an increase in tax basis in depreciable assets (the most significant asset being the Enron North office building) with minimal economic outlay. This was accomplished in the following manner: Enron, through a deconsolidated entity, contributed depreciable assets and preferred stock of an affiliate to a partnership. Bankers Trust (the promoter of the transaction) contributed cash to the partnership. Enron affiliates would periodically acquire (or redeem) the preferred stock from the partnership, with the acquisition/redemption being treated as a taxable dividend eligible for an 80 percent dividends received deduction. Enron's basis in its partnership interest was increased by the total amount of the dividend (without regard to the dividends received deduction). Ultimately, the partnership was to be liquidated in a manner that would result in Enron receiving the depreciable assets with the increased basis. Enron would recover this increased tax basis through higher future depreciation deductions on the Enron North office building and the other depreciable assets.

### Background<sup>388</sup>

#### Reported tax and financial statement effects

Project Teresa involved the reporting of dividend income in the early years, followed by increased depreciation deductions in later years. The transaction was projected to result in Enron reporting additional tax liability of \$75.525 million for years 1997 through 2001.<sup>389</sup> During the entire life of the project, however, it was projected that Enron would report aggregate tax savings (though greater depreciation deductions on the Enron North office building) of \$261.6 million.

The amount of the dividend income that was deducted by virtue of the dividends received deduction (but resulted in an increased partnership basis) gave rise to a permanent book-tax difference. In connection with Project Teresa, Enron recorded financial statement earnings (i.e., earnings through a reduction in the provision for income tax expense) of \$226.0 million during the period 1997-2001.<sup>390</sup>

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<sup>387</sup> As in Project Tanya, Mr. Hermann named this transaction after a hurricane.

<sup>388</sup> The information regarding Project Teresa was obtained from Joint Committee staff interviews of Robert J. Hermann, Robert D. Maxey, Greek L. Rice, and Jordan H. Mintz, as well as from documents and information provided by Enron and the IRS.

<sup>389</sup> According to Enron, the deconsolidated entity paid approximately \$107 million of Federal income tax from years 1997 through 2000.

<sup>390</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 24. Current Enron management stated that Enron recorded a valuation reserve in December 2001 of approximately \$269.8 million in connection with Project Teresa. The \$43.8 million excess of the valuation reserve over the Project Teresa

## Development of Project Teresa

Bankers Trust brought the idea for Project Teresa to Enron. The original contact appears to have been a “cold call” made by someone in the Bankers Trust marketing group to Mr. Rice, though the contact might have been established through Enron’s finance group. In a letter dated May 16, 1996, Bankers Trust provided Mr. Hermann with certain discussion materials regarding a proposed joint venture arrangement developed by Bankers Trust. The discussion materials (modified in subsequent presentations) described the benefits of the transaction as follows:

- (1) Accounting earnings -- recognize deferred tax assets over the five [year] life of the project.
- (2) High basis tax asset -- create an asset(s) with a tax basis much higher than its FMV; the differential can be either recognized over time through depreciation or triggered sooner by a sale of the asset.
- (3) Low tax risk – under current law, if modeled properly, the transaction will be revenue neutral to the IRS; thus, there is little motivation for the Service to challenge this structure upon audit.<sup>391</sup>

The transaction was designed to provide an after-tax accounting benefit of \$230 million, and a net cash flow to Enron of \$30.142 million.<sup>392</sup>

After the initial contact, Messrs. Hermann, Maxey and Rice met with representatives of Bankers Trust and the law firm of King & Spalding (that was representing Bankers Trust in connection with the transaction).<sup>393</sup> Following these discussions, Enron tax personnel began searching for assets that could be utilized in the transaction.

In February 1997, Messrs. Hermann, Maxey and Rice met in Washington, D.C., with representatives of Bankers Trust and King & Spalding to work through the details of the transaction. At the meeting, the Enron representatives indicated that they required a “should” level tax opinion for the transaction. There was some discussion as to who would provide the tax opinion. According to one participant, an attorney from King & Spalding indicated that it would

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financial benefits relates to the GAAP tax accounting for the taxable portion of the dividends. Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 31, 2003, answer 2. It is unclear why Enron used a valuation reserve (as opposed to a reversal of the financial income benefit).

<sup>391</sup> The Project Teresa materials in Appendix B contain the “Description of Partnership Leasing Proposal” in discussion materials from Bankers Trust dated March 27, 1997, EC2 000037929.

<sup>392</sup> *Id.* at EC2 000037931-37932.

<sup>393</sup> The law firm of Akin, Gump, Strauss, Hauer & Feld acted as special counsel to the Bankers Trust entity that was involved in Project Teresa.

receive a \$1 million fee for the transaction regardless of whether King & Spalding provided the tax opinion. Ultimately, it was decided that King & Spalding would provide the tax opinion to Enron. There was also some discussion regarding the timing of the transaction. Of particular concern was the fact that Congress was considering legislation that would affect the transaction structure. Timing also was critical because the lease on the Enron North office building (the primary asset being considered for Project Teresa) was up for renewal. After a few days of meetings, Mr. Rice returned to Houston to apprise Richard A. Causey, Chief Accounting Officer of Enron Corp., of the developments in anticipation of a meeting of the Enron Corp. Board of Directors.

On March 25, 1997, the Executive Committee of the Enron Corp. Board of Directors met to discuss (among other items) Project Teresa. Edmund P. Segner presented an overview of the transaction, and Mr. Causey described the details of the transaction. Mr. Causey stated that the net effect of the transaction would be to create book earnings of \$242.6 million during years 1997 through 2002 by virtue of the deemed dividends paid to the leasing partnership.<sup>394</sup> The Executive Committee adopted a resolution authorizing the transaction, including the contribution of the lessee rights in the Enron North office building to the leasing partnership and a schedule of fees.<sup>395</sup> The Enron Board of Directors heard a report regarding the Executive Committee action at its meeting on May 6, 1997.<sup>396</sup>

The business purpose given for the transaction was to raise third party capital and manage a portfolio of leased assets with enhanced earnings potential.<sup>397</sup> The tax opinion prepared by King & Spalding states “the predominant purpose of Enron and its Affiliates for participating in [the redemption transaction in Project Teresa] was to generate income for financial accounting purposes.”<sup>398</sup>

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<sup>394</sup> Project Teresa estimated earnings benefit, EC2 000037959. According to minutes from the meeting, “[a] thorough discussion ensued during which Messrs. Causey, Rice, and Skilling responded to questions by the Committee.”

<sup>395</sup> Minutes of the Meeting of the Executive Committee of the Board of Directors of Enron Corp., March 25, 1997, EC2 000037952-55.

<sup>396</sup> Minutes of the Meeting of the Board of Directors of Enron Corp., May 6, 1997, ENE 0000000199-200. The Board of Directors had been made aware of the transaction at its previous meeting on February 11, 1997. At that meeting, the Board of Directors reviewed a presentation regarding Enron’s 1997 strategic goals, which contained a projection of future earnings that included a \$280 million benefit during the years 1997 through 2001 attributable to the “building lease tax structure.” Enron Board of Directors Meeting, February 11, 1997, EC 000044834.

<sup>397</sup> Project Teresa Tax Overview, EC2 000037866.

<sup>398</sup> King & Spalding opinion letter, by Abraham N.M. Shashy, Jr. for himself and William S. McKee, to R. Davis Maxey, dated July 29, 1997, Appendix C, Part V, at 4.

## Implementation of Project Teresa

The initial step in the implementation of Project Teresa was the organization and financing of the various participating entities. On March 21, 1997, Enron Corp., together with Potomac Capital Investment Corp. (“Potomac Capital,” a subsidiary of Potomac Electric Power Co.) and EN-BT Delaware, Inc. (“EN-BT Delaware”) (a subsidiary of Bankers Trust) contributed property to Organizational Partner, Inc. (“Organizational Partner” or “OPI”) in exchange for OPI common stock and OPI preferred stock. The property that Enron contributed included: (1) its lessee interest in the Enron North office building,<sup>399</sup> (2) certain interests in aircraft operated by Enron Corp., (3) a note receivable from Houston Pipe Line Co. in the amount of \$1.097 billion and (4) \$10,250 in cash, in exchange for OPI common stock that represented 98 percent of the equity but only 75 percent of its voting rights.<sup>400</sup> Potomac Capital and EN-BT Delaware collectively contributed \$22.4 million in cash in exchange for 20,000 shares of OPI preferred stock that represented two percent of the equity and 25 percent of the voting rights in Organizational Partner.

The second step involved the issuance of the preferred stock that would be used in the redemption transactions. On March 21, 1997, Enron Corp. contributed all of the common stock of Enron Operations Corp. and its subsidiaries to Enron Liquids Holding Corp. (“Enron Liquids”) in exchange for 80 percent of the Enron Liquids common stock. Organizational Partner contributed the note receivable from Houston Pipe Line Co. and \$10,250 in exchange for 20 percent of the Enron Liquids common stock (with a value of \$97.5 million) and 10,000 shares (i.e., 100 percent of the issued and outstanding class) of Enron Liquids preferred stock (with a value of \$1 billion).

The next step was the organization and funding of the partnership that was to hold the Enron Liquids preferred stock through the tax-deconsolidated entity. To accomplish this, on March 27, 1997, Enron Leasing Partners, LP (“Enron Leasing”) was formed. Organizational Partner contributed to Enron Leasing: (1) the lessee interest in the Enron North office building, (2) \$22.4 million in cash, and (3) the Enron Liquids preferred stock (worth \$1 billion), in exchange for a 98 percent limited partner interest. Enron Property Management Co. contributed cash and U.S. Treasury obligations with a value of \$10.433 million in exchange for a one percent general partner interest, and EN-BT Delaware contributed \$10.433 million in cash in exchange for a one percent limited partner interest.

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<sup>399</sup> A contribution agreement between Enron Corp. and Organizational Partner dated March 21, 1997, states that, with respect to the lessee interest, Enron Corp. agrees to designate Organizational Partner as the lessee under the lease (and have the necessary documentation to effectuate the assignment) no later than April 30, 1997. Ecx000006707. The actual transfer occurred on April 14, 1997.

<sup>400</sup> Enron Corp. owned less than 80 percent of the vote of Organizational Partner, and, as a result, Organizational Partner was not a member of the Enron affiliated group (i.e., it was a tax deconsolidated entity). However, Organizational Partner was consolidated with Enron Corp. for financial statement purposes.

Once the entities were organized and funded, the next step was to generate dividend income. As originally contemplated, an Enron affiliate was to make periodic purchases of Enron Liquids preferred stock from Enron Leasing over a five-year period (with the purchase being treated as a dividend from a related corporation under the tax laws). Thus, on May 14, 1997, Enron Pipeline Company (“Enron Pipeline”), a wholly owned subsidiary of Enron Corp., purchased 1,980 shares of Enron Liquids preferred stock from Enron Leasing in exchange for an intercompany promissory note in the principal amount of \$198 million creating dividend income to the partnership. However, a change to the tax laws that became effective in June 1997 eliminated the advantage associated with this structure.<sup>401</sup> Consequently, beginning in March 1998,<sup>402</sup> Enron Liquids implemented a plan of quarterly pro-rata redemptions of its preferred and common stock designed to achieve a similar tax result (i.e., redemptions treated as dividends under the tax laws). Thus, on March 31, 1998, Enron Liquids redeemed (on a pro-rata basis) 40 shares of its common stock in exchange for promissory notes with a principal amount of \$16.979 million and 325 shares of its preferred stock in exchange for promissory notes with a principal amount of \$32.5 million.<sup>403</sup> This amount represented 3.25 percent of each class of stock held by each shareholder. The predominant purpose of Enron Corp. and its affiliates for participating in the redemption was to generate income for financial accounting purposes.<sup>404</sup>

In 1999, Enron Liquids paid dividends on its preferred stock, and engaged in redemptions of its common and preferred stock, in the amount of approximately \$170.7 million.<sup>405</sup> In November 1999, Enron Pipeline sold its remaining 1,045 shares of Enron Liquids preferred stock to Enron Corp. Subsequent to the sale, Enron contributed all of the stock in Enron Pipeline to Enron Operations Corp. (a subsidiary of Enron Liquids) in exchange for preferred stock. In 2000 and 2001, Enron Liquids paid dividends on its preferred stock and engaged in stock redemption transactions in the aggregate amount of approximately \$686.2 million and \$49.5 million, respectively.<sup>406</sup> In total, during the period 1997 through 2001, the amount of dividends on the Enron Liquids preferred stock and the stock sales and redemptions that Enron treated as dividends with respect to the Enron Liquids preferred stock, exceeded \$1 billion.

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<sup>401</sup> Congress amended the extraordinary dividend rules of section 1059, which is discussed in greater detail below.

<sup>402</sup> At some time between May 14, 1997 and March 31, 1998, Enron Pipeline transferred 935 shares of Enron Liquids preferred stock to Enron Corp.

<sup>403</sup> In a letter to King & Spalding dated September 27, 2000, Mr. Maxey represented that Enron Liquid’s current and accumulated earnings and profits for taxable year ended December 31, 1998, exceeded the aggregate amount of the promissory notes and cash transferred by Enron Liquids in connection with the March 31, 1998 redemption.

<sup>404</sup> *Id.*, at EC2 000033830.

<sup>405</sup> Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 25.

<sup>406</sup> *Id.*, at answer 26.

Although the precise exit strategy with respect to Project Teresa is uncertain, it would have involved a reconsolidation of Organizational Partner in the Enron consolidated group.<sup>407</sup> Thereafter, Enron Leasing would be liquidated, with Organizational Partner receiving the Enron North office building in a liquidating distribution (and a tax basis that reflects the gross amount of Enron Leasing's dividend income). This was projected to occur in 2003. At such time, Organizational Partner would begin to recover the increased tax basis via higher depreciation deductions.

The diagram on the next page depicts the general structure of Project Teresa as of December 2001.

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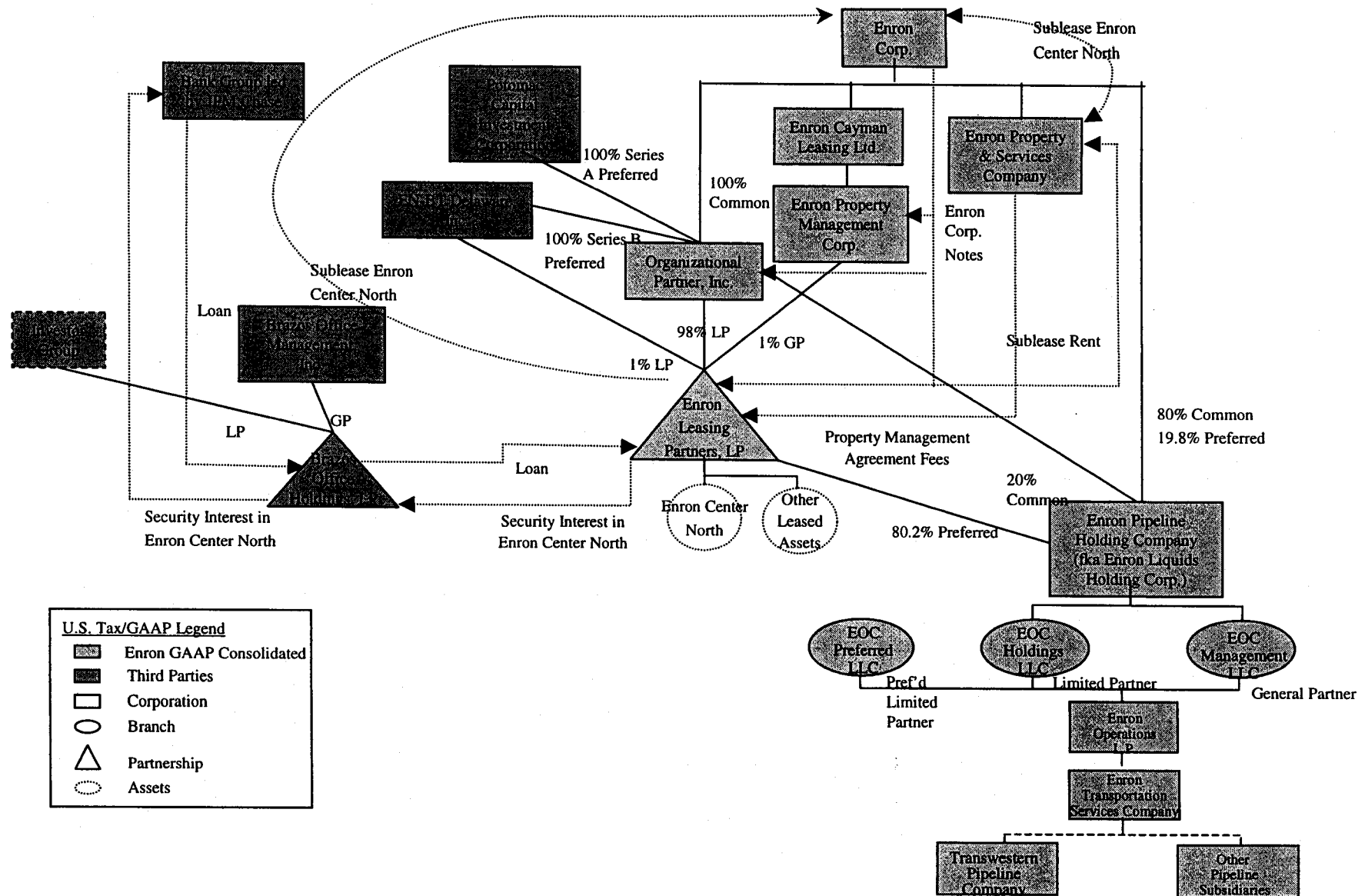
<sup>407</sup> At any time after April 30, 2002, Organizational Partner had the option to redeem all the OPI preferred stock from Bankers Trust and Potomac Capital. Similarly, at any time after December 31, 2003, Bankers Trust and Potomac Capital had the right to force Organizational Partner to redeem the OPI preferred stock.



# Project Teresa Structure as of December 2001

Confidential

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### Role of outside advisors

Bankers Trust promoted the transaction to Enron. A schedule of fees presented at the March 25, 1997, Board of Directors Executive Committee meeting shows that Bankers Trust was to receive a fee of \$11 million in connection with Project Teresa -- an amount representing approximately one percent of the increased basis in the partnership as a result of the deemed dividends. In 1998, the fee was reduced by \$1.375 million to compensate Enron for its role as an accommodation party to Bankers Trust in connection with Project Renegade.<sup>408</sup> The fee to Bankers Trust was to be paid over time as follows: \$6.2 million in 1997; \$1.1 million in 1998; \$1.2 million in 1999; \$1.2 million in 2000 and \$1.2 million in 2001.<sup>409</sup> According to Enron records, as of June 2001, Bankers Trust had received fees of \$8.839 million in connection with Project Teresa.<sup>410</sup>

Enron relied on King & Spalding for its legal representation in connection with Project Teresa. The schedule of fees presented at the March 25, 1997, Executive Committee meeting shows that King & Spalding was to receive a fee of \$1 million in connection with Project Teresa, which was to be paid after the close of the deal when the tax opinion was rendered.<sup>411</sup>

In the tax opinion, King & Spalding concluded that (1) the payment by Enron Pipeline to Enron Leasing for the purchase of the Enron Liquids preferred stock "should" be treated as a distribution in redemption of the stock of Enron Pipeline; (2) the distribution "should" be treated as a dividend distribution; (3) the adjusted basis of the Enron Liquids preferred stock retained by Enron Leasing "should" be increased by an amount equal to Enron Leasing's adjusted basis in the Enron Liquids preferred stock sold to Enron Pipeline; (4) the adjusted basis of Organizational Partner's interest in Enron Leasing "should" be increased by its distributive share of the dividend; (5) for purposes of the dividends received deduction, Organizational Partner "should" be treated as having received its distributive share of the dividend from Enron Pipeline; (6) it is "more likely than not" that Organizational Partner will be treated as owning 20 percent or more of the stock of Enron Pipeline for purposes of the dividends received deduction; and (7) the extraordinary dividend rules "should" not apply to the redemption transaction.<sup>412</sup> According to

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<sup>408</sup> Project Renegade is discussed in detail in the section of the Report that describes transactions in which Enron acted as an accommodation party.

<sup>409</sup> Executive Board Meeting -- Project Teresa, March 25, 1997, schedule of fees, EC2 000037962.

<sup>410</sup> The General Background Materials in Appendix B contain the Estimated Project Fees schedule (6/4/2001), EC2 000036379. According to current Enron management, no subsequent payments have been made. Letter from Enron's counsel (Skadden Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 30.

<sup>411</sup> Executive Board Meeting -- Project Teresa, March 25, 1997, schedule of fees, EC2 000037962.

<sup>412</sup> Appendix C, Part V, contains the King & Spalding opinion letter to R. Davis Maxey, by Abraham N.M. Shashy, Jr. for himself and William S. McKee, dated July 29, 1997.

Enron records, as of June 2001, King & Spalding had received fees of \$1.046 million in connection with Project Teresa.<sup>413</sup>

The accounting firm of Ernst & Young provided an opinion letter regarding the effects on Enron Liquids earnings and profits resulting from Enron's contribution of the Enron Pipeline stock to Enron Operations Corp.

In addition to the fees paid to Bankers Trust and King & Spalding, Enron records reflect that it paid \$250,000 of fees to others, bringing the total amount of fees paid with respect to Project Teresa to \$10.135 million.

Appendix C, Part V, to this Report contains the tax opinion letters Enron received in connection with Project Teresa.

### Subsequent developments

Organizational Partner defaulted on its dividend payments to Potomac Capital and EN-BT Delaware in connection with the OPI preferred stock. Enron Corp. is in default under its sublease agreement with Organizational Partner with respect to the Enron North office building, though a standstill agreement has prevented the lenders from foreclosing on the building. The intercompany receivables were partially written off in December 2001. Potomac Capital and EN-BT Delaware continue to hold their OPI preferred stock. No steps have been taken to unwind the structure.<sup>414</sup>

The IRS is in the process of auditing Enron's tax returns for years 1996 through 2001. Enron received a tax shelter registration number in connection with Project Teresa.

### Discussion<sup>415</sup>

Project Teresa was an elaborate structure designed to achieve a financial statement benefit that results from a shift of \$1 billion in tax basis from a nondepreciable asset (i.e., the Enron Liquids preferred stock) to depreciable assets (the most significant asset being the Enron North office building) via the use of a partnership that Enron controlled. Project Teresa used the related party redemption rules and the dividends received deduction to generate additional tax basis (in excess of book basis). The partnership structure was necessary to accomplish the basis shift. In essence, Enron was willing to incur income tax on 20 cents of each dollar of dividend

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<sup>413</sup> The General Background Materials in Appendix B contain the Estimated Project Fees schedule (6/4/2001), EC2 000036379.

<sup>414</sup> The Project Teresa materials in Appendix B contain the Project Teresa deal basics, EC2 000037870; Letter from Enron's counsel (Skadden Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answers 27, 31.

<sup>415</sup> Enron's bankruptcy effectively prevents Enron from realizing the tax benefits that were contemplated in Project Teresa. Nevertheless, this section discusses the tax benefits that Enron sought to achieve from the transaction (without regard to the bankruptcy).

income (borne by Organizational Partner, a deconsolidated subsidiary of Enron) in exchange for one dollar of future depreciation deductions.

Under the strategy devised in Projects Teresa, the benefits of the increased tax basis (in the form of greater depreciation deductions on the Enron North office building) would inure over a 39-year period and was not expected to be reflected in Enron's consolidated tax return until 2003. However, and potentially more important to Enron, the strategy permitted Enron to begin recording the benefits immediately for financial accounting purposes.<sup>416</sup>

Key to the success of Project Teresa was Organizational Partner's ability to receive a basis increase for the gross amount of the dividends received notwithstanding that 80 percent of such dividends were exempt from tax by virtue of the dividends received deduction. To accomplish this result, the redemption transactions had to be structured in a manner that would (1) generate dividend income (thus making them eligible for a dividends received deduction) and (2) avoid the application of the extraordinary dividend rules (which would require a basis reduction equal to the amount of the dividends received deduction). In addition, the redeeming corporation needed to have sufficient earnings and profits (so that the distributions are treated as dividends).

Also critical to Project Teresa was the use of a partnership. The partnership structure provided the mechanism to achieve the basis shift from the Enron Liquids preferred stock to the Enron North office building. The basis shift would have occurred on a liquidating distribution of the Enron North office building to Organizational Partner.<sup>417</sup>

#### Redemption transactions

As an initial matter, the redemption transactions had to involve a corporation that was not included in Enron's consolidated return because the consolidated return regulations generally reduce basis for untaxed dividends within a consolidated group. This explains why Organizational Partner was capitalized with stock with voting rights that differed from its value. By owning stock that represented 98 percent of Organizational Partner's value but only 75 percent of its voting power, Enron was able to exercise de facto control over the entity without causing it to be a member of Enron's consolidated group. Some might question Enron's non-tax business reason for allowing purported third parties to purchase a 25-percent voting interest in a

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<sup>416</sup> See the Background and Rationale section to this part of the Report which contains a general explanation of relevant aspects of Financial Accounting Standard No. 109, Accounting for Income Taxes.

<sup>417</sup> Section 732(b), which is discussed in greater detail in the next section of this Report (in connection with the partnership transactions), provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest is equal to the partner's adjusted basis in the partnership interest reduced by any money distributed in the same transaction.

company that was valued at over \$1 billion for only \$22.4 million, and whether Bankers Trust and Potomac Capital were truly independent third parties.<sup>418</sup>

The stock redemptions had to be structured in a way that would generate dividend income to Enron Leasing (the partnership that was 98 percent owned by Organizational Partner). The 1997 related party redemption (Enron Pipeline's purchase of 1,980 shares of Enron Liquids preferred stock from Enron Leasing) was structured as a redemption between related corporations.<sup>419</sup> By virtue of the applicable constructive ownership rules, Enron Leasing arguably was in control of both Enron Pipeline and Enron Liquids, and the redemption did not result in a diminution of Enron Leasing's stock interest in Enron Liquids.<sup>420</sup> Therefore, the parties characterized the transaction as a distribution in redemption of Enron Pipeline stock, with the result that the redemption was treated as a dividend. In the years subsequent to 1997, the redemptions took the form of pro-rata redemptions by Enron Liquids. A change to the extraordinary dividend rules in 1997 (discussed below) necessitated the change to a pro-rata redemption.

Also critical to the transaction is that any resulting dividend must qualify for the dividends received deduction. In a partnership structure, each partner takes into account separately its distributive share of certain partnership items, including dividends with respect to which a dividends received deduction is applicable.<sup>421</sup> In Project Teresa, Organizational Partner claimed an 80 percent dividends received deduction.<sup>422</sup>

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<sup>418</sup> As previously noted, after April 30, 2002, Organizational Partner had the option to redeem all the OPI preferred stock from Bankers Trust and Potomac Capital. Similarly, at any time after December 31, 2003, Bankers Trust and Potomac Capital had the right to force Organizational Partner to redeem the OPI preferred stock.

<sup>419</sup> See sec. 304(a)(1).

<sup>420</sup> In determining whether the acquisition is treated by reason of section 302(b) as a distribution in part or full payment in exchange for the stock, reference is made to Enron Leasing's ownership of the Enron Liquids stock. Sec. 304(b)(1).

<sup>421</sup> Sec. 702(a)(5). A partner will increase its basis in its partnership interest by that partner's distributive share of partnership income, including dividend income. Sec. 705(a).

<sup>422</sup> The issue is whether Organizational Partner qualifies for the 80 percent dividends received deduction (as opposed to a 70 percent deduction) by virtue of stock ownership through a partnership. As noted in the discussion of the relevant corporate tax laws, the Treasury Department has permitted stock ownership thresholds to be met by virtue of stock ownership through a partnership. See, Rev. Rul. 71-141, 1971-1 C.B. 211; see also, T.D. 8708, 62 Fed. Reg. 923, 924 (January 7, 1997) (for purposes of section 902, domestic shareholder includes a domestic corporation that "owns" the requisite voting stock in a foreign corporation rather than one that "owns directly" the voting stock; IRS is still considering under what other circumstances Rev. Rul. 71-141 should apply).

### Extraordinary dividend rules

In addition to generating dividend income that qualifies for a dividends received deduction, Project Teresa had to be structured in a manner so as not to implicate the extraordinary dividend rules. If the dividend that Organizational Partner received as part of its distributive share of Enron Leasing income were treated as an extraordinary dividend, then Organizational Partner would be forced to reduce its basis in its partnership interest by the untaxed portion of the dividend, thereby eliminating an important aspect of the transaction.<sup>423</sup>

Congress enacted the extraordinary dividend rules in 1984 in response to a tax-motivated transaction (known as a “dividend strip” transaction) in which a corporation would acquire dividend-paying stock shortly before the stock’s ex-dividend date, receive a dividend that is eligible for a dividends received deduction, and then sell the stock for a short-term capital loss.<sup>424</sup> The extraordinary dividend rules provide that if a corporation receives an extraordinary dividend with respect to stock and the corporation has not held the stock for more than two years after the dividend announcement date, then the corporation’s basis in the stock is reduced (but not below zero) by the non-taxed portion of the dividends.<sup>425</sup> The non-taxed portion of the dividend generally is the amount of the dividends received deduction with respect to the dividend.<sup>426</sup>

While the original purpose of the extraordinary dividend rules was to prevent dividend strip transactions, Congress in recent years has expanded the scope of the extraordinary dividend rules to address other tax-motivated transactions that exploit the dividends received deduction. Of particular relevance to Project Teresa was the change made in 1997, in which the extraordinary dividend rules were expanded to treat certain dividends resulting from a related party redemption as an extraordinary dividend (thus resulting in a basis reduction equal to the amount of the dividends received deduction).<sup>427</sup> The law change was necessary because

“Section 304 is directed primarily at preventing a controlling shareholder from claiming basis recovery and capital gain treatment on transactions that result in a

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<sup>423</sup> In addition, Enron Leasing would have to adjust its basis in the Enron Liquids preferred stock.

<sup>424</sup> Joint Committee on Taxation, *General Explanation of the Revenue Provisions of The Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, at 138-39.

<sup>425</sup> Sec. 1059(a)(1). If the non-taxed portion of the dividends exceeds the corporation’s basis in the stock, then the excess is treated as gain for the taxable year in which the extraordinary dividend is received. Sec. 1059(a)(2).

<sup>426</sup> Sec. 1059(b).

<sup>427</sup> Taxpayer Relief Act of 1997, Pub. L. No. 105-34, section 1013(b) (August 5, 1997) (effective for distributions and acquisitions after June 8, 1997). Specifically, section 1059(e)(1)(A)(iii)(II) provides that if a redemption of stock would not have been treated (in whole or in part) as a dividend absent section 304, then any amount treated as a dividend with respect to such redemption is treated as an extraordinary dividend.

withdrawal of earnings from corporate solution. . . . Different concerns may be present if the shareholder is a corporation, due in part to the availability of the dividends received deduction.”<sup>428</sup>

Enron Pipeline’s 1997 purchase of 1,980 shares of Enron Liquids preferred stock from Enron Leasing raised a number of issues regarding the potential application of the extraordinary dividend rules to the related party redemption.<sup>429</sup> These issues were rendered moot by the 1997 expansion of the extraordinary dividend rules. However, by modifying the transaction to make it a pro-rata redemption (and thus avoiding the related party redemption rules), Enron avoided the effects of the 1997 law change and continued to claim the desired benefits from Project Teresa.

#### Earnings and profits in a consolidated group

A distribution with respect to stock (including certain redemptions) is treated as a dividend only to the extent that the distribution is from the corporation’s current or accumulated earnings and profits.<sup>430</sup> Enron contributed stock in Enron Pipeline to Enron Operations Corp. (a subsidiary of Enron Liquids) apparently in an effort to bolster the earnings and profits of Enron Liquids.<sup>431</sup>

There is little guidance regarding the tiering up of earnings and profits when the location of a member within a consolidated group changes. Two examples in the consolidated return regulations provide that “appropriate adjustments must be made to the members to prevent earnings and profits from being eliminated.”<sup>432</sup> The regulations also provide an anti-avoidance

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<sup>428</sup> Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), December 17, 1997, at 207.

<sup>429</sup> For a detailed discussion of these issues, *see* the King & Spalding opinion letter to R. Davis Maxey, by Abraham N.M. Shashy, Jr. for himself and William S. McKee, dated July 29, 1997, Appendix C, Part V, at 28-36.

<sup>430</sup> Sec. 316(a).

<sup>431</sup> *See*, tax opinion by Kevin A. Duvall of Ernst & Young to R. Davis Maxey, dated November 16, 1999, Appendix C, Part V. The sole issue raised in this tax opinion was the extent to which Enron Corp.’s contribution of Enron Pipeline stock will result in Enron Pipeline’s earnings and profits being replicated in the earnings and profits of Enron Operations Corp. and Enron Liquids. The opinion letter concludes that, “more likely than not,” Enron Pipeline’s earnings and profits will be replicated, and therefore, Enron Liquids should have sufficient earnings and profits to treat \$237 million of distributions and stock redemptions in 1999 as dividends for purposes of section 301.

<sup>432</sup> Treas. Reg. sec. 1.1502-33(f)(2). The regulations appear to focus on the elimination of earnings and profits through changing the location of a member within a group rather than the replication of earnings and profits.

rule warning that adjustments must be made as necessary to carry out the purpose of the section.<sup>433</sup>

### Partnership issues

As previously noted, the partnership structure was essential in order to achieve the basis shift. Although the precise exit strategy with respect to Project Teresa is uncertain, it presumably involved Organizational Partner exercising its option to redeem all the OPI preferred stock from Bankers Trust and Potomac Capital (resulting in a reconsolidation of Organizational Partner in the Enron consolidated group). Thereafter, Enron Leasing would be liquidated, with Organizational Partner receiving the Enron North office building in a liquidating distribution with a tax basis that reflects the gross amount (not the taxed amount) of Enron Leasing's dividend income. Organizational Partner would recover the increased tax basis via higher depreciation deductions. If a section 754 election were not in effect, then any remaining asset owned by Enron Leasing would retain its basis (when the Enron North office building is distributed to Organizational Partner).<sup>434</sup>

The Treasury Department has issued regulations that apply the extraordinary dividend rules to partnerships.<sup>435</sup> Known as the partnership anti-abuse regulations,<sup>436</sup> the regulations state that if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate Federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for Federal tax purposes to achieve tax results that are consistent with the intent of subchapter K.<sup>437</sup> Under this theory, Enron Leasing should be viewed as inconsistent with the intent of subchapter K, considering that (1) the predominant purpose for the formation of Enron Leasing was to generate income for financial accounting purposes,<sup>438</sup> (2) the financial accounting income was attributable solely to the shifting of tax basis to depreciable assets (in

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<sup>433</sup> Treas. Reg. sec. 1.1502-33(g).

<sup>434</sup> As discussed in greater detail in the next section of this Report (in connection with the partnership tax laws), a section 754 election may have required a downward basis adjustment with respect to the assets owned by Enron Leasing following the liquidating distribution.

<sup>435</sup> Sec. 1059(g); Treas. Reg. sec. 1.701-2(f) example 2 (a partnership comprised of two corporate partners that receives an extraordinary dividend has to make appropriate basis adjustments).

<sup>436</sup> The partnership anti-abuse regulations are discussed in greater detail in connection with transactions that raise partnership tax issues.

<sup>437</sup> Treas. Reg. sec. 1.701-2(b). For a discussion of why the partnership anti-abuse rules should not apply to Enron Leasing, *see* the King & Spalding opinion letter to R. Davis Maxey, by Abraham N.M. Shashy, Jr. for himself and William S. McKee, dated July 29, 1997, Appendix C, Part V, at 38-44.

<sup>438</sup> *Id.*, at 37-38.



excess of book basis),<sup>439</sup> and (3) the accounting benefits of the transaction could not be accomplished without the partnership.<sup>440</sup> Such a conclusion is further supported by recent court decisions that have rejected the existence of an otherwise valid partnership because of the lack of a non-tax business purpose.<sup>441</sup>

## **Recommendations**

In order to achieve the desired tax results from Project Teresa, Enron needed the assistance of an unrelated accommodation party. Bankers Trust, which was the promoter and (along with Potomac Capital) an investor in Project Teresa, facilitated the planned temporary deconsolidation of Organizational Partner (which gave rise to the dividends received deduction). Bankers Trust also participated in the partnership structure (through which the basis shift was accomplished). The following specific recommendations are perhaps appropriate to address specific issues raised by Project Teresa. However, specific tax rules cannot adequately address the broader concerns that arise when an accommodation party acts in concert with a taxpayer to achieve a desired tax result. Implicit in the income tax system is an assumption that unrelated parties have adverse economic interests. When this paradigm breaks down, it is not surprising that the tax laws generate unwarranted results. Transactions with accommodation parties must be addressed by a rigorous application of the various common-law doctrines applicable to tax motivated transactions.<sup>442</sup>

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<sup>439</sup> The argument that a financial accounting benefit constitutes a substantial non-tax business purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a non-tax business purpose requirement. *See, e.g., American Electric Power, Inc. v. U.S.*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) (“AEP’s intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings ‘were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,’” citing *Winn-Dixie v. Commissioner*, 113 T.C. 254, 287 (1999)).

<sup>440</sup> *See*, the King & Spalding opinion letter to R. Davis Maxey, by Abraham N.M. Shashy, Jr. for himself and William S. McKee, dated July 29, 1997, Appendix C, Part V, at 40.

<sup>441</sup> *See, e.g., Boca Investorings Partnership v. U.S.*, 2003 U.S. App. LEXIS 429 at \*12 (D.C. Cir. Jan. 10, 2003) (“As we noted in *Saba Partnership*, ‘ASA makes clear that the absence of a nontax business purpose is fatal to the argument that the Commissioner should respect an entity for federal tax purposes,’” citing *Saba Partnership*, 273 F.3d at 1141 (quoting *ASA Investorings*, 201 F.3d at 512).

<sup>442</sup> 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

Similarly, the partnership anti-abuse rules were promulgated to deter partnership arrangements in which the principal purpose is to reduce taxes in a manner that is inconsistent with the intent of the partnership tax rules. In Project Teresa, the principal purpose for Enron Leasing appears to have been to facilitate the shifting of tax basis from a nondepreciable asset to depreciable assets (in excess of book basis). If this conclusion is correct, then the partnership anti-abuse regulations should be available to recast the transaction as appropriate. If the partnership anti-abuse regulations do not apply to a transaction such as Project Teresa, then the regulations need to be reevaluated.

In terms of specific recommendations, the extraordinary dividend rules were amended in 1997 to prevent a controlling corporate shareholder from structuring a redemption transaction with a related party to take advantage of the dividends received deduction. Enron concluded that it could circumvent the 1997 law change and continue to claim the desired benefits from Project Teresa. The Joint Committee staff recommends that the extraordinary dividend rules should be further strengthened.

In addition, while guidance exists to prevent the inappropriate elimination of earnings and profits, the Joint Committee staff believes that additional guidance is needed to address situations in which a consolidated group is attempting to create or replicate earnings and profits in a manner inconsistent with the purpose of the consolidated return rules.

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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).

## C. Transactions That Raise Partnership Tax Issues

Several of Enron's structured transactions relied on partnership tax rules to shift basis to assets that would be depreciated or sold, in order to maximize depreciation deductions or minimize taxable gain on sale. The reported tax benefits (and corresponding financial statement benefits) depended on the application of partnership tax rules, including rules that require allocation of tax attributes associated with contributed assets, and rules that permit basis to be shifted to partnership assets when the partnership makes distributions. For example, Project Tomas (done in 1998) relied on some of these rules in order to dispose of a portfolio of low-basis leased assets without gain recognition. Projects Condor (done in 1999) and Tammy I and II (done in 2000 and 2001) also relied on these rules to shift basis to depreciable assets. The "unwind" strategies of Projects Condor, Tammy I and Tammy II also relied on rules protecting a corporation from recognition of gain on the sale or exchange of its stock.<sup>443</sup>

This section of the Report begins with a brief discussion of relevant partnership tax rules and then describes in detail Projects Tomas, Condor, Tammy I and Tammy II.

### 1. Discussion of relevant partnership tax law rules

#### In general

In general, partnerships are not treated as separate taxpayers for Federal income tax purposes. The income of the partnership is taxed to the partners. Items of income, gain, loss, deduction and credit generally are allocated to the partners in accordance with the partnership agreement. Partnership income, unlike corporate income, is thus subject to one level of Federal income tax, which is imposed at the partner level. As a result of the different tax rules applying to partnerships and corporations, taxpayers have structured transactions attempting to combine the benefits contained in each set of rules.<sup>444</sup>

The four structured transactions undertaken by Enron that are described in this section of the Report (Projects Tomas, Condor, and Tammy I and II) utilize the partnership tax rules, and their interaction with corporate tax rules, to attempt to achieve favorable tax treatment.

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<sup>443</sup> Sec. 1032. This rule of present law is described above in Part III.A.1., Discussion of relevant corporate tax laws.

<sup>444</sup> For an example of taxpayers attempting to take advantage of the benefits of both the corporate and partnership rules, *see* Prop. Treas. Reg. sec. 1.337(d)-3 (gain recognition upon certain partnership transactions involving a corporate partner's stock), Notice 89-37, 1989-1 C.B. 679, and Notice 93-2, 1993-2 C.B. 292.

## **Contributions to partnerships generally tax-free**

Generally, a partner does not recognize any gain or loss on a contribution of property to a partnership.<sup>445</sup> The partnership also does not recognize gain or loss when property is contributed.

## **Liquidation of a partner's interest**

### **Tax-free distributions of partnership property**

Generally, a partner and the partnership do not recognize gain or loss on the distribution of partnership property.<sup>446</sup> This includes distributions in liquidation of a partner's interest. There are, however, a number of exceptions to this general rule of non-recognition on a distribution of partnership property.

### **Taxable partnership distributions**

One such exception is that a partner must recognize gain to the extent that any money distributed exceeds the partner's basis in its partnership interest immediately before the distribution.<sup>447</sup>

Two additional exceptions, enacted in 1989 and 1992, provide that gain or loss is recognized on a distribution of partnership property, if a partner contributed property with built-in gain or built-in loss, and either (1) the property is distributed to another partner within seven years of its contribution, or (2) the contributing partner receives a distribution of other property within seven years of the contribution.<sup>448</sup>

In general, this gain recognition rule does not apply to a distribution of property that the distributee partner contributed to the partnership.<sup>449</sup> However, if the property distributed is an interest in an entity (e.g., corporate stock), the exception from gain recognition does not apply to the extent the value of the interest is attributable to property contributed to the entity after the entity was contributed to the partnership.

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<sup>445</sup> Sec. 721(a).

<sup>446</sup> Sec. 731(a) and (b).

<sup>447</sup> Sec. 731(a)(1). The term "money" includes marketable securities; however, marketable securities are excluded from the definition of money for purposes of gain recognition on the distribution if the distributee partner contributed the security to the partnership. Sec. 731(c).

<sup>448</sup> Secs. 704(c)(1)(B) and 737.

<sup>449</sup> Secs. 704(c)(1)(B) and 737(d).

### Tax basis of distributed property received in liquidation of partnership interest

The basis of property distributed in liquidation of a partner's interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction).<sup>450</sup>

### Election to adjust basis of partnership property

When a partnership distributes partnership property, generally, the basis of partnership property is not adjusted to reflect the effects of the distribution or transfer. The partnership is permitted, however, to make an election (referred to as a 754 election) to adjust the basis of partnership property in the case of a distribution of partnership property.<sup>451</sup> The effect of the 754 election is that the partnership adjusts the basis of its remaining property to reflect any change in basis of the distributed property in the hands of the distributee partner resulting from the distribution transaction. Such a change could be a basis increase due to gain recognition, or a basis decrease due to the application of a limitation, for example. If the 754 election is made, it applies to the taxable year with respect to which such election was filed and all subsequent taxable years.

In the case of a distribution of partnership property to a partner with respect to which the 754 election is in effect, the partnership increases the basis of partnership property by (1) any gain recognized by the distributee partner (2) the excess of the adjusted basis of the distributed property to the partnership immediately before its distribution over the basis of the property to the distributee partner, and decreases the basis of partnership property by (1) any loss recognized by the distributee partner and (2) the excess of the basis of the property to the distributee partner over the adjusted basis of the distributed property to the partnership immediately before the distribution. The allocation of the increase or decrease in basis of partnership property is made in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties.<sup>452</sup>

### Disguised sales of property through partnerships

In 1984, Congress enacted a rule providing that if there is a transfer of money or other property by a partner to a partnership and there is a related transfer of money or other property by the partnership to such partner, the two transfers (when viewed together) may be properly characterized as a taxable sale or exchange of property.<sup>453</sup>

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<sup>450</sup> Sec. 732(b).

<sup>451</sup> Sec. 754.

<sup>452</sup> Sec. 755.

<sup>453</sup> Sec. 707(a)(2)(B). Treasury, in regulations issued in 1956, had recognized the possibility that a contribution of property coupled with a distribution of money or other consideration may, in substance, be a sale or exchange of property. See Treas. Reg. secs. 1.721-1(a) and 1.731-1(c)(3).

The regulations provide that a transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances (1) the transfer of money or other consideration would not have been made but for the transfer of property and (2) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.<sup>454</sup> The regulations then provide ten factors that may tend to prove the existence of a sale.<sup>455</sup>

If the two transfers are made within a two-year period (without regard to the order of the transfers), then the transfers are presumed to be a sale of the property unless the facts and circumstances clearly establish otherwise.<sup>456</sup> If, however, the two transfers are more than two years apart, then the transfers are presumed not to be a sale of the property unless the facts and circumstances clearly establish otherwise.<sup>457</sup>

### **Adjustment to basis of assets of a distributed corporation controlled by a corporate partner**

In December 1999, Congress enacted a rule requiring a reduction in the basis of stock distributed by a partnership to a corporate partner, in certain circumstances. The provision was enacted in response to the perceived abuse of the interaction of the tax-favored treatment of partnership distributions and the tax-free treatment of certain corporate liquidations.<sup>458</sup> The Congress was concerned that the downward adjustment to the basis of property distributed by a partnership to a low-basis partner may be nullified if the distributed property is corporate stock. The corporate partner could then liquidate the distributed corporation, eliminating the stock and owning assets directly, so that the stock basis reduction would have no effect.<sup>459</sup>

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<sup>454</sup> Treas. Reg. sec. 1.707-3(b)(1).

<sup>455</sup> Treas. Reg. sec. 1.707-3(b)(2).

<sup>456</sup> Treas. Reg. sec. 1.707-3(c)(1).

<sup>457</sup> Treas. Reg. sec. 1.707-3(d).

<sup>458</sup> Sec. 732(f) was enacted in the Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, section 538(a) (December 17, 1999). Section 732(f) is effective for distributions made after July 14, 1999. However, in the case of a corporation that is a partner in a partnership as of July 14, 1999, section 732(f) is effective for distributions made to that partner from that partnership after June 30, 2001 (approximately a two-year deferred effective date).

<sup>459</sup> Generally, section 332 provides that no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation in which it holds 80 percent of the stock (by vote and value).

The provision provides for a basis reduction to assets of a corporation, if stock in that corporation is distributed by a partnership to a corporate partner, and after the distribution the corporate partner controls the distributed corporation.<sup>460</sup> The amount of the reduction in basis of property of the distributed corporation generally equals the amount of the excess of (1) the partnership's adjusted basis in the stock of the distributed corporation immediately before the distribution over (2) the corporate partner's basis in that stock immediately after the distribution.<sup>461</sup>

### **Partnership allocations with respect to contributed property**

#### Allocations to contributing and non-contributing partners to reflect pre-contribution gain or loss

The partnership rules generally provide that a partner's distributive share of partnership income, gain, loss, or deduction is allocated to the partner in accordance with the partner's interest in the partnership.<sup>462</sup> However, a special rule requires that income, gain, loss, and deduction with respect to contributed property must be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution to the partnership.<sup>463</sup> The purpose of this rule is to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. Under regulations promulgated by the Treasury Department, three different allocation methods are generally reasonable in carrying out the purpose of this rule.<sup>464</sup> However, an allocation method (or combination of methods) is not reasonable if the contribution of property and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.<sup>465</sup>

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<sup>460</sup> For this purpose, the term "control" means ownership of stock meeting the requirements of section 1504(a)(2) (generally, an 80-percent vote and value requirement).

<sup>461</sup> Sec. 732(f)(1). The provision limits the amount of the basis reduction in two respects. First, the amount of the basis reduction may not exceed the amount by which (1) the sum of the aggregate adjusted bases of the property and the amount of money of the distributed corporation exceeds (2) the corporate partner's adjusted basis in the stock of the distributed corporation. Second, the amount of the basis reduction may not exceed the adjusted basis of the property of the distributed corporation. Sec. 732(f)(3).

<sup>462</sup> Sec. 704(b).

<sup>463</sup> Sec. 704(c).

<sup>464</sup> The methods are the traditional method, the traditional method with curative allocations, and the remedial method. Treas. Reg. sec. 1.704-3.

<sup>465</sup> Treas. Reg. sec. 1.704-3(a)(10).

### Sale of partnership interest with pre-contribution gain or loss

If a contributing partner transfers a partnership interest, pre-contribution built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner.<sup>466</sup> If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner.<sup>467</sup>

### Basis of a partner's interest in a partnership

In general, a partner's basis in its partnership interest is increased by that partner's distributive share of partnership income and is decreased by that partner's distributive share of partnership losses.<sup>468</sup> Increasing the partner's basis in this manner ensures that a partner is taxed only once on its distributive share of partnership income, and deducts its share of partnership loss only once. In addition, a partner's basis is increased by the partner's distributive share of non-taxable income so that the partner does not lose the benefit of that type of income.

### Sale of stock contributed to a partnership

In Rev. Rul. 99-57,<sup>469</sup> the IRS addressed the tax treatment of gain on the sale of a corporate partner's stock that it had previously contributed to the partnership. In the ruling, the IRS concluded that the corporate partner's share of the gain resulting from the partnership's sale of the stock was not subject to tax. Effectively, the IRS treated the corporate partner as owning an undivided interest in its own corporate stock, and that as such it does not recognize gain or loss on the receipt of money or other property in exchange for the its own stock.<sup>470</sup> In addition, the corporate partner increased its basis in its partnership interest thereby preserving the non-recognition result of the transaction in accordance with the policy underlying section 1032 (preventing a corporation from recognizing gain or loss when dealing in its own stock). A similar analysis would apply to a transaction in which a corporate partner is allocated a loss from a transaction involving the disposition of stock of the corporate partner held by the partnership.

In Notice 99-57,<sup>471</sup> the IRS stated its intent to promulgate regulations under section 705 to address certain situations in which gain or loss may be improperly created by adjusting the

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<sup>466</sup> Treas. Reg. sec. 1.704-3(a)(7).

<sup>467</sup> *Id.*

<sup>468</sup> Sec. 705(a).

<sup>469</sup> 1999-2 C.B. 678 (Dec. 20, 1999). For an example of an earlier agency decision applying partnership aggregate principles to section 1032, see Priv. Ltr. Rul. 9822002 (Oct. 23, 1997).

<sup>470</sup> Section 1032.

<sup>471</sup> 1999-2 C.B. 693 (Dec. 20, 1999).



basis of a partnership interest for partnership income that is not subject to tax, or for partnership losses or deductions that are permanently denied, with respect to a partner. The regulations will apply to situations in which a corporation acquires an interest in a partnership that holds stock in that corporation, and a section 754 election is not in effect. In those situations, a corporate partner may increase the basis in its partnership interest under section 705 only by the amount of its portion of the section 1032 gain that the partner would have realized had a section 754 election been made. The IRS also stated that the regulations will apply to situations in which the price paid for a partnership interest reflects built-in gain or accrued income items that will not be subject to income tax, or built-in loss or accrued deductions that will be permanently denied, when allocated to the transferee partner, and the partnership has not made a section 754 election. The IRS also warned that it may challenge any transaction within the scope of the Notice under the anti-abuse provisions of Treas. Reg. sec. 1.701-2.<sup>472</sup>

#### Proposed regulations on partnership distributions of corporate stock

Similarly, under Notice 89-37,<sup>473</sup> which was issued in response to a well-known transaction engaged in by the May Company,<sup>474</sup> the IRS addressed certain situations in which gain may be avoided through the use of a partnership and stock of a corporate partner. The notice states that if a partnership distributes to a corporate partner the stock of such corporation or the stock of an affiliate of such corporation after March 9, 1989, the distribution is characterized as a redemption of the corporate partner's stock with "property consisting of its partnership interest." In other words, gain recognition will apply instead of the general partnership non-recognition provisions on distributions of property. In addition, the Notice also states that if a partnership acquires stock of a corporate partner after March 9, 1989, the IRS intends to treat the acquisition as resulting in a "deemed redemption" of the corporate partner's stock.<sup>475</sup> In such case, the deemed redemption rule will apply so that "gain will be recognized at the time of, and to the extent that, the acquisition has the economic effect of an exchange by a corporate partner of its interest in appreciated property for an interest in its stock [or stock of an affiliate] owned or acquired by the partnership."

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<sup>472</sup> On January 3, 2001, the Treasury and the IRS published a notice of proposed rulemaking under section 705 (REG-106702-00, 2001-4 I.R.B. 424). On March 28, 2002, the Treasury and the IRS issued final regulations under section 705 (T.D. 8986, 67 Fed. Reg. 15112 (March 29, 2002)). On March 28, 2002, the Treasury Department and the IRS issued a notice of proposed rulemaking under section 705, addressing remaining issues that Treasury and the IRS considered during the development of the final regulations (REG-16748-01, 67 Fed. Reg. 15132 (March 29, 2002)).

<sup>473</sup> 1989-1 C.B. 679.

<sup>474</sup> In this transaction, a corporate partner contributed property with a built-in gain to a partnership. The partnership made a distribution of corporate stock.

<sup>475</sup> In the Notice, the IRS stated that the deemed redemption rule would apply to other transactions, including partnership purchases of a corporate partner's stock, disproportionate distributions, and amendments to the partnership agreement.

In December 1992, Treasury issued proposed regulations interpreting the Notice.<sup>476</sup> The proposed regulations, which have not been finalized, describe the tax consequences of a distribution of a partner's stock after the application of the deemed redemption rule.

The IRS has stated "further study is appropriate for cases in which affiliation did not exist prior to a distribution of stock by a partnership to a corporate partner, but rather results from such distribution."<sup>477</sup> As a result, the proposed regulations will be amended to limit their application to cases in which affiliation exists immediately before the deemed redemption or distribution.

### **Partnership anti-abuse regulations**

In late 1994, the Treasury Department issued regulations containing two anti-abuse rules relating to subchapter K. The first rule focuses on the intent of subchapter K, which is to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements: (1) the partnership must be bona fide and each partnership transaction or series of related transactions must be entered into for a substantial business purpose; (2) the form of each partnership transaction must be respected under substance over form principles; and (3) the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partner's economic agreement and clearly reflect the partner's income.<sup>478</sup> If a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate Federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for Federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances.<sup>479</sup>

The second rule permits the Commissioner to treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Code or regulations.<sup>480</sup> However, this second rule does not apply to the extent that a provision of the Code (or regulations) prescribes the treatment of a partnership as an entity, in whole or in part, and that treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.<sup>481</sup>

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<sup>476</sup> PS-91-90, 1993-2 I.R.B. 29; 57 Fed. Reg. 59324 (December 15, 1992).

<sup>477</sup> Notice 93-2, 1993-2 C.B. 292.

<sup>478</sup> Treas. Reg. sec. 1.701-2(a).

<sup>479</sup> Treas. Reg. sec. 1.701-2(b).

<sup>480</sup> Treas. Reg. sec. 1.701-2(e).

<sup>481</sup> *Id.*

## **Summary**

The present-law rules discussed above were integral to effectuating the beneficial tax results sought by Enron in Projects Tomas, Condor, Tammy I, and Tammy II. Project Tomas uses the partnership distribution rules in connection with the corporate tax-free liquidation provisions to generate tax deductions without an economic outlay. Projects Condor, Tammy I, and Tammy II use the partnership allocation rules and the non-recognition treatment accorded to dealings in one's own stock to purportedly enable Enron to generate tax deductions without an economic outlay.

## **2. Project Tomas**

### **Brief overview**

Project Tomas was structured to increase the tax basis of a portfolio of leased assets that Enron liquidated. The increased basis of the assets eliminated approximately \$270 million of taxable gain for Enron on the disposition of the property. The transaction involved the assumption, and repayment, of debt to increase the basis of the assets without an economic outlay. At the same time, Enron took the position that tax savings from the transaction generated financial accounting earnings of \$18.1 million for 1998, and \$18.4 million for 2000.

The transaction involved the formation of a partnership between an existing Enron subsidiary holding low-basis leased assets, and two subsidiaries of Bankers Trust. By contributions to the partnership, and later liquidation of the Enron subsidiary's interest in the partnership, the Bankers Trust subsidiaries acquired the leased assets. Later, through the partnership, they would start to sell them off.

When the partnership was formed, the Enron subsidiary, PGH, contributed both the portfolio of depreciable assets that had high value but a low tax basis, and all the stock of another corporation, Oneida. The Bankers Trust partners contributed cash for small partnership interests. The partnership assumed a large amount of debt. Oneida, the corporation whose stock the partnership held, received valuable assets in the form of notes receivable from a Bankers Trust affiliate. After a period of time, the partnership distributed the stock of Oneida back to the Enron affiliate, PGH, in redemption of its partnership interest. The basis of the Oneida stock was reduced, under the tax law, to equal the amount of PGH's low basis in its partnership interest.

At the same time, the partnership made a 754 election to increase the basis of the depreciable assets it retained. The basis increase was equal to the amount of the reduction in basis of the distributed Oneida stock. No corresponding reduction in the basis of Oneida's assets, however, was required under the law in effect at the time of the transaction. Thus, the basis of those assets was unaffected by the distribution of corporate stock, while the amount of the reduction in stock basis resulting from the distribution was added to the basis of the partnership's remaining assets. In effect, this amount of basis was duplicated in the transaction, and this duplicated amount of basis was shifted from the corporate stock to the partnership's other assets, that is, the portfolio of leased assets. Gain on their later sale would be reduced by this increase in basis.

## **Background**<sup>482</sup>

### Reported tax and financial statement effects

Enron reported that it was not subject to tax on approximately \$270 million of built-in gain.<sup>483</sup> This tax benefit is attributable to the step-up in the basis and subsequent disposition of the leased assets without Federal income tax on the built-in gain.<sup>484</sup> Since the transaction was put in place in 1998, subsequent tax legislation has changed some of the tax results of this type of transaction.<sup>485</sup>

Enron reported annual financial statement benefits from the Tomas transaction of \$18.1 million for 1998, and \$18.4 million for 2000.<sup>486</sup> It is represented that current management is not aware of any reversals of these financial statement benefits.<sup>487</sup>

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<sup>482</sup> The information regarding Project Tomas was obtained from Joint Committee staff interviews of Mr. Hermann and Mr. Maxey, as well as from documents and information provided by Enron and the IRS.

<sup>483</sup> Enron Corp. Presentation to Joint Committee on Taxation staff, Washington, D.C., June 7, 2002, at 26. Appendix B, Part I contains this document.

<sup>484</sup> The Structured Transactions Group, Summaries of Project Earnings and Cash Flows, November 2001 (which is contained in Appendix B, Part I) showed that the estimated current tax benefit attributable to Project Tomas was \$109 million as of the end of 2001.

<sup>485</sup> Sec. 538 of Pub. L. No. 106-170, the "Ticket to Work and Work Incentives Improvement Act of 1999," provided for a corresponding reduction in the basis of assets of a distributed corporation controlled by a corporate partner.

<sup>486</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, January 13, 2003, answer 101.

<sup>487</sup> *Id.* Another Enron calculation of the financial statement benefits of Project Tomas differed. The Structured Transactions Group, Summaries of Project Earnings and Cash Flows, November 2001 (which is contained in Appendix B, Part I) showed that the net income for financial reporting purposes from Project Tomas totalled approximately \$113 million through 2001. The yearly financial statement income or loss shown was \$55.99 million in 1998, \$9.85 million in 1999, and \$51.29 million in 2000, with losses of under \$10 million estimated or projected for 2001 through 2004, and smaller amounts of income projected annually through 2010.

## Development of Project Tomas<sup>488</sup>

Portland General Holdings ("PGH"), a wholly-owned Enron subsidiary acquired in 1997, held "burned-out" leases of depreciable property. These leased assets were held through subsidiaries of PGH. The leased assets consisted of property such as commercial aircraft, containers for containerized shipping, and rail cars, as well as other types of assets such as an acid-recovery plant used in making pickles. The leases were "burned out" in the sense that the tax basis of the leased property had been reduced to approximately \$8 million, a small fraction of the property's value, by depreciation deductions. Nevertheless, the property had substantial economic value of approximately \$280 million (not taking into account nonrecourse debt of approximately \$170 million).

In December of 1997, Enron received a letter from Arthur Andersen regarding a technique for "permanent gain deferral."<sup>489</sup> The letter described "a technique through which a corporate partner may redeem its partnership interest while minimizing any potential tax consequences on the redemption."<sup>490</sup> The letter urged, "[b]ecause of the substantial benefits that the product provides, and the possibility of legislative action, you should be advised to utilize the technique now, as its shelf life may be limited."<sup>491</sup>

At Enron, Project Tomas was approved by the Enron Board of Directors Executive Committee at a meeting on March 2, 1998.<sup>492</sup> At a meeting of the Board of Directors of Enron Corp. on May 4-5, 1998, Mr. John Duncan reported to the Board that the Executive Committee had approved Project Tomas.<sup>493</sup>

Although \$250 million of debt used in the transaction was incurred in July of 1998, the Enron tax department was still considering modifications to the series of transactions involved in Project Tomas during August of 1998.<sup>494</sup>

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<sup>488</sup> Like several other transactions in which Enron affiliates engaged, Project Tomas was named after a recent hurricane beginning with the letter "T."

<sup>489</sup> Letter from Robert P. Palmquist of Arthur Andersen to Mr. David Maxey of Enron dated Dec. 11, 1997, EC2 000038050 - EC2 000038052.

<sup>490</sup> *Id.*

<sup>491</sup> *Id.*

<sup>492</sup> Minutes, Meeting of the Executive Committee of the Board of Directors, Enron Corp., March 2, 1998, EC2 000037991 - EC2 000037994.

<sup>493</sup> Minutes, Meeting of the board of Directors, Enron Corp., May 4-5, 1998, EC2 000037995 - EC2 000037996.

<sup>494</sup> Project Tomas, August 4, 1998, EC2 000038005 - EC2 000038018; Project Tomas, August 14, 1998, EC2 000038019 - EC2 000038032.

Project Tomas' tax goal was to increase the tax basis of the "burned-out" leased property without incurring tax, permitting elimination or reduction of gain (or increase of loss) on the later sale of the depreciable property (or greater depreciation deductions in the future). The transaction was designed to result in the liquidation of these assets for Enron. At the same time, the financial accounting goal was to increase earnings. The financial accounting treatment (to increase earnings) was the opposite of the tax treatment (to eliminate or reduce gains).

#### Implementation of Project Tomas

PGH, a wholly-owned Enron affiliate acquired in 1997, owned a portfolio of leased assets through subsidiaries.<sup>495</sup> In total, the leased assets had a fair market value of approximately \$280 million and were encumbered by non-recourse debt totaling approximately \$170 million. The tax basis of the leased assets was approximately \$8 million.

PGH also owned all the stock of Oneida Leasing, Inc. ("Oneida"). Oneida had no significant assets at the beginning of the transaction.

On July 17, 1998, PGH borrowed approximately \$250 million on a recourse basis from Toronto Dominion, an unrelated Texas bank.<sup>496</sup> This recourse debt was not secured by any property, although Enron guaranteed the debt. On the same date, PGH contributed the \$250 million cash proceeds to its subsidiary, Oneida. Oneida in turn loaned \$250 million to Enron in exchange for Enron's demand promissory note, also dated July 17, 1998.<sup>497</sup> Thus, the \$250 million cash proceeds were cycled from PGH through its subsidiary, Oneida, and then back to Enron, the guarantor of the Toronto Dominion debt. PGH was still liable on its \$250 million recourse debt to the Toronto Dominion bank.

On September 9, 1998, PGH formed a partnership with two affiliates of Bankers Trust. PGH's two partners were BT Leasing and EN-BT Delaware. The partnership was named Seneca Leasing Partners, L.P. ("Seneca"). The three partners of Seneca contributed assets to the partnership in exchange for their interests in the partnership.

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<sup>495</sup> One of the subsidiaries was Columbia Willamette Leasing, Inc. ("CWL"). CWL in turn owned all the stock of Rail Leasing, Inc. ("Rail Leasing"). CWL held 16 groups of leased assets (the aircraft, containers for shipping, and similar large assets), and Rail Leasing held one lot of leased rail cars. On September 4 and September 10, 1998, CWL and Rail Leasing merged into their parent corporation, PGH. As a result of these two mergers, PGH owned all of the assets formerly held by CWL and Rail Leasing, which consisted of the 17 groups of leased assets.

<sup>496</sup> The loan was due on or before October 30, 1998.

<sup>497</sup> The terms of the demand note were that Enron agreed to pay the principal amount upon the earlier of demand or July 31, 2003.

On September 15 and 30, 1998, PGH transferred the leased assets to the Seneca partnership.<sup>498</sup> PGH also transferred all of the Oneida stock to Seneca on September 15, 1998. In exchange for the assets and stock it contributed, PGH received a 95-percent limited partnership interest.

PGH's limited partnership interest in Seneca provided for a floating preferred return on approximately \$68 million of its capital in the partnership. This limited partnership interest also included a retirement right, permitting PGH to withdraw from the partnership after two years.<sup>499</sup> On September 16, 1998, PGH transferred its limited partnership interest to PGH LLC, a Delaware limited liability company formed two days before that was disregarded (treated as part of PGH) for Federal income tax purposes.

BT Leasing, one of the two Bankers Trust affiliates that were partners in Seneca, contributed approximately \$9 million cash to Seneca in exchange for a four-percent general partnership interest. The other partner, EN-BT Delaware, contributed approximately \$2 million cash to Seneca in exchange for a one-percent general partnership interest.<sup>500</sup>

On September 15, 1998, the partnership, Seneca, assumed the \$250 million recourse debt from PGH to Toronto Dominion. As a result, BT Leasing and EN-BT Delaware, as general partners of Seneca, became primarily liable on the debt. Enron remained as guarantor of this \$250 million debt for two more days until the debt was repaid.

On September 15, 1998, the \$250 million PGH had borrowed in July from Toronto Dominion changed hands several times. On that date, but prior to the contribution of Oneida stock to the partnership, Enron transferred approximately \$250 million cash to Oneida in satisfaction of Enron's July 17 demand promissory note to Oneida. Oneida loaned approximately \$250 million on a recourse basis to Bankers Trust in exchange for Bankers Trust's

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<sup>498</sup> The fair market value of the 17 leased assets remained at approximately \$280 million on PGH's transfer to the partnership and the non-recourse debt encumbering the assets remained at approximately \$170 million. As of September 15, PGH transferred 16 of the 17 groups of assets, and was obligated to transfer the 17<sup>th</sup> leased asset (a Mack Truck facility) or its cash equivalent value to Seneca, and did transfer the 17<sup>th</sup> leased asset to Seneca on September 30, 1998.

<sup>499</sup> Under the retirement right associated with this partnership interest, at any time after two years from September 30, 1998, PGH LLC, as the transferee of PGH's 95 percent limited partnership interest in Seneca, could exercise its right to compel the partnership to liquidate its interest in exchange for assets of the partnership. PGH LLC was to receive distributions in an amount equal to the positive balance in its capital account (adjusted to account for revaluation of partnership assets), plus the amount of nonrecourse debt assumed by it.

<sup>500</sup> BT Leasing and EN-BT Delaware were to pay all ordinary and necessary expenses of Seneca in exchange for a management fee of \$300,000 per year. Pursuant to a service agreement dated September 15, 1998, Oneida was required to pay BT Leasing \$300,000 per year to act as its agent to engage in the business of owning and operating a portfolio of leased equipment.

demand promissory note. In turn, Bankers Trust loaned approximately \$250 million on a recourse basis to Seneca in exchange for Seneca's note. Seneca repaid \$250 million to Toronto Dominion on September 17, 1998.

The end result of the borrowings and repayments on September 15 and 17 among Enron, PGH, Oneida, Seneca, and Bankers Trust was that Oneida held a note receivable from Bankers Trust for approximately \$250 million.

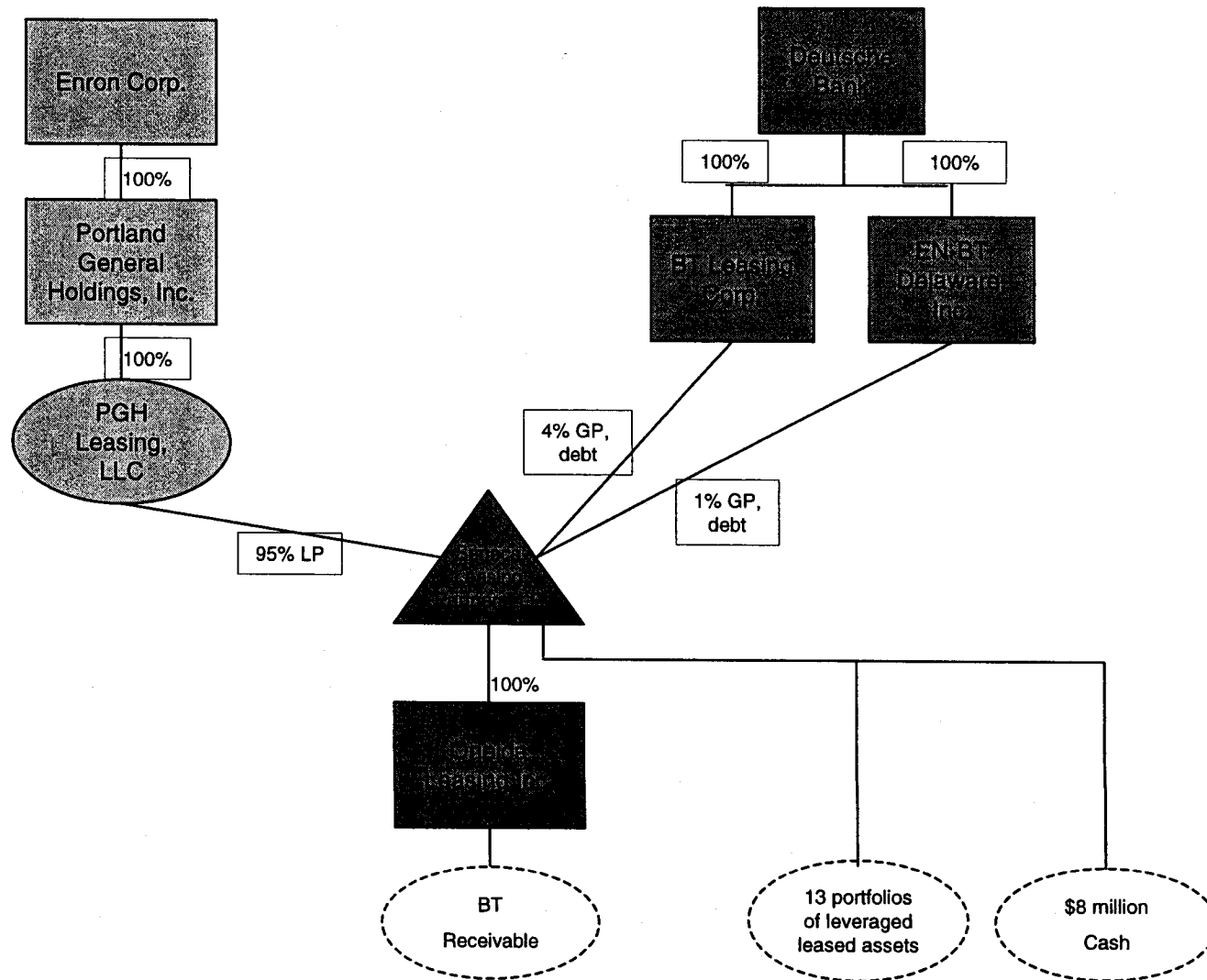
The following diagram depicts the structure of Project Tomas after the formation of and contributions to the partnership in September, 1998.



# Project Tomas

## Structure as of September 30, 1998

Confidential



**U. S. Tax/GAAP Legend**

	Enron GAAP Consolidated
	Third Parties
	Equity Method Investment
	Corporation
	Partnership
	Branch
	Assets

Less than two years later, in June 2000, PGH LLC (the wholly-owned company to which PGH had transferred its partnership interest in Seneca) gave notice of its intent to withdraw from the Seneca partnership. Pursuant to the retirement right under PGH LLC's 95-percent limited partnership interest, this notice triggered a public bid valuation process to determine the retirement price. The actual distribution of Oneida stock did not take place until just over two years after the last contribution of property by PGH to the Seneca partnership on September 30, 1998.

On October 2, 2000 (two years and two days after the last contribution to the partnership on September 30, 1998), PGH LLC's interest in the partnership was liquidated. Seneca distributed the Oneida stock to PGH LLC, the Enron subsidiary, in liquidation of its partnership interest. Because the value of Oneida stock was greater than PGH LLC's capital account in the partnership, PGH LLC also assumed debt of Seneca.<sup>501</sup> The amount of debt assumed was approximately equal to the excess of the value of Oneida stock over PGH LLC's capital account.

Under the tax rules, PGH LLC's basis in the distributed Oneida stock was equal to PGH LLC's basis in its partnership interest (adjusted for the debt assumed in liquidation). As a result, the basis of the Oneida stock was required to be reduced in the hands of PGH LLC.

Seneca made a section 754 election and increased the basis of its remaining property, the leased assets.<sup>502</sup> PGH's low basis in its stock of Oneida would become irrelevant on a liquidation of Oneida into PGH, under the partnership tax rules then in effect, because at that time, the basis of the property inside Oneida was not required to be reduced corresponding to the reduction in the basis of Oneida stock.

#### Role of outside advisors

Bankers Trust signed an engagement letter dated September 15, 1998, agreeing to serve as Enron's exclusive financial advisor for the transaction.<sup>503</sup> The letter provides that a partnership would be structured between Enron representatives and Bankers Trust

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<sup>501</sup> Oneida issued a demand promissory note to Bankers Trust for \$156 million on October 2, 2000 (the date PGH LLC's interest in the Seneca partnership was liquidated). On that same date, Bankers Trust demanded payment of the \$156 million, and the note was cancelled. Meanwhile, Bankers Trust agreed to pay Oneida \$21 million, in a demand promissory note also dated October 2, 2000. Demand Promissory Note, \$156,005,946, October 2, 2000 (ECx000007853 - ECx000007855); Letter of Bankers Trust to PGH Leasing, LLC, Attention: Mr. R. Davis Maxey (October 2, 2000), ECx000007871; Cancelled - Demand Promissory Note, \$156,005,946, October 2, 2000, ECx000007872 - ECx000007874; Demand Promissory Note, \$21,661,889.67, October 2, 2000, ECx000007876 - ECx000007878.

<sup>502</sup> In April 1999, two of the leased assets were sold to the lessees and a third lease was renegotiated and renewed.

<sup>503</sup> Letter of Brian J. McGuire of Bankers Trust to Mr. Richard A. Causey of Enron, dated September 15, 1998, EC2 000038045 - EC2 000038049. Appendix B, Part VI contains this document.

representatives for purposes of the transaction. Bankers Trust agreed to advise and assist in designing an appropriate structure for the transaction and to perform other services. Bankers Trust would be paid fees of \$10 million. This amount did not include fees for additional services such as leased asset management and disposition fees, swaps, bridge financing, valuation services and other services. As of June 4, 2001, Bankers Trust was paid an estimated \$11.875 million in project fees in connection with Project Tomas.<sup>504</sup>

The opinion letter regarding the Federal tax issues in the transaction<sup>505</sup> was provided by Akin, Gump, Strauss, Hauer & Feld, L.P. ("Akin, Gump"), and was dated November 23, 1998 (after the formation of and contributions to the partnership in September, 1998). In its opinion letter, Akin, Gump concluded that (1) mergers of PGH subsidiaries holding the leased assets should be treated as corporate liquidations, (2) Seneca should be treated as a partnership for Federal tax purposes, (3) PGH's transfers of the leased assets and the stock of Oneida to Seneca should be tax-free contributions to a partnership, (4) neither the Seneca's receipt of the leased assets subject to \$170 million nonrecourse debt, nor Seneca's assumption of the \$250 million recourse debt, should be treated as a disguised sale taxable to PGH, (5) the nonrecourse debt should be allocated to PGH first to the extent of the partnership's minimum gain, second to the extent of PGH's precontribution gain, and third, in accordance with its 95-percent profit share, (6) PGH LLC will be disregarded for Federal tax purposes, (7) no gain should be recognized in the event PGH LLC exercises its retirement right and receives distributions of cash, the leased assets and stock of Oneida, no gain should be recognized to PGH LLC (except to the extent cash distributed exceeds its basis), because the exceptions for distributions of property the partner contributed should apply, and (8) the foregoing opinions should not be subject to change under the business purpose doctrine, section 269 (relating to acquisitions made to evade or avoid income tax), the substance-over-form doctrine, or the section 701 partnership anti-abuse regulations. Akin, Gump was paid fees of \$813,694 in connection with Project Tomas.<sup>506</sup>

In addition, the firm of Andrews & Kurth provided legal counsel with respect to aircraft sales that were planned to take place following operation of the partnership created in the Project Tomas transactions.<sup>507</sup> Accounting support was provided by Arthur Andersen.<sup>508</sup>

As of June 4, 2001, project fees had been paid to several parties in connection with Project Tomas, in addition to Bankers Trust and Akin, Gump. Arthur Andersen, Enron's auditor,

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<sup>504</sup> Estimated Project Fees Paid to Date, 6/4/2001, EC2 000036379. Appendix B, Part I, contains this document.

<sup>505</sup> Appendix C, Part VI to this Report contains the Akin, Gump tax opinion letter Enron received in connection with Project Tomas (EC2 000033917 - EC2 000033979).

<sup>506</sup> Estimated Project Fees Paid to Date, 6/4/2001, EC2 000036379. Appendix B, Part I, contains this document.

<sup>507</sup> Project Tomas, Advisory History, EC2000037987.

<sup>508</sup> *Id.*

was paid fees of \$252,593 in connection with Project Tomas. In addition, another \$600,000 in fees was paid to “others” in connection with the transaction.<sup>509</sup>

#### Subsequent developments

PGH LLC’s interest in the Seneca partnership was liquidated on October 2, 2000, just over two years after the assets had been contributed to the partnership in September, 1998. After the liquidation of PGH's LLC interest, the leased assets remained in the partnership. The partnership was owned by the remaining two partners, the two Bankers Trust affiliates (BT Leasing and EN-BT Delaware). Thus, Enron no longer had an interest in the leased assets held by the partnership.

The following diagram depicts the structure of Project Tomas after the liquidation of the partnership interest of the Enron affiliate, PGH LLC, on October 2, 2000.

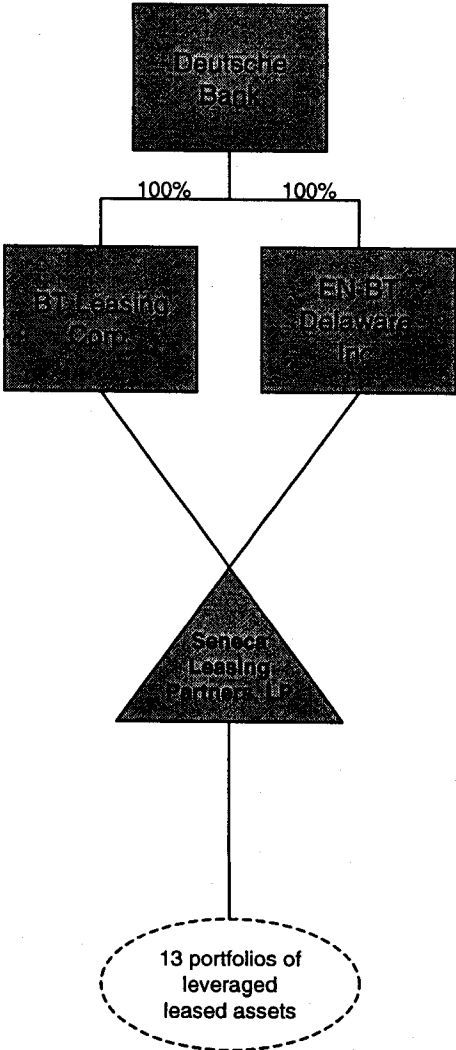
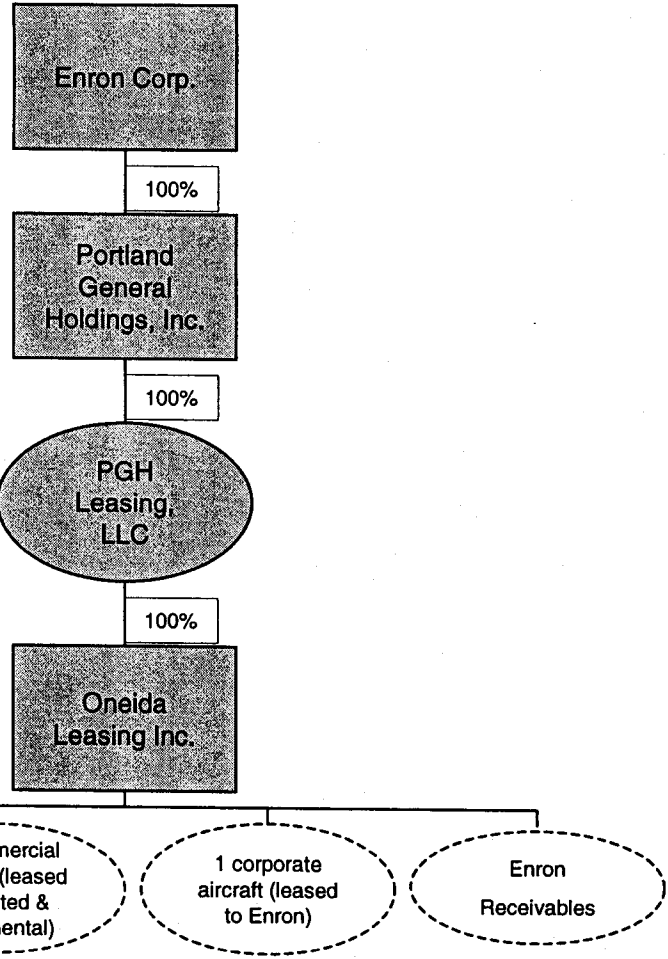
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<sup>509</sup> Estimated Project Fees Paid to Date, 6/4/2001, EC2 000036379. Appendix B, Part I, contains this document.

# Project Tomas

## Structure as of December 31, 2001

Confidential



**U. S. Tax/GAAP Legend**

	Enron GAAP Consolidated
	Third Parties
	Equity Method Investment
	Corporation
	Partnership
	Branch
	Assets

After PGH LLC's interest in Seneca was liquidated in October, 2000, the Seneca partnership sold 18 of its assets on three dates in December, 2000.<sup>510</sup> The sale price for 11 of these assets was reported to be equal to the tax basis, due to the basis increase claimed pursuant to the Tomas transaction. Thus, the Seneca partners (the Bankers Trust affiliates) would have had no taxable gain to report with respect to these 11 sales. In addition to the sales in 2000, the Seneca partnership had sold four assets during 1999, at least one at a loss.<sup>511</sup>

Later, in December 2001, Oneida collected on a "large Deutsche Bank receivable."<sup>512</sup> Bankers Trust had been acquired by Deutsche Bank, so this receivable may have been the note receivable from Bankers Trust for \$250 million that Oneida entered into in 1998, in the course of Project Tomas.<sup>513</sup>

One of the representations made by PGH described in the Akin, Gump opinion letter was that PGH intended "that Oneida acquire a substantial portfolio of lease equipment that will further diversify the Partnership's portfolio of equipment."<sup>514</sup> In July 2000, Oneida had acquired two leased assets.<sup>515</sup> These two assets were aircraft, one a Boeing 747 leased to United Airlines, and the other a McDonnell-Douglas DC-9 leased to Continental Airlines. This acquisition preceded by a few months the October, 2000, distribution of Oneida's stock by the Seneca partnership in liquidation of the partnership interest of Enron's subsidiary, PGH LLC. Towards the end of 2001, after Oneida had been distributed to PGH, Enron contacted 13 potential counterparties in connection with disposing of the aircraft. In June, 2002, the sale of the two commercial aircraft by Oneida for \$10.3 million (reduced by approximately \$4 million of back

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<sup>510</sup> December 11, 20 and 21, 2000, as provided in Exhibit XX -- Sales of Leased Assets by Seneca Leasing Partners, L.P., EC2 000054818. Appendix B, Part VI, contains this document.

<sup>511</sup> The assets sold in by Seneca in 1999 were: Acid Recovery Plant, sold 4/1/99 for \$4,649,500 (though the tax basis was \$1,278,230, giving rise to a tax loss); Rail Cars (CSX 1998-1), sold 1/4/99 for \$8,908,000; Rail Cars (SOO Line 1989), sold 8/2/99 for \$32,198; and Tank Cars (GATC 86-1), sold 2/12/99 for \$13,871. The tax basis for the latter three items was not stated on Exhibit XX -- Sales of Leased Assets by Seneca Leasing Partners, L.P., EC2 000054818. Appendix B, Part VI, contains this document.

<sup>512</sup> Structured Transactions Group, Summaries of Project Earnings and Cash Flows, November 2001. Appendix B, Part I contains this document.

<sup>513</sup> Oneida also held a demand promissory note of Bankers Trust for \$21 million, dated October 2, 2000 (the date PGH LLC's interest in the Seneca partnership was redeemed). Demand Promissory Note, \$21,661,889.67, October 2, 2000, ECx000007876 - ECx000007878.

<sup>514</sup> Akin, Gump opinion letter at 10. Appendix C, Part VI, contains this document.

<sup>515</sup> Structured Transactions Group, Summaries of Project Earnings and Cash Flows, November 2001. Appendix B, Part I contains this document.

rent and interest due) was approved by Enron.<sup>516</sup> Oneida also acquired a corporate aircraft that was leased to Enron.<sup>517</sup>

## **Discussion**

The result of the series of transactions comprising Project Tomas was that Enron had disposed tax-free of a portfolio of leased assets that had a built-in gain of \$270 million, while the tax basis of assets that Enron received in exchange (i.e., assets held by Oneida) was not reduced. Further, the \$270 million built-in gain ultimately was not taxed to the Bankers Trust affiliates that (through the partnership) commenced selling off the portfolio of leased assets.

This permanent tax saving associated with Project Tomas resulted in a significant financial accounting benefit to Enron. Enron could not immediately utilize some types of tax benefits, such as increased deductions or losses, as it was already in a loss position with NOL carryovers. Rather, the permanent tax saving that led to the financial statement benefits from Project Tomas arose from the fact that the Enron received Oneida's underlying assets with a high tax basis without incurring an economic cost (i.e., the recognition of gain on disposed leased assets).

### **Sale of the leased assets**

Central to the structure of Project Tomas was the use of a partnership as a means of exchange between Enron and Bankers Trust of the leased assets that Enron disposed of. Several provisions of present law, designed to prevent the characterization of an otherwise taxable sale as a tax-free partnership contribution and distribution, are implicated in the transaction.

Receipt of property that the Enron affiliate had contributed to the partnership.—Seneca's distribution of the Oneida stock raises the issue of the potential for gain recognition under the "seven-year" rule of present law. Under this rule, gain or loss is recognized on a distribution of partnership property, if a partner contributed property with built-in gain or built-in loss (i.e., the leased assets), and that partner receives a distribution of other property (i.e., stock of a corporation, Oneida, holding a large note) within seven years of the contribution.<sup>518</sup> If this gain recognition rule applied in Project Tomas, PGH LLC would be required to include in income the pre-contribution gain of approximately \$270 million on the leased assets when Seneca distributed the Oneida stock.

The transaction is structured so as to rely on the exception providing that this gain recognition rule does not apply to a distribution of property that the distributee partner

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<sup>516</sup> Enron Risk Assessment and Control - Deal Approval Sheet, dated June 26, 2002. EC2 000038061 - EC2 000038065. Appendix B, Part VI contains this document.

<sup>517</sup> Enron Corp. Presentation to Joint Committee on Taxation staff, Washington, D.C., June 7, 2002, Appendix at A-8. Appendix B, Part I contains this document.

<sup>518</sup> Sec. 737.

contributed to the partnership.<sup>519</sup> However, the present-law exception goes on to provide if the property distributed is an interest in an entity (e.g., corporate stock), the exception from gain recognition does not apply to the extent the value of the interest is attributable to property contributed to the entity after the entity was contributed to the partnership. Although the Akin, Gump opinion letter refers to several examples in the regulations in which partnership distributions of stock were taxed to the extent of the value added to a corporation after its stock is contributed to the partnership, the opinion letter does not apply this notion to Seneca's distribution of the Oneida stock. The Akin, Gump opinion letter does not address the point that the \$250 million in value was contributed by PGH to Oneida less than two months before the Oneida stock was contributed to the partnership, nor that Enron paid \$250 million to Oneida in satisfaction of its note on the same day, September 15, that the Oneida stock was contributed to the partnership. Whether there should be a link between these events as part of an overall planned transaction is not addressed.

Disguised sale treatment.—The tax opinion letter does not discuss whether the contribution of leased assets and the distribution of Oneida stock, taken together, should be characterized as a disguised sale.<sup>520</sup> The Akin, Gump opinion letter refers to the distribution of the Oneida stock hypothetically, "in the event that PGH exercises the retirement right."<sup>521</sup> Nevertheless, it could be inferred that the transaction was deliberately structured to attempt to avoid the disguised sale rules, by ensuring that the partnership distribution does not take place until two years and two days after the last contribution.

Treasury regulations provide a presumption that a transaction does not amount to a disguised sale if the transfer of property and the related contribution of property to the partnership take place more than two years apart.<sup>522</sup> Under these regulations, such transfers are presumed not to be a sale "unless the facts and circumstances clearly establish that the transfers constitute a sale."<sup>523</sup> The two-year presumption in the regulations has two aspects. First, if the contributing and distributing transfers are made within two years, there is presumed to be a sale, unless the facts and circumstances clearly establish there is not a sale. Disclosure to the IRS is required.<sup>524</sup> Second, if the contributing and distributing transfers are made more than two years

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<sup>519</sup> Sec. 737(d). Akin, Gump opinion letter at 33-34. Appendix C, Part VI contains this document.

<sup>520</sup> The tax opinion does discuss whether the partnership's taking the leased assets subject to \$170 million of nonrecourse debt, and the partnership's assumption of \$250 million of recourse debt, constitute disguised sales of all or part of the leased assets or the Oneida stock PGH contributed to the partnership. Based on a technical analysis applying debt proceeds tracing rules, the opinion concludes that neither constitutes a disguised sale. Akin, Gump opinion letter at 26. Appendix C, Part VI contains this document.

<sup>521</sup> Akin, Gump opinion letter at 31. Appendix C, Part VI contains this document.

<sup>522</sup> Treas. Reg. sec. 1.707-3(d).

<sup>523</sup> *Id.*



apart, the transfers are presumed not to be a sale, unless the facts and circumstances clearly establish that the transfers constitute a sale.<sup>525</sup> No disclosure is required.

Structuring a transaction so that the partnership contribution and distribution are two years and two days apart, as in the case of Project Tomas, may be a fact indicating that a sale should be presumed. Further, the fact that PHG LLC had a "retirement right" under the partnership agreement, permitting it to compel the partnership to liquidate its interest in the partnership after two years, may be a fact indicating that PGH LLC bore very little risk during the two-year period and that it effectively was disposing of the leased assets despite its retention of a 95-percent interest in the partnership during the two-year period. For the IRS to administer this determination based facts and circumstances may be difficult, however, without any requirement of disclosure in the case of transfers more than two years apart.

Partnership anti-abuse rules.—The partnership anti-abuse regulations state that if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate Federal tax liability in a manner that is inconsistent with the intent of subchapter K (the tax rules governing partnerships), the Commissioner can recast the transaction for Federal tax purposes to achieve tax results that are consistent with the intent of subchapter K.<sup>526</sup> The opinion letter concludes that this rule should not result in recasting the transaction to provide that the Oneida stock was never contributed to the partnership, because PGH LLC has a low basis in the Oneida stock upon its distribution. However, the fact that PGH LLC had easy access to the high-basis, high-value assets Oneida held through the simple expedient of liquidating Oneida<sup>527</sup> cannot be dismissed as irrelevant to the rules of partnership taxation,<sup>528</sup> as it was available to achieve the tax savings that were central to Project Tomas. The use of a partnership to achieve the tax-free disposition of built-in gain assets should be considered inconsistent with the intent of subchapter K, within the meaning of these regulations.

Tax legislation over the past two decades has included several provisions intended to prevent the use of partnerships as a vehicle to disguise sales of assets as tax-free transactions. In 1984, Congress enacted the rule providing that if there is a transfer of money or other property

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<sup>524</sup> Treas. Reg. sec. 1.707-3(c).

<sup>525</sup> Treas. Reg. sec. 1.707-3(d).

<sup>526</sup> Treas. Reg. sec. 1.701-2(b).

<sup>527</sup> Sec. 332, discussed in the Akin, Gump opinion letter at 48. Appendix C, Part VI contains this document.

<sup>528</sup> This argument is made in the Akin, Gump opinion letter at 48. Appendix C, Part VI contains this document. Partnership tax legislation enacted in 1999, before the distribution of Oneida stock was consummated, would have applied to this transaction and required that the basis of Oneida's assets be reduced, except for a transition rule providing a two-year window for distributions from existing partnerships. See Pub. L. No. 106-170, section 538(a) (December 17, 1999), enacting section 732(f).

by a partner to a partnership and there is a related transfer of money or other property by the partnership to such partner, the two transfers (when viewed together) may be properly characterized as a sale or exchange of property and will therefore be treated as such. In 1989 and 1992, Congress added rules requiring gain recognition with respect to appreciated property contributed to a partnership in the event that distributions (either of the contributed property to a noncontributing partner, or of other property to the contributing partner) are made within seven years of the contribution.<sup>529</sup> Though it postdates the initiation of Project Tomas, in 1999, Congress enacted rules providing that the basis of a corporation's assets is reduced to parallel the reduction in the basis of the corporation's stock when it is distributed to a partner with a low basis in its partnership interest.<sup>530</sup> The enactment of these rules indicates a concern over the use of partnerships to transfer property among persons in a manner that avoids tax that would be due on sale of the property. Project Tomas' use of partnership rules for a tax-free disposition of the leased assets owned by Enron affiliates to the Bankers Trust affiliates, who remained as partners after the Enron affiliate retired from the partnership, contravenes the intent of this legislation in subchapter K.

#### Use of debt

In the Project Tomas transaction, the basis increase to the leased assets arose from recent debt incurred by an Enron affiliate and guaranteed by Enron. Whether this debt had real economic substance apart from its use to facilitate tax benefits in the transaction could be questioned. This debt was cycled through Oneida, assumed by the partnership and was paid off by the partnership within two months of when the debt was incurred. As the proceeds of the debt were passed from one party to the transaction to another, a debt obligation of Bankers Trust to Oneida was created that later may have served as Bankers Trust's "payment" to Enron in the "sale" of the leased assets. The purpose, function, and economic substance of debt whose proceeds are rapidly cycled through parties to a complex transaction warrant close examination.

#### Business purpose

Scrutiny of Project Tomas as a whole, rather than as numerous separate pieces of a complex series of transactions, gives a different picture of the goal of the transaction. While the tax opinion concluded that utilizing the lease management expertise of Bankers Trust was an appropriate business purpose for the transaction, it also concluded that the expectation of financial accounting benefits constituted a business purpose.<sup>531</sup> The tax benefits with respect to a transaction that satisfies the literal requirements of a particular tax provision may not be respected if the transaction fails the statutory rules and judicial doctrines (such as business purpose and economic substance) that are often applied to evaluate the purported tax benefits in

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<sup>529</sup> Secs. 704(c)(1)(B) and 737.

<sup>530</sup> Sec. 732(f).

<sup>531</sup> Akin, Gump opinion letter at 7. Appendix C, Part VI contains this document.

tax-motivated transactions. Therefore, any analysis of whether the tax benefits in Project Tomas would be respected must take into account the applicability of these doctrines.<sup>532</sup>

#### Duplication of tax basis of assets

The opinion letter for Project Tomas did not address the issue of whether the basis of Oneida's assets should be reduced to parallel the reduction in the basis of the Oneida stock when it was distributed to a partner with a low basis in its partnership interest.<sup>533</sup> The provision that would require such a reduction in the basis of Oneida's assets was not enacted until 1999.<sup>534</sup> This provision was designed to prevent taxpayers from nullifying the downward basis adjustment to property distributed by a partnership to a corporate partner with a low basis in its partnership interest. If the property distributed to a corporate partner is corporate stock, then a subsequent liquidation of the corporation so distributed could nullify the required adjustment to the stock basis, if the basis of the distributed corporation's assets is not also reduced.

Enron was made aware of the likelihood of legislative change in this area as Project Tomas was being planned. The December 11, 1997, letter from Arthur Andersen to Enron setting forth an early version of the Project Tomas transaction describes this technique, and notes that among the possible risks of doing such a transaction would be the risk that Congress would change the rule, identifying it as "a possible target for legislative change."<sup>535</sup> The letter concluded, "[b]ecause of the substantial benefits this product provides, and the possibility of legislative action, you should be advised to utilize the technique now, as its shelf life may be

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<sup>532</sup> For detailed information on 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).

<sup>533</sup> The opinion letter did refer to possible legislation, but concludes that Congress "has chosen not to revise the Code in such a fashion." Akin, Gump opinion letter at 48. The provision was enacted on December 17, 1999 (Pub. L. No. 106-170).

<sup>534</sup> Sec. 732(f). In the case of a partnership already in existence on July 14, 1999, the rule applied to distributions after June 30, 2001. The distribution of the Oneida stock by the Seneca partnership took place on October 2, 2000.

<sup>535</sup> Letter from Robert P. Palmquist of Arthur Andersen to David Maxey of Enron Corp., dated December, 11, 1997, EC2 000038050 – EC2 000038052. Appendix B, Part VI contains this document.

limited.”<sup>536</sup> The assets of the distributed corporation, Oneida, consisted principally of a note from Bankers Trust.<sup>537</sup> If the basis of the note had been reduced, Enron affiliates would have been subject to tax on the gain when the notes were collected or when Oneida was liquidated.

In enacting the downward basis adjustment rule<sup>538</sup> in 1999, Congress directly addressed the type of basis duplication that occurred in the Tomas transaction. Had the downward basis adjustment rule applied to the Tomas transaction, Enron would not have been able to take the position that the transfer of the portfolio of leased assets to the Bankers Trust affiliates that remained as Seneca partners would result ultimately in no tax to Enron or its affiliates. Gain would have resulted from liquidation of Oneida or sale or other disposition of the assets held by Oneida. Project Tomas was the only transaction of this type in which Enron engaged.

### **Recommendations**

To dispose of the leased assets with a stepped-up basis without incurring tax, Enron formed a partnership with Bankers Trust, which in essence served as an accommodation party in the transaction. Without a willing though unrelated third party to hold the leased assets through a partnership for at least two years before selling them off, the tax savings and financial statement benefits claimed through the use of this structure would not have been possible. Use of accommodation parties to achieve results under tax rules that contemplate parties with adverse interests can give rise to unintended results. The Joint Committee staff recommends that use of accommodation parties under the tax rules be addressed.

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. Congress has repeatedly enacted legislation to limit the utility of partnerships as vehicles for the tax-free disposition of assets. However, enforcement some of these rules, especially those involving a facts and circumstances determination, may be difficult without adequate disclosure of the transactions to the IRS. For example, extending the disclosure requirement under the disguised sale rules to seven years, the period applicable to contributions and distributions under the pre-contribution gain rules,<sup>539</sup> could make a facts and circumstances determination by the IRS both more likely to occur and easier for the IRS to administer. Despite the possible recordkeeping burden it might impose on taxpayers, a longer disclosure period would facilitate examination of tax motivated transactions without impeding legitimate joint ventures.

For the IRS to identify this transaction on Enron's voluminous tax return may be difficult without specific signposts pointing to it, because the high basis in Oneida's assets would be

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<sup>536</sup> *Id.*

<sup>537</sup> Oneida also acquired two commercial aircraft, which it sold in 2002, and a corporate jet leased to Enron.

<sup>538</sup> Sec. 732(f).

<sup>539</sup> Secs. 704(c)(1)(B) and 737.

recovered primarily as depreciation deductions over time, or as the absence of gain recognition on receipt of payment on a note Oneida held. As a corollary to increased disclosure of contributions to and distributions from partnerships, a more detailed or earlier disclosure to the IRS of the source of permanent book-tax differences could facilitate the discovery of questionable transactions on audit.

### 3. Project Condor

#### Background

##### Brief overview

Project Condor<sup>540</sup> was structured to generate approximately \$930 million of Federal income tax deductions without incurring any economic outlay. In addition, because there was no corresponding financial statement expense, the tax savings associated with these deductions were anticipated to generate approximately \$330 million after-tax financial statement income. Enron intended to report the \$330 million of financial statement income over the anticipated 16-year life of the structure, whereas the \$930 million of Federal income tax deductions were not anticipated to be available to offset Enron's taxable income until beginning in 2015.

The structure involved the use of an existing partnership, Whitewing Associates, LP ("Whitewing LP"), between Enron Corp. and an outside investor (the "Osprey Investors") that held Enron Corp. preferred stock.<sup>541</sup> In 1999, purportedly in connection with a restructuring of the partnership, Houston Pipe Line Company ("HPL"), a wholly owned subsidiary of Enron Corp., contributed natural gas pipelines and related storage facilities (the "Bammel Assets") with a fair market value of approximately \$930 million and minimal tax basis<sup>542</sup> to Whitewing in return for a preferred partnership interest. The contributed assets were immediately leased back to HPL for a period of 18 years.

Because the fair market value of the Bammel Assets was different than their adjusted tax basis, the partnership tax rules operate to specially allocate the taxable income of the partnership to take into account the tax consequences of this disparity (the "pre-contribution gain").<sup>543</sup> Enron planned to use these rules to allocate \$930 million of deductions to Enron Corp. and to allocate \$930 million of income to HPL over a 16-year period. Because Enron Corp. and HPL were both members of the Enron consolidated group, the allocation and the offsetting allocation, in essence, equalized so as not to create any additional tax liability for the consolidated group. However, under the partnership tax rules, the special allocation of income and deductions results

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<sup>540</sup> The information regarding Project Condor was obtained from Joint Committee staff interviews of Robert J. Hermann, R. Davis Maxey, James A. Ginty, and Anne Marie Tiller, as well as from documents and information provided by Enron Corp. and the Internal Revenue Service.

<sup>541</sup> The primary purpose of the original transaction between Enron and the Osprey investors had been to convert debt to equity. EC2 000037507.

<sup>542</sup> Enron reported that the assets had \$31 million of tax basis and a fair market value of \$930 million.

<sup>543</sup> Sec. 704(c).

in a reduction of Enron Corp.'s tax basis in its partnership interest to zero<sup>544</sup> and an increase in HPL's tax basis in its partnership interest from zero to \$930 million.<sup>545</sup>

The strategy anticipated distributing the Bammel Assets back to HPL in redemption of its Whitewing preferred partnership interest after 16 years. Under the partnership tax rules, HPL would ascribe its partnership tax basis to the Bammel Assets. Thus, the tax basis would be "stepped-up" from zero to \$930 million and HPL could begin to depreciate the Bammel Assets for Federal income tax purposes. The Enron preferred stock held by the partnership would be "stepped-down" by a corresponding amount; however, Enron Corp. could use one of several strategies to avoid recognizing any taxable gain with respect to such stock.

#### Reported tax and financial statement effects

Project Condor generated approximately \$88 million in net earnings for financial reporting purposes through the third quarter of 2001.<sup>546</sup> Project Condor had no impact on Enron's tax return through 2001<sup>547</sup> other than the deduction of approximately \$2 million of transaction costs.<sup>548</sup>

#### Development of Project Condor

The development of the tax aspects of Project Condor began as early as December of 1998.<sup>549</sup> Correspondence between Deloitte & Touche LLP ("Deloitte & Touche"), and Mr. Maxey and other Enron tax personnel indicate that during the early months of 1999 various

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<sup>544</sup> The \$930 million of deductions would have exceeded Enron Corp.'s tax basis, thus resulting in some deductions being suspended under sec. 704(d). However, the structure envisioned Enron Corp. purchasing the interest of the Osprey Investors or contributing cash to alleviate this problem.

<sup>545</sup> Sec. 705.

<sup>546</sup> In December 2001, Enron recorded an \$84.1 million financial accounting charge in order to place a valuation reserve against the previously reported earnings. The Project Condor materials in Appendix B contain an opinion letter to Chase Securities, Inc. from Arthur Andersen regarding the the financial accounting implications of a transaction that mirrors Project Condor. Enron indicated that it was unclear why Chase Securities, Inc. received this opinion or why they sent it to Enron. Presumably, that Chase was marketing or engaging a transaction similar to Project Condor and was interested in ascertaining the accounting benefits of such transaction. EC2 000037515 - EC2 000037520.

<sup>547</sup> The approximately \$930 million of tax deductions to be generated by Project Condor were projected to be available beginning in 2015.

<sup>548</sup> Information obtained from a summary discussion of Project Condor. EC2 000037455. Enron stated it was amortizing the transaction costs over a three-year period.

<sup>549</sup> Structured Transactions Group Summary Nov. 2001 - Project Condor.

models were developed to evaluate the benefits to Enron of engaging in the tax strategy.<sup>550</sup> The models used differing assumptions as to assets contributed, the tax basis of the assets contributed, and residual value of the contributed property.

In April 1999, a draft presentation was prepared for Project Condor providing a broad overview of the transaction structure, financial accounting impacts, the tax benefits of the transaction, and the risks of the transaction and mitigating factors.<sup>551</sup> The presentation materials identified the following transaction risks (1) the need for a business purpose, (2) a fiscal year 2000 budget proposal that would tighten the standards applicable to corporate tax shelters and basis shifting transactions, and (3) a general risk of law change. The primary mitigating factors listed were that (1) the transaction would occur as part of an overall restructuring of an existing partnership, (2) the budget proposals were not expected to receive Congressional support and could be structured around, and (3) the transaction could be unwound at any time and the complications on an “unwind” are minimized since the transaction occurs mainly between two Enron entities. A subsequent presentation document indicated that another mitigating factor was that the audit risk is very low because no position is taken on Enron’s consolidated tax return until assets are distributed from the Whitewing structure (anticipated to be 2015).<sup>552</sup>

The evaluation of the proposed transaction continued into the summer months and on August 20, 1999, an engagement letter between Enron and Deloitte & Touche was signed.<sup>553</sup> The agreement provided that Deloitte & Touche would advise Enron on structuring a preferred return partnership interest to be issued out of an existing entity.

At a special meeting of the Board of Directors of Enron on September 17, 1999, the Board of Directors was presented with a broad overview of the proposed restructuring of the Whitewing partnership, including the redemption of Whitewing’s existing Enron preferred stock in exchange for a new class of Enron preferred stock and the contribution of merchant assets to the Whitewing structure. Following the presentation, the Board of Directors approved a resolution authorizing Enron to undertake the transactions involved in the refinancing of approximately \$1 billion of mandatory convertible preferred stock of Enron.

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<sup>550</sup> A memo from Steven E. Klig of Deloitte & Touche to Mr. Maxey dated February 27, 1999 provided a summary of various alternatives and detailed schedules of the implications of these alternatives for the anticipated sixteen year period of the structure. EC2 000037456 - EC2 000037481.

<sup>551</sup> There is no indication of who prepared or received copies of the presentation materials. The Project Condor materials in Appendix B contain the presentation materials. EC2 000037482 - EC2 000037493.

<sup>552</sup> Discussion materials for Project Condor dated November 9, 1999. EC2 000037500.

<sup>553</sup> Richard J. Causey on behalf of Enron and Stephen E. Klig on behalf of Deloitte & Touche signed the agreement.



Enron's stated business purpose for contributing the Bammel Assets to the Whitewing LP structure was to provide enhanced collateral to support the Osprey Investors investment, thereby reducing the overall financing cost to Enron.

#### Implementation of Project Condor

HPL Asset Holdings LP ("HPL Asset Holdings"), a Delaware limited partnership, was formed on November 9, 1999. On November 10, 1999, HPL and Enron Corp.<sup>554</sup> contributed property to HPL Asset Holdings in return for partnership interests. HPL transferred the Bammel Assets<sup>555</sup> to HPL Asset Holdings in return for a 99.89 percent limited partner interest and a 0.01 percent general partner interest.<sup>556</sup> Enron contributed \$1 million to HPL Asset Holding in return for a 0.10 percent limited partnership. The Bammel Assets contributed by HPL had adjusted tax basis of approximately \$30 million and an ascribed fair market value of \$930 million. The Bammel Assets were immediately leased back to HPL for a period of 18 years.<sup>557</sup>

Immediately following the contribution, HPL assigned its general partnership interest to Blue Heron I LLC, ("Blue Heron") a single member limited liability company owned by Whitewing LP, in exchange for an interest in Blue Heron. Immediately thereafter HPL assigned its interest in Blue Heron and its 99.89 percent limited partnership interest in HPL Asset Holding to Whitewing LP in exchange for a preferred partnership interest in Whitewing LP. HPL, immediately thereafter, contributed its limited partnership interest in Whitewing LP to Kingfisher I LLC ("Kingfisher"), a single member Delaware limited liability company owned by HPL.<sup>558</sup>

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<sup>554</sup> Enron's interest was legally held by Peregrine I LLC. Because Enron Corp. elected to disregard Peregrine I LLC for Federal income tax purposes, Enron Corp. is considered the owner for Federal income tax purposes. As such, this Report reflects Enron Corp. as the owner rather than Peregrine.

<sup>555</sup> The Bammel Assets consisted of an underground natural gas storage reservoir and related facilities, the storage facility equipment, and the Houston Loop and Texas City Loop natural gas pipelines and related assets.

<sup>556</sup> Information contained in Agreement of Limited Partnership of HPL Asset Holdings. Ecx000002059.

<sup>557</sup> The lease agreement between HPL Asset Holding and HPL required the parties to obtain an appraisal to determine the fair value and residual value of the Bammel Assets for purposes of computing the appropriate base rent between the related parties. This was to be performed by December 31, 1999. The appraisal was never done.

<sup>558</sup> Because HPL elected to disregard Kingfisher I LLC for Federal income tax purposes, HPL is considered the owner of the Whitewing partnership interest for Federal income tax purposes. As such, this Report reflects HPL as the owner rather than Kingfisher I LLC.

As a result of the aforementioned steps, Whitewing LP owned a 99.89 percent limited partnership interest and 0.01 percent general partnership interest in HPL Asset Holdings<sup>559</sup> and Enron Corp. owned a 0.10 percent limited partnership interest in HPL Asset Holdings. In addition, the Osprey Investors and HPL owned preferred partnership interests of Whitewing LP with Enron Corp. and a partnership between Enron Corp. and the Osprey Investors owning the remaining interests in Whitewing LP.

Because the Bammel Assets contributed by HPL had a minimal tax basis and an ascribed value of \$930 million at the time of contribution, the assets were subject to the tax allocation rules of section 704(c). HPL Asset Holdings elected to use the remedial allocation method under section 704(c) with respect to the Bammel Assets.<sup>560</sup> For purposes of section 704(c), HPL Asset Holdings elected to recover the Bammel Assets using the 150-percent declining balance method over 15 years.<sup>561</sup>

The amended Whitewing LP partnership agreement contains special provisions that allocate 100 percent of the depreciation deductions associated with the Bammel Assets to Enron and 100 percent of the income, gains, deductions and losses associated with the Bammel Assets to Enron and HPL.<sup>562</sup> Thus, the allocations required under section 704(c) and any income or loss in the Bammel Assets would impact only Enron and its affiliate, HPL. The special partnership provision, in connection with the section 704(c) allocation rules, would cause Enron Corp.'s tax basis in Whitewing to decrease by \$930 million and HPL's to increase by \$930 million over the recovery period of the Bammel Assets.

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<sup>559</sup> Whitewing's interest in HPL Asset Holdings was legally owned by Blue Heron. However, Whitewing disregarded Blue Heron for Federal income tax purposes. Thus, Whitewing is considered the owner of the HPL Asset Holding partnership interest for Federal income tax purposes. As such, this Report reflects Whitewing as the owner rather than Blue Heron.

<sup>560</sup> As a result of HPL contributing its partnership interests in HPL Asset Holdings to Whitewing LP (and Blue Heron), the regulations under section 704(c) require that Whitewing LP allocate its distributive share of HPL Asset Holdings income and loss with respect to the section 704(c) property in a manner that takes into account the contributing partner's remaining built-in gain or loss. Treas. Reg. sec. 1.704-3(a)(9).

<sup>561</sup> Asset Class 46.0 ascribed a recovery period of 15 years to assets used in the commercial and contract carrying of natural gas by means of pipes. See Rev. Proc. 87-56, 1987-2 CB 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 CB 785).

<sup>562</sup> The Osprey Investors had no economic interest in the income, gain, loss, or deduction associated with the Bammel Assets. E 28035 - E28036.

The strategy envisioned distributing the Bammel Assets back to HPL after 16 years, in redemption of HPL's partnership interest.<sup>563</sup> Under the partnership tax rules, HPL would ascribe its partnership tax basis (as increased through the partnership allocations) to the distributed pipeline. Thus, it was anticipated that the tax basis in the Bammel Assets would be "stepped-up" from approximately zero to \$930 million. Whitewing, if a section 754 election were made, would be required to decrease the basis of the remaining partnership property by an offsetting amount. The strategy anticipated that Whitewing's only asset at such time would be Enron stock. As such, the Enron stock would be reduced by \$930 million. However, Enron Corp. could avoid recognizing the inherent gain in the Enron stock either through section 1032 or by other tax strategies. Thus, Project Condor would result in an additional \$930 million of tax deductions without any economic outlay.

The diagram on the next page depicts the Project Condor structure.

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<sup>563</sup> Although the Whitewing partners generally had no right to a return of capital contributions, a special provision of the partnership agreement permitted HPL to request a distribuion of the Bammel Assets to the extent of its capital account. E28035



### Role of outside advisors

Deloitte & Touche promoted the strategy and was the tax advisor on the structuring of the preferred partnership structure. In addition, Vinson & Elkins was engaged to provide tax advice on the transaction including a tax opinion regarding the Federal income tax treatment of certain partnership events and activities.

Deloitte & Touche was paid \$8.325 million for its services.<sup>564</sup> Vinson & Elkins was paid \$1.2 million for its services.<sup>565</sup>

### Subsequent developments

In June 2001, Enron Corp. sold HPL stock to American Electric Power (“AEP”), an unrelated party. In connection with the sale, HPL transferred its leasehold interest in the Bammel Assets and its interest in Whitewing LP to BAM Lease Company, a wholly owned subsidiary of Enron. In addition, BAM Leasing Company subleased the Bammel Assets to AEP for 30 years with a option to extend for an additional 20 years.<sup>566</sup>

### Discussion

Project Condor was specifically structured to take advantage of the interaction between the partnership allocation and basis rules and section 1032, which provides for the nonrecognition of gain or loss to a corporation on the receipt of money or other property in exchange for stock of such corporation. Described in its simplest form, Project Condor purports to permit Enron to shift approximately \$930 million of tax basis from Enron’s own stock to the Bammel Assets owned by HPL, a wholly owned subsidiary of Enron. Under the strategy devised in Project Condor, the benefits of the increased tax basis would inure over a 16-year period and would not be available for use on Enron’s consolidated tax return until the end of that

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<sup>564</sup> Engagement letter between Deloitte & Touche and Enron Corp. dated August 20, 1999. EC2 000037496 - EC2000037498.

<sup>565</sup> Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated Jan 13, 2003, answer 57.

<sup>566</sup> As mentioned above, Enron did not obtain an appraisal of the Bammel Assets in 1999 as required under the original lease agreement. Enron ascribed a value of approximately \$930 million to the Bammel Assets for purposes of section 704(c). In 2001, in connection with the sale of HPL to AEP, an internal Enron memorandum valued the Bammel Assets at \$460 million. EC2 000054384. Because no independent appraisal was done in 1999, it is not clear whether the value of the Bammel Assets declined by 50 percent between 1999 and 2001 or whether the original valuation ascribed by Enron was grossly overstated to maximize the tax benefits of Project Condor.

period (2015). However, and potentially more important to Enron, the strategy permitted Enron to begin to record the benefits immediately for financial accounting purposes.<sup>567</sup>

### Business purpose

A determination of whether Enron should be entitled to the tax benefits Project Condor purported to provide necessarily involves an analysis regarding Enron's satisfaction of the literal requirements of the tax rules as well as the rules and judicial doctrines (such as business purpose and economic substance) that are often applied to evaluate claimed tax benefits in tax-avoidance transactions.<sup>568</sup>

### Partnership allocations

Project Condor's strategy involved the use of the remedial allocation method under section 704(c) to allocate deductions to Enron while allocating an offsetting amount of income to HPL. As described in more detail in present law, these rules were enacted in order to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. Under these rules, the required allocations generally have significant tax implications to the partners.<sup>569</sup> However, when related parties are involved, the shifting of income and deductions among the partners, which would normally have significant economic implications to each partner, is no longer a concern. Thus, a taxpayer is potentially able to use the required allocation rules to shift tax attributes among related entities to its advantage without any economic implications to the taxpayer.

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<sup>567</sup> This occurs in certain situations because Statement of Financial Accounting Standard 109 in some cases permits the recognition of financial accounting benefits prior to the period in which the tax benefits are recognized for income tax purposes. See the Background and Rationale section to this part of the Report, which contains a general explanation of relevant aspects of Financial Accounting Standard No. 109, Accounting for Income Taxes.

<sup>568</sup> For detailed information of the present law rules and judicial doctrines applicable to tax avoidance 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).

<sup>569</sup> In many situations, the allocation method chosen by the partnership to account for the pre-contribution gain can be one of most contentious tax negotiations between the partners because of the tax implications to the respective partners.

Highlighting that the allocation had no economic impact on the Enron partners, the Whitewing partnership agreement contained a special provision that allocated 100 percent of the depreciation deductions associated with the Bammel Assets to Enron (instead of its ratable ownership share). Normally, such a special allocation would be detrimental to the contributing partner as it would result in additional taxable income to such partner, but because both Enron and HPL were part of the Enron consolidated tax return, the allocations had no impact on the consolidated group's taxable income.

The use of the remedial allocation method and the special provision allocating 100 percent of the Bammel Assets depreciation to Enron Corp. facilitated the maximization of the purported tax benefits of the structure. Without these items Enron Corp. and HPL would have been able to effectuate a basis shift between themselves of only a portion of the \$930 million value.<sup>570</sup> However, through these items, a basis shift of the full \$930 million value of the Bammel Assets could be accomplished at no economic cost and the exit strategy could be undertaken.

#### Partnership basis rules on liquidating distributions and section 754 adjustments

The strategy anticipated distributing the Bammel Assets back to HPL in redemption of its Whitewing preferred partnership interest after 16 years. Under the partnership rules, HPL ascribes its partnership tax basis to the Bammel Assets. Thus, the tax basis would be "stepped-up" from zero to \$930 million and HPL could begin to depreciate the Bammel Assets for Federal income tax purposes. It was anticipated that the only remaining asset of Whitewing would be Enron stock, and that the stock would be "stepped-down" by a corresponding amount. However, Enron Corp. could use one of several strategies to avoid recognizing any taxable gain with respect to such stock under section 1032. The permanent exclusion of this gain allowed Enron to report a financial accounting benefit with respect to the transactions.<sup>571</sup>

#### Application of May Company regulations

If finalized, it is possible that the transaction would be subject to proposed regulations regarding gain recognition upon certain partnership transactions involving a partner's own stock.<sup>572</sup> Specifically, under the proposed regulations, the contribution of the Bammel Assets to the Whitewing partnership (which held Enron preferred stock) may have resulted in a deemed

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<sup>570</sup> The exact amount would depend on the partnership ownership percentages and operations.

<sup>571</sup> If the partnerships held assets other than Enron stock, then instead of a permanent exclusion of gain, the transactions would have generated only a deferral of gain (because Enron eventually would pay tax with respect to the assets) with no resulting financial statement income.

<sup>572</sup> Prop. Treas. Reg. sec. 1.337(d)-3(d). These regulations apply to transactions or distributions occurring after March 9, 1989. *See also*, Notice 89-37, 1989-1 C.B. 679, and Notice 93-2, 1993-2 C.B. 292 (effective date of proposed regulations under sec. 1.337(d)-3).

redemption requiring gain recognition by HPL.<sup>573</sup> In addition, if Whitewing distributed to Enron its own stock (or the stock of an affiliate), the distribution would be characterized as a redemption (or an exchange of the stock of the partner) for a portion of the partner's partnership interest with a value equal to the stock distributed.<sup>574</sup> Thus, gain could be recognized on that portion of the distribution.<sup>575</sup>

In evaluating the risks of the proposed regulations to Project Condor, Enron stated that, in off-the-record discussions, Treasury Department personnel had indicated that the regulation will never be finalized, and even if finalized, the regulation would take a different form.<sup>576</sup> Because the regulations have not been finalized, they are not authoritative at this time.<sup>577</sup>

#### Application of partnership allocation anti-abuse rule

The section 704(c) regulations upon which Enron relied to trigger the basis shift state that generally, the remedial allocation method is a reasonable method for allocating pre-contribution gain.<sup>578</sup> However, an anti-abuse rule states that an allocation method is not reasonable if the contribution of the property and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in-gain or loss among partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.<sup>579</sup> Although the allocations between the Enron entities offset for tax purposes, considering that Enron had prearranged all of the steps to cause a substantial reduction of its tax

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<sup>573</sup> Because of the special allocations, distribution rights, and Enron Corp. being a partner, it is not certain that HPL would be considered to have exchanged appreciated property for an interest in Enron stock.

<sup>574</sup> Prop. Treas. Reg. sec. 1.337(d)-3(e).

<sup>575</sup> *Id.*

<sup>576</sup> The Project Condor materials in Appendix B contain part of an interoffice memorandum regarding the proposed restructuring of Whitewing LP from Anne Marie Tiller dated February 26, 1999. EC 000850731- EC00850735. See also, Project Condor materials in Appendix B, document titled "Nighthawk Restructuring Summary." EC 000850800 - EC 000850801. Enron called the overall restructuring of which Project Condor was a part Project Nighthawk and Project Daybreak.

<sup>577</sup> For the legal authority attributed a proposed regulation, see *Freesen v. Commissioner*, 84 TC 920 (1985) (proposed regulations carry no more weight than position or argument advanced by party on brief), *Estate of H.A. True, Jr. v. Commissioner*, 82 T.C. Memo 2001-167 ("we [courts] accord them [proposed regulations] no more weight than a litigating position").

<sup>578</sup> Treas. Reg. sec. 1.704-3(a)(1).

<sup>579</sup> Treas. Reg. sec. 1.704-3(a)(10).



liability, and made affirmations that it would complete the steps,<sup>580</sup> the anti-abuse rule should apply to preclude the use of the remedial allocation method in this situation.<sup>581</sup> If the anti-abuse rule does not preclude this type of activity, then the meaningfulness of this rule must be questioned.<sup>582</sup>

#### Application of partnership anti-abuse regulations

Subchapter K contains two anti-abuse rules relating to partnerships.<sup>583</sup> These rules state that if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate Federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for Federal tax purposes, as appropriate, to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances.<sup>584</sup>

One factor that is potentially indicative of abuse is whether substantially all of the partners are related. Using the Whitewing partnership superficially provided Enron with an unrelated partner (the Osprey investors). However, a review of the documents indicates that the

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<sup>580</sup> In order for Enron to record the financial accounting benefits of such transaction it was required to reasonably represent to its independent auditor that it has a planning strategy that, without incurring significant cost, would enable it to retire or dispose of the Enron shares without incurring a tax cost.

<sup>581</sup> Treasury Regulation 1.704-3(a)(1) states that an allocation method is not necessarily unreasonable merely because another allocation method would result in a higher aggregate tax liability. However, related parties acting in concert should be a situation that warrants the imposition of the anti-abuse rule. In this situation, had Enron used the traditional allocation method the tax results it was intending to obtain would not have been available. It is also possible that the traditional method with curative allocations would not have precluded it from obtaining the desired results.

<sup>582</sup> Interestingly, neither the Vinson & Elkins tax opinion nor any of the tax advice the Joint Committee staff reviewed from Deloitte & Touche discussed the application or potential application of the section 704(c) anti-abuse rule. However, Enron internal documentation indicates that the application of the remedial allocation method should not run afoul of the rule and, in fact, follows it to the letter. The document indicates that the anti-abuse regulation is not applicable because in this case, the tax consequences are not being "shifted" but are instead being allocated to the partner whose contribution of property had the built-in gain. EC 000850646. This reading of the regulation results in the remedial allocation never being subject to the anti-abuse rule, a result specifically rejected by the Treasury Department in the issuance of the final regulations (TD 8585, 1995-1 CB 120). The Project Condor materials in Appendix B contain the internal document in its entirety. EC 000850644- EC 000850647.

<sup>583</sup> Treas. Reg. sec. 1.701-2.

<sup>584</sup> Treas. Reg. sec. 1.701-2(b).

unrelated partner did not share in any of the economic income or loss in the Bammel Assets. Specifically, any income, gain, loss, or deduction associated with the Bammel Assets was allocated solely to Enron or HPL. In addition, the partnership agreement contains a special provision that requires the distribution of Bammel Assets to HPL upon HPL's request.<sup>585</sup> These facts reflect that, substantively, these transactions were solely between Enron and its wholly owned subsidiary HPL.

Another factor that is potentially indicative of abuse is the lack of a business purpose. Enron's stated business purpose for engaging in the structure was to enhance the collateral of the Whitewing LP structure to lower its financing cost with the Osprey investors. However, the amended and restated Whitewing LP agreement was completed on September 24, 1999. The partnership agreement permits, but does not require, Enron to make further capital contributions to Whitewing.<sup>586</sup> As described above, the Osprey investor had no economic interest in the income, gain, loss, or deduction with respect to the Bammel Assets. In reality, the reviewed documents indicate that the Whitewing LP partnership and its financial restructuring were used to facilitate a transaction that arguably had no business relationship to the overall financial restructuring.

## **Recommendations**

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. Although the Joint Committee staff believes that the partnership allocation anti-abuse rules should apply to preclude the tax benefits Project Condor purported to generate, 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.

In addition, transactions that use partnership tax rules and section 1032 to obtain unintended tax results appear to continue unabated. The Treasury Department has issued guidance addressing certain situations in which gain or loss may be improperly created by adjusting the basis of a partnership interest for partnership income that is not subject to tax under section 1032, but as with many tax-motivated transactions, it is difficult to keep pace with the promoters of these ideas. In light of this activity, the Joint Committee staff believes that further guidance is needed to address the interaction of the partnership basis rules with the corporate nonrecognition of gain rules under section 1032. Of particular concern is gain being excluded by

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<sup>585</sup> Absent this special provision, the Whitewing LP partners had no ability to request a distribution of their capital contributions.

<sup>586</sup> The Whitewing partnership agreement permitted Enron or an affiliate to make additional capital contributions in exchange for additional partnership interests so long as such interests are subordinate to the Osprey Investors preferred interest in Whitewing.

virtue of section 1032 that is attributable to a downward basis adjustment mandated by a section 754 election.

The Joint Committee staff recommends that either (1) section 1032 limit the nonrecognition of any realized gain allocated to the corporate partner to the extent that the gain is attributable to an economic benefit accruing to the corporate partner, or (2) that the partnership basis rules should be altered to preclude an increase in basis to an asset if the offsetting basis reduction would be allocated to stock of a partner (or related party). For example, if a partnership sells the stock at a gain and the gain is due not to appreciation in the value of the stock but rather to a decrease in the basis of the stock (as required by a section 754 election), then the realized gain is not due to an economic benefit accruing to the partner (i.e., increase in stock value). Rather, it is simply due to a reduction to the basis of the stock that was offset by an increase in basis to another asset. Consequently, the corporate partner should not be permitted to utilize section 1032 to avoid recognition of the realized gain allocated to it (or to have increased the basis of an asset)

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.

#### **4. Projects Tammy I and Tammy II**

##### **Brief overview**

Projects Tammy I and Tammy II were structured to generate financial statement benefits attributable to an increase in tax basis (in excess of book basis) in the Enron South office building and other depreciable assets. In a simplified version of the transaction, Enron Corp. and several of its subsidiaries contributed assets with significant unrealized built-in gains to a newly-formed partnership. Financial institutions provided \$500 million of financing to the partnership in exchange for a preferred interest. Following the formation of the partnership, Enron and all but one of the Enron partners transferred approximately 95 percent of their partnership interests to a single Enron affiliate. The partnership then sold built-in gain assets, with the gain (and the resulting basis increases) allocated almost entirely to the single Enron affiliate -- giving the single Enron affiliate a high basis in its partnership interest. The partnership was to use the sales proceeds to: (1) purchase a low value depreciable asset, (2) purchase Enron preferred stock, and (3) repay the financial institutions.

In a later year, the partnership would distribute the low value depreciable asset to the single Enron affiliate in redemption of its partnership interest. The depreciable asset would inherit the single Enron affiliate's high basis in its partnership interest. The only remaining asset in the partnership would be Enron preferred stock. The Enron partners then could implement exit strategies to avoid the recognition of gain with respect to the Enron preferred stock.

## **Project Tammy I – background**<sup>587</sup>

### Reported tax and financial statement effects

Project Tammy I was projected to generate \$1.09 billion in Federal income tax deductions (without any economic outlay) resulting primarily from enhanced depreciation deductions attributable to the Enron South office building. These deductions were anticipated to be available to offset Enron's taxable income beginning in 2007. The tax savings associated with these deductions would have generated approximately \$406.5 million of financial statement income. The financial statement income would accrue during the years 2001 through 2005.<sup>588</sup>

In actuality, Enron did not report a financial statement benefit with respect to Project Tammy I for year 2001. As to the Federal income tax benefits, Project Tammy I was terminated prior to their realization. However, the three dispositions by the partnership in year 2001 did result in the recognition of gain (which was offset by losses from the Enron consolidated group).

### Development of Project Tammy I

Deloitte & Touche proposed the idea for Project Tammy I to Enron. Enron held appreciated non-core business assets that it planned to sell. Enron had sufficient net operating losses to offset the projected gains from such sales. Project Tammy I was a mechanism that allowed Enron to shift basis to another asset held by the Enron consolidated group (resulting in greater future depreciation deductions).

The transaction was the product of collaboration between the Enron tax department and Deloitte & Touche, Akin Gump, and Vinson & Elkins. Much time was spent on identifying the proper Enron assets to place in the project structure. In addition, the structure originally contemplated an intercompany sale of the partnership interests. The structure later was revised to involve a tax-free transfer of the partnership interests.

On August 7, 2000, the Finance Committee of Enron Corp.'s Board of Directors approved Project Tammy I for recommendation to the Enron Corp. Board of Directors. At the Enron Corp. Board of Directors meeting (held later that day), Rebecca C. Carter presented a report of the Finance Committee's action, and the Board of Directors approved and ratified Project Tammy I.<sup>589</sup> On May 1, 2001, the Enron Corp. Board of Directors adopted and ratified all of the actions taken with respect to Project Tammy I and authorized the creation of a new

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<sup>587</sup> The information regarding Project Tammy I was obtained from Joint Committee staff interviews of James A. Ginty, Robert J. Hermann, Robert D. Maxey, and Alicia L. Goodrow, as well as from documents and information provided by Enron and the IRS.

<sup>588</sup> The General Background Materials in Appendix B contain the Structured Transactions Group, Summary of Project Earnings & Cash Flows, November 2001.

<sup>589</sup> Agenda item #5(c) of the Meeting of the Finance Committee of the Enron Corp. Board of Directors, August 7-8, 2000, EC 000043879, 000043966-43972.

series of Enron preferred stock in the amount of \$1 billion to be sold to a subsidiary of the partnership.<sup>590</sup>

### Implementation of Project Tammy I

The implementation of Project Tammy I involved several steps that were to be executed over a period of years. The steps involved: (1) the formation of a partnership, (2) a transfer of the partnership interests, (3) a sale of the built-in gain assets, and (4) certain post-sale events.

Formation of the partnership.—The initial step in the implementation of Project Tammy I was the formation of the partnership through which the reallocation of built-in gain would occur. The partnership, called Enron Finance Partners, LLC (“Enron Finance”), was formed on July 14, 2000, with three members of the Enron consolidated group being the initial members.<sup>591</sup> New members were admitted to the partnership during October and November 2000.

On November 28, 2000, Enron Finance’s membership interests were reclassified into Class A Members, Class B Members, and Class C Members. The managing member of the partnership<sup>592</sup> owned the Class A Membership interest, the Enron consolidated group members owned the Class B Membership interests, and Zephyrus LLC (“Zephyrus”), through which the minority interest was held,<sup>593</sup> owned the Class C Membership interest.

In exchange for their membership interests, the members contributed various assets and had various liabilities assumed by Enron Finance. Zephyrus contributed \$500 million in exchange for its Class C Membership interest.<sup>594</sup> The Class B Members contributed several assets with significant unrealized built-in gain. For example, Enron Corp. contributed 11.5 million shares of EOG Resources, Inc. stock with an agreed fair market value of \$485.875

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<sup>590</sup> Minutes of the Meeting of the Enron Corp. Board of Directors, May 1, 2001, EC 000049817-49828.

<sup>591</sup> The three members were Smith Street Land Company (“Smith Street”), Enron Capital Investments Corp., and Enron Global Exploration & Production, Inc. Smith Street was developing the Enron South office building.

<sup>592</sup> Enron Finance Management, LLC, a disregarded entity from its sole owner, Enron, was the sole manager of Enron Finance.

<sup>593</sup> Zephyrus was a Delaware limited liability company formed on November 17, 2000. Its initial members were Chase Equipment Leasing, Inc., Bank of America, N.A., BNP Paribas, and Fleet National Bank. Royal Bank of Scotland subsequently was admitted as a member. The members contributed to Zephyrus an aggregate of \$481.725 million in their capacities as “lenders” and \$18.275 million in their capacities as “certificate purchasers,” for a total of \$500 million in minority interest financing.

<sup>594</sup> Zephyrus received ten membership units evidencing the Class C Membership interest. Each Class C unit represented a capital contribution of \$50 million. The Class C Membership interest was to have been redeemed sometime in year 2005.

million (subject to a debt of approximately \$461.5 million) and a tax basis of approximately \$40.71 million. Another Class B Member executed an option that allowed Enron Finance to purchase (for \$1) the stock of Enron Renewable Energy Corp. with an agreed fair market value of \$550 million (subject to a debt of approximately \$524 million) and a tax basis of approximately \$200 million.<sup>595</sup> Another Class B Member contributed all of the outstanding stock of Enron Oil & Gas India Ltd. with an agreed fair market value of \$550 million (subject to a debt of \$523.2 million).<sup>596</sup> Other built-in gain assets contributed to Enron Finance included the outstanding stock of Enron LNG Power (Atlantic) Ltd., with an agreed fair market value of \$260 million (subject to a debt of \$118.750 million) and a tax basis of \$14.283 million, and a partnership interest in Enron Capital Management III Limited Partnership with an agreed fair market value of \$99.083 million (subject to a debt of \$93.634 million) and a tax basis of \$21.288 million.<sup>597</sup>

Collectively, the Class B members (i.e., Enron Corp. and its subsidiaries) contributed property with a gross value of approximately \$1.95 billion (subject to a debt of \$1.85 billion) and an estimated tax basis of \$500 million. In each instance, the contributing member remained liable for the debt that Enron Finance had assumed in connection with the contributions.

Transfers of partnership interests.—The second step of the transaction involved a transfer of the partnership interests within the Enron consolidated group. In this regard, Enron and all but one of the Class B members contributed 95 percent of their respective Class B Membership interests to Enron Capital Investments Corp. (the other Class B Member) in exchange for Enron Capital Investments common stock.<sup>598</sup> Each contributor remained liable for the debt that Enron Finance had previously assumed. After the transfers, Enron Capital Investments Corp. owned more than 98 percent of the Class B Membership interests in Enron Finance, and the other Class B members (Enron Corp., Smith Street, Enron Global, Enron Caribbean Basin, and Boreas

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<sup>595</sup> The option was intended to transfer tax ownership of the Enron Renewable Energy Corp. stock to Enron Finance without requiring the approval of the Federal Energy Regulatory Commission to transfer the stock. Discussion material for Project Tammy, June 30, 2000, EC2 000037666.

<sup>596</sup> Enron's tax basis in the Enron Oil & Gas India Ltd. stock is unclear.

<sup>597</sup> Capital contribution schedule for Project Tammy I as of May 30, 2002, EC 000851323.

<sup>598</sup> On November 21, 2000, Enron, Smith Street, Enron Global, and Enron Caribbean Basin LLC contributed their interests to Enron Capital Investments Corp. On December 11, 2000, Boreas Holdings agreed to contribute 95 percent of its Class B Membership interest in Enron Finance in exchange for Enron Capital Investments Corp. stock with a value of \$5.177 million. ECx000005165-5167.

Holdings) collectively owned less than two percent of the Class B Membership interests.<sup>599</sup> The net value of the transferred Class B Membership interests was \$95,302,656.<sup>600</sup>

Sale of built-in gain assets.—Following the transfers of the Class B Membership interests to Enron Capital Investments Corp., Enron Finance was to sell the unrealized built-in gain assets.<sup>601</sup> Enron Finance, through a lower-tiered partnership,<sup>602</sup> sold the following assets: (1) the stock of Enron Oil & Gas India Ltd. for \$388 million,<sup>603</sup> (2) the stock of EOG Resources, Inc. for approximately \$400 million,<sup>604</sup> and (3) an interest in an East Coast power plant.<sup>605</sup>

Post-sale events.—Enron Finance was to use the sales proceeds to: (1) purchase the Enron South office building from Smith Street, (2) purchase newly-issued Enron preferred stock and (3) redeem the Class C Membership interest held by Zephyrus.<sup>606</sup> Thereafter, Enron Finance was to distribute the Enron South office building to Enron Capital Investment Corp. in liquidation of its partnership interest, leaving the Enron preferred stock as Enron Finance's only asset. The precise exit strategy with respect to the Enron preferred stock was unclear -- one option under

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<sup>599</sup> ECx000005156.

<sup>600</sup> ECx000005155.

<sup>601</sup> As discussed below, this would result in the recognition of the built-in gain (of which 95 percent would have been allocated to Enron Capital Investments Corp., thereby increasing its tax basis in its partnership interest).

<sup>602</sup> Enron Finance contributed the assets to Enron Intermediate Holdings (a disregarded entity), which, in turn, contributed the assets to Enron Asset Holdings. Enron Asset Holdings continues to hold the unsold assets.

<sup>603</sup> A revised agreement was signed on January 22, 2002, with a sales price of \$350 million. Enron Deal Approval Sheet for EOGIL Divestiture, EC2 000037748-37752.

<sup>604</sup> Enron Risk Assessment and Control Deal Approval Sheet for Cerberus (involving the divestiture of the EOG stock), EC2 000037753-61. The EOG Resources, Inc. stock had already been monetized for approximately \$517.5 million through an arrangement with the Cooperatieve Centrale Raiffeisen-Boerenleenbank B.A. ("Rabobank"). As part of the arrangement, Enron North America entered into an equity swap with Rabobank to make up any shortfall between the \$517.5 million and the proceeds from the disposition of the EOG Resources, Inc. stock.

<sup>605</sup> Enron transaction history of Project Tammy I, EC2 000037647.

<sup>606</sup> As originally planned, Enron Asset Holdings was to purchase approximately \$630 million of Enron Corp. preferred stock in September 2000, using the proceeds from the monetization of the EOG Resources, Inc. stock. As previously discussed, the Enron Corp. Board of Directors did not approve the issuance of a new class of Enron Corp. preferred stock until May 1, 2001. Enron Asset Holdings never purchased the Enron Corp. preferred stock, nor did it purchase the Enron South office building.

consideration was for Enron Finance to distribute the stock to the remaining partners (all members of the Enron consolidated group) in liquidation of their partnership interests.<sup>607</sup>

The diagram on the next page depicts the Project Tammy I structure as of December 31, 2001.

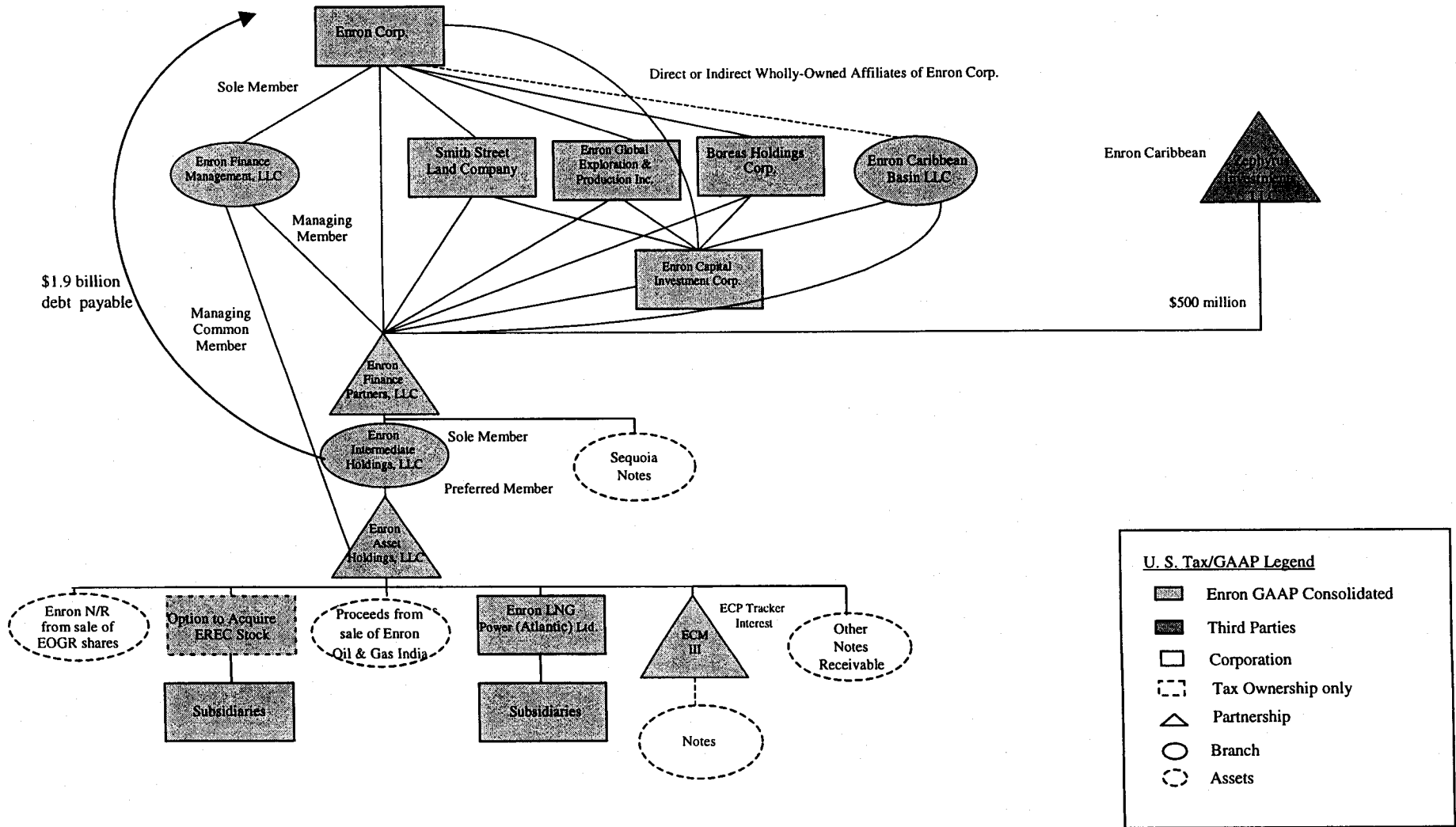
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<sup>607</sup> Discussion material for Project Tammy I dated June 30, 2000, pgs. EC2 000037662-37665.



# Project Tammy I Structure as of December 2001

227



\$1.9 billion debt payable

\$500 million

### Role of outside advisors

Deloitte & Touche promoted the idea of Project Tammy I to Enron and was a principal advisor with respect to its structuring. Deloitte & Touche received fees totaling \$8 million in connection with the transaction.<sup>608</sup> Vinson & Elkins acted as Enron's corporate and tax counsel in Project Tammy I and received fees totaling \$698,775 for its services. Vinson & Elkins provided a tax opinion in connection with the transaction. In the opinion, Vinson & Elkins concluded that (1) no gain or loss "should" be recognized by Enron or the other Class B Members upon the contributions of the assets to Enron Finance; (2) no gain or loss "should" be recognized by Enron Capital Investments Corp. or the Class B Members on the contribution of 95 percent of their interests to Enron Capital Investments Corp.; (3) 95 percent of the built-in gain with respect to the contributed assets "should" be allocable to Enron Capital Investments Corp. by reason of the contribution, and on the subsequent sale of the contributed assets, Enron Capital Investments Corp.'s basis in its partnership interest "should" be increased by the built-in gain allocated to it; and (4) the creation and use of Enron Finance "should" not be disregarded as a sham and should not be subject to the partnership anti-abuse rules.

Akin, Gump also served as tax counsel to Enron and received fees totaling \$235,234 for its services.<sup>609</sup>

Appendix C, Part VIII to this Report contains the tax opinion Enron received in connection with Project Tammy I.

### Subsequent developments

Enron's bankruptcy foreclosed the ability to recognize the anticipated financial and tax benefits with respect to Project Tammy I. Enron and Zephyrus are in litigation/settlement discussions over defaults in payments related to the minority interest financing. In addition, some groups are reviewing some of the asset sales, and a number of issues are expected to be

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<sup>608</sup> The General Background Materials in Appendix B contain the Estimated Project Fees schedule (6/4/2001), EC2 000036379.

<sup>609</sup> Other law firms that were involved in Project Tammy I included LeBouef, Lamb, Greene & Mac (received fees totaling \$219,231) and Freshfields Bruckhaus Deringer (received fees totaling \$145,000).

Arthur Andersen acted as Enron's principal advisor on accounting and financial statement issues in connection with Project Tammy I and received a fee of \$152,250 in connection with the transaction.

JP Morgan Chase led the group of financial institutions that invested \$500 million in Project Tammy I (through Zephyrus). JP Morgan Chase received fees totaling \$2.289 million in connection with the transaction.

presented to the creditors committee.<sup>610</sup> The IRS is in the process of auditing Enron's tax returns for years 1996 through 2001.

### **Project Tammy II – background**<sup>611</sup>

Project Tammy II employed the same structure as Project Tammy I. The only differences were the assets to be sold and the depreciable asset(s) that would benefit from the increased tax basis. As originally contemplated, the primary asset Enron Corp. intended to sell through the Project Tammy structure was its interest in Portland General Electric Company ("PGE"). However, in order to reduce its exposure in connection with an IRS audit of the transaction, the Enron tax department decided to create two separate Project Tammy structures to dispose of the unwanted assets. Project Tammy II was the vehicle through which Enron was to sell its PGE stock. Enron never identified the depreciable assets that were to benefit from the increased tax basis.

#### Reported tax and financial statement effects

Project Tammy II was expected to generate approximately \$1.06 billion of Federal income tax deductions (without any economic outlay) resulting primarily from enhanced depreciation deductions attributable to unidentified depreciable assets. These deductions were anticipated to be available to offset Enron's taxable income beginning in 2007. In addition, the tax savings associated with these deductions would have generated approximately \$370 million of financial statement income. The financial statement income would accrue during the years 2002 through 2005.<sup>612</sup>

In actuality, Enron did not report a financial statement benefit with respect to Project Tammy II. As to the Federal income tax benefits, Project Tammy II was terminated prior to their realization. However, the two dispositions by the partnership in 2001 did result in the recognition of gain (which was offset by losses from the Enron consolidated group).

#### Development of Project Tammy II

As previously discussed, Projects Tammy I and II relied on the same legal analysis and involved similar structures (except for the assets to be sold and the depreciable asset(s) that

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<sup>610</sup> The Project Tammy I materials in Appendix B contain the Project Tammy I deal basics, EC2 000037649.

<sup>611</sup> The information regarding Project Tammy II was obtained from Joint Committee staff interviews of R. Davis Maxey, Robert J. Hermann, and Alicia L. Goodrow, as well as from documents and information provided by Enron, the IRS, and filings with the United States Bankruptcy Court in the Southern District of New York.

<sup>612</sup> The General Background Materials in Appendix B contain the Structured Transactions Group, Summary of Project Earnings & Cash Flows, November 2001.

would benefit from the increased tax basis).<sup>613</sup> The primary motivation for using multiple projects was to reduce Enron's IRS audit exposure with respect to the transactions.

On April 30, 2001, Finance Committee of Enron Corp.'s Board of Directors approved Project Tammy II for recommendation to the full Board of Directors. At the Enron Corp. Board of Directors meeting held the following day, Herbert S. Winokur, Jr. presented a report of the Finance Committee's action, and the Board of Directors approved and ratified Project Tammy II.<sup>614</sup> At the same time, the Board authorized the creation of a new series of Enron Corp. preferred stock in the amount of \$1 billion that was to be sold to a subsidiary of the partnership.<sup>615</sup>

### Implementation of Project Tammy II

Like Project Tammy I, the implementation of Project Tammy II involved several steps that were to be executed over a period of years. The steps involved: (1) the formation of the partnership, (2) the transfer of the partnership interests, (3) the sale of the partnership's built-in gain assets, and (4) certain post-sale events.

Formation of the partnership.—The initial step was the formation of the partnership that would be used to reallocate the built-in gains. The partnership, called Enron Northwest Finance, LLC ("Enron Northwest"), was formed on May 2001, with Enron Corp., Enron Property & Services Corp. ("Enron Property"), and JILP-LP<sup>616</sup> (all members of the Enron consolidated group) as the initial members.<sup>617</sup>

In exchange for a Class B Membership interest in Enron Northwest, the members contributed various assets and had various liabilities assumed by Enron Northwest.<sup>618</sup> Enron Corp. contributed the following assets:

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<sup>613</sup> Current Enron management is not aware of any written documentation prepared by Deloitte & Touche in connection with the development and implementation of Project Tammy II. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 98.

<sup>614</sup> Agenda item #8(c) of the Meeting of the Enron Corp. Board of Directors, EC 000049507, ENE 0000001542, 15550-15555.

<sup>615</sup> *Id.*

<sup>616</sup> JILP-LP was a wholly-owned subsidiary of Enron North America.

<sup>617</sup> Enron Finance Management, a disregarded entity from its sole owner (Enron Corp.) was the sole manager of Enron Northwest. Enron Finance Management contributed \$1,000 to Enron Northwest for its Class A Membership interest. Enron Finance Management also acted as the sole managing member in the Project Tammy I structure.

<sup>618</sup> In each instance, the contributing member remained liable on the debt that was assumed by Enron Northwest in connection with the particular transfer.

- (1) An agreement that granted Enron Northwest an option to purchase (for \$1) all the stock of PGE (a wholly-owned subsidiary of Enron) with an agreed fair market value of \$2.1 billion and a tax basis of approximately \$1.25 billion (“PGE Option”),
- (2) 3,276,811 common units of EOTT Energy Partners, LP (the “EOTT Units”) with an agreed fair market value of \$58,491,076, and a zero tax basis, and
- (3) A derivative interest that tracked the economic value of its limited partnership interest in Joint Energy Development Investments, LP (“JEDI”) relating to an indirect interest in 67,849 shares of common stock of Hanover Compressor.

Enron Property assigned to Enron Northwest a \$200 million demand note issued by Enron to Enron Property with an agreed fair market value of \$200 million.

JILP-LP contributed a derivative interest that tracked the economic value of its limited partnership interest in Ponderosa Assets, LP relating to an interest in 1,680,840 shares of common stock of Hanover Compressor.

In the aggregate, the Class B members (i.e., Enron Corp. and its subsidiaries) contributed property with a gross value of approximately \$2.1 billion (subject to liabilities of \$2 billion) and an estimated tax basis of \$1 billion. In each instance, the contributing member remained liable for the debt that Enron Northwest had assumed in connection with the contributions.<sup>619</sup>

Enron Northwest was designed to raise \$500 million of minority interest financing, but the financing was never arranged.<sup>620</sup>

Transfers of partnership interests.—Following the formation of the partnership, Enron Corp. contributed 2.715 percent of its Class B Membership interest in Enron Northwest to Enron Property (another holder of a Class B Membership interest). JILP-LP contributed 95 percent of its Class B Membership interest in Enron Northwest to Enron Property in exchange for shares of Enron Property common stock.

Sale of built-in gain assets.—In the second half of 2001, Enron Northwest, through a lower-tiered partnership, sold (1) the EOTT Units for \$64.55 million (all of which was gain),<sup>621</sup>

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<sup>619</sup> Enron Northwest contributed the assets (and transferred the liabilities) to Enron Northwest Intermediate LLC, which in turn, contributed the assets to Enron Northwest Assets, LLC. Enron Northwest Assets, LLC continues to hold the unsold assets.

<sup>620</sup> Project Tammy II Tax Overview, EC2 000037764; Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 94.

<sup>621</sup> Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 95.

and (2) the derivative interest in the Hanover Compressor stock.<sup>622</sup> In October 2001, Northwest Natural Gas Company entered into an agreement to purchase the PGE stock from Enron (and Enron Northwest Assets, LLC). Because of issues raised by Enron's bankruptcy, however, the purchase was never consummated. The parties terminated the agreement in May 2002.<sup>623</sup>

Post-sale events.—Project Tammy II effectively was terminated before Enron Northwest purchased either the depreciable asset for distribution to Enron Property or the Enron Corp. preferred stock.<sup>624</sup>

The diagram on the next page depicts the Project Tammy II structure.

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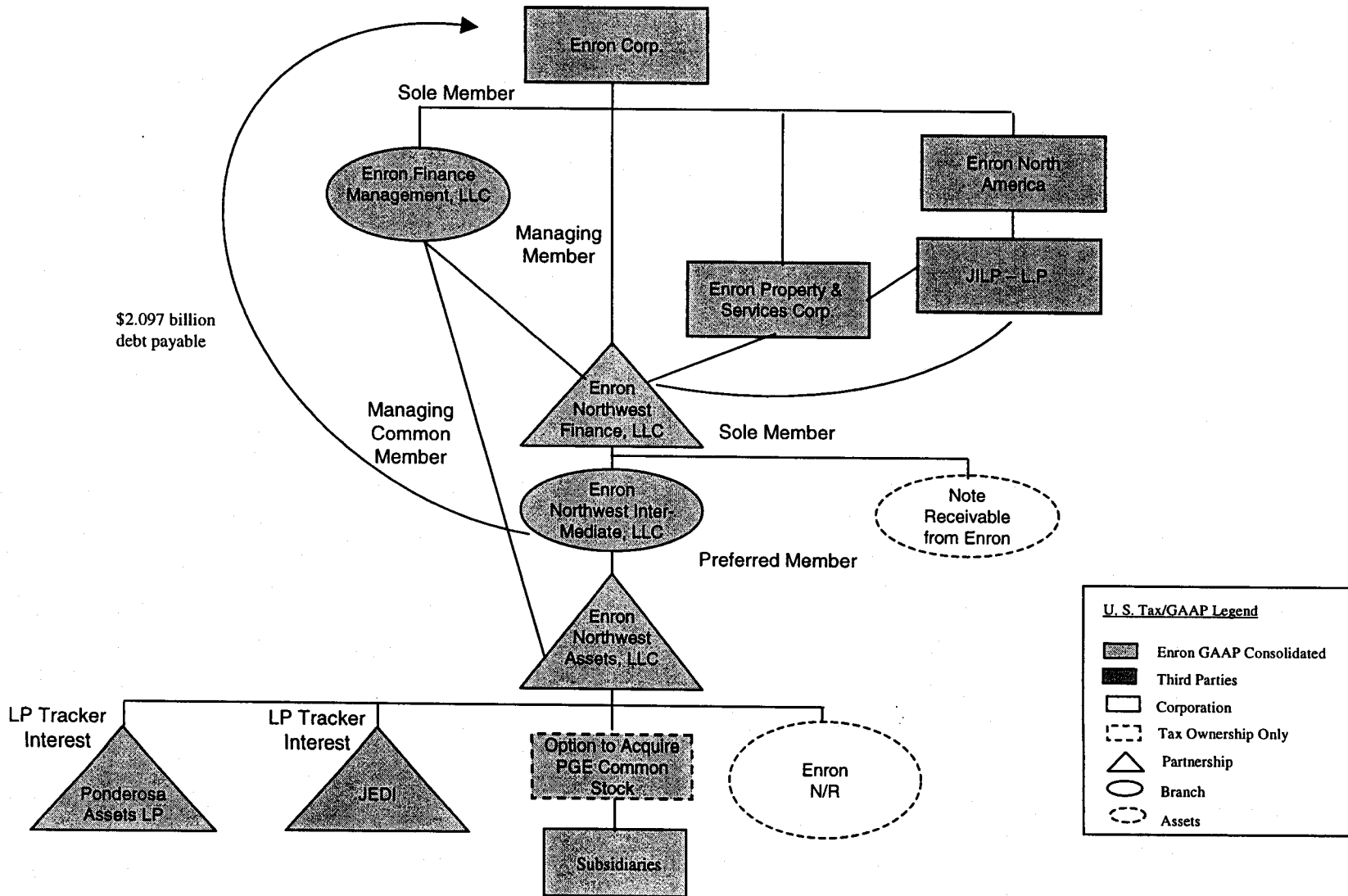
<sup>622</sup> Project Tammy II Tax Overview, EC2 000037766.

<sup>623</sup> *See In re Enron Corp., et al.*, Motion of Enron Corp., et al., for an Order, Pursuant to Sections 105, 363(b), and 365 of the Bankruptcy Code and Rules 2002, 6004 and 9013 of the Federal Rules of Bankruptcy Procedure, Authorizing and Approving (a) the Execution and Delivery of Termination Agreements in connection with the PGE Option Agreement, (b) the Execution and Delivery of a Tax Allocation Agreement, and (c) the Consummation of the Transactions Contemplated Therewith, Filed by Debtors and Debtors in Possession, U.S. Bankruptcy Court (S.D.N.Y.), Dec. 6, 2002.

<sup>624</sup> Current Enron management is not aware that any replacement asset was ever identified. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 97.

# Project Tammy II Structure as of December 2001

Confidential



### Role of outside advisors

Vinson & Elkins acted as corporate and tax counsel to Enron on Project Tammy II. Deloitte & Touche advised Enron with respect to the tax structuring and other related matters. Enron did not receive any tax opinions in connection with Project Tammy II.<sup>625</sup>

### Subsequent developments

Enron's bankruptcy foreclosed the ability to recognize the anticipated financial and tax benefits with respect to Project Tammy II. Pursuant to a motion filed and approved by the bankruptcy court, effective December 23, 2002, Enron Corp., Enron Northwest Intermediate LLC, and Enron Northwest terminated the PGE Option and the assumption of the Enron Corp. liabilities.

The IRS is in the process of auditing Enron's tax returns for years 1996 through 2001.

### **Discussion**<sup>626</sup>

Similar to Project Condor, the transactions in Projects Tammy I and II were designed to generate a total of over \$2 billion in additional depreciable tax basis via the shifting of tax basis (in excess of book basis) to long-lived assets. The expected tax benefits were the result of the interaction of the partnership tax rules that address the allocation of built-in gains with respect to contributed assets,<sup>627</sup> the partnership basis rules on liquidating distributions,<sup>628</sup> and, depending on the exit strategy, the interaction of the partnership basis rules and the corporate nonrecognition rules in exchanges involving a corporation's own stock.<sup>629</sup> These rules are discussed below.

Under the strategy devised in Projects Tammy I and II, the benefits of the increased tax basis (in the form of greater depreciation deductions) would inure over a 39-year period and was not expected to be reflected in Enron's consolidated tax return until 2007. However, and

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<sup>625</sup> The Project Tammy II materials in Appendix B contain the Project Tammy II deal basics, EC2 000037767; Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 99.

<sup>626</sup> Enron's bankruptcy effectively prevents Enron from realizing the tax benefits that were contemplated in Projects Tammy I and II. Nevertheless, this section discusses the tax benefits that Enron sought to achieve from the transactions (without regard to the bankruptcy).

<sup>627</sup> Sec. 704(c).

<sup>628</sup> Sec. 732(b).

<sup>629</sup> Secs. 705 and 1032.



potentially more important to Enron, the strategy permitted Enron to begin recording the benefits immediately for financial accounting purposes.<sup>630</sup>

### Partnership allocations

One of the first steps in the implementation of Projects Tammy I and II involved the contribution of built-in gain assets by members of the Enron consolidated group to a partnership. As previously discussed, present law requires that any income, gain, loss, and deduction with respect to contributed property must be shared among the partners so as to take account of the variation between the tax basis of the property to the partnership and its fair market value at the time of contribution.<sup>631</sup> The purpose of this rule is to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. However, the regulations under section 704(c) state that when a contributing partner transfers a partnership interest (or a portion of such interest), built-in gain or loss (proportionate to the interest transferred) must be allocated to the transferee partner as it would have been allocated to the transferor partner.<sup>632</sup> Therefore, in Projects Tammy I and II, when the various members of the Enron consolidated group transferred 95 percent of their partnership interests (the “transferring members”) to another Enron partner the “single Enron affiliate”),<sup>633</sup> a corresponding amount of the built-in gain on the contributed property had to be allocated to the single Enron affiliate. Typically, such a transaction does not present a problem and results in an appropriate tax and economic result. Under this rule, the sale of the built-in gain assets will result in 95 percent of the built-in gain being allocated to the single Enron affiliate, with a corresponding increase in the affiliate’s tax basis in the partnership interest.<sup>634</sup>

In Projects Tammy I and II, the transferring members remained liable on the indebtedness that Enron Finance (in Tammy I) and Enron Northwest (in Tammy II) assumed in connection with the formation of the partnerships.<sup>635</sup> Similarly, when the transferring members contributed their 95 percent partnership interests to the single Enron affiliate, the transferring members

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<sup>630</sup> See the Background and Rationale section to this part of the Report which contains a general explanation of relevant aspects of Financial Accounting Standard No. 109, Accounting for Income Taxes.

<sup>631</sup> Sec. 704(c)(1)(A).

<sup>632</sup> Treas. Reg. sec. 1.704-3(a)(7).

<sup>633</sup> The single Enron affiliate was Enron Capital Investments Corp. in Project Tammy I and Enron Property in Project Tammy II.

<sup>634</sup> Whether the gain is allocated to the single Enron affiliate or to Enron Corp. is irrelevant because both partners are members of the Enron consolidated group (and the gain will be offset by consolidated net operating losses).

<sup>635</sup> By remaining liable on the indebtedness, the contributing partners avoided any gain recognition that would have resulted by virtue of having been deemed to receive a distribution of money in excess of the partners’ basis. See secs. 752(b) and 731(a)(1).

remained liable on their respective amount of indebtedness (presumably to avoid a deemed distribution or discharge on the transfer).

The contribution of the 95 percent partnership interests has the effect of splitting each partnership interest into two components: (1) a five percent equity interest that guarantees partnership debt (which the transferring partners retained), and (2) a 95 percent equity interest (which the transferring partners transferred to the single Enron affiliate). In general, when a part of a larger property is sold, the tax basis is equitably apportioned among the parts for determining gain or loss.<sup>636</sup> This determination is usually not difficult to make. However, the determination becomes much more difficult when dealing with a transfers of a non-economic property interest. This is what occurred in Projects Tammy I and Tammy II. While the 95 percent equity interest had economic value as measured by the value of the partnership assets, the interest was uneconomical if the associated tax liabilities embedded in the partnership interest are considered. Enron determined that the single Enron affiliate would take a zero basis in the 95 percent equity interest.<sup>637</sup> This result, coupled with the partnership allocation rules, enabled Enron to shift tax basis to a depreciable asset in excess of its value.

The following example illustrates how the basis shift occurred. Assume that a partnership has a single long-lived depreciable asset with a value of \$1 billion, a tax basis of \$200 million, and a \$900 million partnership liability that the partner (“transferor partner”) guarantees.<sup>638</sup> The transferor partner has a \$200 million basis in its partnership interest. Assume further that the transferor partner transfers 95 percent of its partnership interest (with no guarantee of the liability) to another partner, and that the transferee partner ultimately will receive an interest in the long-lived asset in a liquidating distribution. The transferee partner has received an interest in partnership property worth \$95 million (95 percent x \$100 million value) with an associated tax liability of \$266 million (\$800 million of sec. 704(c) gain x 95 percent x 35 percent tax rate).<sup>639</sup> The unresolved question is what portion of the transferor partner’s \$200

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<sup>636</sup> Treas. Reg. sec. 1.61-6(a).

<sup>637</sup> This conclusion was based on an interpretation of Rev. Rul. 84-53, 1984-1 C.B. 159. This revenue ruling involves the determination of tax basis in connection with a sale of a partial partnership interest to an unrelated purchaser. In Projects Tammy I and II, the transactions involved a tax-free transfer of a partial interest to members of the same consolidated group.

<sup>638</sup> This hypothetical is similar to an example that Steve Klig of Deloitte & Touche provided to Alicia Goodrow of Enron, in a message dated October 23, 2001, regarding the application of Rev. Rul. 84-53 to Project Tammy I. The Project Tammy I materials in Appendix B contain a Message from Steven E. Klig to Alicia L. Goodrow, subject: Tammy Example.

<sup>639</sup> While the built-in gain will give rise to \$760 million in greater future depreciation deductions (\$800 million x 95 percent), unrelated taxpayers (without capital losses) generally would be unwilling to realize \$760 million of current year gain in exchange for \$760 million in future depreciation deductions. If the partner could force an immediate liquidation of the partnership, then the transferee partner would be entitled to receive \$95 million and would have a \$665 million capital loss (that would offset most of the \$760 million of gain).

million basis should be ascribed to the transferred interest. Under similar facts, Enron apportioned a zero basis to the transferred partnership interest because the transferee partner (i.e., the single Enron affiliate) did not assume any of the liabilities. While there is support for this position,<sup>640</sup> the result is difficult to justify and easy to manipulate (particularly when the transferor and transferee are related). A more theoretically sound approach may be to apply principles similar to the excess loss account rules of the consolidated return regulations,<sup>641</sup> (that allow downward basis adjustments below zero) to the transferee partner's interest. The basis reduction rules of section 358(h) also might serve as a useful model.<sup>642</sup> These approaches more accurately reflect the underlying economics of the transfer, and would negate the tax and financial accounting benefits that Enron sought to achieve from Projects Tammy I and II.<sup>643</sup>

To summarize, the partnership built-in gain rules generally provide appropriate economic results with respect to partnerships whose partners have adverse interests. When the partners are related, however, the section 704(c) rules may be manipulated to produce uneconomic and unwarranted results. This was the case in Project Condor, and the pattern continued in Projects Tammy I and Tammy II.

#### Partnership basis rules on liquidating distributions and section 754 adjustments

In Projects Tammy I and II, the partnership was to use the proceeds from the sale of the built-in gain assets to purchase (1) a low value depreciable asset(s) and (2) a new series of Enron preferred stock. Subsequently, the low value depreciable asset(s) was to be distributed to the single Enron affiliate in liquidation of the affiliate's high basis partnership interest. Under the

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<sup>640</sup> See, Rev. Rul. 84-53, 1984-1 C.B. 159 (situation four).

<sup>641</sup> The excess loss account rules allow negative adjustments to a consolidated member's stock basis that exceed the shareholder's basis in such stock. The resulting negative amount is the shareholder's excess loss account in the stock and is treated as negative basis. Treas. Reg. sec. 1.1502-19.

<sup>642</sup> Section 358(h), previously discussed in the corporate section of this Report, mandates a basis reduction in stock received by a transferor in connection with a tax-free transfer (but not below its fair market value) by the amount of any liability that is assumed in the exchange which was not treated as money received by the taxpayer. If the resulting outside basis is lower than the partnership's basis in the asset, then basis reduction principles similar to section 732(f), previously discussed in this section of the Report, also may be appropriate.

<sup>643</sup> The idea of using low-basis high value assets to maximize the financial accounting benefits in Project Tammy I was not lost on the Deloitte & Touche advisors. As Steven E. Klig from Deloitte & Touche noted in an electronic message to the Enron tax department, "THE MORAL OF THE STORY IS THAT THE HIGHER THE BASIS OF THE BUILT-IN GAIN PROPERTY TRANSFERRED TO THE PARTNERSHIP, THE SMALLER THE SHIFT IN BUILT-IN GAIN AS A PERCENTAGE OF TOTAL BUILT-IN GAIN." EC2 000054817. The Project Tammy I materials in Appendix B contain an Electronic Message from Steven E. Klig to Alicia L. Goodrow, subject: Tammy Example, at 2.

partnership tax laws, the depreciable asset(s) would take a tax basis equal to the affiliate's basis in its partnership interest. This results in larger depreciation deductions over the life of the depreciable asset (or a larger loss on the sale of such asset). This was the tax benefit that Enron sought to achieve.<sup>644</sup>

The excess of the basis of the depreciable asset in the hands of the single Enron affiliate over its basis in the hands of the partnership immediately prior to the distribution would trigger a downward basis adjustment in some or all of the remaining partnership property assuming that a section 754 election was in effect. If the only remaining partnership property was Enron preferred stock and it was of a similar character to the depreciable asset, then the partnership would be required to reduce its basis in the Enron preferred stock, thereby creating built-in gain on the Enron preferred stock.<sup>645</sup> This is a desirable result -- Enron would not recognize gain when the partnership sells the Enron preferred stock,<sup>646</sup> but Enron would increase its basis in the partnership interest by its proportionate share of the gain. The permanent exclusion of this gain allowed Enron to report a financial accounting benefit with respect to the transactions.<sup>647</sup>

#### Business purpose

As is the case with several of Enron's structured transactions, any analysis of whether the tax benefits in Projects Tammy I and II would be respected must take into account the applicability of the relevant rules and judicial doctrines regarding tax-motivated transactions.<sup>648</sup>

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<sup>644</sup> See generally Christopher H. Hanna, *Partnership Distributions: Whatever Happened to Nonrecognition?* 82 Ky. L. J. 465, 488-92 (1994) (various examples, ranging from a bag of peanuts to a typewriter, in which a low value, low basis asset would receive a high basis on liquidation of a partner's interest).

<sup>645</sup> The depreciable asset distributed to the single Enron affiliate should be section 1231(b) property (assuming it was held by the partnership for more than one year). If the partnership distributes the depreciable asset and is required to make a downward adjustment to the basis of its remaining partnership property, the downward adjustment must be made to property of a similar character, i.e., capital assets or section 1231(b) property. See sec. 734(c), sec. 755(b), and Treas. Reg. sec. 1.755-1(c). The Enron preferred stock should be a capital asset and therefore the downward adjustment would be made to it.

<sup>646</sup> Sec. 1032.

<sup>647</sup> If the partnerships held assets other than Enron stock, then instead of a permanent exclusion of gain, the transactions would have generated only a deferral of gain (because Enron eventually would pay tax with respect to the assets) with no resulting financial statement income.

<sup>648</sup> 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* (JCS-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

The Vinson & Elkins tax opinion states that Enron engaged in the transaction “to secure \$500 million of financing from unrelated banks through a structure that would provide favorable ‘minority interest’ treatment.”<sup>649</sup> The tax opinion discusses a Tax Court memorandum decision<sup>650</sup> in which the court respected a partnership arrangement that yielded significant tax benefits because the taxpayer established that the investment had a valid non-tax business purpose. The tax opinion states that “[c]learly, [Project Tammy I] serves an important business purpose as it facilitates the raising of \$500 million of funds for use within the Enron Group,” and on this basis, concludes that the transaction should not be treated as a sham or without substance.<sup>651</sup>

The business purpose test is a subjective inquiry into the motives of the taxpayer -- that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose.<sup>652</sup> While a proper analysis of the non-tax business purpose requires a more thorough knowledge of the relevant facts and circumstances (which is beyond the scope of this Report), some general observations are appropriate. The tax opinion apparently accepts as fact the notion that the partnership structure “facilitates” the borrowing, but fails to explain how it facilitates the borrowing. The tax opinion also fails to analyze (1) recent court cases that have disregarded the existence of a partnership structure that serves little business purpose other than to achieve tax benefits,<sup>653</sup> or (2) the possibility that a court may separate a transaction in which independent activities with non-tax objectives are combined with an unrelated transaction having only tax-avoidance objectives in order to establish an overall business purpose.<sup>654</sup>

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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).

<sup>649</sup> Opinion Letter from Vinson & Elkins to Enron Corp., February 9, 2001, Appendix C, Part VIII, at 19.

<sup>650</sup> *Salina Partnership LP v. Commissioner*, 80 T.C.M. 686 (2000)

<sup>651</sup> Opinion Letter from Vinson & Elkins to Enron Corp., February 9, 2001, Appendix C, Part VIII, at 19-20.

<sup>652</sup> See, e.g., *Rice's Toyota World v. Commissioner*, 752 F.2d 89 (4<sup>th</sup> Cir. 1985); *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'd* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999); *Peerless Indus. v. Commissioner*, 1994-1 U.S.T.C. (CCH) para. 50,043 (E.D. Pa. 1994).

<sup>653</sup> See, e.g., *ASA Investorings Partnership v. Commissioner*, 76 T.C.M. (CCH) 325 (1998), *aff'd*, 201 F.3d 505 (D.C. Cir. 2000), *cert. denied*, 531 U.S. 871 (2000).

<sup>654</sup> *ACM Partnership v. Commissioner*, 157 F.3d 231, 256 at n. 48 (3d Cir. 1998), *aff'd* 73 T.C.M. (CCH) 2189 (1997), *cert. denied*, 526 U.S. 1017 (1999). Otherwise, any tax-motivated transaction that is combined with, for example, a borrowing, would be respected.

Of greater concern is the fact that the opinion letter regards and analyzes each element of the transaction (i.e., the contributions to the partnership, the transfer of the partnership interests, and the allocation of the built-in gain) as if the steps were independent and isolated. The tax opinion fails to consider the tax consequences of the anticipated exit strategy and does not provide an overall evaluation of the transaction (notwithstanding that the tax opinion describes the strategy).<sup>655</sup> Project Tammy I was a multi-step, orchestrated arrangement, whose tax and financial statement benefits were known to Enron, the promoter, and the accountants<sup>656</sup> long before Vinson & Elkins issued its tax opinion. Ignoring the exit strategy and failing to provide an overall evaluation should call into question (1) the tax advisor's compliance with the relevant tax shelter opinion standards,<sup>657</sup> and (2) Enron's reliance on the tax opinion to establish reasonable cause and good faith.<sup>658</sup>

### **Recommendations**

The Joint Committee staff recommendations regarding Project Condor<sup>659</sup> include recommendations regarding the partnership allocation rules under section 704(c) and corporate

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<sup>655</sup> Opinion Letter from Vinson & Elkins to Enron Corp., February 9, 2001, Appendix C, Part VIII, at 7-8.

<sup>656</sup> Arthur Andersen provided an opinion regarding the appropriate application of GAAP to the transaction in June, 2000. EC2 000037676-000037685.

<sup>657</sup> Proposed regulations under Circular 230, Regulations Governing Practice Before the IRS, provide that, in rendering a tax shelter opinion to a client, the advisor must not rely on unreasonable factual assumptions. An unreasonable factual assumption includes "a factual assumption that the practitioner knows or has reason to believe is incorrect, incomplete, inconsistent with an important fact, or another factual assumption, or implausible in any material respect." Circular 230, Prop. Sec. 10.35(a)(1)(ii)(A). Even the standards applicable to marketed tax shelter opinions provides, "[a] practitioner who provides a tax shelter opinion analyzing the Federal tax effects of a tax shelter investment shall . . . [w]here possible. . . provide an overall evaluation whether the material tax benefits in the aggregate more likely than not will be realized. Where such an overall evaluation cannot be given, the opinion should fully describe the reasons for the practitioner's inability to make an overall evaluation." Circular 230, Sec. 10.33(e).

<sup>658</sup> An accuracy-related penalty is not imposed with respect to any portion of any underpayment if the taxpayer can show that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion. Sec. 6664(c)(1). Reliance on a tax opinion constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. Among the elements needed to establish such reliance, "[t]he advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances." Treas. Reg. sec. 1.6664-4(c)(1)(i).

<sup>659</sup> Project Condor is discussed in this partnership section of the Report (following Project Tomas).

nonrecognition of gain rules under section 1032. Those recommendations also are appropriate with respect to Projects Tammy I and Tammy II. In addition, the Joint Committee staff believes that further guidance is needed regarding the apportionment of tax basis upon the transfer of a partial partnership interest (particularly when the transfer involves related parties).

## D. Other Structured Transactions

### 1. Project Apache

#### Brief overview

Project Apache was a financing arrangement in which the Enron group borrowed funds from third-party foreign lenders. By channeling this third party borrowing through an Enron controlled foreign corporation and blending this borrowing with debt that the Enron group owed itself, the Enron group sought to claim U.S. tax deductions not only for interest paid on the third-party debt, but also for the interest paid to itself, without triggering any offsetting income inclusion on the Enron controlled foreign corporation's receipt of such interest. Viewed another way, the transaction was intended to generate deductions on the Enron U.S. consolidated return in an amount roughly equal to the entire cash flow paid by Enron to the third-party lenders -- not only the interest, but also the repayment of principal. The third-party borrowing also was designed to be treated as "mezzanine," or minority interest financing for financial reporting and rating agency purposes, notwithstanding its characterization as debt for U.S. Federal income tax purposes.

In general terms, the transaction involves a U.S. corporation and its unrelated foreign lenders indirectly establishing and funding a Dutch entity that in turn lends its funds indirectly to the U.S. corporation. The U.S. corporation indirectly contributes 60 percent of the cash in exchange for common ownership units representing 60 percent of the value of the entity, and the foreign lenders indirectly contribute 40 percent of the cash in exchange for preferred ownership units representing 40 percent of the value of the entity. The terms of the ownership units ensure that no earnings can be distributed on the U.S. corporation's common units while the foreign lenders' preferred units remain outstanding. The preferred units are redeemable at the option of the Dutch entity and are entitled to cumulative preferred distributions out of retained earnings and to a liquidation preference equal to the foreign lenders' initial investment in the Dutch entity.

The Dutch entity lends nearly all of its funds indirectly to the U.S. corporation, which deducts all of the interest on this debt on its U.S. tax return.<sup>660</sup> In view of the relative cash contributions to the Dutch entity, 60 percent of this debt is effectively owed by the U.S. corporation to itself, and 40 percent represents borrowing by the U.S. corporation from third parties.

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<sup>660</sup> In Enron's case, as explained in further detail below, the bulk of these deductions took the form of factoring deductions arising from purported sales of trade receivables to a financial asset securitization investment trust ("FASIT"). The discounts that generated the factoring deductions may be regarded as equivalent to interest, since the factoring transactions, to the extent that they had any significant non-tax effect, were economically similar to short-term secured borrowings (cf. Treas. Reg. sec. 1.861-9T(b)(3)(i), treating factoring discounts as interest expense for sourcing purposes). As explained below, this form was chosen in an effort to avoid the restrictions of section 163(j).



The Dutch entity is treated as a controlled foreign corporation, which ordinarily would entail current U.S. taxation of the entity's passive type earnings under subpart F. The interest that the Dutch entity receives indirectly from the U.S. corporation is subpart F income, and the Dutch entity's debt investment normally would be subject to the deemed repatriation rules of section 956. However, since the terms of the ownership units and the earnings of the Dutch entity are structured and managed in such a way as to render it impossible for any earnings of the Dutch entity to be distributed to the U.S. corporation, the U.S. corporation takes the position that none of the entity's subpart F income is allocable to the U.S. corporation, and that there is no deemed repatriation of earnings to the U.S. corporation under section 956. In other words, the parties effectively seek to specially allocate all adverse subpart F consequences to the foreign lenders, who are indifferent to it because subpart F does not apply to them.

When the transaction is unwound, the redemption of the foreign lenders' preferred units (i.e., the repayment of their principal) is treated under the terms of the instruments as a distribution of the Dutch entity's remaining undistributed earnings (i.e., the rest of the interest income received indirectly from, and deducted by, the U.S. corporation). The U.S. corporation takes the position that this elimination of the preferred units also eliminates all of the Dutch entity's earnings and profits for U.S. tax purposes, allowing the U.S. corporation to liquidate the entity without any recognition of income.

In sum, by effectively allocating all of the principal repayment on the combined debt to the U.S. corporation's common units and all of the interest payments on the combined debt to the foreign lenders' preferred units, the U.S. corporation ultimately claims U.S. tax deductions approximating the entire cash flow from its group to the foreign lenders -- both interest and principal -- while making no offsetting income inclusions under subpart F or otherwise.

## **Background**<sup>661</sup>

### Purported tax and financial statement effects

Project Apache was projected to increase Enron's financial net income by \$167 million over the years 1999-2006. Ultimately, according to the company, the transaction increased financial net income by \$50.7 million (\$11.3 million, \$20.6 million, and \$18.8 million for 1999, 2000, and 2001, respectively) before the company declared bankruptcy at the end of 2001. This increase in financial net income was attributable to the tax benefit of interest and receivables factoring deductions that were not offset on the company's tax return by subpart F inclusions or other potential tax liabilities.

On its 1999 return, the company claimed \$47.6 million of factoring deductions and \$33 million of interest deductions on short-term debt, for a total of \$80.8 million of deductions for the year in connection with the transaction. On its 2000 return, the company claimed \$110.5 million of factoring deductions and \$49.9 million of interest deductions on short-term debt, for a

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<sup>661</sup> The Joint Committee staff obtained this information through interviews of Robert Hermann, James A. Ginty, and R. Davis Maxey, as well as from documents and materials provided by Enron Corp.

total of \$160.5 million of deductions for the year in connection with the transaction. Sixty percent of these amounts were effectively circular -- i.e., paid by the Enron group to itself.

In addition, the Enron group's net borrowing in the amount of \$500 million, which was treated as debt for U.S. tax purposes, was treated as minority interest, or "mezzanine" financing, for financial statement and rating agency purposes.

### Development of Project Apache

The idea for Project Apache was brought to Enron by Chase Securities, an affiliate of Chase Manhattan Bank, in mid-1998. Mr. Hermann named the transaction after a favorite golf course in Arizona.<sup>662</sup>

As originally proposed, the transaction involved direct lending by the Dutch controlled foreign corporation to Enron.<sup>663</sup> After a concern was raised that interest on a direct loan might be subject to the restrictions of section 163(j), the transaction was redesigned to direct the loan through a FASIT, with the FASIT borrowing from the Dutch controlled foreign corporation and using the borrowed funds to purchase trade receivables from Enron affiliates, effectively loaning the funds to Enron based on the security of the receivables.<sup>664</sup> The transaction was structured to designate a third party as the owner of the FASIT, and Enron was able to take the equivalent of interest deductions largely in the form of receivables factoring deductions.

On September 25, 1998, a presentation was made to management regarding the transaction. The transaction was approved by a corporate officer of Enron, and Enron's Board of Directors' Executive Committee approved the transaction on November 2, 1998. At a meeting on December 8, 1998, Enron's full Board of Directors approved and ratified the transaction. Mr. Maxey and Mike Herman were instructed to execute the transaction.

### Implementation of Project Apache

#### Blending third-party and related-party lending through controlled foreign corporation

In May of 1999, Enron Corp. transferred \$748.5 million to Seminole Capital, LLC ("Seminole"), a newly formed Delaware limited liability corporation, in exchange for a 99.8 percent ownership interest in Seminole. The Lucelia Foundation, a New York not-for-profit

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<sup>662</sup> Joint Committee staff interviews.

<sup>663</sup> Memorandum from R. Davis Maxey to Robert J. Hermann, with transaction diagram, June 23, 1998, EC2 000037282, EC2 000037285; Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (*see* Appendix B, Part X to this Report).

<sup>664</sup> Joint Committee staff interviews; Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (with the words "163(j) issue" written by hand on a copy of a diagram showing direct lending by the controlled foreign corporation to Enron) (*see* Appendix B, Part X to this Report).

corporation unrelated to Enron, transferred \$1.5 million to Seminole in exchange for a 0.2 percent ownership interest. Seminole was treated as a partnership for U.S. Federal income tax purposes.

Seminole in turn transferred its \$750 million to Cheyenne Finance SARL (“SARL”), a newly formed Luxembourg company, in exchange for the entire equity interest in SARL. SARL was treated as a corporation for U.S. Federal income tax purposes and was a controlled foreign corporation as defined in section 957.

Rabo Merchant Bank N.V. (“Rabo”), a Dutch bank unrelated to Enron, transferred \$15 million to Choctaw Investors B.V. (“Investors B.V.”), a newly formed Dutch company, in exchange for all of the Investors B.V. common stock. Investors B.V. then borrowed \$485 million from a syndicate of mostly foreign banks.

SARL and Investors B.V. then formed Cherokee Finance VOF (“Dutch VOF”), a Dutch entity treated as a partnership for tax purposes in both the Netherlands and Luxembourg. SARL transferred its \$750 million to Dutch VOF in exchange for all of the “common” ownership units of Dutch VOF (the “Common Units”). Investors B.V. transferred its \$500 million to Dutch VOF in exchange for all of the “preferred ownership units of Dutch VOF (the “Preferred Units”).<sup>665</sup> The holder of the Common Units had the right to elect two out of the three directors of Dutch VOF, and the holder of the Preferred Units had the right to elect one director. Pursuant to an election under the “check the box” regulations, Dutch VOF was treated as a corporation for U.S. Federal income tax purposes. Dutch VOF also was a controlled foreign corporation as defined in section 957, because Enron Corp. (through Seminole and SARL) indirectly owned more than 50 percent of the Dutch VOF stock.

The Common Units held indirectly by Enron Corp. could not receive any distributions of earnings while any of the Preferred Units remained outstanding. The Preferred Units had an initial liquidation preference of \$500 million, as well as the right to a floating-rate cumulative preferred distribution out of retained earnings equal to a percentage of the liquidation preference, as declared by the Board of Directors. The Preferred Units were subject to redemption at a stated date ten years from issuance, at which time any outstanding units would be redeemed for their liquidation preference. Dutch VOF also had the right to redeem the Preferred Units in whole or in part at any time, again for the units’ liquidation preference. The initial \$500 million liquidation preference would be increased by the amount of any accrued but unpaid preferred distributions and would be decreased by the amount of any redemption proceeds received.

#### Generating receivables factoring and interest deductions through FASIT transactions

Of the \$1.25 billion that Dutch VOF possessed immediately upon its formation by SARL and Investors B.V., Dutch VOF invested \$1.23 billion in monthly senior debt obligations (the “Interim Notes”) of Sequoia Financial Assets, LLC, a FASIT (the “FASIT”). When each Interim Note matured and was repaid, Dutch VOF would reinvest the proceeds in another Interim Note.

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<sup>665</sup> This \$500 million represented Enron’s net third-party borrowing in the transaction and was treated as minority interest financing for financial accounting purposes.

Dutch VOF earned interest on the Interim Notes in the form of short-term original issue discount. The FASIT in turn effectively loaned the Interim Note proceeds to Enron at the beginning of each month by making discounted purchases of third-party trade receivables from Enron North America and Enron Power Marketing, domestic affiliates of Enron Corp.<sup>666</sup> In cases in which the FASIT received payment on the receivables prior to the end of the month, these funds were used to purchase Enron North America commercial paper from Enron Corp. The transactions between Enron Corp. and its affiliates and the FASIT generated factoring deductions on the Enron consolidated return (reflecting the discount on the sales of the receivables), as well as interest deductions with respect to the commercial paper.

The “owner interest” in the FASIT was held by Ojibway, Inc., a domestic corporation unrelated to the Enron group. Ojibway contributed \$2 million to the FASIT for this interest. Enron Corp. contributed \$50 million to the FASIT in exchange for a subordinated interest in the FASIT.<sup>667</sup> Enron’s interest in the FASIT was treated as a “regular interest” under the FASIT rules. The \$1.23 billion Interim Notes held by Dutch VOF also were characterized as “regular interests” under the FASIT rules. Enron Corp. acted as the servicer of the FASIT. In this capacity, Enron Corp. not only handled the accounting, billing, collection, and other administrative functions with respect to the receivables sold by its affiliates to the FASIT, but also held the receivables and other assets of the FASIT and administered the monthly reinvestment program described above.

#### Intended exit strategy and net effects of transaction

At the time of the transaction, it was anticipated that Dutch VOF would exercise its right to redeem the Preferred Units of Investors B.V. in 2006, and that Dutch VOF and SARL would be liquidated immediately thereafter. Since all of Dutch VOF’s earnings and profits (i.e., the interest paid by the FASIT) would have been allocated to the Preferred Units, the company would take the position that the redemption of the Preferred Units eliminated Dutch VOF’s earnings and profits, and thus that Dutch VOF and SARL could be liquidated tax-free. In order to achieve this characterization, the redemption of the Preferred Units had to be treated as a dividend for U.S. tax purposes. In furtherance of this goal, Seminole had been granted an option to purchase all of the outstanding shares of Investors B.V. from Rabo. This option was intended to make Enron Corp. the “owner” of all of the stock of Investors B.V. and Dutch VOF under the constructive ownership rules of section 318(a)(4), such that the redemption of Investors B.V.’s Preferred Units would be treated as a dividend under section 302 and would eliminate Dutch VOF’s earnings and profits.

Over the 7 years that the project was intended to have been in place, the structure would have generated receivables factoring and interest deductions on the Enron group’s U.S.

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<sup>666</sup> The receivables arose primarily from Enron North America’s natural gas and electric power businesses. The collection rate on these receivables exceeded 98 percent. “Discussion Material for Sequoia Financial Asset Trust,” Mar. 2, 1999, at EC2 000037245.

<sup>667</sup> Enron’s subordinated interest was intended to insulate Dutch VOF, and hence the third-party foreign lenders, from credit risk on the receivables.

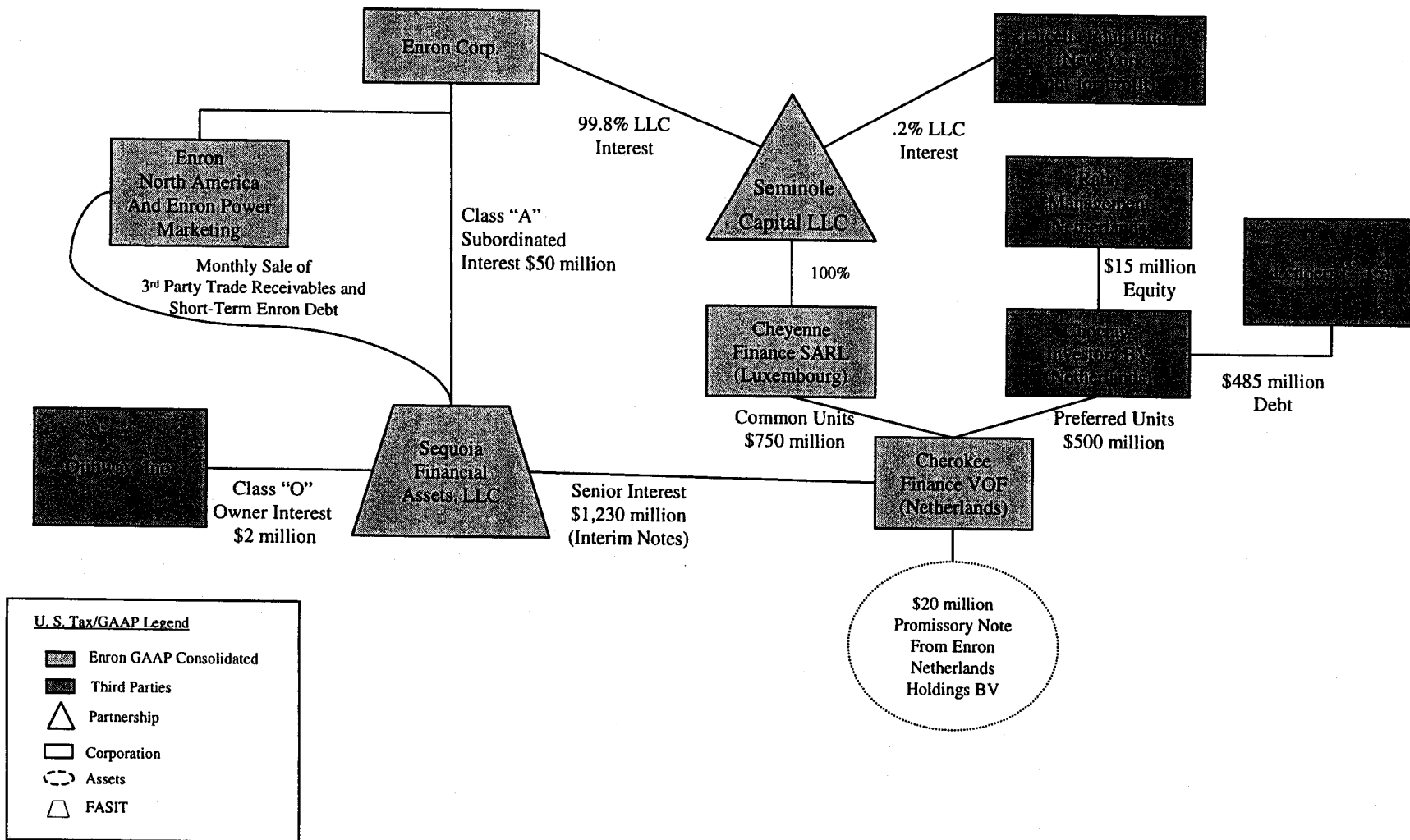
consolidated return approximating the entire cash flow from the Enron group to the unrelated foreign lenders. As it happened, the transaction generated \$80.8 million and \$160.5 million of such deductions for 1999 and 2000, respectively. These annual deductions were expected to increase gradually through 2006, thus generating deductions at least equal to the principal and interest on the \$500 million that the Enron group borrowed from third parties in the transaction. It was intended that this benefit be unmitigated by any offsetting U.S. tax under subpart F or otherwise, despite the fact that 60 percent of the debt in the structure, or \$750 million, constituted a circularity in the sense that it was owed by the Enron group to itself.

The diagram on the following page depicts the Project Apache structure.

# Project Apache Structure as of May 28, 1999

Confidential

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### Role of outside advisors

As noted above, Chase Manhattan Bank promoted the transaction to Enron. Chase Manhattan personnel presented the idea to Messrs. Hermann and Maxey in a meeting and gave them promotional materials.

Shearman & Sterling provided a “should” opinion as to the key intended tax consequences of the transaction, in particular the treatment of the transaction under subpart F, the characterization of various instruments as debt or equity, and the appropriateness of respecting the form of the transaction rather than disregarding it as an economic sham.

Shearman & Sterling also provided a separate tax opinion as to issues relating to the use of the FASIT in the transaction, including qualification as a FASIT (“will” opinion), treatment of Ojibway as the owner of the FASIT (“will” opinion), treatment of the receivables transactions as true sales (“should” opinion), the inapplicability of section 163(j) (“should” opinion), and the inapplicability of U.S. withholding tax on interest paid by the FASIT to Dutch VOF (“should” opinion). This latter opinion letter also included a separate “comments” section that addressed other issues, including the potential treatment of the FASIT as the originator of debt.

As of June 2001, Enron had paid over \$14 million in fees in connection with the transaction, including \$10,362,038 to Chase Manhattan, \$2,070,000 in “syndicate bank fees” relating to various administrative costs of concluding the transaction, \$1,108,940 to Shearman & Sterling for its U.S. tax opinions, and \$300,000 to Freshfields LLC for a foreign-law opinion, among other fees.<sup>668</sup>

Appendix C, Part IX to this Report contains the tax opinions that Enron received in connection with Project Apache.

### Subsequent developments

On January 13, 2003, the company advised the Joint Committee staff that no steps had been taken to unwind the Project Apache transaction structure, but that the parties had stopped cycling cash through the structure since Enron’s bankruptcy filing.<sup>669</sup>

Following the bankruptcy filing, JP Morgan Chase Bank (the successor to Chase Manhattan Bank) exercised its right under the Dutch VOF organizing documents to appoint a majority of Dutch VOF’s directors. JP Morgan Chase also initiated litigation against Enron on behalf of Dutch VOF and its investors, seeking the turnover of \$2.1 billion of accounts receivable, commercial paper, cash, and other property that JP Morgan Chase believes is still

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<sup>668</sup> Enron Estimated Structured Transaction Project Fees as of June 4, 2001, EC2 000036379 (*see* Appendix B, Part I to this Report).

<sup>669</sup> Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, Jan. 13, 2003, answer 74.

held by Enron in its capacity as servicer of the FASIT.<sup>670</sup> JP Morgan Chase claims that this property is not part of the Enron bankruptcy estate and fears dissipation of the assets if they remain in Enron's hands.

## **Discussion**

### In general

In order for Project Apache to provide the tax benefits intended, a number of different issues would have to be resolved in Enron's favor. First, the transaction would have to survive scrutiny under the judicial doctrines applicable to tax-avoidance transactions, despite the obvious tax motivation and large circular flow of cash at the heart of the transaction.<sup>671</sup> Second, the intended allocation of all of Dutch VOF's earnings and profits to the Preferred Units for subpart F purposes<sup>672</sup> would have to be sustained, in order for Enron to avoid current income inclusions under subpart F. Third, the receivables factoring and interest deductions arising from the FASIT transactions would have to be allowed, despite the tax motivation for the use of the FASIT and its close relationship to Enron.

### Judicial doctrines and the circular flow of cash

The intended tax benefits of Project Apache arguably should be denied on the grounds that the bulk of the transaction lacked economic substance and non-tax business purpose. The overall transaction undoubtedly had a significant tax motivation, and in particular the circular flow of cash in the form of \$750 million of debt (and the interest thereon) owed by the Enron group to itself appears to have lacked both economic substance and non-tax business purpose. Instead, this self-owed debt seems to have been created solely for the purpose of blending it with the third-party debt through Dutch VOF in order to generate interest and interest equivalent

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<sup>670</sup> Since the assets are under Enron's control, JP Morgan Chase could not be sure of the amount and composition of the assets and thus based its complaint on an estimate. The complaint thus also seeks a full and complete accounting of the assets. Complaint, *JP Morgan Chase Bank v. Enron Corp., et al.*, Chapter 11 Case No. 01-16034 (AJG), Adversary Proceeding No. 01-03637 (Bankr. S.D. N.Y.), Dec. 11, 2001, EC2 000054744.

<sup>671</sup> For detailed information on the present-law rules and judicial doctrines applicable to tax-avoidance 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).

<sup>672</sup> See Treas. Reg. sec. 1.951-1(e)(2).



deductions in excess of those attributable to the third-party debt, while at the same time avoiding any of the offsetting income inclusions that normally apply. To the extent that the receivables factoring and interest deductions claimed by Enron are attributable to this circularity, they arguably should be denied as lacking economic substance and non-tax business purpose. Since this debt accounted for 60 percent of the overall debt in Project Apache, it could reasonably be argued that 60 percent of the deductions claimed by Enron in connection with the structure should be denied.

According to Enron, the non tax business purposes of Project Apache were to raise \$500 million of outside financing that would qualify as minority interest financing for financial accounting and rating agency purposes, as well as to manage the trade receivables generated in the course of its affiliates' gas pipeline and electric power wholesale businesses by engaging in factoring transactions.

With respect to the first purpose cited, even if managing financial statement presentation and rating agency evaluations are found to constitute a valid business purpose, this purpose can justify only part of the transaction. This purpose fails to account for the complex and unusual manner in which Enron went about raising \$500 million of minority interest financing. Indeed, this purpose fails to account for the majority of the debt involved in the transaction -- the business need to raise \$500 million of outside financing does not explain the inclusion of \$750 million of intra-group debt in the same structure. The only evident explanation for the use of the intra-group debt relates to the intended tax benefits of the transaction.

The receivables factoring business purpose cited also seems unconvincing. According to Enron tax department personnel interviewed by the Joint Committee staff, Enron did not even consider including trade receivables in the transaction until it concluded that the initial transaction design, which involved a more straightforward loan from Dutch VOF to Enron, was vulnerable to attack under section 163(j), which denies deductions for certain interest on related-party debt.<sup>673</sup> Thus, a tax-motivated transaction structure that did not involve any trade receivables was designed first, and the later inclusion of the receivables and use of the FASIT served the primary purpose of reducing one of the perceived tax risks in the transaction.

Moreover, to the extent that the factoring transactions were ultimately financed 60 percent by intra-group debt, the transactions cannot be said to have achieved the same non-tax effects as factoring transactions with unrelated parties. Factoring transactions generally serve the purpose of accelerating the conversion of trade receivables into cash, thus increasing liquidity and decreasing credit exposure. To the extent that a company effectively advances the bulk of the cash in a factoring transaction to itself and retains an indirect interest in the receivables, these benefits are not realized.

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<sup>673</sup> See also Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (with the words "163(j) issue" written by hand on a copy of a diagram showing direct lending by the controlled foreign corporation to Enron) (Appendix B, Part X to this Report).

In sum, while the matter is not free from doubt, the Joint Committee staff believes that a strong argument could be made to deny the intended tax benefits of Project Apache under longstanding judicial doctrines addressing tax-motivated transactions.

#### Avoidance of subpart F and other potential offsetting tax liabilities

Allocation of subpart F income away from Enron.—The deductions generated by Project Apache would confer no net tax benefit to Enron if they were offset by subpart F inclusions. Under section 951(a), a U.S. shareholder of a controlled foreign corporation generally must include in income its pro rata share of the corporation's subpart F income for the year, as well as its pro rata share of the corporation's deemed repatriations for the year determined under section 956. Enron Corp., as an indirect 60-percent shareholder of Dutch VOF, which was a controlled foreign corporation, ordinarily would have been subject to current U.S. tax with respect to 60 percent of Dutch VOF's subpart F income. Dutch VOF's interest income was treated as subpart F income, and thus, under normal circumstances, it would be expected that Enron Corp. would include 60 percent of this interest income on a current basis for U.S. tax purposes. This of course would have the effect of offsetting 60 percent of the deductions generated in the transaction, thus eliminating the intended tax benefit. This treatment would, however, comport with the overall economics of the transaction, given that 60 percent of the total lending in Project Apache was a self-owed circularity.

Enron sought to avoid these current subpart F inclusions by structuring Dutch VOF's ownership instruments in such a way as to allocate all of the earnings and profits to the Preferred Units held by Investors BV, and none of the earnings and profits to the Common Units held by SARL, and thus indirectly by Enron. In determining a shareholder's pro rata share of subpart F income in cases involving multiple classes of stock, Treas. Reg. section 1.951-1(e)(2) provides that the subpart F income attributable to a class of stock is that proportion of the controlled foreign corporation's total subpart F income that the earnings and profits distributable to such class in a hypothetical year end distribution of all of the corporation's earnings and profits would bear to the corporation's total earnings and profits. Since Dutch VOF's ownership instruments provided that no earnings distributions could be made on the Common Units as long as any Preferred Units remained outstanding, Enron took the position that the Common Units would be entitled to no distribution at all in a hypothetical distribution of all of Dutch VOF's earnings and profits in any particular year, and thus that none of Dutch VOF's subpart F income was allocable to the Common Units (and thus to Enron Corp.) under Treas. Reg. section 1.951-1(e)(2). Even if Dutch VOF's right to redeem the Preferred Units were taken into consideration in this analysis, Enron took the position that the result would not change, on the basis that even a complete redemption of the Preferred Units would be treated as a dividend distribution by reason of the option attribution arrangement described above in connection with Enron's intended exit strategy.

The allocation method applicable to subpart F income also applies in the case of section 956 inclusions, and thus Enron took the same allocation position with respect to both subpart F income and section 956 inclusions.

Enron found support for this allocation position in the case of *Barnette v. Commissioner*,<sup>674</sup> a memorandum opinion of the Tax Court addressing a similar issue that arose under the foreign personal holding company regime.<sup>675</sup> The issue was one of 15 issues decided in the case, which addressed several tax years of an individual who had been convicted of both tax fraud and government contracting fraud in connection with the foreign business arrangements at issue.<sup>676</sup> The present discussion of the case is limited to the issue pertinent to Enron's subpart F position in Project Apache.

Among other tax reduction strategies, the taxpayer in the *Barnette* case arranged for a Panamanian foreign personal holding company that he controlled to issue a new class of preferred stock, with a conceded purpose of deflecting foreign personal holding company income away from himself. As in Project Apache, the terms of the ownership instruments provided that no distributions could be made on the taxpayer's common stock while the preferred stock remained outstanding. Under the applicable Treasury regulation, if a foreign personal holding company has outstanding both preferred and common stock, and the preferred stock is entitled to a specified dividend before any distribution can be made on the common stock, foreign personal holding company income is treated as being distributed first with respect to the preferred shares.<sup>677</sup> Thus, like Enron under the subpart F multiple-classes-of-stock regulation, the taxpayer in *Barnette* took the position that none of the "tainted" foreign income was allocable to the common shares that he held. The IRS, on the other hand, contended that all such income should have been allocated to the taxpayer's common shares, since there was no reason for the creation of the preferred shares other than tax avoidance.

The court ruled in favor of the taxpayer on this issue, sustaining his allocation of foreign personal holding company income away from himself under the regulation, despite the acknowledged tax motivation for the issuance of the preferred stock and related transactions. The court concluded that, even if the sole purpose for creating and transferring the preferred stock were tax avoidance, the stock's existence still could not be ignored. Since the transactions at issue altered the taxpayer's financial position, the court decided that no non-tax business purpose was necessary. In other words, the court seems to have concluded that the foreign personal holding company income allocation regulation was to be applied literally, and its results

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<sup>674</sup> 63 T.C.M. (CCH) 3201 (1992), *reh'g denied*, 64 T.C.M. (CCH) 998 (1992).

<sup>675</sup> The foreign personal holding company regime (secs. 551-558) is an anti-deferral regime that preceded subpart F, and that now has been largely supplanted by it. Under coordination rules applicable for taxable years of U.S. shareholders beginning after July 18, 1984, subpart F generally trumps the foreign personal holding company regime. Sec. 951(d). During the taxable years at issue in the *Barnette* case, however, the foreign personal holding company rules generally trumped the subpart F rules. Sec. 951(d), prior to amendment by P.L. 98-369.

<sup>676</sup> The case also involved several tax years of the individual's company and certain members of his family.

<sup>677</sup> Treas. Reg. sec. 1.551-2(c).

respected, even with respect to a tax-motivated structure entirely lacking any non-tax business purpose.

Given the similarities between the foreign personal holding company issue raised in the *Barnette* case and the subpart F issue raised in Project Apache, the *Barnette* case arguably lends support to Enron's position that none of Dutch VOF's subpart F income should be allocated to Enron, regardless of the tax motivation behind the structuring of the ownership instruments. Nevertheless, if the issue were litigated, a court would approach the issue de novo and accord the *Barnette* case little or no precedential weight. As a memorandum opinion (as opposed to a "regular," or "T.C." opinion) of the Tax Court, the case is not regarded as controlling precedent by any court, including the Tax Court itself.<sup>678</sup> Memorandum opinions are generally limited to their specific facts; if a case raises novel legal issues, the Tax Court generally issues a "regular" opinion, which the court then regards as controlling precedent.

Thus, a court determining how to apply Treas. Reg. section 1.951-1(e)(2) to Enron and Dutch VOF would be free to analyze the issue on its own merits and would not be bound by the earlier memorandum decision of the Tax Court applying Treas. Reg. section 1.551-2(c) to the taxpayer in *Barnette*. On this basis, it is impossible to predict how a court might resolve the issue. A literal application of the regulation to the carefully structured ownership instruments of Dutch VOF appears to yield the results intended by Enron. However, it is possible that a court would sustain an argument along the same lines advocated by the IRS in the *Barnette* case. In other words, a court might conclude that the transaction was structured to generate tax benefits not intended by the Congress, that there was no significant non-tax business purpose for the complex manner in which the transaction was structured, and that the subpart F income allocation sought by Enron would violate the purpose of subpart F and would abuse the rule set forth in Treas. Reg. section 1.951-1(e)(2), thus requiring an allocation of some subpart F income to Enron.

A court might reach this conclusion on a somewhat narrower basis by disregarding Seminole's option to purchase the Investors B.V. stock as lacking any non-tax business purpose. The court then could apply the hypothetical of Treas. Reg. section 1.951-1(e)(2) by treating Dutch VOF's redemption right as exercised, and treating the hypothetical redemption of the Preferred Units as a sale instead of a dividend distribution, which in turn would leave earnings and profits distributable to the Common Units in a hypothetical year-end distribution, thus requiring an allocation of subpart F income to Enron.

Avoidance of other potential offsetting tax liabilities.—Subpart F was the main, but not the only, potential source of U.S. tax that needed to be avoided in order for Project Apache to generate the net tax benefits intended. For example, if the interest paid to Dutch VOF had been subject to U.S. withholding tax, then the transaction would not have been worthwhile, even if the other tax issues raised by the transaction were resolved in Enron's favor. In this regard, Enron took the position that no withholding tax applied, principally because the interest earned by

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<sup>678</sup> See, e.g., *Darby v. Comm'r*, 97 T.C. 51, 67 (1991); *Nico v. Comm'r*, 67 T.C. 647, 654 (1977), aff'd in part and rev'd in part on other grounds, 565 F.2d 1234 (2d Cir. 1977); *McGah v. Comm'r*, 17 T.C. 1458 (1952).

Dutch VOF on the Interim Notes took the form of short-term original issue discount, which is exempt from withholding tax.<sup>679</sup>

Another potential U.S. tax problem for the structure, the passive foreign investment company regime,<sup>680</sup> was avoided by reason of Dutch VOF's status as a controlled foreign corporation, and Enron's status as a U.S. shareholder of Dutch VOF. Under section 1297(e), which Congress enacted in 1997 to address the overlap of the passive foreign investment company rules and subpart F, a controlled foreign corporation generally is not also treated as a passive foreign investment company with respect to a U.S. shareholder of the corporation. Thus, even though Enron took the position that it would not be allocated any of Dutch VOF's subpart F income, Enron's status as a U.S. shareholder of Dutch VOF within the meaning of section 951(b) nevertheless exempted Enron from the application of the passive foreign investment company rules in connection with Dutch VOF.

#### Use of a FASIT to avoid earnings stripping rules

As explained above, Project Apache as originally conceived did not involve the use of a FASIT. Rather, the original transaction design would have used direct lending by Dutch VOF to Enron to cycle funds through the structure and generate the desired deductions.<sup>681</sup> Only after a concern was raised that the interest on such a direct loan might be subject to disallowance under section 163(j) was the transaction redesigned to direct the loan through a FASIT.<sup>682</sup> Since the limits of section 163(j) generally apply only to interest paid between related parties, Enron took the position that interposing an unrelated FASIT between itself and Dutch VOF rendered those limits inapplicable. The FASIT rules<sup>683</sup> in turn made it possible for Enron to place a relatively small "owner interest" in the FASIT with an unrelated party, and thereby to take the position that the FASIT was unrelated to Enron, despite the fact that Enron: (1) was the largest investor in the

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<sup>679</sup> Sec. 871(g)(1)(B). Even if the interest did not qualify as short-term original issue discount, the portfolio debt exception of section 881(c)(2)(B) might have shielded the interest from withholding taxes. In addition, U.S. income tax treaties with the Netherlands and Luxembourg arguably would have provided a further backstop against the imposition of withholding tax.

<sup>680</sup> Secs. 1291-1298.

<sup>681</sup> Memorandum from R. Davis Maxey to Robert J. Hermann, with transaction diagram, June 23, 1998, EC2 000037282, EC2 000037285; Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (*see* Appendix B, Part X to this Report).

<sup>682</sup> Joint Committee staff interviews; Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (with the words "163(j) issue" written by hand on a copy of a diagram showing direct lending by the controlled foreign corporation to Enron) (*see* Appendix B, Part X to this Report).

<sup>683</sup> Secs. 860H - 860L.

FASIT; (2) exercised day-to-day control over the FASIT through the servicing arrangement; and (3) treated the FASIT as an Enron consolidated entity for financial reporting purposes.

Although the Treasury Department has never issued final regulations under section 163(j), a comprehensive set of proposed regulations was issued in 1991.<sup>684</sup> Under these proposed regulations, the IRS would have broad authority to disregard entities created with a principal purpose of avoiding section 163(j). Specifically, the proposed regulations provide that “[a]rrangements, including the use of partnerships and trusts, entered into with a principal purpose of avoiding the rules of section 163(j) and [the proposed regulations] shall be disregarded or recharacterized to the extent necessary to carry out the purposes of section 163(j).”<sup>685</sup>

In the case of Project Apache, it is clear from Joint Committee staff interviews with Enron personnel involved in planning the transaction, as well as from documentary evidence and the structure of the transaction itself, that the FASIT arrangement was established “with a principal purpose of avoiding section 163(j).” In addition, given that the arrangement was used to ensure that no interest or interest-equivalent deductions would be disallowed on what in substance was a related-party borrowing, and that Enron maintained that the payments in question were not subject to any offsetting Federal tax (e.g., withholding tax, or tax arising under subpart F), recharacterizing the transaction would “carry out the purposes of section 163(j).”<sup>686</sup> Thus, if the proposed regulation had applied to the transaction, the conditions for the application of the anti-avoidance rule would have been present.

Proposed regulations do not have the force of law, but taxpayers commonly use them as guidance and as indicators of the government’s position on the issues addressed. In this case, Enron disregarded a proposed regulation that was directly on point and contrary to its return position.

The Shearman & Sterling opinion letter that addressed FASIT-related issues briefly discussed the proposed regulations and concluded that “the anti-abuse rule in the proposed regulations should not be applicable to disregard [the FASIT], because no principal purpose of the transaction is to avoid section 163(j).”<sup>687</sup> In light of the evidence that avoiding section 163(j) in fact was the principal purpose for using a FASIT in the first place, the Joint Committee staff finds this statement in the opinion letter troubling.

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<sup>684</sup> Prop. Reg. sec. 1.163(j)-1 *et seq.*

<sup>685</sup> Prop. Reg. sec. 1.163(j)-1(f).

<sup>686</sup> This issue, of course, would not be reached if it were determined that Dutch VOF’s subpart F income was taxable to Enron, since the amounts then would be subject to Federal tax, canceling out the benefit of the interest deductions. Sec. 163(j)(3)(A).

<sup>687</sup> Letter from Shearman & Sterling to Enron Corporation and Cherokee Finance VOF c/o Rabobank Management B.V., May 28, 1999, at 10-11 (Appendix C, Part IX to this Report).

Although the analysis of the opinion letter is somewhat elliptical on this point, it implies that avoidance of section 163(j) could not have been a principal purpose of using the FASIT, since payments of interest directly from the obligors on the receivables (i.e., Enron's natural gas and electric power customers) to Dutch VOF would have been payments between unrelated parties, and thus would not have been subject to section 163(j).<sup>688</sup> Of course, the FASIT was not interposed in any larger lending transaction between Enron's customers and Dutch VOF; it was interposed in a larger lending transaction between Enron and Dutch VOF. The purported sales of trade receivables by Enron affiliates to the FASIT may be viewed as secured financings comprising merely one component of the larger financing arrangement -- in other words, Dutch VOF loaned funds to the FASIT, and the FASIT in turn effectively loaned the funds to Enron on the strength of the receivables. Viewed in this manner, the transaction may be understood as avoiding section 163(j), since the interest, if paid directly by Enron to Dutch VOF (and not subjected to Federal tax) potentially would have been subject to section 163(j). The opinion letter raises this possibility, and dismisses it, in a footnote.<sup>689</sup>

The opinion letter's explanation of the transaction is that "the principal purpose of the arrangement is to create a revolving securitization vehicle for accounts receivable generated by [domestic affiliates of Enron]."<sup>690</sup> Again, this declared purpose is implausible, given that the idea to use a FASIT in fact arose as a solution to a perceived section 163(j) problem, and that the structure did not generate the non-tax benefits (increased liquidity, decreased credit exposure) that normally accompany third-party factoring transactions, due to the circularity at the heart of the arrangement. The Joint Committee staff believes that, at a minimum, the opinion letter reflects an unquestioning reliance on company representations as to business purpose, as well as a failure to look beyond isolated parts of an overall transaction to evaluate it in its totality.

Notwithstanding these concerns about the opinion letter's analysis of the proposed regulations, the fact remains that the lack of final regulations on this issue, combined with the availability under the FASIT rules of an entity that Enron could control but treat as unrelated for tax purposes, enabled Enron to take the position that section 163(j) could be avoided through the expedient of interposing an additional entity.<sup>691</sup>

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<sup>688</sup> The opinion letter acknowledges that this reasoning would not apply to the Enron-group commercial paper held by the FASIT. The opinion letter instead downplays the importance of this debt, implying that it could not be significant enough to form "a principal purpose" of avoiding section 163(j). *Id.*, at 10-11.

<sup>689</sup> *Id.*, at 11, n.7.

<sup>690</sup> *Id.*, at 10.

<sup>691</sup> Subsequent to the closing of the transaction, the Treasury Department issued proposed regulations under the FASIT rules, which included a broad anti-abuse rule. Prop. Reg. sec. 1.860L-2 (Feb. 7, 2000). In view of the company's treatment of the anti-abuse rule provided in the proposed regulations under section 163(j), it would seem unlikely that a second anti-abuse rule in proposed form would have caused Enron or its advisors to reach a different conclusion as to the appropriateness of the use of the FASIT.

## **Recommendations**

### **In general**

As discussed above, Project Apache raises a set of familiar concerns encountered in connection with tax-motivated transactions, in particular issues relating to the economic substance and business purpose doctrines. In addition to these general concerns, however, the transaction also raises some specific issues regarding the potential abuse of particular statutory and regulatory provisions. The Joint Committee staff believes that amendments to some of these provisions should be considered in order to render them less prone to abuse in tax-motivated transactions.

### **Allocation of subpart F income**

Project Apache exploited a highly mechanical earnings and profits allocation rule in Treas. Reg. sec. 1.951-1(e)(2) in an effort to achieve results that cannot have been envisioned or intended by the Treasury Department when it issued the regulation. The putative ability to allocate all of the subpart F income of Dutch VOF to tax indifferent foreign parties was critical to Enron's position that it could blend its third-party debt with self-owed debt within Dutch VOF in order to generate inflated interest and interest-like deductions without incurring any offsetting tax liability under subpart F. The transaction thus illustrates that special allocation abuses similar to those that have been encountered in the partnership taxation area<sup>692</sup> are also possible in the context of controlled foreign corporations. Enron took the position that it could specially allocate the subpart F "taint" to tax-indifferent parties, and it was able to find some support for this position under both the regulation and analogous non-subpart-F case law.

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 subpart F income allocation method set forth in the regulation for cases involving allocations of earnings and profits to tax-indifferent shareholders, if such allocations are made for tax avoidance purposes. If such an exception had been applicable to Project Apache, the transaction would not have been viable.

### **Passive foreign investment company regime**

Another concern raised by Project Apache involves the statutory elimination of the so-called overlap between the passive foreign investment company regime and the subpart F regime. In 1997, Congress enacted section 1297(e) in order 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. Section 1297(e) largely eliminates this overlap by providing that a corporation generally is not treated as a passive foreign investment company with respect to a particular shareholder if the corporation is also a controlled foreign corporation, and the shareholder is a

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<sup>692</sup> See, e.g., sec. 704(b); Treas. Reg. sec. 1.704-1(b)(2) (addressing special partnership allocations that lack "substantial economic effect").



“U.S. shareholder” as defined in section 951(b). Thus, subpart F is allowed to trump the passive foreign investment company rules, and a U.S. shareholder generally no longer needs to contend with these rules in connection with the ownership of controlled foreign corporation stock.

As applied to Project Apache, section 1297(e) enabled Enron to claim exemption from the passive foreign investment company rules with respect to its ownership of Dutch VOF stock on the basis of Enron’s subpart F status as a U.S. shareholder, despite the fact that Enron had implemented a structure designed to render it impossible for Enron to recognize any income under subpart F in connection with the stock. Thus, in a case in which Enron was a 60-percent U.S. shareholder of a foreign corporation with nothing but passive assets and passive income, Enron could take the position that neither subpart F nor the passive foreign investment company rules applied.

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 under subpart F. Accordingly, the Joint Committee staff recommends adding an exception to section 1297(e) for cases in which the likelihood that a U.S. shareholder would have to include income under subpart F is remote. In such a case, the subpart F rules and the passive foreign investment company rules cannot be said to “overlap” in the manner that the Congress found objectionable in 1997. Rather, allowing the two regimes to “overlap” in these cases would allow the passive foreign investment company rules to serve the useful purpose of providing a backstop to subpart F. If the passive foreign investment company rules had applied to Enron in Project Apache, the transaction as structured would not have been viable, even if Enron’s position under subpart F were sustained.

#### FASIT rules

As explained above, the availability under the FASIT rules<sup>693</sup> of an entity that Enron could control but treat as unrelated for tax purposes enabled Enron to take the position that section 163(j) could be avoided through the expedient of interposing an additional entity. In view of the wide range of rules under the Code that apply special restrictions to transactions between related parties, the ability to treat a FASIT as unrelated for tax purposes while maintaining effective control of it for other purposes renders FASITs prone to abuse in a wide range of situations. Regulatory anti-abuse rules,<sup>694</sup> if issued in final form, might mitigate this potential to some extent, but history suggests that the administration of such rules would be problematic, leaving considerable potential for abuse remaining. Moreover, recent commentary suggests that the 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.<sup>695</sup>

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<sup>693</sup> Secs. 860H - 860L.

<sup>694</sup> *See, e.g.*, Prop. Reg. sec. 1.163(j)-1(f); Prop. Reg. sec. 1.860L-2.

<sup>695</sup> *See, e.g.*, New York State Bar Association, “Report on Securitization Reforms” (Dec. 20, 2002) (“It is clear that the FASIT rules are not being used to any significant degree and

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.

### Earnings stripping regulations

The lack of final regulations under section 163(j) has created a void in an area in which more definitive guidance is needed. Project Apache illustrates that taxpayers may treat proposed regulations as a one-way street, to be relied upon when supportive of the desired return position, and to be disregarded when contrary to such position. If the anti-abuse rule of the proposed regulations under section 163(j)<sup>696</sup> had been in final form, Enron might have reconsidered this transaction. As noted above, the administration of such rules is always problematic, but the existence of a finalized anti-abuse rule directly on point would induce at least some change to a company's cost benefit assessment of a transaction like Project Apache. Accordingly, the Joint Committee staff recommends that the regulations implementing an anti-abuse rule to combat the avoidance of section 163(j) should be finalized expeditiously.

## **2. Project NOLy<sup>697</sup>**

Project NOLy was a series of transactions structured to generate sufficient taxable income so that Enron could offset all of its tax losses from earlier years. Enron engaged in this transaction because it would allow Enron to settle and close tax examinations for those years. Project NOLy involved the constructive sale rules and the partnership rules. The following is a discussion of these rules, followed by a detailed discussion of Project NOLy.

### Discussion of relevant tax laws

#### Tax treatment of section 1259 constructive sales

For transactions entered into after June 8, 1997, taxpayers are required to recognize gain (but not loss) upon entering into a constructive sale of any appreciated position in stock, a partnership interest, or certain debt instruments as if such position were sold, assigned or otherwise terminated at its fair market value on the date of the transaction.<sup>698</sup> If the requirements

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accordingly are not achieving their purpose"); New York State Bar Association, "Simplification of the Internal Revenue Code" (March 18, 2002), reprinted in 95 Tax Notes 575 (April 22, 2002) ("In our experience, the FASIT legislation is not being used by those who would be expected to benefit from it and it is unlikely that situation will change"); Letter from James M. Peaslee and David Z. Nirenberg to Assistant Treasury Secretary (Tax Policy) Mark A. Weinberger (June 6, 2001), reprinted in 91 Tax Notes 2079 (June 18, 2001) ("The FASIT legislation has failed").

<sup>696</sup> Prop. Reg. sec. 1.163(j)-1(f).

<sup>697</sup> The project was named for "Molly," a girlfriend of one of the attorneys on the transaction. Joint Committee staff interview.

<sup>698</sup> Sec. 1259, enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1001(a). A "position" is defined as an interest, including a futures or forward contract, short

for a constructive sale are met, the taxpayer recognizes gain in a constructive sale as if the position were sold at its fair market value on the date of the transaction and immediately repurchased.<sup>699</sup>

In general, a taxpayer is treated as making a constructive sale of an appreciated position if and when the taxpayer (or, in certain circumstances, a person related to the taxpayer) does one of the following: (1) enters into a short sale of the same (or substantially identical) property; (2) enters into an offsetting notional principal contract with respect to the same (or substantially identical) property; or (3) enters into a futures or forward contract to deliver the same (or substantially identical) property.<sup>700</sup> In addition, in the case of an appreciated financial position that itself is a short sale, a notional principal contract, or a futures or forward contract, the holder is treated as making a constructive sale when it acquires the same (or substantially identical) property as the underlying property for the position.<sup>701</sup> Finally, to the extent provided in Treasury regulations, a taxpayer is treated as making a constructive sale when it enters into one or more other transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described.<sup>702</sup>

A forward contract results in a constructive sale of an appreciated financial position only if the forward contract provides for delivery, or for cash settlement, of a substantially fixed

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sale, or option. A “position” includes a notional principal contract or other derivative instrument that provides that a taxpayer make or receive payments (or contractual credits) that approximate the economic effect of ownership of stock, a debt instrument or a partnership interest. For example, a contract that provides a right to receive payments (or contractual credits) based on a calculation having the effect of interest on a notional principal amount is treated as a position with respect to a debt instrument.

<sup>699</sup> Sec. 1259(a)(1).

<sup>700</sup> Sec. 1259(c)(1). A constructive sale does not include a transaction involving an appreciated financial position that is mark to market, including positions governed by section 475 (mark to market for securities and commodities dealers and traders) or section 1256 (mark to market for futures contracts, options and currency contracts). Nor does a constructive sale include any contract for sale of an appreciated financial position which is not a “marketable security” (as defined in section 453(f) if the contract settles within one year after the date it is entered into).

<sup>701</sup> *Id.*

<sup>702</sup> Sec. 1259(c)(1)(E). Future Treasury regulations are anticipated to treat as constructive sales other financial transactions that, like those specified in section 1259, have the effect of eliminating substantially all of the taxpayer’s risk of loss and opportunity for income and gain with respect to the appreciated financial position. It is anticipated that the Treasury regulations, when issued, will provide specific quantitative standards for determining whether several common transactions will be treated as constructive sales. H.R. Rep. No. 105-148, at 442-443 (1997).

amount of property and a substantially fixed price.<sup>703</sup> Thus, a forward contract providing for delivery of property, such as shares of stock, the amount of which is subject to significant variation under the contract terms does not result in a constructive sale.<sup>704</sup>

#### Tax treatment of partnership formation

Generally, a partner does not recognize gain or loss on the exchange of property for a partnership interest<sup>705</sup> and a partner's basis in a partnership interest acquired by contribution of property to a partnership is the amount of money plus the partner's adjusted basis of the property contributed.<sup>706</sup> In Rev. Rul. 80-235<sup>707</sup> the IRS held that if the property contributed to a partnership is an obligation of the contributing partner, that partner's basis is not increased to reflect the partner's obligation because the partner has no basis in its own obligation under certain circumstances. Treasury regulations provide that if parties enter into an off-market swap with significant nonperiodic payments, the contract is treated for Federal income tax purposes as two separate transactions, an on-market swap and a loan.<sup>708</sup> Consequently, it could be argued that the loan part of the swap transaction would be within the holding of Rev. Rul. 80-235 and the contributing partner would receive no basis in its partnership interest as a result of contributing its own obligation.

#### Liquidation of a partnership

Gain is not recognized to a partner as a result of a distribution from a partnership except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution.<sup>709</sup> No loss generally will be recognized to a partner upon receipt of a distribution from a partnership except upon a distribution in complete liquidation of a partner's interest in the partnership if no property other than money, unrealized receivables and inventory is received.<sup>710</sup> If the criteria for recognizing a loss are met, the loss is recognized to the extent of the excess of the adjusted basis of the partner's interest in the partnership over the sum of the money distributed and the basis to the distributee, as determined

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<sup>703</sup> See Sec. 1259(d)(1).

<sup>704</sup> H.R. Rep. No. 105-148, at 442 (1997).

<sup>705</sup> Sec. 721.

<sup>706</sup> Sec. 722.

<sup>707</sup> 1980-2 C.B. 229. See also, *Gemini Twin Fund III v. Commissioner*, T.C. Memo 1991-315 (1991) *aff'd without published opinion*, 8 F3d 26 (9<sup>th</sup> Cir. 1993).

<sup>708</sup> Treas. Reg. sec. 1.446-3(g)(4).

<sup>709</sup> Sec. 731.

<sup>710</sup> Sec. 731(a)(2).

under section 732, of any unrealized receivables and inventory distributed.<sup>711</sup> Gain or loss recognized as a result of a distribution pursuant to section 731 is treated as gain or loss from the sale or exchange of the partnership interest of the distributee partner<sup>712</sup> and is generally treated as gain or loss from the sale of a capital asset.<sup>713</sup> If a distribution is made to a partner of the partner's obligation received by the partnership in exchange for a partnership interest, there is no direct authority as to how this should be treated.<sup>714</sup> Commentators have indicated that this should be treated as a nonevent for tax purposes.<sup>715</sup> As a result the loss on the liquidation would be recognized to the extent basis exceeds the amount of cash distributed plus the basis to the distributee of any unrealized receivables and inventory received.<sup>716</sup>

### Capital loss carryback

Capital losses are required to be carried back three years and, if not used in the carryback years, carried forward five years.<sup>717</sup> A capital loss carryback cannot increase or produce a net operating loss for the year to which it is carried back.<sup>718</sup> Treasury regulations provide ordering rules for capital loss carrybacks in situations when there are also net operating losses at issue.<sup>719</sup> Generally, the capital loss carryback would offset capital gains in the carryback year to the extent a net operating loss is not created or increased in the carryback year. To the extent a net operating loss from a year prior to the year that produced the capital loss was carried into the carryback year and offset capital gains, that net operating loss is freed up to be carried to a subsequent year.<sup>720</sup>

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<sup>711</sup> *Id.*

<sup>712</sup> *Id.*

<sup>713</sup> Sec. 741.

<sup>714</sup> Treas. Reg. sec. 1.731-1(c)(2) and Rev. Rul. 93-7, 1993-1 C.B. 125, involve partner obligations that were either a loan or were acquired from a third party.

<sup>715</sup> McKee, Nelson & Whitmire, *Federal Income Taxation of Partnerships and Partners*, Para. 19.02[5] (1997).

<sup>716</sup> Sec. 731(a)(2).

<sup>717</sup> Sec. 1212(a)(1)(A) and (B).

<sup>718</sup> Sec. 1212(a)(1)(A)(ii).

<sup>719</sup> Treas. Reg. sec. 1.1212-1(a)(3).

<sup>720</sup> *See* Examples 4 and 5 of Treas. Reg. sec. 1.1212-1(a)(3).

### Statute of limitations on NOL carryover years and adjustment of NOL carryover

Generally tax must be assessed within three years from the date a return for that year is filed.<sup>721</sup> Courts have held that, although the period of limitations for the year a net operating loss carryover arose is not open, the amount of net operating loss carryover from a barred year can be recalculated when determining a deficiency for an open year.<sup>722</sup>

### IRS Appeals' "no immediate tax consequence" policy

If a taxpayer does not agree with adjustments made by an examiner, generally a taxpayer has the opportunity to take that dispute to Appeals, a dispute resolution function within the IRS. Most cases considered by Appeals involve disputed tax liability and as a general rule Appeals will not consider cases when there is "no immediate tax consequence."<sup>723</sup> However, cases can arise in which there is no disputed tax liability for the period under consideration. In such cases, if required by law, IRS policy, regulation, ruling or procedure, Appeals will consider issues that do not have an immediate tax consequence.<sup>724</sup> Appeals has indicated that one example of such a case is a year in which a net operating loss carryover arises and the carryforward year has not yet been examined.<sup>725</sup> The IRS has recently established other dispute resolution procedures and at least one of these might be available in no immediate tax consequence situations.<sup>726</sup>

### **Brief overview of Project NOLy**

Project NOLy was a series of transactions structured to "soak up" losses generated in the 1996 through 2000 taxable years so that Enron could settle and close tax examinations for those years. The transactions involve using limited liability companies ("LLCs") taxed as partnerships and the constructive sale rules of section 1259 to generate capital gains that can be offset by NOL carryovers to and losses incurred in 2000. Because the exact amount of the losses for 2000 was not known, Enron used two techniques to try to match the amount of gain as closely as possible to the ultimately determined losses. First, it set up 14 different LLCs, each with a different amount of potential gain available, so that when the amount of the losses was finally determined, it could be matched as closely as possible by using a combination of LLCs. Also,

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<sup>721</sup> Sec. 6501(a).

<sup>722</sup> *Hill v. Commissioner*, 95 T.C. 437, 440 (1990) and *Stiebling v. Commissioner*, 1994 T.C. Memo 233, *aff'd without published opinion* 113 F3d 1242 (9<sup>th</sup> Cir. 1997). See also Rev. Rul. 56-285, 1956-1 C.B. 134.

<sup>723</sup> IRM 8.1.2.2.3(1) (February 2, 1999). Apparently one reason for this position is that Appeals resources should not be used in cases when there is no tax currently at issue.

<sup>724</sup> IRM 8.1.2.2.3(2) (February 2, 1999).

<sup>725</sup> *Id.*

<sup>726</sup> Internal IRS correspondence indicates that early referral might be available in such a situation. See Rev. Proc. 99-28, 1999-2 C.B. 109, for a description of the early referral program.

Enron used certain technical provisions of the constructive sale rules to delay determining how much gain to report in 2000 until the end of March 2001.<sup>727</sup> Enron intended to recognize the corresponding loss in a subsequent year.

## **Background**<sup>728</sup>

### Reported tax and financial statement effects

Enron reported a capital gain of \$5.6 billion on its 2000 consolidated tax return as a consequence of Project NOLy and paid taxes of \$63 million in that year. The partnerships were liquidated in late 2001, causing recognition of a capital loss of \$5.6 billion.<sup>729</sup> That capital loss was carried back to 2000, offsetting capital gain that resulted from the constructive sale in that year.<sup>730</sup> Pursuant to the ordering rules, NOLs would be freed up allowing them to be carried to subsequent years.<sup>731</sup> Enron anticipated that application of the capital loss carryback would also result in a refund of the \$63 million in taxes paid in 2000.<sup>732</sup>

For financial purposes, this transaction was considered to be neutral.<sup>733</sup>

### Development of Project NOLy

Project NOLy was initially developed internally within Enron. Enron wanted to close out examinations on back years from which there were loss carryovers and believed that to do so they needed to trigger enough gain so that there was tax liability for 2000. The Managing Director and General Tax Counsel asked one of the directors in the Tax Department to devise a plan to accomplish this. A plan was developed that utilized the constructive sale rules of section 1259 to generate gain in 2000 by segregating the gain portion of existing financial contracts into partnerships so that the gain could be recognized. Pursuant to section 1259, a taxpayer is deemed to have sold an appreciated financial asset if derivatives or short sales are used to lock in the gain. The gain part of the project had to be completed by the end of 2000. However, by

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<sup>727</sup> Sec. 1259(c)(3) discussed in more detail below.

<sup>728</sup> The information regarding Project NOLy was obtained from Joint Committee staff interviews of Robert J. Hermann, Greek L. Rice, and Stephen H. Douglas as well as from documents and information provided by Enron and the IRS.

<sup>729</sup> Enron Presentation to the Joint Committee on Taxation Staff, June 7, 2002, at 15. The General Background Materials in Appendix B contain this document.

<sup>730</sup> *Id.*

<sup>731</sup> Treas. Reg. sec. 1.1212-1(a)(3).

<sup>732</sup> EC2 000038222. Part of a document entitled, “Chiricahua Partnerships and Related Transactions (“Project NOLY”)” provided to the Joint Committee staff by Enron.

<sup>733</sup> Joint Committee staff interview.

using 14 different LLCs taxed as partnerships and certain technical requirements of section 1259(c)(3), determining the exact amount of the gain to be recognized was postponed until late March 2001.

The business purpose of Project NOLy was stated to be to economically segregate the “in-the-money” portion of the financial trading book of Enron North America, Corp., a wholly owned subsidiary of Enron Corp. (“ENA”).<sup>734</sup> The reason 14 LLCs were needed to do this was not given.

#### Implementation of Project NOLy<sup>735</sup>

ENA routinely entered into positions, including swaps, futures contracts, options and forward contracts with third parties relating to the price of natural gas and other commodities. Usually ENA would enter into offsetting positions with its wholly owned subsidiary Risk Management and Trading Corp. (“RMT”) pursuant to an ISDA Master Agreement<sup>736</sup> dated March 31, 1997, and periodic confirmations executed in association with that agreement (“ENA Master Swap”). This served to place the risks for these types of transactions in one entity, RMT, which made managing the risk easier.

On December 20, 2000, 14 Delaware LLCs were formed by RMT and FS 360 Corp., a wholly owned subsidiary of RMT (“FS 360”).<sup>737</sup> These 14 LLCs, which elected to be taxed as partnerships, were named RMT Chiricahua I<sup>738</sup> through RMT Chiricahua XIV (“Chiricahuas”). FS 360 owned a .01 percent interest in the capital, profits and losses of each partnership, which it acquired in exchange for a cash contribution to that entity. RMT acquired a 99.99 percent

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<sup>734</sup> Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 114. The answer references a memorandum to Robert J. Hermann from Stephen H. Douglas dated August 29, 2001. Appendix B, Project NOLy contains this document.

<sup>735</sup> This section is based in large part on an opinion letter from Vinson & Elkins to Enron Corp. dated February 26, 2001, contained in Appendix C, Part X to this Report; a draft opinion letter from Vinson & Elkins to Enron Corp. dated December 17, 2001, also contained in Appendix C, Part X to this Report; summaries of the transaction provided to the Joint Committee staff by Enron at EC2 000038199-206 and a memorandum from Stephen H. Douglas to Robert J. Hermann dated August 29, 2001. Appendix B, Project NOLy contains this memorandum.

<sup>736</sup> An ISDA Master Agreement is a standard form agreement copyrighted by the International Swap Dealers Association that sets forth the terms and conditions governing any specific swaps made pursuant to the agreement among the parties to it.

<sup>737</sup> Current Management is not aware of any internal approval process for Project NOLy. Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 110.

<sup>738</sup> The Chiricahua partnerships were named for a golf course at the Desert Mountain Golf Club in Scottsdale, Arizona. Joint Committee staff interviews.



interest in the capital, profits and losses of each entity, in exchange for a cash contribution and its agreement to enter into an ISDA Master Agreement dated December 20, 2000, between RMT and the Chiricahuas and the associated confirmation dated December 27, 2000 (“RMT Swaps”), which represented offsetting positions with respect to certain of the contracts held by RMT. All of the RMT Swaps were substantially in the money at the time of execution and represented a transfer of value from RMT to the Chiricahuas. The amount of the net cash payments required to be made under each of the RMT Swaps to each Chiricahua was based upon the specific terms set forth in the associated confirmation based on the notional volumes and prices set forth therein. It was anticipated that a substantial net payment would be made by RMT to each Chiricahua over the life of the RMT Swaps rather than requiring a payment to be made by the Chiricahuas to RMT. None of the Chiricahuas was required, under the terms of the RMT Swaps, to make any net payments in the aggregate to RMT in excess of the amounts actually received by such entity from RMT.

Tularosa LLC was a Delaware LLC whose members were ENA and Mangas I Corp., a wholly owned subsidiary of ENA (“Mangas”). ENA owned a 99.99 percent interest in Tularosa and Mangas owned the remaining .01 percent interest. Subsequent to the execution of the RMT Swap, RMT entered into an ISDA Master Agreement dated December 20, 2000 with Tularosa and an associated confirmation dated December 27, 2000, for a total return swap (“Tularosa Swap”) with respect to RMT’s membership interest in each Chiricahua. Under the terms of the Tularosa Swap, RMT was entitled to receive from Tularosa on the settlement date, a fixed sum equal to the fair market value of RMT’s membership interests in the Chiricahuas on the initial contract date and RMT was required to pay Tularosa the fair market value of the membership interests in the Chiricahuas on the settlement date, plus the amount of any distributions from the Chiricahuas during the term of the contract. The Tularosa Swap was effective December 27, 2000, and the settlement date was January 2, 2002. Enron Corp. guaranteed Tularosa’s obligation under the Tularosa Swap. By entering into the Tularosa Swap, RMT became subject to the constructive sale rules of section 1259, causing it to recognize \$5.6 billion in gain (the difference between its basis in the Chiricahuas and the fair market value of its interest in the Chiricahuas) in the 2000 taxable year.

Because it would take a few months to determine precisely the amount of losses at the end of its 2000 taxable year, Enron sought to use technical rules contained in section 1259(c)(3) to delay final determination of the amount of gain until the end of March 2001. There is an exception to constructive sale treatment for any transaction that is closed before the end of the 30th day after the close of the taxable year in which it was entered into.<sup>739</sup> This exception to the constructive sale rules is only available if the taxpayer holds the appreciated financial position to which the transaction relates throughout the 60-day period beginning on the date such transaction is closed and at no time during such 60-day period is the taxpayer’s risk of loss reduced (under the principals of section 246(c)(4)) by holding positions with respect to substantially similar or related property.<sup>740</sup>

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<sup>739</sup> Sec. 1259(c)(3).

<sup>740</sup> *Id.*

To this end, less than 30 days after the end of the taxable year, on January 29, 2001, RMT and Tularosa entered into an early settlement of the Tularosa Swap. This early settlement triggered a \$701.8 million termination payment by Tularosa to RMT (because gas prices had declined since December 27, 2000) and was considered to be a closed transaction, nullifying the constructive sale, provided the 60-day rule was not applicable.<sup>741</sup> However, Enron intended to use the 60-day rule to further extend the time for determining how much gain was needed to offset the losses. By March 27, 2001, Enron's Tax Department had concluded that the entire \$5.6 billion gain should be recognized in 2000. In order to ensure that the entire gain was recognized, RMT and Tularosa entered into a new total return swap within 60 days of termination of the termination of the original Tularosa Swap. This brought the transactions within the 60-day rule<sup>742</sup> with the result that the \$5.6 billion gain was deemed to be recognized in 2000. RMT's basis in the Chiricahuas was increased by the same amount.

At the time Project NOLy was developed and implemented, it was assumed that it would be unwound in January 2002.<sup>743</sup> However, due to Enron's financial deterioration in 2001, a decision was made to unwind Project NOLy in 2001 by liquidating the Chiricahuas thereby triggering the offsetting \$5.6 billion capital loss. The Chiricahuas were liquidated in December 2001.<sup>744</sup>

The following consequences resulted from the liquidation of the Chiricahuas.<sup>745</sup> FS 360 redeemed its original \$500,000 investment and all other assets and liabilities were transferred to RMT. The only assets of the Chiricahuas were accounts receivable from RMT, the RMT Swaps and cash. When the liquidation occurred, RMT was distributed cash and the RMT Swaps. RMT's basis now included the \$5.6 billion gain recognized in 2000. Because it received relatively little cash and its own liability, the RMT Swaps, on which it recognized no gain or loss, a large capital loss, essentially equal to the \$5.6 billion capital gain in the previous year, was recognized. The recognition of this loss and the resultant carryback to earlier years was projected to result in a refund of the \$63 million of tax paid in 2000. Because the capital loss carryback from 2001 cannot increase or produce an NOL, the approximately \$2.5 billion of operating losses that arose in 2000 would continue to offset capital gains of that amount in 2000.

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<sup>741</sup> *Id.*

<sup>742</sup> *Id.*

<sup>743</sup> Opinion letter from Vinson & Elkins to Enron Corp. dated February 26, 2001, at 2. Appendix C, Part X to this Report contains this letter.

<sup>744</sup> Enron Corp. Presentation to the Joint Committee on Taxation Staff, June 7, 2002, at 15. The General Background materials in Appendix B contain this document.

<sup>745</sup> Draft opinion letter from Vinson & Elkins dated December 17, 2001, at 4-10. Appendix C, Part X to this Report contains this letter.

However, the pre-2000 NOL carryovers would be freed up and available to be carried to subsequent years.<sup>746</sup>

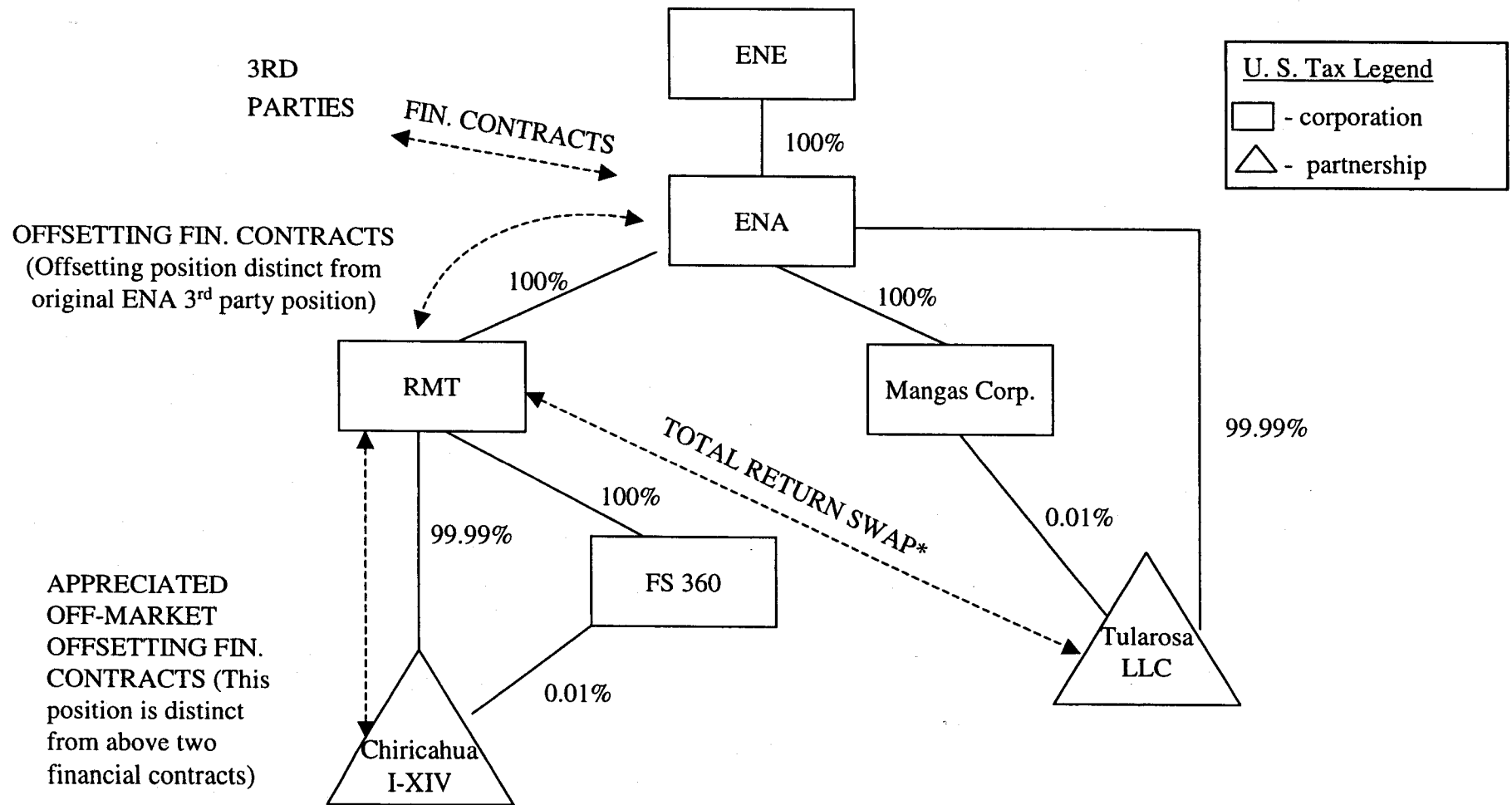
The diagram on the next page depicts the Project NOLy structure as of December 2000.

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<sup>746</sup> EC2 000038222. Part of a document entitled, “Chiricahua Partnerships and Related Transactions (Project NOLy)” provided by to the Joint Committee staff by Enron.

# Project NOLy - December 2000

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\*Total return swap contract whereby Tularosa LLC agrees to pay RMT \$5.556 billion in return for RMT's obligation to pay to Tularosa LLC all returns related to RMT's interest in Chiricahua LLC. Net cash settlement of difference between (i) FMV of Chiricahua interest at settlement date + distributions on such interest, and (ii) \$5.556 billion fixed payment.

### Role of outside advisors

Although the plan that became Project NOLy originated within the Enron Tax Department, Vinson & Elkins became involved during the development stage. Arthur Andersen was involved on the accounting side of the transaction and concluded that it was a “neutral” transaction for financial accounting purposes.<sup>747</sup>

In an opinion letter dated February 26, 2001, Vinson & Elkins opined that the transactions should result in the following: (1) a constructive sale of RMT’s membership interest in Chiricahua under section 1259; (2) the recognition of gain in an amount equal to the excess of the fair market value of RMT’s member interest in Chiricahua over its basis in such interest; and (3) an increase in RMT’s basis in its interest in Chiricahua in an amount equal to the gain recognized as a result of the constructive sale.<sup>748</sup> An important element in conclusion (2) was that RMT did not receive any basis for its interest in any of the Chiricahuas as a result of its agreement to enter into the RMT Swap because it was an obligation of a partner in which the partner had no basis.

In a separate letter, Vinson & Elkins opined with regard to the tax consequences of the liquidation of all of the Chiricahuas concluding the liquidation should generate capital losses that Enron would be able to carry back to 2000. Vinson & Elkins also concluded that RMT’s basis in the Chiricahuas would be increased by the amount of gain recognized on the constructive sale in 2000. When the partnerships were liquidated, RMT received only cash and the RMT Swaps. Vinson & Elkins concluded that for the same reasons it was viewed as a nonevent in the formation of the Chiricahuas, it should be viewed as a nonevent in the liquidation. Consequently, RMT should be regarded as receiving only cash in the liquidation enabling it to recognize a loss in the amount its basis exceeded the cash received.

Appendix C, Part X to this Report contains the tax opinions Enron received in connection with Project NOLy.

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<sup>747</sup> Joint Committee staff interviews and letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 107, which indicates that current management of Enron is unaware of “any documents relating to the financial accounting for Project NOLy, other than a passing comment in a document Bates stamped EC2 000038207.” The Project NOLy materials in Appendix B contain this document -- a memorandum to Robert J. Hermann from Stephen H. Douglas dated August 29, 2001. The document states “[t]he transaction will not result in negative accounting consequences for ENA because the tax gain resulting at the outset of the transaction will be offset with subsequently recognized tax losses in an equal amount...”

<sup>748</sup> Enron indicated that the February 26, 2001 opinion letter was a final opinion. Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 111. However, the copy bears numerous hand-written changes, and therefore does not appear to be the final version.

Fees billed by Vinson & Elkins for project NOLy totaled approximately \$90,000.<sup>749</sup> Enron's current management is not aware of any fees paid to Arthur Andersen in connection with services that may have been performed with respect to Project NOLy.<sup>750</sup>

### Subsequent developments

By mid-October of 2001, IRS was close to completing the examination cycle involving the losses that were to be carried forward. At that time, it was likely that the examination would be agreed with the exception of one issue. IRS appears to have been concluded that the Appeals Office could take jurisdiction of the remaining disputed issue in the years the NOLs arose.<sup>751</sup> If the disputed issue were resolved, this would allow the examination cycle for those years to be closed.

The IRS is in the process of examining Enron's tax returns for years 1995 through 2001.

### Discussion

Enron had loss carryovers from the 1996 through 1999 taxable years into the 2000 taxable year of approximately \$3 billion.<sup>752</sup> Based on operations in 2000, it was anticipated that additional operating losses of more than \$2 billion would be generated in that year.<sup>753</sup> The Enron Tax Department wanted to close out the earlier loss years to finalize the tax treatment of items in those years, but believed that they needed to use up the loss carryovers and pay some tax in order to do so. Project NOLy was designed to generate sufficient gains to soak up all of the NOLs and losses so that Enron paid some tax in 2000.

The IRS has provided exceptions to its general policy that the Appeals Office will not accept cases unless there is tax at issue.<sup>754</sup> One of the exceptions to this no immediate tax consequence policy is for adjustments made to an NOL carryforward when the carryforward year has not yet been examined. By mid-October of 2001, IRS was close to completing its

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<sup>749</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 113. The answer indicates that Enron has paid \$77,228.62 of this amount. The remainder, \$13,363.75, was billed in the fall of 2001 and related to the liquidation of the Chiricahua entities, but may not have been paid due to the bankruptcy filing.

<sup>750</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 108.

<sup>751</sup> Internal IRS correspondence.

<sup>752</sup> Opinion letter from Vinson & Elkins to Enron Corp. dated December 17, 2001. Appendix C, Part X to this Report contains this letter.

<sup>753</sup> *Id.*

<sup>754</sup> IRM 8.1.2.2.3(2) (February 2, 1999).

examination of a cycle including years in which the net operating loss carryforwards arose with only one issue remaining unagreed. IRS appears to have concluded that an Appeals forum would be available to Enron in that situation to resolve the unagreed issue.<sup>755</sup>

The stated reason for Project NOLy was to finalize the treatment of items in the years the net operating losses were generated, 1996 through 1999. These were the years in which Enron implemented a number of the structured transactions described in this Report. It appears that the purpose behind Enron's implementation of Project NOLy was to use technical tax rules to manipulate its tax situation in order to put the IRS in the position that it would have to sign off on years in which Enron implemented other structured transactions.

Project NOLy is also another example of the disparity between financial statement treatment of a transaction and tax treatment of the same transaction. For financial statement purposes, Project NOLy was neutral. However, for tax purposes, the taxpayer recognized \$5.6 billion of capital gains in one year and an essentially equal amount of capital losses in the next year.

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<sup>755</sup> IRS internal correspondence.

## E. Transactions in Which Enron is an Accommodation Party

### 1. Project Renegade

#### Brief overview

Enron was an accommodation party in Project Renegade. Project Renegade was designed to enable Bankers Trust to achieve favorable tax benefits while Enron received an accommodation fee of \$1.375 million for engaging in the transaction.

Project Renegade involved Bankers Trust loaning \$320 million to ECT Equity Corporation (“ECT Equity”), a wholly owned subsidiary of Enron, in return for a long-term note payable. Almost immediately, ECT Equity contributed the \$320 million to Enron Finance Holding Corporation (“Enron Finance”), a wholly owned subsidiary of ECT Equity, which loaned \$8 million of the proceeds to Enron Corp. and contributed the remainder (\$312 million) to Wiltshire Financial Assets, LLC (“Wiltshire”) in return for approximately 98 percent ownership of Wiltshire.<sup>756</sup> Wiltshire also received a capital contribution of \$8 million from a Bankers Trust subsidiary in return for approximately a two percent ownership interest. Subsequently, Wiltshire used the \$320 million to purchase from Bankers Trust \$320 million note issued by the ECT Equity. Thus, after the circular flow of funds through the various entities, Enron had effectively borrowed \$8 million from Bankers Trust. However, as a result of certain tax rules with respect to financial asset securitization investment trusts (“FASITs”), Bankers Trust was able to achieve its desired tax goals.

#### Background<sup>757</sup>

##### Reported tax and financial statement effects

Project Renegade generated \$1.375 million of taxable income in 1998. The taxable income was the fee paid by Bankers Trust to Enron for acting as an accommodation party in the transaction. In lieu of paying Enron directly, Enron stated that Bankers Trust reduced its fee for advising on Project Teresa by \$1.375 million.<sup>758</sup> In addition, Project Renegade increased

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<sup>756</sup> Wiltshire elected to be classified as a financial asset securitization investment trust for Federal income tax purposes.

<sup>757</sup> The information regarding Project Renegade was obtained from Joint Committee staff interviews of Robert J. Hermann and R. Davis Maxey, as well as from documents and information provided by Enron Corp. and the Internal Revenue Service.

<sup>758</sup> An amended Project Teresa engagement letter between Bankers Trust and Enron was signed on December 29, 1998 to reflect the fee reduction. EC2 000037573 - EC2 000037592.



reported financial statement earnings in 1998 by approximately \$800,000 (\$1.375 million accommodation fee less associated income taxes on such amount).<sup>759</sup>

### Development of Project Renegade

Bankers Trust promoted the concept of Project Renegade to Enron in December 1998.<sup>760</sup> Enron named the proposed project after one of the five golf courses at Desert Mountain Golf Club.<sup>761</sup> The project was presented to Enron as a structure that would enable Enron to use a special purpose entity, owned by Bankers Trust and Enron, to raise capital.

On December 18, 1998 the Executive Committee of the Board of Directors of Enron reviewed the proposed structure. Richard A. Causey presented the proposal to the Executive Committee with Mr. Hermann in attendance.<sup>762</sup> Mr. Causey's presentation indicated that the proposed transaction would create a financial structure that would enable Enron to obtain financing from independent investors at a lower cost of funds.

The presentation to the Executive Committee indicated that a financial institution would loan Enron \$320 million in exchange for a long-term note. Subsequently, the note would be contributed by the financial institution to a limited liability company in which Enron would acquire four tranches of debt obligations issued by the limited liability company in an amount approximately equal to the \$320 million loaned by the financial institution. As part of the transaction the financial institution agreed to use its best efforts to offer for sale to independent investors the most senior tranche of the debt obligations. The total amount offered was expected to be approximately \$80 million. The interest rate payable was expected to be significantly lower than currently available to Enron on borrowed funds. The Executive Committee was informed of two specific risks of entering into the transaction and mitigating factors to such risk. The two specific risks identified were (1) the ability of the outside party to market the debt obligation, and (2) the Federal income tax consequences of the transaction.<sup>763</sup> The Executive

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<sup>759</sup> The tax return and financial statements are also impacted by the payment of interest expense on the net \$8 million loan from Bankers Trust. The interest expense is accounted for in the same manner as any third party loan.

<sup>760</sup> Discussion Material for Project Renegade dated December 17, 1998 prepared by Bankers Trust. The Project Renegade materials in Appendix B contain the materials. EC2 000037527-EC2 000037544.

<sup>761</sup> Enron also used three of the other four Desert Mountain Country Club golf course names to identify other tax department structured transactions. They are Cochise, Apache, and Chiricahua. The other golf course, Geronimo, was also used, but none of the transactions that used its name were completed.

<sup>762</sup> Minutes of the December 18, 1998 meeting of the Executive Committee, EC 000037550.

<sup>763</sup> Presentation materials titled "Below Market Financing Proposal." EC2 000037546-EC2 000037548.

Committee was informed that the marketing risk was mitigated by (1) the best efforts underwriting agreement, and (2) the fact that the transaction could be unwound at the end of the marketing period. The tax risks were mitigated by (1) an indemnification agreement between Enron and Bankers Trust for any adverse tax consequences to Enron, and (2) the fact that the transaction could be unwound in the event of any adverse tax law change.<sup>764</sup> At the conclusion of the presentation, the Executive Committee adopted resolutions approving the transaction.<sup>765</sup>

Enron's stated business purpose for entering into the transaction was to obtain a net borrowing at a relatively low interest rate and earning fee income for engaging in the transaction with Bankers Trust.<sup>766</sup>

#### Implementation of Project Renegade

On December 23, 1998, Bankers Trust London branch loaned \$320 million to ECT Equity. The note was a 25-year note with interest payable semiannually and principal due at the end of the term.<sup>767</sup> Also, on December 23, 1998, ECT Equity and Bankers Trust entered into a deposit agreement that required ECT Equity to deposit the loaned funds with Bankers Trust for seven days with no right of withdrawal.<sup>768</sup> The deposit agreement would terminate on December 29, 1998, if ECT Equity requested the funds be credited to the account of Enron Finance. Enron Finance also entered into an agreement with Bankers Trust on December 23, 1998, to deposit the funds loaned to ECT Equity on December 29, 1998 unless Enron Finance purchased approximately \$312 million of debt securities from Wiltshire.

In addition, on December 23, 1998, Enron Finance and Bankers Trust also entered into a put option that permitted Bankers Trust to sell the \$320 million ECT Equity note to Enron Finance unless the note had been validly assigned to Wiltshire before December 30, 1998.<sup>769</sup> Enron Corp. and Bankers Trust also entered into an agreement to permit Enron to purchase the

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<sup>764</sup> *Id.*

<sup>765</sup> Information contained in the minutes of the December 18, 1998 meeting of the Executive Committee. EC 000037551. The Board of Directors of Enron was provided the details of the transaction as part of its meeting on February 8, 1999. At such time, the Board of Directors of Enron approved the recommendation of the Executive Committee, EC2 000037556.

<sup>766</sup> Per Project Renegade tax overview. EC 000037523.

<sup>767</sup> The note had a temporary interest rate of 7.2825 percent for the period December 23 through December 29. In addition, Enron indicated that the permanent rate was also 7.2825 percents. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 31, 2003, answer 5.

<sup>768</sup> The deposit earned interest at a rate of 4.9844 percent per annum.

<sup>769</sup> After assigning the note to Wiltshire, Bankers Trust would have recouped \$312 million of the \$320 million loaned to ECT Equity and Enron would own all but \$8 million of the note.

ECT Equity note on December 30, 1998, if the note had not been validly assigned to Wiltshire, and Bankers Trust had not exercised its put option. Thus, through the various deposit agreements and put agreement, Bankers Trust was able to ensure Enron would complete the steps and make certain the funds would be deposited with Bankers Trust during the implementation of the transactions.

In accordance with the preconceived plan, on December 29, 1998, ECT Equity loaned \$320 million to Enron Finance. Enron Finance subsequently loaned \$8 million of the proceeds to Enron Corp. and exchanged approximately \$312 million for \$72 million of Class A interests, \$40 million of Class B-1 interests, \$40 million of Class B-2 interests, and \$160 million of Class B-3 interests of Wiltshire.<sup>770</sup> Subsequently, an affiliate of Bankers Trust exchanged \$8 million for an equivalent amount of Class A interests of Wiltshire and Bankers Trust London Branch exchanged \$1,000 for all of the Class O interests of Wiltshire. Wiltshire then used the \$320 million to purchase the ECT Equity note from Bankers Trust London branch.

Upon its formation, Wiltshire elected to be classified as a FASIT for Federal income tax purposes. The Wiltshire LLC agreement reflects the Class A and Class B interests as regular interests under the FASIT rules (such rules generally treat the interests as a debt instrument) and the Class O interest as the designated ownership interest. Under the Wiltshire LLC agreement the cash flow generated from its assets (\$320 million ECT Equity note receivable) was to be used in the following order: (1) to pay the current yield and principal on the Class A interests; (2) the current yield on the Class B-1, Class B-2, and Class B-3 interests, respectively; (3) the principal on the Class B-1, Class B-2, and Class B-3 interests, respectively; and (4) the Class O interests.

In addition, on December 29, 1998, Bankers Trust and Enron Finance entered into a tax indemnity agreement. In general, the tax indemnity agreement provided that Bankers Trust would pay any taxes, penalty, and interest that Enron incurred as a result of its participation in the transactions in excess of the amount of taxes that would be due if the interests Enron Finance purchased were treated as debt instruments with the same economic terms as the Class A and Class B interests purchased.<sup>771</sup>

Enron Finance, Bankers Trust London branch, and BT Alex Brown Incorporated (“BT Alex Brown”) entered into a placement agreement on December 29, 1998 in which Enron engaged BT Alex Brown as its exclusive placement agent (on a best efforts basis) for the sale of \$72 million of Class A interests in Wiltshire until June 30, 1999. BT Alex Brown’s fee was \$50,000 plus out-of-pocket expenses. However, the fee was to be paid by Bankers Trust not Enron.

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<sup>770</sup> The Class A interests accrued interest at 5.7 percent per annum, the Class B-1 accrued interest at 7.126283289 percent per annum, the Class B-2 accrued interest at 7.276283289 percent per annum, and the Class B-3 accrued interest at 7.426283289 percent per annum. It was anticipated that the Class A interests would be fully amortized by December 31, 2002.

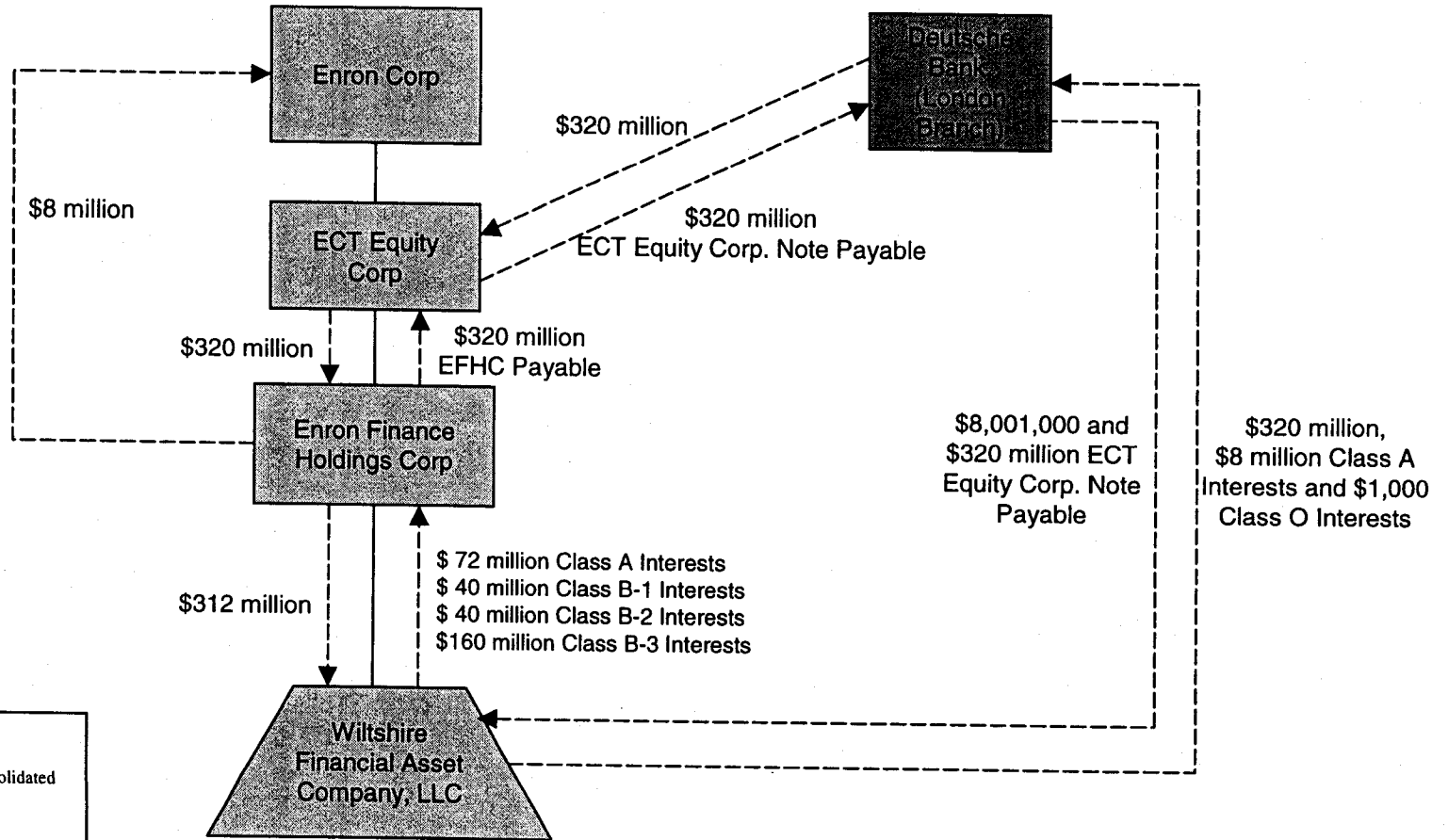
<sup>771</sup> The Project Renegade materials in Appendix B contain the tax indemnity agreement. ECx000002324-Ecx000002336.

Bankers Trust and Enron Finance also entered into a purchase option agreement on December 29, 1998, permitting Enron Finance the right to purchase Bankers Trust Class O interests in Wiltshire on or after December 15, 2006, provided no Wiltshire Class A interests are then outstanding.

The diagram on the next page depicts the Project Renegade structure.

# Project Renegade Structure as of December 29, 1998

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**US Tax/GAAP Legend**

	Enron GAAP Consolidated
	Third Parties
	Corporation
	FASIT
	Branch
	Assets

### Subsequent developments

The placement of the \$72 million of Wiltshire Class A interests held by Enron Finance was not a success. Enron stated that it was unaware of the efforts, if any, that BT Alex Brown made to sell the Class A shares or what market conditions resulted in the sale being unsuccessful.<sup>772</sup> As such, except for interest on approximately \$8 million, the interest on the \$320 million ECT Equity note held by Wiltshire was returned to Enron Corp. via Enron Finance's interest in Wiltshire.

### Discussion

Enron's corporate resolutions state that Enron engaged in Project Renegade to obtain financing at a significantly lower cost of capital than could be obtained through more traditional means. However, Enron tax personnel involved in the project indicated that the primary reason for entering into the arrangement was to earn an accommodation fee. The fact that Project Renegade only provided Enron with \$8 million of financing, and such financing was anticipated to fully amortize within five years, lends credence to their statements that Enron engaged in the transaction as an accommodation party. In addition, Enron could not produce any risk analysis, investment analysis, or other documentation regarding the determination of the appropriate market rate of interest on the Class A and B interests in Wiltshire.<sup>773</sup> Enron also could not produce any analysis illuminating the financial reasons an investor would be willing to purchase a general obligation ECT Equity debt instrument at a lower yield than a comparable Enron debt instrument.<sup>774</sup> The lack of contemporaneous financial analysis also indicates that Enron's main objective in the transaction was to earn an accommodation fee.

A review of the documents involved in Project Renegade reflects that many agreements were subject to additional agreements with related parties that effectively altered the actual economic arrangement of the parties and further supports the notion that Enron would not have engaged in the transactions absent the accommodation fee.

For example, ECT Equity borrowed \$320 million from Bankers Trust in return for a 25-year note. However, deposit agreements among ECT Equity, Enron Finance, and Bankers Trust required the funds to be deposited with Bankers Trust for one week with no right of withdrawal except for the purpose of enabling ECT Equity and Enron Finance to effectuate the prearranged steps to facilitate Bankers Trust goals. If the prearranged steps were not completed within one week, an option agreement between Bankers Trust and Enron permitted Bankers Trust to put the ECT Equity note to Enron. Thus, through the deposit agreements and the option agreement,

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<sup>772</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 44.

<sup>773</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 47.

<sup>774</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 46. Enron stated that this type of analysis would normally be undertaken by outside advisors.

Bankers Trust could ensure that the \$320 million would never be outside its control unless ECT Equity and Enron Finance completed the prearranged steps. If the steps were completed, Bankers Trust was assured of having only \$8 million of capital at risk.<sup>775</sup> Thus, although ECT Equity and Bankers Trust documented a \$320 million note, the economic reality was that Bankers Trust was willing to put only \$8 million of capital at risk and only if Enron and its controlled subsidiaries engaged in the prearranged steps for the benefit of Bankers Trust.<sup>776</sup>

Although Enron did not engage in Project Renegade to generate a Federal income tax benefit for itself, Project Renegade highlights the potential for abuse of tax code provisions if taxpayers act in concert. In this transaction Enron and Bankers Trust, arguably in an attempt to shroud the facts of its financial relationship, had Bankers Trust pay the accommodation fee via a reduction of fees owed to Bankers Trust with respect to another structured transaction.

As the focus of this Report is to address Enron's tax situation, the Joint Committee staff has not been able to review Bankers Trust's tax situation to determine the reasons Banker Trust desired to engage in the transaction. However, the structure appears to have enabled Bankers Trust to report taxable gain on the sale of the \$320 million ECT Equity note to Wiltshire in 1998 that would reverse at a later date.<sup>777</sup>

The taxable gain results from the treatment required for contributions of property to a FASIT under section 860L. In general, gain (but not loss) is recognized immediately by the owner of the FASIT upon the transfer of assets to a FASIT. A taxpayer generally computes any recognized gain based on the fair market value of the contributed assets. However, in the case of debt instruments that are not traded on an established securities market, special valuation rules apply for purposes of computing gain on the transfer of such debt instruments to a FASIT. Under these rules, the value of such debt instruments is the sum of the present values of the reasonably expected cash flows from such obligations discounted over the weighted average life of such assets. The discount rate is 120 percent of the applicable federal rate, compounded semiannually, or such other rate that the Secretary shall prescribe by regulations. Using this formula, Bankers Trust, as the Federal income tax owner of the Wiltshire FASIT, likely reported a taxable gain on the sale of the ECT Equity note irrespective no such gain occurred on the sale.

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<sup>775</sup> This result occurs because one of the prearranged steps required Wiltshire to purchase the ECT Equity note from Bankers Trust for \$320 million. Wiltshire paid for such purchase using \$312 of the \$320 million purportedly loaned to ECT Equity and returning the \$8 million contributed by Bankers Trust for a Class A interest.

<sup>776</sup> The Bankers Trust materials presented to Enron specifically highlighted the circular cash flow arrangement with the end result being a \$10 million loan to Enron. The Project Renegade materials in Appendix B contain the documents. EC2 000037544. The executed documents resulted in only an \$8 million loan to Enron.

<sup>777</sup> Although taxpayers do not normally accelerate taxable income, there are circumstances when such acceleration is beneficial to taxpayers (e.g., *see* Project NOLy in this Report). As stated above, the Joint Committee staff has not reviewed Bankers Trust tax situation.

In summary, the Joint Committee staff believes that the documents reviewed reflect that Project Renegade had no purpose to Enron other than to facilitate its participation as an accommodation party in a tax motivated transaction undertaken by Bankers Trust.

## **2. Project Valhalla**

### **Brief overview**

Project Valhalla was a financing transaction structured to provide tax benefits to Deutsche Bank under foreign law. Enron served as an accommodation party and effectively received a fee for its participation in the transaction. It appears that the transaction allowed Deutsche Bank to receive from Enron a stream of income that was treated as a nontaxable dividend under German law, but to finance this stream of income with deductible interest payments made to Enron. Enron's fee took the form of a rate spread between these two amounts.

In implementing Project Valhalla, Enron formed a German entity that was treated as a corporation under German law, but that elected to be treated as a disregarded entity for U.S. Federal tax purposes. Deutsche Bank transferred \$2 billion to this entity in return for participation rights that provided for minimum distribution payments at a 7.7-percent rate of interest. The participation rights were treated as debt for U.S. Federal tax purposes, but as equity for German tax purposes. The German entity used the cash received from Deutsche Bank to purchase preferred stock in an Enron domestic affiliate, and then used the dividend income from the preferred stock to fund the minimum distribution payments on the participation rights.

At the same time, the parties established a largely offsetting loan and payment stream, in which Enron transferred \$1.95 billion to a Deutsche Bank branch in exchange for a promissory note bearing interest at a rate of 8.74 percent.

Under German law, since the participation rights were treated as equity, the minimum distribution payments associated with these rights were treated as dividends, which Deutsche Bank was able to receive free of tax under German law. At the same time, the payments of interest to Enron on the note presumably were deductible to the Deutsche Bank branch. Taken together, it appears that this treatment allowed Deutsche Bank to use deductible payments to finance a stream of tax-exempt income.

From Enron's perspective, the rate spread in its favor between the note and the participation rights generated net pre-tax interest income and effectively constituted Enron's accommodation fee. Enron deducted the smaller payments on the participation rights as interest expense, and included the larger payments received on the note as interest income, thus reporting net interest income on its U.S. Federal consolidated return as a result of the transaction.



## Background<sup>778</sup>

### Reported tax and financial statement effect

The \$2 billion in participation rights less the \$1.95 billion note resulted in a net \$50 million borrowing by Enron from Deutsche Bank.

The interest rate spread in Enron's favor was expected to yield approximately \$100 million of pre-tax income, or approximately \$65 million in financial net income, over the intended five-year life of the structure.<sup>779</sup> Enron reported approximately \$7 million of financial net income from the transaction for 2000, and \$9 million through the third quarter of 2001. The primary tax return effect for 2000 was net taxable income of \$11 million.<sup>780</sup>

### Development of Project Valhalla

Based on Joint Committee staff interviews, it appears that Deutsche Bank originated the idea for Project Valhalla and prepared the early promotional materials for the transaction. R. Davis Maxey and Tina Livingston were the primary Enron personnel working on the transaction.

On December 13, 1999, Richard A. Causey introduced the idea for Project Valhalla to Enron's Board of Directors' Finance Committee. Mr. Causey described the transaction as a proposed subsidiary preferred stock financing. He stated that as part of Enron's overall financing plan, the Company was proposing the sale of up to \$2.2 billion of securities to a non-affiliated investor group. The proposed sale of securities was approved for recommendation to Enron's Board of Directors.<sup>781</sup>

The following day, Herbert S. Winokur, Jr. addressed Enron's Board of Directors and recommended the Finance Committee's proposal for a subsidiary preferred stock financing. The Board approved the proposal maintaining that it was in Enron's best interest to provide financing and liquidity to its affiliates and provided for the sale of up to \$2.2 billion of securities to an investor or investor group not affiliated with Enron.<sup>782</sup>

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<sup>778</sup> The information regarding Project Valhalla was obtained from Joint Committee staff interviews of Robert Herrman, James A. Ginty, R. Davis Maxey, Jordan Mintz, and Tina Livingston, as well as from documents and information provided by the Enron Corporation.

<sup>779</sup> Enron "Project Valhalla Business Review," EC2 000038364-65.

<sup>780</sup> Enron "Tax Overview of Project Valhalla," EC2 000038072.

<sup>781</sup> Agenda for the Meeting of the Finance Committee of the Enron Board of Directors, December 13, 1999, item #3, at EC2 000038092; Minutes of the Meeting of the Finance Committee of the Enron Board of Directors, December 13, 1999, paragraph 4, at EC2 000038098.

<sup>782</sup> Minutes of the Meeting of the Board of Directors of Enron Corp., December 14, 1999, EC2 000038084-87.

## Implementation of Project Valhalla

In May 2000, Enron and Enron Diversified Investments Corporation (“EDIC”), a domestic affiliate of Enron, formed Enron Valkyrie (“Valkyrie”), a Delaware limited liability company that elected to be classified as a partnership for U.S. Federal income tax purposes. Enron contributed \$67,535,500 in exchange for a 95 percent membership interest in Valkyrie, and EDIC contributed \$3,554,500 in exchange for a five percent membership interest in Valkyrie. Under Valkyrie’s company agreement, all items of income, gain, loss, deduction, and credit were allocated in accordance with the members’ respective interests.

Shortly thereafter, Valkyrie formed Valhalla GmbH (“Valhalla”), a German limited liability company. Valkyrie contributed \$71.09 million to Valhalla in exchange for all of the common shares of Valhalla. Valhalla, in turn, contributed \$71.09 million to Rheingold GmbH (“Rheingold”), a German limited liability company, in exchange for all of the common shares of Rheingold. Rheingold obtained additional financing through a loan from Enron of \$106.63 million and issuance of a note to Enron evidencing the loan with interest payable at a rate of 7.7 percent.<sup>783</sup> Valhalla and Rheingold both elected to be treated as disregarded entities for U.S. Federal income tax purposes.

Following this series of transactions, Valhalla and Rheingold entered into a subscription and procurement agreement, pursuant to which Valhalla agreed to procure a subscriber for, or to subscribe for, certain participating debt rights in Rheingold. The subscription price for the participation rights was \$2 billion. Then Rheingold, Valhalla, and Deutsche Bank entered into an agreement on the participation rights, pursuant to which Valhalla waived its right to subscribe for such rights and Rheingold issued the participation rights to Deutsche Bank in exchange for \$2 billion.

Deutsche Bank is a German corporation that is engaged in the banking and financial services business. It is a resident of Germany for German tax purposes and therefore is eligible for benefits under the U.S.-German income tax treaty. Under German corporate law, Deutsche Bank, as holder of the participation rights, had no voting rights and generally had the rights of a creditor. The terms of Deutsche Bank’s participation rights were as follows: (1) participation with the common stock in distributions made by Rheingold to the extent of their ratable share of Rheingold’s capital; (2) entitlement to minimum distributions paid annually by Rheingold at a rate of 7.7 percent to the extent Rheingold had sufficient distributable profits; (3) participation in liquidation proceeds to the extent of their ratable share of Rheingold’s capital; and (4) a fixed maturity of 35 years.<sup>784</sup>

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<sup>783</sup> In order to address certain German tax and accounting issues, the note provided for repayment of the greater of: (1) the Euro equivalent of \$106.63 million at the exchange rate on the date of issuance; or (2) the Euro equivalent of \$106.63 million on the day the note was repaid. Rheingold had the right under the note to prepay all or any portion of the principal amount of the loan.

<sup>784</sup> Agreement on Participation Rights, May 2, 2000, Ecx000009413.

Subsequent to Deutsche Bank purchasing the participation rights, Valhalla, Valkyrie, and Deutsche Bank entered into put and call option agreements. The agreements generally required Deutsche Bank to sell the rights back to the Enron group within a five-year period. Deutsche Bank and Valhalla entered into a put option agreement pursuant to which Valhalla granted Deutsche Bank the right to sell its participation rights to Valhalla upon the occurrence of a “put circumstance.”<sup>785</sup> At the same time, Valkyrie and Deutsche Bank entered into a call option agreement<sup>786</sup> pursuant to which Deutsche Bank granted Valkyrie the right to acquire the participation rights upon the occurrence of a “call circumstance.”<sup>787</sup>

The sale and repurchase agreements served two purposes. They facilitated unwinding the financing transaction in a manner that would minimize both U.S. and German tax consequences, and they provided a mechanism for substantiating Valhalla’s beneficial ownership of the participation rights under a U.S. debt-equity analysis. If the participation rights were treated as an equity interest for U.S. tax purposes, it would jeopardize Rheingold’s disregarded entity status and result in additional tax to the Enron group. Therefore, the terms related to the put and call option agreements were structured to prevent beneficial ownership of the rights from transferring to Deutsche Bank.

Risk Management and Trading Corporation (“RMT”), a domestic affiliate of Enron, was engaged in the business of hedging and trading financial instruments and commodities. Rheingold used the funds it received from Deutsche Bank’s purchase of the participation rights, along with the funds it received from Valhalla’s capital contribution and the loan from Enron, to purchase two classes of RMT preferred stock. The first class (“Series 1”) was non-voting, non-participating (except to the extent of a fixed 7.54048 percent dividend), and not convertible into any other class of RMT stock. The second class (“Series 2”) included voting rights, but was non-participating (except to the extent of a fixed 7.54048 percent dividend).<sup>788</sup> Valkyrie granted Rheingold the right to put the RMT preferred stock to Valkyrie at a price that was the greater of (1) the original issue price of the preferred stock or (2) the U.S. dollar equivalent of the original Deutsche mark price on the date the put was exercised.<sup>789</sup>

As one of the final steps to the transaction, Enron loaned \$1.95 billion to Deutsche Bank’s New York branch in accordance with the terms of a promissory note. Later in 2000, Deutsche Bank’s London branch took the place of the New York branch as obligor on the note.

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<sup>785</sup> Put Option Agreement between Deutsche Bank AG and Valhalla, May 2, 2000, Ecx000009474.

<sup>786</sup> Call Option Agreement, May 2, 2000, Ecx000009432.

<sup>787</sup> The put and call circumstances included, among other things, a downgrade in Enron’s long-term credit rating.

<sup>788</sup> Securities and Purchase Agreement between Risk Management and Trading Corp. and Rheingold GmbH, May 2, 2000, Ecx0000099500.

<sup>789</sup> Put Option Agreement between Enron Valkyrie, LLC and Rheingold GmbH, May 2, 2000.

The note was due and payable on May 2, 2005 (or earlier if a “payment event” occurred) and required Deutsche Bank to make annual coupon payments at a fixed rate of 8.74 percent.<sup>790</sup> The spread between the 8.74 percent interest rate on the note and the 7.7-percent rate on the participation rights<sup>791</sup> served as Enron’s accommodation fee on the transaction.

The \$1.95 billion promissory note largely offset Enron’s \$2 billion liability to Deutsche Bank with respect to the participation rights. Enron personnel interviewed by the Joint Committee staff could not fully explain why Enron made a net \$50 million borrowing from Deutsche Bank on the transaction, but recalled that Deutsche Bank requested that the two instruments not completely offset each other.

The parties intended for the financing arrangement to remain outstanding for a period of up to five years, until May 2005.

The diagram on the following page depicts the Project Valhalla structure.

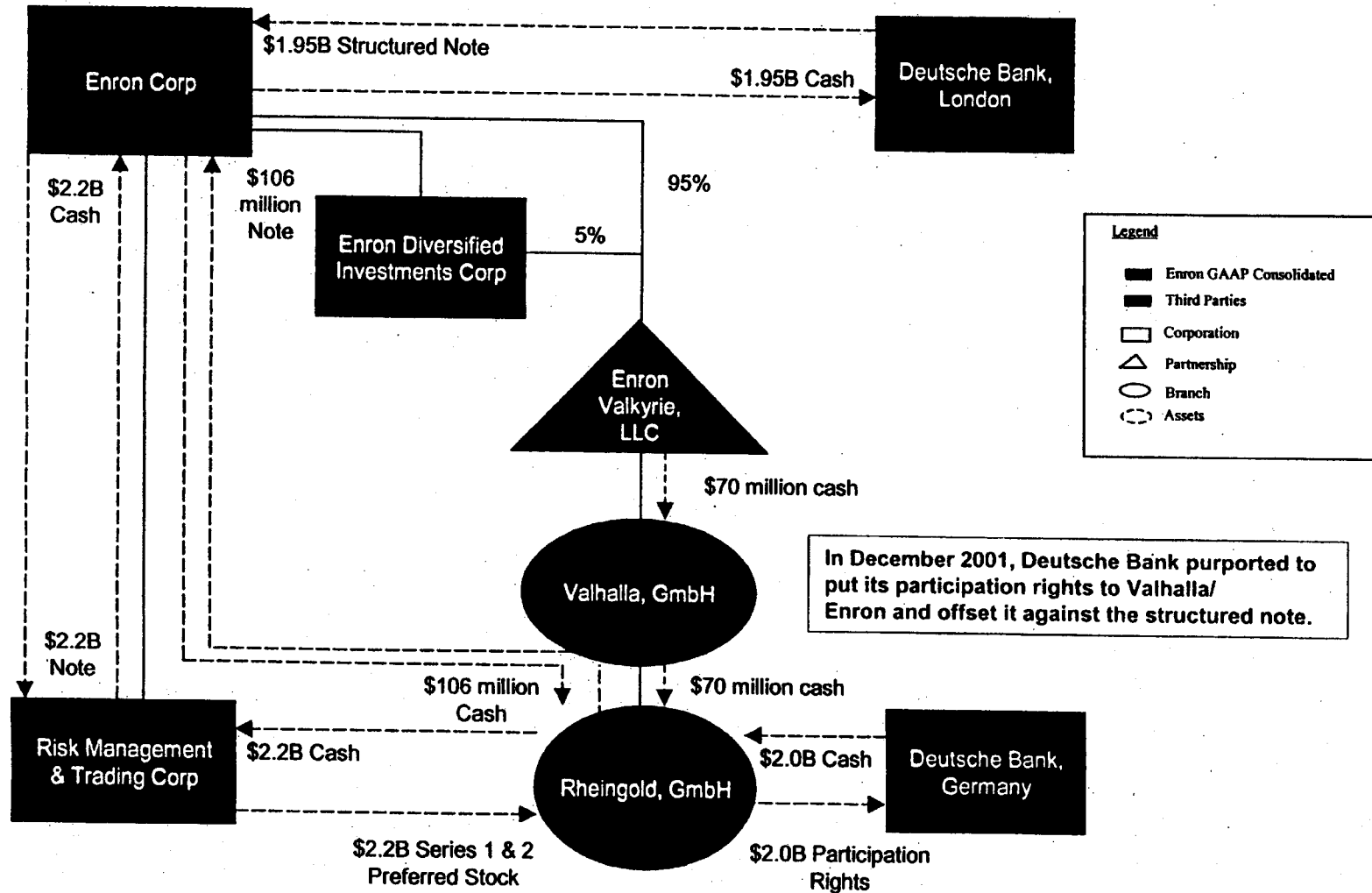
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<sup>790</sup> This rate was fixed through the use of an interest rate swap. Enron personnel interviewed by the Joint Committee staff stated that, for reasons unknown to Enron, Deutsche Bank requested the use of a swap to generate the fixed rate, instead of using a simple fixed rate note in the first place.

<sup>791</sup> Promissory Note issued by Deutsche Bank AG New York Branch to Enron Corporation, Ecx000009541.

# Project Valhalla

## General Structure



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EC2 000038067

### Role of outside advisors

In connection with Project Valhalla, Vinson & Elkins provided a tax opinion discussing the U.S. Federal tax treatment of the transaction. The specific issues addressed in the opinion were: (1) the treatment of Valhalla and Rheingold as disregarded entities; (2) the treatment of the transactions comprising the financing transaction as a loan from Deutsche Bank to Valkyrie (including the purchase of the participation rights, the put and call agreements, and the purchase of RMT preferred stock); (3) the continued status of RMT as a member of the Enron group after the issuance of Series 1 and Series 2 preferred stock; (4) Enron and EDIC's eligibility for a dividends-received deduction with respect to dividends from RMT allocated to them under Valkyrie's company agreement; (5) the deductibility by Enron and EDIC of their distributive shares of Valkyrie's interest expense with respect to the minimum distributions paid on the participation rights; (6) the applicability of U.S. withholding tax on dividends payments from RMT to Rheingold; and (7) the applicability of U.S. withholding tax on interest payments made by Rheingold to Deutsche Bank.

Enron also received a tax opinion from Clifford, Chance and Punder, which addressed a number of German tax issues.

Appendix C, Part XI to this Report contains the tax opinions that Enron received in connection with Project Valhalla.

### Subsequent developments

Shortly before the filing of Enron's bankruptcy petition, Deutsche Bank gave notice of intent to exercise its option to put the Rheingold participation rights to Valhalla, and to treat Deutsche Bank's obligations on the promissory note as thereby satisfied. No other steps have been taken to unwind the structure.<sup>792</sup>

### **Discussion**

As explained above, Project Valhalla was structured to provide tax benefits to Deutsche Bank, by allowing Deutsche Bank to use deductible payments to finance a stream of income that was tax-exempt under German law. Because the Joint Committee staff's focus in this report is on Enron and its U.S. tax issues, the staff was not able to gather detailed information or conduct a complete analysis of the Deutsche Bank tax benefits at the center of the transaction.<sup>793</sup>

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<sup>792</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy Paull, Joint Committee on Taxation, dated Jan. 13, 2003, at 10.

<sup>793</sup> Although a complete analysis of Deutsche Bank's tax benefits is beyond the scope of this report, it seems clear that the transaction raises significant issues regarding the ability of taxpayers to exploit differences and inconsistencies between different countries' tax systems (e.g., with respect to debt-equity characterization, or entity classification). See, e.g., Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, vol. I at p. 96 (noting that the interaction between the tax

Enron acted as an accommodation party in Project Valhalla and received a fee for its participation in the transaction in the form of an interest rate spread in its favor. This fee was included as net interest income on Enron's U.S. consolidated tax return. Strictly speaking, from a U.S. Federal tax perspective, Enron's benefit from Project Valhalla was a non-tax benefit, as it originated entirely in pre-tax income and actually increased Enron's tax liability. Nevertheless, some may question the appropriateness of Enron's facilitating, for a fee, the tax-avoidance arrangements of another party.

Leaving aside the question of the appropriateness of Enron's serving as an accommodation party, Enron's tax issues in the transaction mainly involved ensuring that, apart from the net increase in taxable income attributable to the accommodation fee, the structure created a tax-neutral result for Enron. For example, the participation rights had to be characterized as debt for U.S. Federal income tax purposes, the payments on those rights had to be deductible as interest expense, and the dividend payments received by Rheingold from RMT had to qualify for the dividends-received deduction, among other issues. These issues are addressed in the tax opinion letter that Enron received from Vinson & Elkins.<sup>794</sup> In this regard, it does not appear that Enron derived any inappropriate U.S. Federal tax benefits in connection with the transaction -- the sum and substance of Enron's tax treatment of the transaction was that the company deducted interest expense that it paid to a third party and included interest income that it received from a third party.

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laws of the United States and those of foreign countries "can lead to tax arbitrage opportunities for taxpayers, particularly when the foreign laws and the U.S. tax rules yield inconsistent tax results for the same transaction").

<sup>794</sup> See Appendix C, Part XI, to this Report.

## II. COMPANY-OWNED AND TRUST-OWNED LIFE INSURANCE

### A. Summary

Enron implemented company-owned life insurance (“COLI”) and trust-owned life insurance (“TOLI”) programs. The discussion below provides background on the structure of COLI and TOLI arrangements, summarizes the present law tax treatment, describes Enron's COLI and TOLI arrangements, and provides discussion and recommendations. COLI generally has been the subject of considerable publicity due to its Federal income tax and financial accounting benefits,<sup>795</sup> and Congress has sought to limit its use as a tax arbitrage mechanism in Federal tax legislation since the 1940's.<sup>796</sup>

### B. Background, Present Law, Discussion and Recommendations

#### 1. Background and present law relating to the tax treatment of company-owned life insurance

##### Structure of COLI and TOLI arrangements historically

The term COLI refers to life insurance contracts owned by a business (whether or not the business is actually in corporate form). The structure of a COLI arrangement generally has been that a business buys life insurance of a type that has a cash value, and after the cash value has built up sufficiently, the business borrows some portion of the cash value. The business can borrow directly from the policy under a loan administered by the insurance company that issued the policy. In such a case, the amounts borrowed with respect to the contracts may be repaid by means of a reduction in the death benefits when the person insured under the contract dies. Alternatively, the business may borrow from a third party lender, perhaps using the life insurance contract as security for the loan, either formally or informally. The life insurance contract or contracts in COLI arrangements typically have covered the life or lives of employees, customers, or other individuals in whom the business has an insurable interest under applicable State law. The type of life insurance contract used for COLI is a type of contract that has cash value, and is often referred to generically as whole life insurance. This type of life insurance can be distinguished from term life insurance, which normally has no cash value. A TOLI arrangement

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<sup>795</sup> See, e.g., Francis, *Bill Seeks Disclosure on Insuring Employees*, Wall St. J., Feb. 5, 2003; Francis, *Insurance Disclosure of S&Ls May Change*, Wall St. J., Jan. 27, 2003; Gettlin, *Tax-Free Earnings: A Life-And-Death Issue*, National J., Oct 26, 2002, at 3140; Clark, *Better Off Dead?*, U.S. News & World Report, May 6, 2002, at 32; Schultz and Francis, *The Economy: Senator to Target Tax Boon to Firms Insuring Workers*, Wall St. J., May 3, 2002; Francis and Schultz, *Big Banks Quietly Pile Up 'Janitors' Insurance*, Wall St. J., May 2, 2002; Francis and Schultz, *Many Banks Boost Earnings with 'Janitors' Life Insurance*, Wall St. J., April 26, 2002; Francis and Schultz, *Why Secret Insurance on Employees Pays Off*, Wall St. J., April 25, 2002; Schultz and Francis, *Why Are Workers in the Dark? Most States Don't Force Firms To Disclose 'Janitors' Insurance, But Congress May Change That*, Wall St. J., April 24, 2002; Schultz and Francis, *Valued Employees: Worker Dies, Firm Profits*, Wall St. J., April 19, 2002.

<sup>796</sup> A description of Federal tax legislation on this subject is below.



is similar to a COLI arrangement, except that the life insurance contracts are held by a trust that is generally controlled by the business, such as a trust that maintains assets to fund qualified or nonqualified employee benefits.

#### Use as funding vehicle

COLI policies have been used as an indirect funding vehicle for employee benefits (or for any other cash need of the business). Because the policies are not specifically allocated to fund a particular expenditure, they can be used as a means of providing liquidity when direct funding of a future obligation is not necessary or is undesirable. For example, borrowings under COLI policies have been used to pay employers' obligations under retiree health plans, or to make payments under unfunded deferred compensation arrangements.

#### Financial statement benefits

COLI policies provide the financial statement benefit that the increase in the cash surrender value (including earnings under the contract) and death benefits received under the policy are treated as income for financial reporting purposes. By contrast, cash value increases and death benefits generally are not included in income for Federal income tax purposes, thus generally resulting in a permanent book-tax difference.<sup>797</sup>

#### Borrowing in connection with COLI

Patterns of business borrowings with respect to life insurance contracts the business owns have changed over the past several decades. These changes have resulted from growth in the marketing to businesses of life insurance on employees, customers or other individuals, and also from changes in the tax law, and from other factors.

Borrowing by a business with respect to a life insurance contract is attractive because the earnings under the policy ("inside buildup") increase tax-free. The loans permit the borrower to have the current use of income that has not been taxed. Interest paid by the borrower is credited to the policy, which it owns, so the effect is equivalent to paying interest to itself. The amount of the loan reduces the death benefit when the insured person dies, if the loan has not yet been repaid; however, this is not a disadvantage to the borrower if another person (such as an employee's spouse) is the recipient of the death benefit. A further advantage of borrowing with respect to a life insurance policy would arise to the extent the interest on the policy loan is deductible.

### **Tax treatment**

#### Pattern of COLI legislation

Provisions of tax legislation designed to limit the tax arbitrage of deducting interest on borrowings with respect to a life insurance contract date to the 1940's.<sup>798</sup> The deductibility of

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<sup>797</sup> Premiums and interest associated with the policies, however, are treated as an expense for financial reporting purposes, and are not deductible for Federal income tax purposes.

interest on borrowings that relate to life insurance contracts has been limited most recently by Federal tax legislation in 1986, 1996, and 1997.

In 1986, deductible interest on borrowings under life insurance contracts was capped at debt of \$50,000 per contract, to combat the use of life insurance loans as an “unlimited tax shelter.”<sup>799</sup> This provision was effective for contracts purchased on or after June 20, 1986. Life insurance contracts purchased before that date were grandfathered; the \$50,000 cap did not apply to interest on debt borrowed under such contracts.

A pattern then developed of businesses insuring the lives of thousands of their employees to increase the amount of interest to deduct on borrowings under the contracts.<sup>800</sup> In 1996, a broader limitation on deductibility of interest on debt under a life insurance contract was enacted, generally replacing the \$50,000 cap. That rule provided that no deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance, annuity or endowment contracts owned by the taxpayer, and covering the life of any individual who is or has been (1) an officer or employee of, or (2) financially interested in, any trade or business currently or formerly carried on by the taxpayer.<sup>801</sup> A key person insurance exception was provided. The 1996 legislation applied generally to interest paid or accrued after October 13, 1995, with a phase-in rule. However, the grandfather rule for pre-June 20, 1986 contracts was preserved, with a new interest rate cap based on a Moody's rate.<sup>802</sup>

The interest deduction limitation was further expanded in 1997 when Congress became aware of the practice of businesses insuring the lives of customers or debtors (for example, financial institutions insuring the lives of mortgage borrowers while borrowing under the life

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<sup>798</sup> Section 129 of the Revenue Act of 1942 (Pub. L. No. 753, 77th Cong., 56 Stat. 798) added Internal Revenue Code section 24(a)(6), which provided that no deduction was allowed for “any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. For the purposes of this paragraph, if substantially all the premiums on a life insurance or endowment contract are paid within a period of four years from the date on which such contract is purchased, such contract shall be considered a single premium life insurance or endowment contract.”

<sup>799</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, at 579. See Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1003, 100 Stat. 2388 (1986).

<sup>800</sup> See Lee Sheppard, “‘Janitor’ Insurance as a Tax Shelter,” *Tax Notes*, Sept. 25, 1995, p. 1526.

<sup>801</sup> Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104<sup>th</sup> Congress* (JCS-12-96), Dec. 18, 1996, p. 365. See Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, sec. 510, 110 Stat. 2090 (1996).

<sup>802</sup> Sec. 264(e)(2).

insurance policies, or maintaining other debt, and deducting the interest thereon).<sup>803</sup> The 1997 legislation provided that no deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual. It also provided that, for taxpayers other than natural persons, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values of a life insurance, annuity or endowment contract. An exception is provided under this proration rule for contracts that cover an individual who is a 20 percent owner, officer, director or employee of the taxpayer's trade or business.<sup>804</sup> The pro rata interest deduction limitation applied generally to contracts issued after June 8, 1997. Thus, the phase-in rule under the effective date of the 1996 legislation, and the grandfather rule under the 1986 and 1996 legislation for contracts purchased on or before June 20, 1986, were not affected.

#### Inside buildup and death benefits under life insurance contracts generally tax-free

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract<sup>805</sup> ("inside buildup").<sup>806</sup> Further, an exclusion from

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<sup>803</sup> See "Fannie Mae Designing a Program to Link Life Insurance, Loans," *Washington Post*, Feb. 8, 1997, p. E3; "Fannie Mae Considers Whether to Bestow Mortgage Insurance," *Wall St. Journal*, April 22, 1997, at C1.

<sup>804</sup> This proration rule applies to policies issues after June 8, 1997. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1084, 111 Stat. 951 (1997), and see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), Dec. 17, 1997, p. 272.

<sup>805</sup> By contrast to the treatment of life insurance contracts, if an annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract (sec. 72(u)).

<sup>806</sup> This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59 1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.<sup>807</sup>

Premium and interest deduction limitations with respect to life insurance contracts

Premiums.—Under present law, no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract.<sup>808</sup>

Interest paid or accrued with respect to the contract.—In addition, no deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual,<sup>809</sup> with a key person insurance exception.<sup>810</sup>

Pro rata interest limitation.—A pro rata interest deduction disallowance rule also applies. Under this rule, in the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values.<sup>811</sup> Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance, annuity and endowment contracts, to (2) the sum of the average unborrowed cash values (or average adjusted bases, for other assets) of all the taxpayer's assets.

Under the pro rata interest disallowance rule, an exception is provided for any contract owned by an entity engaged in a trade or business, if the contract covers only one individual who is a 20-percent owner of the entity, or an officer, director, or employee of the trade or business.

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<sup>807</sup> Sec. 101(a).

<sup>808</sup> Sec. 264(a)(1).

<sup>809</sup> Sec. 264(a)(4).

<sup>810</sup> This provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest under applicable State law when the contract is first issued, except as otherwise provided under special rules with respect to key persons and pre-1986 contracts. Under the key person exception (sec. 264(e)), otherwise deductible interest may be deductible, so long as it is interest paid or accrued on debt with respect to a life insurance contract covering an individual who is a key person, to the extent that the aggregate amount of the debt does not exceed \$50,000. The deductible interest may not exceed the amount determined by applying a rate based on Moody's Corporate Bond Yield Average-Monthly Average Corporates. A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) five individuals, or (2) the lesser of five percent of the total number of officers and employees of the taxpayer, or 20 individuals.

<sup>811</sup> Sec. 264(f). This applies to any life insurance, annuity or endowment contract issued after June 8, 1997.

The exception also applies to a joint-life contract covering a 20 percent owner and his or her spouse.

"Single premium" and "4-out-of-7" limitations.—Other interest deduction limitation rules also apply with respect to life insurance, annuity and endowment contracts. Present law provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity or endowment contract.<sup>812</sup> In addition, present law provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, annuity or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise).<sup>813</sup> Under this rule, several exceptions are provided, including an exception if no part of four of the annual premiums due during the initial seven year period is paid by means of such debt (known as the “4-out-of-7 rule”).

#### Judicial decisions relating to COLI

Interest deductions under COLI arrangements have also been limited by recent case law applying general principles of tax law, including the sham transaction doctrine. These cases generally cover taxable years of the taxpayers before the recent 1996 and 1997 legislation took effect. These principles of tax law continue to apply after enactment of the specific interest deduction limitation rules.

The case of *Winn-Dixie Stores, Inc. v. Commissioner*<sup>814</sup> involved the application of the sham transaction doctrine. In 1993, Winn-Dixie entered into a company-owned life insurance (COLI) program on the lives of its 36,000 employees. Under the program, Winn-Dixie purchased whole life insurance policies and was the sole beneficiary. Winn-Dixie borrowed periodically against the policies' account value at interest rates that averaged 11 percent. The 11 percent average interest rate, when coupled with the administrative fees, outweighed the net cash surrender value and benefits paid on the policy. Thus, although Winn-Dixie lost money on the program each year, the tax deductibility of the interest and fees yielded a benefit of several billion dollars over 60 years. In 1997, Winn-Dixie terminated its participation in the COLI program following the enactment of tax law changes in 1996 that limited the deductibility of interest on COLI policy loans. On audit, the IRS disallowed the deductions for interest and administrative fees that Winn-Dixie claimed on its 1993 tax return with respect to its COLI program and COLI policy loans.

On petition to the Tax Court, Winn-Dixie argued that the deductions relating to its COLI program were proper because: (1) the COLI program satisfied the business purpose and economic substance prongs of the sham transaction doctrine, and (2) in any case, the sham

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<sup>812</sup> Sec. 264(a)(2).

<sup>813</sup> Sec. 264(a)(3).

<sup>814</sup> *Winn-Dixie*, 113 T.C. 254 (1999), *aff'd* 254 F.3d 1313 (11<sup>th</sup> Cir. 2001), *cert. denied*, April 15, 2002.

transaction doctrine was inapplicable because Congress explicitly authorized the deductions in connection with the COLI program. However, the Tax Court sustained the IRS disallowance of the COLI-related deductions claimed by Winn-Dixie, concluding that the COLI program (including the associated policy loans) was a sham.

In arguing that its COLI program had a business purpose and economic substance, Winn-Dixie asserted that it used the earnings from the COLI program to fund the flexible benefits program that it provided to its full time employees.<sup>815</sup> However, the Tax Court determined that the COLI program lost money on a pre-tax basis, and that the program generated positive earnings and cash flow only on an after-tax basis after taking into account the deductions for interest and administrative costs. Thus, the court concluded that the COLI program was a sham:

Even if we were to accept [the testimony of Winn-Dixie's financial vice president] that he intended to use tax savings to fund [Winn-Dixie's flexible benefits program], that would not cause the COLI plan to have economic substance. If this were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, every sham tax shelter device might succeed. Petitioner's benefit from the COLI plan was dependent on the projected interest and fee deductions that would offset income from petitioner's normal operations. The possibility that such tax benefits could have been used as a general source of funds for petitioner's [flexible benefits program] obligations (or any other business purpose) does not alter the fact that the COLI plan itself had only one function and that was to generate tax deductions which were to be used to offset income from its business and thereby reduce petitioner's income tax liabilities in each year.<sup>816</sup>

With regard to whether Congress sanctioned the deductibility of interest and costs relating to COLI programs, Winn-Dixie argued that the sham transaction doctrine was not pertinent to its COLI program because Congress has repeatedly addressed the treatment of COLI plans over the years and has permitted deductions attributable to certain COLI plans that either satisfied explicit statutory requirements or predated the enactment of legislation to restrict such deductions.<sup>817</sup> However, the Tax Court concluded that any legislative approval of COLI programs was premised upon programs that had economic substance and were not shams:

It is clear that Congress and the Treasury Department were aware of the problems associated with interest deductions on life insurance loans. However, we are not persuaded that Congress, by enacting and amending section 264 or other related provisions that restrict the deductibility of interest, intended to allow interest deductions under section 163 based on transactions that lacked with economic substance or business

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<sup>815</sup> *Winn-Dixie*, 113 T.C. at 286.

<sup>816</sup> *Id.* at 287-88 [footnote omitted].

<sup>817</sup> *Id.* at 290.

purpose. In *Knetsch*,<sup>818</sup> the Supreme Court noted that nothing in the legislative history of section 264 suggests that Congress intended to protect sham transactions. Similarly, we find nothing in the more recent legislative history of section 264 suggesting that Congress intended to allow deductions arising from sham transactions that lacked economic substance and business purpose.<sup>819</sup>

Accordingly, the Tax Court upheld the disallowance by the IRS of the deductions claimed by Winn-Dixie for interest and administrative costs relating to its COLI program. On appeal, the Eleventh Circuit Court of Appeals adopted the reasoning of the Tax Court and affirmed its decision.<sup>820</sup>

Other recent cases have also upheld the disallowance by the IRS of deductions for interest relating to COLI programs. In *Internal Revenue Service v. CM Holdings, Inc.*,<sup>821</sup> Camelot Music had purchased COLI policies in 1990 covering the lives of 1,430 employees. Camelot borrowed under the policies to pay the first three annual premiums and sought to deduct the interest on the borrowings. Camelot subsequently filed a petition under chapter 11 of the Bankruptcy Code, and the IRS filed proofs of claim based on disallowance of the interest deductions. The District Court held that the interest deductions should be disallowed, and also concluded that the application of accuracy-related penalties was appropriate. The court stated that there were two rationales for the interest deduction disallowance. First, the interest deductions were part of a transaction that was in part a factual sham and therefore did not meet the "4-out-of-7" exception to the interest deduction disallowance rule of Code section 264(a)(3). In addition, the COLI plan lacked economic substance and business purpose, and was a sham in substance.<sup>822</sup> On appeal, the Third Circuit affirmed, "based on the . . . reasoning, that the COLI policies lacked economic substance and therefore were economic shams."<sup>823</sup> The Appellate Court also affirmed the assessment of penalties.

In *American Electric Power, Inc. v. U.S.*,<sup>824</sup> the District Court concluded that interest deductions on policy loans under a COLI program covering the lives of over 20,000 employees should be disallowed. The court concluded that the "plan as a whole was a sham in

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<sup>818</sup> *Knetsch v. United States*, 364 U.S. 361 (1960) (disallowing deduction for prepaid interest on a nonrecourse, riskless loan used to purchase deferred-annuity savings bonds) (footnote supplied).

<sup>819</sup> *Winn-Dixie*, at 293-94.

<sup>820</sup> 254 F.3d 1313 (11<sup>th</sup> Cir. 2001) (per curiam).

<sup>821</sup> *Internal Revenue Service v. CM Holdings, Inc.*, 254 B.R. 578 (D. Del. 2000).

<sup>822</sup> *Id.* at 583, 654.

<sup>823</sup> *IRS v. CM Holdings, Inc. (In Re: CM Holdings, Inc.)*, 301 F.3d 96 (3d Cir. 2002), at 96.

<sup>824</sup> *American Electric Power, Inc. v. U.S.*, 136 F.Supp. 2d 762 (S. D. Ohio 2001).

substance,"<sup>825</sup> as well as concluding that first year policy loans, and the first year and fourth through seventh year loading dividends and corresponding portions of the premiums, were factual shams. The court stated that it had "independently reached many of the same conclusions as the [District] court in *C.M. Holdings*," and that the policies in that case were in all relevant respects identical to those involved in this case.<sup>826</sup>

## **2. Enron's COLI and TOLI transactions**

### **Brief overview**

During the 1980s and early 1990s, Enron bought approximately 1,000 life insurance contracts covering employees. Approximately \$178 million had been borrowed under these life insurance contracts at the end of 1994, after which Enron stopped purchasing life insurance contracts covering employees. By late 2001, the amount borrowed under Enron's life insurance contracts had grown to approximately \$432 million. In addition to its own contracts, Enron acquired Portland General Electric in 1997, which also owned life insurance contracts covering its employees. As of 1999, Portland General Electric had approximately \$79 million worth of such life insurance contracts, and its affiliates owned approximately \$59 million worth. Policies covering a total of 2,315 Portland General Electric employees were purchased between 1996 and 1999. Following Enron's bankruptcy filing on December 2, 2001, Enron surrendered its life insurance contracts during 2002. Portland General Electric's life insurance contracts were in the process of being surrendered as of early 2003.

Company-owned life insurance provides tax benefits and financial statement benefits, in addition to providing life insurance coverage of persons in whom the company has an insurable interest (such as officers, managers or other employees). Life insurance is tax favored in that death benefits paid by reason of the death of the insured person generally are excludable from income, and also in that earnings on amounts credited to the policy generally are excluded from the policyholder's income as well. Premiums paid on business-owned life insurance generally are not deductible.

From a financial statement perspective, the untaxed income earned inside the contract and the untaxed death benefits received under the contract can generally be credited as income on the income statement. Accrued interest on borrowings under the contract is treated as an expense for financial statement purposes.

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<sup>825</sup> *Id.* at 795.

<sup>826</sup> *Id.* at 769.



## Background<sup>827</sup>

### Reported tax and financial statement effects

Enron treated premium payments for its COLI policies as nondeductible for Federal income tax purposes, and excluded from income the inside buildup and death benefits under the contracts.<sup>828</sup>

For financial statement purposes, Enron included the increase of the cash surrender value of the COLI policies as income, included the death benefits received as income, treated the premiums for the policies as an expense, and treated the accrued interest on the COLI loans as an expense.<sup>829</sup>

### Development and implementation of COLI and TOLI transactions

Enron's COLI and TOLI contracts.--During the 1980s through the mid-1990s, Enron bought approximately one thousand life insurance contracts on the lives of individuals.<sup>830</sup> These contracts were issued by several different life insurance companies, including Great West,<sup>831</sup> Mass Mutual (formerly Connecticut Mutual), Pacific Life, Security Life of Denver, and CIGNA.

Approximately half of Enron's life insurance contracts covering employees (including a group of 201 contracts purchased June 1, 1986) were purchased before June 20, 1986, the

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<sup>827</sup> The information regarding Enron's COLI and TOLI contracts was obtained from a Joint Committee staff interview of Mr. Hermann, as well as from documents and information provided by Enron and the IRS.

<sup>828</sup> Letter of Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, January 13, 2003, answer 142. Enron made adjustments required under the adjusted current earnings preference of the corporate alternative minimum tax with respect to inclusion of income on life insurance contracts and deductibility of premiums (sec. 56(g)(4)(B)(ii)). *Id.*

<sup>829</sup> *Id.* Enron's net book income adjustment for COLI, per the tax return, was -\$19 million for 1996, -\$24 million for 1997, -\$27 million for 1998, -\$35 million for 1999, and -\$20 million for 2000, as shown on Enron Corp. & Subsidiaries Reconciliation of Net Income per Annual Report to Taxable Income per Enron's Consolidated Tax Return For the Calendar Years 1996 thru 2000 in Enron Corp. Presentation to Joint Committee on Taxation staff, Washington, D.C., June 7, 2002, at 20. Appendix B, Part I contains this document.

<sup>830</sup> From lists of Enron life insurance contracts as of December 31, 1994, EC2 000038640 - EC2 000038689. One company list shows 1,007 contracts (Sheet 1, Enron Corp., Summary of COLI Values @ 12/31/1995, EC2 000038639). Another company list shows 1,046 contracts (Item 11- Attachment A, dated 5/9/2002, 2:11 PM, EC 000768247).

<sup>831</sup> Also referred to as Great Western Life.

effective date of 1986 legislation limiting the tax deduction for interest on debt under a life insurance contract.<sup>832</sup>

In documents prepared by Clark-Bardes (a COLI broker) for Enron in connection with its 1994 purchase of life insurance contracts from CIGNA, the contracts were described as a funding vehicle for Enron's obligation to pay deferred compensation under a 1994 nonqualified deferred compensation arrangement with approximately 300 executives.<sup>833</sup> The life insurance contracts were to fund the deferral of approximately \$3 million of 1994 compensation by 100 of the executives, and also to fund deferrals of compensation elected by the executives for the next seven years. These contracts were held by a trust, rather than directly by the company, and thus can be described as TOLI (trust-owned life insurance) contracts. Enron stopped purchasing contracts covering employees after the purchase of this group of contracts on September 24, 1994.<sup>834</sup>

Enron had borrowed a total of approximately \$178 million under its life insurance contracts as of the end of 1994.<sup>835</sup> At that time, these COLI contracts had a total of approximately \$226 million of gross surrender value.<sup>836</sup> A 1999 summary by Clark-Bardes showed that interest rates charged on loans under some of the contracts -- those issued by Massachusetts Mutual and Great West -- ranged from 6.75 percent to 11.75 percent during the period 1983 - 1999.<sup>837</sup> As the cash surrender value of the contracts increased, Enron continued to borrow under the contracts. The summary states, "Enron's policy blocks retain 100% loan interest deductibility under current legislation; this deductibility is a commodity that is no longer available in the insurance marketplace."<sup>838</sup>

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<sup>832</sup> Item 11- Attachment A, dated 5/9/2002, 2:11 PM, EC 000768247. Appendix B contains this document.

<sup>833</sup> Attachment D, Enron Corp. 1994 Deferral Plan, Plan Funding Conclusions and Recommendations, Prepared by Corporate Compensation, Corporate Treasury, Clark/Bardes, Inc., EC 000768252. Appendix B contains this document.

<sup>834</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, January 31, 2003, answer 11.

<sup>835</sup> Documents listing COLI contracts as of December 31, 1994, EC2 000038640 - EC2 000038689.

<sup>836</sup> *Id.* Gross surrender value generally is the cash surrender of the contract (the amount that would be received on surrender of the contract to the insurer that issued it), not taking into account fees or other charges, or the amount loaned under the contract.

<sup>837</sup> Attachment B, Enron Corporation Executive Summary, EC 000768248-9. Appendix B contains this document.

<sup>838</sup> *Id.*

PGE's COLI and TOLI contracts.—Enron indirectly acquired COLI and TOLI contracts through the 1997 acquisition of Portland General Electric Company ("PGE") and its affiliates. PGE had purchased life insurance on employees in 1986, approximately 10 years before Enron acquired PGE. The premiums were paid by PGE, and the employees had no interest in the policies. The life insurance contracts were to fund corporate officers' and directors' deferred compensation and pension plans. Policies covering a total of 2,315 Portland General Electric employees were purchased between 1996 and 1999.<sup>839</sup> PGE had approximately \$79 million worth of insurance contracts on the lives of its employees, and affiliates held another \$59 million worth. These figures represent the contracts' cash surrender value as of 1999.

In preparation for a sale of PGE to Sierra Pacific that was anticipated for 2000, Enron planned during 1999 to acquire the life insurance contracts from PGE. This expected transfer of life insurance contracts from PGE to Enron was named "Project Granite."<sup>840</sup> Enron tax department analysis concluded that transferring the policies would yield an after-tax benefit to Enron of \$129 million.<sup>841</sup> The sale of PGE to Sierra Pacific, and the transfer of PGE's life insurance contracts to Enron, never took place.<sup>842</sup>

#### Role of outside advisors

Clark-Bardes, an insurance broker, was involved with respect to contracts Enron bought in 1983, 1984, 1985, and 1986 and in 1994. Enron also bought life insurance contracts through the Management Compensation Group/Silverstone Group. These brokers also provided management services to Enron, such as preparing statements listing all the life insurance contracts and showing the contracts' values and loan balances.

#### Subsequent developments

Enron's COLI and TOLI contracts.—In connection with Enron's bankruptcy filing on December 2, 2001, the company filed a statement of contingent and non-contingent interests in certain assets, including life insurance policies.<sup>843</sup> Shortly before Enron's bankruptcy filing,

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<sup>839</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, January 31, 2003, answer 11.

<sup>840</sup> Enron Corp. Project Granite, Executive Compensation/Benefits Trust, October 29, 1999, EC2 000038621 - EC2 000038634.

<sup>841</sup> Interoffice memorandum from J. Anthony Jarrett to File, Subject: Sale of PGE: Options for Trust Owned Life Insurance, August 6, 2002, EC2 000038636 - EC2 000038638. Appendix B contains this document.

<sup>842</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, January 13, 2003, answer 141. The sale of PGE to Sierra Pacific did not take place; Enron listed PGE among its core assets in its bankruptcy filing (Dec. 2, 2001).

<sup>843</sup> "Exhibit B-19, Contingent and non-contingent interests in estate of a decedent, death benefit plan, life insurance policy, or trust," filed August 14, 2002, in the United States Bankruptcy Court, S. D. N.Y. The letter from Enron's counsel (Skadden, Arps) to Lindy L.

Enron held 1,047 life insurance policies, the same number of contracts it had in 1994. The contracts had a gross cash surrender value of approximately \$512 million, of which approximately \$432 million was borrowed (i.e., was included in the loan balance with respect to the policies).<sup>844</sup>

Since the end of 1994, the loans under Enron's COLI contracts had increased by approximately \$254 million (from approximately \$178 million to approximately \$432 million). During this period, the gross surrender value of the contracts increased by approximately \$286 million (from approximately \$226 million to approximately \$512 million). Approximately half (493 of 1,047 contracts) of Enron's COLI contracts were purchased before June 20, 1986, and were grandfathered under the 1986 and 1996 legislation limiting interest on debt with respect to life insurance contracts.

Enron's life insurance contracts on employees were surrendered during the period May through July, 2002.<sup>845</sup>

PGE's COLI and TOLI contracts.—PGE is listed as a core asset in Enron's December 2, 2001, bankruptcy filing. The sale of PGE to a third party, and the transfer of PGE's life insurance contracts to Enron, did not take place as anticipated.

The life insurance contracts held by Portland General Electric were in the process of being surrendered as of January 31, 2003. At that time, some of the contracts had been surrendered.<sup>846</sup>

## **Discussion**

Enron's COLI and TOLI arrangements were leveraged, showing approximately \$432 million of debt on \$512 million of life insurance coverage by November, 2001. The purchase of

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Paull, Joint Committee on Taxation, January 31, 2003, answer 11, states that the amount borrowed was approximately \$432 million as of November 30, 2001.

<sup>844</sup> *Id.* The values of assets in this filing were required to be stated as of the month-end prior to the December 2, 2001, petition date, that is, as of November 30, 2001.

<sup>845</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, January 31, 2003, answer 11, and Enron Corp. COLI Policies Surrendered in 2002, EC2 000057702. The latter document is contained in Appendix B. According to a company document (Item 11 - Attachment A, EC000768247), by August 9, 2002, 767 of Enron's life insurance contracts covering the lives of individuals, with annual premiums of approximately \$12.7 million, had been surrendered. Another 279 life insurance contracts held by Enron on individuals remained in force as of that date, according to the document, and final premium payments were made in 2000 for 78 of the Enron contracts remaining in force, and annual premium payments on the other 201 of the contracts totalled approximately \$5.8 million.

<sup>846</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, January 31, 2003, answer 11.

these contracts predated the 1996 and 1997 legislation limiting interest deductions under life insurance contracts and imposing a pro rata reduction on interest deductions in the case of taxpayers that have life insurance contracts but do not borrow directly under the contracts.

The grandfather rule under the 1986 COLI legislation would apply to those contracts Enron purchased on or before June 20, 1986. Under this grandfather rule, neither the 1986 \$50,000 per-contract cap on debt, nor the broader 1996 rule disallowing interest on debt under a life insurance contract, applied to contracts Enron purchased on or before June 20, 1986 (although for interest incurred after the 1996 legislation, those contracts were subject to an interest rate cap based on a Moody's rate relating to corporate bond yields).

This grandfather rule continues in effect, allowing the continued deduction of interest on debt under contracts that were purchased on or before June 20, 1986. As years pass from the 1986 date, the value of this tax treatment increases with the growth of the cash surrender value of the grandfathered contracts (assuming they are not treated as materially changed or otherwise ceasing to be pre-June 20, 1986 contracts). This result could be viewed as inconsistent with Congress' repeated legislation limiting interest deductions with respect to life insurance contracts.

### **Recommendations**

In light of the growth of interest on debt incurred under Enron's life insurance contracts that remained deductible due to the grandfather rule applicable to pre-June 20, 1986 contracts, the Joint Committee staff recommends termination of the grandfather rule for such contracts. Even though Enron did not purchase any additional life insurance contracts after 1994, Enron's debt and deductible interest under life insurance contracts continued to increase throughout the 1980s and 1990s (along with the cash surrender value of the contracts). This result is inconsistent with the legislative limitations imposed by Congress in 1986, 1996 and 1997 on interest associated with the tax-free inside buildup of life insurance contracts. If the 1986 grandfather rule was intended to provide transition relief to businesses that had purchased life insurance contracts before the 1986 date, sufficient time has passed that a redeployment of such businesses' assets could have been possible. The grandfather rule can no longer serve any reasonable need for transition relief.

### **III. STRUCTURED FINANCING TRANSACTIONS**

#### **A. Background and Rationale**

During the 1990s, Enron's rapid growth necessitated significant infusions of new capital. At tension with its capital requirements, however, was the need for Enron to maintain its credit rating, particularly as Enron's creditworthiness had a direct impact on its stock price. As a consequence of this circumstance, Enron raised nearly \$10 billion through various structured financing transactions, including tiered preferred securities, investment unit securities, and commodity prepay transactions. The primary advantage to Enron from some of these transactions was its ability to raise capital without ostensibly incurring additional debt. Thus, such transactions enabled Enron to maintain its credit rating and, in turn, avoid the downward pressure on its market valuation that would likely result from additional leverage. In other transactions, the primary advantage to Enron was its ability to liquidate appreciated equity investments--and eliminate its risk of loss from future declines in the value of these investments--without actually disposing of the investments and incurring immediate recognition of gain for Federal income tax purposes.

In the case of the tiered preferred securities and investment unit securities, the favorable tax treatment accorded these transactions was a principal factor in Enron's decision to raise additional capital by issuing such securities. In the case of the commodity prepay transactions, Enron initially engaged in these transactions solely for tax purposes, but in later years used these transactions to manipulate its reported operating results. Throughout its participation in the commodity prepay transactions, Enron exercised a significant degree of selectivity in its tax treatment of these transactions, including the transactions that were carried out primarily for financial reporting purposes in later years.

## **B. Discussion of Present Law Relating to Certain Structured Financing Transactions**

### **1. Debt characterization**

Whether a financial instrument is treated for tax purposes as debt, equity, or some other characterization is determined on the basis of the pertinent facts and circumstances. If an instrument qualifies as equity, the issuer generally does not receive a deduction for dividends paid and the holder generally includes such dividends in income (although corporate holders generally may obtain a dividends-received deduction of at least 70 percent of the amount of the dividend). If an instrument qualifies as debt, the issuer generally receives a deduction for accrued interest and the holder generally includes such interest in income, subject to certain limitations.

Under present law, the Treasury Department has the statutory authority to issue regulations classifying an interest in a corporation as debt or equity.<sup>847</sup> In 1989, the Treasury Department's authority to issue such regulations was expanded to include classification of an interest as part equity and part indebtedness.<sup>848</sup> In 1992, Congress enacted additional rules to require, in certain circumstances, that an issuer's characterization of an interest be binding on the issuer and the holders.<sup>849</sup> Although the Treasury Department published proposed and final regulations pursuant to its authority, these regulations have been withdrawn and there are no currently applicable regulations.

### **2. Constructive sales**

For transactions entered into after June 8, 1997, taxpayers are required to recognize gain (but not loss) upon entering into a "constructive sale" of any appreciated position in stock, a partnership interest or certain debt instruments as if such position were sold, assigned or otherwise terminated at its fair market value on the date of the transaction.<sup>850</sup> If the requirements for a constructive sale are met, the taxpayer recognizes gain on a constructive sale as if the position were sold at its fair market value on the date of the transaction and immediately repurchased.<sup>851</sup>

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<sup>847</sup> Sec. 385, enacted in the Tax Reform Act of 1969, Pub. L. No. 91-172, sec. 415(a).

<sup>848</sup> Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, sec. 7208(a)(1).

<sup>849</sup> Sec. 385(c), enacted in the Energy Policy Act of 1992, Pub. L. No. 102-486, sec. 1936(a).

<sup>850</sup> Sec. 1259, enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1001(a). A "position" generally is defined as an interest, including a futures or forward contract, short sale, or option.

<sup>851</sup> Sec. 1259(a)(1).

In general, a taxpayer is treated as making a constructive sale of an appreciated position if and when the taxpayer (or, in certain circumstances, a person related to the taxpayer) does one of the following: (1) enters into a short sale of the same (or substantially identical) property; (2) enters into an offsetting notional principal contract with respect to the same (or substantially identical) property; or (3) enters into a futures or forward contract to deliver the same (or substantially identical) property.<sup>852</sup> In addition, in the case of an appreciated position that itself is a short sale, a notional principal contract, or a futures or forward contract, the holder is treated as making a constructive sale when it acquires the same (or substantially identical) property as the underlying property for the position.<sup>853</sup> Finally, to the extent provided in Treasury regulations, a taxpayer is treated as making a constructive sale when it enters into one or more other transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described.<sup>854</sup>

A forward contract results in a constructive sale of an appreciated position only if the forward contract provides for delivery, or for cash settlement, of a substantially fixed amount of property and a substantially fixed price.<sup>855</sup> Thus, a forward contract providing for delivery of property, such as shares of stock, the amount of which is subject to significant variation under the contract terms does not result in a constructive sale.<sup>856</sup>

### 3. Disqualified indebtedness

For most debt instruments issued after June 8, 1997, no deduction is allowed for interest or original issue discount (“OID”) on a debt instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that is payable in stock of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), including a debt instrument a substantial portion of which is mandatorily convertible or convertible at the issuer's option into stock of the issuer or a related party.<sup>857</sup> In addition, a debt instrument is treated as payable in stock if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of stock of the

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<sup>852</sup> Sec. 1259(c)(1).

<sup>853</sup> *Id.* See also Rev. Rul. 2002-44, 2002-28 I.R.B. 84.

<sup>854</sup> Sec. 1259(c)(1)(E). Future Treasury regulations are anticipated to treat as constructive sales other financial transactions that, like those specified in section 1259, have the effect of eliminating substantially all of the taxpayer's risk of loss and opportunity for income and gain with respect to the appreciated position. H.R. Rep. No. 105-148, at 442-43 (1997).

<sup>855</sup> See section 1256(d)(1).

<sup>856</sup> H.R. Rep. No. 105-148, at 442 (1997). This treatment of forward contracts is consistent with the anticipated treatment of so-called “collar” transactions under regulations to be issued by the Treasury Department.

<sup>857</sup> Sec. 163(l), enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1005(a).



issuer or related party.<sup>858</sup> A debt instrument also is treated as payable in stock if it is part of an arrangement that is reasonably expected to result in the payment of the debt instrument with or by reference to such stock. For example, a debt instrument may be treated as payable in stock of the issuer or a related party in the case of a forward contract to sell such stock that is entered into in connection with the issuance of the debt.<sup>859</sup>

#### 4. Straddles

A “straddle” generally refers to offsetting positions (sometimes referred to as “legs” of the straddle) with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property. A “position” is an interest (including a futures or forward contract or option) in personal property. When a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for any taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in the straddle.<sup>860</sup> Deferred losses are carried forward to the succeeding taxable year and are subject to the same limitation with respect to unrecognized gain in offsetting positions.

In addition to loss deferral, the straddle rules require taxpayers to capitalize certain otherwise deductible expenditures for personal property if such property is held as part or all of an offsetting position in a straddle.<sup>861</sup> This provision applies to certain specified carrying charges, as well as interest on indebtedness that is incurred or maintained in order to purchase or carry the personal property.<sup>862</sup> On January 18, 2001, the Treasury Department published proposed regulations that elaborate on the operation of the straddle capitalization rules.<sup>863</sup> In addition, the proposed regulations would “clarify” that the straddle rules can apply to a debt instrument that is an obligation of the taxpayer if the debt instrument provides for one or more payments that are linked to the value of personal property or a position with respect to personal property.

The straddle rules generally do not apply to positions in stock. However, the straddle rules apply if one of the positions is stock and at least one of the offsetting positions is: (1) an option with respect to the stock; (2) a securities futures contract (as defined in section 1234B) with respect to the stock; or (3) a position with respect to substantially similar or related property (other than stock) as defined in Treasury regulations. In addition, the straddle rules apply to

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<sup>858</sup> Sec. 163(l)(3)(B).

<sup>859</sup> Sec. 163(l)(3)(C).

<sup>860</sup> Sec. 1092.

<sup>861</sup> Sec. 263(g)(1).

<sup>862</sup> Sec. 263(g)(2).

<sup>863</sup> 66 Fed. Reg. 4746 (Jan. 18, 2001).

stock of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder.

## 5. Prepayment transactions

### Prepaid sales of goods

A taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless the item properly is accounted for in a different period under the taxpayer's method of accounting.<sup>864</sup> In general, a taxpayer may adopt an accounting method that is different than the accounting method of an entity that is affiliated with the taxpayer.<sup>865</sup>

Under an accrual method of accounting, a taxpayer generally is required to include an item in income when all the events have occurred that fix the right to receive such income and the amount of the income can be determined with reasonable accuracy.<sup>866</sup> In general, the IRS has long taken the position that the right to receive income becomes fixed at the earliest of when: (1) the required performance occurs; (2) payment for such performance becomes due; or (3) such payment is made.<sup>867</sup>

Treasury regulations permit taxpayers to defer the recognition of taxable income in certain circumstances if the taxpayer receives an advance payment for the sale of goods that are to be delivered in a later taxable year.<sup>868</sup> In general, such advance payments may be recognized by the taxpayer as taxable income either: (1) in the taxable year of receipt; or (2) the earlier of (a) the taxable year in which the payments would otherwise be included in taxable income under the taxpayer's method of accounting (provided such method results in the inclusion of advance payments in taxable income no later than the time such payments are included in income for financial reporting purposes), or (b) the taxable year in which the payments are included in income for financial reporting purposes (provided the taxpayer's method of accounting for advance payments results in income inclusion earlier for financial reporting purposes than for tax purposes).<sup>869</sup>

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<sup>864</sup> Treas. Reg. sec. 1.451-1(a).

<sup>865</sup> See section 446(d); Treas. Reg. sec. 1.446-1(d).

<sup>866</sup> *Id.*

<sup>867</sup> Rev. Rul. 74-607, 1974-2 C.B. 149.

<sup>868</sup> Treas. Reg. sec. 1.451-5. For this purpose, an "advance payment" is defined as any amount which is received in a taxable year by the taxpayer using an accrual method of accounting for purchases and sales pursuant to an agreement for the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. Treas. Reg. sec. 1.451-5(a).

<sup>869</sup> Treas. Reg. sec. 1.451-5(b)(1).

With regard to the deferral of advance payments relating to the sale of inventoriable goods, Treasury regulations generally provide that, if the taxpayer has on hand (or has available through the taxpayer's normal source of supply) inventory in sufficient quantity to satisfy the contract, then all advance payments that the taxpayer has received for such property by the last day of the second taxable year following the year in which such substantial advance payments are received and not previously included in income according to the taxpayer's accrual method of accounting, must be included in taxable income of the taxpayer in that second taxable year.<sup>870</sup>

### **Prepaid forward contracts**

The gain or loss on a forward contract typically cannot be determined until the settlement date of the contract (at which time the value of the cash payment or physical delivery of the underlying property is determined on the basis of the spot price of the underlying property).<sup>871</sup> Therefore, although there is a paucity of authority that addresses the basic tax consequences of forward contracts, it is generally understood that the common law tax treatment of a forward contract is governed by the "open transaction" doctrine, which provides that the recognition of gain or loss on a transaction is, in effect, "held open" until the transaction is closed and such gain or loss can be quantified.<sup>872</sup> Absent the application of the constructive sale rules described above, taxpayers generally take the view that the open transaction doctrine applies to forward contracts even if a prepayment is made.<sup>873</sup>

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<sup>870</sup> Treas. Reg. sec. 1.451-5(c)(1)(i).

<sup>871</sup> A forward contract is an executory contract that is privately negotiated directly between the parties (i.e., there is no market or exchange intermediation as with futures contracts), and generally provides for the delivery of a specified amount of commodities or other property at a specified price (i.e., the "forward price") and on a specified future date (i.e., the "settlement date"). Depending upon the terms agreed to by the parties, a forward contract may be settled by either physical delivery of the underlying property or by the payment of an amount of cash that is equal to the difference between the spot price (i.e., current price on the settlement date) of the underlying property and the forward price specified in the contract. A prepaid forward contract is a forward contract in which the forward price is payable (generally on a present valued basis) on a date earlier than the settlement date, typically the date that the contract is executed by the parties.

<sup>872</sup> See Warren, *Financial Contract Innovation and Income Tax Policy*, Harv. L. Rev. 460, 464 (1993).

<sup>873</sup> Cf. *Virginia Iron Coal & Coke Co.*, 37 B.T.A. 195 (1938), *aff'd.*, 99 F.2d 919 (4th Cir. 1938), *cert. denied*, 307 U.S. 630 (1939) (holding that option premiums are not earned and, thus, not taxable until the option lapses or is exercised because it is unknown at the time that the option premium is received whether the option premium will be taxed as ordinary income or capital gain).

## 6. Notional principal contracts

Pursuant to the statutory authority to prescribe methods of accounting that clearly reflect income,<sup>874</sup> Treasury regulations provide for the recognition of income and deductions with respect to payments that are made or received pursuant to a notional principal contract.<sup>875</sup> The term “notional principal contract” generally describes an agreement between two parties to exchange payments that are calculated by reference to a notional principal amount.<sup>876</sup> Notional principal contracts include interest rate swap agreements, commodity swap agreements, interest rate cap and floor agreements, currency swap agreements, and other similar contracts.<sup>877</sup>

In a typical interest rate swap agreement, one party agrees to make periodic payments based on a fixed rate while the counterparty agrees to make periodic payments based on a floating rate. Payments are calculated on the basis of an underlying hypothetical or “notional principal amount”, and payment amounts are typically netted when payments are due on common dates. A commodity swap is similar to an interest rate swap except that a commodity price index is used instead of an interest rate index, and the notional principal amount is measured in units of a specified commodity, rather than in dollars.

The notional principal amount is not actually exchanged by the parties. Therefore, the payments due under a typical notional principal contract do not constitute compensation for the use or forbearance of money and therefore are not characterized as “interest.” However, a lump-sum payment under one of these contracts may be economically identical to a loan and, thus, the party making the lump-sum payment receives a return, part of which is properly characterized as interest for tax purposes because it represents compensation for the use or forbearance of money.

The regulations define a notional principal contract as a financial instrument that provides for payments by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to

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<sup>874</sup> Sec. 446(b).

<sup>875</sup> Treas. Reg. sec. 1.446-3.

<sup>876</sup> See Treas. Reg. sec. 1.446-3(c)(1).

<sup>877</sup> These contracts are examples of a broader family of financial instruments known as “derivatives”, which generally are defined as contracts or securities the value of which is derived from the price of an asset, a pool of assets, or (increasingly) anything that can be valued. Derivatives represent contractual relationships between parties to share the economic benefits and burdens of owning an asset (or pool of assets) without necessarily owning the asset itself (hence the “notional” characteristic of such contracts). Because there is no comprehensive statutory regime for the taxation of derivatives, the tax consequences of derivative contracts are governed in a piecemeal fashion by specific rules that are scattered throughout the Code. See, e.g., secs. 1092 (straddles), 1234 (options), 1234A (payments to terminate certain derivatives), 1234B (securities futures contracts), 1256 (certain exchange-traded contracts), and 1259 (constructive sales). As applied to derivatives, these rules are incomplete and often inconsistent in specific situations.

pay similar amounts.<sup>878</sup> The term “specified index” is broadly defined to include almost any fixed rate or variable rate, price, index, or amount based on current, objectively determinable financial or economic information.<sup>879</sup> Thus, notional principal contracts governed by the regulations include interest rate swaps, basis swaps, interest rate caps and floors, commodity swaps, equity swaps, equity index swaps, and similar agreements. However, the regulations provide that certain contracts do not constitute notional principal contracts, including futures contracts, forward contracts, and options.<sup>880</sup>

The regulations generally provide that net income or deduction from a notional principal contract for a taxable year is included in or deducted from gross income for that taxable year. The net income or deduction from a notional principal contract for a taxable year equals the sum of all of the periodic payments that are recognized from that contract for the taxable year and all of the nonperiodic payments that are recognized from that contract for the taxable year.<sup>881</sup>

A periodic payment is defined as a payment that generally is payable at fixed periodic intervals of one year or less during the entire term of a notional principal contract. The ratable daily portions of periodic payments are included in income or deducted in the taxable year to which such portions relate.<sup>882</sup>

A nonperiodic payment is defined as any payment made or received pursuant to a notional principal contract that is not a periodic payment or a termination payment. Thus, a nonperiodic payment includes prepayments for all or one leg of a swap. The ratable daily portions of nonperiodic payments must be included in income or deducted in the taxable year to which such portions relate such that a nonperiodic payment is recognized over the life of the notional principal contract in a manner that reflects the economic substance of the payment. Thus, a nonperiodic payment for a swap generally must be recognized over the term of the contract by allocating it in accordance with the forward rates (or, in the case of a commodity, the forward prices) of a series of cash-settled forward contracts that reflect the specified index and the notional principal amount.<sup>883</sup>

A termination payment is defined as any payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under a notional principal contract. In general, a party to a notional principal contract must recognize a termination payment in the taxable year in which the contract is extinguished, assigned, or

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<sup>878</sup> Treas. Reg. sec. 1.446-3(c)(1)(i).

<sup>879</sup> Treas. Reg. sec. 1.446-3(c)(2).

<sup>880</sup> Treas. Reg. sec. 1.446-3(c)(1)(ii).

<sup>881</sup> Treas. Reg. sec. 1.446-3(d).

<sup>882</sup> Treas. Reg. sec. 1.446-3(e).

<sup>883</sup> Treas. Reg. sec. 1.446-3(f). The regulations provide alternative methods of recognizing nonperiodic payments that primarily affect the rate of amortization.

exchanged. The party also must recognize any other payments that have been made or received under the contract but have not yet been recognized.<sup>884</sup>

The regulations include a special rule with regard to swaps that provide for “significant” nonperiodic payments. Under this rule, a swap with significant nonperiodic payments is treated as two separate transactions, consisting of: (1) an at-the-market swap (i.e., no nonperiodic payments) with level payments; and (2) a loan. The parties to the contract must account for the deemed loan independently of the swap. The imputed interest component of the loan is accounted for as interest for all purposes of the Code.<sup>885</sup> The regulations do not define what amount of nonperiodic payments constitutes “significant”, but examples in the regulations indicate that a nonperiodic payment that is less than 10 percent of total payments under a swap is not significant, while a nonperiodic payment that is 40 percent or more of total payments is significant.<sup>886</sup>

## **7. Application of present law to Enron structured financing transactions**

Enron raised significant amounts of capital by issuing several different types of structured financial instruments that implicate a multitude of tax rules. Enron issued tiered preferred securities, the tax treatment of which primarily involved the application of the rules concerning debt characterization. Enron also issued investment unit securities, which involved debt characterization in general, as well as the constructive sale, disqualified indebtedness, and straddle rules. Enron entered into commodity prepay transactions, which involved debt characterization in general, as well as the tax treatment of prepayment transactions and notional principal contracts.

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<sup>884</sup> Treas. Reg. sec. 1.446-3(h).

<sup>885</sup> Treas. Reg. sec. 1.446-3(g)(4).

<sup>886</sup> Treas. Reg. sec. 1.446-3(g)(6), Examples 2 and 3.

## C. Tiered Preferred Securities

### 1. Brief overview

Between 1993 and 1997, Enron raised over \$800 million through the issuance of hybrid financial instruments that combined characteristics of both indebtedness and equity (“tiered preferred securities”). By synthesizing these characteristics into a single financial instrument, Enron was able to report the financing as indebtedness for Federal income tax purposes, while reporting the same financing as a minority ownership interest on its financial statements. Consequently, these transactions enabled Enron to deduct the yield on its financings as interest expense for tax purposes without increasing the amount of liabilities reported in financial statements. Although the individual transactions varied in their details, they shared several common elements, primarily the issuance of securities by a special purpose entity to public or private investors and the transfer of the proceeds from such issuance to Enron in the form of a loan.

### 2. Background

#### Reported tax and financial statement effects

With regard to its tiered preferred securities, Enron took the position for Federal income tax purposes that it had issued a debt instrument to the special purpose entity, which Enron treated as a separate entity that was not part of the Enron consolidated group. Accordingly, Enron claimed interest expense deductions of the yield payments on the purported debt instrument.

For financial reporting purposes, Enron disregarded the purported debt instrument because the special purpose entity was consolidated with Enron on its financial statements.<sup>887</sup> Instead, Enron reported the preferred securities as though Enron had issued the preferred securities directly to the outside investors (rather than through the special purpose entity). These securities received equity credit from rating agencies because the borrowing by Enron from the special purpose entity that supported the preferred securities exhibited certain equity characteristics, including a long-term maturity, deep subordination, and an option for Enron to defer the payment of interest for the first several months (or years) that the borrowing was outstanding. Thus, Enron denominated the preferred securities as mezzanine equity, rather than indebtedness, on its balance sheet.<sup>888</sup> Enron reported yield payments to the holders of the preferred securities as “Dividends on Preferred Stock of Subsidiary”.

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<sup>887</sup> As amended by Statement of Financial Accounting Standards No. 94, Accounting Research Bulletin No. 51, requires companies to consolidate majority owned subsidiaries unless control of the subsidiary is likely to be temporary, or the majority owner does not actually control the subsidiary. Because of the common ownership interest retained by the ultimate borrower, special purpose entities that issue tiered preferred securities generally satisfy the financial accounting requirements for consolidation with the borrower.

<sup>888</sup> Specifically, Enron’s financial statement balance sheets referred to the tiered preferred securities as “Preferred Stock of Subsidiary” in 1993 and 1994, and thereafter have

## Development of tiered preferred securities

In 1993, Goldman, Sachs & Co. began marketing a new financial instrument, dubbed monthly income preferred securities (“MIPS”), that was designed to be treated as a debt instrument (with deductible interest payments) for Federal income tax purposes, while simultaneously providing equity treatment for financial reporting and rating agency purposes.<sup>889</sup> Other investment banks subsequently marketed their own version of MIPS, such as trust originated preferred securities (“TOPrS”) introduced by Merrill Lynch.<sup>890</sup> Whereas the special purpose entity involved in MIPS is characterized as a partnership for Federal income tax purposes, the special purpose entity involved in TOPrS is characterized as a grantor trust.<sup>891</sup> Regardless of the particular classification of the special purpose entity, the common feature of these transactions in this respect is that the special purpose entity is not classified as a taxable corporation under the entity classification rules.

In general, these financial instruments involve the creation of a special purpose entity by the ultimate borrower.<sup>892</sup> The special purpose entity is treated as a separate entity from the

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referred to the securities as “Company-Obligated Preferred Securities of Subsidiaries”. This is consistent with the guidance provided in SEC Regulation S-X, Article 5, Rule 5-02.27.

<sup>889</sup> The issuance of debt instruments containing certain features that are characteristic of equity, such as subordination and deferred interest arrangements, allows borrowers to obtain capital with less impact on their credit rating than straight debt financing because such instruments receive “equity credit” from rating agencies. In addition, the Federal Reserve Board has stated that certain tiered preferred securities can qualify as Tier 1 equity capital for banks. *See* Federal Reserve Press Release, Oct. 21, 1996 (“To be eligible as Tier 1 capital, such instruments must provide for a minimum five-year consecutive deferral period on distributions to preferred shareholders. In addition, the intercompany loan must be subordinated to all subordinated debt and have the longest feasible maturity.”); *Capital Briefs--Rule on Cumulative Preferred Stock Eased*, American Banker, Oct. 22, 1996; Padgett, *Surge of New Issues Seen as Fed Approves Use of Hybrid Security*, American Banker, Oct. 24, 1996.

<sup>890</sup> Goldman Sachs also began marketing a variation on MIPS, called quarterly income preferred securities (“QUIPS”), which differ materially from MIPS only in that payments on QUIPS are made quarterly instead of monthly. *See, e.g.*, BFGoodrich Capital 83% Cumulative Quarterly Income Preferred Securities (June 30, 1995).

<sup>891</sup> By using a grantor trust rather than a tax partnership as the special purpose entity, TOPrS significantly reduce the SEC reporting burdens associated with the securities. *See* John C. Reid, *MIPS Besieged--Solutions in Search of a Problem*, 76 Tax Notes 1057, 1058 (Dec. 1, 1997).

<sup>892</sup> Special purpose entities involved in earlier transactions usually were formed offshore. However, with the enactment of limited liability company laws in several States and the issuance by the SEC of “no action” letters exempting the entities from registration under the Investment Company Act of 1940, special purpose entities involved in more recent transactions have been formed as domestic pass-through entities.



borrower for tax purposes, but is not itself subject to tax. For financial reporting purposes, the special purpose entity is disregarded as separate from the borrower because it is consolidated with the borrower. In general, the special purpose entity issues its voting securities (with a nominal value) to the borrower, and issues nonvoting preferred securities to investors. The special purpose entity then lends the proceeds from the preferred securities issuance (along with any cash contributed by the borrower) to the borrower in exchange for a long-term (typically, 30-year) debt instrument. Distributions on the preferred securities closely correspond to the interest payments on the debt instrument issued to the entity by the borrower. When the loan from the special purpose entity to the borrower ultimately matures, the special purpose entity redeems the MIPS for cash.

For tax purposes, the debt instrument issued to the special purpose entity by the ultimate borrower is respected because the entity is treated as separate from the borrower. Thus, the borrower claims interest deductions on the debt instrument. For financial reporting purposes, the debt instrument is disregarded because the special purpose entity is not treated as separate from the borrower. Instead, the borrower is considered to have issued preferred securities directly to the investors. As mentioned earlier, these securities receive equity credit from rating agencies because the debt instrument issued by the borrower that supports the securities is long term, deeply subordinated, and provides the borrower an option to defer the payment of interest for an extended period of time (typically, the first five years) during which the debt instrument is outstanding. Thus, the preferred securities tend to be denominated as mezzanine equity, rather than indebtedness, on the financial statements of the borrower.

### **Issuance of Enron tiered preferred securities**

As indicated, Enron raised over \$800 million through several issuances of tiered preferred securities, including MIPS, TOPrS, and adjustable-rate trust securities (“ACTS”).<sup>893</sup> In general, the ACTS were substantially similar to TOPrS, except that ACTS provided for a variable (rather than fixed) yield.

Table 2 on the next page summarizes the tiered preferred securities that Enron entered into between 1993 and 1997.

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<sup>893</sup> See, e.g., Minutes, Meeting of the Board of Directors, Enron Corp., December 10, 1996 at 5-6 (approving the 1996 Enron TOPrS issuance), EC 000045039 through EC 000045067; Minutes, Meeting of the Executive Committee of the Board of Directors, Enron Corp., December 18, 1996 (approving proposed resolution authorizing 1997 Enron TOPrS issuance), EC 000045073 through EC 000045079; Minutes, Meeting of the Executive Committee of the Board of Directors, Enron Corp., June 5, 1997 (approving proposed resolution authorizing 1997 ACTS issuance). EC 000045650 through EC 000045655. The structured financing materials in Appendix B contain these minutes.

**Table 2.—Enron Tiered Preferred Securities Issuances**

<b>Issuance</b>	<b>Year of issuance</b>	<b>Proceeds of issuance (millions of dollars)<sup>1</sup></b>	<b>Stated yield (percent)</b>	<b>Initial term to maturity<sup>2</sup> (years)</b>	<b>Extended term to maturity<sup>3</sup> (years)</b>	<b>Interest payment deferral period (months)</b>
MIPS	1993	\$200	8.00	50	50	18
MIPS <sup>4</sup>	1994	75	9.00	30	19	60
TOPrS	1996	200	8.30	20	n/a	18
TOPrS	1997	150	8.125	20	n/a	18
ACTS	1997	200	Variable <sup>5</sup>	49	n/a	60

**Notes:**

<sup>1</sup> Amount of proceeds is based upon the amount indicated in the prospectus of each issuance. Actual amount of proceeds from each issuance may differ somewhat from the amount indicated due to over-allotments.

<sup>2</sup> Based upon the loan from the special purpose entity (e.g., Enron Capital LLC) to Enron.

<sup>3</sup> Based upon the loan from the special purpose entity (e.g., Enron Capital LLC) to Enron, not including the initial term to maturity.

<sup>4</sup> This issuance was not formally an issuance of MIPS because the lead underwriter was Merrill Lynch & Co., not Goldman, Sachs & Co. However, this issuance was substantially similar to a MIPS issuance. Thus, this issuance is referred to as MIPS only for purposes of convenience.

<sup>5</sup> The ACTS issuance provided for yield payments at an initial rate of 5.813 percent through September 5, 1997, with subsequent quarterly resets of the yield based upon a Dutch auction process to obtain a yield reflective of current market conditions.

### 1993 Enron MIPS

On September 27, 1993, Enron convened a special meeting of its Board of Directors primarily for the purpose of hearing a management presentation concerning the issuance of perpetual preferred stock.<sup>894</sup> In its presentation, management stated that Enron would continue to require cash infusions because of its ongoing growth and expansion. However, management also indicated that maintaining Enron's credit quality was a high priority. Management then presented two options that had been proposed to Enron: (1) issuance of standard perpetual preferred stock underwritten by Merrill Lynch & Co.; and (2) issuance of tax deductible perpetual preferred stock underwritten by Goldman, Sachs & Co. According to management, Arthur Andersen & Co. had indicated to Enron that neither option would be treated as indebtedness for financial accounting purposes. In addition, the credit rating agencies had indicated that they would reach the same conclusion. Management also said that the law firm Sullivan & Cromwell had issued a letter confirming the tax deductibility of the option proposed by Goldman, Sachs & Co., but noting that future tax law changes could negate deductibility. Based upon the presentation by management, the Board adopted a resolution that authorized the registration, issuance and sale of up to \$250 million of either standard or tax deductible perpetual preferred stock, and authorized the appointment of a special preferred stock committee to determine the terms of the issuance.

On October 12, 1993, the Finance Committee of the Enron Board of Directors met to discuss further the issuance of perpetual preferred stock by Enron.<sup>895</sup> At this meeting, management indicated to the committee that the "determination of the question of whether or not the preferred stock offering would be tax deductible was key to management's decision to proceed."<sup>896</sup> The committee concluded its consideration of perpetual preferred stock by agreeing to recommend that the Board restate its previous resolution and authorize the registration, issuance and sale of: (1) up to \$575 million of perpetual preferred stock if the yield on the stock was determined to be tax deductible and the credit rating agencies would treat the stock as equity for debt rating purposes; or (2) up to \$350 million of perpetual preferred stock if the yield on the stock was not determined to be tax deductible.<sup>897</sup>

On October 13, 1993, the Enron Board of Directors heard the recommendation of the Finance Committee and approved a resolution authorizing a shelf registration of fixed rate

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<sup>894</sup> Minutes, Special Meeting of the Board of Directors, Enron Corp., September 27, 1993 at 1. EC2 000055435 through EC2 000055450. The structured financing materials in Appendix B contain these minutes.

<sup>895</sup> Minutes, Meeting of the Finance Committee of the Board of Directors, Enron Corp., October 12, 1993. EC2 000055452 through EC2 000055456. The structured financing materials in Appendix B contain these minutes.

<sup>896</sup> *Id.* at 2.

<sup>897</sup> *Id.*

perpetual preferred stock in the amount of either \$575 million (if tax deductible and rated as equity) or \$350 million (if not tax deductible).<sup>898</sup>

Pursuant to the resolution, Enron formed Enron Capital LLC under the law of Turks and Caicos Islands for the sole purpose of issuing shares and lending the net proceeds to Enron.<sup>899</sup> Enron acquired the common shares of Enron Capital LLC for approximately \$53.165 million.<sup>900</sup>

In November 1993, Enron Capital LLC authorized the issuance of \$9.2 million shares of cumulative guaranteed MIPS with a cumulative preferred dividend rate of 8 percent (“1993 MIPS”).<sup>901</sup> The MIPS became redeemable (at the option of Enron Capital LLC) on or after November 30, 1998, at a redemption price of \$25.00 per share plus accumulated and unpaid dividends. Following the issuance of the shares and as part of the prearranged transaction, Enron Capital LLC loaned to Enron both the \$53.165 million proceeds from the issuance of its common shares to Enron, and the \$200 million proceeds from the sale of the MIPS, for an aggregate principal amount of \$253.165 million.<sup>902</sup> The loan from Enron Capital LLC to Enron provided a stated interest rate of 8 percent until maturity, payable on the last day of each calendar month of each year beginning on November 30, 1993.<sup>903</sup>

Under the terms of the loan from Enron Capital LLC to Enron, Enron was permitted to defer payment of the monthly interest up to 18 months (provided Enron was not in default on the loan), during which time Enron would not be permitted to declare dividends on any of its capital stock. During any such period of interest payment deferment, Enron Capital LLC would continue to accrue the interest income being deferred, and the deferred interest income would be allocated (but not distributed) to the holders of the MIPS.<sup>904</sup>

The loan provided a maturity date of November 30, 2043 for repayment of the entire principal amount, together with any accrued and unpaid interest, or on any earlier date if Enron

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<sup>898</sup> Minutes, Meeting of the Board of Directors, Enron Corp., October 13, 1993. The structured financing materials in Appendix B contain these minutes.

<sup>899</sup> Prospectus Supplement, Enron Capital LLC 8% Cumulative Guaranteed Monthly Income Preferred Shares (Nov. 4, 1993) at S-6 [hereinafter “1993 Prospectus”].

<sup>900</sup> 1993 Prospectus at S-14.

<sup>901</sup> Terms of the 8% Cumulative Guaranteed Monthly Income Preferred Shares of Enron Capital LLC (Nov. 4, 1993) at 1. Of the total authorized MIPS, Enron Capital LLC issued 8,000,000 shares at \$25.00 per share, for a total of \$200 million. The remaining unissued 1,200,000 shares of MIPS were reserved for the underwriters’ over-allotment option. 1993 Prospectus at S-6.

<sup>902</sup> 1993 Prospectus at S-14.

<sup>903</sup> 1993 Prospectus at S-15.

<sup>904</sup> 1993 Prospectus at S-20.

or Enron Capital LLC was dissolved, wound up or liquidated. The loan could not be prepaid prior to November 30, 1998. Upon repayment by Enron, the loan provided that the repaid principal could be reloaned to Enron under certain conditions, with a final maturity date of the new loan not later than the 100th anniversary of the issuance of the MIPS.<sup>905</sup> The loan was subordinate to all present and future senior indebtedness of Enron.

Enron guaranteed the payment of dividends by Enron Capital LLC to the holders of the MIPS. However, the guarantee agreement constituted an unsecured obligation of Enron and ranked: (1) subordinate and junior in right of payment to all liabilities of Enron; (2) *pari passu* with the most senior preferred or preference stock of Enron; and (3) senior to Enron's common stock. In the event of the bankruptcy of Enron (among other events), Enron Capital LLC automatically would dissolve and be liquidated.<sup>906</sup> In the event of the bankruptcy of Enron (among other events), the holders of a majority in liquidation preference of the outstanding MIPS were entitled to appoint and authorize a trustee to enforce the creditor rights of Enron Capital LLC against Enron, and to declare and pay dividends on the MIPS.<sup>907</sup>

Enron evidently used the loan proceeds to repay other indebtedness, and for general corporate purposes.<sup>908</sup> In its filings with the SEC, Enron stated that "the average cost of long-term debt declined to 8.2 percent at December 31, 1993 from 8.9 percent at December 31, 1992. The decline was accomplished primarily through the retirement of additional higher coupon long-term debt which was subject to call provisions during [1993]."<sup>909</sup>

### **Role of outside advisers**

In the case of the 1993 MIPS, Goldman, Sachs & Co. was the lead underwriter, while Merrill Lynch & Co. was the lead underwriter for the 1994 Enron tiered preferred securities and the 1996 and 1997 TOPrS. The lead underwriter for the 1997 ACTS was Deutsche Morgan Grenfell.

For each transaction except the ACTS transaction, Vinson & Elkins LLP provided a tax opinion letter that analyzed the tax implications of the transaction. For the ACTS transaction, Skadden, Arps, Meagher & Flom LLP provided a tax opinion letter that analyzed the tax implications of the transaction.

With regard to the 1993 MIPS, Vinson & Elkins LLP concluded that:

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<sup>905</sup> 1993 Prospectus at S-7. The repaid principal may not be reloaned to Enron if (among other things) Enron is in bankruptcy.

<sup>906</sup> 1993 Prospectus at S-8.

<sup>907</sup> 1993 Prospectus at S-8 to S-9.

<sup>908</sup> 1993 Prospectus at S-5.

<sup>909</sup> 1993 Enron Form 10-K at 32.

- (1) the proceeds received by Enron from Enron Capital LLC “should” be classified as loans for Federal income tax purposes;
- (2) Enron Capital LLC “would” be treated as a partnership rather than a corporation or taxable mortgage pool for Federal income tax purposes; and
- (3) interest paid by Enron on the proceeds received from Enron Capital LLC “would” qualify as portfolio interest within the meaning of section 1441(c)(9) and, thus, Enron “would” not be required to deduct and withhold tax with respect to such interest.<sup>910</sup>

Vinson & Elkins LLP subsequently issued a second tax opinion letter concerning the 1993 MIPS, in which the law firm concluded that:

- (1) Enron “would” be liable for any tax that should have been withheld to the extent such tax is not paid by the holders of the Enron Capital LLC preferred shares;
- (2) because of the “reasonable cause” exception, Enron “should not” be liable for penalties or additions to tax by reason of any failure to withhold in respect of a payment (of interest) on the proceeds received by Enron from Enron Capital LLC; and
- (3) Enron “would” be liable for interest on any tax that should have been withheld during any calendar year, but that such interest “should not” start to accrue until March 15 of the following year and “should” cease to accrue upon payment of the tax against which such withholding tax may be credited by the holders of the preferred shares issued to investors by Enron Capital LLC (which may be as early as April 15 of such following year).<sup>911</sup>

Arthur Andersen provided an accounting opinion letter that analyzed the financial accounting implications of a hypothetical MIPS transaction and concluded that: (1) the special purpose entity issuing the securities (i.e., the MIPS) should be consolidated with the company that formed the entity; and (2) the securities should be reflected in the company’s financial statements as minority interests.<sup>912</sup>

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<sup>910</sup> Vinson & Elkins LLP tax opinion letter to Enron, dated November 4, 1993. EC2 000036276 through EC2 000036289. The structured financing materials in Appendix B contain this opinion letter.

<sup>911</sup> Vinson & Elkins LLP tax opinion letter to Robert J. Hermann, Vice President - Tax, Enron, dated December 17, 1993. EC2 000036290 through EC2 000036302. The structured financing materials in Appendix B contain this opinion letter.

<sup>912</sup> Arthur Andersen opinion letter to Goldman Sachs & Co., dated September 13, 1993. With regard to the accounting treatment of the outside investors as minority interests, the opinion letter states that “[w]hile some may argue that where [sic] a subsidiary’s only role is to loan funds to others in the consolidated group and the non affiliated stockholders of the subsidiary can

Table 3 summarizes that amounts of fees and expenses that Enron paid in connection with the tiered preferred share issuances:<sup>913</sup>

**Table 3.—Enron Tiered Preferred Securities Issuance Fees and Expenses**

<b>Issuance</b>	<b>Year of issuance</b>	<b>Lead underwriter</b>	<b>Lead underwriter fees</b>	<b>Other estimated expenses</b>
MIPS	1993	Goldman, Sachs & Co.	\$14,390,000	\$300,000
MIPS	1994	Merrill Lynch & Co.	\$11,800,000	\$400,000
TOPrS	1996	Merrill Lynch & Co.	\$37,500,000	\$400,000
TOPrS	1997	Merrill Lynch & Co.	\$22,000,000	\$400,000
ACTS	1997	Deutsche Morgan Grenfell	Not available	\$200,000

**IRS review of Enron tiered preferred shares**

Based upon its audit of Enron’s tax returns for the 1993 and 1994 tax years, the IRS issued a statutory notice of deficiency, dated March 4, 1998, in which the IRS determined that Enron improperly deducted interest expense relating to the 1993 MIPS and the 1994 MIPS.<sup>914</sup> In response, Enron filed a petition with the Tax Court on April 1, 1998 contesting the deficiency.<sup>915</sup> Enron also requested consideration of the deficiency determination by the Appeals Division of the IRS, and the IRS assigned the case to the Appeals Division on June 17, 1998.

On May 6, 1998, IRS District Counsel (Midstates Region) sent a memorandum to the IRS National Office requesting technical assistance concerning the proper tax treatment of the 1993 MIPS and 1994 MIPS transactions. On August 12, 1998, the IRS National Office responded with a field service advice memorandum in which the National Office addressed three issues: (1) whether the MIPS securities constituted equity, rather than debt, for tax purposes; (2) whether

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gain control of [the company’s] Board in the event of default on the loan [from the special purpose entity to the company], the non affiliate stockholders of the subsidiary should be treated as creditors in the consolidated financial statements of the [company], this is not practice.” The structured financing materials in Appendix B contain this opinion letter.

<sup>913</sup> This information is based upon a review of the prospectus for each issuance and information provided to the Joint Committee staff by Enron. Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003.

<sup>914</sup> The assessment disallowed interest expenses claimed by Enron in the amounts of: (1) \$2,137,497 in 1993 with respect to the 1993 MIPS; (2) \$21,645,569 in 1994 with respect to the 1993 MIPS; and (3) \$3,512,658 in 1994 with respect to the 1994 MIPS.

<sup>915</sup> *Enron Corp. v. Commissioner*, Docket No. 6149-98. The petition also contested several other deficiencies asserted by the IRS for the 1992-1994 audit cycle, all of which were settled shortly after the filing of the petition.

the MIPS transactions overall lacked economic substance; and (3) whether the special purpose entities issuing the MIPS securities should be treated as taxable corporations, rather than partnerships, for tax purposes.<sup>916</sup>

With regard to whether the MIPS constituted debt or equity, the IRS National Office analyzed the issue by applying the debt-equity characterization factors listed in Notice 94-47<sup>917</sup> to the securities, and concluded that “we do not recommend recharacterizing the debt as equity.” The National Office acknowledged that its analysis focused on the proper characterization of the loans from the special purpose entities to Enron, rather than the proper characterization of the MIPS securities themselves as debt or equity. However, the National Office stated that, even if the special purpose entities were not respected as partnerships for tax purposes, “the conclusions would not be different, and the [MIPS] instruments would still be properly characterized as debt.”

In determining whether the MIPS transactions overall lacked economic substance, the IRS National Office noted that the transactions decreased the average cost of Enron’s long-term debt and decreased Enron’s debt-to-equity ratio from 1.2:1 to 1:1. Consequently, the National Office concluded that, “[i]n the balance, it appears from the available information that [Enron] entered into the transactions to obtain loans at lower interest rates and at lower costs generally and, therefore the underlying transactions possess economic substance. Thus, the interest deduction should not be disallowed.”

With regard to whether the special purpose entities should be treated as taxable corporations, rather than partnerships, for tax purposes, the IRS National Office determined that the entities appeared to have a “reasonable basis” for their classification as partnerships under the entity classification regulations that were in place at the time of the transactions.<sup>918</sup> Therefore, IRS National Office concluded that the partnership treatment of the entities should be respected.

After receiving and reviewing the field service advice memorandum, the Appeals officer assigned to the case drafted an Appeals Transmittal and Case Memorandum. In the memorandum, the Appeals officer voiced strong disagreement with the analysis and conclusions set forth in the field service advice memorandum. Specifically, the Appeals officer indicated his view that the field service advice memorandum should have analyzed the proper characterization of the MIPS securities as debt or equity. In addition, the Appeals officer argued that the field service advice memorandum “addressed what Enron’s business purpose (a partner) was for the MIPS transaction but fail[ed] to provide a business purpose for the partnership itself.”

Contrary to the conclusion reached in the field service advice memorandum, the Appeals officer argued strenuously that the special purpose entities should not be respected as

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<sup>916</sup> The structured financing materials in Appendix B contain the field service advice that the IRS National Office provided to the IRS District Counsel in connection with the 1993 MIPS and 1994 MIPS issued by Enron.

<sup>917</sup> 1994-1 C.B. 357.

<sup>918</sup> See Treas. Reg. sec. 301.7701(f)(2).



partnerships on economic substance grounds, and that disregarding these entities as partnerships and treating the MIPS as having been issued directly by Enron would require the MIPS to be characterized as equity, rather than debt, for tax purposes. Finally, the Appeals officer raised a non-tax public policy concern that, in a more general context, would become central to Enron's bankruptcy a few years later:

Here the taxpayer is admitting that they [sic] are skirting well regulated areas by designing a transaction to avoid the standard investor/creditors warning signals: Too much debt and dilution of their ownership rights.

The taxpayer has designed a transaction that avoids both indicators by becoming debt that comes from equity. That is, this is in the bottom of the debt tier, but it takes its payment source from the top of the dividend class of securities. A bottom feeder if you will. Thus, there appears to be a public policy issue as to whether or not IRS should allow a deduction on a payment that is designed to frustrate some clear combination of GAAP, SEC regulations and regulators, and the regulated debt which is relied on by creditors in indicating too much debt.

Notwithstanding the conclusions reached by the National Office in the field service advice memorandum, the Appeals officer recommended litigating the validity of the interest deductions claimed by Enron in 1993 and 1994 with regard to the MIPS transactions.

On October 20, 1998, representatives from Enron and IRS Appeals met in a conference to discuss the MIPS issue. Notes of the conference taken by the Appeals officer indicate that Enron acknowledged "the MIPS were finely crafted to walk that fine line that does exist between debt and equity," but also argued that the mezzanine treatment of MIPS for financial reporting purposes allowed Enron to raise capital for expansion without eroding its credit rating (because the MIPS were not reported as indebtedness) or earnings per share (because the MIPS were not reported as shareholder equity). Thus, according to Enron, issuing the MIPS served a business purpose that was independent of tax considerations. In a revised version of his Appeals case memorandum, the Appeals officer responded to this point as follows:

Should the IRS condone this treatment of debt to "fool" both GAAP and SEC reporting where both consider the MIPS as having substantial equity features?

Look at it this way: No debt treatment fools creditors, [n]o equity treatment fools the market investors, the extendibility of the LLC and notes in the years at issue allow gradual conversion to actual equity (it seems to me), the continued drain on cash flow without disclosure to the public seems to set up, in [m]acroeconomic terms, a lot of corporations with debt/equity not displayed on they're [sic] books.

If things turn south and payments are suspended:

- (1) A lot of investors will be unhappy
- (2) A lot of corporations may be required to make mandatory payments after 18 or so months (in the depths of a recession) which will endanger shareholders rights and

- (3) If enough corporations are required to do this it could materially affect the nation[']s economy by reducing corporate capital available for operations.

This entire matter seems to be “leveraging” just like buying stocks on margin or leveraging your way to success... . [I]t works great in good times but in economic recessions it leads to bankruptcy. Potential non-tax shareholder derivative questions present in both years...should be considered in a public policy review by counsel. This is beyond IRS jurisdiction but important public policy implications may be present if the MIPS structure violates the [Enron] Board’s duty to its shareholders to maximize shareholder value.

Nevertheless, Enron and the IRS subsequently reached a settlement of the issues concerning the 1993 and 1994 MIPS. In the settlement, the IRS conceded the deductibility of the stated interest payments made by Enron. Specifically, the IRS conceded that: (1) the loan from the special purpose entity to Enron in each transaction constituted indebtedness of Enron for Federal income tax purposes; (2) Enron was entitled to deduct stated interest accrued on such indebtedness; and (3) the special purpose entity was a valid entity that was separate and distinct from Enron for Federal income tax purposes.<sup>919</sup>

Because the settlement of the case (including settlement of the other asserted deficiencies) would result in refunds of overpaid taxes to Enron in excess of \$1 million, the IRS referred the settlement to the Joint Committee on Taxation on July 26, 1999 for review as required under the Code.<sup>920</sup> On September 28, 1999, the Joint Committee staff reviewed the settlement and did not raise an objection to it.

The Tax Court approved the settlement on October 1, 1999.<sup>921</sup>

#### Subsequent developments

Although the offering materials for the tiered preferred securities issued by Enron provided for the dissolution and liquidation of the special purpose entity in the event of the bankruptcy of Enron, the tiered preferred securities remain outstanding except for the securities issued as part of the ACTS transaction.<sup>922</sup> However, the outstanding tiered preferred securities

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<sup>919</sup> First Supplemental Stipulation of Settled Issues, *Enron Corp. v. Commissioner*, Docket No. 6149-98, filed Dec. 24, 1998. See also Counsel Settlement Memorandum, MIPS Issues, In re: Enron Corporation & Consolidated Subsidiaries, Docket Number 6149-98, approved July 26, 1999. The structured financing materials in Appendix B contain the counsel settlement memorandum.

<sup>920</sup> Sec. 6405, as in effect at the time of the settlement.

<sup>921</sup> Decision, *Enron Corp. v. Commissioner*, Docket No. 6149-98, entered Oct. 1, 1999.

<sup>922</sup> Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003. EC2 000055434.

currently trade over the counter for under \$1 per share, down significantly from their \$25 initial offering price and liquidation preference per share.

### **3. Discussion**

#### **In general**

Under present law, taxpayers have significant flexibility in structuring a financial instrument as debt or equity. Frequently, taxpayers may characterize instruments with very similar economic terms selectively either as equity (for example, if the issuer intends to market them to corporate holders that would benefit from a dividends received deduction) or as debt (if the issuer intends to claim a corporate interest deduction or achieve certain other benefits of debt status).

In general, the characterization of a financial instrument as debt can be based on a number of factors, including the presence (or absence) of an enforceable and unconditional promise to pay a specified amount on a specified date,<sup>923</sup> and the length of the term to maturity of an instrument.<sup>924</sup>

#### **Tiered preferred securities**

Tiered preferred share transactions such as MIPS and TOPrS have their genesis in the fundamental principle that leverage generally is favored for tax purposes (because of the deductibility of interest and the non-deductibility of dividends) but disfavored for financial accounting purposes (because reported debt tends to depress marginal share price and credit ratings relative to outstanding equity). Thus, companies generally prefer to obtain equity financing for financial accounting purposes, but prefer to obtain debt financing for tax purposes. Because the financial accounting rules for characterizing financing as either debt or equity do not correspond with the tax rules for determining such characterization, companies have taken advantage of opportunities to arbitrage the financial accounting and tax rules in order to achieve

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<sup>923</sup> See, e.g., *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972); *United States v. Title Guarantee & Trust Co.*, 133 F.2d 990 (6th Cir. 1943).

<sup>924</sup> See, e.g., *Reef Corp. v. Commissioner*, 24 T.C.M. 379 (1965), *aff'd*, 368 F.2d 125 (5th Cir. 1966); *United States v. Snyder Bros. Co.*, 367 F.2d 980 (5th Cir. 1966). Other factors may include (but are not limited to) a fixed maturity or mandatory redemption date, priority over general creditors of the issuer, rights to participate in the management of the issuer (including voting rights), the level of capitalization of the issuer, and the intent of the parties (although this last “factor” arguably is actually the fundamental question that the other factors attempt to answer as to the characterization of a financial instrument). However, the IRS has indicated that the right to receive a sum certain at maturity “is a *sine qua non* of debt treatment under the Code.” Field Service Advice 199940007 (June 15, 1999). See also *Gilbert v. Commissioner*, 248 F.2d 399 (2nd Cir. 1957); *Johnson v. Commissioner*, 108 F.2d 104 (8th Cir. 1939). Section 385(b) provides a non-exclusive list of several traditional factors that Treasury regulations might take into account in determining the classification of an interest in a corporation.

an ideal objective--financing that can be reported on financial statements as equity and on tax returns as indebtedness. Tiered preferred shares are the financial instruments with which many companies have accomplished this result.<sup>925</sup>

Absent more definitive guidance concerning the characterization of the tiered preferred securities themselves, it generally has been believed that certain conditions must be satisfied in order for the tax benefits of tiered preferred share transactions to be realized by the ultimate borrower. Specifically, the special purpose entity that is used in such transactions must be respected for tax purposes as an entity separate from the borrower, and the debt instrument issued by the borrower to the entity in exchange for the proceeds from the issuance of preferred securities by the entity must be respected as indebtedness for tax purposes.

Because the special purpose entity issues two separate classes of securities to two different parties (i.e., the voting securities issued to the borrower and the nonvoting preferred securities to the investors), borrowers take the position that the entity cannot be disregarded as separate from the borrower for tax purposes. With regard to whether the debt instrument issued by the borrower to the special purpose entity should be respected as indebtedness for tax purposes, borrowers take the position that the debt characteristics (in particular, the repayment of a sum certain on a fixed maturity date) of the instrument outweighs its equity characteristics (i.e., long term to maturity, subordination, and the option to defer interest payments) and, thus, it should properly be characterized as indebtedness for tax purposes.

In response to the growth of hybrid financial instruments “that combine long maturities (greater than 50 years) with substantial equity characteristics” (including MIPS and other similar securities), the IRS issued Notice 94-47.<sup>926</sup> In the notice, the IRS listed eight factors to be taken into account in determining whether a security constitutes debt or equity for tax purposes:

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<sup>925</sup> The tax benefits of tiered preferred securities can permit companies to offer securities with a higher yield to investors than they might otherwise offer for comparable conventional preferred securities with non-deductible dividend yield payments. For example, General Motors Corporation (“GM”) announced a tender offer in June 1997 to exchange certain classes of its outstanding preferred stock for a new issue of TOPrS. In exchange for an outstanding class of preferred stock that yielded a 7.92 percent dividend, GM issued a class of TOPrS that yielded 8.67 percent to tendering shareholders. In exchange for an outstanding class of preferred stock that yielded a 9.12 percent dividend, GM issued a class of TOPrS that yielded 9.87 percent to tendering shareholders. *See* General Motors Amendment No. 4 to Form S-4, filed June 2, 1997. Although the 75 basis point increase in the yield paid to the tendering shareholders of each class of preferred stock reportedly cost GM an additional \$2.7 million per year before taxes, the deductibility of the TOPrS yield payments (as opposed to the nondeductible dividends paid on the tendered preferred stock) reportedly provided GM a tax savings of approximately \$9 million per year. Interestingly, the rating agencies gave the GM TOPrS the same equity credit rating as they had given to the preferred stock that TOPrS replaced. *See* Lee A. Sheppard, *GM’s Tax-Deductible Preferred Exchange Offer*, 75 Tax Notes 1458 (June 16, 1997).

<sup>926</sup> 1994-1 C.B. 357.

- (1) whether there is an unconditional promise to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;
- (2) whether holders of the securities possess the right to enforce the payment of principal and interest;
- (3) whether the rights of the holders of the securities are subordinate to the rights of general creditors of the issuer;
- (4) whether the securities give the holder the right to participate in the management of the issuer of the securities;
- (5) whether the issuer of the securities is thinly capitalized;
- (6) whether there is identity between holders of the securities and stockholders of the issuer;
- (7) the labels placed on the securities by the parties; and
- (8) whether the securities are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial purposes.

In the notice, the IRS warned that it “will scrutinize [instruments that combine both debt and equity characteristics] to determine if their purported status as debt for federal income tax purposes is appropriate.” However, the notice did not specifically mention MIPS.

Notice 94-47 did not appear to have any discernible impact on the appetite of taxpayers to obtain financing through the issuance of MIPS. In response, the Treasury Department in 1996 proposed an amendment to section 385(c) that would have required an issuer to treat an instrument as equity if the instrument: (1) has a maximum term of more than 20 years; and (2) is not shown as indebtedness on the separate balance sheet of the issuer. In the case of an instrument with a maximum term of more than 20 years issued to a related party (other than a corporation) that is eliminated in a consolidated balance sheet that includes the issuer and the holder, the proposal would have treated the issuer as having characterized the instrument as equity if the holder or some other related party issues a related instrument that is not shown as indebtedness on the consolidated balance sheet. For this purpose, an instrument would not have been treated as shown as indebtedness on a balance sheet merely because it is described as such in financial statement footnotes or other such narrative disclosures. The proposal would have applied only to corporations that file annual financial statements (or are included in financial statements filed) with the SEC.<sup>927</sup> The proposal generally was interpreted as an effort by the Treasury Department to combat tiered preferred securities such as MIPS and TOPrS.

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<sup>927</sup> See Department of the Treasury, *General Explanations of the Administration's Revenue Proposals*, March 1996; Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1997: Analytical Perspectives*, H. Doc. 104-162/Vol. 3, at 35-48; Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 1997 Budget Proposal (Released March 19, 1996)* (JCS-2-96), March 27, 1996 at 65.

In 1997, the Treasury Department again proposed amending section 385(c) to foreclose debt characterization of tiered preferred securities.<sup>928</sup> The 1997 proposal was the same as the 1996 proposal, except that the 20 year term that would have triggered the application of the 1996 proposal was reduced to 15 years in the 1997 proposal. Proponents of this proposal took the view that corporations should not be permitted to characterize a financial instrument as indebtedness for tax purposes but not for financial reporting purposes. Furthermore, the extent to which tiered preferred securities such as MIPS and TOPrS have displaced preferred stock may suggest that the securities are viewed in the marketplace as having features closely similar to those of preferred stock.<sup>929</sup> However, others point out that financial statement characterization has not traditionally governed the characterization of items for tax purposes because the goals of generally accepted accounting principles and income tax rules are often different.<sup>930</sup> Indeed, many believe that the purported characterization of tiered preferred securities as indebtedness by the tax rules--not the characterization of such securities for financial statement purposes as equity--is the correct characterization.<sup>931</sup>

Congress did not enact either version of the Treasury proposal and, in fact, the IRS later issued a 1998 technical advice memorandum concluding that a taxpayer that issued tiered preferred securities (apparently, a MIPS transaction) was entitled to the interest deductions claimed in connection with the securities.<sup>932</sup> Specifically, the IRS applied the factors initially set forth in Notice 94-47 and ruled that: (1) loans made to the taxpayer by a foreign limited liability company ("LLC") that it formed constituted debt (rather than equity) for tax purposes; and (2) in any case, the preferred securities issued by the LLC to fund the loans constituted debt, even if the

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<sup>928</sup> See Department of the Treasury, *General Explanations of the Administration's Revenue Proposals*, February 1997; Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1998: Analytical Perspectives*, at 45-60.

<sup>929</sup> Joint Committee on Taxation, *Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal* (JCS-10-97), April 16, 1997 at 7.

<sup>930</sup> *Id.*

<sup>931</sup> See, e.g., John C. Reid, *MIPS Besieged--Solutions in Search of a Problem*, 76 Tax Notes 1057, 1068 (Dec. 1, 1997) ("In an all-or-nothing world of the tax law, where an instrument must be debt or equity, MIPS must come down on the debt side of the scale. If an error has been committed in analyzing MIPS, it was committed by the rating agencies, not the tax lawyers."); Victor Fleischer, *Enron's Dirty Tax Secret: Waiting For the Other Shoe to Drop*, 94 Tax Notes 1045, 1046 (Feb. 25, 2002) ("It's never easy to draw a coherent line between debt and equity, but most people agree that the IRS was right to concede, and that MIPS should be treated as debt."). However, Mr. Fleischer also observes that, during the bankruptcy of Enron, the Enron MIPS have been trading significantly lower than Enron traditional debt. Consequently, "now that Enron is in trouble, the deep subordination of MIPS means that the market is treating MIPS more like common stock than debt." *Id.*

<sup>932</sup> Priv. Ltr. Rul. 199910046 (Nov. 16, 1998).

transaction was recast or the separate existence of the LLC was disregarded for tax purposes such that the preferred securities were treated as having been issued directly by the corporation.

The IRS also concluded that the LLC's issuance of the preferred securities and the subsequent loans to the corporation had economic substance because the transaction served non-tax business purposes, including: (1) the provision of funds for working capital and general corporate purposes, including the repayment of outstanding indebtedness; (2) a reduction in the corporation's overall cost of capital; and (3) a reduction in the corporation's debt/equity ratio. In spite of the statutory requirement that partnerships must be formed for the purpose of sharing business profits,<sup>933</sup> the tax transparency of the LLC (which the taxpayer treated as a partnership for tax purposes) apparently did not particularly concern the IRS, which stated:

The fact that LLC earns no profit on the issuance of the Preferred Securities and the subsequent loans made to Corporation A does not imply the transactions lack economic substance. Although LLC is a "tax-transparent" investment vehicle that acts to pass through the interest earned on the loans to the Preferred Securities holders, the underlying transactions have economic substance.

The remarkable evolution in the reaction of the IRS and the Treasury Department to tiered preferred securities such as MIPS and TOPrS highlights the longstanding and pervasive tax policy dilemma of distinguishing between debt and equity--a problem that one Supreme Court justice presciently identified almost sixty years ago:

Tax liability should depend upon the subtle refinement of corporate finance no more than it does upon the niceties of conveyancing. Sheer technicalities should have no more weight to control federal tax consequences in one instance than in the other. The taxing statute draws the line broadly between "interest" and "dividend". This requires one who would claim the interest deduction to bring himself clearly within the class for which it was intended. That is not done when the usual signposts between bonds and stock are so obliterated that they become invisible or point equally in both directions at the same time.

Dividend" and "interest," "stock" and "bond," "debenture" or "note," are correlative and clearly identifiable conceptions in their simple and more traditional exemplifications. But their distinguishing features vanish when astute manipulations of the broad permissions of modern incorporation acts results in a "security device" which is in truth neither stock nor bond, but the half-breed offspring of both. At times only the label enables one to ascertain what the manipulator intended to bring forth. But intention clarified by label alone is not always legally effective for the purpose in mind. And there is scarcely any limit to the extent or variety to which this kind of intermingling of the traditional features of stock and bonds or other forms of debt may go, as the books abundantly testify. The taxpayer should show more than a label or a hybrid

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<sup>933</sup> Sec. 761(a).

security to escape his liability. He should show at the least a substantial preponderance of facts pointing to “interest” rather than “dividends.”<sup>934</sup>

The either/or approach taken by the present-law tax rules (i.e., a financial instrument generally must be characterized in its entirety as either equity or indebtedness) is a principal contributor to the difficulties that have long plagued the tax rules concerning the characterization of financial instruments.<sup>935</sup> This rigidity in the tax rules stands in contrast to the analysis of financial instruments undertaken by credit rating agencies, which employs a more flexible scaled approach that can accommodate and give recognition to the presence of both equity and debt characteristics in the same instrument.<sup>936</sup>

With regard to companies that choose to finance their activities with tiered preferred securities rather than traditional indebtedness (or, as in Enron’s case, replace existing indebtedness with newly issued tiered preferred securities), it may be argued that such securities do not raise tax policy issues surrounding the distinction between debt and equity,<sup>937</sup> at least to the extent that questions of corporate governance do not fall within the purview of tax policy. On the other hand, it may be the case that companies more commonly have used tiered preferred securities to largely supplant preferred stock (rather than debt) financing, which more directly implicates tax policy concerns to the extent that the tax rules influence the behavior of corporate taxpayers and the financial markets.<sup>938</sup>

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<sup>934</sup> *John Kelley Co. v. Commissioner*, 326 U.S. 521, 534-35 (1945) (Rutledge, J., dissenting) (citations omitted).

<sup>935</sup> Although section 385(a) permits Treasury to issue regulations that characterize certain interests in a corporation as “in part stock and in part indebtedness,” no such regulations exist currently.

<sup>936</sup> See John C. Reid, *MIPS Besieged--Solutions in Search of a Problem*, 76 Tax Notes 1057, 1065 n.70 (Dec. 1, 1997) (“[T]he tax administrators are making a binary inquiry; an instrument is either debt or it is equity. The rating agencies on the other hand, are placing the instruments somewhere in the range between pure debt and pure equity.”).

<sup>937</sup> *Id.* at 1059 (“To the extent that corporations issue MIPS when they would otherwise issue debt, Treasury has no reason to be concerned with the tax treatment of MIPS because interest paid on conventional debt is deductible.”).

<sup>938</sup> See Joint Committee on Taxation, *Description and Analysis of Certain Revenue-Raising Provisions Contained in the President’s Fiscal Year 1998 Budget Proposal* (JCS-10-97), April 16, 1997, at 6 (noting that tiered preferred securities such as MIPS and TOPrS “are reportedly largely replacing regular preferred stock issuances in today’s market,” and citing Bary, *Preferred Vehicle--How Goldman, Merrill Altered an Entire Market*, Barron’s, August 21, 1995, at 13); Norris, *Bush’s Plan Taxes Certain Dividends, Fine Print Reveals*, New York Times, January 9, 2003, at A1 (noting that 72 percent of existing preferred stock is actually comprised of hybrid securities that are treated as equity for financial statement purposes but as indebtedness for tax purposes, according to a Merrill Lynch analyst).



The hindsight that the Enron bankruptcy provides may be useful in further evaluating the role that the tax rules play in fostering the development and marketing of tiered preferred securities and other similar hybrid financial instruments that are treated as equity for financial reporting purposes but indebtedness for tax purposes. Consequently, Congress may wish to consider whether such a role raises policy concerns that should outweigh the supposed importance of ensuring that the tax rules in isolation provide the appropriate characterization of such instruments.

#### **4. Recommendations**

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 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. This approach would largely eliminate opportunities to arbitrage the various tax and non-tax criteria for determining the character of hybrid financial instruments.
- (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. While more definite debt-equity factors ideally would be self-executing (rather than executed through Treasury regulations), developing an appropriate statutory framework for the application of such factors may be exceedingly difficult.<sup>939</sup>
- (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 key 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. Similar to the approach used by credit rating agencies in evaluating hybrid financial instruments, this approach would provide

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<sup>939</sup> In any event, section 385 should be amended to apply more broadly to interests in non-corporate entities, as well as corporations.

an alternative to the existing binary debt-equity characterization of financial instruments in appropriate circumstances.

- (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.<sup>940</sup> By providing more equivalence in the tax consequences of debt and equity, this approach would eliminate tax considerations from the process by which corporate taxpayers decide to obtain financing. This approach also recognizes the diminishing usefulness of the continuing debate among commentators concerning which regulatory or statutory regime provides the so-called “correct” characterization of financial instruments as debt or equity.

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<sup>940</sup> In fact, it has been observed that tiered preferred securities may already achieve effective equivalence in the tax treatment of interest and dividends under present law, which may explain the apparent preference of issuers for such securities over conventional preferred stock. See Victor Fleischer, *Enron’s Dirty Tax Secret: Waiting For the Other Shoe to Drop*, 94 Tax Notes 1045, 1046 (Feb. 25, 2002) (noting that “Enron has engaged in a sort of self-help corporate integration, getting the equivalent of a dividends-paid deduction, which some reformers would want to give out anyway”).

## **D. Investment Unit Securities**

### **1. Brief overview**

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

### **2. Background**

#### **Reported tax and financial statement effects**

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

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

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

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

earnings (i.e., earnings through a reduction in the provision for income tax expense) in the amount of \$61 million.<sup>942</sup>

### **Development of investment unit securities**

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

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

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<sup>942</sup> Enron Corp. and Subs, 1998 Footnote, Detail of Assets and Stock Sales (Enron tax rate reconciliation workpaper). EC2 000036393.

<sup>943</sup> Typically, the issuing corporation issues one unit of the instrument for each unit of reference stock.

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

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

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

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

### **1995 issuance of Enron investment unit securities**

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

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

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

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

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

offering. This offering reduced Enron's stock ownership of EOG from 80 percent to approximately 54 percent.<sup>950</sup>

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

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

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

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<sup>950</sup> 1995 Prospectus at 1.

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

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

<sup>953</sup> 1995 Prospectus at 4.

<sup>954</sup> 1995 Prospectus at 24.

### Subsequent developments

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

### 1999 issuance of Enron investment unit securities

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

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

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

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

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

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

<sup>959</sup> 1999 Prospectus at 5-6.

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

### Subsequent developments

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

### Role of outside advisers

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

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<sup>960</sup> 1999 Prospectus at 4.

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

<sup>962</sup> 1999 Prospectus at 5.

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

<sup>964</sup> EC2 000055434.

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

<sup>966</sup> 1995 Prospectus at 24; 1999 Prospectus at 28.



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

- (1) At the time of issuance of the investment unit securities, the holder of the securities irrevocably deposited with Enron a fixed amount of cash equal to the initial price of the securities to assure the fulfillment of the holder's purchase obligation at maturity of the securities;
- (2) until maturity of the investment unit securities, Enron was obligated to pay interest at seven percent as compensation to the holder of the securities for Enron's use of the cash deposit during the term of the securities; and
- (3) at maturity of the investment unit securities, the cash deposit unconditionally and irrevocably would be applied by Enron in full satisfaction of the holder's obligation under the forward contract, and Enron would deliver to the holder the number of shares of EOG common stock that the holder is entitled to receive at maturity of the securities.<sup>967</sup>

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

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

### **3. Discussion**

#### **In general**

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

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

<sup>968</sup> 1999 Prospectus at 14 (use of proceeds) and 29.

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

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

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

#### Investment unit characterization

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

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

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

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

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

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

### **Constructive sale treatment**

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

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

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

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

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

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

### **Disqualified indebtedness treatment**

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

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<sup>976</sup> Sec. 1259.

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

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

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

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

### **Straddle treatment**

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

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<sup>978</sup> Sec. 163(l)(3)(C).

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

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

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

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

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

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

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<sup>981</sup> Field Service Advice 199940007 (June 15, 1999).

<sup>982</sup> Field Service Advice 200131015 (May 2, 2001).

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

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

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

#### **4. Recommendations**

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

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

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

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

## E. Commodity Prepay Transactions

### 1. Brief overview

Beginning in 1992, Enron entered into several structured financial transactions arranged by various financial institutions wherein Enron received upfront payments in exchange for the future delivery of a specified commodity such as crude oil or natural gas (“commodity prepay transactions”).<sup>986</sup> Although such transactions are common in the energy industry in general, the Enron commodity prepay transactions were unique in that they involved a circular cash flow arrangement among Enron, the arranging financial institution, and a special purpose entity. The parties devised this circularity by engaging in multiple commodity transactions that involved a substantially identical amount of the underlying commodity. Upon termination of the overall transaction, no amount of the underlying commodity actually would be transferred. Rather, the initial cash flow to Enron that originated with the financial institution (or, in the case of some later transactions, outside investors) when the transaction was initiated essentially would be reversed when the transaction was terminated (i.e., Enron would return the funds to the financial institution or outside investors).

In general, the overall economic effect of the transactions was that Enron enjoyed the use of money provided to it during the pendency of the transactions, and returned the money (along with a premium) at the conclusion of the transactions. However, because of the way in which the transactions were structured, Enron portrayed its financial condition in a more favorable light -- from the standpoint of its credit rating and market valuation -- by reporting the transactions as part of its trading operations rather than as debt for financial accounting purposes.

The purposes for entering into most of these transactions apparently were twofold: (1) to accelerate the recognition of taxable income in order to utilize section 29 credits (relating to fuel production from nonconventional sources);<sup>987</sup> or (2) to generate cash flow, often immediately

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<sup>986</sup> September 22, 1999 memorandum from Morris R. Clark to Jordan Mintz, “Federal Income Tax Treatment of Prepayments” [hereinafter “Clark memorandum”]. EC2 000033005 through EC2 000033021. The structured financing materials in Appendix B contain the Clark memorandum. *See also The Role of the Financial Institutions in Enron’s Collapse: Hearings Before the Permanent Subcommittee on Investigations of the Senate Comm. on Governmental Affairs* (July 23, 2002) (testimony of Robert Roach, Chief Investigator) [hereinafter “Roach testimony”].

<sup>987</sup> Clark memorandum (noting that Enron entered into three prepayment transactions in 1992 and 1993 “primarily as a means for generating taxable income in order to take advantage of [section] 29 credits generated by [Enron Oil and Gas] which, at that time, was part of Enron’s consolidated group”). Section 29 credits may only be used against regular tax liability (secs. 29(b)(6)), and cannot be carried forward except as additional alternative minimum tax carryforward credits (sec. 53(d)(1)(B)). Consequently, Enron would not have been able to utilize its section 29 credits in 1992 and 1993 without the taxable income generated by the prepayment transactions because it otherwise would have been in an alternative minimum tax position.



preceding the close of a financial statement reporting period, that could be reported for financial accounting purposes as cash from trading operations rather than proceeds from debt financing.<sup>988</sup>

Enron entered into one or two commodity prepay transactions per year between 1992 and 1997, but entered into several more per year between 1998 and September 2001. Over this period of time, Enron entered at least 12 commodity prepay transactions with J.P. Morgan Chase & Co. (“J.P. Morgan”),<sup>989</sup> for an aggregate notional amount of approximately \$3.7 billion, and at least 12 such transactions with Citigroup, Inc.,<sup>990</sup> for an aggregate notional amount of approximately \$4.9 billion.<sup>991</sup>

## **2. Background<sup>992</sup>**

### **Reported tax and financial statement effects**

For financial accounting purposes, Enron treated the commodity prepay transactions as trading contracts.<sup>993</sup> Accordingly, Enron reported the proceeds from the transactions as cash flow from trading (or price risk management) operations and the obligation to close the

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<sup>988</sup> With regard to enhancing cash flow (as opposed to generating taxable income in order to utilize section 29 credits), the Roach testimony states that “Enron had two major reasons to reduce its balance sheet debt and increase cash flow from operations: 1) to improve Enron’s credit rating and 2) to support and even boost Enron’s share price.” Roach testimony at A-2. Apparently, Enron entered into only one commodity prepay transaction for actual commercial purposes, which occurred in 1992 and involved a notional amount that was “considerably smaller than any of the other...prepayments.” Clark memorandum.

<sup>989</sup> On December 31, 2000, The Chase Manhattan Corporation, the bank holding company of The Chase Manhattan Bank, N.A., merged with J.P. Morgan & Co., Inc. to become J.P. Morgan Chase & Co. All references herein to J.P. Morgan Chase & Co. include relevant constituent and predecessor firms.

<sup>990</sup> On October 8, 1998, Citicorp, the bank holding company of Citibank, N.A., merged with Traveler’s Salomon-Smith Barney to become Citigroup. All references herein to Citigroup include relevant constituent and predecessor firms.

<sup>991</sup> Roach testimony at A-8. *See* Roach testimony at Appendix E for more details concerning the individual transactions (e.g., dates of the transactions, dollar amounts of the transactions, underlying commodities, and status at bankruptcy).

<sup>992</sup> The following description of the development and implementation of Enron’s commodity prepay transactions is based in substantial part upon the Roach testimony, which provides a more comprehensive description and non-tax analysis of the transactions.

<sup>993</sup> Apparently, the commodity prepay contracts were treated in a similar fashion by the credit rating agencies. Clark memorandum (“The transaction is not treated as traditional debt for accounting and credit rating purposes, but rather, the prepayment is viewed as a part of Enron’s overall price risk management activity.”).

transactions as trading (or price risk management) liabilities.<sup>994</sup> In reporting its financial accounting income, Enron treated the proceeds from the transactions as deferred revenue, with income recognized over time as the underlying commodity was (or the cash proceeds from selling the commodity on behalf of the counterparty financial institution were) delivered by Enron pursuant to its obligations under the contract between Enron and the financial institution.

The Federal income tax treatment of the commodity prepay transactions by Enron depended upon Enron's objective for entering into the transaction. If Enron's objective was to generate immediate taxable income in order to utilize section 29 credits, Enron would treat the transaction as a sale of inventoriable goods under the applicable tax rules and would recognize the prepayment as taxable income in the year of receipt.<sup>995</sup> In order to characterize these transactions as a sale of goods for tax purposes, Enron structured the prepaid forward contracts to provide for settlement of the contracts by physical delivery of the underlying commodity (rather than non-physical cash settlement based upon the spot price of the underlying commodity on the settlement date of the contracts). However, because the counterparty financial institution presumably did not desire to take physical delivery of the underlying commodity, the parties structured the transactions to achieve the same practical effect as cash settlement by committing Enron to market or sell the underlying physical commodity at the spot price on behalf of the financial institution and remit the cash proceeds from such sale to the institution.<sup>996</sup>

By contrast, if Enron's intention was to generate cash flow for financial reporting purposes, but not recognize taxable income immediately, Enron initially relied upon the tax rules that provide for limited deferral of taxable income recognition with respect to inventoriable goods.<sup>997</sup> However, because such deferral constitutes a method of tax accounting, Enron had to

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<sup>994</sup> Roach testimony at A-2 to A-3; Clark memorandum. The decision by Enron to report these transactions as part of its trading activities, rather than as loan proceeds, has generated intense controversy and scrutiny. The Roach testimony concludes that "the basic transaction fails as a prepay and what remains is a loan to Enron using a bank and an obligation on Enron's part to repay the principal plus interest." Roach testimony at 1.

<sup>995</sup> Clark memorandum. Apparently, the need to utilize section 29 credits existed primarily during the time that Enron Oil & Gas was consolidated with Enron. *See The Role of the Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcommittee on Investigations of the Senate Comm. on Governmental Affairs* (July 23, 2002) (testimony of Jeffrey Dellapina, Managing Director, Credit and Rates Group, J.P. Morgan Chase & Co.: "Chase understood that the transactions originally had tax benefits to Enron. Later, Chase learned, Enron no longer received tax benefits from the transactions but chose to continue to engage in prepaid forward transactions for other corporation purposes."). However, consideration was given to using these transactions to generate immediate taxable income in order to absorb Enron's extensive and growing net operating losses. Clark memorandum.

<sup>996</sup> *Id.*

<sup>997</sup> Treas. Reg. sec. 1.451-5.

execute these transactions using entities that had not previously entered into transactions for the purpose of generating immediate taxable income to utilize section 29 credits.<sup>998</sup>

In later commodity prepay transactions, Enron structured the transactions with cash settled commodity contracts rather than physically settled contracts. Because Enron would market or sell the underlying commodity on behalf of the counterparty financial institution in the earlier transactions involving physical settlement, the use of cash settled contracts in the later transactions did not alter meaningfully the economic substance of the overall transaction. However, the change from physical settled contracts to cash settled contracts meant that the tax rules governing prepaid sales of goods no longer applied to the transactions. In addition, some of the commodity prepay transactions were funded by outside investors (rather than the financial institution arranging the transaction) through the issuance of so-called “credit-linked” notes. With regard to these transactions, Enron changed its characterization of the commodity prepay transactions for Federal income tax purposes and treated the transactions as loans for Federal income tax purposes, with the prepayment to Enron upon entering into the transaction treated as nontaxable loan proceeds and the termination of the transaction treated as a repayment of the loan.<sup>999</sup>

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<sup>998</sup> *Id.* The Enron entities that entered into the transactions for the purpose of generating immediate taxable income (and, thus, could not defer the recognition of taxable income from prepayments in subsequent transactions) included Enron Reserve Acquisition Corp., Enron Power Services, and EGS Hydrocarbon Corp. Enron Capital & Trade Resources Corp. (“ECT”), the predecessor to Enron North America, similarly was required to recognize immediate taxable income from these transactions because it had merged with some of the foregoing entities (and, thus, adopted their method of accounting for these transactions). Consequently, “although ECT may be the preferred entity to effectuate prepayment transactions from a commercial or legal perspective (since the counterparty may already have a master swap agreement in place with ECT or because the counterparty otherwise has familiarity with ECT from other commercial deals), ECT may not be the preferred entity from a tax perspective.” *Id.* The Enron entities that entered into the transactions for the purpose of generating cash flow for financial reporting purposes without the immediate recognition of taxable income included Enron Hydrocarbons Marketing Corp., Enron Cushing Oil Marketing, Inc., and Enron Natural Gas Marketing. *Id.* Apparently, Enron formed a new entity every year from 1993 to 1996 in order execute new prepayment transactions that could achieve the desired tax results. *Id.*

<sup>999</sup> *Id.*; Roach testimony at 2; April 10, 2001 memorandum from AnnMarie Tiller and Brent Vasconcellos to Jim Sandt, “Enron Credit Linked Notes Due 2005” (“For book purposes, Enron will record the upfront payment under the Prepaid Swap in income and record Enron’s obligation under the Prepaid Swap as a price risk management expense and liability. For tax purposes, these income and expense entries will be reversed with an M-1 adjustment.”) [hereinafter “Tiller memorandum”]. EC 000850722 through EC 000850726. The structured financing materials in Appendix B contain this memorandum. The later commodity prepay transactions may have been restructured using cash settled contracts for tax purposes because it appears that the limited two-year deferral available for the recognition in taxable income of advance payments relating to inventorable goods was considered insufficient for Enron’s purposes inasmuch as the transactions (including the forward contracts) were structured to be

## Development and implementation of Enron commodity prepay transactions

### Basic structure

In general, these transactions involved a special purpose entity created by the financial institution that was arranging the transaction.<sup>1000</sup> The special purpose entity would enter into a prepaid forward contract with the financial institution providing for a cash payment by the financial institution to the special purpose entity in exchange for a promise by the special purpose entity to deliver to the financial institution a fixed quantity of a commodity (typically, crude oil or natural gas) on a specified future date.<sup>1001</sup> The amount of the cash payment made by the financial institution to the special purpose entity would equal the estimated future price (“forward price”) of the reference commodity on the future delivery date.

Simultaneously, the special purpose entity would enter into an identical prepaid forward contract with Enron providing for a cash payment by the special purpose entity to Enron in exchange for a promise by Enron to deliver to the special purpose entity a fixed quantity of a commodity on a specified future date.<sup>1002</sup> The terms of this contract (e.g., the amount of the cash

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outstanding for three to six years. Clark memorandum (“[S]ince both natural gas and oil are carried in Enron’s inventory, these prepayments fall under the inventoriable goods exception and, as such, gain recognition may only be deferred for a period of two years after the year of receipt.”).

<sup>1000</sup> With regard to the transactions that Enron entered into with J.P. Morgan, the special purpose entity (“Mahonia Ltd.”) was directly owned by the Eastmoss Charitable Trust, which J.P. Morgan formed in Jersey for the purpose of owning special purpose entities that J.P. Morgan would utilize in arranging financing transactions for its clients. Roach testimony at C-5. The Roach testimony concludes that, notwithstanding its formal ownership by a purportedly independent charitable trust, Mahonia Ltd. was controlled by J.P. Morgan to the point that it was “a non-substantive entity established for the benefit of [J.P. Morgan].” *Id.* at C-6. The Enron commodity prepay transactions that were arranged by Citigroup utilized a special purpose entity (“Delta Energy Corporation”) that was incorporated in the Cayman Islands. *Id.* at D-6, fn. 9.

<sup>1001</sup> Although various media reports and congressional testimony have used the terms “forward contract” and “swap contract” somewhat interchangeably to describe Enron’s commodity prepay transactions (perhaps to distinguish between physically and financially settled contracts), references herein to forward contracts refer only to contracts that do not provide for periodic payments, and references herein to swap contracts refer only to contracts that do provide for period payments.

<sup>1002</sup> Clark memorandum (“The [prepayment transactions intended to accelerate taxable income] were typically structured as forward oil sale contracts with a counterparty arranged by a financial institution (Chase Manhattan or Citibank), whereby the counterparty would make a significant upfront payment in exchange for Enron’s obligation to deliver oil on a monthly basis over a 3 to 4 year period.”), noting that the financial institution would not actually receive physical oil or gas from Enron pursuant to the transaction but, rather, Enron would sell the oil or gas on behalf of the financial institution and remit the proceeds from the sale to the institution.

payment by the special purpose entity to Enron, the quantity and type of the reference commodity, and the delivery date (and location) involved in the contract between the special purpose entity and Enron) all would mirror the terms of the contract between the special purpose entity and the financial institution.

Simultaneous with the execution of these prepaid forward contracts, Enron and the financial institution would enter into a commodity swap contract providing for the periodic payment of a fixed cash amount by Enron to the financial institution in exchange for the periodic payment of a variable, or floating, cash amount by the financial institution to Enron. The swap had the effect of eliminating the residual price risk that otherwise would be incurred by Enron from the transaction.

At the conclusion of the transaction, the special purpose entity would close the forward contract with Enron by taking delivery of the reference commodity from Enron, the financial institution would close the forward contract with the special purpose entity by taking delivery of the reference commodity from the special purpose entity (i.e., the same commodity delivered by Enron to the special purpose entity pursuant to their forward contract), and the financial institution would sell the commodity on the spot market (often to an Enron-affiliated entity).<sup>1003</sup> However, while some of the transactions provided for physical settlement through actual delivery of the reference commodity, many of the transactions provided for financial (or non-physical) settlement.<sup>1004</sup>

The diagram on the following page partially depicts a commodity prepay transaction that Enron entered into with Citigroup in August 2000 as an example of the basic structure of Enron's commodity prepay transactions.<sup>1005</sup>

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<sup>1003</sup> The particulars of the individual transactions often varied somewhat from the basic transactional structure. For example, prior to 1996 the special purpose entity and the financial institution would enter into a swap contract (rather than a forward contract), the special purpose entity (rather than the financial institution) would take ultimate delivery of the commodity pursuant to closing the forward contract with Enron and sell the commodity on the spot market, and the special purpose entity would hedge its price risk by entering into a futures contract. Roach testimony at C-3, fn. 3. In addition, the final commodity prepay transaction that Enron entered into involved three swaps rather than two prepaid forward contracts and one swap. *Id.* at C-9.

<sup>1004</sup> All but one of the transactions between Enron and J.P. Morgan involved physical settlement, while all but one of the transactions between Enron and Citigroup involved financial settlement. Roach testimony at A-8, fn. 33.

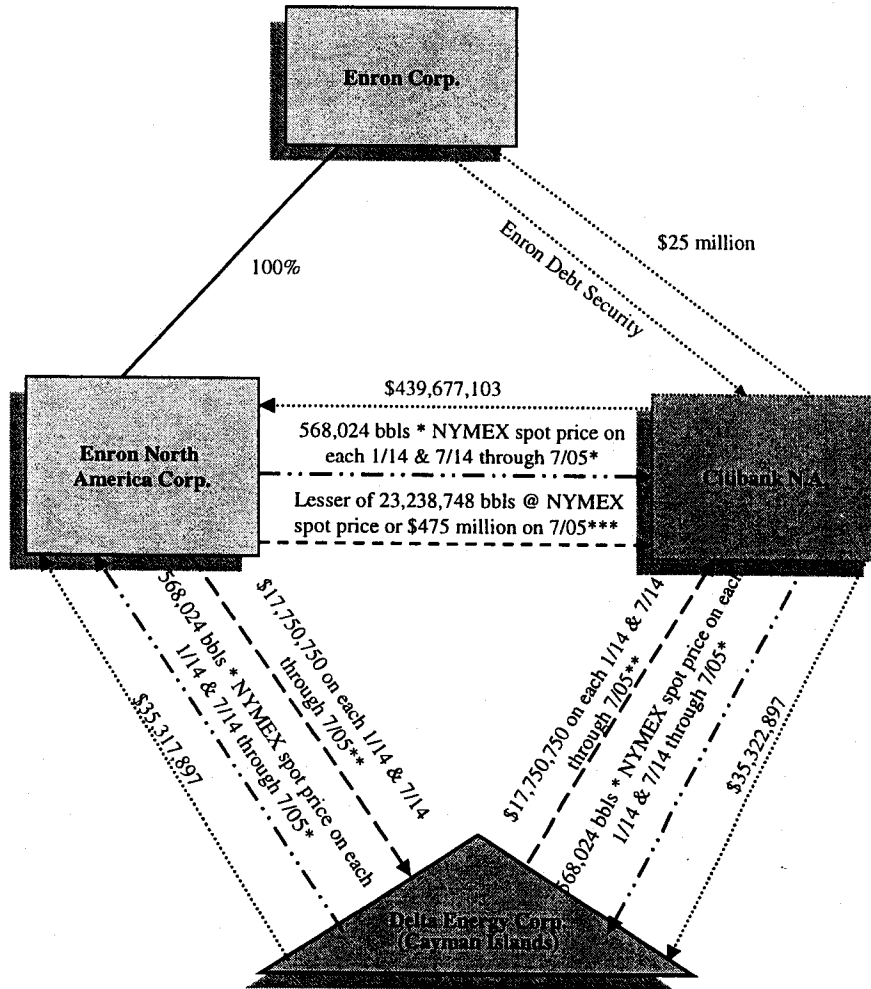
<sup>1005</sup> The diagram is only partial because it does not include the external financing obtained for this particular transaction from outside investors through the issuance of Enron credit-linked notes by an off-balance sheet trust (discussed below). *See* Diagram [2] below for a complete illustration of this particular transaction, including the issuance of Enron credit-linked notes.

# ENA \$475 Million Prepay Transaction

## August 25, 2000

### (Partial Diagram)

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U.S. GAAP/Tax Legend	
	Enron GAAP Consolidated
	Third Parties
	Corporation
	Partnership

#### Prepay Legend

Initial Payments	.....
Periodic Floating Payments	- . . . -
Periodic Fixed Payments	-----
Final Payment	-----

\*As a result of the 8/25 closing date, the notional amount for the first periodic floating payment was 533,312 bbls

\*\*As a result of the 8/25 closing date, the the first periodic fixed payment was \$16,665,982

\*\*\*Any shortfall below \$475 million on the final payment to Citibank is made up through a final payment on the ENA/Delta Swap and Delta/Citibank Swap.

### Credit-linked financial transactions

Whereas J.P. Morgan itself provided the funding for its commodity prepay transactions with Enron, several of the later commodity prepay transactions that Citigroup entered into with Enron were funded with the proceeds of notes that were issued through an off-balance sheet trust.<sup>1006</sup> Apparently, the financing of these transactions through the issuance of notes to investors who were otherwise external to the transaction was necessary because the internal credit policy of Citigroup precluded the extension of any additional credit to Enron.<sup>1007</sup> These transactions have become known publicly as the “Yosemite” transactions.

In the Citigroup transactions that involved external financing (i.e., the Yosemite transactions), the proceeds from the note issuances were loaned by the trust to the special purpose entity, which used the funds to make the prepayment as part of the prepaid forward contract entered into between the special purpose entity and Enron. The repayment of the notes by the trust was contingent upon (or “linked to”) the credit rating of Enron.<sup>1008</sup> By issuing notes that were linked to Enron’s creditworthiness, the exposure to a default by Enron on its

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<sup>1006</sup> Roach Testimony at D-1.

<sup>1007</sup> January 12, 2001 memorandum from AnnMarie Tiller to Dave Maxey, “Enron Credit Linked Notes Due 2005”. EC 000850727 through EC 000850728. The structured financing materials in Appendix B contain this memorandum. According to an Enron internal communication, “Yosemite accomplished the following:

- Released bank capacity for future Enron deals by effectively refinancing the prepay structures into the bond market.
- Provided a longer-term financing option for our prepay structures (bond coupon could extend out to 10+ years)
- Provides for the ability to substitute transactions within Yosemite without having to prepay the bonds
- Provides for the ability to amend transactions within Yosemite through which is typically difficult in a bond transaction. Versus a bank deal, the Yosemite transaction allows for easier execution of an amendment because we only have to deal with Citibank versus a syndicate group.
- Retain the flexibility to sell Enron credit default swaps to the banks as an alternative method for freeing up their lending capacity.”

Electronic mail message from Doug McDowell to Brent Vasconcellos, dated April 18, 2000. EC2 000033469.

<sup>1008</sup> These notes were designed to provide credit quality that was comparable to Enron senior unsecured obligations, and were referred to as Enron Linked Obligations (“LEOs”). Undated PowerPoint presentation, “Yosemite Securities Trust I: \$750,000,000 Linked Enron Obligations (LEOs<sup>SM</sup>)”. EC2 000033095 through EC2 000033108.

obligations in the underlying commodity prepay transaction (i.e., the “credit risk”) would be borne ultimately by the outside investors in the notes.<sup>1009</sup>

Yosemite transactions.—Between 1999 and 2001, Enron issued credit-linked notes for some of its commodity prepay transactions through four trusts known as Yosemite I, Yosemite II, Yosemite III, and Yosemite IV.<sup>1010</sup> In these transactions, Enron would enter into cash-settled commodity contracts (including the large initial premium payments to Enron) with Citigroup and a special purpose entity, similar to the basic commodity prepay transactions described above.<sup>1011</sup> In addition, Citigroup (through its special purpose entity) and the trust would enter into a credit default swap transaction whereby, in the absence of a credit event on the part of Enron (such as default of its obligations in the transaction or bankruptcy), the trust would make periodic (semi-annual) payments to Citigroup in an amount equal to the yield received by the trust on the loan to the special purpose entity that it made with the proceeds of credit-linked obligations that were issued by the trust to outside investors. In return, Citigroup would make periodic (semi-annual) payments sufficient for the trust to make yield payments on the credit-linked obligations and the trust certificates.

In the Yosemite transactions, the circular commodity prepay transactions among Enron, Citigroup, and the special purpose entity involved cash-settled commodity swaps, whereby Enron received an upfront payment from Citigroup (in the case of the swap between Enron and Citigroup) in exchange for an obligation to make periodic (semi-annual) floating payments (based upon the spot price for a notional amount of the underlying commodity) and a final payment at the end of the swap.<sup>1012</sup>

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<sup>1009</sup> January 12, 2001 memorandum from AnnMarie Tiller to Dave Maxey, “Enron Credit Linked Notes Due 2005”. EC 000850727 through EC 00085078.

<sup>1010</sup> *Id.* In general, credit-linked financial transactions typically involve some form of derivative, such as a total return swap, default swap, credit risk option, or credit-linked notes. Credit-linked notes generally are comprised of fixed or variable interest rate debt instruments issued by a party that is unrelated to the issuer of the underlying obligation(s) the repayment of which determines the repayment of the credit-linked notes. If no default (or other specified similar credit event) occurs with regard to the underlying obligation(s), the credit-linked notes are repaid at maturity. However, if a default (or other specified similar credit event) does occur with regard to the underlying obligation(s), the maturity of the credit-linked notes is accelerated but no amount is required to be repaid or a reduced amount is repaid by reference to the fair market value of the underlying obligations. See Nirenberg and Kopp, *Credit derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes*, 87 J. Tax’n 82, 94 (August 1997).

<sup>1011</sup> March 27, 2001 Electronic mail message from AnnMarie Tiller to Ryan Siurek (describing Yosemite III commodity prepay transaction). EC2 000033031. The structured financing materials in Appendix B contain this electronic mail message.

<sup>1012</sup> Roach testimony at D-3; Tiller memorandum. Because the funding for the commodity prepay transactions was channeled from the trust to Citigroup through its special



Initially, Enron and Citigroup owned equal shares of the equity certificates in Yosemite I in order to avoid financial statement disclosure of the trust (and the debt issued by the trust) by Enron and Citigroup.<sup>1013</sup> After Enron determined that its percentage of equity ownership in the trust would exceed the amount permissible to avoid financial statement disclosure, Enron sold the necessary portion of its equity ownership through LJM2 to a related entity, Whitewing.<sup>1014</sup> Similar events occurred with regard to Yosemite II.<sup>1015</sup>

The following describes, in general, the cash flows involved in some of these transactions:<sup>1016</sup>

### **Yosemite Trust Cash Flows**

- The Yosemite trust receives \$X billion from offering credit-linked notes.
- The trust loans the offering proceeds to the special purpose entity (which, in turn, transfers the proceeds to Citigroup through a prepaid commodity swap).<sup>1017</sup>
- The Yosemite trust pays the interest on the credit-linked notes from the yield on the loans made by the trust to the special purpose entity and the premium received from Citigroup for entering into the credit default swap.
- The Yosemite trust repays principal on the credit-linked notes from the proceeds of the repayment upon maturity of the loans made by the trust to the special purpose entity.

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purpose entity, Enron entered into the commodity contract directly with Citigroup rather than through the special purpose entity.

<sup>1013</sup> Roach testimony at D-10, fn. 39.

<sup>1014</sup> *Id.*

<sup>1015</sup> *Id.* at D-11, fn. 41.

<sup>1016</sup> Citibank/Salomon Smith Barney presentation to Enron, “The ‘Next’ Yosemite,” dated May 2, 2000. EC2 000033439 through EC2 000033468.

<sup>1017</sup> With regard to the Yosemite III and IV transactions, the trust used the proceeds of the offering to acquire Citigroup certificates of deposit from the special purpose entity (rather than loaning the proceeds to the special purpose entity) as collateral for the funding provided by Citigroup to Enron through the contract between Citigroup and Enron. Roach testimony at D-11, fn. 41. As part of the collateral arrangement, the trust and Citigroup entered into a credit default swap that effectively permitted Citigroup to repay the certificates of deposit by delivering to the trust so-called “Enron Deliverable Obligations” in the event that Enron defaulted on its contract with Citigroup or became insolvent or bankrupt. The Enron Deliverable Obligations would be senior unsecured obligations of Enron and any amounts recovered by the trust from these obligations would be used to repay principal on the credit-linked notes issued by the trust. Tiller memorandum.

### **Credit Default Swap Cash Flows**

- The Yosemite trust receives a premium from entering into the credit default swap with Citigroup.
- If a credit event on the part of Enron occurs (such as default on its obligations in the transaction or bankruptcy), the Yosemite trust transfers to Citigroup the notes on the loans that it has made to the special purpose entity and, in exchange, receives senior, unsecured obligations of Enron; in turn, the trust repays the credit-linked notes out of any proceeds received by the trust from the sale or workout of the Enron obligations received from Citigroup.

### **Enron Cash Flows**

- Citigroup enters into a commodity swap contract with Enron that provides a prepayment by Citigroup to Enron in the amount of \$X billion.
- Enron makes periodic (semi-annual) payments to Citigroup pursuant to the commodity swap contract.

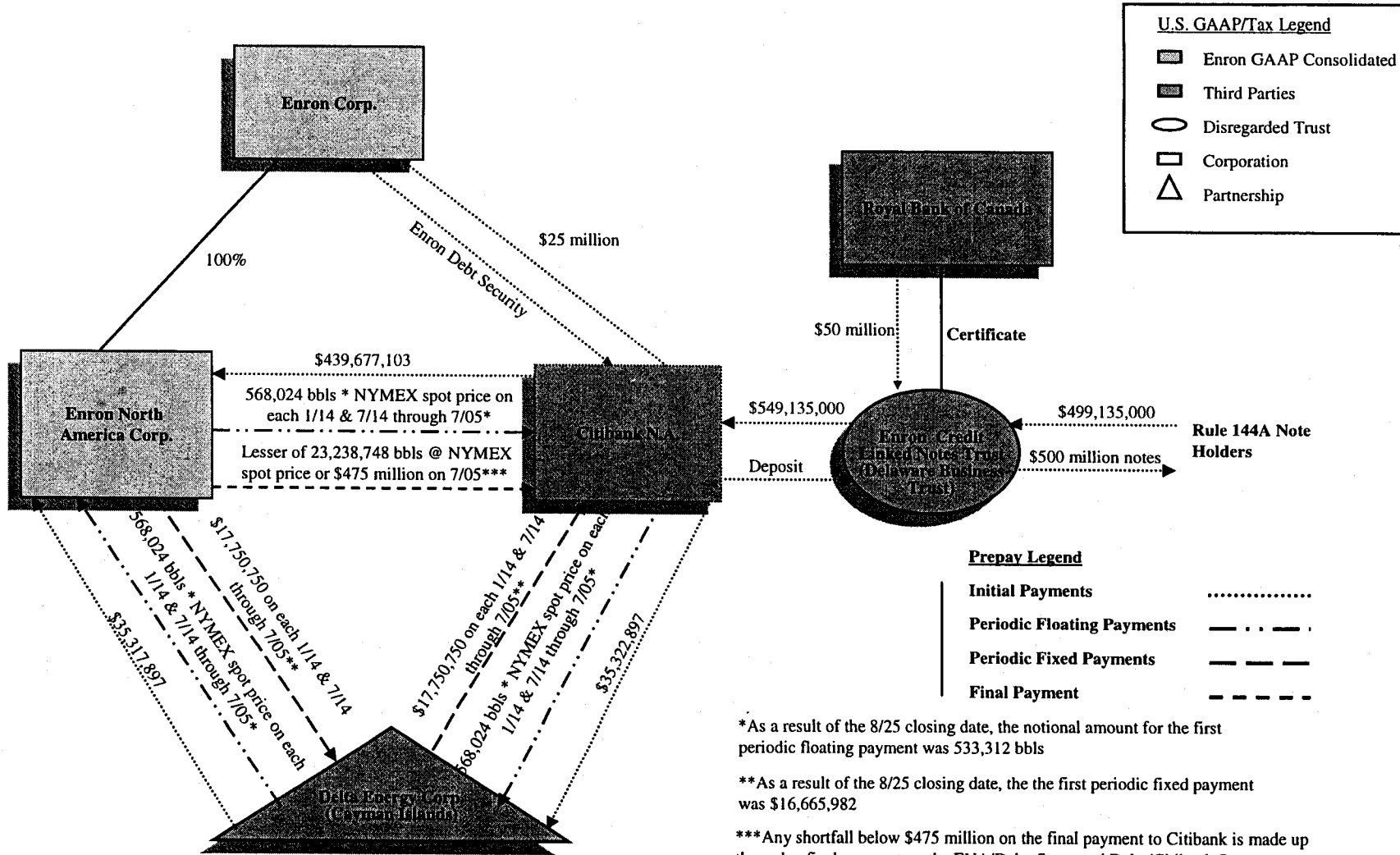
The diagram on the following page depicts the commodity prepay transaction that Enron entered into with Citigroup in August 2000 as an example of an Enron commodity prepay transaction that included the issuance of credit-linked notes.

# ENA \$475 Million Prepay Transaction

## August 25, 2000

Confidential

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\*As a result of the 8/25 closing date, the notional amount for the first periodic floating payment was 533,312 bbls

\*\*As a result of the 8/25 closing date, the the first periodic fixed payment was \$16,665,982

\*\*\*Any shortfall below \$475 million on the final payment to Citibank is made up through a final payment on the ENA/Delta Swap and Delta/Citibank Swap.

## **Role of outside advisors**

The roles of J.P. Morgan and Citigroup in these transactions have been chronicled extensively.<sup>1018</sup> In general, it appears that Enron compensated these financial institutions for their involvement in the transactions primarily through spreads built into the circular contracts that were used in the transactions (rather than through explicit fees). For example, in a commodity prepay transaction entered into with Citigroup in June 1999, Enron essentially received approximately \$250 million in net up-front payments upon entering into the transaction, and paid approximately \$253 million in net payments when the transaction closed.<sup>1019</sup> Similarly, the Yosemite III transaction provided for Enron to receive net up-front payments in the amount of approximately \$483 million at the initiation of the transaction, and provided for Enron to make a payment of approximately \$492 million when the transaction terminated, thus resulting in compensation to Citibank in the approximate amount of approximately \$9 million.<sup>1020</sup>

Enron apparently did not receive tax opinion letters in connection with the basic commodity prepay transactions. Rather, it appears that Enron tax personnel primarily developed the tax analysis of these transactions with some legal assistance provided by Vinson & Elkins LLP.

## **3. Discussion**

### **In general**

The primary tax policy issue surrounding the basic structure of the Enron commodity prepay transactions involves the selectivity that Enron exercised in determining the tax consequences of substantially similar transactions based upon the underlying objectives of Enron in executing the transactions.<sup>1021</sup> In earlier commodity prepay transactions, Enron treated the transactions as prepaid sales of goods. Within the tax rules governing the treatment of prepaid

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<sup>1018</sup> See, e.g., *The Role of the Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcommittee on Investigations of the Senate Comm. on Governmental Affairs* (July 23, 2002); Peter Behr and Ben White, *J.P. Morgan Had Many Ties With Enron*, *The Washington Post* (Feb. 23, 2002) at E1; Kurt Eichenwald, *Questions Raised on Enron Offshore Gas Trades*, *The New York Times* (Feb. 19, 2002) at C1.

<sup>1019</sup> July 8, 1999 Memorandum from Michael L. Herman to R. Davis Maxey, "US\$ 500 million Prepaid Forward and Swap Contracts with respect to Crude Oil, dated June 29, 1999". EC2 000033290 through EC2 000033294. Apparently, Enron also paid Citigroup a stated fee of \$1 million in connection with the transaction. *Id.*

<sup>1020</sup> March 27, 2001 Electronic mail message from AnnMarie Tiller to Brent Vasconcellos (describing Yosemite III commodity prepay transaction). EC2 000033031.

<sup>1021</sup> For example, see RMTCLiquids (Prepay) 1999 and 2000 tax workpapers providing the tax return treatment of certain commodity prepay transactions entered into by Enron affiliate RMTCLiquids. EC2 000033554, EC2 000033529 and EC2 000033568. The structured financing materials in Appendix B contain these workpapers.

sales of goods, Enron essentially elected its tax treatment of these transactions (i.e., current recognition of prepayments from some transactions and limited deferral of prepayments from other transactions) by selecting the entity within the Enron consolidated group to execute the transaction based upon the entity's tax accounting method for prepaid sales of goods.

In later years, Enron exercised selectivity in the tax treatment of its commodity prepay transactions through the characterization of the transaction as a loan (resulting in no recognition of taxable income or subsequent offsetting deduction).<sup>1022</sup> Although these later transactions involved cash settled contracts (rather than physically settled contracts) and were funded by outside investors (rather than the arranging financial institution), they were no different economically from the earlier transactions in any material respect. However, their characterization as loans (specifically, loans from the Yosemite trusts to Enron) apparently provided certain timing and withholding tax advantages over alternative characterizations.<sup>1023</sup>

Because the commodity prepay transactions would generate an offsetting deduction when they closed (or would produce no deductions in the case of loan characterization), the transactions generally did not produce a permanent tax benefit. Rather, the selectivity that Enron exercised in the tax treatment of the transactions affected the timing of the recognition by Enron of taxable income.

### **Yosemite transactions**

Enron's reliance upon credit-linked notes in the Yosemite transactions to effectively create credit capacity for additional commodity prepay transactions raises questions that are pertinent primarily to corporate governance and financial accounting. From the perspective of tax policy, the Yosemite transactions involve issues that are common to most credit-linked financial transactions. Because of their fairly recent advent, the overall tax treatment of the various types of credit-linked financial transactions remains uncertain. In substance, such transactions have been depicted in terms similar to the following description:

In such transactions, a counterparty seeks to purchase protection against the default of a particular issuer. This protection can be most simply thought of as default insurance. This type of credit derivative is also most commonly thought

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<sup>1022</sup> Electronic mail message from AnnMarie Tiller to Jill Erwin, Danny Wilson, and Kerrie Smith, dated January 11, 2000 ("Although [Yosemite I's] current investments are a complicated set of interests in debt and swaps, we are taking the position for tax purposes (given [Yosemite I's] current investments, at least), that [Yosemite I] owns a debt instrument issued by Enron with terms that match the aggregate payments due to the [Yosemite I] Certificateholders and the holders of the [credit-linked] Notes"). EC2 000033045 through EC2 000033047.

<sup>1023</sup> January 14, 2000 memorandum from Brent Vasconcellos to AnnMarie Tiller, "Yosemite I Withholding". EC2 000033237 through EC2 000033244. The structured financing materials in Appendix B contain this memorandum. October 28, 1999 Yosemite Financing outline of various tax issues. EC 000850764 through EC 000850773. The structured financing materials in Appendix B contain this outline.

of as a default or credit put option in which the holder of the put option holds the right to transfer obligations of the Reference Entity [i.e., the entity for which protection against default is being sought] to the credit derivative protection seller in exchange for either money or other value.<sup>1024</sup>

In effect, a credit-linked financial transaction brings together a party that desires to lend money without undertaking the associated credit risk and a counterparty that desires to undertake credit risk without lending money. Economically, these transactions can be described as synthetic loans in which the party that assumes the credit risk from the ostensible lender becomes the actual lender.

In characterizing a credit-linked note for Federal income tax purposes, it is not certain that repayment conditioned upon the non-occurrence of a credit event (such as default) constitutes the requisite promise to pay a specified amount at maturity that is necessary for a financial instrument to properly be characterized as indebtedness for Federal income tax purposes.<sup>1025</sup> In most transactions involving credit-linked notes, the classification of the notes as indebtedness for Federal income tax purposes can be critical because the loss of interest deductions that is occasioned by the loss of debt classification can destroy the economic rationale of the overall transaction.<sup>1026</sup>

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<sup>1024</sup> *The Role of the Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcommittee on Investigations of the Senate Comm. on Governmental Affairs* (July 23, 2002) (testimony of Ronald M. Barone, Managing Director, Standard & Poor's Ratings Services). Actual default is only one of a variety of types of events (e.g., changes in credit ratings) that can be incorporated as a triggering event into the terms of a credit-linked obligation. See Kayle, *Will the Real Lender Please Stand Up? The Federal Income Tax Treatment of Credit Derivative Transactions*, 50 *Tax Lawyer* 569, 577 (Spring 1997) (citing imposition of exchange controls by borrower's home country as another example of "quasi-credit risks" that can be embedded into a credit-linked obligation or other security) [hereinafter "Kayle"].

<sup>1025</sup> *But see* Nirenberg and Kopp, *Credit derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes*, 87 *J. Tax'n* 82, 95 (August 1997) (arguing that credit-linked notes can be treated as indebtedness for tax purposes). As with many types of financial instruments for which questions concerning the proper tax treatment remain largely unanswered, commentators generally have analyzed credit-linked notes by analogy to other types of transactions of which the tax treatment is more clear, particularly with regard to the fundamental tax issues of timing, character, and source of payments and receipts pursuant to a financial transaction. See Kayle, at 577-578 (noting the resemblance of credit-linked notes to guarantees and letters of credit).

<sup>1026</sup> To the extent that the credit-linked notes are marketed to foreign investors, the loss of debt classification could upend further the overall economics of the transaction because the interest income that generally otherwise would be exempt from U.S. withholding tax under the portfolio interest exemption would also be recharacterized (e.g., as dividends on an equity interest) in a manner that would result in the imposition of U.S. withholding tax.

Even if credit-linked notes appropriately can be classified as indebtedness to some extent for tax purposes, questions similar to those involving DECS can be raised concerning the precise nature of credit-linked notes as indebtedness. Some commentators believe that credit-linked notes, like DECS, can be viewed as a combination of a standard noncontingent debt instrument and a swap that provides for payments based upon the specified credit events underlying the credit-linked notes (e.g., a credit default swap).<sup>1027</sup> However, this analysis merely shifts the unanswered questions regarding appropriate tax treatment to those involving credit default swaps and, more generally, the ability to “componentize” a financial instrument for tax purposes.<sup>1028</sup> The unsatisfactory state of affairs discussed above with regard to the tax treatment of hybrid financial instruments in general is particularly detrimental with regard to credit-linked transactions, as one commentator has described:

Credit derivatives have proven themselves in the marketplace to be powerful and versatile tools for market participants to manage credit risk. Like other powerful tools, they have their dangers. In no small part, those dangers relate to their tax consequences. The dangers...are those for potential users of credit derivatives, but there are dangers for the Treasury as well, as taxpayers may resolve doubts in their own favor using the benefit of hindsight. Thus, uncertainty surrounding the tax treatment of credit derivative transactions is in the interest neither of the Treasury nor the public.<sup>1029</sup>

In the case of the Yosemite transactions, Enron evidently employed an economic substance analysis to arrive at a conclusion that these transactions constituted lending transactions for tax purposes, rather than prepaid sales of goods (as in the previous commodity prepay transactions). Beyond the characterization of the transactions as loans, determining which party should be treated as the lender was crucial to the feasibility of these transactions. Enron was concerned that treating the off-shore special purpose entity in the Yosemite transactions as the lender could have given rise to tax withholding obligations that would have made the transactions uneconomic. Therefore, Enron took advantage of this aspect of uncertainty in the treatment of credit-linked notes and treated the Yosemite trusts as the lender in these transactions.

### **Selective tax treatment of Enron commodity prepay transactions**

The questions surrounding the Enron commodity prepay transactions can be analogized to the problems discussed above with regard to DECS financing transactions. Specifically, drastically different tax consequences can arise on the basis of different characterization of the same or substantially similar economic transactions. The sole reason that such a circumstance -- and the characterization selectivity that stems from it -- is even possible can be attributed to the

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<sup>1027</sup> Kayle, at 609-611.

<sup>1028</sup> *Id.* at 591 (“[T]he credit default swap is in many respects the most difficult of the genre [of credit-linked financial transactions] to analyze.”).

<sup>1029</sup> Kayle, at 613.

fact that the tax consequences of a financial transaction are dictated largely by tax rules that traditionally have assigned labels to transactions that may not reflect in all cases the underlying economics of the transaction in question.

The effort that has been expended to differentiate among various types of financial transactions, and the analytical techniques (such as analogy, integration and bifurcation) that have been employed in such efforts, suggests that any structural differences among these transactions have largely been eliminated through modern financial engineering. The convergence of financial transactions -- and even some transactions that traditionally have been thought of as non-financial, such as prepaid sales of goods--suggests that the tax consequences of such transactions no longer can be based upon their assigned labels.

#### **4. Recommendations**

The commodity prepay transactions entered into by Enron demonstrate the convergence of traditionally dissimilar transactions that has occurred in recent years through financial engineering. This convergence presents increasing challenges to the rationality of certain tax rules that have been developed on the basis of categorical distinctions that may no longer reflect meaningful economic distinctions. In general, the tax rules should endeavor to reduce or eliminate the extent to which the tax consequences of economically similar transactions are impacted by their characterization.

Given the inherent complexity and customization of structured financial transactions such as those in which Enron engaged, the opportunities for tax-advantaged characterization of such transactions are particularly great and, to a certain extent, unavoidable. Nevertheless, in developing any new rules concerning the tax treatment of financial transaction and products, careful attention should be given to the potential for unintentionally creating new opportunities for *de facto* taxpayer electivity that, once recognized, might be considered unwarranted.<sup>1030</sup> For example, notional principal contracts with significant upfront nonperiodic payments, prepaid forward contracts, and secured lending transactions should all have the same or similar tax consequences to the extent that they all yield the same or similar economic results.

Similarly, greater attention should be paid to coordinating the tax rules governing financial transactions with those governing what have traditionally been thought of as non-financial (or physical) transactions, so that financial transactions cannot be restructured as economically similar non-financial transactions (and vice versa) simply for the purpose of accessing more favorable tax rules. For example, prepaid sales of goods should have the same or similar tax consequences as prepaid forward contracts and secured lending transactions to the extent that they yield the same or similar economic results.

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<sup>1030</sup> See Notice 2001-44, 2001-30 I.R.B. 77 (noting that, “in the financial products area, it is particularly important to pay attention to the neutrality principle, i.e., consistent treatment of difference instruments with similar economic characteristics”).



## IV. USE OF FOREIGN ENTITIES BY ENRON

Enron owned interests in several hundred entities established in foreign jurisdictions that imposed no tax on such entities. Press reports have raised questions about the number and purposes of such entities. The discussion below begins with an overview of the relevant Federal international tax rules. The discussion then explains Enron's general posture under these rules and addresses Enron's use of the foreign entities. The discussion concludes with a Joint Committee staff recommendation.

### A. Overview of Selected International Tax Rules

#### 1. In general

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F<sup>1031</sup> and the passive foreign investment company rules.<sup>1032</sup> A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes.<sup>1033</sup>

#### 2. Foreign tax credit

The United States generally provides a credit for foreign income taxes paid or accrued.<sup>1034</sup> In the case of foreign income taxes paid or accrued by a foreign subsidiary, a U.S. parent corporation is generally entitled to a "deemed paid" credit for such taxes when it receives an actual or deemed distribution of the underlying earnings from the foreign subsidiary.<sup>1035</sup> The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source

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<sup>1031</sup> Secs. 951-964.

<sup>1032</sup> Secs. 1291-1298.

<sup>1033</sup> Secs. 901, 902, 960, 1291(g).

<sup>1034</sup> Sec. 901.

<sup>1035</sup> Secs. 902, 960.

income, in order to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.<sup>1036</sup>

Due to this limitation, a taxpayer must allocate gross income and expenses between U.S. and foreign sources in order to determine the amount of allowable foreign tax credits. Under present law, interest expense that a U.S.-based multinational corporate group incurs in the United States is allocated to U.S. and foreign sources based on the gross assets located in the United States relative to those located abroad (measured either by basis or by fair market value).<sup>1037</sup> Thus, a U.S.-based multinational with a significant portion of its assets overseas must allocate a significant portion of its U.S. interest expense to foreign-source income, which reduces the foreign tax credits allowable (even though the interest expense incurred in the United States is not deductible in computing the actual tax liability under applicable foreign law).

The foreign tax credit limitation is applied separately to different types of foreign-source income, in order to reduce the extent to which excess foreign taxes paid in a high-tax foreign jurisdiction can be “cross-credited” against the residual U.S. tax on low-taxed foreign-source income. For example, if a taxpayer pays foreign tax at an effective rate of 45 percent on certain active income earned in a high-tax jurisdiction, and pays little or no foreign tax on certain passive income earned in a low-tax jurisdiction, then the earning of the untaxed (or low-taxed) passive income could expand the taxpayer’s ability to claim a credit for the otherwise uncreditable excess foreign taxes paid to the high-tax jurisdiction, by increasing the foreign tax credit limitation without increasing the amount of foreign taxes paid. This sort of cross-crediting is constrained by rules that require the computation of the foreign tax credit limitation on a category-by-category basis.<sup>1038</sup> Thus, in the example above, the rules would place the passive income and the active income into separate limitation categories (or “baskets”), and the low-taxed passive income would not be allowed to increase the foreign tax credit limitation applicable to the credits arising from the high-taxed active income. Present law provides nine separate baskets as a general matter, and effectively many more in situations in which various special rules apply.<sup>1039</sup>

If a taxpayer generates an overall foreign loss (“OFL”) for the year -- whether as the result of business losses or expense allocations under U.S. tax rules -- it will not be able to claim foreign tax credits for that year, since it will have no foreign-source income and thus will have a foreign tax credit limitation of zero. Moreover, if the taxpayer does generate foreign-source income in later years, some portion of such income will be “recaptured,” or recharacterized as U.S.-source, thus reducing the foreign tax credit limitation in later years.<sup>1040</sup> The rationale for OFL recapture is that the foreign-source losses offset U.S.-source income in the year generated,

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<sup>1036</sup> Secs. 901, 904.

<sup>1037</sup> Sec. 864(e); Temp. Reg. sec. 1.861-11T.

<sup>1038</sup> Sec. 904(d).

<sup>1039</sup> *Id.*

<sup>1040</sup> Sec. 904(f). These rules also operate on a category-by-category basis.

thereby reducing the U.S. tax collected with respect to U.S.-source income. The U.S. fisc would not be made whole when the taxpayer subsequently earns foreign-source income if the U.S. tax on such income were completely offset by foreign tax credits.

### **3. Anti-deferral regimes**

#### **In general**

Generally, income earned indirectly by a domestic corporation through a foreign corporation is subject to U.S. tax only when the income is distributed to the domestic corporation, because corporations generally are treated as separate taxable persons for Federal tax purposes. However, this deferral of U.S. tax is limited by anti-deferral regimes that impose current U.S. tax on certain types of income earned by certain corporations, in order to prevent taxpayers from avoiding U.S. tax by shifting passive or other highly mobile income into low-tax jurisdictions. Deferral of U.S. tax is considered appropriate, on the other hand, with respect to most types of active business income earned abroad.

#### **Subpart F**

Subpart F,<sup>1041</sup> applicable to controlled foreign corporations and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A controlled foreign corporation generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).<sup>1042</sup> Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation on their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.<sup>1043</sup>

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,<sup>1044</sup> insurance income,<sup>1045</sup> and certain income relating to international boycotts and other violations of public policy.<sup>1046</sup> Foreign base company income consists of foreign personal holding company income, which includes passive income (e.g., dividends, interest, rents, and royalties), as well as a number of categories of non-passive income, including foreign

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<sup>1041</sup> Secs. 951-964.

<sup>1042</sup> Secs. 951(b), 957, 958.

<sup>1043</sup> Sec. 951(a).

<sup>1044</sup> Sec. 954.

<sup>1045</sup> Sec. 953.

<sup>1046</sup> Sec. 952(a)(3)-(5).

base company sales income, foreign base company services income, foreign base company shipping income and foreign base company oil-related income.<sup>1047</sup>

In effect, the United States treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution out of the corporation's subpart F income. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's earnings invested in U.S. property.<sup>1048</sup>

### **Passive foreign investment companies**

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies. A passive foreign investment company generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.<sup>1049</sup> Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a passive foreign investment company, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment companies that are “qualified electing funds,” under which electing U.S. shareholders currently include in gross income their respective shares of the company’s earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.<sup>1050</sup> A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.<sup>1051</sup> A third set of rules applies to passive foreign investment company stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as “marking to market.”<sup>1052</sup>

### **Coordination**

Detailed rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes. For example, a corporation generally is not treated as a passive foreign investment company with

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<sup>1047</sup> Sec. 954.

<sup>1048</sup> Secs. 951(a)(1)(B), 956.

<sup>1049</sup> Sec. 1297.

<sup>1050</sup> Sec. 1293-1295.

<sup>1051</sup> Sec. 1291.

<sup>1052</sup> Sec. 1296.

respect to a particular shareholder if the corporation is also a controlled foreign corporation, and the shareholder is a “U.S. shareholder” as defined in section 951(b). Thus, subpart F is allowed to trump the passive foreign investment company rules.

#### **4. Transfer pricing**

##### **In general**

Due to the variation in tax rates and tax systems among countries, a multinational enterprise may have an incentive to shift income, deductions, or tax credits among commonly controlled entities in order to arrive at a reduced overall tax burden. Such a shifting of items between commonly controlled entities could be accomplished by establishing artificial, non-arm’s-length prices for transactions between group members.

Under section 482, the Secretary of the Treasury is authorized to redetermine the income of an entity subject to U.S. taxation when necessary to prevent an improper shifting of income between that entity and a commonly controlled entity. The statute generally does not prescribe any specific reallocation rules that must be followed, other than establishing the general standards of preventing tax evasion and clearly reflecting income. Treasury regulations adopt the concept of an arm's length standard as the method for determining whether reallocations are appropriate. Thus, the regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length.

Special transfer pricing rules apply to transactions involving intangible property and services. These transactions present particular challenges to the administration of the arm’s length standard, since intangibles and services may be unique, thus rendering a comparison with third-party market transactions difficult or impossible.

##### **Transactions involving intangible property**

In the case of a related-party sale or license of an intangible, section 482 requires that the income with respect to such transfer or license be “commensurate with the income” generated by the intangible. Similarly, section 367(d) provides that, if an intangible is transferred to a related foreign corporation in a nonrecognition transaction (e.g., a transfer under section 351), the transaction is treated as a sale for contingent payments, resulting in the inclusion by the transferor of income “commensurate with the income” generated by the intangible. This approach seeks to avoid some of the difficulties of determining a single arm’s length price at the time of the transaction by instead determining the appropriate income attributable to the intangible on an ongoing basis, as the intangible generates income.

In view of the uncertainty that this method may impose on taxpayers, regulations under section 482 provide an alternative method for allocating the income attributable to intangibles among the members of a group of related companies, in the form of “qualified cost-sharing arrangements.”<sup>1053</sup> Under such an arrangement, if the parties share the costs of developing the

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<sup>1053</sup> Treas. Reg. sec. 1.482-7.

intangible in proportion to their reasonably anticipated benefits, make arm's length buy-in payments with respect to any previously developed intangibles contributed to the arrangement, and otherwise comply with the terms of the regulation, then the IRS will not seek to make reallocations under the general rules of section 482.<sup>1054</sup>

### **Transactions involving services**

In the case of services, the regulations under section 482 generally seek to distinguish between services that provide only incidental, or indirect and remote, benefits to a related party, in which case no arm's length charge is normally required, and services that provide more meaningful and direct benefits to a related party, in which case an arm's length charge is required.<sup>1055</sup> Even in the latter case, however, the requirement of an arm's length charge is generally considered met if the recipient of the services pays the provider's costs, unless the services constitute an "integral part" of the business of either the provider or the recipient of the services.<sup>1056</sup> Services are regarded as "integral" under this test if: (1) either the renderer or the recipient is in the trade or business of rendering the same or similar services to third parties; (2) providing services to related parties is one of the principal activities of the renderer; (3) the renderer is "peculiarly capable" of providing the services, the services are a principal element in the operations of the recipient, and the value of the services is substantially greater than the costs or deductions of the renderer; or (4) the recipient has received the benefit of a substantial amount of services from a related party or parties during the year.<sup>1057</sup>

### **5. Entity classification**

Prior to 1997, entity classification for Federal tax purposes was determined on the basis of a multi-factor test provided in regulations under section 7701. In distinguishing between a corporation and a partnership, these regulations set forth four characteristics indicative of a corporation: continuity of life, centralization of management, limited liability, and free transferability of interests. If a business entity possessed three or more of these characteristics, then it was treated as a corporation; if it possessed two or fewer, then it was treated as a partnership.<sup>1058</sup> Thus, in order to achieve characterization as a partnership under this system, taxpayers needed to arrange the governing instruments of an entity in such a way as to eliminate two of these characteristics. For example, a taxpayer desiring partnership classification for an entity might include transferability restrictions and dissolution provisions in order to eliminate the characteristics of free transferability and continuity of life. Partnerships also needed to have at least two members, as the term suggests.

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<sup>1054</sup> *Id.*

<sup>1055</sup> *See* Treas. Reg. sec. 1.482-2(b).

<sup>1056</sup> *Id.*

<sup>1057</sup> Treas. Reg. sec. 1.482-2(b)(7).

<sup>1058</sup> Treas. Reg. sec. 301.7701-2, as in effect prior to 1997.

Since January 1, 1997, new entity classification regulations have been in effect that generally allow taxpayers simply to elect the desired classification for many types of entities, including certain limited-liability entities available under the laws of many State and foreign jurisdictions.<sup>1059</sup> These regulations are commonly referred to as the “check the box” regulations. The regulations generally eliminate the need for modifications to the terms of governing documents in order to secure a particular entity classification, and they make it possible for a taxpayer to elect branch treatment for a single-member limited-liability entity, thus enabling the taxpayer to achieve both flow-through taxation and limited liability with respect to a foreign entity without adding a second member.

## **6. Treaties**

In addition to the U.S. and foreign statutory rules for the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or eliminate withholding taxes imposed by a treaty country on certain types of income (e.g., dividends, interest and royalties) paid to residents of the other treaty country. Treaties also contain provisions governing the creditability of taxes imposed by the treaty country in which income was earned in computing the amount of tax owed to the other country by its residents with respect to such income. Treaties further provide procedures under which inconsistent positions taken by the treaty countries with respect to a single item of income or deduction may be mutually resolved by the two countries.

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<sup>1059</sup> Treas. Reg. sec. 301.7701-1, *et seq.*

## B. Enron's General International Tax Posture<sup>1060</sup>

### 1. Foreign tax credit problems arising from interest allocation rules

From the time that Enron began significant foreign expansion in the early 1990s, its tax posture in the international area was defined in large part by one major problem: as a result of large allocations of U.S. interest expense against foreign source income under section 864(e), Enron was persistently unable to use foreign tax credits. The company thus faced the possibility of significant double taxation of its foreign source income. This potential for unmitigated double taxation was of paramount concern in Enron's international tax planning and significantly influenced the structures of Enron's international operations and transactions.

Enron was not unique among companies of comparable size in facing foreign tax credit utilization problems arising from the interest allocation rules of section 864(e). U.S.-based multinational corporations have long complained about the impact of these rules on their capacity to use foreign tax credits, and legislation has been considered by Congress from time to time addressing this concern.<sup>1061</sup> In Enron's case, the adverse impact of the interest allocation rules was particularly acute as it expanded its activities abroad, due to Enron's high level of investment in foreign assets (e.g., power plants in foreign countries) and comparatively low level of foreign income. The high levels of foreign assets generated a large allocation of interest expense against relatively low levels of foreign source income, thus generating an ever expanding, and eventually nearly insurmountable, overall foreign loss account.<sup>1062</sup>

Enron's overall foreign loss account first arose in 1992 and grew at a rate of \$20 million to \$25 million per year.<sup>1063</sup> As early as 1993, Enron appears to have concluded that it would not be able to claim foreign tax credits at any time in the foreseeable future.<sup>1064</sup>

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<sup>1060</sup> The information in this section of the report is based on documents provided by Enron and the IRS, and on interviews with Robert Hermann, James A. Ginty, Cullen A. Duke, Edward R. Coats, Leesa M. White, and Stephen H. Douglas.

<sup>1061</sup> *See, e.g.*, H.R. 285, 108<sup>th</sup> Cong., 1<sup>st</sup> Sess., sec. 310 (2003); H.R. 5095, 107<sup>th</sup> Cong., 2d Sess., sec. 311 (2002); Taxpayer Refund and Relief Act of 1999, H.R. Conf. Rep. No. 106-289, sec. 901 (1999) (vetoed by President Clinton).

<sup>1062</sup> For example, according to a company memorandum, EOG Canada's asset basis of \$86 million attracted an allocation of U.S. interest expense of \$7 million against income of only \$400,000 for 1992. Memorandum, "Enron FTC Position," June 26, 1992, at EC2 000036091.

<sup>1063</sup> Enron Foreign Operations White Paper, June 28, 1996, at EC2 000036150.

<sup>1064</sup> Memorandum, "Structuring for Enron's Foreign Operations," Mar. 11, 1993, at EC2 000036120.



## 2. Planning techniques addressing the foreign tax credit problem

### In general

Enron determined relatively early in its international expansion that it would not be feasible to attempt to eliminate the overall foreign loss account and thereby regain the ability to use foreign tax credits.<sup>1065</sup> Instead, the company accepted the fact that it would not be able to use foreign tax credits and sought to structure its international investments and activities in such a way as to minimize the impact of this problem. The company employed two main strategies in this regard: deferral and deconsolidation.

### Deferral strategy

Under the deferral strategy, Enron conducted many of its international operations under a holding company and planned never to repatriate the earnings from a foreign project back to the United States. As long as the subpart F and passive foreign investment company rules did not apply to the earnings, U.S. tax on the foreign earnings generally could be deferred indefinitely, and double taxation would be avoided, albeit at the cost of losing the flexibility to repatriate funds to the United States.

Under applicable financial accounting standards, deferred U.S. taxes on foreign earnings need not be accrued for book purposes if the company has plans for permanently reinvesting the earnings offshore.<sup>1066</sup> In other words, to the extent that Enron could avoid actual or deemed repatriations of its foreign earnings, the company's inability to claim foreign tax credits would have no direct financial statement impact.

Thus, in Enron's case, the U.S. international tax rules (particularly the interest expense allocation rules), combined with the relevant financial accounting standards, created a significant incentive for the company not to repatriate foreign earnings to the United States. It is impossible to determine the extent to which this incentive may have caused the company to invest more heavily in foreign assets, and less heavily in U.S. assets, than its non-tax business strategy otherwise would have dictated. In this regard, it appears that the company anticipated major growth opportunities abroad, and that the foreign reinvestment encouraged by this incentive may not have been inconsistent with the company's non-tax business strategy -- indeed, it appears that the company's foreign investment plans called for more funds than the company was generating in its international operations.<sup>1067</sup> In addition, in cases in which the repatriation of funds was considered desirable, the company had the option of using the deconsolidation strategy.

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<sup>1065</sup> *Id.*

<sup>1066</sup> See *Accounting Principles Board (APB) Opinion No. 23; Statement of Financial Accounting Standards (FAS) 109.*

<sup>1067</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, Jan. 13, 2003, answer 133.

## Deconsolidation strategy

Under the deconsolidation strategy, Enron was able in some cases to circumvent its foreign tax credit limitation problem by investing in a foreign project through a U.S. entity that was not a member of the Enron consolidated group. The interest allocation problem, large overall foreign loss account, and resulting inability to use foreign tax credits pertained only to the Enron consolidated group. In cases in which Enron was willing to allow an unrelated party to take an ownership interest exceeding 20 percent in the U.S. entity through which a foreign project was conducted, the entity's ability to use foreign tax credits would not be affected by the foreign tax credit problems of the Enron consolidated group.<sup>1068</sup>

The deconsolidation strategy entailed a number of costs to the company, however, which rendered the strategy unsuitable in many cases. First, it required significant equity participation on the part of an unrelated investor, which Enron may not have considered desirable from a non-tax perspective. Second, the strategy caused dividends paid by the deconsolidated entity to Enron to qualify for only the 80-percent dividends-received deduction under section 243, instead of the 100-percent deduction that would apply to dividends from an 80-percent-or-greater-owned company. Finally, the strategy involved greater transaction and compliance costs than comparable investments made in a more straightforward manner through the Enron consolidated group. In light of these considerations, Enron employed this strategy only in a few situations in which repatriation of earnings was considered highly desirable -- i.e., in connection with high-income projects in high-tax foreign jurisdictions, in which case substantial foreign tax credits would be generated, and any benefit of deferral would be small. Generally, however, the deconsolidation strategy was regarded as too costly and cumbersome, and thus the deferral strategy was by far more commonly employed.<sup>1069</sup>

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<sup>1068</sup> For example, Enron held its interests in certain projects that were subject to higher rates of foreign tax through Enron Equity Corp. Enron held all of the common stock of Enron Equity Corp., and an institutional investor (John Hancock Insurance Co.) held all of the preferred stock, which carried sufficient voting power and value that the company was not a member of the Enron consolidated group for tax purposes. Enron Tax Deconsolidation and Foreign Tax Credit Planning Discussion Paper, April 30, 1998, at EC2 000036194.

<sup>1069</sup> Joint Committee staff interviews.

## C. Proliferation of Foreign Entities in Enron's Ownership Structure<sup>1070</sup>

### 1. Background

Press reports have suggested that Enron employed an unusually large number of offshore entities, particularly in countries that impose no tax on such entities, in an effort to avoid taxes.<sup>1071</sup> Enron did in fact establish a complex entity structure that included a large number of foreign entities, including many entities in countries that imposed no tax on such entities. It is important to note, however, that the mere existence of a large number of entities, even entities formed in jurisdictions that do not impose an income tax, does not necessarily indicate that Enron was using these entities inappropriately from a U.S. Federal tax perspective. Moreover, the number of foreign entities established by a company does not necessarily bear a significant relationship to the amount of any reduction in U.S. Federal tax that the company might have achieved through the structuring of the company's international activities. In order to evaluate Enron's practices in this regard, the reasons behind its complex entity structure must be examined.

### 2. General reasons for complex entity structures

It is not uncommon for large multinational business enterprises to organize themselves into complex structures consisting of multiple domestic and foreign corporations, partnerships, and branch entities. Non-tax business considerations such as liability management, regulatory requirements, management accounting, and financing needs may influence the decision to conduct a particular operation or make a particular investment through a certain kind of entity or combination of entities. For example, the laws of a foreign country in which an enterprise wishes to do business may provide that certain activities may be conducted only by a corporation established under local law; or the involvement of a third-party foreign investor or partner in a project may necessitate the use of a certain combination of foreign business entities. Tax considerations generally also factor into the decision, both with respect to the choice of jurisdiction and the choice of entity within a particular jurisdiction. Jurisdictions differ in terms of overall tax burden, special tax rules applicable to certain types of income and activities, and tax treaty networks. Some entities are treated as separate taxable persons (e.g., corporations), some are not (e.g., branches), and some fall somewhere in between (e.g., partnerships). In structuring complex international investments and operations, prudent tax planning typically requires a U.S.-based multinational enterprise to use a combination of many different entities in

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<sup>1070</sup> The information in this section of the report is based on documents provided by the company and by the IRS, and on interviews with Robert Hermann, James A. Ginty, Cullen A. Duke, Edward R. Coats, Leesa M. White, and Stephen H. Douglas.

<sup>1071</sup> See, e.g., David Cay Johnston, *Enron Avoided Income Taxes in 4 of 5 Years*, New York Times, Jan. 17, 2002 ("Enron paid no income taxes in four of the last five years, using almost 900 subsidiaries in tax-haven countries and other techniques, an analysis of its financial reports to shareholders shows"); Glenn R. Simpson, *Enron's Quest to Avoid Taxes Took the Firm to the Netherlands*, Wall Street Journal, Feb. 7, 2002 ("Enron's quest to avoid taxes by using offshore tax havens took the company to some unlikely places").

many different jurisdictions, even if the enterprise's tax planning goals are limited to the generally unobjectionable ones of deferring U.S. Federal income tax on active, non-subpart-F income until such income is repatriated, and mitigating the double taxation of foreign income to the extent allowable under the foreign tax credit and the U.S. tax treaty network.

For this combination of non-tax and tax reasons, a multinational business enterprise that conducts several lines of business in many different countries cannot avoid developing a somewhat complex organizational structure, as it seeks to manage the potential liabilities of the various businesses, satisfy all applicable local regulatory requirements, facilitate the evaluation of manager performance in the different businesses, arrange the desired mix of debt and equity financing from internal and external sources, and undertake sound tax planning measures with respect to all relevant jurisdictions.

### **3. The number of foreign entities in Enron's ownership structure**

While the number and types of entities in the Enron ownership structure varied over time, as of the end of 2001, this structure included approximately 1,300 different foreign entities.<sup>1072</sup> The vast majority (approximately 80 percent) of Enron's foreign entities were "dormant" -- in other words, inactive shells that did not hold and were not engaged in or associated with any ongoing business, and that were therefore largely irrelevant for tax purposes.<sup>1073</sup> Approximately 20 percent of Enron's foreign entities were associated with ongoing businesses and thus had some potential relevance for tax purposes. Overall, leaving aside the dormant entities, Enron conducted its foreign operations during 2001 through a network of roughly 250 different foreign entities.

Enron created many entities in jurisdictions that imposed no tax on such entities. In particular, as of the end of 2001, the Enron ownership structure included 441 entities formed in the Cayman Islands, a country that has never imposed a corporate income tax.<sup>1074</sup> The majority of these entities were dormant.<sup>1075</sup> The role of the Cayman entities, and the reasons why so many were dormant, are explained in Part IV.C.4, below.

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<sup>1072</sup> This figure includes foreign corporations and foreign partnerships that were controlled by Enron, as well as certain other entities in which Enron owned a significant stake (e.g., "noncontrolled section 902 corporations," in which Enron owned at least a ten percent stake). This figure does not include "branch" entities, which are disregarded for Federal tax purposes (e.g., pursuant to a "check the box" election) -- the activities, income, and deductions of branches are treated as those of their owners for Federal tax purposes. The inclusion of foreign branch entities would yield a total count of approximately 1,500 foreign entities for 2000. *See* Enron Presentation to Joint Committee staff, June 7, 2002, at 9 (Appendix B, Part I to this Report).

<sup>1073</sup> *Id.*; Joint Committee staff interviews.

<sup>1074</sup> Enron Submission to IRS Examination Team, Feb. 26, 2002.

<sup>1075</sup> *Id.*; Joint Committee staff interviews.

An article in the New York Times presented some figures in this regard that appear to reflect some confusion regarding certain information set forth the 2000 Form 10-K that Enron filed with the SEC. According to the article, Enron created “881 subsidiaries abroad, including 692 in the Cayman Islands, 119 in the Turks and Caicos, 43 in Mauritius and 8 in Bermuda.”<sup>1076</sup> These figures appear to be based on Exhibit 21 of Enron’s 2000 SEC Form 10-K, which lists subsidiaries of the filing company. In preparing this list, Enron used a somewhat confusing presentation format in which a single subsidiary would appear on the list multiple times if a number of other Enron subsidiaries held interests in it. Given this format, a simple line-by-line count of list entries would lead to substantial multiple-counting of certain entities, and thus to inflated numbers in some cases. For example, a review of Exhibit 21 of Enron’s 2000 SEC Form 10-K suggests that multiple-counting of two Turks and Caicos companies (specifically Smith/Enron Cogeneration Limited Partnership and Smith/Enron O&M Limited Partnership) was largely responsible for the count of 119 Turks and Caicos companies reported in the article. According to materials submitted to the IRS by the company, Enron in fact established only 4 Turks and Caicos companies.<sup>1077</sup>

It is generally difficult to make useful tax inferences from the data that companies file with the SEC in this regard. Companies have considerable flexibility in determining the content and format of Exhibit 21, and the filing generally contains little or no information as to the various subsidiaries’ assets, activities, tax treatment, and interrelationships. Moreover, different companies appear to have different standards as to the circumstances under which a subsidiary is regarded as “significant,” and therefore required to be reported on Exhibit 21. Some companies may report relatively few of the overall entities in their structure on this form; others may report most or all of their entities. Ultimately, the only reporting regime that yields the information needed to determine the relevance of the various foreign entities to the administration of the Federal tax rules is the information reporting regime required under those rules.<sup>1078</sup>

Most importantly, regardless of the data source (whether it be SEC or IRS filings), it must be noted that relatively little can be inferred from a mere count of a company’s foreign entities in various jurisdictions without examining why the entities were established and how they are used transactionally. On the one hand, it is possible for a company to own numerous foreign entities, even many formed in jurisdictions imposing no tax on such entities, without using these entities for any inappropriate Federal tax purposes. (And even if some entities are used for such inappropriate purposes, their sheer number does not necessarily bear a significant relationship to the amount of any reduction in U.S. tax that the company might be attempting to achieve.) On the other hand, it is possible for a company to employ a relatively simple entity structure, with no entities in jurisdictions typically regarded as tax havens, and yet attempt to

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<sup>1076</sup> David Cay Johnston, *Enron Avoided Income Taxes in 4 of 5 Years*, New York Times, Jan. 17, 2002.

<sup>1077</sup> Enron Submission to IRS Examination Team, Feb. 26, 2002.

<sup>1078</sup> Of course, the information provided under this regime generally is not made public. See sec. 6103.

achieve significant inappropriate reductions in Federal taxes through the use of its foreign entities.

Even with reference to Enron itself, it appears that the company's most aggressive tax-reduction strategy relating to the international tax rules was the Project Apache structured transaction, which did not require the involvement of any entity created in a jurisdiction generally regarded as a tax haven.<sup>1079</sup> The attempt to draw general conclusions about a company's international tax practices by simply following the trail of Cayman entities thus may focus attention on certain unexceptional practices and yet fail to reveal the company's most aggressive practices.

In sum, Enron undoubtedly had a complex entity structure, but the tax implications of that structure cannot be understood without examining the purposes and functions of the various entities comprising that structure.

#### **4. Sources of complexity in Enron's ownership structure**

##### **Number of foreign infrastructure projects**

One major component of Enron's international growth strategy over the 10-year period preceding the company's bankruptcy involved bidding for, constructing, and eventually selling foreign infrastructure projects, such as power plants and gas pipelines. Enron began developing its first major foreign project in 1991, which was a power plant project in the United Kingdom. By 1995, the company had undertaken project development activities in over 30 different countries.<sup>1080</sup> The Enron domestic affiliate primarily responsible for this line of business was Enron Development Corporation, which reorganized as Enron International in December 1997.

Foreign infrastructure development was a high risk business, in which each project opportunity represented a relatively small chance of generating very large returns. Enron pursued numerous project opportunities around the world, anticipating that most projects would fail but expecting that a few would be sufficiently profitable to make the overall line of business successful for the company.<sup>1081</sup> Each project, whether successful or not, typically had its own separate entity structure. In view of this practice, and the number of projects that the company initiated, the foreign infrastructure development business became the most significant contributor to the proliferation of entities within Enron's overall ownership structure.

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<sup>1079</sup> See Part I.D.1, above, for a discussion of Project Apache.

<sup>1080</sup> Enron Foreign Operations White Paper, June 28, 1996, at EC2 000036151.

<sup>1081</sup> According to Enron, the company's success rate in winning project bids was "well under 20 percent." In addition, many projects that Enron pursued encountered serious difficulties or were abandoned either before submitting a bid or well after winning one. Letter from Enron's counsel (Vinson & Elkins) to IRS, Sep. 13, 2001, at EC2 000055688-689.

## **Multiple entities for each project**

Enron generally formed a few separate entities for each foreign infrastructure project that it pursued. As explained in Part IV.B, above, Enron's dominant Federal income tax concern in the structuring of its foreign operations was its persistent inability to use foreign tax credits, and a deferral strategy was the company's principal response to this problem. Enron's typical deferral structure required that a few different entities be created for each project. In addition to a local project entity, the ownership of which might be divided between Enron and an unrelated co-venturer, Enron generally employed a tiered arrangement of foreign holding companies through which it held its own interest in the project entity. These tiered arrangements were established primarily to facilitate potential sell-downs of Enron's interests in the project entities, while to the extent possible maintaining deferral of U.S. taxes on any project earnings.<sup>1082</sup>

The nature of these arrangements changed over time in response to developments in U.S. tax law. In particular, as explained in further detail below, the issuance of the "check the box" entity classification regulations, effective at the beginning of 1997, enabled Enron to implement holding company structures that made use of fewer entities and offered greater flexibility without sacrificing U.S. tax deferral.<sup>1083</sup> Both before and after the issuance of these regulations, however, the practice of establishing multiple entities for each foreign project produced considerable complexity within the Enron ownership structure.

In a typical project structure established prior to the issuance of the "check the box" regulations, Enron would hold its interest in a project through three separate Cayman Islands holding companies, in addition to a project entity formed under local law in the project jurisdiction. The domestic Enron entity responsible for the project would own the stock of the first Cayman Islands holding company ("Cayman Parent"), which would be treated as a corporation for U.S. Federal tax purposes.<sup>1084</sup> Cayman Parent in turn would own all of the stock of a second Cayman Islands company ("Cayman Sub"), which also would be treated as a corporation for U.S. Federal tax purposes. Cayman Parent and Cayman Sub in turn would own 99 percent and 1 percent, respectively, of the ownership interests in a Cayman Islands Limited Life Company ("Cayman LLC"), which Enron would treat as a partnership for U.S. Federal tax purposes. Cayman LLC in turn would directly hold the Enron-side interest in the project entity. If Enron had a partner in the project venture, then that partner also would own an interest in the project entity. Cayman Sub, Cayman LLC, and the project entity typically would be dedicated exclusively to the particular project.

The diagram on the following page depicts this structure.

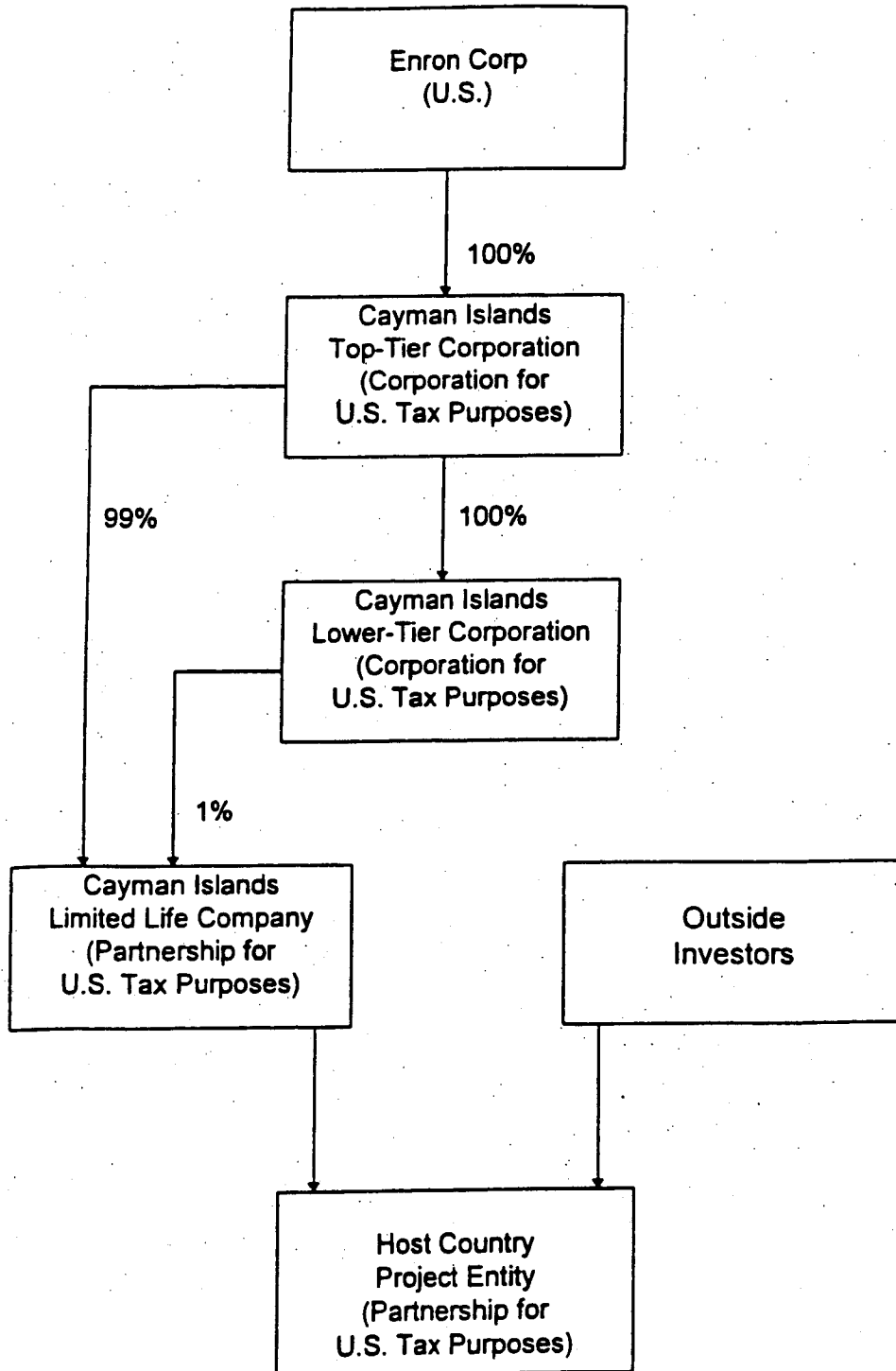
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<sup>1082</sup> Enron Foreign Operations White Paper, June 28, 1996, at EC2 000036159; Joint Committee staff interviews.

<sup>1083</sup> Treas. Reg. sec. 301.7701-1, *et seq.*

<sup>1084</sup> Cayman Parent could also hold interests in lower-tier entities established in connection with other projects.

**DIAGRAM OF TYPICAL CAYMAN ISLANDS  
MULTI-TIERED OWNERSHIP STRUCTURE**



EC2 000036190



The project entity usually was an entity treated as a corporation in the project jurisdiction, due to regulatory requirements under local law, the needs of the venture partner, or both. For U.S. Federal income tax purposes, however, it was desirable to treat the project entity as a partnership, so that Enron's Cayman Islands holding companies could receive distributions of earnings from the project entity without generating subpart F income. Qualifying the project entity as a partnership enabled Cayman LLC to be treated essentially as if it had earned the project income itself. Thus, assuming that the project itself generated active type income that was not subject to subpart F, U.S. Federal taxes on project income generally could be deferred within the Cayman holding company structure until the earnings were repatriated to the United States.<sup>1085</sup>

In order to achieve characterization of the project entity as a partnership prior to the issuance of the "check the box" regulations, the entity could possess no more than two out of the four following corporate characteristics: limited liability, centralized management, free transferability of interests, and unlimited life.<sup>1086</sup> In view of the practical importance of limited liability and centralized management, Enron generally opted to eliminate the characteristics of free transferability of interests and unlimited life, by adding share transferability restrictions and dissolution provisions. Thus, for example, Cayman LLC typically would not be allowed to sell its interest in the project entity without the consent of the venture partner, and the organizing documents of the project entity would provide for dissolution in the event of the bankruptcy of Cayman LLC or the venture partner. The transferability restrictions added to the complexity of the project structure, since it required Enron to add a tier to its side of the structure in order to be able to sell its interest in the project without obtaining the consent of its venture partner.<sup>1087</sup>

The three Cayman Islands entities on the Enron side of the structure comprised a so-called "Cayman Triangle."<sup>1088</sup> The involvement of Cayman Sub, and its nominal level of ownership of Cayman LLC, was intended to ensure that Cayman LLC also would be treated as a partnership for U.S. tax purposes. Treatment of Cayman LLC as a partnership was important to avoid the creation of subpart F income on the distribution of earnings from the foreign project entity up through the Cayman holding company structure. If Cayman LLC were treated as a corporation, then distributions of project earnings from Cayman LLC to Cayman Parent

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<sup>1085</sup> Such deferral was not always possible, however, even with respect to active business income generated by a project. For example, certain income generated by the pipeline transportation of natural gas across national borders could be subject to subpart F as "foreign base company oil-related income." Sec. 954(g).

<sup>1086</sup> Treas. Reg. sec. 301.7701-2, as in effect before 1997.

<sup>1087</sup> In some instances there were other advantages to selling an interest in a Cayman holding company rather than an interest in a local project entity, including avoidance of project-country taxes, ownership registration requirements, and other regulatory or contractual restrictions on the transferability of interests under local law.

<sup>1088</sup> Joint Committee staff interviews; Enron Foreign Operations White Paper, June 28, 1996, at EC2 000036159.

generally would have been dividends treated as subpart F income.<sup>1089</sup> Characterizing Cayman LLC as a partnership for U.S. Federal income tax purposes made it possible for Cayman Parent and Cayman Sub to receive distributions from Cayman LLC without generating subpart F income.<sup>1090</sup>

The advent of the “check the box” entity classification regulations made it possible for Enron to plan for sell-downs and to achieve the desired deferral of U.S. taxes without using a “Cayman Triangle,” since these regulations enabled taxpayers to treat eligible single owner entities as disregarded entities, and to elect to treat multi-owner entities as partnerships, without the need to contend with the four-factor test of the old entity classification regulations. Thus, as of 1997, Enron could achieve deferral of U.S. taxes on project earnings through a simpler structure in which Cayman Parent was the sole owner of the interest in Cayman LLC, which in turn held the Enron interest in the project entity. Cayman Sub could be eliminated, and there was no need to include transferability restrictions or dissolution provisions in the project entity’s governing documents. In some cases, it might even have been possible for Cayman LLC to be eliminated, and to have Cayman Parent invest directly in the project entity, but project country tax considerations and regulatory or contractual transferability restrictions generally rendered it desirable to invest in the project entity through at least one project specific Cayman Islands entity underneath Cayman Parent.

### **Formation of project entity structures at early stage of project development**

Another contributor to the proliferation of entities within the Enron ownership structure was the company’s practice of establishing the separate entity structures described above at a very early stage in the evaluation, bidding, and development process. As a result of this practice, even those project opportunities that were abandoned before reaching any significant level of development would contribute a number of new entities to Enron’s overall structure.

The principal reason that Enron established separate offshore entity structures so early in the project development process was a concern that the project opportunity (perhaps reflected in non-binding preliminary agreements, letters of intent, or “memoranda of understanding”) could be found to constitute intangible property for tax purposes. Given this possibility, if preliminary project activities were undertaken directly by a U.S. entity, and then the project were later carried out by a foreign entity, the company was concerned that it might be deemed to have made an outbound transfer of the intangible property. Such a transfer would have been subject to the rules of section 367(d), which treat the transfer as a sale for contingent payments and require the U.S. entity to include in income a stream of payments from the foreign entity “commensurate with the income” generated by the intangible. By establishing a separate offshore entity

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<sup>1089</sup> The “same country dividend” exception of sec. 954(c)(3) requires that the dividend paying controlled foreign corporation be engaged in a trade or business in its country of incorporation, and thus would not have been available in the case of a holding company owning an interest in a project entity in another country.

<sup>1090</sup> The relatively small distributions from Cayman Sub to Cayman Parent, however, generally would generate subpart F income.

structure from the outset of a project, and having the project specific entities execute any preliminary agreements, the company sought to mitigate this risk.<sup>1091</sup>

The company recognized that there was a cost to this practice, in the form of the creation of multiple entities for projects that would never advance beyond the preliminary stages of development. These entities would be costly to establish and maintain, but ultimately would serve little or no purpose. Nevertheless, the company evidently concluded that the expected reduction of the company's exposure to IRS adjustments under section 367(d) outweighed these costs.

### **Retention of dormant entities**

The considerations described above explain why Enron's infrastructure project development business, and the manner in which the company conducted this business, led to the creation of not just a large number of foreign entities, but also inevitably to a large number of foreign entities that would become dormant. Indeed, as noted in Part IV.C.3 above, the vast majority of foreign entities in Enron's corporate structure fit this description. This observation suggests that Enron could have achieved a great deal of simplification of its entity structure by eliminating these dormant entities, but that the company chose instead to maintain them.

According to Enron tax department personnel interviewed by the Joint Committee staff, the tax department consistently objected to the practice of maintaining dormant entities, and on several occasions recommended to Enron's legal and commercial groups that these entities be liquidated. The tax department argued that maintaining the dormant entities generally served little purpose other than to create unnecessary administrative and compliance costs for the company (e.g., annual filings of IRS Form 5471, "Information Return of U.S. Persons with Respect to Certain Foreign Corporations," under section 6038).

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<sup>1091</sup> Enron also proposed legislation to eliminate this potential pitfall, but the company's efforts in this regard were not successful. See Enron "Non-binding Intent Agreements" Policy Memorandum, March 2000, Appendix B, Part XV to this Report.

The following table shows the number of Enron's filings of IRS Form 5471 by year:

**Table 4.—Enron's Information Returns Relating to Controlled Foreign Corporations**

<b>Year</b>	<b>Number of Forms 5471 Filed</b>
1992	84
1993	108
1994	128
1995	211
1996	247
1997	378
1998	491
1999	501
2000	564

In addition to controlled foreign corporations, Enron's ownership of other types of entities (e.g., controlled foreign partnerships)<sup>1092</sup> also entailed U.S. Federal tax information reporting on an annual basis, even if such entities were empty shells. On average, the tax department estimated that the company incurred \$5,000 to \$10,000 of administrative and compliance costs per entity per year.<sup>1093</sup> Given the number of dormant entities within the Enron ownership structure, these arguably unnecessary compliance costs would total several million dollars every year.

Notwithstanding these costs, and the recommendation of the tax department, the company for the most part chose not to unwind its dormant entities. According to the Enron tax department personnel interviewed, if there was even a remote chance that the project for which an entity was created might be revived, the commercial and legal groups preferred that the entity not be liquidated.<sup>1094</sup> This practice seems to have allowed the number of entities within the Enron ownership structure to grow beyond what the tax department viewed as the reasonable needs of the business, with little tax or non-tax effect other than for the company to incur additional compliance costs.

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<sup>1092</sup> See sec. 6038(a), (e)(1), (e)(3).

<sup>1093</sup> See Enron "Non-binding Intent Agreements" Policy Memorandum, March 2000, Appendix B, Part XV to this Report.

<sup>1094</sup> In some cases there may have been a U.S. tax logic to this practice. For example, if the dormant entity had some sort of preliminary agreement relating to the project, then the section 367(d) concerns described above might weigh in favor of leaving that entity and its potential intangible property in place.

## D. Transfer Pricing Issues

### **In general**<sup>1095</sup>

For a multinational enterprise of its size, Enron's activities did not present an unusual level or range of transfer pricing issues. Unlike many other enterprises of its size (e.g., a typical globally integrated manufacturing enterprise), Enron's business generally did not rely on routine related party transactions. The nature of the company's business model thus limited somewhat the potential scope of the company's transfer pricing issues.

### **Performance of services for the benefit of related foreign entities**

One aspect of Enron's business, however, did raise persistent and significant transfer pricing issues. These issues involved the treatment of services performed by Enron for the benefit of related foreign entities in connection with the foreign infrastructure development business.

Enron's foreign infrastructure projects generally were prospected and developed by personnel of Enron Development Corp. and Enron International, companies included in Enron's U.S. Federal consolidated tax return. These personnel identified the project opportunity, performed the financial analysis of the project's feasibility, and negotiated preliminary agreements with the relevant local authorities and other parties, among other development activities.<sup>1096</sup> As described in Part IV.C.4 above, at a very early stage in the project development process, the project typically was handed off to a local project entity that was owned by Enron (often jointly with a third-party co-venturer), with Enron's interest in the project entity typically held under two or more Cayman Islands holding companies. Thus, as of an early stage in the project development process, some portion of the services performed by personnel of Enron Development Corp. and Enron International could be regarded as performed on behalf of the project-specific entities.

Based on Joint Committee staff interviews with Enron and IRS personnel, as well as materials provided by the company, it appears that: (1) the company took the position that it was entitled to take deductions on its U.S. consolidated return for certain salary and other compensation related expenditures that were attributable to services provided by U.S. personnel in support of these foreign projects; and (2) the company did not always receive an adequate fee from either the project entity or the relevant foreign holding companies to reflect the benefit of

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<sup>1095</sup> The discussion in this section of the report is based on information and documents provided by the company and by the IRS, and on interviews with Robert Hermann, James A. Ginty, Cullen A. Duke, Edward R. Coats, Leesa M. White, Stephen H. Douglas, and IRS personnel.

<sup>1096</sup> In the heyday of Enron's foreign infrastructure project development business, these development activities were performed by a team of roughly 30 developers employed by Enron Development Corp. and Enron International, led by Rebecca Mark and Joe Sutton. Joint Committee staff interviews.

the services provided in connection with the foreign projects. In this manner, Enron arguably sought to shift offshore a portion of the income attributable to the services of its U.S. employees.

Enron generally did charge the project specific entities a fee reflecting the cost (with no mark-up) of providing some of these services. Enron did not include all compensation related expenditures relating to project personnel in this charge, however. In particular, the cost of bonuses provided to Enron Development Corp. and Enron International employees was not included in this charge, despite the fact that such bonuses were geared to the anticipated value of particular projects and to the achievement of certain milestones with respect to such projects.<sup>1097</sup> The cost of providing these bonuses was capitalized by Enron when awarded and then deducted on its U.S. Federal consolidated tax return when paid.<sup>1098</sup>

It should be noted that the IRS examination team identified these issues and proposed adjustments in this regard for every taxable year of the company since 1997. Thus, unlike the “structured transactions” discussed in Part I above, the arguably aggressive practices at issue here were readily detectable in the course of a normal audit and did not present the serious problems of tax administration that those transactions did.<sup>1099</sup> It also should be noted that the law in the area of transfer pricing for services and intangible property is unsettled, and that Enron’s treatment of these expenditures, while arguably aggressive, was not entirely lacking support in the law. In this regard, the Treasury Department is currently working on a regulation project in an effort to provide more detailed and appropriate guidance in this area, with proposed regulations anticipated in 2003.<sup>1100</sup>

The current regulations under section 482 generally seek to distinguish between services that provide only incidental, or indirect and remote, benefits to a related party, in which case no arm’s length charge is normally required, and services that provide more meaningful and direct benefits to a related party, in which case an arm’s length charge is required.<sup>1101</sup> Even in the latter case, however, the requirement of an arm’s length charge is generally considered met if the recipient of the services pays the provider’s costs, unless the services constitute an “integral part” of the business of either the provider or the recipient of the services.<sup>1102</sup> Services are regarded as

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<sup>1097</sup> Joint Committee staff interviews. See Part Four, III.B.3, below, for a detailed discussion of the terms of these arrangements, the projects covered, and the compensation related issues that arose in connection with Enron’s tax treatment of the arrangements.

<sup>1098</sup> Joint Committee staff interviews.

<sup>1099</sup> These taxable years and issues were still open as of early 2003. In order to avoid interfering with the IRS examination process, the Joint Committee staff provides only a general discussion of these issues in this Report, and does not reach specific conclusions as to particular projects.

<sup>1100</sup> See, e.g., Bob Ackerman, *et al.*, “Global Transfer Pricing Update,” 29 Tax Notes Int’l 375, Jan. 27, 2003.

<sup>1101</sup> See Treas. Reg. sec. 1.482-2(b).

<sup>1102</sup> *Id.*

“integral” under this test if: (1) either the renderer or the recipient is in the trade or business of rendering the same or similar services to third parties; (2) providing services to related parties is one of the principal activities of the renderer; (3) the renderer is “peculiarly capable” of providing the services, the services are a principal element in the operations of the recipient, and the value of the services is substantially greater than the costs or deductions of the renderer; or (4) the recipient has received the benefit of a substantial amount of services from a related party or parties during the year.<sup>1103</sup>

Enron generally had three main arguments supporting its tax treatment of the services performed by Enron Development Corp. and Enron International personnel. First, depending on the ownership percentages in a project conducted jointly by Enron and a co-venturer, Enron could take the position that the project-specific entities were not under Enron’s “control,” and that the fees reflected actual arm’s length bargaining, rendering section 482 inapplicable.<sup>1104</sup> If that argument failed or could not be made, then Enron could take the position that Enron Development Corp., and later Enron International, was a venture-capital-type operation, and that the services performed by its personnel were in the nature of “stewardship” expenses to protect what was appropriately characterized as an investor’s interest in the foreign projects, rather than expenses incurred on behalf of a particular project entity itself. On this theory, the services performed by Enron Development Corp. and Enron International personnel were performed primarily for the benefit of such companies, and not for the benefit of the project-specific entities. Under this theory, the regulations described above would not apply, and no charge at all would be required, since no substantial services would be regarded as provided for the direct benefit of related entities.<sup>1105</sup> If the services were regarded as performed for the direct benefit of a particular project entity, then Enron still could take the position in some cases that the services provided were not “integral,” and thus that a fee reflecting cost was sufficient.

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<sup>1103</sup> With respect to the second and fourth categories of integrality set forth above (i.e., the “principal activities” and “substantial amount” tests), cost-based safe harbors are available. Under the “principal activities” safe harbor, services generally are not treated as a principal activity of the renderer if the cost of providing such services does not exceed 25 percent of its total costs or deductions for the taxable year. Under the “substantial amount” safe harbor, a recipient of services generally is not treated as receiving a substantial amount of services if the cost of providing such services does not exceed 25 percent of the recipient’s total costs or deductions for the taxable year. Manufacturing, production, extraction, and construction services are not eligible for the “principal activities” cost safe-harbor. Treas. Reg. sec. 1.482-2(b)(7).

<sup>1104</sup> Enron’s contemporaneous transfer pricing documentation for 1995 through 2000, for example, makes this argument with respect to several different projects (EC2 000039103-39623). Of course, it has long been recognized that it is possible for two otherwise unrelated parties to act in concert to shift income to a jointly held entity, and that section 482 allocations may be made in such situations. *See, e.g., B. Forman Co. v. Comm’r*, 453 F.2d 1144 (2d Cir. 1972).

<sup>1105</sup> *See* Treas. Reg. sec. 1.482-2(b)(2)(i), (ii) (providing that no section 482 allocations are required in cases of certain “indirect or remote” benefits or cases in which the service merely duplicates a service that the renderer is performing for itself).

While the matter is not free from doubt, and cannot be conclusively determined without a detailed analysis of each individual project, on balance it appears that certain project-specific entities related to Enron for purposes of section 482 derived substantial and direct benefits from services provided by Enron Development Corp. and Enron International personnel. Thus, Enron Development Corp. and Enron International probably were required under section 482 to include in income a fee at least reflecting the full cost of providing such services. It also appears likely that in many cases the services provided by Enron Development Corp. and Enron International personnel were “integral” within the meaning of the applicable regulations,<sup>1106</sup> thus requiring an arm’s length charge reflecting the value of such services.

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<sup>1106</sup> Treas. Reg. sec. 1.482-2(b)(7). Enron’s contemporaneous transfer pricing documentation for 1995 through 2000 conceded the “integrality” of the services in many instances, while taking the position that section 482 did not apply due to lack of common control (EC2 000039103-39623).



### **E. Recommendation: Information Reporting with Respect to Disregarded Entities**

Present law requires no ongoing information reporting with respect to entities that are disregarded pursuant to a “check the box” election.<sup>1107</sup> 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. As a result, the IRS encounters considerable difficulty in keeping track of the various foreign entities in a company’s structure and monitoring how these entities are being used in transactions. In Enron’s case, the company filed 103 “check the box” elections in 1997, 191 in 1998, 151 in 1999, and 97 in 2000.<sup>1108</sup> After the year in which these elections were filed, the IRS would encounter great difficulty in monitoring how these entities were being used transactionally.

On the one hand, this lack of separate information reporting may be seen as appropriate, given that the entities are supposed to be “disregarded” for Federal tax purposes pursuant to the election. Nevertheless, it is also widely recognized that the application of the “check the box” regulations in the international setting has raised a number of issues that the IRS has an interest in monitoring. One example is the range of issues relating to the use of “hybrid entities” (foreign entities that are disregarded for U.S. Federal tax purposes but treated as separate taxable entities under foreign law).<sup>1109</sup> In addition, the IRS recently has focused some attention on the so-called “check and sell” practice, in which a “check the box” election is filed with respect to a lower-tier controlled foreign corporation in order to avoid the creation of subpart F income in connection with the sale of the stock of such corporation by a higher-tier controlled foreign corporation. The “check the box” election in these cases may convert what would have been a sale of stock (which generally creates subpart F income) into a sale of operating assets (which generally does not create subpart F income).<sup>1110</sup> Proposed regulations have been issued to restrict this practice, and the IRS appears to have been actively auditing the issue in the field.<sup>1111</sup> The existence of these and other issues relating to the use of “check the box” entities suggests that, although such entities are generally disregarded in terms of tax treatment, the IRS has an interest in monitoring their use.

The Joint Committee staff believes that a regime of annual information reporting with respect to entities disregarded pursuant to “check the box” elections would 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. The information to be reported could be similar to that required to be provided on Form 5471 with respect to controlled

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<sup>1107</sup> Treas. Reg. sec. 301.7701-1, *et seq.*

<sup>1108</sup> IRS Forms 8832 filed by Enron.

<sup>1109</sup> *See, e.g.*, Notice 98-11, 1998-6 I.R.B. 18; Notice 98-35, 1998-27 I.R.B. 35.

<sup>1110</sup> *See* sec. 954(c)(1)(B).

<sup>1111</sup> *See, e.g.*, Prop. Reg. sec. 301.7701-3(h) (Nov. 29, 1999); CCA 199937038; FSA 200046008; FSA 200049002.

foreign corporations, and thus could include income-statement and balance-sheet information, as well as such other information as the Secretary of the Treasury may require. The statement also should include information about the entity's classification and tax treatment under the law of its country of organization.

## V. OFF-BALANCE SHEET TRANSACTIONS

### A. Overview

#### 1. Introduction to off-balance sheet transactions

Enron engaged in certain off-balance sheet partnership arrangements that were motivated by financial reporting objectives rather than by tax benefits. Three of these arrangements included Chewco Investments, LP (“Chewco”), LJM Cayman, LP (“LJM1”), and LJM2 Co-Investment, LP (“LJM2”). Enron did not own equity interests in Chewco or in the LJM partnerships. Ownership of those entities was held by certain Enron employees and, in the case of the LJM partnerships, outside parties.<sup>1112</sup> Enron employees, however, controlled Chewco and the LJM partnerships. In the cases of Chewco and LJM2, Enron owned interests in joint ventures in which Chewco and LJM2 participated. Further, in the case of LJM2, Enron entered into transactions using disregarded entities owned by Enron.<sup>1113</sup>

The participation of Enron and Enron employees in these off-balance structures raised issues regarding the appropriate accounting treatment of Chewco, the LJM partnerships, and their affiliates, and of Enron’s transactions with those entities.<sup>1114</sup> These arrangements also provided significant financial benefits to certain Enron employees.<sup>1115</sup> Certain of the corporate

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<sup>1112</sup> In this sense, Enron used employees as accommodation parties in order for Enron to attain its financial statement objectives.

<sup>1113</sup> See Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, at 40 (June 7, 2002).

<sup>1114</sup> Enron’s accounting treatment with respect to the Chewco, LJM1, and LJM2 arrangements was determined with significant assistance from its outside auditor, Arthur Andersen. On January 21, 2003, the Financial Accounting Standards Board (“FASB”) issued guidance on special purpose entities and other types of “variable interest entities” which provides new accounting rules for off-balance sheet structures such as Chewco, LJM1, and LJM2, and nullifies certain accounting guidelines, including Emerging Issues Task Force Notice 90-15, that had served as the basis for the special purpose entity accounting treatment adopted by Enron with respect to these off-balance sheet partnerships. See FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an interpretation of ARB No. 51 (January 2003), generally effective after January 31, 2003.

<sup>1115</sup> For example, Enron reported to the Securities and Exchange Commission that it believed that Andrew S. Fastow earned in excess of \$30 million relating to his LJM management and investment activities. Enron Corp., Form 10-Q filed with the Securities and Exchange Commission (November 19, 2001), at 19. Michael J. Kopper reportedly received at least \$10 million from these arrangements. Powers Report at 3.

governance and management oversight issues relating to these transactions were discussed in the Powers Report and examined by other investigative bodies.<sup>1116</sup>

The Chewco, LJM1, and LJM2 structures were off-balance sheet arrangements involving ownership by Enron employees and outside parties and were not part of Enron's consolidated Federal income tax returns. For this reason, as well as the various ongoing law enforcement investigations into these structures, the Joint Committee staff was unable to investigate this area in detail. Accordingly, the following description, which relies heavily on the Powers Report, is necessarily incomplete.

## **2. Description of Chewco and JEDI I structure and transactions**

### JEDI I

Enron and the California Public Employees Retirement System ("CalPERS") formed JEDI I in 1993. JEDI I was not included in Enron's consolidated balance sheet for financial accounting purposes.

JEDI I's partnership agreement stated its purpose was to acquire, own, hold, make, participate in, exercise rights with respect to, and dispose of qualified investments, dispose of Enron stock and put options, and engage in any such other business purpose to accomplish the foregoing purposes.<sup>1117</sup> JEDI I's consolidated financial statements described its purpose as investing in and managing certain natural gas and energy related assets.<sup>1118</sup> At the end of 1996, JEDI I held interests in eight separate limited partnerships formed to acquire and develop oil and gas properties.<sup>1119</sup> JEDI I had contributed approximately \$57.4 million to these eight partnerships and was committed to contributing an additional \$32.2 million.<sup>1120</sup> JEDI I also held 12 million shares of Enron stock.<sup>1121</sup> As of September 30, 1997, JEDI's portfolio characteristics comprised the following based on total portfolio values: private equity: 41 percent; public equity:

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<sup>1116</sup> Powers Report at 148-200. *E.g.*, Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate, *The Role of the Board of Directors in Enron's Collapse*, Report 107-70, at 77 (July 8, 2002).

<sup>1117</sup> Amended and Restated Partnership Agreement of JEDI. E48090.

<sup>1118</sup> *See* JEDI: limited partnership and subsidiaries- Consolidated Financial Statements as of December 31, 1996, together with Auditor's Report. E48322.

<sup>1119</sup> *See Id.*

<sup>1120</sup> *See Id.*

<sup>1121</sup> Powers Report at 59.

18 percent; Enron stock and put options: 26 percent; working interests: 2 percent; subordinated debt: 6 percent; partnerships: 4 percent; and loans: 4 percent.<sup>1122</sup>

### Chewco

In 1997, Enron and CalPERS agreed to redeem CalPERS' interest in JEDI I. Because JEDI I had only two partners, a redemption of CalPERS' interest, without a substitute partner to replace CalPERS, would cause JEDI I to cease to be a partnership for State law purposes, and cause JEDI I to be consolidated with Enron in its financial statements. Enron employees formed Chewco to acquire and own the JEDI I investment previously held by CalPERS.<sup>1123</sup> CalPERS' 50 percent interest in JEDI I was redeemed in November 1997 and Chewco became JEDI I's limited partner. Chewco was structured as an unconsolidated special purpose entity to achieve off-balance sheet treatment with respect to Enron, and to preserve off-balance sheet treatment with respect to Enron's continued ownership in JEDI I.<sup>1124</sup>

As of its date of formation, Chewco had no equity. The parties put together the Chewco structure on short notice and arranged \$383 million of bridge financing provided equally by Barclays Bank PLC ("Barclays") and Chase Manhattan Bank, and guaranteed by Enron, so Chewco could acquire CalPERS' interest in JEDI I.<sup>1125</sup> In November 1997, JEDI made a liquidating distribution to CalPERS of \$383 million.<sup>1126</sup> Concurrently, Chewco purchased a

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<sup>1122</sup> JEDI, Quarterly Reporting Package to Pacific Corporate Advisors, Inc. (September 20, 1997). E73563.

<sup>1123</sup> Initially, Mr. Fastow intended to participate as an owner of Chewco. Mr. Fastow was advised by Vinson & Elkins that his participation in Chewco would require a proxy statement disclosure and approval from the Chairman and Chief Executive Officer under Enron's Code of Conduct of Business Affairs. Mr. Fastow arranged to have Mr. Kopper, an Enron Global Finance employee, become the owner and manager of Chewco. Although Mr. Kopper's participation would require approval under Enron's Code of Conduct of Business Affairs, Mr. Kopper was not a senior officer of Enron, and would not be subject to the proxy statement disclosure requirement.

<sup>1124</sup> Chewco was described as perhaps the first instance where "Enron's Finance Group (under Mr. Fastow) used a special purpose entity managed by an Enron employee to keep a significant investment partnership outside of Enron's consolidated financial statements." See Powers Report at 41. Enron had previously used off-balance sheet entities prior to the formation of Chewco, including JEDI I, to hold business investments, but the implication is that its prior arrangements involved investors and managers that were unaffiliated with Enron and with Enron's employees.

<sup>1125</sup> This reportedly was required to satisfy a closing deadline imposed by CalPERS. Criminal Complaint, *United States of America v. Andrew S. Fastow*, U.S. District Court, Southern District of Texas (Case No. H-02-8889-M), at 11.

<sup>1126</sup> Enron Corp., Form 8-K, filed with the Securities and Exchange Commission (November 8, 2001), at 18.

limited partner interest in JEDI I for \$383 million.<sup>1127</sup> In November or December 1997, a longer term capital structure was created whereby three financing transactions took place: (1) a \$240 million unsecured subordinated loan to Chewco was made by Barclays and guaranteed by Enron; (2) a \$132 million advance from JEDI I to Chewco was made under a revolving credit agreement; and (3) \$11.5 million in equity (representing 3 percent of Chewco's \$383 million of assets) was provided by Chewco's general and limited partners.<sup>1128</sup> The sum of these amounts (i.e., \$240 million, \$132 million, and \$11.5 million) equaled the \$383 million CalPERS redemption price.

Mr. Kopper invested \$115,000 in Chewco's general partner, and \$10,000 in its limited partner. Mr. Kopper later transferred his limited partnership interest in Chewco to his acquaintance, Mr. Dodson. Barclays Bank provided "equity loans" in the amount of \$11.4 million to Big River Funding, LLC ("Big River"), Chewco's sole limited partner, and to Little River Funding LLC ("Little River"), Big River's sole member. Barclays Bank characterized the advances as loans for business and regulatory purposes. Enron and Chewco characterized them as equity contributions for accounting purposes. In order to secure its repayment right, Barclays Bank required Big River and Little River to establish a cash reserve account funded with \$6.6 million in cash at closing. The reserve account also had to be fully pledged to secure payment of the \$11.4 million advance. JEDI I made a special \$16.6 million distribution to Chewco, a portion of which was used to fund the reserve account.

Following Chewco's replacement of CalPERS as the limited partner of JEDI I, Enron continued to treat JEDI I as an unconsolidated affiliate for financial statement purposes, and engaged in a variety of transactions with Chewco and JEDI I designed to enable Enron to accelerate revenue for financial statement purposes. For Federal income tax purposes, Enron reported its pro rata share of income and losses.<sup>1129</sup>

### **Specific transactions between Enron and Chewco or JEDI I**

#### Overview

Without a substantial outside investor in JEDI I such as CalPERS, Enron was able to enter into transactions with JEDI I and Chewco without having to obtain the consent of an unrelated third party. Enron repeatedly used Chewco and JEDI I to generate or accelerate financial reporting revenues through the use of loan guaranty fees, required payment management fees, and the reporting of appreciation of value in Enron stock held by JEDI I.<sup>1130</sup>

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<sup>1127</sup> *Id.*

<sup>1128</sup> Powers Report at 49; *see also* Enron Corp., Form 8-K, filed with the Securities and Exchange Commission (November 8, 2001), at 18.

<sup>1129</sup> *See* Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, at 40 (June 7, 2002).

<sup>1130</sup> Powers Report at 56-60.

### Enron's loan guaranty fee

Chewco had agreed to pay Enron a guaranty fee of \$10 million in cash at closing, plus an additional 315 basis points annually on the average outstanding balance of the \$240 million Barclays Bank loan provided to Chewco. In the 12 months that the Barclays Bank loan was outstanding, Chewco paid \$17.4 million to Enron. Enron characterized these payments as structuring fees for financial statement purposes and reported income from the \$10 million up-front guaranty fee in December 1997, rather than ratably over the 12-month term of the loan.<sup>1131</sup>

### Enron's management fee

The December 1997 JEDI I amended partnership agreement provided that JEDI I would pay Enron an annual management fee equal to the greater of 2.5 percent of \$383 million (less any distributions received by Chewco) or \$2 million. The management services relating to the management fees would cover a five-year period, 1998 through 2003. In March 1998, Enron and Chewco amended the partnership agreement to convert 80 percent of the annual management fee to a "required payment" payable to Enron, and took the position for accounting purposes that Enron was entitled to recognize the entire "required payment" as revenue immediately.<sup>1132</sup> Consistent with this position, Enron immediately recognized, in its first quarter 1998 income, \$25.7 million with respect to the required payment portion of the management fee.<sup>1133</sup>

### Appreciation in Enron shares held by JEDI I

JEDI I held 12 million shares of Enron stock in its portfolio. JEDI I carried its assets at fair value, and Enron reported its investment in JEDI I under the equity method of accounting. Enron reported as income Enron's share of the increase in value of Enron stock held by JEDI I. Enron reported \$126 million of income in Enron stock appreciation for shares held by JEDI I in the first quarter of 2000 alone.<sup>1134</sup> Enron's independent auditor informed Enron at some point during 2000 that Enron could no longer include in its financial statements its share of JEDI I's gain attributable to Enron stock. When Enron's stock declined in value during the first quarter of 2001, JEDI I's value of Enron shares declined by \$94 million. Enron did not report its approximate \$90 million share of this loss.<sup>1135</sup> This treatment had the effect of increasing Enron's earnings by \$126 million in the first quarter of 2000 (when Enron's stock increased in value) without Enron reporting a loss when the value of the shares held by JEDI I declined in 2001.

### Tax indemnity payment paid by Enron

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<sup>1131</sup> *Id.* at 56-57.

<sup>1132</sup> *Id.* at 57-58.

<sup>1133</sup> *Id.* at 58.

<sup>1134</sup> *Id.* at 59.

<sup>1135</sup> *Id.*

In 1997, when Chewco purchased the JEDI I limited partnership interest, Enron and Chewco executed a tax indemnity agreement. This agreement reportedly compensated Chewco for the difference between Chewco's current tax obligations and its cash receipts during the term of the partnership. The tax indemnity agreement required Enron to make payments to Chewco for current tax obligations and cash receipts.<sup>1136</sup> In September 2001, Enron paid Chewco \$2.6 million in connection with the March 2001 buyout of Chewco.<sup>1137</sup>

#### Other Chewco fees and payments

In December 1998, Chewco received a \$400,000 payment from Enron in what has been described as a "restructuring," "amendment," or "nuisance" fee.<sup>1138</sup>

#### Subsequent developments and buyout agreement

In March 2001, Enron repurchased Chewco's limited partnership interest in JEDI I for \$35 million and consolidated JEDI I into its consolidated financial statements for the first quarter 2001.<sup>1139</sup> The buyout contract price of \$35 million was calculated by taking into account the following: (1) a \$3 million cash payment that had been agreed to in the year 2000; (2) \$5.7 million to cover the remaining required payments portion of the management fee due to Enron under the JEDI I partnership agreement (Enron reduced the \$35 million purchase payment by this amount); and (3) \$26.3 million to satisfy Chewco's outstanding \$41.3 million obligation under the revolving credit agreement with JEDI I.<sup>1140</sup>

#### Accounting adjustments due to the unwind of Chewco

Enron and its independent auditor concluded in late 2001 that Chewco and JEDI I did not satisfy the non-consolidated special purpose entity accounting rules prior to Enron's buyout of Chewco and related consolidation of JEDI I in early 2001. In November 2001, Enron announced that it would consolidate Chewco and JEDI I retroactive to 1997. The retroactive consolidation reduced Enron's reported net income by \$28 million (out of \$105 million total) in 1997, by \$133

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<sup>1136</sup> *Id.* at 64-65.

<sup>1137</sup> *Id.* There apparently was a dispute between Enron and Chewco regarding whether the \$2.6 million payment was required under the original tax indemnity agreement.

<sup>1138</sup> *Id.* at 55.

<sup>1139</sup> Enron Corp., Form 8-K, filed with the Securities and Exchange Commission (November 8, 2001), at 4, 19. JEDI I remained a wholly owned subsidiary of Enron. *Id.* at 19.

<sup>1140</sup> Powers Report at 62-63. Chewco was not required to pay off the entire \$41.3 million obligation, and instead paid \$26.3 million, with the remaining \$15 million converted to a term loan due in January 2003.



million (out of \$703 million total) in 1998, by \$153 million (out of \$893 million total) in 1999, and by \$91 million (out of \$979 million total) in 2000.<sup>1141</sup>

### **3. Description of LJM1 structure and transactions**

LJM1 was formed as LJM Cayman, LP, a limited partnership registered in the Cayman Islands. Its initial partners consisted of LJM Partners, LP, the general partner, and ERNB Partnership, Limited (“ERNB”) and Campsie Limited (“Campsie”), as limited partners. LJM Partners, LP was owned by Mr. Fastow and LJM Partners LLC, whose sole member was Mr. Fastow. ERNB and Campsie were entities controlled by Credit Suisse First Boston and National Westminster Bank, respectively, two banks with which Enron had banking relationships. Mr. Fastow controlled LJM1 through his control of the management duties possessed by the general partner. Enron did not own an interest in LJM1.<sup>1142</sup>

LJM1 was formed to provide Enron an accounting hedge against the decline in value of Rhythms Net stock. Enron purchased a put option provided by an LJM1 subsidiary that was designed to protect Enron against accounting risks relating to potential declines in value of the Rhythms Net shares. LJM1 also engaged in the purchase from Enron of a portion of Enron’s interest in the Cuiaba, Brazil pipeline assets.

#### **Overview of hedging transactions**

The LJM partnerships engaged in transactions that involved the use of hedging. The definition of a hedging transaction varies widely depending upon the purpose for which the term is used. For example, a hedging transaction for Federal income tax purposes is defined as any transaction that is entered into in the normal course of a trade or business that is properly identified as managing the risk of price changes, currency fluctuations, interest rate changes, or any other risk prescribed in regulations with respect to ordinary property or borrowings.<sup>1143</sup> By contrast, a hedging transaction for financial accounting purposes is defined as a derivative that is designated as a hedge, but only to the extent that the changes in the value of the derivative are effective in offsetting changes in the fair value or cash flow of an exposure or changes in the value of net investment in a foreign operation.<sup>1144</sup> Hedging transactions typically involve contractual arrangements with a creditworthy third party who has the financial wherewithal to honor its obligations to the hedging party. Hedges may be effected through a variety of

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<sup>1141</sup> Enron Corp., Form 10-Q, filed with the Securities and Exchange Commission (November 19, 2001), at 16. Enron’s reported debt also increased by \$711 million in 1997, by \$561 million in 1998, by \$685 million in 1999, and by \$628 million in 2000, reflecting both JEDI I’s and Chewco’s borrowings. *Id.*

<sup>1142</sup> The interests of ERNB and Campsie were subsequently purchased by Mr. Fastow and others in early 2000 through a partnership, Southampton, LP. Powers Report at 92-94. Criminal Complaint, *United States of America. v. Andrew S. Fastow*, at 31-32.

<sup>1143</sup> Sec. 1221(b)(2).

<sup>1144</sup> See Financial Accounting Standards Board Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

mechanisms, including the use of forward contracts, put and call options, short sales, and notional principal contracts such as swaps, caps, and floors.

In the LJM context, Enron was concerned with protecting itself against declines in the market value of certain of its portfolio investments in publicly traded stock. The LJM hedges were structured to protect Enron against financial accounting risks due to the volatility in value of equity positions Enron held in such investments.<sup>1145</sup> Although Enron retained the underlying investment, it would offset losses attributable to a decline in value of the underlying investment with the offsetting gain on the hedging position that Enron held with respect to that investment. Enron did not have to report losses attributable to the special purpose entity's exposure under the hedge as long as the special purpose entity could be treated as unconsolidated and had assets at least equal to its liabilities.

Enron provided the LJM special purpose entities those assets that were to be used to honor their contractual obligations to Enron in the event the hedged investments declined in value. In most of the LJM hedging transactions, Enron's hedge protection against the decline in value of its investment assets consisted of Enron stock or stock rights.

#### Rhythms Net hedge

In 1998, Enron acquired 5.4 million shares of Rhythms Net stock for \$10 million.<sup>1146</sup> The value of the Rhythms Net shares increased to over \$300 million during 1999, and Enron reported the appreciation as income for financial statement purposes under the mark-to-market method of accounting.<sup>1147</sup> Enron was concerned that the value of the Rhythms Net shares would decline and require Enron to report investment losses relating to the shares in such case. In 1999, Enron implemented a purported hedging transaction with LJM1 and an LJM1 subsidiary to address its accounting exposure concerns relating to the Rhythms Net stock.

To effect the hedge, Enron purchased a put option provided by an LJM1 subsidiary, LJM 1 Swap Sub, LP ("Swap Sub"), valued by the parties at \$104 million.<sup>1148</sup> The put option obligated Swap Sub to purchase the 5.4 million Rhythms Net shares owned by Enron for a purchase price of \$56 per share.<sup>1149</sup> In exchange for the put option and LJM1's promissory note

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<sup>1145</sup> See Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation at 39-40 (June 7, 2002). See also, Interoffice Memorandum dated April 19, 2000, from AnnMarie Tiller and Brent Vasconcellos to R. Davis Maxey ("The commercial purpose for the [Talon] transaction is to create a risk management program *to hedge from a financial accounting perspective the volatility in value of equity positions* Enron or its affiliates are expected to hold in various companies, both public and private, many or most of which are expected to be in the telecommunications and/or broadband communications areas.") (italics added). EC 000850875.

<sup>1146</sup> Powers Report at 77.

<sup>1147</sup> *Id.*

<sup>1148</sup> *Id.* at 81.

<sup>1149</sup> *Id.*

in the amount of \$64 million, Enron transferred 3.4 million shares of its own stock to LJM1 to be used by LJM1 as credit support to honor any obligation LJM1 might incur under the hedge. The Enron shares had an unrestricted value at the time of the transfer of \$276 million, but the parties discounted their value to \$168 million because Enron prohibited LJM1 from selling the shares for four years.<sup>1150</sup> Thus, the parties treated the transactions as Enron providing \$168 million of Enron stock to LJM1 in exchange for a put option valued at \$104 million and a \$64 million note.

Enron agreed in the first quarter of 2000 to provide LJM1 a put option that gave LJM1 the right to sell Enron shares to Enron at a price of \$71.31 per share.<sup>1151</sup> In March 2000, Enron and LJM1 agreed to terminate the Rhythms Net hedge and related financial instruments. Pursuant to that agreement, Enron received the shares of Enron stock held by Swap Sub and paid LJM1 approximately \$26.8 million.<sup>1152</sup> Enron treated the settlement of the put options as a realization event both for financial reporting and Federal income tax purposes.<sup>1153</sup>

### **Sale of Cuiaba assets**

In September 1999, Enron transferred to LJM1 a 13 percent equity interest in a company owning a power project in Brazil for \$10.8 million.<sup>1154</sup> This enabled Enron to take the position that it could recognize financial statement revenues of \$65 million, \$14 million, and \$5 million from a commodity contract with the company owning the power project in 1999, 2000, and 2001, respectively.<sup>1155</sup> Enron paid LJM1 a marketing fee of \$240,000 in May 2000.<sup>1156</sup> Enron

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<sup>1150</sup> *Id.* at 79-82. LJM1 was not prohibited from pledging the Enron shares as collateral for a loan, however, which meant that LJM1 and Swap Sub could use the shares to obtain a loan to generate cash proceeds to honor the put obligation to Enron should Enron exercise the hedge. Powers Report at 80.

<sup>1151</sup> Enron Corp., Form 10-Q, filed with the Securities and Exchange Commission (November 19, 2001), at 17.

<sup>1152</sup> *Id.*

<sup>1153</sup> *See* Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, at 39-40 (June 7, 2002). Enron reported gain for book and tax purposes on the settlement of the put option of \$104 million, and did not make a tax reporting change following the Form 8-K restatement that occurred in November 2001. *Id.*

<sup>1154</sup> Enron Corp., Form 10-Q, filed with the Securities and Exchange Commission (November 19, 2001), at 23. LJM1 also paid \$500,000 to acquire redeemable preference shares in a related company. *Id.*

<sup>1155</sup> *Id.*

<sup>1156</sup> *Id.*

repurchased LJM1's interest in the Cuiaba assets and the preference shares for \$14.4 million in 2001.<sup>1157</sup>

#### **4. Description of LJM2 structure and transactions**

In October 1999, Messrs. Fastow and Kopper formed LJM2 as a Delaware limited partnership. Enron described LJM2 as “a private investment company that primarily engages in acquiring or investing in energy and communications-related investments, primarily involving either assets Enron had decided to sell or risk management activities intended to limit Enron's exposure to price and value fluctuations with respect to various assets.”<sup>1158</sup> LJM2 participated in various transactions pursuant to which it acquired from Enron or an Enron affiliate various assets, securities or other ownership interests involving Enron's energy or communications businesses.<sup>1159</sup> LJM2 is perhaps best known, however, for its four separate Raptors projects, which were variations of hedging transactions that are described below.

LJM2 was controlled by Messrs. Fastow and Kopper through their ownership and control of LJM2 Capital Management LP, the general partner of LJM2.<sup>1160</sup> The limited partners of LJM2 were approximately fifty investors who made their investments pursuant to a private placement.<sup>1161</sup>

#### **Specific transactions between Enron and LJM2 or affiliated entities**

##### The Raptors transactions

The LJM2 transactions that had the greatest impact on Enron's financial statements involved the hedging structures known as the “Raptors.” The Raptors structures allowed Enron to avoid reflecting almost \$1 billion of losses on merchant investments during their existence,

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<sup>1157</sup> *Id.*

<sup>1158</sup> Enron Corp., Form 14 Proxy, filed with the Securities and Exchange Commission (March 2, 2001), at 29.

<sup>1159</sup> *Id.* Enron's asset sales to LJM2 included (1) a 75 percent equity interest in a power project in Poland; (2) ownership rights to certain natural gas reserves; (3) an equity investment in a Nigerian barge company; (4) dark fiber optic cable; and (5) a contractual right to acquire a gas turbine. Enron Corp., Form 10-Q, filed with the Securities and Exchange Commission (November 19, 2001), at 23-24.

<sup>1160</sup> The general partner of LJM2 Capital Management LP was a limited liability company, LJM2 Capital Management LLC, of which Mr. Fastow was the sole member and Mr. Kopper was an authorized signatory. The limited partners were Mr. Fastow and a Mr. Kopper-controlled limited liability company (Big Doe LLC).

<sup>1161</sup> Hearings Before the Permanent Subcommittee of Investigations of the Committee on Governmental Affairs, United States Senate, 107<sup>th</sup> Cong. (July 23 and 30, 2002), *The Role of the Financial Institutions in Enron's Collapse* - Volume 2, at 2241, 2291.

including \$501 million in 2000 and \$453 million for 2001.<sup>1162</sup> In the last two quarters of 2000, Enron recognized revenues of \$500 million on derivative transactions with Raptor entities, which offset losses in Enron's merchant investments, and recognized pre-tax earnings of \$532 million (including net interest income).<sup>1163</sup> Enron reported that the combined notional principal amount of the derivatives transactions entered into between Enron and LJM2 was approximately \$2.1 billion.<sup>1164</sup>

The Raptors were four separate and complex transactions that began in mid-2000 and ended in 2001. The first, Raptor I, involved the use of Enron Corp. stock and stock rights to hedge against the potential decline in value of certain Enron investments, including Internet company stocks. The second and fourth, Raptors II and IV, involved using Enron stock and stock rights to hedge other Enron investments. Raptor III involved a hedge relating to Enron's investment in New Power Holdings, Inc. ("NPW"), and differed from the other Raptors structures because it used NPW stock rather than Enron stock to effect the purported hedge.

Each of the Raptor structures involved a special purpose entity formed by an Enron wholly-owned limited liability company and LJM2. The Raptors structures were designed to permit Enron to (1) exclude LJM2 from both its consolidated financial statement balance sheet and consolidated Federal tax return; and (2) exclude the special purpose entity from Enron's consolidated financial statement balance sheet, but include the special purpose entity in Enron's consolidated Federal tax return.

#### Raptor I (Talon)

Raptor I was formed in April 2000 and used a special purpose entity named Talon I, LLC ("Talon"). Talon was created for the purpose of engaging in hedging transactions with Enron. Its investors were LJM2, through its affiliate LJM2-Talon, LLC, and Harrier I, LLC ("Harrier"), a wholly owned special purpose entity of Enron Corp. formed to participate in Raptor I. Talon's assets consisted of cash, a promissory note, and Enron stock and stock contracts. LJM2 invested \$30 million cash, and Harrier invested a \$50 million promissory note and Enron stock and stock contracts valued by the parties at approximately \$537 million. Talon was prohibited from selling, pledging or hedging the Enron stock for three years, and the parties discounted the Enron stock by 35 percent from its unrestricted fair market value. Harrier received a membership interest and a \$400 million revolving promissory note from Talon in exchange for the invested assets. LJM2 was the party responsible for managing Talon.

Under Talon's limited liability company agreement, both LJM2 and Harrier held membership interests in Talon for State law purposes. The parties treated LJM2 as an equity owner of Talon for financial accounting purposes but not for Federal income tax purposes. An

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<sup>1162</sup> Enron Corp., Form 10-Q, filed with the Securities and Exchange Commission (November 19, 2001), at 20-21.

<sup>1163</sup> See Powers Report at 14.

<sup>1164</sup> Enron Corp., Form 14 Proxy, filed with the Securities and Exchange Commission (March 2, 2001), at 30.

internal memorandum dated April 19, 2000, states that Enron treated LJM2's investment as debt, and Talon as a single member LLC which Enron regarded as its owner for Federal income tax purposes.<sup>1165</sup> The memorandum further stated that "[n]otwithstanding the legal form or title given to the interest LJM2 holds in Talon (which as described above was necessary solely for financial accounting purposes), Talon's [l]oan to LJM2 has all the important indicia of debt."<sup>1166</sup> As indicated above, the structure was designed to permit Enron to: (1) exclude LJM2 from both its consolidated financial statement balance sheet and consolidated tax return; and (2) exclude Talon from its consolidated financial statement balance sheet, but include Talon in Enron's consolidated Federal tax returns.

LJM2's economic rights differed from those of Harrier with respect to their Talon interests. The parties agreed that Talon would not engage in hedging transactions until it had distributed a minimum return from the income of Talon to LJM2, equal to the greater of \$41 million or a 30 percent annualized return. By treating the minimum return as from Talon's income, rather than from Talon's capital, the parties determined they could treat the \$30 million invested by LJM2 as capital for the 3 percent equity test applicable to related special purpose entities.<sup>1167</sup> After the minimum return was provided to LJM2, Harrier was entitled to all of any further distributions of Talon's income. Thus, for financial accounting purposes LJM2 was treated as an equity investor in Talon, though for Federal income tax purposes it was treated as the holder of a debt instrument issued by Talon (i.e., Talon's obligation to pay LJM2 the greater of \$41 million or a 30 percent annualized return before any distribution could be made to Harrier).

Talon and Enron entered into numerous swaps pursuant to which Talon purportedly benefited from the upside, and was at risk for the downside, with respect to the underlying Enron investments. One such investment was stock in Avici Systems, Inc. ("Avici"), a public company in which Enron held a large stake.<sup>1168</sup> For financial statement purposes, Enron had accounted for its ownership of the Avici shares under the mark-to-market method, which meant that Enron

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<sup>1165</sup> Interoffice Memorandum from AnnMarie Tiller and Brent Vasconcellos to R. Davis Maxey (April 19, 2000) ("[i]n order for Talon to be viewed as an independent entity for financial accounting purposes, the \$30 [million] that LJM2 transfers to Talon will be exchanged for what will legally be called a member interest in Talon."). EC 000850876. *See* Interoffice Memorandum from AnnMarie Tiller and Brent Vasconcellos to Ben Glisan (August 19, 2000) ("[o]ur earlier conclusion that we could treat LJM2's original investment in Talon as debt solely for tax purposes was in large measure based on Talon's capitalization or wherewithal to pay some few months after the closing.") EC 000850968.

<sup>1166</sup> *Id.* at EC 000850877.

<sup>1167</sup> This meant that Talon could be viewed, for financial accounting purposes, as off-balance sheet with respect to Enron, because LJM2 (a non-Enron entity) had provided outside equity of at least 3 percent of Talon's total assets.

<sup>1168</sup> Avici is a provider of carrier-class routing solutions for the Internet. Avici Systems Inc., Press Release dated December 11, 2002.

booked gain or loss on the 1.09 million shares<sup>1169</sup> of Avici stock it owned as Avici's stock price increased or decreased. Enron and Talon entered into a swap arrangement regarding the 1.09 million Avici shares effective as of August 3, 2000, the date on which Avici shares traded at its all-time high stock price (\$163.50 per share). Under the swap arrangement, Enron retained outright ownership of the Avici shares, but shifted to Talon the upside and downside with respect to the Avici stock. Enron accounted for Talon on a cost basis, which meant Enron did not have to book any losses Talon realized on its swap position with respect to the Avici shares.<sup>1170</sup>

#### Raptor II (Timberwolf)

Raptor II was created in June 2000 through the formation of Timberwolf I, LLC, a Delaware limited liability company. Timberwolf's members were LJM2-Timberwolf, LLC, an LJM2 affiliate, and Grizzly I, LLC, a wholly-owned subsidiary of Enron Corp.<sup>1171</sup> The Raptor II hedging structure was similar to that of Raptor I, with Enron paying the special purpose entity \$41 million to acquire a hedge against its investments, including certain assets in South America. Enron capitalized Timberwolf by contributing a restricted contingent forward contract for 7.8 million shares of Enron stock and a \$50 million note payable.<sup>1172</sup>

#### Raptor III (Porcupine)

Raptor III was formed on September 27, 2000, to enter into hedging transactions with Enron with respect to NPW, a power delivery company created by Enron and in which Enron held a 75 percent ownership interest.<sup>1173</sup> Raptor III differed from the other Raptors in two respects: (1) it was formed to hedge a single Enron investment, NPW, rather than multiple Enron investments; and (2) it held the stock of NPW, the company whose stock it was intended to hedge, rather than Enron stock, for its credit support. Enron reportedly did not use its own stock to serve as the hedge because it did not have sufficient shares available to transfer to the structure without obtaining Board approval to issue additional common stock.<sup>1174</sup>

Raptor III was conducted through a special purpose entity, Porcupine I, LLC ("Porcupine"). Porcupine was a two-member limited liability company, with LJM2 holding one membership interest, through its affiliate LJM2-Porcupine, LLC, and Enron's wholly-owned

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<sup>1169</sup> Criminal Complaint, *United States v. Andrew S. Fastow*, at 27.

<sup>1170</sup> Interoffice Memorandum from AnnMarie Tiller and Brent Vasconcellos to R. Davis Maxey (April 19, 2000). EC 000850875.

<sup>1171</sup> Notes to Financial Statements, Timberwolf I, LLC, December 31, 2000. E100025.

<sup>1172</sup> *Id.*

<sup>1173</sup> NPW initially was a wholly owned subsidiary of Enron. Subsequently it included other investors, and in October 2000 it became a public company. Enron Corp., Form 8-K, filed with the Securities and Exchange Commission (November 8, 2001) at 13.

<sup>1174</sup> Powers Report at 116-118.

special purpose entity, Pronghorn I, LLC, holding the other. LJM2 contributed \$30 million cash in exchange for its membership interest. Enron, through Pronghorn, transferred warrants for 24 million shares of NPW stock to Porcupine in exchange for Porcupine's promissory note in the amount of \$259 million.<sup>1175</sup>

Porcupine's economic interests were structured in a manner similar to those of Raptor I, and provided LJM2 a minimum return prior to Pronghorn receiving any distributions. LJM2's minimum return was the greater of \$39.5 million or a 30 percent annualized return. Enron, through Pronghorn, was to receive all Porcupine distributions after LJM2 received its minimum return.

On October 5, 2000, the day of the NPW initial public offering, Porcupine made a \$39.5 million distribution to LJM2, the requisite minimum return, permitting Porcupine to commence hedging activities with Enron. On the same day, Enron and Porcupine entered into swaps with respect to NPW stock at \$21 per share, pursuant to which Porcupine obtained the economic upside if NPW stock rose above \$21, but became obligated to pay Enron when NPW stock fell below that price. Because Porcupine was treated as an unconsolidated special purpose entity, Enron did not have to book any of Porcupine's investment losses attributable to decreases in value of NPW shares.<sup>1176</sup>

Shortly after NPW's initial public offering, its stock declined in value to below \$21 per share. This meant that Porcupine's swap obligation to Enron increased, which was designed to offset Enron's investment losses on the NPW shares it held outright. However, because Porcupine's only asset available to honor its obligation to Enron was NPW stock, Porcupine's ability to honor its swap obligation diminished at the same time (and to the same extent) that its obligation to Enron increased. This provided Enron no economic protection under the hedge, and required Enron to report as income for financial reporting purposes the excess of Porcupine's obligations over its assets (i.e., its negative credit capacity).<sup>1177</sup> By the end of December 2000, NPW's stock had dropped to below \$10 per share, and Raptor III had a substantial negative credit capacity.

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<sup>1175</sup> The documents recorded this transfer of NPW shares at \$10.75 per share. The parties treated the transfer as a sale at \$10.75 rather than a contribution of the shares. This apparently was done to enable the parties to take the position that Enron did not hold an equity stake in Porcupine for financial reporting purposes, so that Porcupine was not required to be included in Enron's consolidated financial statements. LJM2's \$30 million cash contribution was intended to constitute equity for financial reporting purposes in order to satisfy the 3 percent outside equity requirement. Enron treated Porcupine as a disregarded entity of which Enron (through Pronghorn) was regarded as the owner of its assets. Notes to Financial Statements, Porcupine I, LLC, December 31, 2000. E100240.

<sup>1176</sup> Powers Report at 115-118.

<sup>1177</sup> This was required under the accounting principles applicable to unconsolidated special purpose entities, which permitted off-balance sheet treatment only if the special purpose entity had the financial wherewithal to honor its obligations.



### Raptor IV (Bobcat)

Raptor IV was formed in August 2000. Its hedging structure replicated those of Raptors I and II, with Enron paying to acquire the hedge. Raptor IV was implemented through Bobcat I, LLC (“Bobcat”), a limited liability company with LJM2-Bobcat, LLC, an LJM2 affiliate, and Roadrunner I, LLC, a wholly owned subsidiary of Enron Corp., as its members. Although Raptor IV was capitalized, it was never used to engage in hedging transactions with Enron.<sup>1178</sup>

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<sup>1178</sup> Instead its assets were used as credit support for Raptors I and III to address their respective negative credit capacities. *See* Notes to Financial Statements, Bobcat I, LLC, December 31, 2000. E 100330.

## **PART FOUR: ISSUES RELATING TO COMPENSATION**

### **I. INTRODUCTION TO COMPENSATION-RELATED ISSUES**

#### **A. Overview of Issues Relating to Compensation**

##### **In general**

The compensation arrangements of Enron have 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”). 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 retirement plans. Much of the media attention regarding the effect of the bankruptcy on employees’ benefits relates to the significant plan holdings in Enron stock, particularly in the Enron ESOP and the Enron Savings Plan.<sup>1179</sup> For many Enron employees, the benefits provided under the Enron qualified retirement plans may have been the individual’s primary source of retirement income.

Attention has also focused on the overall compensation arrangements of Enron, particularly the magnitude and forms of compensation provided to executives. This Part Four addresses both of these aspects of Enron’s compensation arrangements. Issues relating to the qualified retirement plans are discussed first.<sup>1180</sup>

##### **Enron qualified plans**

During the period covered by the Joint Committee staff review, Enron maintained three main qualified retirement plans: the Enron Corp. Employee Stock Ownership Plan (the “Enron ESOP”); the Enron Corp. Retirement Plan (the “Enron Retirement Plan”), which was modified and renamed the Enron Corp. Cash Balance Plan (the “Enron Cash Balance Plan”); and the Enron Corp. Savings Plan (the “Enron Savings Plan”).

The discussion relating to Enron qualified retirement plans begins with an overview of present law relating to qualified retirement plans generally, with particular attention paid to the rules relating to the types of qualified retirement plans maintained by Enron.<sup>1181</sup> This is followed

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<sup>1179</sup> Enron stock represented 62 percent of Savings Plan at the end of 2000. 2000 SEC Form 11-K of the Enron Savings Plan.

<sup>1180</sup> Qualified retirement plan issues are discussed in Part II, and other compensation-related issues are discussed in Part III of this Part Four.

<sup>1181</sup> See Part II.A., below. All cross references within this Part Four refer to this Part Four unless otherwise indicated.

by a description of each of the qualified retirement plans maintained by Enron, both currently and historically.<sup>1182</sup>

Certain specific issues relating to the qualified plans, and their impact on retirement benefits of Enron employees are addressed in detail, including a description of relevant present law, factual background, and a discussion of tax and other issues. The specific qualified plan issues addressed in this manner are: (1) the phase out 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 ESOP in Enron stock; (4) a change in recordkeeper under the Enron Savings Plan shortly before the bankruptcy that resulted in a blackout period during which investment changes could not be made, including selling Enron stock; (5) investments under the Enron Savings Plan; and (6) a claim made by a former Enron employee that benefit funds were allegedly misused by Enron.<sup>1183</sup>

### **Other compensation-related issues**

Part III of this Part Four discusses Enron's general compensation structure and arrangements. The section begins with a general overview of compensation of Enron, including philosophies and tools used in determining how compensation for Enron employees would be structured.<sup>1184</sup> This is followed with an overview of executive compensation, including a general discussion of Enron's executive compensation structure and philosophy, as well as a description of particular executive compensation arrangements.<sup>1185</sup> The principal forms of compensation used by Enron are discussed in detail.

The section concludes with a detailed analysis of certain compensation arrangements, including a description of present law, factual background, and a discussion of issues. These issues were chosen for discussion based on a variety of factors, including the prevalence of use of the arrangement, the media and other attention the arrangement has received, and potential tax issues. The matters addressed in this manner are: (1) Enron's nonqualified deferred compensation arrangements; (2) stock-based compensation (3) employee loans; (4) the purchase by Enron of annuity contracts from Kenneth L. Lay and his wife; (5) split-dollar life insurance arrangements; and (6) the application of the \$1 million limitation on the employer deduction for certain executive compensation.<sup>1186</sup>

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<sup>1182</sup> See Part II.B., below.

<sup>1183</sup> See Part II.C., below.

<sup>1184</sup> See Part III.A., below.

<sup>1185</sup> See Part III.B., below.

<sup>1186</sup> See Part III.C., below.

## **B. Overview of Enron Internal Functions Relating to Compensation**

In order to understand how decisions relating to compensation matters were made at Enron, it is helpful to be familiar with the structure of the Enron Corp. Human Resources Department. Enron's corporate and departmental structure changed from time to time. The description here is intended as a general overview of the structure preceding the bankruptcy.

Different departments within the Human Resources Department handled different matters. The Benefits Department handled matters generally relating to all employees, including qualified retirement plans, health and welfare plans, and miscellaneous employee benefits, such as parking. The Compensation Department handled compensation matters relating to executives, generally vice presidents and above. Specific arrangements handled by the Compensation Department include nonqualified deferred compensation plans and bonuses. These departments had various names over time. In addition, each business unit might have its own human resources department that handled employee benefit matters for that business unit.

Specialized compensation arrangements for particular individuals were not handled in the same manner as other arrangements. Interviews with Enron employees indicated there was no single department or person that handled such arrangements; many of them did not appear to be handled by the Human Resources Department. The Office of the Corporate Secretary was responsible for compiling the information for the top-five executives for proxy purposes, and therefore may have become aware of various arrangements, but was not responsible for setting up or implementing the arrangements. Based on interviews with Enron employees, it was difficult to identify the persons who were knowledgeable about specialized arrangements, particularly arrangements involving top management.

## II. QUALIFIED PLANS

### A. Overview of Present Law Relating to Qualified Retirement Plans

#### 1. In general

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code<sup>1187</sup> (“a qualified retirement plan”) is accorded special tax treatment under present law. Employees do not include qualified retirement plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified retirement plan even though the contributions are not currently included in an employee’s income. Contributions to a qualified retirement plan are held in a tax-exempt trust.

Employees, as well as employers, may make contributions to a qualified retirement plan. Employees may, subject to certain restrictions, make both pre-tax and after-tax contributions to a qualified retirement plan. Pre-tax employee contributions may be made to a qualified cash or deferred arrangement, i.e., a 401(k) plan. Such contributions are referred to in the Code as “elective deferrals” and are generally treated the same as employer contributions for Federal tax purposes.

Present law imposes a number of requirements on qualified retirement plans that must be satisfied in order for the plan to obtain tax-favored status.<sup>1188</sup> One of these requirements is that a qualified retirement plan must be maintained for the exclusive benefit of employees. In particular, a qualified retirement plan must prohibit the diversion of assets for purposes other than the exclusive benefit of employees and their beneficiaries (the “exclusive benefit rule”).

In addition, minimum participation and coverage rules and nondiscrimination rules are designed to ensure that qualified retirement plans benefit an employer’s rank-and-file employees as well as highly compensated employees. Under the minimum coverage rules, a plan must satisfy one of the following requirements: (1) the plan benefits at least 70 percent of employees who are nonhighly compensated employees;<sup>1189</sup> (2) the plan benefits a percentage of nonhighly

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<sup>1187</sup> Except as otherwise indicated, this discussion refers to rules in the Internal Revenue Code. The Employee Retirement Income Security Act of 1974 (“ERISA”) also contains rules relating to qualified plans. In some cases the ERISA requirements are identical or substantially similar to Code requirements. ERISA’s requirements generally may be enforced through administrative actions by the Department of Labor or by lawsuits brought by plan participants, the Department of Labor, or plan fiduciaries.

<sup>1188</sup> In some cases, special provisions apply to certain types of plans, such as qualified retirement plans maintained by State and local governments and churches. This document discusses the rules applicable to qualified retirement plans without regard to such special provisions, except as specifically mentioned.

<sup>1189</sup> Under present law, an employee is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) either (a) had compensation for the preceding year in excess of \$90,000 (for 2002) or (b) at

compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan; or (3) the plan satisfies an average benefits test which compares the benefits received by highly compensated employees and nonhighly compensated employees.<sup>1190</sup> Present law also contains a general nondiscrimination requirement which provides that a qualified retirement plan may not discriminate in favor of highly compensated employees. This requirement generally applies to all benefits, rights, and features under the plan, not just to contributions and benefits.<sup>1191</sup> Special rules apply to plans that primarily benefit key employees (called “top-heavy plans”).<sup>1192</sup>

The plan qualification standards also define certain rights of plan participants and beneficiaries and provide some limits on the tax benefits for qualified retirement plans. A limit of \$200,000 (for 2003) applies to the amount of a participant’s compensation that may be taken into account for qualified retirement plan purposes.<sup>1193</sup> Limits apply also to the benefits or contributions provided to a participant and to the amount an employer may deduct for contributions to a qualified retirement plan, based on the type of plan.<sup>1194</sup>

Certain rules that apply to qualified retirement plans are designed to ensure that the amounts contributed to such plans are used for retirement purposes. Thus, for example, an early withdrawal tax applies to premature distributions from qualified retirement plans,<sup>1195</sup> and the ability to obtain distributions prior to termination of employment from certain types of qualified retirement plans, including defined benefit plans, is restricted.<sup>1196</sup>

Enforcement of the requirements that apply to qualified retirement plans depends on the source of the requirements. The qualification requirements under the Internal Revenue Code are

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the election of the employer had compensation for the preceding year in excess of \$90,000 (for 2002) and was in the top 20 percent of employees by compensation for such year. A nonhighly compensated employee is an employee other than a highly compensated employee. Sec. 414(q).

<sup>1190</sup> Sec. 410(b).

<sup>1191</sup> Sec. 401(a)(4).

<sup>1192</sup> Sec. 416.

<sup>1193</sup> Sec. 401(a)(17).

<sup>1194</sup> *See* secs. 404 and 415. The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) increased many of the limits that apply to qualified retirement plans. These limit increases are generally effective for years beginning after December 31, 2001. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

<sup>1195</sup> Sec. 72(t).

<sup>1196</sup> *See, e.g.*, sec. 401(k)(2).

enforced by the IRS.<sup>1197</sup> If a plan fails to meet the Code's qualification requirements, then the favorable tax treatment for such plans may be denied; that is, the employer may lose tax deductions and employees may have current income taxation. As a practical matter, the IRS rarely disqualifies a plan. Instead, the IRS may impose sanctions short of disqualification and require the employer to correct any violation of the qualification rules.

Certain of the Internal Revenue Code rules relating to qualified plans are enforced through an excise tax rather than through disqualification. For example, a failure to satisfy the minimum funding requirements for defined benefit plans, discussed below, does not result in disqualification of the plan. Instead, an excise tax is imposed on the employer.

After a plan's initial establishment, the employer may find it necessary or desirable to change its terms and provisions by amending it. Amendment of a plan may be necessary to ensure the plan's continued qualification, or may be discretionary, implementing design changes desired by the plan sponsor. Additionally, a plan, including amendments, may be restated from time to time, that is, a new version of a plan document incorporating legal and design changes will be produced to reflect all current provisions.

## **2. Types of qualified retirement plans**

### **In general**

#### Overview

Qualified retirement plans are broadly classified into two categories, defined benefit plans and defined contributions plans, based on the nature of the benefits provided. A defined benefit plan promises to provide a specific benefit specified in the plan. Defined contribution plan benefits are based on the contributions to and investment returns on individual accounts. Certain types of qualified retirement plans are referred to as hybrid plans because they have features of both a defined benefit plan and a defined contribution plan. For example, a cash balance plan is a hybrid plan. Legally, a cash balance plan is a defined benefit plan; however, plan benefits are defined by reference to a hypothetical account balance. Floor offset arrangements are another type of hybrid plan. These arrangements consist of a defined benefit plan, which provides a floor benefit, and a defined contribution plan, which offsets the benefit under the floor plan. Cash balance plans and floor-offset arrangements are discussed below.

#### Defined benefit plans

Under a defined benefit plan, benefits are determined under a plan formula, typically based on compensation and years of service. For example, a defined benefit plan might provide an annual retirement benefit of two percent of final average compensation multiplied by total years of service completed by an employee. Benefits under a defined benefit plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan.

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<sup>1197</sup> Employees do not have a right to sue to enforce the qualified retirement plan requirements under the Internal Revenue Code.

Employer contributions to a defined benefit plan are subject to minimum funding requirements to ensure that plan assets are sufficient to pay the benefits under the plan.<sup>1198</sup> An employer is generally subject to an excise tax for a failure to make required contributions.<sup>1199</sup> Benefits under a defined benefit plan are guaranteed (within limits) by the Pension Benefit Guaranty Corporation (“PBGC”).

### Defined contribution plans

Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. Defined contribution plans fall into three general types: profit-sharing plans, stock bonus plans, and money purchase pension plans. A plan must designate the type of plan it is intended to be.<sup>1200</sup>

Different types of contributions may be made to a defined contribution plan. The type of contributions made to a defined contribution plan depends on the design of the plan. Many plans provide for different types of contributions. Contributions fall into two general types: employee contributions and employer contributions. Further distinctions apply within each type.

Employee contributions can be made on a pre-tax or an after-tax basis. Employee elective deferrals under a 401(k) plan are pre-tax employee contributions. Elective deferral contributions are generally treated the same as employer contributions for income tax purposes and are not subject to tax until distributed from the plan.

Employer contributions consist of two types: nonelective contributions and matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes elective deferrals or after-tax contributions. Depending on the type of defined contribution plan and the plan terms, employer nonelective contributions may be required or may be discretionary. Matching contributions are employer contributions that are made only if the employee makes contributions.

Within the three general types of defined contribution plans are plan designs that contain special features, such as qualified cash or deferred arrangements (or 401(k) plans) and employee stock ownership plans (“ESOPs”), discussed below.

### Cash balance plans

A cash balance plan is a type of defined benefit plan with benefits resembling the benefits usually associated with defined contribution plans. Under a “cash balance” formula, the benefit

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<sup>1198</sup> Sec. 412.

<sup>1199</sup> Sec. 4971.

<sup>1200</sup> While certain rules apply only to certain types of plans, the differences between these types of plans have been blurred over time and are largely historical with respect to some plan characteristics. For example, contributions under a profit-sharing plan are no longer required to depend on the employer’s profits.



is typically defined by a hypothetical account balance, which is periodically credited with an amount based on the participant's compensation (a "pay credit") and interest thereon (an "interest credit").

Benefits paid to the participant are based on the value of the hypothetical account even though the plan does not allocate assets to individual accounts to participants. The hypothetical account is only a method of computing participants' promised benefits. A participant's hypothetical account balance is typically credited with hypothetical contributions and hypothetical earnings designed to mimic the allocations of actual contributions and actual earnings to a participant's account that would occur under a defined contribution plan.

### **Qualified cash or deferred arrangements ("401(k) plans")**

A 401(k) plan legally is not a separate type of plan, but is a profit-sharing or stock bonus plan that contains a "qualified cash or deferred arrangement."<sup>1201</sup> Thus, such arrangements are subject to the rules generally applicable to qualified retirement plans. In addition, special rules apply to such arrangements.<sup>1202</sup>

Under a 401(k) plan, an employee may elect to have the employer pay compensation as contributions to a qualified retirement plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that can be made by an individual is \$12,000 for 2003.<sup>1203</sup> Starting in 2002, an individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a 401(k) plan. The limit on elective deferrals is increased for an individual who has attained age 50 by \$2,000 for 2003.<sup>1204</sup> An employee's elective deferrals must be fully vested.

A special nondiscrimination test applies to elective deferrals under a 401(k) plan, which compares the elective deferrals of highly compensated employees with elective deferrals of

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<sup>1201</sup> Certain pre-ERISA money purchase plans and rural cooperative plans may also include a qualified cash or deferred arrangement.

<sup>1202</sup> Other arrangements are similar to 401(k) plans, but are not subject to all the same rules, such as section 457 plans of State and local governments, and tax-sheltered annuity plans (sec. 403(b)).

<sup>1203</sup> Sec. 402(g). The dollar limit on elective deferrals increases to \$13,000 for 2004, \$14,000 for 2005, and \$15,000 for 2006. After 2006, the limit is adjusted for inflation in \$500 increments. The increases in the limit are subject to the general sunset provision of EGTRRA.

<sup>1204</sup> Sec. 414(v). The additional amount permitted for catch-up contributions increases to \$3,000 for 2004, \$4,000 for 2005, and \$5,000 for 2006. After 2006, the limit is adjusted for inflation in \$500 increments. The increases in the limit are subject to the general sunset provision of EGTRRA.

nonhighly compensated employees.<sup>1205</sup> Employer matching contributions and after-tax employee contributions under a defined contribution plan are also subject to a special nondiscrimination test.<sup>1206</sup>

Employers are not required to offer matching contributions based on employee elective deferrals. Many employers provide a match because doing so makes it easier for the plan to satisfy applicable nondiscrimination rules by encouraging employees to make elective deferrals. For example, a plan could provide that the employer will make matching contributions equal to 50 percent of an employee's elective deferrals, up to a maximum of three percent of compensation.

In addition to or in lieu of matching contributions, some employers make "qualified nonelective contributions" for employees participating in a 401(k) plan, which may be taken into account applying the special nondiscrimination test for elective deferrals test. Like matching contributions, qualified nonelective contributions may make it easier for plans to satisfy the applicable nondiscrimination rules. "Qualified nonelective contributions" are contributions that are made by the employer without regard to whether the employee makes elective deferrals, that are 100 percent vested, and that meet certain other requirements.

Under a safe harbor,<sup>1207</sup> a 401(k) plan is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and satisfies a notice requirement. A plan satisfies the contribution requirement under the safe harbor rule if the employer either: (1) satisfies a matching contribution requirement; or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to the permitted disparity rules. A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee's elective deferrals up to three percent of compensation and (b) 50 percent of the employee's elective deferrals from three to five percent of compensation; and (2) the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. Matching contributions that satisfy the design-based safe harbor for 401(k) plans are deemed to satisfy the special nondiscrimination test for such contributions-test. Certain alternative matching arrangements also can be used to satisfy the safe harbor.

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<sup>1205</sup> Sec. 401(k)(3). (This test is called the actual deferral percentage test or the "ADP" test).

<sup>1206</sup> Sec. 401(m). (This test is called the actual contribution percentage test or the "ACP" test.)

<sup>1207</sup> Sec. 401(k)(12).

## **Employee stock ownership plans (“ESOPs”)**

An ESOP is a defined contribution plan that is designated as an ESOP, is designed to invest primarily in securities of the employer, and meets certain other requirements.<sup>1208</sup> An ESOP can be an entire plan or it can be a component of a larger defined contribution plan.<sup>1209</sup> ESOPs are subject to additional requirements that do not apply to other plans that hold employer securities. For example, voting rights must generally be passed through to ESOP participants, employees must generally have the right to receive benefits in the form of employer securities, and certain ESOP participants must be given the right to diversify a portion of their account into investments other than employer securities.<sup>1210</sup>

In addition, certain benefits are available to ESOPs that are not available to other types of qualified retirement plans that hold employer securities. For example, an ESOP may be “leveraged,” i.e., employer securities held in an ESOP may be purchased with loan proceeds. In a leveraged ESOP, the ESOP typically borrows from a financial institution. The loan is typically guaranteed by the employer and the employer securities are pledged as security for the loan. Alternatively, the loan can be made directly by the employer to the ESOP, or the employer may borrow from a financial institution, and then make a loan to the ESOP. Contributions to the plan are used to repay the loan. Dividends on employer securities may also be used to repay the loan. The employer securities are held in a suspense account and released to participants’ accounts as the loan is repaid.

Special tax benefits also apply to ESOPs. For example, the employer may deduct dividends paid on employer stock held by an ESOP if the dividends are used to repay a loan, if they are distributed to plan participants, or if the plan gives participants the opportunity to elect either to receive the dividends or have them reinvested in employer stock under the ESOP and the dividends are reinvested at the participant’s election.<sup>1211</sup> In addition, special deduction rules apply to ESOPs that do not apply to other types of plans.<sup>1212</sup>

Prior law also provided additional tax benefits for ESOPs that were in effect during the period covered by the Joint Committee staff review of Enron. Prior law provided that banks and

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<sup>1208</sup> Sec. 4975(e)(7); Treas. Reg. sec. 54.4975-11. The plan must be either a stock bonus plan or a stock bonus and money purchase pension plan.

<sup>1209</sup> An ESOP may provide for different types of contributions, including employer nonelective contributions and others. For example, an ESOP may include a 401(k) feature that permits employees to make elective deferrals. Such an ESOP design is sometimes referred to as a “KSOP.”

<sup>1210</sup> See secs. 401(a)(28), 409(e), and 409(h).

<sup>1211</sup> Sec. 404(k). The ability to deduct dividends reinvested at the election of the participant is effective for taxable years beginning after December 31, 2001.

<sup>1212</sup> Sec. 404(a)(9). Additional special rules also apply to ESOPs that hold employer securities that are not publicly traded.

other financial institutions could exclude from income 50 percent of the interest received with respect to a loan used to acquire employer securities for an ESOP.<sup>1213</sup>

In addition, prior law allowed for the transfer of defined benefit plan assets to an ESOP without imposition of the excise tax on reversions.<sup>1214</sup> Under present and prior law, an excise tax is imposed on employer reversions from a qualified plan equal to 20 percent of the reversion (50 percent if the employer does not establish a replacement plan or provide certain benefit increases).<sup>1215</sup> Prior law provided that, if certain requirements are satisfied, the reversion tax did not apply to the extent a reversion upon plan termination was transferred to an ESOP.

In order for the exception for transfers to an ESOP to apply, the following requirements had to be satisfied: (1) within 90 days, or such longer period as the IRS allowed, after the transfer, the amount transferred had to be invested in employer securities or used to repay loans used to purchase employer securities; (2) certain allocation requirements had to be met which generally required that the employer securities be allocated ratably over no more than seven years;<sup>1216</sup> (3) at least half of the participants in the qualified plan had to be participants in the ESOP as of the close of the first plan year for which an allocation of the securities was required; (4) under the plan, employer securities, the acquisition of which satisfied the first condition, had to, except to the extent necessary to meet plan qualification requirements relating to diversification of assets, remain in the plan until distributed to participants in accordance with the provisions of the plan; and (5) the amount had to be transferred after March 31, 1985, and before January 1, 1989, or after December 31, 1988, pursuant to a termination which occurred after March 31, 1985, and before January 1, 1989.

### **3. General rules relating to investment of qualified retirement plan assets**

#### **Risk of investment loss**

The person who bears the risk of investment loss with respect to qualified retirement plan assets depends on whether the plan is a defined benefit plan or a defined contribution plan.

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<sup>1213</sup> The exclusion was added in section 133 of the Code by the Deficit Reduction Act of 1984, Pub. L. No. 98-369 (1984), generally effective for loans used to acquire employer securities after July 18, 1984. Significant changes were made to the interest exclusion by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239 (1989), including a provision generally limiting the exclusion to cases in which the ESOP owned more than 50 percent of the stock of the corporation. The exclusion was subsequently repealed, generally effective for loans made after August 20, 1996. Pub. L. No. 104-188, sec. 1602(a) (1996).

<sup>1214</sup> Sec. 4980(c)(3). This provision was utilized by Enron to provide funding for the Enron ESOP. A “reversion” is any amount of cash or the fair market value of property received by an employer from a qualified plan. A reversion can occur, for example, if a defined benefit plan is terminated and plan assets are greater than plan liabilities.

<sup>1215</sup> Sec. 4980.

<sup>1216</sup> Sec. 4980(c)(3)(C).

In a defined benefit plan, investment risk is generally on the employer as a result of the minimum funding requirements, under which the employer must make contributions in the amount necessary to fund promised benefits, as discussed above. The minimum funding rules also require periodic valuation of defined benefit plan assets. If the plan suffers investment losses, the employer may be required to increase plan contributions to maintain the funded status of the plan.

Benefits under most defined benefit plans are guaranteed (within limits) by the PBGC.<sup>1217</sup> In the event a plan terminates with assets insufficient to pay promised benefits, the PBGC will pay benefits up to the maximum guaranteed amount.<sup>1218</sup> For 2003, the maximum guaranteed benefit for an individual retiring at age 65 is \$3,664.77 per month, or \$43,977.24 per year.

In a defined contribution plan, the benefit to which the participant is entitled is the account balance. Thus, the plan participant bears the risk of investment losses, regardless of whether investment decisions are made by the participant or a plan fiduciary. Defined contribution plans are not insured by the PBGC.

## **General fiduciary rules and investment responsibility**

### Overview

Except with respect to certain investments in employer securities, discussed below, generally neither the Internal Revenue Code nor ERISA imposes restrictions on the specific investments that can be made with qualified retirement plan assets. Rather, ERISA imposes general standards applicable to the conduct of plan fiduciaries. In addition, except with respect to investment in employer securities and the ability of plan participants to direct investments, discussed below, defined benefit plans and defined contribution plans are generally subject to the same rules regarding the investment of plan assets.

### Definition of fiduciary

ERISA provides, in relevant part, that a person is a fiduciary with respect to a plan to the extent he or she exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of plan assets or has any discretionary authority or discretionary responsibility in the administration of the plan.<sup>1219</sup> Fiduciary status extends to those aspects of the plan over which the fiduciary exercises authority or control. The determination of whether an individual is a plan fiduciary often involves significant factual inquiry. Corporate officers and directors are not considered plan fiduciaries merely because of their corporate position--whether they are fiduciaries is determined by reference to whether they have or exercise the requisite authority

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<sup>1217</sup> ERISA sec. 4021.

<sup>1218</sup> See ERISA sec. 4022.

<sup>1219</sup> ERISA sec. 3(21)(A)(i) and (ii).

and control over the plan. Under ERISA, a person who makes investment decisions with respect to a qualified retirement plan is generally a plan fiduciary.

ERISA also provides that every plan must have one or more named fiduciaries.<sup>1220</sup> Named fiduciaries must be named in the plan document (or by the employer, employee organization, or the two acting jointly, pursuant to a procedure specified in the plan). The named fiduciary must have authority to control and manage the operation and administration of the plan. In practice, a committee is often identified as the named fiduciary and has employer officers as its members.

Generally, the plan trustee has exclusive authority and responsibility for managing and controlling plan assets and is thus responsible for investing plan assets. However, the plan may make the trustee subject to the direction of the named fiduciary, or the authority for managing plan assets may be delegated to an investment manager.<sup>1221</sup> An investment manager is a registered investment advisor, bank, trust company, or insurance company that is appointed by a named fiduciary of the plan with the power to manage, acquire, or dispose of plan assets. The investment manager must acknowledge in writing its status as a fiduciary.<sup>1222</sup>

#### General standard of conduct for plan fiduciaries

ERISA contains general fiduciary standards that apply to all fiduciary actions,<sup>1223</sup> including investment decisions made by fiduciaries. ERISA requires that a plan fiduciary generally must discharge its duties solely in the interests of participants and beneficiaries and:

- for the exclusive purpose of providing benefits to plan participants and beneficiaries and defraying reasonable expenses of plan administration;
- with the care, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
- by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
- in accordance with plan documents insofar as they are consistent with ERISA.<sup>1224</sup>

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<sup>1220</sup> ERISA sec. 402(a).

<sup>1221</sup> In such case, ERISA provides that the trustee is obligated to follow the instructions of the named fiduciary unless the directions are contrary to the provisions of ERISA or the plan or trust. *See* ERISA sec. 403(a)(1) and (2).

<sup>1222</sup> ERISA sec. 3(38).

<sup>1223</sup> Although the focus of this discussion is plan investments, fiduciary actions and liability are not limited to issues regarding investment of plan assets.

<sup>1224</sup> ERISA sec. 404(a)(1).

In the case of a defined contribution plan, the diversification requirement and the prudence requirement (only to the extent it requires diversification) are not violated by the acquisition or holding of employer securities.<sup>1225</sup> The application of the fiduciary rules to plans holding employer securities is discussed in more detail in Part II.C.3, below.

The fiduciary rules under ERISA are subject to enforcement through administrative actions by the Department of Labor or by lawsuits brought by plan participants, the Department of Labor, or plan fiduciaries. Plan fiduciaries may be held personally liable for losses resulting from a breach of fiduciary duty.<sup>1226</sup>

In some circumstances, a plan fiduciary may be liable for a breach of fiduciary duty by another fiduciary of the plan.<sup>1227</sup> A fiduciary may be liable for a breach of duty by another fiduciary if the fiduciary: (1) knowingly participates in, or undertakes to conceal, an act or omission of the other, knowing that the act or omission constitutes a breach of duty; (2) enables another fiduciary to commit a breach by failing to comply with their own duty; or (3) knows of a breach by another fiduciary and fails to make reasonable efforts<sup>1228</sup> under the circumstances to remedy it. For purposes of these provisions, constructive knowledge, rather than actual knowledge is sufficient to establish cofiduciary liability. For example, a fiduciary may be liable for the actions of another if the fiduciary knew or should have known of the breach and failed to make reasonable efforts to correct the breach.

Plan investment decisions made by plan fiduciaries may in some cases violate the exclusive benefit rule under the Internal Revenue Code. However, not all fiduciary violations relating to plan investments are violations of the exclusive benefit rule.

### **Special fiduciary rules for participant-directed investments in defined contribution plans**

A defined contribution plan may permit participants or beneficiaries to make investment decisions with respect to their individual accounts. For example, it is common for 401(k) plans to provide participants with investment authority with respect to their own elective deferrals.

Under a so-called safe harbor rule, ERISA fiduciary liability does not apply to investment decisions made by plan participants in deferred contribution plans if plan participants control the investment of their individual accounts.<sup>1229</sup> Many employers design plans so that they can take advantage of this rule in order to minimize fiduciary responsibilities. If the safe harbor applies, a

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<sup>1225</sup> ERISA sec. 404(a)(2).

<sup>1226</sup> ERISA sec. 409.

<sup>1227</sup> ERISA sec. 405. Such liability is often referred to as cofiduciary liability.

<sup>1228</sup> Department of Labor regulations clarify that if a fiduciary takes reasonable steps to remedy a breach by another, the fiduciary generally is not liable under cofiduciary liability merely because the remedial efforts fail. 29 C.F.R. sec. 2509.75-7, at FR-10.

<sup>1229</sup> ERISA sec. 404(c).

plan fiduciary may be liable for the investment alternatives made available, but not for the specific investment decisions made by participants. This includes investments in employer securities made at the direction of the participant. Failure to satisfy the safe harbor rule means that plan fiduciaries may be held liable for the investment decisions of participants. The safe harbor rule is discussed in detail below.<sup>1230</sup>

#### **4. Rules relating to investments of qualified retirement plan assets in employer securities**

##### **In general**

In addition to the general ERISA rules relating to the investment of qualified retirement plan assets, special rules apply to the investment of plan assets in stock or other securities issued by the employer or an affiliate of the employer.<sup>1231</sup> The assets of either a defined contribution plan or a defined benefit plan may be invested in employer securities. However, the rules relating to such investments differ for defined benefit plans and defined contribution plans, as discussed below.

##### **Application of fiduciary rules to plans holding employer securities**

As mentioned above, the general diversification standard applicable to plan fiduciaries (and the general prudence requirement to the extent it requires diversification) generally are not violated by the acquisition or holding of employer securities by a defined contribution plan.<sup>1232</sup> However, under case law, this does not mean that the holding of such securities by such plans never involves a breach of fiduciary duty. This issue, and applicable cases, is discussed in detail below.<sup>1233</sup>

##### **Limits on investments in employer securities**

ERISA imposes restrictions on the investment of qualified retirement plan assets in employer securities. ERISA prohibits defined benefit plans (and money purchase pension plans other than certain pre-ERISA plans) from acquiring employer securities if, after the acquisition, more than 10 percent of the assets of the plan would be invested in employer securities.<sup>1234</sup> Most defined contribution plans, such as profit-sharing plans, stock bonus plans, and certain pre-ERISA money purchase pension plans are not subject to any limit on the amount of employer contributions that can be invested (or required to be invested) in employer securities.<sup>1235</sup>

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<sup>1230</sup> See Part II.C.5.

<sup>1231</sup> Special rules apply also to the investment of plan assets in employer real property.

<sup>1232</sup> ERISA sec. 404(a)(2).

<sup>1233</sup> See Part II.C.3.

<sup>1234</sup> See ERISA sec. 407.

<sup>1235</sup> ERISA sec. 407(b)(1).



In the case of a 401(k) plan, no more than 10 percent of elective deferrals can be required to be invested in employer securities. However, this restriction does not apply if: (1) the amount of elective deferrals required to be invested in employer securities does not exceed more than one percent of any employee's compensation; (2) the fair market value of all individual account plans maintained by the employer is no more than 10 percent of the fair market value of all retirement plans of the employer; or (3) the plan is an ESOP. In addition, there is no limit on the amount of elective deferrals that an employee can choose voluntarily to invest in employer securities.<sup>1236</sup>

The Code requires that ESOP plan participants who are age 55 and have 10 years of plan participation must be permitted to diversify the investment of the participant's account (i.e., to invest the account in assets other than employer securities).<sup>1237</sup> The participant must be given a period each year for six years in which to diversify up to 25 percent (or 50 percent in the last year) of the participant's account, reduced by the portion of the account diversified in prior years. As an alternative to providing diversified investment options in the plan, the plan can provide that the portion of the participant's account that is subject to the diversification requirement is distributed to the participant.

### **Definition of employer securities**

Under ERISA, a qualified retirement plan may hold only a "qualifying employer security."<sup>1238</sup> Any stock issued by the employer or an affiliate of the employer is a qualifying employer security.<sup>1239</sup> In the case of a defined benefit plan (and money purchase pension plans other than certain pre-ERISA plans), in order for stock to be a qualifying employer security, the plan cannot hold more than 25 percent of the aggregate amount of the issued and outstanding stock of the same class, and at least 50 percent of the aggregate amount of that stock must be held by persons independent of the issuer.<sup>1240</sup>

For purposes of ESOP investments, employer securities (or "qualifying employer securities") are defined in the Code to mean only:

- (1) publicly traded common stock of the employer or a member of the same controlled group;

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<sup>1236</sup> ERISA sec. 407(b)(2).

<sup>1237</sup> Sec. 401(a)(28).

<sup>1238</sup> ERISA sec. 407(a)(1)(A).

<sup>1239</sup> ERISA sec. 407(d)(5). Qualifying employer securities also include certain publicly traded partnership interests and certain marketable obligations (i.e., a bond, debenture, note, certificate or other evidence of indebtedness). *Id.*

<sup>1240</sup> ERISA sec. 407(f).

- (2) if there is no such publicly traded common stock, common stock of the employer (or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or
- (3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP.<sup>1241</sup>

## 5. Other rules

### **Prohibited transaction rules**<sup>1242</sup>

Both the Internal Revenue Code and ERISA contain prohibited transaction rules that prohibit the employer, plan fiduciaries, and other persons with a close relationship to a qualified retirement plan from engaging in particular transactions with the plan. These rules are not targeted toward particular types of investments, but rather seek to prevent self-dealing transactions.

Prohibited transactions include (1) the sale, exchange or leasing of property, (2) the lending of money or other extension of credit, (3) the furnishing of goods, services or facilities, (4) the transfer to, or use by or for the benefit of, the income or assets of the plan, (5) in the case of a fiduciary, any act that deals with the plan's income or assets for the fiduciary's own interest or account, and (6) the receipt by a fiduciary of any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

Certain transactions are exempt from prohibited transaction treatment. In addition, the Department of Labor may grant administrative exemptions in particular circumstances.

If a prohibited transaction occurs, the disqualified person who participates in the transaction is subject to a two-tier excise tax under the Code. The first level tax is 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period and is 100 percent of the amount involved.

### **Limitations on contributions and benefits**

Limits apply to the contributions or benefits provided to a participant under a qualified retirement plan, based on the type of plan.<sup>1243</sup>

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<sup>1241</sup> Secs. 4975(e)(7) and 409(l). This document uses the term "employer securities" to refer generally to qualifying employer securities as defined under ERISA and the Code.

<sup>1242</sup> See sec. 4975 and ERISA secs. 407 and 408.

Under a defined contribution plan, the annual additions to the plan with respect to each plan participant cannot exceed the lesser of (1) 100 percent of the participant's compensation or (2) a dollar amount, indexed for inflation (\$40,000 for 2003). Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer.

Under a defined benefit plan, the maximum annual benefit payable to a participant at retirement cannot exceed the lesser of (1) 100 percent of the participant's average compensation, or (2) a dollar amount, indexed for inflation (\$160,000 for 2003). The dollar limit is reduced for benefit commencement before age 62 and increased for benefit commencement after age 65.

### **Deductions for plan contributions**

Employer contributions to qualified retirement plans are deductible subject to certain limits.<sup>1244</sup> In general, the deduction limit depends on the kind of plan. Subject to certain exceptions, nondeductible contributions are subject to a 10-percent excise tax.<sup>1245</sup>

In the case of a defined contribution plan, the amount of deductible contributions is generally limited by compensation. In general, the annual limitation on the amount of deductible contributions to a profit-sharing or stock bonus plan is 25 percent of compensation of the employees covered by the plan for the year.<sup>1246</sup>

In the case of a defined benefit plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. In order to encourage plan sponsors to fully fund defined benefit plans, the maximum amount otherwise deductible generally is not less than the plan's unfunded current liability. In the case of a plan that terminates during the year, the maximum deductible is generally not less than the amount needed to make the plan assets sufficient to fund benefit liabilities as defined for purposes of the PBGC termination insurance program.

If an employer sponsors both a defined benefit plan and a defined contribution plan that covers some of the same employees, the total deduction for all plans for a plan year generally is limited to the greater of (1) 25 percent of compensation or (2) the contribution necessary to meet

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<sup>1243</sup> Sec. 415. EGTRRA increased many of the limits that apply to qualified retirement plans. These limit increases are generally effective for years beginning after December 31, 2001. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

<sup>1244</sup> Sec. 404. EGTRRA increased many of the limits relating to qualified retirement plans. These limit increases are generally effective for years beginning after December 31, 2001. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

<sup>1245</sup> Sec. 4972.

<sup>1246</sup> Additional amounts may be deductible in the case of an ESOP as described in the discussion of ESOPs in Part II.A.2.

the minimum funding requirements of the defined benefit plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

### **Taxation of qualified retirement plan contributions and distributions**

Employer contributions and employee elective deferrals (and earnings) to a qualified retirement plan generally are not includible in an employee's income until distributed.

A distribution of benefits from a qualified retirement plan generally is includible in gross income in the year it is paid or distributed, except to the extent the amount distributed represents a return of the employee's after-tax contributions (i.e., basis). Special rules apply to lump-sum distributions, distributions rolled over to another employer-sponsored retirement plan or IRA, and distribution of employer securities.<sup>1247</sup>

Early distributions from qualified retirement plans generally are subject to an additional 10-percent early withdrawal tax. That is, includible amounts distributed prior to attainment of age 59-1/2 are subject to an additional 10-percent tax, unless the distribution is due to death or disability, is made in the form of certain periodic payments, is made to an employee after separation from service after attainment of age 55, or is used to pay medical expenses in excess of 7.5 percent of adjusted gross income.<sup>1248</sup>

Distributions from a qualified retirement plan are required to begin no later than the participant's required beginning date. The required beginning date is April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70-1/2, or (2) the calendar year in which the employee retires. In the case of an employee who is a five-percent owner, the required beginning date is April 1 of the calendar year following the calendar year the employee attains age 70-1/2. Distributions after the participant's death also must meet certain minimum distribution requirements.<sup>1249</sup>

The sanction for failure to make a minimum required distribution to an employee (or other payee) under a qualified retirement plan is a 50-percent nondeductible excise tax on the excess in any taxable year of the amount required to have been distributed under the minimum distribution rules, over the amount that actually was distributed. The tax is imposed on the individual required to take the distribution. However, in order to satisfy the qualification requirements, a plan must expressly provide that, in all events, distributions under the plan are to satisfy the minimum distribution requirements.<sup>1250</sup>

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<sup>1247</sup> Sec. 402.

<sup>1248</sup> Sec. 72(t). Certain other exceptions to the tax may also apply.

<sup>1249</sup> Sec. 401(a)(9).

<sup>1250</sup> Sec. 4974.

## **Qualified retirement plan reporting and disclosure requirements**

A qualified retirement plan is subject to annual reporting and disclosure requirements under both the Internal Revenue Code and ERISA.

The plan administrator of a qualified retirement plan generally must submit an annual report of certain information with respect to the qualification, financial condition, and operation of the plan to the Department of Labor.<sup>1251</sup> The plan administrator must also file an annual registration statement with the IRS with respect to certain participants who separate from service during the year.<sup>1252</sup> The plan administrator must also furnish an individual statement to each participant who separates from service and is listed in the annual registration statement described above.<sup>1253</sup>

The plan administrator must automatically provide participants with a summary of the annual report.<sup>1254</sup> A plan administrator is also required to furnish participants with a summary plan description that includes certain information, including administrative information about the plan, the plan's requirements as to eligibility for participation and benefits, the plan's vesting provisions, and the procedures for claiming benefits under the plan.<sup>1255</sup> The plan administrator must also furnish participants with a summary of any material modification in the terms of the plan and any change in the information required in the summary plan description within 210 days after the end of the plan year in which the modification or change occurs.<sup>1256</sup> Under ERISA, a plan administrator must also furnish a benefit statement to any participant or beneficiary who makes a written request for such a statement.<sup>1257</sup> This requirement applies in the case of any plan that is subject to ERISA, including defined contribution and defined benefit plans.

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<sup>1251</sup> ERISA secs. 103 and 104. Defined benefit plans must also provide certain reports or notices if the plan is underfunded (ERISA secs. 4010 and 4011), if a plan amendment significantly reduces the rate of future benefit accrual (sec. 4980F and ERISA sec. 204(h)), or if plan assets are transferred to health benefit accounts pursuant to sec. 420 (sec. 101(e) of ERISA).

<sup>1252</sup> Sec. 6057.

<sup>1253</sup> ERISA secs. 101(a)(2) and 105(c).

<sup>1254</sup> ERISA secs. 101(a) and 104(b)(3).

<sup>1255</sup> ERISA secs. 101(a), 103, and 104(3). The summary plan description must also be furnished to the Department of Labor on request. ERISA sec. 104(a)(6).

<sup>1256</sup> ERISA secs. 102 and 104(b).

<sup>1257</sup> ERISA sec. 105.

## **IRS compliance**

The IRS has three programs to ensure that plans comply with the numerous requirements under the Code for a retirement plan to receive the tax benefits of qualified plan status: (1) the determination letter program; (2) the examination program; and (3) the Employee Plans Compliance Resolution System (“EPCRS”).

The IRS permits plan sponsors to voluntarily submit plans for review to ensure that plans comply with tax law requirements for retirement plans. The IRS reviews the plan design reflected in the plan documents and certain operational requirements. The determination letter program involves the issuance of determination letters to requesting plan sponsors, which are a statement of the IRS’ determination that a plan meets the qualification requirements of the Code.

The examination program involves the IRS’ examination of plans to determine whether the qualification requirements are met in operation. The qualified plan examination program reviews issues of plan design as well as those arising in plan operation. For example, a plan that, by its terms, provides for contributions in a manner satisfying tax law requirements may in operation result in contribution levels that impermissibly favor highly compensated employees.

Additionally, the IRS has established EPCRS, which is a comprehensive system of correction programs for sponsors of retirement plans and annuities that are intended, but have failed, to satisfy the requirements of section 401(a), section 403(a), or section 403(b), as applicable.<sup>1258</sup> EPCRS permits employers to correct compliance failures and continue to provide their employees with retirement benefits on a tax-favored basis.

The basic elements of the programs that comprise EPCRS are self-correction, voluntary correction with IRS approval, and correction on audit. The Self-Correction Program generally permits a plan sponsor that has established compliance practices to correct certain insignificant failures at any time (including during an audit), and certain significant failures within a 2-year period, without payment of any fee or sanction. The Voluntary Correction Program permits an employer, at any time before an audit, to pay a limited fee and receive IRS approval of a correction. For a failure that is discovered on audit and corrected, the Audit Closing Agreement Program provides for a sanction that bears a reasonable relationship to the nature, extent, and severity of the failure and that takes into account the extent to which correction occurred before audit.

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<sup>1258</sup> Rev. Proc. 2002-47, 2002-29 I.R.B. 1.

## B. Overview of Enron's Qualified Retirement Plans

This part provides an overview of qualified retirement plans maintained by Enron during the period covered by the Joint Committee review: the Enron Corp. Retirement Plan (“Enron Retirement Plan”), which was modified and is now the Enron Corp. Cash Balance Plan (“Enron Cash Balance Plan”); the Enron Corp. ESOP (“Enron ESOP”); and the Enron Corp. Savings Plan (“Enron Savings Plan”).<sup>1259</sup> The plans collectively are referred to as the Enron qualified plans. The Enron Retirement Plan and the Enron Cash Balance Plan are referred to collectively as the Enron Retirement Plan/Cash Balance Plan. Additionally, this part describes matters common to all of Enron's qualified retirement plans, plan administration, and pending legal matters involving the plans.

### 1. In general

Over time, the Enron Qualified Plans have been amended and restated to comply with legal requirements and, in some instances, to implement design changes. Because of changes in plan design, Enron employees may have earned benefits under more than one retirement formula within the same plan. Additionally, Enron employees may earn benefits under more than one plan.

The Enron Retirement Plan, a defined benefit plan was initially established effective July 1, 1986, as an amendment and restatement of the InterNorth, Inc. Retirement Income Plan II. At the same time, the Houston Natural Gas Corporation Retirement Plan, maintained by the Houston Natural Gas Corporation, an Enron subsidiary (“HNG”), was merged into the Enron Retirement Plan. The Enron Retirement Plan was amended and restated and renamed the Enron Corp. Cash Balance Plan effective January 1, 1996.

Enron established the Enron ESOP effective November 1, 1986.<sup>1260</sup> During 1986, Enron loaned the Enron ESOP \$335 million to purchase shares of Enron Corp. common stock that had previously been held as treasury stock. As a result of this purchase, the Enron ESOP held approximately 19 percent of Enron's outstanding common stock. During 1987, \$230 million of the principal amount of the loan was repaid with proceeds received from the terminating InterNorth, Inc. Pension Plan I.<sup>1261</sup> The final payment on the Enron ESOP loan was made in March 1993.

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<sup>1259</sup> Other qualified retirement plans were maintained by other members of Enron's controlled group. For example, PGE maintained a separate defined benefit plan. This report focuses on the retirement plans of Enron Corp. which were the largest plans within the Enron controlled group, and generally available to employees of Enron Corp. and related entities.

<sup>1260</sup> Materials reviewed by the Joint Committee staff indicate that Enron also sponsored a “tax-credit ESOP” which was effective in 1975 and terminated in 1988. Joint Committee staff did not review this plan.

<sup>1261</sup> Notes to Financial Statements, 1990 Form 5500 for the Enron Savings Plan, at 5. Descriptions of the mechanics of the repayment vary. Other sources explain that a block of Enron stock was purchased by the Enron ESOP in February 1987 with \$230 million received by

Enron established a floor-offset arrangement, involving the Enron Retirement Plan and the Enron ESOP effective January 1987. The Enron Retirement Plan was amended effective January 1, 1995, to eliminate the offset arrangement between the Enron Retirement Plan and the Enron ESOP for benefits accruing after 1994 and to freeze the amount of the offset over the period 1996 to 2000. The amendment of the floor-offset arrangement is discussed in detail in Part II.C.1., below.

The Enron Savings Plan began as a plan originally effective June 1, 1956.<sup>1262</sup> The Enron Savings Plan is a defined contribution plan which includes a qualified cash or deferred arrangement (i.e., it is a so-called “section 401(k)” plan). Participants may make elective deferrals and after-tax contributions to the Enron Savings Plan, and have a range of investment choices available for their contributions. 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 only after attaining age 50. The Enron ESOP was amended and merged into the Enron Savings Plan effective August 30, 2002, with the result that the provisions of the Enron Savings Plan generally replace the provisions of the Enron ESOP in their entirety.<sup>1263</sup>

## **2. Recent and pending legal matters involving the Enron qualified plans**

### **IRS audit**<sup>1264</sup>

The IRS has performed only one audit with respect to the Enron qualified plans.<sup>1265</sup> In 1998, the Tax Exempt and Government Entities Division of the IRS (“TE/GE”) audited the plans with respect to 1995 and 1996. IRS personnel informed the Joint Committee staff that the audit came about due to a request made by the Large and Mid-Size Business division of the IRS (“LMSB”), which was conducting an audit of Enron tax’s return. LMSB did not identify any issues for audit, but asked TE/GE if they could perform what the IRS refers to as a “support audit.” TE/GE personnel said that they determined they had the time and the resources and agreed to perform the audit.

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Enron as the reversion. *See* Enron’s July 21, 1994, request for an advisory opinion from the Department of Labor.

<sup>1262</sup> Forms 5500 for the Enron Savings Plan.

<sup>1263</sup> “Merger of Enron Corp. Employee Stock Ownership Plan with and into Enron Corp. Savings Plan,” EC 000899959-000899961. Pursuant to the merger, the assets held under the ESOP were transferred to the Enron Savings Plan to be held under the trust maintained thereunder.

<sup>1264</sup> This information was obtained primarily through interviews conducted by the Joint Committee staff of IRS personnel.

<sup>1265</sup> The IRS noted that Enron has qualified plans other than the Enron Savings Plan, Enron ESOP, and Enron Retirement Plan/Cash Balance Plan. In conducting the audit, they focused on these three plans because they are the largest.



IRS personnel said the audit was a long, labor intensive process. Among other things, the IRS reviewed Forms 5500 for the Enron qualified plans and checked Enron's deductions for qualified plan contributions. They had a computer audit specialist make an examination to determine if the Enron qualified plans were qualified in form, but spent the bulk of the time looking at plan operations.

### **PBGC actions**

In connection with Enron's filing for bankruptcy protection on December 2, 2001, the PBGC filed claims against Enron in October 2002.<sup>1266</sup> The PBGC's claim for unfunded benefit liabilities of the Enron Cash Balance Plan was approximately \$270 million. The PBGC's estimate of the underfunding may increase if the IRS rules adversely on the amendment to phase out the floor-offset arrangement<sup>1267</sup> and the benefits attributable to offset amounts become liabilities of the Enron Cash Balance Plan.<sup>1268</sup>

### **Department of Labor actions**

Following Enron's filing of voluntary petitions for Chapter 11 bankruptcy organization protection on December 2, 2001, the Department of Labor and Enron agreed in February 2002 to replace the Administrative Committee with an independent fiduciary to administer the Enron Qualified Plans. On March 14, 2002, the Department of Labor announced that a team of experts from State Street Bank and Trust had been selected to act in that capacity.<sup>1269</sup>

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<sup>1266</sup> See, e.g., Statement of the Pension Benefit Guaranty Corporation in Support of Its Claim for Unfunded Benefit Liabilities of the Enron Corp. Cash Balance Plan, at ¶ 8, filed in *In re Enron Corp., et al*, Case No. 01-16034, U.S. Bankruptcy Court, Southern District of New York.

<sup>1267</sup> This issue is discussed in detail in Part II.C.1., below.

<sup>1268</sup> The PBGC estimates that could increase by as much as 100 percent or more, if the phasing out of Enron's floor-offset arrangement (Part II.C.1, below) is determined by the IRS to fail the qualification requirements and the benefits attributable to offset amounts again become liabilities of the Enron Cash Balance Plan. Statement of the Pension Benefit Guaranty Corporation in Support of Its Claim for Unfunded Benefit Liabilities of the Enron Corp. Cash Balance Plan, at paragraph 8, filed in *In re Enron Corp., et al*, Case No. 01-16034, U.S. Bankruptcy Court, Southern District of New York.

<sup>1269</sup> First Amendment to Enron Corp. Cash Balance Plan, EC01747538-EC01747541. See Department of Labor news release, *Department Of Labor Announces Enron Independent Fiduciary State Street To Replace Enron's Retirement Administrative Committee*, [www.dol.gov/opa/media/press/opa/OPA2002145](http://www.dol.gov/opa/media/press/opa/OPA2002145).

The Department of Labor is investigating Enron's qualified retirement plans.<sup>1270</sup> The investigation is ongoing and comprehensive. The Department of Labor has been deposing "scores of witness and review[ing] literally millions of documents."<sup>1271</sup>

### **Private lawsuits**

Additionally, several lawsuits involving the Enron qualified plans have been filed. The lead case involving the plans is *Tittle v. Enron Corp.*, pending in U.S. District Court in the Southern District of Texas.<sup>1272</sup> *Tittle* was filed on behalf of an estimated 24,000 current and former participants in the Enron Savings Plan, the Enron ESOP, and the Enron Cash Balance Plan. A consolidated and amended complaint in the case was filed April 8, 2002.<sup>1273</sup> The case was brought by Enron workers who allege that their retirement accounts lost millions of dollars when Enron collapsed.<sup>1274</sup> They allege that the defendants were fiduciaries of the Enron retirement plans and that, rather than act prudently and solely in the interests of the Enron retirement plans and their participants and beneficiaries, the fiduciaries did nothing to protect the participants and beneficiaries from suffering huge losses even though the defendants knew or should have known that the plans were paying too much for Enron stock and that financial misstatements threatened the integrity of the retirement benefits.

The complaint seeks to recover losses incurred by participants or beneficiaries of the Enron Savings Plan, the Enron ESOP and the Enron Cash Balance Plan who were affected by a variety of alleged misconduct by the various defendants relating to the Enron stock in the Enron Plans. The complaint is framed to recover on behalf of the Enron Qualified Plans as a whole

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<sup>1270</sup> Speech by Assistant Secretary of Labor Ann L. Combs to the Annual Conference of the Society of American Business Editors and Writers (delivered Nov. 4, 2002), [www.dol.gov/pwba](http://www.dol.gov/pwba).

<sup>1271</sup> *Id.*

<sup>1272</sup> The plaintiffs in *Tittle* seek class action status.

<sup>1273</sup> The following cases were consolidated by orders of the U.S. District Court for the Southern District of Texas, dated December 12, 2001, and January 18, 2002: *Tittle v. Enron Corp.*, No. H-01-3913; *Rinard v. Enron Corp.*, No. H-01-4060; *Harney v. Enron Corp.*, No. H-01-4063; *Kemper v. Enron Corp.*, No. H-01-4089; *Clark v. Enron Corp.*, No. H-01-4125; *Ricketts v. Enron Corp.*, No. H-01-4128; *Pottratz v. Enron Corp.*, No. H-01-4150; *Stevens v. Enron Corp.*, No. H-01-4208; *Prestwood v. Gathman*, No. H-01-4209; *Walt v. Lay*, No. H-01-4299; *Moore v. Enron Corp.*, No. H-01-4236.

<sup>1274</sup> The plaintiffs in *Tittle* are Pamela M. Tittle, Thomas O. Padgett, Gary S. Dreadin, Janice Farmer, Linda Bryan, John L. Moore, Betty J. Clark, Shelly Farias, Patrick Campbell, Fanette Perry, Charles Prestwood, Roy Rinard, Steve Lacey, Catherine Stevens, Roger W. Boyce, Wayne M. Stevens, Norman L. and Paula H. Young, Michael L. McCown, Dan Shultz, on behalf of themselves and a class of persons similarly situated, and on behalf of the Enron Corp. Enron Savings Plan, the Enron Corp. Employee Stock Ownership Plan and the Enron Corp. Cash Balance Plan.

whether or not a class or classes are certified. The complaint covers alleged misconduct during January 20, 1998, through December 2, 2001.

Among the defendants named in *Tittle*, in addition to Enron itself, are certain current and former Enron directors and officers and the members of the Administrative Committee for the Plans, who were all Enron employees appointed by Enron.<sup>1275</sup> Defendants in the case moved to dismiss the action on May 8, 2002, generally arguing that there is no set of facts that the plaintiffs have alleged that would make them liable for the losses suffered by the Enron plans and the retirement accounts of these workers.

The Department of Labor filed a brief as *amicus curiae* opposing the defendants' motion to dismiss. According to the brief, based on the allegations in the complaint, ERISA required the fiduciaries to take action to protect the interests of the Enron plans, their participants and beneficiaries, and ERISA provides remedies for the failure to have done so. The Department of Labor argues that the allegations of the complaint are sufficient to withstand motions to dismiss and that the plaintiffs should be allowed to conduct discovery to prove the allegations.

In its brief, the Department of Labor makes a number of points. First, it argues that the fiduciaries responsible for monitoring the Administrative Committee that directly manages the Enron Savings Plan (the "appointing fiduciaries") have a duty under ERISA to ensure that the Committee is properly performing its duties, and that it has the tools and the information necessary to do its job. Initially, the Department of Labor concludes that because the appointing fiduciaries had the power to appoint, retain, and remove the members of the Administrative Committee, the Appointing Fiduciaries have discretionary authority over the management and administration of the plan and are thus plan fiduciaries under ERISA.

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<sup>1275</sup> The parties named as defendants in *Tittle* are: Enron Corp., Enron Corp. Savings Plan Administrative Committee, Enron Employee Stock Ownership Plan Administrative Committee, Cindy K. Olson, Mikie Rath, James S. Prentice, Mary K. Joyce, Sheila Knudsen, Rod Hayslett, Paula Rieker, William D. Gathmann, Tod A. Lindholm, Philip J. Bazelides, James G. Barnhart, Keith Crane, William J. Gulyassy, David Shields, John Does Nos. 1-100 Unknown Fiduciaries of the Enron Corp. Savings Plan or the ESOP, the Northern Trust Company, Kenneth L. Lay, Jeffrey K. Skilling, Andrew S. Fastow, Michael Kopper, Richard A. Causey, James V. Derrick, Jr., The Estate of J. Clifford Baxter, Mark A. Frevert, Stanley C. Horton, Kenneth D. Rice, Richard B. Buy, Lou L. Pai, Robert A. Belfer, Norman P. Blake, Jr., Ronnie C. Chan, John H. Duncan, Wendy L. Gramm, Robert K. Jaedicke, Charles A. Lemaistre, Joe H. Foy, Joseph M. Hirko, Ken L. Harrison, Mark E. Koenig, Steven J. Kean, Rebecca P. Mark-Jusbasche, Michael S. McConnell, Jeffrey McMahon, J. Mark Metts, Joseph W. Sutton, Arthur Andersen & Co. Worldwide Societe Cooperative, Arthur Andersen, LLP, UK Arthur Andersen, David B. Duncan, Thomas H. Bauer, Debra A. Cash, Roger D. Willard, D. Stephen Goddard, Jr., Michael M. Lowther, Gary B. Goolsby, Michael C. Odom, Michael D. Jones, William Swanson, John Stewart, Nancy A. Temple, Don Dreyfus, James Friedlieb, Joseph F. Berardino, Does 2 Through 1800 Unknown Partners in Andersen LLP, Merrill Lynch & Co., Inc., J.P. Morgan Chase & Co., Credit Suisse First Boston Corporation, Citigroup, Inc., Salomon Smith Barney Inc., Vinson & Elkins, LLP, Ronald T. Astin, Joseph Dilg, Michael Finch, and Max Hendrick III.

The Department of Labor also argues that fiduciaries may not deceive plan participants or allow others to do so. Rather, fiduciaries are obligated to take appropriate actions to carry out their responsibilities. This may include investigating allegations of fraud, disclosing facts to participants, other fiduciaries, or the public, and stopping further investment in company stock, as required by a standard of prudence.

Additionally, the Department of Labor asserts, fiduciaries have an obligation to ensure that investments in employer securities in a defined contribution plan are prudent, notwithstanding plan provisions that favor such investments. Further, the Department of Labor states that even if fiduciaries have “insider information” about the value of employer securities, Federal securities law does not prevent the fiduciaries from taking some action to protect the Enron qualified plans, such as public disclosure or temporarily suspending further purchase of employer securities. Finally, the Department of Labor argues that directed trustees cannot follow directions that they know or should know are imprudent or violate ERISA.

Defendants’ motion to dismiss *Tittle* is pending.

### **3. Administration of the Enron qualified retirement plans**

#### **In general**

##### The Administrative Committee

The Enron Cash Balance Plan, the Enron Savings Plan, and the Enron ESOP generally vest responsibility for plan administration in an administrative committee consisting of one or more individuals appointed by Enron.<sup>1276</sup> Each Plan provides for a separate administrative committee for that Plan. In practice, however, the same individuals (typically senior Enron officials appointed by the Chairman of the Board of Enron), served on all three Committees and issues with respect to all three Plans were addressed in a single Committee meeting. This document uses the term “Administrative Committee” to refer to the all three committees provided for under the Enron qualified plans. The members of the Administrative Committee are fiduciaries under ERISA.

The duties of each Plan Administrative Committee are specified in detail in each Plan document. Many of these duties are similar for all three Plans. There are, however, responsibilities which are specific to each Plan. An overview of the Administrative Committee’s duties and activities is provided here; a detailed discussion follows.

According to interviews with former Administrative Committee members, there was no formal process for the selection of Administrative Committee members; suggestions for new members were typically made by the Enron Benefits Department to the Office of the Chairman. The Chairman would then make an appointment.

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<sup>1276</sup> Under the Enron ESOP, the Administrative Committee is also the “named fiduciary” with respect to general administration of the Enron ESOP. Under the Enron Cash Balance Plan and the Enron Savings Plan, however, Enron is the “named fiduciary” with respect to general administration.

The Joint Committee staff interviewed former members of the Administrative Committee, including two former chairmen, and reviewed minutes of Administrative Committee meetings. The view presented of the activities of the Administrative Committee is similar. The interviews confirm that the members of the Administrative Committee viewed their role as relatively narrow. In practice, the main activities of the Administrative Committee were: (1) review of the investment performance under the Enron Cash Balance Plan; (2) review of the performance of the various investment options under the Enron Savings Plan (other than Enron stock)<sup>1277</sup>; and (3) participant appeals with respect to all three plans. These appeals generally related to the denial or calculation of benefits. One former member of the Administrative Committee said that the two main issues addressed during his five-year tenure on the Administrative Committee involved a change in a family of investment funds offered under the Enron Savings Plan and the merging of a PGE plan and the Enron Savings Plan.

The Administrative Committee generally did not evaluate Enron stock as an appropriate investment under either the Enron ESOP or the Enron Savings Plan. As described by one Administrative Committee member, the Enron ESOP plan terms provided for investment of plan assets in Enron stock, so there was no need to review that investment. The Administrative Committee questioned for the first time whether it should be examining Enron stock as an investment under the Enron qualified plans on November 1, 2001.<sup>1278</sup>

Administrative Committee meetings were generally attended by a member of the Enron Benefits Department and the Enron Treasury Department (who focused on investment matters, particularly with respect to the Enron Cash Balance Plan). Others also attended on an as needed basis, including in-house counsel, Enron counsel, and the Administrative Committee's counsel. The Committee received advice on numerous occasions from outside Enron ERISA counsel. The role of these parties may not always have been clear to Committee members; one former member indicated he was not sure whether the Enron ERISA counsel lawyer represented the Committee or Enron.

The Administrative Committee was briefed on occasion regarding their duties by Enron's ERISA counsel. In once such briefing, the Committee members were counseled to think of their fiduciary role as a "parable of hats." They were advised that each member has four hats, an Enron hat, an Enron Cash Balance Plan hat, an Enron Savings Plan hat, and an Enron ESOP hat; the member could wear only one hat at a time. Interviews with Administrative Committee members indicated that they generally understood that they were plan fiduciaries and that they were to act in the best interests of plan participants. It is not clear whether the members understood the special nature of ERISA fiduciary duties; one member told the Joint Committee staff that he missed a briefing on ERISA fiduciary duties, but that he had experience in fiduciary matters and therefore understood his obligations.

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<sup>1277</sup> In reviewing investment performance under the Enron Cash Balance Plan and the Enron Savings Plan, the Administrative Committee relied on the advice of third parties, as well as in-house personnel.

<sup>1278</sup> Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001). EC000001847.

The Enron qualified plans provide that Enron will indemnify Administrative Committee members against expenses and liabilities arising out of their administrative functions or fiduciary duties (other than expenses and liabilities arising out of gross negligence or willful misconduct).

There was no set schedule for Administrative Committee meetings, although there appeared to be a general intent to meet at least quarterly. There may be some lapse in the recordkeeping with respect to such meetings; Enron informed the Joint Committee staff that the Administrative Committee did not meet during the one-year period from October 19, 1998, to October 26, 1999. However, documents provided by Enron and interviews with former Administrative Committee members indicate that during this period the Administrative Committee was actively involved in issues relating to the merging of the Enron and PGE Plans.

The Administrative Committee started having weekly, then daily meetings near the end of 2001 as the stock price of Enron was falling rapidly. These frequent meetings focused at first on the change of recordkeepers and the blackout under the Enron Savings Plan, and later on the questions involving Enron stock as a suitable investment and pending law suits.

As described above, on March 14, 2002, the Department of Labor announced that a team of experts from State Street Bank and Trust had been selected to administer the Enron qualified plans.<sup>1279</sup>

#### Role of Enron

The day-to-day operations of the Enron qualified plans were generally performed by the Enron Benefits Department.<sup>1280</sup> According to interviews with current and former Enron personnel, the Benefits Department processed distributions, prepared retirement packages, provided customer service, and answered telephone calls. The Benefits Department was generally responsible for employee communications with respect to Enron's retirement plans. Additionally, Benefits Department employees interviewed by Joint Committee staff reported varying levels of discretion and involvement in amendments to the plans. The Administrative Committee generally did not oversee the activities of the Enron Benefits Department.

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<sup>1279</sup> First Amendment to Enron Corp. Cash Balance Plan (Jan. 1, 2001, restatement), EC01747538-EC01747541. According to the Department of Labor announcement of the selection of State Street Bank and Trust, State Street is responsible for, among other things, the investment of Enron qualified plan assets, the selection and monitoring of investment managers, the investment of Enron qualified plan assets in employer securities, representation of the interests of the Enron qualified plans in litigation. This includes representation of the plans' interests in the Enron bankruptcy and the selection and monitoring of funds and investment options offered under the Enron Savings Plan. Department of Labor news release, *Department Of Labor Announces Enron Independent Fiduciary State Street To Replace Enron's Retirement Administrative Committee*, [www.dol.gov/opa/media/press/opa/OPA2002145](http://www.dol.gov/opa/media/press/opa/OPA2002145).

<sup>1280</sup> Third-parties, such as recordkeepers, also had responsibilities with respect to some plan activities. The appointment of State Street Bank and Trust to administer the Enron qualified plans does not appear to affect these responsibilities.

Enron, not the Administrative Committee was responsible for plan design and plan amendments. The Administrative Committee would receive briefings regarding proposed Plan changes, but typically was not involved in the decision-making process.

#### Role of the Compensation Committee

The Compensation Committee of the Board also had a role with respect to Enron Plans. The Committee approved Plan amendments; in some cases this approval was final, in other cases amendments were approved for action by the full Board of Directors. The extent to which the members of the Compensation Committee understood their role with respect to the Enron qualified plans is unclear; one former member of the Compensation Committee interviewed by the Joint Committee staff indicated he did not remember having any responsibilities with respect to such plans.

#### Membership of the Administrative Committee

During the period reviewed by Joint Committee staff, there appears to have been no formal, written process for the selection of members to the Administrative Committee. Rather, membership on the Administrative Committee was generally subject to the discretion of the Chairman of Enron. Individuals in Enron's Benefits Department would typically recommend individuals for Committee membership to the Chairman's office. If the Chairman agreed with the recommendation of the Benefits Department, he would send a letter to the individuals requesting that they volunteer for the Administrative Committee. A former chair of the Administrative Committee indicated to the Joint Committee staff that, in looking for Administrative Committee members, the general approach was to look for someone at the officer level who would be interested in serving on the Administrative Committee and who would be qualified either by background or interest. He also indicated that changes to the Administrative Committee were not made very often, so the issue did not arise very much. Another former chair of the Administrative Committee stated that he believed people within Enron viewed serving on the Administrative Committee as an honor.

The Enron qualified plans provide that Administrative Committee members served until they resigned, died, or were removed by Enron. The Enron qualified plans provide that Administrative Committee members are not compensated for their Administrative Committee service.

There was no established number of persons on the Administrative Committee. Former Administrative Committee members told the Joint Committee staff that typically, there were four to eight individuals on the Administrative Committee at various points in time.

#### Meetings of the Administrative Committee

The Administrative Committee did not have a regular meeting schedule. Meetings of the Administrative Committee were generally held at the discretion of the Administrative Committee chair.

During the period of the Joint Committee staff review, the frequency of Administrative Committee meetings varied. Minutes of Administrative Committee meetings<sup>1281</sup> as well as interviews with former Administrative Committee members demonstrate a general intent to meet quarterly. However, this did not always happen, and attendance was sometimes an issue.<sup>1282</sup>

A major gap in meetings appears to have occurred for slightly more than one year, from the October 19, 1998, meeting until the October 26, 1999, meeting. Enron informed the Joint Committee staff that the Committee did not meet during this period. However, documents provided by Enron, as well as interviews with former Administrative Committee members indicate that the Administrative Committee conducted business during this time. These sources indicate that the Enron and PGE plans were being merged, and that the Administrative Committee was involved in this merger. One member of the Administrative Committee at this time said the merger of these plans was one of the two major issues addressed during his tenure on the Administrative Committee. There are briefing materials prepared for the Administrative Committee regarding the merger dated November 1998. There are no other indications of what the Administrative Committee did during this time period. It may be that there is a gap in recordkeeping for this period.

In 2001, the Administrative Committee met quarterly until October/November, when they started meeting as frequently as weekly. In late 2001, the Administrative Committee met on a daily basis. The reason for more frequent meetings was, at first, primarily to address the issue of the change in recordkeepers and blackout period under the Enron Savings Plan.<sup>1283</sup> Later, the meetings addresses issues related to Enron's financial problems, including the possibility of obtaining an investment advisor to assess the suitability of Enron stock as an investment and pending lawsuits.

In addition to Administrative Committee members, meetings were attended by others. An Enron benefits department representative and an Enron Treasury Department representative would usually attend. The Enron Treasury Department representative generally addressed issues relating to investments under the Enron Cash Balance Plan. Others also attended on an as-needed basis, including legal counsel for Enron (in-house as well as outside counsel) and legal counsel for the Administrative Committee. The sources of legal advice for the Administrative Committee are discussed further, below.

### **Plan provisions regarding the Administrative Committee**

Under the Enron qualified plans, the Administrative Committee is to “supervise the administration and enforcement of the Plan[s] according to the terms and provisions [t]hereof and shall have all powers necessary to accomplish these purposes.” Under all of the Plans, the Administrative Committee's powers include, but not by way of limitation, the right, power, authority, and duty:

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<sup>1281</sup> Minutes of the Administrative Committee Meeting (Sept. 26, 2000).

<sup>1282</sup> *Id.*

<sup>1283</sup> This issue is discussed in detail in Part II.C.4., below.



- to make rules, regulations, and bylaws for the administration of the Plan that are not inconsistent with the terms and provisions of the Plan, provided such rules, regulations, and bylaws are evidenced in writing, and to enforce the terms of the Plan and the rules and regulations promulgated thereunder by the Administrative Committee;
- to construe in its discretion all terms, provisions, conditions, and limitations of the Plan, and, in all cases, the construction necessary for the Plan to qualify under the applicable provisions of the Code shall control;
- to correct any defect or to supply any omission or to reconcile any inconsistency that may appear in the Plan in such manner and to such extent as the Administrative Committee deems expedient in its discretion to effectuate the purposes of the Plan;
- to employ and compensate such accountants, attorneys, investment advisors, and other agents, employees, and independent contractors that the Administrative Committee may deem necessary or advisable for the proper and efficient administration of the Plan;
- to determine in its discretion all questions relating to eligibility;
- to make a determination in its discretion as to the right of any person to a benefit under the Plan and to prescribe procedures to be followed by distributees in obtaining benefits;
- to prepare, file, and distribute, in such manner as the Administrative Committee determines to be appropriate, such information and material as is required by the reporting and disclosure requirements of ERISA;

With respect to the Enron Savings Plan only, the Administrative Committee also has the power:

- to require and obtain from Enron and the Plan and their beneficiaries any information or data that the Administrative Committee determines is necessary for the proper administration of the Plan;
- to instruct the trustee as to the loans to participants;
- to direct the Trustee as to the investment of the trust fund in Enron stock or Enron Oil & Gas stock as the Administrative Committee may deem to be appropriate and in accordance with the provisions of the Enron Savings Plan;
- to appoint investment managers; and
- to direct the trustee as to the exercise of rights or privileges to acquire, convert, or exchange Enron stock or Enron Oil & Gas stock.

With respect to the Enron ESOP only, the Administrative Committee has the power:

- to make a determination as to the right of any person to a benefit under the Enron ESOP;
- to receive and review reports from the Plan trustee as to the financial condition of the trust fund established under the Plan, including its receipts and disbursements;
- to instruct the trustee in the voting of Enron stock, provided, that the Administrative Committee shall follow the directions of the members to the extent required by the Plan and further provided that the Administrative Committee may in its discretion

- appoint a voting fiduciary to receive voting directions from the participants and direct the trustee with respect thereto;
- to select an appraiser to value Enron stock held by the Plan;
  - to direct the trustee as to the purchase and sale of Enron stock, including, but not limited to, tender or exchange decisions in accordance with Members' decisions...and decisions as to the purchase of Company Stock pursuant to the option granted to the trustee...and to cause the trustee to enter into an Exempt Loan and to purchase Enron stock for the Trust Fund with the proceeds of such Exempt loan;
  - to instruct the trustee as to the loans to participants; and
  - to instruct the trustee as to the management, investment and reinvestment of the trust fund generally.

With respect to the Enron Cash Balance Plan only, the Administrative Committee has the power:

- to issue directions to the trustee concerning all benefits that are to be paid from the trust fund according to the plan; and
- to receive and review reports from the trustee as to the financial condition of the trust fund, including its receipts and disbursements.

No supplemental written guidelines specifying the Administrative Committee's responsibilities were provided to Administrative Committee members.

Review of the minutes of Administrative Committee meetings and interviews with former Administrative Committee members provide a picture of the specific issues addressed by the Administrative Committee with respect to each Plan in practice. The Administrative Committee would oversee and review the performance of investments of Enron Retirement Plan/Cash Balance Plan assets made by the professional investment managers. One former Administrative Committee member described this process as follows: typically, the Administrative Committee reviewed investment performance of plan assets for the previous quarter. However, the Administrative Committee would normally not act based on a single quarter's performance. Rather, it tended to take a long-term view. If an investment manager was not performing in at least the fiftieth percentile for their family of managers, the Administrative Committee would instruct the Enron Finance or Treasury Department to analyze the performance. If the investment manager was consistently underperforming, the Administrative Committee was authorized to change investment managers. Experts would appear before the Administrative Committee and recommend investments.

The Administrative Committee would also oversee the investment options under the Enron Savings Plan. The Administrative Committee would review the investments and consider whether they were adequate and whether the participants had adequate choices. The Administrative Committee would also periodically change investment options available to Enron Savings Plan participants.

The Administrative Committee also handled participant appeals with respect to benefit determinations and other issues under all three Plans. Pursuant to Plan terms, the Enron ESOP was invested primarily in Enron stock. As a result, the Administrative Committee generally did

not review Enron ESOP Plan investments. The primary activity of the Administrative Committee with respect to the Enron ESOP was participant appeals.

### **Sources of legal advice for the Administrative Committee**

Legal counsel was available to the Administrative Committee from Enron's in-house lawyers and also from legal advisors outside Enron. The Administrative Committee had counsel that represented the Committee. In addition, the Committee received advice from outside counsel for Enron. This individual was referred to by former Administrative Committee members and Enron employees as the "ERISA counsel." Here, he is referred to as Enron's ERISA counsel. While the Enron ERISA counsel represented Enron, not the Committee, he provided advice to the Committee, as well as Enron benefits personnel, regarding a variety of matters. For example, as discussed below, the Enron ERISA counsel briefed the members of the Committee regarding their fiduciary duties.

Some Committee members may not have fully understood the precise relationship between the various legal counsel and the Committee. For example, one former Committee member indicated he was not sure whether the Enron ERISA counsel represented the Committee or Enron, but that he was consulted periodically by the Committee.

### **Overview of briefings provided to Administrative Committee members regarding their duties**

Members of the Administrative Committee received periodic briefings regarding their obligations under ERISA. During the period 1996 through 2001,<sup>1284</sup> the Administrative Committee received two briefings regarding their duties and fiduciary responsibilities. These briefings occurred at the Administrative Committee meetings of December 6, 1996, and March 9, 2000. In addition, as described below, selected issues with respect to the Administrative Committee's duties were addressed at other meetings.<sup>1285</sup>

In the meeting on December 5, 1996, the Administrative Committee was advised in a presentation by Enron's ERISA counsel that each Plan sponsored by Enron had a separate Administrative Committee, and that each Administrative Committee is a fiduciary with respect to the Plan it administers. The Administrative Committee was also advised that Enron Corp. is a fiduciary with respect to each Plan, and that the individual committee members are plan fiduciaries.

The briefing materials provided to the Committee include a summary of the basic ERISA fiduciary standards,<sup>1286</sup> including the exclusive purpose rule, the prudent man rule, the rule

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<sup>1284</sup> The first year for which the Joint Committee staff reviewed Administrative Committee minutes was 1996.

<sup>1285</sup> The materials describing the duties of the Administrative Committee presented at these meetings are included in Appendix D to this Report.

<sup>1286</sup> ERISA's fiduciary rules are described in Part II.A.3., above.

relating to diversification of investments, and the duty to act in accordance with plan documents and the “reasonable person” standard. The materials note the existence of the prohibited transaction rules, as well as rules regarding investment duties. The materials also discuss the Committee’s responsibilities with respect to appeals by plan participants.

Minutes for the March 9, 2000, Administrative Committee meeting indicate that the meeting had been called for the purpose of reviewing of the members’ duties and responsibilities. Enron’s ERISA counsel made a presentation to the members describing the members and Enron’s respective Administrative, trustee, and fiduciary duties as defined in the Enron qualified plans. The minutes state that the information was presented as documented. Unlike the December 1996, briefing, this briefing did not focus on fiduciary issues, but also addressed issues such as the role of Enron, the specific powers and duties of the Administrative Committee under the terms of the Plans, and the role of third parties. There were follow-up items that were to be researched by Enron’s ERISA counsel, including the appointing of a voting fiduciary, differentiation between “power to” versus “responsibility” and whether the Administrative Committee has shared or sole responsibility for the administration of the Enron qualified plans.

Minutes for the meeting of September 26, 2000, state that the Chair stressed the need to have Administrative Committee meetings quarterly and emphasized the importance of attendance. The minutes state that the Administrative Committee revisited the responsibilities of the Administrative Committee and referenced the March 9, 2000, meeting. The representatives from the Enron Finance and Benefits Departments were charged to list their duties and responsibilities for supporting the Administrative Committee.

In response to this last item, the September 26, 2000, minutes include the following list of duties of the Administrative Committee secretary:

- Record and hold minute records,
- Facilitate addition and removal of Committee members,
- Type agenda items as determined by the Committee,
- facilitate meeting location and time,
- distribute agenda to committee members as well as review materials provided by presenters or members themselves.

This list also indicates that the Enron Service Director of Benefits brings appeals requiring an Administrative Committee vote to the question of the Administrative Committee and that the Administrative Committee determines meeting times and agendas.<sup>1287</sup>

At the November 2, 2000, Administrative Committee meeting, there was a discussion of the Administrative Committee’s responsibilities with respect to the decision of the outsourcing of the Enron qualified plans and whether the Administrative Committee was responsible for reviewing the expenses of outsourcing. The Committee Secretary advised the Administrative Committee that, based on the presentation made by ERISA counsel at the March 9, 2000,

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<sup>1287</sup> The materials presented at this meeting are included in Appendix D to this Report.

meeting, this issue was specifically addressed and determined to be the role of Enron and not the Administrative Committee. The Committee Secretary was directed to obtain written documentation of this from Enron ERISA counsel.

#### **4. The Enron Corp. Retirement Plan (“Enron Retirement Plan”)**

##### **Historical background**

Enron established the Enron Corp. Retirement Plan, a defined benefit plan, effective July 1, 1986, as an amendment and restatement of the InterNorth, Inc. Retirement Income Plan II. At the same time, the Houston Natural Gas Corporation Retirement Plan, maintained by HNG, was merged into the Enron Retirement Plan. For the period preceding July 1, 1986, participants in the Enron Retirement Plan were generally credited with their service in amounts equal to all service credited under predecessor plans as such plans existed on June 30, 1986.

The Enron Retirement Plan was amended and restated and renamed the Enron Corp. Cash Balance Plan effective January 1, 1996.

##### **Plan features**

###### **Participation**

Individuals employed by Enron, one of its subsidiaries, or affiliated companies on its domestic payroll who were age 21 or older generally were eligible to participate in the Enron Retirement Plan. In general, such employees could participate in the Enron Retirement Plan beginning on the first day of the month of their first anniversary of employment, as long as they had worked at least 1,000 hours during that year. Collective bargaining unit employees were generally not eligible to participate in the Enron Retirement Plan.

###### **Benefits**

Participants in the Enron Retirement Plan accrued benefits under a final average pay formula. Under the formula, participants were generally entitled to benefits based upon the sum of different percentages of their final average pay multiplied by years of accrued service.<sup>1288</sup> Contributions to the Enron Retirement Plan by participants were not permitted.<sup>1289</sup>

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<sup>1288</sup> For example, the January 1, 1989, restatement of the Enron Retirement Plan, provided that participants who retire on or after their normal retirement date are entitled to receive a benefit that is the actuarial equivalent of a pension beginning on the first day of the month coinciding with or next following the date of their retirement, each monthly payment is equal to: (1) 1.45 percent of participant’s final average pay multiplied by years of accrual service not in excess of 25 years; plus (2) 0.45 percent of the participant’s final average pay multiplied by years of accrual service in excess of 25 years, up to a maximum of 10 years; plus (3) 0.45 percent of final average pay in excess of a factor related to Social Security integration; plus (4) 1 percent of final average pay multiplied by years of accrual service in excess of 35 years; plus (5) one-twelfth of an amount equal to 25 percent of the aggregate contributions (without interest) made by the participant to the Houston Natural Gas Corporation Retirement

Effective January 1987, Enron established a floor-offset arrangement, involving the Enron Retirement Plan and the Enron ESOP.<sup>1290</sup> Under the floor-offset arrangement, a participant's accrued benefit in the Enron Retirement Plan is offset by the annual annuity value<sup>1291</sup> of Enron stock held in the participant's Retirement Subaccount as of certain determination dates, generally the date that benefit payments from the Enron Retirement Plan commence. However, distributions from the Enron ESOP before the determination date were also taken into account.

Depending on the value of Enron stock, the amount of the offset might be greater than the value of a participant's benefit under the Enron Retirement Plan at any given time. If so, the excess in the Enron ESOP Retirement Subaccount would have been used to offset the participant's future benefits under the final average pay formula. If the offset amount was less than the benefit under the Enron Retirement Plan, the Enron Retirement Plan would pay the portion of the benefit that is not offset by the Enron ESOP Retirement Subaccount. In 1994, the Enron Retirement Plan was amended to provide that the offset would not apply with respect to benefits accrued after 1994 and the amount of the offset for prior years would be set over the period 1996-2000. These amendments are discussed in detail in Part II.C.2., below.

### Vesting

Participants were fully vested in their benefits under the Enron Retirement Plan after five years of service with Enron.

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Plan before February 1, 1980, excluding any contributions refunded to the participant; minus (6)(a) the monthly benefit payable from the normal retirement date under the life annuity form used to determine the value of assets transferred from the InterNorth, Inc. Retirement Income Plan, or a lump sum amount paid with respect to a period of employment include in accrual service otherwise factored in and (b) the monthly benefit commencing at age 65 the participant has received or is entitled to receive under any other qualified defined benefit plan to the extent attributable to a period of service or employment for which the participant is credited with accrual service under the plan. Sec. 5.1, Enron Retirement Plan (Jan. 1, 1989, restatement). (Items (1) through (4) of the computation appears to describe annual benefit amounts, and so must be divided by 12 for a monthly amount.)

<sup>1289</sup> However, according to sec. 11.1 of the Enron Retirement Plan (Jan. 1, 1989, restatement), contributions were made to the Plan by participants through prior plans.

<sup>1290</sup> The floor-offset arrangement does not affect benefits earned before 1987. *See* the discussion of the Enron ESOP in Part II.B.5.

<sup>1291</sup> The annual annuity value is the dollar amount available each year if the account balance at retirement were used to purchase an annuity, using standard assumptions for life expectancy and interest. The value of the ESOP offset was based on the amount of a monthly single life annuity that could be purchased by the value of an individual's ESOP offset as of certain determination dates. For purposes of this calculation, Enron assumed annuity returns of 8.5 percent annually.

## Distributions

Benefits under the Enron Retirement Plan were generally payable in the case of retirement, disability, or death and were paid in the form of an annuity. The automatic form of benefit was a single life annuity or a joint and survivor annuity in the case of married participants. Participants could also choose certain other optional forms of benefit, including a term certain annuity and a lump sum, in certain cases.

## Compliance

The IRS issued favorable determination letters with respect to the tax-qualified status of the Enron Retirement Plan on June 2, 1988, and December 20, 1995. The Plan was amended and restated effective as of January 1, 1989.<sup>1292</sup>

On July 24, 1994, Enron requested an advisory opinion from the Department of Labor<sup>1293</sup> concerning the Enron Retirement Plan and Enron ESOP as to whether a proposed restructuring of the plans and dismantling of the floor-offset arrangement with respect to future benefit accruals would cause it to be newly “established” such that it would lose its grandfathered status under ERISA.<sup>1294</sup> Enron proposed to split the Enron ESOP from the defined benefit plan and

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<sup>1292</sup> Certain documents provided to Joint Committee staff indicate that Enron entered into a closing agreement for 1989 and 1990 in order for the Enron Retirement Plan to remain qualified.

<sup>1293</sup> An advisory opinion is an opinion of the Department of Labor as to the application of one or more sections of ERISA, regulations promulgated under ERISA, ERISA interpretive bulletins, or exemptions from certain ERISA provisions issued by the Department of Labor to a specific factual situation. ERISA Procedure 76-1, 41 Fed. Reg. 36281 (Aug. 27, 1976). The advisory opinion is a written statement issued to an individual or organization, or to the authorized representative of such individual or organization, and typically applies only to the situation described in the request and provides reliance only to the parties described in the request for the opinion. *Id.*

<sup>1294</sup> Previously, in December 1992, Enron requested an advisory opinion from Department of Labor for the Enron ESOP and for the Enron Retirement Plan. Letter from Vinson & Elkins to Department of Labor, (Dec. 8, 1992). Pursuant to a series of intercorporate transactions, Enron intended to transfer certain of its affiliates’ assets and liabilities to Enron Oil Trading & Transportation Company (“EOTT”), a wholly-owned subsidiary of Enron. *Id.* After completion of such transfers, the Enron ESOP was to receive EOTT shares incident to the spinoff in the same manner as any other shareholder of Enron. *Id.* EOTT shares received by the Enron ESOP were to be credited to participants’ accounts in the ESOP with reference to the shares of Enron Stock credited to such accounts. *Id.* Enron sought the Department of Labor’s opinion (1) that the grandfather provision of sec. 9345(a)(3) of OBRA 1987 would not be rendered inapplicable by the Enron ESOP’s retention of the EOTT shares; (2) that the sale by the Enron ESOP of the EOTT shares pursuant to the spinoff and the investment of the proceeds of such sale in Enron stock would not render the grandfather provision of sec. 9345(a)(3) of OBRA 1987 inapplicable; and (3) that the sale by the Enron ESOP of the EOTT shares pursuant to the

allocate no additional shares of Enron stock to the offset account as of December 31, 1994. Enron proposed to permanently fix the value of one-fifth of the shares of Enron stock allocated to each participant's offset account each January 1 during the period 1996-2000. In connection with the restructuring, the Enron Board of Directors adopted an amendment to the Enron Retirement Plan to temporarily suspend accruals. If the Department of Labor had not issued favorable opinions regarding the restructuring, the suspension of accruals under the Enron Retirement Plan would have been retroactively rescinded as though the suspensions had never been made.<sup>1295</sup>

Advisory Opinion 94-42A was issued to Enron by the Department of Labor on December 9, 1994. According to the Advisory Opinion, Enron's dismantling of the floor-offset arrangement over a five-year period would not adversely affect the application of the special provision.

## **5. The Enron Corp. Employee Stock Ownership Plan ("Enron ESOP")**

### **Historical background**

Enron Corp. established the Enron ESOP effective November 1, 1986. The Plan document and summary plan description state that the primary purpose of the Plan was to enable plan participants to acquire stock ownership interests in Enron. The Enron ESOP also provided that it could be used to meet Enron's general financing requirements, including capital growth and transfer in the ownership of Enron stock. The Plan document also provides that the Enron ESOP may receive loans (or other extensions of credit) to finance the acquisition of Enron stock, secured primarily by a commitment by Enron to make contributions to the plan sufficient to repay principal and interest on the loan and employer securities acquired with the loan. The Enron ESOP was funded from two transactions, the proceeds of an exempt loan transaction and a reversion from a terminating pension plan within the Enron controlled group.

During 1986, Enron loaned the Enron ESOP \$335 million to purchase shares of Enron Corp. common stock that had previously been held as treasury stock. As a result of this purchase, the Enron ESOP held approximately 19 percent of Enron's outstanding common stock. During 1987, \$230 million of the principal amount of the loan was repaid with proceeds received from the terminating InterNorth, Inc. Pension Plan I.<sup>1296</sup> Stock acquired with the loan proceeds

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spinoff and the investment of the proceeds of such sale in assets other than Enron stock would not render the grandfather provision of sec. 9345(a)(3) of OBRA 1987 inapplicable. *Id.* By letter dated January 18, 1994, Enron withdrew its request for an advisory opinion.

<sup>1295</sup> Notice of Temporary Suspension of Accruals under the Enron Corp. Retirement Plan, EC000020212.

<sup>1296</sup> Notes to Financial Statements, 1990 Form 5500 for the Enron Savings Plan, at 5. The mechanics of this repayment are described variously in different sources. Enron's July 21, 1994, request for an advisory opinion from the Department of Labor explains that a block of Enron stock was purchased by the Enron ESOP in February 1987 with \$230 million received by Enron as the reversion.



and the reversion were held in suspense accounts in the Plan and allocated to participants over the period required under applicable law (in the case of the reversion) and the terms of the exempt loan (in the case of the exempt loan amount). Cumulative cash dividends paid on Enron stock held by the trustee were used to make the periodic payments of principal and interest necessary to retire the loan.<sup>1297</sup> The final payment on the Enron ESOP loan was made in March 1993.<sup>1298</sup>

The Enron ESOP was amended and merged into the Enron Savings Plan effective August 30, 2002, with the result that the provisions of the Enron Savings Plan generally replace the provisions of the Enron ESOP in their entirety.<sup>1299</sup> Pursuant to the merger, the assets held under the Enron ESOP would be transferred to the Enron Savings Plan to be held under the trust maintained thereunder. Participants in the Enron Savings Plan who participated in the Enron ESOP are entitled to benefits at least equal to the benefit they would have been entitled to receive immediately before the merger if the Enron ESOP was then terminated. Enron ESOP participants who did not otherwise participate in the Enron Savings Plan as of the date of the merger became participants in the Enron Savings Plan as of that date.

## **Plan features**

### Participation

As originally adopted, the Enron ESOP covered most full-time employees and certain part-time employees of Enron and other entities adopting the Enron ESOP. Full-time employees could begin participating in the Enron ESOP on the date they began working for Enron. Part-time or temporary employees could generally begin participating in the Enron ESOP on the January 1 following their one-year anniversary of working for Enron. Employees generally excluded from Enron ESOP participation were: employees whose terms and conditions of employment were governed by a collective bargaining agreement, nonresident aliens receiving no earned income from U.S. sources, and leased employees. Beginning January 1, 1995, new Enron employees were no longer allowed to participate in the Enron ESOP.

### Contributions/allocations

The Enron ESOP provided that contributions by Enron were to be made in amounts authorized by the Board of Directors and were payable in cash or in shares of Enron stock, as determined by the Board of Directors. Although the Enron ESOP provided for discretionary employer contributions, Enron has never made any direct contributions to it (i.e., account balances are attributable to the shares purchased with the 1986 loan and the 1987 reversion).<sup>1300</sup>

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<sup>1297</sup> 1993 Form 5500, Notes to Financial Statements.

<sup>1298</sup> *Id.*

<sup>1299</sup> “Merger of Enron Corp. Employee Stock Ownership Plan with and into Enron Corp. Savings Plan,” EC 000899959-000899961, <http://www.enron.com/corp/proofsofclaim/plans.html>.

<sup>1300</sup> Form 5300 Attachment I, Item 11b.

Participants in the Enron ESOP were neither required nor permitted to make contributions to the plan. Rollovers from amounts received from an IRA or annuity or from another qualified plan were accepted.

Each participant's account in the Enron ESOP was comprised of separate subaccounts: a Savings Subaccount and a Retirement Subaccount. In general, at the end of each year, shares of Enron common stock were allocated (1) to each participant's Savings Subaccount in an amount equal to 10 percent of the participant's compensation for the year and (2) to each participant's Retirement Subaccount based on the participant's length of service with Enron, age, and compensation. Additionally, Enron made a five percent allocation to a Special Allocation Subaccount for participants who were actively employed by Enron on December 31, 1994.<sup>1301</sup> This five percent allocation was made in lieu of an accrual for 1995 to the Enron Retirement Plan.<sup>1302</sup>

The initial loan made in 1986 to fund the Enron ESOP was held in a Suspense Account, which was credited with Enron stock acquired with the proceeds of the exempt loan. The Enron ESOP provided that as of the last day of each plan year, a certain number of shares of financed stock held in a stock suspense account would be allocated to participants' accounts. Allocations to participants from the suspense account were made over periods required (1) under applicable law (in the case of the reversion amount) and (2) by the terms of the exempt loan (in the case of the exempt loan amount). All payments on the exempt loan were made out of dividends on the stock held in the suspense account as well as out of allocated stock held by the Enron ESOP.

Beginning January 1, 1987, the Enron ESOP was integrated with the Enron Retirement Plan as part of the floor-offset arrangement. Significant changes were made to the operation of the offset in 1994.<sup>1303</sup>

The Enron ESOP was amended to provide final allocations to participants' Retirement Subaccounts and Savings Subaccounts for 1994. Although the Enron ESOP was ongoing, no further allocations were made to participants' accounts.

### Vesting

Participants were vested in their Enron ESOP accounts at a rate of 25 percent for each year they worked for Enron. Any amounts forfeited by participants who were not fully vested

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<sup>1301</sup> Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995), included in Appendix D. The allocations made under the Enron ESOP are discussed in Part II.C.1.

<sup>1302</sup> *Id.* Enron estimated that the shares actually allocated to participants' accounts would be approximately 4.4 to 4.6 percent of base pay, net of dividends. *Id.* Questions and answers for use by Enron human resources personnel in responding to questions from employees state that the difference would be made up in the allocation under the Enron Cash Balance Plan for 1996. *Id.*

<sup>1303</sup> The floor-offset arrangement is discussed in detail in Part II.C.1., below.

upon termination of employment were available, after a five-year holding period, for allocation to a Special Allocation Subaccount for participants who are eligible to receive them. Participants terminating employment with Enron for reasons other than retirement, total or permanent disability, or death were entitled to their vested interest in their account. Participants who attained normal retirement age under the Plan or terminated employment with Enron due to business circumstances, layoff, or corporate reorganization were 100 percent vested in amounts allocated to their accounts.

An Enron ESOP participant who was actively employed by Enron as of December 31, 1994, the date the plan was frozen, was 100 percent vested in his or her Retirement Subaccount, as required by law.

### Loans

Under the 1989 restatement of the Enron ESOP, loans to participants were permitted. The amount of any loan could not exceed the lesser of 50 percent of the total value of a participant's vested interest in the participant's Savings Subaccount and \$50,000. Loans are not permitted under the 1999 restatement of the Enron ESOP.

### Distributions and withdrawals

In general, the Enron ESOP provided that participants were entitled to a benefit based on the total value of their accounts as of the date they turn age 65 or terminate employment with Enron. Participants are generally required to begin receiving distributions by the April 1 following the calendar year in which they turn age 70½. If participants left Enron before turning age 65, they generally were entitled to receive the vested portion of their Retirement Subaccount balance upon turning age 55<sup>1304</sup> and the vested portion of their Savings Subaccount 90 days after leaving Enron.<sup>1305</sup>

Initially, participants in the Enron ESOP could elect to receive their benefits in a lump sum or periodic installment payments for a term not longer than fifteen years.<sup>1306</sup> In general, participants could elect to receive their distributions from the Enron ESOP in shares of Enron stock.<sup>1307</sup> Beginning in 1989, participants could elect to receive benefits in the form of an annuity purchased from an insurance company, but could no longer elect installment payments.<sup>1308</sup> Effective November 1, 1996, the Enron ESOP was amended to provide that the

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<sup>1304</sup> This rule also applied to the Special Allocation Account which held a special allocation made to participants' accounts in 1994. *See* Part II.C.1., below.

<sup>1305</sup> Sec. 12.1(a)(iii), Enron ESOP (Jan. 1, 1999, restatement).

<sup>1306</sup> Sec. 11.02(a), Enron ESOP (effective Nov. 1, 1986).

<sup>1307</sup> Sec. 11.02(c), Enron ESOP (effective Nov. 1, 1986), Sec. 12.2, Enron ESOP (Jan. 1, 1989, restatement), and Sec. 12.2(c), Enron ESOP (Jan. 1, 1999, restatement).

standard benefit generally was a joint and survivor annuity for married participants and a single life annuity for unmarried participants.<sup>1309</sup> However, the 1999 restatement of the Enron ESOP provided that an annuity was an alternative form of benefit to the standard lump sum. As described below, effective August 15, 2001, the Enron ESOP was amended to eliminate all forms of benefit other than lump sums.

In connection with the phasing out of the floor-offset arrangement, the Enron ESOP was amended effective March 1, 1994, to provide eligible participants access to the shares of Enron stock allocated to their Savings Subaccount.<sup>1310</sup>

Beginning in 1996, dividends from shares of Enron stock in all of participants' subaccounts, including those to which they had not yet gained access, began to be paid directly to them each quarter.<sup>1311</sup>

Under the version of the Enron ESOP effective in 1989, participants could withdraw (1) from his or her Enron ESOP Savings Subaccounts amounts held for 24 months or more which were not in excess of the greater of 100 shares of Enron stock or 25 percent of the vested balance of his or her account or (2) allocations of company contributions, financed stock, or reversion amounts credited to his or her Enron ESOP Savings Subaccount for at least 60 cumulative months, but any case not more than the greater of 100 shares of Enron stock or 25 percent of the value of the vested interest in his or her ESOP Savings Subaccount.<sup>1312</sup> Under the 1999 restatement of the Enron ESOP, the limits were changed to the vested interests of participants' ESOP Savings Subaccount.

### Compliance

The IRS issued a favorable determination letter for the Enron ESOP on June 2, 1988. The Enron ESOP was amended and restated effective January 1, 1989.

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<sup>1308</sup> Sec. 12.2, Enron Corp. ESOP (Jan. 1, 1989, restatement). The annuity distribution option was initially added by Enron effective January 1, 1990, under the Fifth Amendment to the Enron Corp. ESOP (effective Nov. 1, 1986).

<sup>1309</sup> Twelfth Amendment to the Enron ESOP (Jan. 1, 1989, restatement), effective Nov. 1, 1996. Under the amendment, the Enron ESOP provided that the annuity was the standard form of benefit with respect to the portion of participants' accounts not subject sec. 409(h). Sec. 409(h) provides that a participant who is entitled to a distribution from the plan has the right to demand that his or her benefit be distributed in the form of employer securities or if the employer securities are not readily tradeable on an established market has a right to require that the employer repurchase employer securities under a fair valuation formula.

<sup>1310</sup> The details of this process are discussed in Part II.C.1., below.

<sup>1311</sup> *Enron - Benefit Plans and Related Programs, Policies and Practices--Employee Stock Ownership Plan* (Dec. 14, 2001), EC000021272-EC000021280.

<sup>1312</sup> Enron ESOP section 13.2 (Jan. 1, 1989, restatement).

By letter dated January 6, 1993, Enron submitted to the IRS requests for rulings with respect to the Federal income tax consequences of proposed transactions involving the Enron ESOP. Enron intended to transfer certain assets and liabilities to Enron Oil Trading & Transportation Company (“EOTT”), a wholly-owned subsidiary of Enron. After completing such transfers, Enron would distribute all of its EOTT shares to its shareholders in a spinoff transaction. After the spinoff, Enron would no longer own any EOTT shares, EOTT would not own any equity interest in Enron and EOTT would not maintain or sponsor the Enron ESOP for its employees. As a holder of Enron stock, the Enron ESOP would receive EOTT shares incident to the spinoff in the same manner as any other shareholder of Enron. EOTT shares received by the Enron ESOP would be credited to participants’ accounts in the Enron ESOP. Enron requested rulings with respect to the applicability of certain excise taxes relating to prohibited transactions and employer reversions from qualified plans.<sup>1313</sup>

In general, in a letter dated December 20, 1993,<sup>1314</sup> the IRS ruled that, for purposes of the section 4975(a) excise tax on prohibited transactions, it would not be a violation of the requirement that an ESOP invest primarily in qualifying employer securities if shares of EOTT stock or assets other than Enron stock purchased with the proceeds from the sale of such shares are allocated to participants accounts on the same basis as are Enron shares. As such, the excise tax on prohibited transactions would not apply.<sup>1315</sup>

Additionally, the IRS ruled that the spinoff transaction would satisfy an exception to the section 4980(a) excise tax on the amount of an employer reversion from a qualified plan.<sup>1316</sup> Specifically, the IRS ruled that the retention by the Enron ESOP of the shares of EOTT stock which are allocated to a reversion suspense account under the Enron ESOP until distribution to participants would not be treated as a disposition of Enron shares.<sup>1317</sup> The IRS also ruled favorably on the sale by the Enron ESOP of the shares of EOTT stock which are allocated to the reversion suspense account and the use of the proceeds from such sale to acquire Enron stock.<sup>1318</sup> However, the IRS ruled that the sale of EOTT shares and the use of the proceeds from such sale to acquire assets other than Enron stock would violate the requirement that employer securities purchased with a reversion amount remain in the Enron ESOP until distribution to participants in accordance with the plan terms.<sup>1319</sup>

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<sup>1313</sup> Specifically, Enron requested rulings as to the applicability of secs. 4975(a) and 4980(a).

<sup>1314</sup> Priv. Ltr. Rul. 9411038 (Dec. 20, 1993).

<sup>1315</sup> *Id.*

<sup>1316</sup> *Id.*

<sup>1317</sup> *Id.*

<sup>1318</sup> *Id.*

<sup>1319</sup> *Id.*

The IRS issued favorable determination letters for the Enron ESOP on August 20, 1993, and March 6, 1996. The Plan was amended and restated effective January 1, 1999.

In late February or early March 2000, the Enron ESOP was referred to the IRS National Office for technical advice in connection with the issue of whether the Enron ESOP was at all times required to offer a joint and survivor spouse annuity as the standard form of benefit rather than as an alternative form of benefit to the Enron ESOP's standard lump sum distribution form.<sup>1320</sup> The IRS is currently reviewing this issue.

An application for determination of the tax-qualified status of the Enron ESOP was submitted to the IRS on February 15, 2002. The application requested that the IRS take into account all of the plan qualification requirements of the Uruguay Round Agreements Act, the Small Business Job Protection Act of 1986, the Uniformed Services Employment and Reemployment Rights Act of 1994, the Taxpayer Relief Act of 1997, the Restructuring and Reform Act of 1998, and the Community Renewal Tax Relief Act of 2000.

### **Plan provisions in effect in 2001 and 2002**

Effective January 1, 2001, the Enron ESOP was amended to preclude that Enron would make any contributions to the Enron ESOP.<sup>1321</sup>

Beginning August 15, 2001, all forms of distribution from the Enron ESOP except lump sums were eliminated.<sup>1322</sup> Additionally, the Enron ESOP was amended effective November 1, 2001, to provide that regular withdrawals from the Enron ESOP would be paid in company stock unless the participant elected to receive a withdrawal in cash.

As described above, the Enron ESOP was amended and merged into the Enron Savings Plan effective August 30, 2002.<sup>1323</sup> The assets held under the Enron ESOP were transferred to the Enron Savings Plan. Participants in the Enron Savings Plan who participated in the Enron ESOP are entitled to benefits at least equal to the benefit they would have been entitled to receive immediately before the merger if the Enron ESOP was then terminated. Enron ESOP participants who did not otherwise participate in the Enron Savings Plan as of the date of the merger became participants in the Enron Savings Plan as of that date.

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<sup>1320</sup> Attachment I to Form 5300 for Enron ESOP, submitted to the IRS on February 15, 2002.

<sup>1321</sup> Adoption of Administrative Procedures Relative to the Suspension of Contributions to the Enron Corp. Employee Stock Ownership Plan (executed Feb. 12, 2002), EC2000008923.

<sup>1322</sup> As described below, the IRS is currently reviewing this issue.

<sup>1323</sup> "Merger of Enron Corp. Employee Stock Ownership Plan with and into Enron Corp. Savings Plan", EC 000899959-000899961, <http://www.enron.com/corp/proofsofclaim/plans.html>.

## **6. The Enron Corp. Cash Balance Plan (“Enron Cash Balance Plan”)**

### **Historical background**

Effective January 1, 1996, the benefit formula under the Enron Retirement Plan was changed from the traditional defined benefit formula to a cash balance formula.<sup>1324</sup> Additionally, the Plan was amended, restated, and renamed “the Enron Corp. Cash Balance Plan.”

### **Plan features**

#### Participation

Employees of Enron who were age 21 or older were generally eligible to participate in the Enron Cash Balance Plan, except nonresident aliens who receive no earned income from sources within the United States, leased employees, individuals who are designated, compensated, or otherwise classified or treated by Enron as an independent contractor or other non-common law employee, and any employees whose terms and conditions of employment are governed by a collective bargaining agreement unless such agreement provides for coverage under the Plan.

#### Benefits

On conversion to the cash balance formula, each participant under the Enron Retirement Plan retained the benefit of their final average pay formula benefit based on their compensation and service as of December 31, 1994, which was the last day prior to the 1995 plan year during which all accruals under the Enron Retirement Plan were suspended. Thus, the benefit under the Enron Cash Balance Plan is equal to this preserved benefit plus amounts earned under the cash balance formula.

Hypothetical accounts are maintained for the participants in the Enron Cash Balance Plan. Such accounts are generally credited with five percent of participants’ monthly base pay.<sup>1325</sup> Additionally, at the end of each calendar month for which participants have cash balance accounts, their accounts are credited interest based on 10-year Treasury bond yields.

The Enron Cash Balance Plan does not accept rollover contributions from other qualified plans or IRAs.

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<sup>1324</sup> For a general description of the characteristics of cash balance plans, see Part II.A.2., above.

<sup>1325</sup> A special accrual was credited to the accounts of participants hired on or before Dec. 31, 1995. Their accounts were credited with 1.223 percent of their annualized base pay for each calendar month in 1994, EC000020097. Second Amendment to Enron Corp. Cash Balance Plan (effective Jan. 1, 1996) (executed May 6, 1997).

### Vesting

Participants in the Enron Cash Balance Plan are fully vested in their benefit under the plan on the earlier of completing five years of service or attaining the normal retirement age under the plan, which is age 65. If an Enron Cash Balance Plan participant accrued benefits under the Enron Retirement Plan under the final average pay formula, they are 100 percent vested in those benefits at all times.

### Distributions

The standard form of benefit for a participant who is married on his or her annuity starting date is a joint and survivor annuity. The standard form of benefit for a participant who is not married is an annuity payable for the life of the participant. Participants in the Enron Cash Balance Plan could also elect one of the following optional forms of benefit:

- (1) A single life annuity for the participant's life;
- (2) An annuity for the joint lives of the participant and any joint annuitant designated by the participant providing 50 percent or 100 percent benefits to the surviving joint annuitant;
- (3) For the portion of the participant's benefit consisting of a final average pay benefit, an annuity for a term certain of five, ten, or fifteen years and continuous for the life of the participant if the participant survives such term certain or continuing to the end of such term certain to the beneficiary or beneficiaries designated by the participant in the event of the participant's death before the end of such term certain; or
- (4) A single lump sum cash payment for the portion of the participant's benefit under the cash balance formula.

Participants in the Enron Cash Balance Plan can receive their benefits upon normal and early retirement, disability, termination, and on an employee's death. Payment of benefits generally begins after a participant reaches the Plan's normal retirement age of 65. However, participants may withdraw the vested portion of their benefit that accrued after 1995 if they leave Enron for any reason. The Enron Cash Balance Plan also provides for an early retirement benefit.

### Compliance

The IRS issued favorable determination letters to the Enron Cash Balance Plan on December 20, 1995, November 14, 1996, and January 22, 1997.

An IRS examination of the Enron Cash Balance Plan resulted in a request by IRS examiners for technical advice from the IRS National Office during 2000. The request arrived in National Office of the IRS on March 17, 2000, and is currently under review.



On April 12, 2000, Enron submitted to the IRS a request for a determination of the tax-qualified status of the Enron Cash Balance Plan.

On September 5, 2000, the Enron Cash Balance Plan was submitted to the National Office for review, in accordance with a September 15, 1999, directive from the National Office of the IRS that all qualification determination filings and field audits with respect to defined benefit plans which have been or are being converted from one formula into a cash balance formula be referred to the National Office of the IRS in connection with its ongoing review of technical issues relating to such conversions.<sup>1326</sup> The IRS notified Enron that its request for a determination letter would be associated with the 2000 request for technical advice from IRS examiners.

An application for determination of the tax-qualified status of the Enron Cash Balance Plan was submitted to the IRS on February 15, 2002. The application requested that the IRS take into account all of the plan qualification requirements of the Uruguay Round Agreements Act, the Small Business Job Protection Act of 1986, the Uniformed Services Employment and Reemployment Rights Act of 1994), the Taxpayer Relief Act of 1997, the Restructuring and Reform Act of 1998, and the Community Renewal Tax Relief Act of 2000.

#### **Plan provisions in effect in 2001 and 2002**

The Enron Cash Balance Plan was amended and restated effective January 1, 2001.

In general, participation in the 2001 version of the Enron Cash Balance Plan was open to the same Enron employees as under the January 1, 1996, version of the Plan.

Participants in the Enron Cash Balance Plan are generally credited with a cash balance accrual equal to five percent of their compensation for each month during which they are employed by Enron and otherwise qualify to participate in the Plan. Enron Cash Balance Plan participants are at all times 100 percent vested in their final average pay benefit under the Enron Retirement Plan benefit formula.

In general, the normal retirement benefit under the Enron Cash Balance Plan is equal to the sum of participants' monthly final average pay benefit under the Enron Retirement Plan benefit formula and the monthly amount derived by converting their cash balance benefit as of their annuity starting date into a single life annuity. A portion of the final average pay benefit otherwise payable under the Enron Cash Balance Plan will be offset by the equivalent annuity value of a participant's interest in the Enron ESOP as determined over the period 1996-2000. The normal form of retirement benefit for a participant who is married on their annuity starting date will be a joint and survivor annuity. For a participant who is not married on their annuity starting date, the normal form of benefit will be an annuity payable for the life of the participant.

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<sup>1326</sup> Announcement 2003-1, 2003-2 I.R.B. 281, <http://www.irs.gov/pub/irs-drop/a-03-1.pdf>.

In October 2002, the PBGC filed claims against Enron in its bankruptcy proceeding.<sup>1327</sup> The PBGC's claim for unfunded benefit liabilities of the Enron Cash Balance Plan was approximately \$270 million.<sup>1328</sup> The PBGC's estimate of the underfunding may increase if the IRS rules adversely on the phasing out of the floor-offset arrangement<sup>1329</sup> and the benefits attributable to offset amounts become liabilities of the Enron Cash Balance Plan.<sup>1330</sup>

Accruals under the Enron Cash Balance Plan were frozen as of December 31, 2002.

## **7. The Enron Corp. Savings Plan (“Enron Savings Plan”)**

### **Historical background**

The Enron Savings Plan began as a plan originally effective June 1, 1956.<sup>1331</sup> The Enron Savings Plan is a defined contribution plan which provides for elective deferrals pursuant to section 401(k),<sup>1332</sup> and after-tax contributions. Additionally, Enron contributed as matching contributions to the Enron Savings Plan amounts equal to a percentage of participants' contributions. Enron's matching contributions were discontinued effective November 28, 2001.<sup>1333</sup>

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<sup>1327</sup> See, e.g., Statement of the Pension Benefit Guaranty Corporation in Support of Its Claim for Unfunded Benefit Liabilities of the Enron Corp. Cash Balance Plan, at paragraph 8, filed in *In re Enron Corp., et al*, Case No. 01-16034, U.S. Bankruptcy Court, Southern District of New York.

<sup>1328</sup> This represents the PBGC's estimate of the Plan's underfunding.

<sup>1329</sup> The phasing out of the floor-offset arrangement is discussed in detail in Part II.C.1., below.

<sup>1330</sup> The PBGC estimates that the unfunded benefit liabilities could increase by as much as 100 percent or more if the phasing out of the floor-offset arrangement is deemed to have been illegal and the benefits attributable to offset amounts again become liabilities of the Enron Cash Balance Plan. See, e.g., Statement of the Pension Benefit Guaranty Corporation in Support of Its Claim for Unfunded Benefit Liabilities of the Enron Corp. Cash Balance Plan, at paragraph 8, filed in *In re Enron Corp., et al*, Case No. 01-16034, U.S. Bankruptcy Court, Southern District of New York, discussed in Part II.B.2., below.

<sup>1331</sup> Forms 5500 for the Enron Savings Plan.

<sup>1332</sup> The Enron Savings Plan refers to elective deferrals as “Before-Tax Contributions.” See discussion in Part II.A.2., above.

<sup>1333</sup> First Amendment to Enron Corp. Savings Plan (As Amended and Restated Effective July 1, 1999), DOL020351-DOL020354.

## Plan features

### Participation

In general, all employees of Enron are eligible to participate in the Enron Savings Plan. Exceptions include nonresident aliens with no U.S. source income, leased employees, and employees whose terms and conditions of employment are governed by a collective bargaining agreement. Participation is voluntary and generally begins on the first day of the first month coincident with or next following the date on which an employee first works for Enron.<sup>1334</sup>

The HNG Savings Plan was merged into the Enron Savings Plan effective July 1, 1986. Participants in the HNG Savings Plan were immediately covered by the provisions of the Enron Savings Plan. The Enron Savings Plan was amended and restated effective January 1, 1989, January 1, 1994, and July 1, 1999. From time to time, other plans were merged into the Enron Savings Plan as a result of corporate events.<sup>1335</sup>

### Contributions

Participants may contribute to the Enron Savings Plan from one percent to 15 percent of their base pay<sup>1336</sup> in any combination of elective deferrals or after-tax contributions, subject to certain limits prescribed by the Code.<sup>1337</sup> The Enron Savings Plan also accepts certain qualifying

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<sup>1334</sup> Additionally, a number of participants in the Enron ESOP who did not otherwise participate in the Enron Savings Plan as of the August 30, 2002, merger of the plans may have become participants in the Enron Savings Plan as of that date.

<sup>1335</sup> Effective June 1, 1999, the portion of the Koch General Holdings, Inc. Retirement Savings Plan consisting of the accounts of those individuals who became employed by EOTT Energy Corp. as a result of that entity's acquisition in 1998 of certain assets of Koch Industries, Inc. were merged into the Enron Plan. The OmniComp Inc., Salary Savings Plan, Bentley Engineering Co. Savings Plan, and Portland General Holdings, Inc. Retirement Savings Plan were also merged into the Enron Savings Plan as of June 1, 1999. Effective September 1, 1999, a portion of the Cogen Technologies 401(k) Savings Plan, consisting of accounts attributable to Cogen participants who became employed by Enron were merged into the Enron Savings Plan. Effective February 1, 2001, the WarpSpeed Communications 401(k) Plan was merged into the Enron Savings Plan. Source: Form 5300 Application for Determination for Employee Benefit Plan, Attachment I, Item IX (February 12, 2002).

<sup>1336</sup> The Enron Savings Plan generally defines "base pay" as a participant's basic rate of compensation for a payroll period (or other period established by the Administrative Committee) based on the hourly pay rate, weekly salary, established benefit rate, or similar unit of base compensation applicable to the participant under regular payroll accounting as of the last day of the period. The plan provides that the base pay of any participant taken into account for purposes of the plan is limited to the applicable limit under sec. 401(a)(17).

<sup>1337</sup> The maximum amount of the permitted employee contribution as a percentage of based pay varied historically.

contributions rolled over from individual retirement accounts and annuities and other qualified plans (“rollover contributions”).

Additionally, Enron contributed as matching contributions to the Enron Savings Plan amounts equal to a percentage of participants’ contributions. Enron’s matching contributions were credited to a separate account called the “company contribution account.” The amount of the matching contribution made by Enron varied over time.<sup>1338</sup> As described above, Enron’s matching contributions were discontinued effective November 28, 2001.<sup>1339</sup>

On at least one occasion, Enron also made a special cash contribution to the Enron Savings Plan on behalf of active, regular full-time Enron employees.<sup>1340</sup>

### Investments

Investments under the Enron Savings Plan are discussed in detail in Part II.C.5., below. A general overview is provided here.

The Enron Savings Plan permits participants to direct the investment of their elective deferrals, after-tax contributions, and rollover contributions to the Enron Savings Plan. Participants have approximately 20 investment options to choose from, including Enron stock and a self-directed brokerage account subject to certain restrictions defined by the Plan.<sup>1341</sup> Plan participants can change their investment mix on a daily basis.<sup>1342</sup>

The Enron Savings Plan provides that all Enron matching contributions are invested in the common stock of Enron corp. Only upon attaining age 50, participants can elect to reallocate their company contribution account balances to other investment options offered under the Enron Savings Plan.

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<sup>1338</sup> The amount of the matching contribution made by Enron is discussed in detail in Part II.C.5.

<sup>1339</sup> Third Amendment to Enron Corp. Savings Plan (July 1, 1999, restatement).

<sup>1340</sup> *EnSight* (Nov. 1996), EC000020134-EC000020137.

<sup>1341</sup> *Enron Explains Basic Facts About Its 401k Savings Plan*, <http://www.enron.com/corp/pressroom/releases/2001/ene/100-121401ReleaseLtr.html>; *Retirement Insecurity: 401(k) Crisis at Enron*, Hearing before the Committee on Governmental Affairs, United States Senate, S.Hrg. 107-378, at 32 (Feb. 5, 2002). Beginning July 1, 1999, participants could also begin choosing to invest their contributions through a Schwab self-directed brokerage account, subject to certain restrictions, as defined by the plan. 1999 SEC Form 11-K.

<sup>1342</sup> *Enron - Benefit Plans and Related Programs, Policies and Practices--Savings Plan* (May 31, 2002), <http://www.enron.com/corp/proofofclaim/plan/SavingsPlanSPD.pdf>.

### Vesting

Under the Enron Savings Plan, participants are fully vested at all times in their elective deferrals, after-tax contributions and rollover contributions. Participants vest in their company contribution accounts at a rate of 25 percent per year of service but are automatically 100 percent vested in such accounts upon attaining age 65. For plan years 1998 and later, the Plan was amended to provide that participants are fully vested in their company contribution accounts.<sup>1343</sup> In connection with the July 1, 1999, restatement of the Enron Savings Plan, the plan was amended to provide that participants hired by Enron prior to July 1, 1999, were 100 percent vested in their company contribution accounts and the actual earnings thereon. Participants hired on or after July 1, 1999, would become vested in the company contribution account after completing one year of service (or, prior to one year of service, upon reaching age 65, becoming totally and permanently disabled, involuntary termination, or upon death while an employee).

### Loans

Additionally, participants can borrow a minimum of \$1,000, up to a maximum amount equal to the lesser of \$50,000 or 50 percent of their vested balance under the Enron Savings Plan but cannot have more than one loan outstanding at a time. Loan terms cannot exceed five years, except for loans used to purchase a primary residence. Additionally, the Enron Savings Plan provides that effective January 1, 1998, participants can withdraw from their company contribution account amounts that were allocated prior to such date if held for 24 months or more, but not in excess of their vested interest in such amounts.<sup>1344</sup>

### Distributions and withdrawals

The Enron Savings Plan provides that participants may receive a distribution of the vested balance under the Plan due to termination of service, death, disability, or retirement. Distributions must begin no later than April 1 following the calendar year in which they attain age 70½. Normal retirement date under the Enron Savings Plan is the date a participant turns age 65.

Historically, such distributions could be paid out in the form of a joint and survivor annuity for married persons, a single life annuity for unmarried persons, or in the form of a single lump sum payment. As discussed at below, effective August 15, 2001, all forms of benefit payable from the Enron Savings Plan except lump sum distributions were eliminated.

Participants who choose to leave Enron and whose vested balance is greater than \$5,000 can leave their balance in the Plan or receive it as an annuity or lump sum. Balances of \$5,000 or less are automatically distributed in a lump sum.

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<sup>1343</sup> Sixth Amendment to Enron Corp. Savings Plan (Jan. 1, 1999, restatement).  
DOL020424-DOL020425.

<sup>1344</sup> *Id.*

Participants in the Enron Savings Plan can make certain withdrawals from the Enron Savings Plan while they are still employed by Enron.<sup>1345</sup>

### Compliance

The IRS issued favorable determination letters to the Enron Savings Plan on June 22, 1988, and March 5, 1996. The Plan was amended and restated effective January 1, 1989, January 1, 1994, and January 1, 1999.

An application for determination of the tax-qualified status of the Enron Savings Plan was submitted to the IRS on February 15, 2002. The application requested that the IRS take into account all of the plan qualification requirements of the Uruguay Round Agreements Act, the Small Business Job Protection Act of 1986, the Uniformed Services Employment and Reemployment Rights Act of 1994, the Taxpayer Relief Act of 1997, the Restructuring and Reform Act of 1998, and the Community Renewal Tax Relief Act of 2000.

### **Plan provisions in effect in 2001 and 2002**

Effective August 15, 2001, all forms of benefits payable from the Enron Savings Plan except lump sum distributions were eliminated. Any individual who had a right to receive a distribution from the Enron Savings Plan and had elected payment or commencement of payment before August 15, 2001, had the right to elect any form of payment as provided under the then current terms of the plan.

The Enron Savings Plan was amended effective November 28, 2001, to eliminate Enron's matching contributions unless they were required to continue the tax-qualified status of the Enron Savings Plan. Any matching contributions made after November 28, 2001, (other than contributions attributable to periods before such date) were made in cash. At the same time, the Enron Savings Plan was amended to provide that participants may invest the amounts in their company contribution account among the investment alternatives offered under the Plan.

Effective February 15, 2002, the Plan was amended to provide that the portion of a rollover contribution including Enron stock or other "employer securities" will continue to be so invested until the participant elects to convert it into another investment under the Plan. Effective March 15, 2002, the Enron Savings Plan was amended to provide that participants may not elect to convert any investment of any portion of their account into an investment in Enron stock or any other "employer security."

As described above, the Enron ESOP was amended and merged into the Enron Savings Plan effective August 30, 2002, with the result that the provisions of the Enron Savings Plan

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<sup>1345</sup> In general, participants can withdraw any amount not in excess of the value of the after-tax contributions or rollover contributions in their account. Withdrawals can be made from the company contribution account so long as the amount is attributable to contributions allocated thereto prior to 1987 and in certain other limited cases. Participants aged 59½ or older may withdraw an amount not in excess of the value of the elective deferrals in their account. Enron Savings Plan sec. 11.1 (July 1, 1999, restatement).

generally replace the provisions of the Enron ESOP in their entirety.<sup>1346</sup> Pursuant to the merger, the assets held under the Enron ESOP were transferred to the Enron Savings Plan to be held under the trust maintained thereunder. Participants in the Enron Savings Plan who participated in the Enron ESOP are entitled to benefits at least equal to the benefit they would have been entitled to receive immediately before the merger if the Enron ESOP was then terminated. Enron ESOP participants who did not otherwise participate in the Enron Savings Plan as of the date of the merger became participants in the Enron Savings Plan as of that date.

Coincident with the August 30, 2002, merger of the Enron ESOP with and into the Enron Savings Plan, participants' Enron ESOP accounts were initially invested in Enron stock, notwithstanding any pre-existing investment direction of an Enron Savings Plan participant. After the initial transfer of Enron ESOP accounts to the Enron Savings Plan, the plan amendment provided that participants would be permitted to direct the investment of their Enron ESOP plan accounts in accordance with the Enron Savings Plan. Upon investment by a participant of any portion of their Enron ESOP plan account in any investment other than Enron stock, the amount would no longer be part of the Enron ESOP and would become part of the Enron Savings Plan.<sup>1347</sup>

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<sup>1346</sup> “Merger of Enron Corp. Employee Stock Ownership Plan with and into Enron Corp. Savings Plan”, EC 000899959-000899961, <http://www.enron.com/corp/proofsofclaim/plans.html>.

<sup>1347</sup> *Id.*

## C. Discussion of Specific Issues

### 1. Phase out of the ESOP offset under the Enron Corp. Retirement Plan

#### Present Law

##### Floor-offset arrangements in general

A “floor-offset arrangement” coordinates benefits from a defined benefit plan with those of a defined contribution plan.<sup>1348</sup> The defined benefit plan, the “floor,” establishes a minimum benefit level in accordance with the benefit formula specified by the plan. The defined contribution plan provides the “offset.” The projected value of the participant’s benefit under the defined contribution plan offsets the amount of the participant’s benefit payable under the defined benefit plan. If the offset provides a benefit at least equal to the minimum established under the floor, the participant receives the balance of the defined contribution plan account. In such cases, no benefit is paid from the floor plan. If, however, the defined contribution plan provides less than the minimum benefit established under the floor plan, e.g., as a result of investment performance, benefits will be paid from the floor plan to make up the shortfall in the defined contribution plan benefit. That is, the difference between the floor benefit and the defined contribution plan benefit will be paid from the defined benefit plan. The benefit under a typical floor-offset arrangement payable at normal retirement age generally can be determined through the following steps:

- (1) the initial monthly vested benefit under the defined benefit Plan formula is determined (the “gross benefit”);
- (2) the vested account balance in the defined contribution plan is determined;
- (3) the accumulated vested account balance is converted to an actuarially equivalent monthly accrued benefit, using the interest and mortality factors in the plan document;<sup>1349</sup> and
- (4) if the amount determined in step (3) is greater than that determined in step (1), no benefits are due from the defined benefit plan and all benefits will be paid from the defined contribution plan. If the amount determined in step (1) is greater than the amount determined in step (3), the participant is entitled to the vested account balance in the defined contribution plan plus--from the defined benefit plan--an amount equal to the difference between step (1) and step (3).

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<sup>1348</sup> See Part II.A.2., above, for a definition of defined benefit plans and defined contribution plans.

<sup>1349</sup> Although this actuarially equivalent benefit is used as the offset amount, the defined contribution plan is not actually required to provide such a benefit to participants.



If the benefit is payable prior to normal retirement age, then the vested account balances in the defined contribution plan is projected to normal retirement age, using the interest factor specified in the plan, before performing step (3).

Floor-offset arrangements, particularly those involving ESOPs, can be attractive from the perspective of both employers and employees. Present law encourages the establishment of ESOPs by providing special tax benefits to employers that adopt such plans.<sup>1350</sup> A floor-offset arrangement involving an ESOP generally allows participants to benefit from an increase in value of the employer securities held by the ESOP, while protecting them from losses in value by providing a minimum floor benefit under the defined benefit plan. The benefit under the defined benefit plan is guaranteed by the PBGC, thus providing additional protection. A plan sponsor might establish a floor-offset arrangement because such arrangements may offer employees the better of two worlds: there is a defined contribution plan benefit and a minimum benefit from a defined benefit plan. As described below, floor-offset arrangements involving defined contribution plans with large investments in employer securities, such as ESOPs, were found to present additional exposure to the PBGC compared to a typical defined benefit plan, and rules relating to such plans were changed in 1986, which had the effect of prohibiting floor-offset plans involving ESOPs.

### **Code provisions relating to floor-offset arrangements**

#### **Background (Rev. Rul. 69-502, 1969-2 C.B. 89)**

Prior to the enactment of ERISA in 1974, the IRS took the position in a Revenue Ruling that neither the defined benefit plan portion nor the defined contribution plan portion of a floor offset arrangement would meet the Code's qualification requirements.<sup>1351</sup> The Ruling involved a floor-offset arrangement consisting of a defined benefit plan and a defined contribution profit-sharing plan. In it, the taxpayer had established a defined contribution plan and a defined benefit plan for the same employees. The defined benefit plan provided a monthly retirement benefit after age 65 equal to 50 percent of each employee's average annual compensation, offset by the actuarial value of any amounts to which the employee might be entitled under the defined contribution plan. In the ruling, the IRS addressed whether the provision for offsetting benefits under the defined benefit plan by amounts received under the first affected the qualification of the plans.

With respect to the defined contribution plan, the IRS held that since the funds held in an employee's account under the defined contribution plan would be used to reduce the employee's benefits under the second plan, the employer will be relieved from contributing to the second plan to the extent of those funds. Thus, the first plan is not for the exclusive benefit of the

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<sup>1350</sup> Present law affecting employers adopting ESOPs is discussed in Part II.A.2., above.

<sup>1351</sup> Rev. Rul. 69-502, 1969-2 C.B. 89

employees in general within the meaning of the regulations.<sup>1352</sup> Accordingly, it was held that the plan did not meet Code requirements for tax qualification.

Additionally, the IRS held that with respect to the defined benefit plan, because the amount of benefits payable out of the funds held under the plan was contingent upon the amount available under the defined contribution plan, the benefits an employee will receive under the second plan are not definitely determinable as required by applicable Treasury Regulations.<sup>1353</sup> In particular, the requirement that the amount of benefits not depend on the plan sponsor's profitability would be violated because the benefits under the defined benefit plan would depend on the assets in the profit-sharing plan, and the profit-sharing plan depended on the profits of the employer. Accordingly, it was held that the plan does not meet Code requirements for tax qualification.

#### Present-law rules

In 1976, the IRS reversed its position in a Revenue Ruling, citing a Code provision which was added by ERISA.<sup>1354</sup> Again considering a floor-offset arrangement involving a defined benefit pension plan and a defined contribution profit sharing plan, the IRS succinctly concluded that under the Code "as amended by ERISA an arrangement described in [the Revenue Ruling] does not fail to satisfy the requirements...of the Code...merely because of the type of such arrangement." Under the new Code provision, a defined benefit plan generally may qualify even though it provides benefits derived from employer contributions based partly on the balance of the separate account of participants.<sup>1355</sup> Such a hybrid plan is treated as a defined contribution plan for some purposes and a defined benefit plan for other purposes.<sup>1356</sup>

The 1976 Revenue Ruling provides that the defined benefit plan part of a floor-offset arrangement must specify the actuarial basis that will be used to determine the benefit after offset. Thus, the plan must specify the interest and mortality assumptions to be employed, as well

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<sup>1352</sup> Treas. Reg. sec. 1.401-1(b)(3), enacted before ERISA, provides that a qualified plan must benefit the employees in general even though it need not provide benefits for all the employees. That section also provides that a profit-sharing plan is not for the exclusive benefit of the employees in general if the funds therein may be used to relieve the employer from contributing to a pension plan operating concurrently and covering the same employees.

<sup>1353</sup> Treas. Reg. sec. 1.401-1(b)(1)(i), enacted before ERISA, provides that a pension plan, within the meaning of sec. 401(a), is a plan established and maintained by the employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Under Treas. Reg. sec. 1.401(a)-1(b)(i), the definitely determinable benefit requirement continues to apply under ERISA.

<sup>1354</sup> Rev. Rul. 76-259, 1976-2 C.B. 111.

<sup>1355</sup> Pub. L. No. 93-406, sec. 1015 (1974).

<sup>1356</sup> Sec. 414(k).

as the date as of which the determination shall be made, in a way that precludes discretion on the part of the employer. Additionally, the Revenue Ruling indicates that the benefits under a defined benefit plan will not fail to be definitely determinable merely because the defined contribution plan does not have a definite contribution formula. Thus, even though contributions to the defined contribution plan may vary from year to year, the defined benefit plan benefit is not precluded from being definitely determinable. The Revenue Ruling provides that the determination of whether the defined benefit plan satisfies accrual rules under the Code may be made based on the pre-offset benefit in certain cases. Finally, only the vested benefit in the defined contribution plan may be used to offset the benefit under the defined benefit plan.

Generally, any defined benefit plan may be part of a floor-offset arrangement. There are, however, restrictions on the types of defined contribution plans that may be part of a floor-offset arrangement. Specifically, defined contribution plans with section 401(k) cash or deferred arrangements may not be part of a floor-offset arrangement because of the requirement that no benefits other than matches may be conditioned on whether the employee makes or does not make elective deferrals.<sup>1357</sup> However, arrangements established by April 16, 1986, are not subject to this restriction.<sup>1358</sup>

Like other qualified plans, floor-offset arrangements are subject to the Code's qualification requirements. Because floor-offset arrangements combine the features of two different types of plans, special rules are applied in some cases, particularly to reconcile the differences between the rules that apply only to one type of plan. For example, defined benefit plans are subject to joint and survivor annuity requirements that do not apply to many defined contribution plans. To reconcile this difference, Treasury regulations provide that the defined contribution portion of a floor-offset arrangement must comply with qualified joint and survivor requirements even if the plan would not otherwise be subject to those requirements.<sup>1359</sup>

One of the generally applicable qualification requirements that is relevant to the Enron floor-offset arrangement is the "anticutback" rule, which provides that an amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant.<sup>1360</sup> An amendment is treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit.<sup>1361</sup>

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<sup>1357</sup> Sec. 401(k)(4)(A).

<sup>1358</sup> Pub. L. No. 99-514, sec. 1116(f)(5) (1986).

<sup>1359</sup> Treas. Reg. sec. 1.401(a)-(20), Q&A 5(a).

<sup>1360</sup> Sec. 411(d)(6) and sec. 204(g) of ERISA.

<sup>1361</sup> With respect to the effect of an amendment on future benefits, the Code and ERISA provide that a defined benefit pension plan or a money purchase pension plan may not be amended so as to provide for a significant reduction in the rate of future benefit accrual (including any elimination or reduction of a significant early retirement benefit or retirement-

For purposes of these rules, a participant's accrued benefit under a defined benefit plan is generally the participant's accrued benefit determined under the plan and expressed in the form of an annuity beginning at normal retirement age.<sup>1362</sup> Consistent with this definition, the formula under the plan for determining the annuity payable to the participant beginning at normal retirement age (the "normal retirement annuity") is the basis for the participant's accrued benefit.

### **ERISA provisions**

While defined contribution plans that invest in employer securities (including ESOPs), may be part of a floor-offset arrangement, ERISA generally provides that a defined benefit plan cannot invest more than 10 percent of its assets in qualifying employer securities.<sup>1363</sup> In 1987, ERISA was amended to clarify that the defined contribution plan in a floor-offset arrangement is treated as part of the defined benefit plan for this purpose.<sup>1364</sup> This clarification reflected concern that if individual accounts under a floor-offset arrangement are invested primarily or exclusively in employer securities, financial difficulties of the employer and a decline in the price of employer securities could cause the defined benefit plan to experience a funding deficiency at a time when the employer is least able to fund it, resulting in an unreasonable risk to the benefit security of the plan participants and to the PBGC.<sup>1365</sup>

This change had the practical effect of prohibiting floor-offset arrangements involving ESOPs or other defined contribution plans in which more than 10 percent of the combined asset values of the defined benefit plan and the defined contribution plan are invested in employer securities. However, the 1987 change applies only with respect to arrangements established after December 17, 1987.<sup>1366</sup> The Enron floor-offset arrangement was therefore unaffected by the provision.<sup>1367</sup>

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type subsidy) unless certain notice requirements are met. Sec. 4980F of the Code and sec. 204(h) of ERISA.

<sup>1362</sup> Sec. 411(a)(7)(A)(i) and sec. 3(23)(A) of ERISA.

<sup>1363</sup> ERISA sec. 407.

<sup>1364</sup> ERISA sec. 407(d)(3)(C) and (d)(9), as enacted by sec. 9345 of Pub. L. No. 100-203 (1987).

<sup>1365</sup> H.R. Rep. No. 100-391, at 116-117 (1987).

<sup>1366</sup> Pub. L. No. 100-203, sec. 9345(a)(3) (1987).

<sup>1367</sup> According to Steven Kandarian, Executive Director of the PBGC, Enron's floor-offset ESOP arrangement and those of about 150 other companies were permitted under the "grandfather" provision. Statement of Steven A. Kandarian, Executive Director, PBGC, to the Senate Finance Committee, on February 27, 2002, [http://www.pbgc.gov/news/speeches/test\\_02\\_27\\_2002.htm](http://www.pbgc.gov/news/speeches/test_02_27_2002.htm).

ERISA contains general fiduciary duty standards that apply to all fiduciary actions. Among them are requirements that plan fiduciaries generally discharge their duties solely in the interest of participants and beneficiaries and with care, prudence, and diligence. A plan fiduciary that breaches any of the fiduciary responsibilities, obligations, or duties imposed by ERISA is personally liable to make good to the plan any losses to the plan resulting from such breach and to restore to the plan any profits the fiduciary has made through the use of plan assets. A plan fiduciary may be liable also for a breach of responsibility by another fiduciary in certain circumstances.

As discussed above, under a so-called safe harbor provision, fiduciaries generally are not liable for the investment decisions of plan participants in a defined contribution plan if the participants control the investment of their account.<sup>1368</sup> The Department of Labor has stated this safe harbor<sup>1369</sup> does not apply to the defined contribution plan portion of a floor-offset arrangement.<sup>1370</sup> Thus, the general fiduciary rules apply, even with respect to decisions made by participants.

### **Factual Background**

The floor-offset arrangement involving Enron's Retirement Plan and the Enron ESOP was established in 1987.<sup>1371</sup> Under the arrangement, benefits accrued by participants under the Enron Retirement Plan for service during 1987 through 1994 generally would be offset by the equivalent annuity value<sup>1372</sup> of Enron stock held in one of two main subaccounts maintained for participants in the Enron ESOP as of certain determination dates, generally the date that benefit payments from the Enron Retirement Plan commence. The portion of the Enron ESOP that was used as the basis for the offset was called the "ESOP Retirement Subaccount." The computation of the offset took into account previous distributions from the Enron ESOP. If the gross annuity value of a participant's ESOP Retirement Subaccount was greater than the benefit determined

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<sup>1368</sup> See Part II.A.4., above.

<sup>1369</sup> See Part II.A.3., below.

<sup>1370</sup> Preamble to the final regulations under ERISA sec. 404(c), 57 Fed. Reg. 46906, 46907, n.6 (Oct. 13, 1992).

<sup>1371</sup> At the time, the Enron ESOP was not subject to the 10-percent limitation on investment in qualifying employer securities. Further, because the floor-offset arrangement between the Enron Retirement Plan and the Enron ESOP was established before December 1, 1987, ERISA changes limiting such arrangements, as discussed above, did not apply to it.

<sup>1372</sup> This is defined by the Enron Retirement Plan as the single life annuity that could be purchased under the Metropolitan Life Insurance Company Group Annuity Contract No. 9373-0 (or any successor contract) based on a specified date of implementation of the purchase of an annuity contract, a specified date of the first benefit payment under an annuity contract, and an amount of distribution from a participant's ESOP Retirement Subaccount. Sec. 20.2(a) of the Enron Retirement Plan.

under the Enron Retirement Plan benefit formula, the participant would be entitled to the excess.<sup>1373</sup>

In general, depending on the value of Enron stock, the amount of the offset might be greater than the value of a participant's benefit under the Enron Retirement Plan at any given time. If so, the excess in the ESOP Retirement Subaccount would have offset the participant's future benefits under the final average pay formula. If the offset amount was less than the benefit under the Enron Retirement Plan, the Enron Retirement Plan would pay the portion of the benefit that is not offset by the ESOP Retirement Subaccount.

By 1994, Enron began to consider strategies for phasing out the floor-offset arrangement.<sup>1374</sup> Based on the prevailing price of Enron stock, there was concern that many Enron employees would be better off if the stock in their Enron ESOP accounts were made available to them instead of remaining in the plan.<sup>1375</sup> According to one Enron official, because the Enron ESOP did not allow for in-service distributions from the Retirement Subaccount, some employees had left Enron in order to access the value in their Enron ESOP accounts. Giving them access to their accounts, it was thought, might mitigate this trend.<sup>1376</sup> An Enron executive told the Joint Committee staff that a study performed for Enron by an outside consultant showed that 97 percent of Enron employees would be better off if the Enron ESOP assets were freed up and made available to them. This reportedly made freeing up the assets under the Enron ESOP preferable to maintaining the current plan. Materials prepared for Enron's human resources personnel for responding to employee questions explain that phasing out the floor-offset arrangement would "enabl[e] [employees] to take advantage of the strong performance of Enron stock in the Enron Employee Stock Ownership Plan (ESOP) and benefit directly from any excess value in [their] ESOP Retirement Subaccount[s]."<sup>1377</sup>

Enron would also benefit from the change. According to the materials prepared for Enron's human resources personnel, Enron would "receive an up-front reduction in the Enron Retirement Plan's expense for 1995 because of the ESOP."<sup>1378</sup>

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<sup>1373</sup> See *Enron Retirement Program Guide*, included in Appendix D to this Report.

<sup>1374</sup> Facsimile memorandum dated May 26, 1994, from Patrick Mackin to Carol Jewett concerning alternative strategies for phasing out the floor-offset arrangement. EVE1214712-EVE1214724.

<sup>1375</sup> Additionally, according to one Enron executive interviewed by Joint Committee staff some employees had left Enron in order to get access to their ESOP accounts.

<sup>1376</sup> *Id.*

<sup>1377</sup> Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995), included in Appendix D to this Report. See also, *The Enron Retirement Plan & ESOP Program Guide for Former Employees*, EC000020149-EC000020166.

<sup>1378</sup> *Id.*

Enron officials decided to phase out the floor-offset arrangement on a gradual, five-year schedule. For each year during the period 1996 through 2000, (1) the value of 20 percent of the stock in participants' Retirement Subaccounts would be frozen permanently and used to offset participant's final average pay benefit accrued during the period 1987 through 1994 and (2) participants generally would have access to 20 percent of their vested Enron ESOP Retirement Subaccount balances.<sup>1379</sup>

Each January during 1996 through 2000, 20 percent of participants' ESOP Retirement Subaccount was withdrawable at their election. As discussed in detail below, participants had four options with respect to each 20 percent increment of their ESOP Retirement Subaccount released to them. For participants who chose to leave their shares in the Enron ESOP, the value of that increment was fixed. A separate offset value was calculated for each 20 percent increment of participants' Retirement Subaccounts. The closing market stock price as of January 1 of each year determined the value of the offsets, permanently fixing that component of the offset.<sup>1380</sup> If no sale of Enron stock occurred on such date, the closing price for the next preceding day on which a sale occurred would be used. Subsequent changes in the value of Enron stock did not change the part of the offset that had been fixed. The floor-offset arrangement is discussed in further detail below.

The concept of locking in the stock price for the offset was developed by Enron employees and executives as well as outside counsel. According to Enron's outside counsel, Enron management wanted "to take extra-ordinary efforts to find a way, if at all possible, to avoid making all of the shares in the ESOP Retirement Account available at one time."<sup>1381</sup> Enron officials participating in the design of the phase out told the Joint Committee staff that they were generally motivated by an orderly roll out of employees' Enron ESOP accounts. They believed that staggering the availability of employees' shares in their Retirement Subaccounts would "avoid market distortions in the trading of Enron stock...reduce the risk of fixing the offsets based on an aberrant value, and...deter participants from making precipitous decisions regarding the disposition of amounts that become distributable from their Offset Accounts."<sup>1382</sup> The rationale was also explained as preventing "all of the shares [from] hit[ting] the market in a

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<sup>1379</sup> Active employees with an ESOP Special Allocation Subaccount also had access to the vested portion of that account. In addition, employees who were active and who were at least age 50 and with at least five years of accrual service on January 1, 1995, received 100 percent access to their shares in the Retirement Subaccount in January 1996.

<sup>1380</sup> Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995) states that the "specific day in January will probably be the closing price on the first trading day of the year." These materials are included in Appendix D to this Report.

<sup>1381</sup> Facsimile memorandum dated May 26, 1994, from Patrick Mackin to Carol Jewett of Vinson & Elkins, EVE1214721-EVE1214722.

<sup>1382</sup> Facsimile memorandum dated May 26, 1994, from Pat Mackin to Carol Jewett of Vinson & Elkins, EVE1214721-EVE1214722. *Also see* Department of Labor Advisory Opinion 94-42A (Dec. 9, 1994).

given year as this could have a negative impact on the stock price. In addition, this allows [employees] to lock in the offset at multiple points in time and continue to focus on increasing the value of Enron stock through [their] efforts.”<sup>1383</sup>

In connection with the phasing out of the floor-offset arrangement, the Enron ESOP was frozen and the Enron Retirement Plan was continued as an independent plan.<sup>1384</sup> No additional shares of Enron stock were allocated to participants’ ESOP Savings Subaccounts after December 31, 1994, and participants were deemed to be 100 percent vested in those accounts as of that date.<sup>1385</sup> Participants would vest in their Special Allocation Subaccounts over four years at a rate of 25 percent per year.<sup>1386</sup>

Enron ESOP participants who were actively employed by Enron on January 1, 1995, and who during such employment had both attained age 50 and completed five or more years of accrual service under the Enron Retirement Plan as of January 1, 1995, (“senior participants”)

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<sup>1383</sup> Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995).

<sup>1384</sup> Enron effected a transitional benefit accrual freeze under the Retirement Plan conditioned on receipt of a favorable advisory opinion from the Department of Labor. *See* Department of Labor Adv. Op. 94-42A (Dec. 9, 1994). The freeze provided that no participant would be credited with accrual service for the 1995 plan year and any provisions of the Retirement Plan which affect accrued benefits by reason of changes pertaining to a participant’s employment (including compensation changes) would not apply to affect a member’s accrued benefit by reason of events occurring in 1995.

<sup>1385</sup> *See* Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995), included in Appendix D to this Report. Additionally, in late 1994, 1995 and 1996, small allocations were made to the accounts of existing ESOP participants. On December 31, 1994, participants received an allocation originally targeted to be five percent of their December 31, 1994, annualized base pay, adjusted for projected 1995 dividends. The actual 1994 allocation was 2.826 percent of base pay. In 1995, an additional 0.427 percent of base pay was allocated from nonvested shares forfeited by former participants. In 1996, an allocation of 0.524 percent was made. This represented the difference between the total allocation and the five percent target amount, 1.223 percent of December 31, 1994, base pay, which was to be provided as a credit under the Enron Cash Balance Plan. This allocation and the special credit to the Enron Cash Balance Plan were made in lieu of a Retirement Plan accrual for 1995. In 1996, participants in the Enron ESOP began to directly receive the dividends on shares held in their Retirement Subaccounts and Special Subaccounts, including those to which participants had not gained access, EC000021272-EC000021280. *Enron - Benefit Plans and Related Programs, Policies and Practices--Employee Stock Ownership Plan* (Dec. 14, 2001). The dividends are paid in cash on a quarterly basis to participants. *Id.*

<sup>1386</sup> Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995).



could annually withdraw all of their vested interest in their ESOP Retirement Subaccounts as of that date.<sup>1387</sup> Beginning in January 1996, senior participants could also annually access in 20 percent increments special allocation subaccounts set up to hold special allocations made in 1994.

Also, beginning January 15, 1996, participants other than senior participants could withdraw 20 percent of (1) their ESOP Retirement Accounts and (2) the vested portions of the special allocation accounts set up to hold special allocations made in 1994.<sup>1388</sup> Any amount not withdrawn would be added to the future amounts available for withdrawal.<sup>1389</sup> Table 1 shows the schedule on which participants could withdraw shares from their accounts.

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<sup>1387</sup> Tenth Amendment to the Enron Corp. Employee Stock Ownership Plan (Jan. 1, 1989 restatement), EC002674029. *See also* Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995). Participants electing to retire from active employment at retirement age who were 100 percent vested could withdraw their total benefit from the Enron ESOP. *Id.* The benefits of participants under the Enron Retirement/Cash Balance Plan who left Enron before retiring would also be subject to the phased out floor-offset arrangement.

<sup>1388</sup> The ESOP also provided that participants could withdraw (1) from their ESOP Savings Subaccounts amounts held for 24 months or more or (2) allocations of company contributions, financed stock or reversion amounts credited to their ESOP Savings Subaccount for at least 60 cumulative months, but in either case no amount in excess of the value of the vested interest in their accounts was withdrawable. ESOP section 13.1 (Jan. 1, 1999, restatement).

<sup>1389</sup> Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995). Participants could also elect to receive a partial withdrawal and/or a partial rollover to an IRS or to the Enron Savings Plan. *Id.* However, only one such transaction could be processed each month. *Id.*

**Table 1.—Amounts Available for Withdrawal under the Phase Out of the Floor-Offset Arrangement 1996-2000**

Date First Withdrawable	Number of Shares of Enron Stock Becoming Withdrawable
January 15, 1996	One-fifth of total allocated shares.
January 15, 1997	An additional number of shares equal to the number of shares which became withdrawable as of January 15, 1996, plus one-fourth of the amount of any shares purchased with earnings after January 15, 1996, if any, to the extent such shares have not become previously withdrawable.
January 15, 1998	An additional number of shares equal to the number of shares which became withdrawable as of January 15, 1996, plus one-third of the amount of any shares purchased with earnings after January 15, 1996, if any, to the extent such shares have not become previously withdrawable.
January 15, 1999	An additional number of shares equal to the number of shares which became withdrawable as of January 15, 1996, plus one-half of the amount of any shares purchased with earnings after January 15, 1996, if any, to the extent such shares have not become previously withdrawable.
January 15, 2000	An additional number of shares equal to the number of shares which became withdrawable as of January 15, 1996, plus all remaining shares which had have not become previously withdrawable.

For each year for which the floor-offset arrangement was phased out, the following four options were available to participants with respect to the portion of their Retirement Subaccount and Special Allocation Subaccount then accessible to them.<sup>1390</sup> Participants could:

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<sup>1390</sup> See Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995).

- (1) Leave it in the Enron ESOP where it would remain invested in Enron stock;<sup>1391</sup>
- (2) Roll it over to the Enron Savings Plan where it would initially be invested in Enron stock but could be reinvested in the Enron Savings Plan's other investment options;
- (3) Roll it over to an IRA; or
- (4) Receive the shares of Enron stock (although partial shares were distributable in cash).<sup>1392</sup>

Enron communicated the phasing out of the floor-offset arrangement to employees in a variety of ways, including through Enron's employee benefits newsletter *EnSight*<sup>1393</sup> and special employee meetings.<sup>1394</sup> Enron also provided employees with statements during the second quarter of 1995 containing the estimated January 1, 1987, through December 31, 1994, accrued benefit under the Enron Retirement Plan.<sup>1395</sup> Employees would also receive a communication to assist them in comparing the estimated value of their ESOP Retirement Subaccounts as compared to their estimated Enron Retirement Plan accrued benefit for that time period.<sup>1396</sup>

Coincident with phasing out the floor-offset arrangement, Enron sought an advisory opinion from the Department of Labor. Enron wanted the Department of Labor's opinion as to whether progressively phasing out the floor-offset arrangement over a five-year period would

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<sup>1391</sup> If a participant elected to leave a portion of their Retirement Subaccount in the Enron ESOP at the time it first became withdrawable, the participant thereafter had rights to withdraw it or to roll it over to an IRA or the Enron Savings Plan.

<sup>1392</sup> *ESOP Subaccounts Summary of Options*, EC000021992; see Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995).

<sup>1393</sup> *EnSight* (Nov. 1994), EC000020204-EC000020211.

<sup>1394</sup> Memorandum dated January 11, 1995, from Phil Bazelides, Director of Enron Corporate Human Resources, to all Enron employees enclosing the *Enron Retirement Program Guide* and announcing schedule of employee meetings. EC000020294. In addition, participants were encouraged to review the International Association for Financial Planning's *Consumer Guide to Comprehensive Financial Planning*. Memorandum from Kenneth Lay and Richard Kinder to all Enron employees (July 26, 1995), EC000020144-000020146.

<sup>1395</sup> Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995).

<sup>1396</sup> *Id.*

render the “grandfather” treatment for pre-1987 ESOPs inapplicable.<sup>1397</sup> The Department of Labor issued a favorable opinion on the phaseout on December 9, 1994.<sup>1398</sup>

Effective January 1, 1996, the final average pay benefit formula under the Enron Retirement Plan was converted to a cash balance formula and the plan was renamed the “Enron Corp. Cash Balance Plan.” The phased out floor-offset arrangement was retained under the Enron Cash Balance Plan. Thus, under the Enron Cash Balance Plan, the portion of the final average pay benefit under the Enron Retirement Plan attributable to years of accrual service credited under the plan between January 1, 1987, and December 31, 1994 (“Offsetable Benefit”) is offset according to the phasing out floor-offset arrangement. That is, the Offsetable Benefit is reduced (but not below zero) by reference to sum of the five separate Enron ESOP offset amounts (the total Enron ESOP Offset Amount).

An “Offsetable Amount” equal to the actuarially equivalent annuity for such 20 percent would be determined based on the market value of the 20 percent portion on the release dates. The annuity purchase values used to value the 20 percent increments were based on an interest rate of 8.5 percent.<sup>1399</sup>

Exhibits to the Enron Cash Balance Plan are described as the “definitive interpretations” of the floor-offset arrangement provisions.<sup>1400</sup> Using an example included in those exhibits, Table 2 shows how phasing out the floor-offset arrangement works for a participant who retires or is terminated having left all the stock in their ESOP Retirement Subaccount. The example includes a final average pay benefit attributable to years of service credited under the plan prior to January 1, 1987 (“Non-Offsetable Benefit”).<sup>1401</sup>

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<sup>1397</sup> According to Steven Kandarian, Executive Director of the PBGC, Enron’s floor-offset arrangement and those of about 150 other companies were permitted under the “grandfather” provision. Statement of Steven A. Kandarian, Executive Director, PBGC, to the Senate Finance Committee, on February 27, 2002, [http://www.pbgc.gov/news/speeches/test\\_02\\_27\\_2002.htm](http://www.pbgc.gov/news/speeches/test_02_27_2002.htm).

<sup>1398</sup> Department of Labor Adv. Op. 94-42A (Dec. 9, 1994).

<sup>1399</sup> Prior to the phase out of the floor-offset arrangement, annuity purchase values were determined under the Enron Retirement Plan as the single life annuity that could be purchased under the Metropolitan Life Insurance Company Group Annuity Contract No. 9373-0 (or any successor contract) based on a specified date of implementation of the purchase of an annuity contract, a specified date of the first benefit payment under an annuity contract, and an amount of distribution from a participant’s ESOP Retirement Subaccount. First Amendment to Enron Corp. Cash Balance Plan (effective Jan. 1, 1996), EC000020095-EC000020100.

<sup>1400</sup> Enron Cash Balance Plan sec. 5.4 (effective Jan. 1, 1996). The exhibits are included in Appendix D to this Report.

<sup>1401</sup> In the case of participants who are eligible to begin receiving benefits before reaching normal retirement age, the benefit payable to such participants are reduced to reflect early commencement of payments in accordance with the schedule for early reduced retirement

**Table 2.—Example of Benefit Calculation Under  
the Phased Out Floor-Offset Arrangement**

Date of Birth	07/15/45
Date of Hire	09/15/84
Non-Offsetable Benefit, 12/31/94	\$1,620
Offsetable Benefit, 12/31/94	\$6,109
Total Final Average Pay Benefit before Offset, 12/31/94	\$7,729
Enron ESOP Retirement Account Balance, 12/31/95	800 shares

History of ESOP Releases	Date of Release	# Shares Released	Share Price at Release	Market Value of Release
Release 1	01/01/1996	160	\$31	\$4,960
Release 2	01/01/1997	160	\$34	\$5,440
Release 3	01/01/1998	160	\$34	\$5,440
Release 4	01/01/1999	160	\$37	\$5,920
Release 5	01/01/2000	160	\$39	\$6,240

Calculation of ESOP Offset Amount	(a) Age at Release	(b) Actuarial Equiv. Annuity Factor	(c) Market Value of Release	(c)/(b) ESOP Offset Amount
Release 1	50 and 5 months	2.476355	\$4,960	\$2,003
Release 2	51 and 5 months	2.686845	\$5,440	\$2,025
Release 3	52 and 5 months	2.915227	\$5,440	\$1,866
Release 4	53 and 5 months	3.163021	\$5,920	\$1,872
Release 5	54 and 5 months	3.431878	\$6,240	\$1,818
<b>Total ESOP Offset Amount = \$9,584</b>				

Calculation of Final Average Pay Benefit at Normal Retirement	(1) Non-Offsetable Benefit	(2) Offsetable Benefit	(3) Total ESOP Offset Amount
	\$1,620	\$6,109	\$9,584
<b>Normal Retirement Benefit = (1) + [(2) - (3), but not less than zero] = \$1,620</b>			

benefits under the Enron Cash Balance Plan. Enron Cash Balance Plan (effective Jan. 1, 1996), sec. 5.4(b).

In the example shown in Table 2, the benefit payable to the participant is comprised of an Offsettable Benefit of \$6,109 and a Non-Offsettable Benefit of \$1,620. The total ESOP Offset Amount is \$9,584 and the normal retirement benefit payable from the Enron Cash Balance Plan is \$1,620. Thus, the final average pay benefit attributable to years of accrual service credited under the Enron Retirement Plan between January 1, 1987, and December 31, 1994, is entirely offset by the Enron ESOP Offset Amount.

During 1996 to 2000, Enron stock was trading between approximately \$18 and \$44.<sup>1402</sup> At the end of 2002, Enron's stock was trading at \$0.62.<sup>1403</sup>

### **IRS review**

Enron's floor-offset arrangement is currently under review by the IRS. The issues under review are discussed below.

### **Discussion of Issues**

#### **Calculation of benefits under floor-offset arrangements generally**

In a typical floor-offset arrangement, when a participant retires, the value of the participant's benefit under the defined benefit plan is determined without regard to the offset. Then, the value of the participant's defined contribution plan account is converted to an annuity starting at retirement. This amount is then offset against the benefit determined under the defined benefit plan to determine how much of the participant's benefits will be paid from each plan. The defined benefit plan provides a floor so that if, for example, there is poor investment performance in the defined contribution plan, a plan participant will receive a benefit at least equal to the benefit under the defined benefit plan.

For example, suppose a participant has earned a benefit under the defined benefit plan portion of a floor-offset arrangement (determined before the offset) equal to an annuity of \$60,000 per year starting at retirement, and that the annuity equivalent of the participant's defined contribution plan account is \$5,000 per year. Under the floor-offset, the participant would not receive \$65,000 a year -- the combination of the two -- rather only \$60,000. The \$5,000 per year annuity equivalent under the defined contribution plan is subtracted from the annuity under the defined benefit plan, so the participant receives an annuity of \$55,000 per year under the defined benefit plan, plus the account balance under the defined contribution plan.

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<sup>1402</sup> Split-adjusted stock prices are as reported in the Historical Market Data Center™ from Dow Jones & Company, Inc. According to an attachment to minutes of the November 1, 2001, meeting of the Administrative Committee, the price of Enron stock ranged from \$36.63 to \$63.81 during 1996 to 2000. *ESOP Facts*, attachment to Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001), EC00001855. Although it is not clear from the attachment, the Enron stock prices listed in *ESOP Facts* do not appear to reflect stock splits that occurred during this time period.

<sup>1403</sup> *Id.*

On the other hand, suppose the annuity equivalent of the defined contribution account was \$100,000 per year for offset purposes, the participant would be entitled only to the amount in the defined contribution plan and would not receive any benefit from the defined benefit plan.

The Enron floor-offset arrangement operated in this general manner, at least until it was phased out and the value of the offset was set over the period 1996 to 2000. Issues relating to the termination of Enron floor-offset arrangement, as well as other issues raised by the arrangement, are discussed below.

### **“Locking in” the offset**

The IRS is reviewing the floor-offset arrangement to determine if it meets applicable qualification requirements. The main issue raised is the “locking in” of the value of the offset applicable to benefits earned under the Enron Retirement Plan during 1987 to 1994. As described above, during 1996 through 2000, Enron stock traded at approximately \$18 to \$44. At the end of 2002, the price of Enron stock was \$0.62. Thus, for example, for a participant retiring in 2002, the locked in value of the ESOP offset is far higher than the offset would be if it were computed at retirement under the original terms of the plan.

As a result of its review, the IRS informed Enron that it was intending to issue an adverse determination with respect to the floor-offset arrangement. The IRS and Enron had a conference in December 2002, regarding the proposed adverse determination. During the conference, the IRS explained to Enron that the bases for the proposed adverse determination include that the locking in of the offset violates the anticutback rule and that the locking in results in an impermissible forfeiture. Enron has until February 24, 2002, to provide any additional information or legal arguments in support of its position that the locking in of the offset meets the qualification requirements.

The effect of the resolution of this issue on plan participants may vary depending on the participant’s circumstances. For example, whether the locking in of the offset caused a reduction in a participant’s accrued benefit may depend on whether the participant took a distribution at the time of the locking in or left his or her account balance in the ESOP.

The final resolution of the issue is made more complicated by the bankruptcy. Enron and its creditors have an interest in the potential liability Enron might have if the offset is determined to be invalid. The interest of the creditors may affect the actions Enron takes in connection with the proposed adverse determination. For example, Enron could agree to correct the problem and make appropriate additional contributions. However, depending on the amount involved, the creditors may or may not agree with such an approach. A variety of other resolutions are also possible at this point in time.

### **Other issues**

In addition to the locking-in, other issues may arise under the floor-offset arrangement.

Under the applicable authorities, the defined benefit plan in a floor-offset arrangement must provide definitely determinable benefits taking into account the offset.<sup>1404</sup> Thus, the plan must specify the interest and mortality assumptions, as well as the date as of which the determination shall be made. Plan documents reviewed by Joint Committee staff indicate that for purposes of determining the offset amount associated with a particular ESOP release, the Enron Retirement/Cash Balance Plan used the single life annuity commencing at age 65 that is actuarially equivalent to the market value of the stock released under the Enron ESOP at the date of release based on the participant's age, an 8.5 percent interest rate assumption and post-age 65 mortality assumptions under the 1984 Unisex Pension Mortality Table set back one year.<sup>1405</sup>

Further, under a floor-offset arrangement, only the vested benefit in the defined contribution plan may be used to offset the benefit under the defined benefit plan.<sup>1406</sup> Materials reviewed by Joint Committee staff show that under Enron's floor-offset arrangement, the offset amount was based on shares of Enron stock in participants' Enron ESOP Retirement Subaccounts.<sup>1407</sup> Any Enron ESOP participant who was actively employed by Enron as of December 31, 1994, was 100 percent vested in his Retirement Subaccount.<sup>1408</sup> Thus, benefits accrued under the Enron Retirement Plan were offset by vested benefits under the Enron ESOP.<sup>1409</sup>

Additionally, under applicable regulations, the defined contribution portion of a floor-offset arrangement must comply with qualified joint and survivor requirements even if the plan would not otherwise be subject to those requirements. Thus, the Enron ESOP may be required to offer benefits in the form of a qualified joint and survivor annuity because the portion of the benefit accrued under the final average pay formula of the Enron Retirement Plan during 1996 to 2000 may be offset by a participant's vested benefit in the Enron ESOP. In some cases, prior to the November 1996 amendment to the Enron ESOP providing that the standard form of benefit for married participants generally was a joint and survivor annuity, participants in the Enron Retirement Plan/Cash Balance Plan whose accrued benefits under the Plan were completely

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<sup>1404</sup> Rev. Rul. 76-259, 1976-2 C.B. 111.

<sup>1405</sup> Sec. 5.2(1), Enron Cash Balance Plan (Jan. 1, 2001, restatement).

<sup>1406</sup> See Rev. Rul. 76-259, 1976-2 C.B. 111.

<sup>1407</sup> Sec. 5.4, Enron Cash Balance Plan (Jan. 1, 2001, restatement).

<sup>1408</sup> The offset-arrangement applies to benefits accrued under the Enron Retirement Plan from January 1, 1987, through December 31, 1994.

<sup>1409</sup> Prior to the phase out of the floor-offset arrangement, in the case of a distribution prior to retirement, the offset was based on the value of the amount distributed from the ESOP, which was vested amounts.



offset by their benefit under the Enron ESOP may not have been offered a qualified joint and survivor annuity.<sup>1410</sup>

## **2. Conversion of the Enron Retirement Plan to the Enron Cash Balance Plan**

During 1994, Enron considered changing the design of the Enron Retirement Plan.<sup>1411</sup> By the end of 1994, plans were in place to convert the benefit formula under the Enron Retirement Plan to a cash balance formula.

### **Present Law**

#### **Overview**

As described above,<sup>1412</sup> a cash balance plan is a defined benefit plan with benefits resembling the benefits associated with defined contribution plans. Under a cash balance formula, the benefit is defined by reference to a hypothetical account balance, which is credited with pay credits and interest credits. Although a participant's benefit under a cash balance plan is described in terms of a hypothetical account balance, as a defined benefit plan, a cash balance plan is required to provide benefits in the form of a life annuity commencing at a participant's normal retirement age. This annuity is determined as the actuarial equivalent of the participant's account balance at normal retirement age, using interest and mortality factors specified in the plan. The annuity payable at normal retirement age serves as the basis for the participant's accrued benefit.

Cash balance plans are subject to the qualification requirements applicable to defined benefit plans generally. However, because such plans have features of both defined benefit plans and defined contributions plans, questions arise as to the proper application of the qualification requirements to such plans, particularly if a defined benefit plan with a typical benefit formula is converted to a cash balance plan formula. Issues that commonly arise include, in the case of a conversion to a cash balance plan formula, the application of the rule prohibiting a cutback in accrued benefits<sup>1413</sup> and the application of the age discrimination rules. These rules are discussed below. Other issues have been raised in connection with cash balance plans, including

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<sup>1410</sup> As described above, in Part II.B.5., in November 1996, the Enron ESOP was amended to provide that the standard form of benefit generally was a joint and survivor annuity for married participants and a single life annuity for unmarried participants. Under the 1999 restatement of the Enron ESOP, an annuity was an alternative form of benefit to the standard lump sum. The annuity form of benefit under the Enron ESOP was eliminated effective August 15, 2001.

<sup>1411</sup> Minutes of the Meeting of the Administrative Committee (Apr. 13, 1994), EC0000766692.

<sup>1412</sup> See Part II.A.2., above.

<sup>1413</sup> Sec. 411(d)(6).

the proper method for applying the accrual rules and the proper method for determining lump sum distributions.

There is little guidance under present law with respect to many of the issues raised by cash balance conversions. In 1999, the IRS imposed a moratorium on determination letters for cash balance conversions pending clarification of applicable legal requirements.<sup>1414</sup> Under the moratorium, all determination letter requests regarding cash balance plans are sent to the National Office for review; however, the National Office is not currently acting on these plans.<sup>1415</sup> As described below, the Treasury Department recently issued proposed regulations addressing certain issues relating to cash balance plans.

Under ERISA, employer decisions regarding plan design are generally considered “settler functions” that are not subject to ERISA’s fiduciary rules. Implementation of plan design changes may, however, involve discretionary authority with respect to plan administration and, thus, may involve fiduciary obligations.

In addition to raising legal questions, conversions of cash balance plans in the 1990’s also received considerable media attention. A major issue raised in the media was the treatment of longer-service workers, who were expected to receive greater benefits under a typical defined benefit plan than under a cash balance plan. Concerns were raised that, under certain plan designs, longer-service workers (who also tend to be older), were being treated unfairly (even if legal requirements had technically been met) upon conversion to a cash balance plan.

### **Protection of accrued benefits**

#### In general

The Code generally prohibits an employer from amending a plan’s benefit formula to reduce benefits that have already accrued (the “anticutback rule”).<sup>1416</sup> For this purpose, an amendment is treated as reducing accrued benefits if it has the effect of eliminating or reducing an early retirement benefit or a retirement-type subsidy or of eliminating an optional form or benefit.<sup>1417</sup>

The “anticutback rule” applies in the context of cash balance plan conversions. Because of this rule, after conversion to a cash balance design, a plan still must provide employees with

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<sup>1414</sup> Announcement 2003-1, 2003-2 I.R.B. 281, <http://www.irs.gov/pub/irs-drop/a-03-1.pdf>.

<sup>1415</sup> *Id.*

<sup>1416</sup> Sec. 411(d)(6). The provisions do not, however, protect benefits that have not yet accrued but would have in the future if the plan’s benefit formula had not changed.

<sup>1417</sup> Sec. 411(d)(6)(B).

the normal retirement benefit that he or she had accrued before the conversion.<sup>1418</sup> However, the plan may determine benefits for years following the conversion in a variety of ways, while still satisfying the anticutback rule. Common plan designs are discussed below.

#### Wearaway (or “greater of” approach)

Under a “wearaway” approach, a participant does not accrue any additional benefits after the conversion until the participant’s benefits under the cash balance formula exceed their preconversion accrued benefit. Because of this effect, plans with a wearaway are also referred to as using the “greater of” method of calculating benefits. Plan design can greatly affect the length of any wearaway period.

Upon a conversion to a cash balance plan, participants are given an opening account balance. The pay and interest credits provided under the plan are then added to this opening account balance. The opening account balance may be determined in a variety of ways and is generally a question of plan design. For example, an employer may create an opening account balance that is designed to approximate the benefit a participant would have had, based on the participant’s compensation and years of service, if the cash balance formula had been in effect in prior years. As another example, an employer may convert the preconversion accrued benefit into a lump sum amount and establish this amount as the opening account balance. Depending on the interest and mortality assumptions used, this lump sum amount may or may not equal the actuarial present value of the participant’s accrued benefit as of the date of conversion, determined using the statutory interest and mortality assumptions required for lump sum calculations.

Under the wearaway approach, the participant’s protected benefit is compared to the normal retirement benefit that is provided by the account balance (plus pay and interest credits), and the participant does not earn any new benefits until the new benefit exceeds the protected accrued benefit. For example, suppose the value of the protected accrued benefit is \$40,000, and the opening account balance under the cash balance formula provides a normal retirement benefit of \$35,000. The participant will not earn any new benefits until the hypothetical balance under the cash balance formula increases to the extent that it provides a normal retirement benefit exceeding \$40,000.

#### No wearaway (or “sum of ” approach)

Under a plan without a wearaway, a participant’s benefit under the cash balance plan consists of the sum of (1) the benefit accrued before conversion plus (2) benefits under the cash balance formula for years of service after the conversion.<sup>1419</sup> This approach is more favorable to

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<sup>1418</sup> Certain other plan features, such as early retirement subsidies, must also be protected.

<sup>1419</sup> In some cases, the plan may convert the protected benefit into a lump sum equivalent for purposes of the opening account balance. Even if at the time of the initial calculation the opening balance equals the value of the protected benefit, the account balance may not continue to reflect the value of the protected benefit over time, depending on the actuarial assumptions

plan participants than the wearaway approach, because they earn benefits under the new plan formula immediately. This approach is also sometimes referred to as the “A + B” method, where A is the protected benefit and B is benefits under the cash balance formula.

### Grandfathering

For older and longer-service participants, benefits under a cash balance formula tend to be lower than the benefits a participant may have expected to receive under the traditional defined benefit formula (the “old” formula).<sup>1420</sup> The employer might therefore provide some type of “grandfather” to participants already in the plan or to older or longer-service employees. For example, the participants might be given a choice between the old formula and the cash balance formula for future benefit accruals, or, in the case of a final average pay plan, the plan may stop crediting service under the old formula, but continue to apply post-conversion pay increases, so the employee’s preconversion benefit increases with post-conversion pay increases. This approach goes beyond preserving the benefit protected by the anticutback rules.

### Age discrimination

In general, the Code prohibits reductions in the benefit accrual rates (including the cessation of accruals) for defined benefit plan participants on account of attainment of any age.<sup>1421</sup> Attainment of any age means a participant’s growing older. Similarly, the Code prohibits a defined contribution plan from ceasing allocations, or reducing the rate at which amounts are allocated to a participant’s account due to attainment of any age. Parallel requirements exist in ERISA and the Age Discrimination in Employment Act (“ADEA”).<sup>1422</sup>

These provisions do not necessarily prohibit all benefit formulas under which a reduction in accruals is correlated with participants’ age in some manner. Thus, for example, a plan may limit the total amount of benefits, or may limit the years of service or participation considered in determining benefits.<sup>1423</sup>

In general terms, an age discrimination issue arises under cash balance plans because there is a longer time for interest credits to accrue on hypothetical contributions to the account. Thus, for example, a \$1,000 hypothetical contribution made when a plan participant is age 30

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used. Thus, a cash balance plan may not rely on the cash balance formula to protect accrued benefits because it may encounter problems under the anticutback rule (depending on the actuarial assumptions used).

<sup>1420</sup> This is sometimes the reduction in benefits that is referred to in connection with cash balance conversions, i.e., a reduction in expected benefits, not accrued benefits.

<sup>1421</sup> Sec. 411(b)(1)(H).

<sup>1422</sup> Parallel provisions are found in ERISA sec. 204(b)(1)(H) and ADEA, 29 U.S.C. sec. 623(i).

<sup>1423</sup> Sec. 411(b)(1)(H)(ii).

will be worth more at normal retirement age (e.g., age 65) and thus provide a higher annuity benefit at normal retirement age than the same contribution made on behalf of an older participant closer to normal retirement age. This issue is not limited to cash balance plan conversions, but applies to cash balance plans generally. Other age discrimination issues may also arise, depending in part on plan design, e.g., whether the plan has a “wearaway” (described below).

### **Proposed regulations issued**

On December 10, 2002, the Treasury Department issued proposed regulations relating to the application of age discrimination prohibitions to defined benefit plans, including special rules for cash balance plans.<sup>1424</sup> The proposed regulations permit a participant’s rate of benefit accrual for a year under a cash balance benefit plan to be determined without regard to interest credits, the right to which accrued before the beginning of the year. Therefore, compliance with the prohibition on a reduction in the rate of benefit accrual on account of the attainment of any age may be tested by reference to the pay credits provided under the plan. As a result, a plan that provides all participants with the same rate of pay credit generally will not violate this prohibition.<sup>1425</sup> However, the converted plan must qualify as an “eligible cash balance plan.” In order to be an “eligible cash balance plan,” a defined benefit plan must satisfy each of the following requirements for accruals in the current plan year:

- (1) The normal form of benefit is stated as an immediate payment of the balance in a hypothetical account; and
- (2) At the same time the participant accrues an addition to the hypothetical account, the participant accrues the right to annual (or more frequent) future interest credits (without regard to future service) at a reasonable rate of interest that does not decrease because of the attainment of any age. These interest credits must be provided for all future periods, including after normal retirement age. An eligible cash balance plan cannot treat interest credits after normal retirement age as actuarial increases that are offset against the otherwise required accrual.

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<sup>1424</sup> Prop. Treas. Reg. sec. 1.411(b)-2. The proposed regulations provide guidance on how to determine the rate of benefit accrual or rate of allocation. The proposed regulations also address a number of other issues, including nondiscrimination testing for cash balance plans.

<sup>1425</sup> This approach is consistent with the court’s interpretation of the age discrimination prohibition in *Eaton v. Onan Corporation*, 117 F. Supp. 2d 812 (S.D. Ind. 2000). In that case, the court rejected plaintiffs’ argument that, for purposes of this prohibition, the rate of benefit accrual under a cash balance plan for a year should be determined by reference to the increase in a participant’s normal retirement benefit that results from the pay credit for the year and any related future interest credits the right to which accrues in that year (similar to the manner in which the accrual rules apply to a cash balance plan).

Additionally, the proposed regulations provide that, if the plan was converted to a cash balance plan, the conversion must be accomplished in one of two ways. Specifically, the converted plan must either:

- (1) Determine each participant's benefit as not less than the sum of the participant's benefits accrued under the traditional defined benefit plan and the cash balance account (the "sum of" method); or
- (2) Establish each participant's opening account balance as an amount not less than the actuarial present value of the participant's prior accrued benefit, using reasonable actuarial assumptions (the "greater of" method).<sup>1426</sup>

The preamble to the proposed regulations states that the regulations cannot be relied on until adopted in final form. Even if the proposed regulations are issued in final form, the preamble indicates that they will apply on a prospective basis only.

The IRS moratorium on determination letters for cash balance plans will not end before the proposed regulations are issued in final form.<sup>1427</sup>

### **Notice of a significant reduction in future benefit accruals**

As a result of concerns that participants affected by conversions to cash balance plans had not received sufficient notice of the effect of the conversion, a specific notice requirement was enacted in 2001.<sup>1428</sup> Under present law, the plan administrator of a defined benefit plan or a money purchase pension plan must provide notice concerning a plan amendment that provides for a significant reduction in the rate of future benefit accrual, including any elimination or significant reduction of an early retirement benefit for retirement-type subsidy.<sup>1429</sup> Details of the notice requirement are contained in Treasury regulations.<sup>1430</sup> An excise tax is imposed on failures to comply with the notice requirement.<sup>1431</sup>

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<sup>1426</sup> Depending on the actuarial assumptions used, this amount may or may not equal the present value of a participants' protected accrued benefit, determined using statutory interest and mortality assumptions.

<sup>1427</sup> Announcement 2003-1, 2003-2 I.R.B. 281, <http://www.irs.gov/pub/irs-drop/a-03-1.pdf>.

<sup>1428</sup> Pub. L. No. 107-16, sec. 659(a)(1) (2001).

<sup>1429</sup> Sec. 4980F. There is also a comparable ERISA provision.

<sup>1430</sup> Treas. Reg. sec. 54.4980F-1.

<sup>1431</sup> Sec. 4980F. The excise tax is generally equal to \$100 per day for each person with respect to whom a failure to comply occurs, subject to a maximum of \$500,000 per taxable year in the case of unintentional failures.

## Factual Background

### Decision to convert to a cash balance formula

In 1994, Enron officials began to consider implementing a new benefit formula under the Enron Retirement Plan.<sup>1432</sup> The information provided to the Joint Committee staff does not contain much information regarding the reasons the Enron Retirement Plan was converted to a cash balance formula. Interviews with former Enron personnel familiar with the issue indicate that several reasons influenced the decision.

Enron envisioned its work force as increasingly mobile and consisting of “fewer full career or single career employees.”<sup>1433</sup> It was thought that Enron’s employees desired benefits which were more portable than their benefits under the Enron Retirement Plan.<sup>1434</sup> A cash balance formula was viewed as meeting the needs of Enron’s workforce. Additionally, the new formula was described as better matching Enron’s vision of future workforce benefit plans.<sup>1435</sup> In addition, a cash balance formula would be simpler, making it easier for employees to understand and track the value of their retirement benefit.<sup>1436</sup> The decision was described to employees as “an effort to align Enron’s retirement program with the company’s approach to business.”<sup>1437</sup>

According to materials reviewed by Joint Committee staff, Enron’s decision to convert to a cash balance formula was “not a cost savings decision.”<sup>1438</sup> However, when the prospect of a conversion was presented to the Administrative Committee by Enron’s Vice President for Human Resources, one of Enron’s “benefit objectives” was described as “shared responsibility

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<sup>1432</sup> Minutes of meeting of Enron Corp. Retirement Plan Administrative Committee (April 20, 1994), EC00766693-EC000766710.

<sup>1433</sup> Presentation to Administrative Committee - *Retirement Plan - from Defined Benefit to Cash Balance*, presented at April 20, 1994, meeting of Enron Corp. Retirement Plan Administrative Committee, EC000766696-EC000766710.

<sup>1434</sup> Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995), included in Appendix D to this Report.

<sup>1435</sup> Presentation to Administrative Committee - *Retirement Plan - from Defined Benefit to Cash Balance*, presented at April 20, 1994, meeting of Enron Corp. Retirement Plan Administrative Committee, EC000766696-EC000766710.

<sup>1436</sup> *EnSight* (Dec. 1994), EC000020204-EC000020213.

<sup>1437</sup> *Id.*

<sup>1438</sup> Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995).

for cost,” in a shift away from the historical “paternalistic traditional defined benefit pension plan” and toward “individual responsibility.”<sup>1439</sup>

While converting to a cash balance formula would mean a reduction in Enron’s expense for 1995, for each of the subsequent nine years, the new formula would be more expensive than the old formula and for the 10-year period going forward, the new formula would be slightly more expensive for Enron.<sup>1440</sup> In fact, a comparative analysis prepared by an outside consultant showed that Enron was expected to contribute more cash under the new formula than under the old formula until 2002.<sup>1441</sup>

Enron chose a five percent of pay cash balance formula to be competitive with other companies’ retirement benefits.<sup>1442</sup>

### **Plan provisions related to conversion**

As of January 1, 1996, participants in the Enron Cash Balance Plan were credited with accruals of five percent of their monthly compensation as well as interest accruals as of the last day of each calendar month starting January 1, 1997.<sup>1443</sup>

Under the Enron Cash Balance Plan, normal retirement benefits consist of the actuarial equivalent of a series of monthly payments for a participant’s life commencing on the first day of the month coinciding with or next following the date of their retirement. Each monthly payment is equal to the sum of (1) the monthly amount of the participant’s final average pay benefit (using the same formula as under the Enron Retirement Plan)<sup>1444</sup> and (2) the monthly payment

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<sup>1439</sup> *Id.*

<sup>1440</sup> *Id.* In a letter to the Department of Labor submitted in connection with its 1994 request for an advisory opinion, Enron’s outside counsel explained that because the cash balance formula would have the effect of accelerating accruals into a participant’s earlier years of employment with Enron, the effect, from a funding perspective, would be to increase the funding to the plan in the short run above that which would be required if its original formula were retained. Letter dated November 23, 1994, from Enron’s outside counsel to the Department of Labor.

<sup>1441</sup> The comparative analysis of Enron’s estimated funding obligations under the final average pay formula and the cash balance formula is included in Appendix D to this Report.

<sup>1442</sup> Questions and answers for use by Enron human resources personnel in responding to questions from employees (Jan. 1995), included in Appendix D to this Report.

<sup>1443</sup> Sec. 4 of Cash Balance Plan (effective Jan. 1, 1996).

<sup>1444</sup> The portion of a participant’s final average pay benefit which is attributable to accruals under the plan during January 1, 1987, through December 31, 1994, are offset by their interest in their ESOP Retirement Subaccount. The offset does not apply to the benefit the participant would have received under the plan as of December 31, 1986, or to any benefit



derived by converting the participant's cash balance accrual as of the annuity starting date into a single life annuity on an actuarially equivalent basis. Thus, under the terms of the converted plan, a participant's benefit generally is the sum of the participant's benefits accrued under the traditional defined benefit plan and the cash balance account.

Additionally, the Enron Cash Balance Plan includes special provisions for participants in the Enron Retirement Plan who:

- (1) as of January 1, 1995, (a) were employed by Enron; (b) had attained age 50; and (c) completed five years of service under the Enron Retirement Plan ("Transition Participants"), and
- (2) who retired from Enron on or before January 1, 2002.

The special provisions were intended to provide protection for such Transition Participants against adverse affects of the conversion to the cash balance formula.<sup>1445</sup> According to Enron, there were approximately 790 such Transition Participants but only about 140 would be adversely affected by the conversion.<sup>1446</sup>

Under the special provision, the retirement benefit for Transition Participants is the normal retirement benefit as described above, with the application of some special rules. The special rules are, in general, that Transition Participants who retired by January 1, 2002, are entitled to the better of the old or the new benefit formula through the participant's last day worked.<sup>1447</sup> That is, benefits for Transition Participants are increased by crediting additional

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accrued under the cash balance formula. Enron Cash Balance Plan section 5.1 (Jan. 1, 2001, restatement).

<sup>1445</sup> Letter dated October 25, 1994, from Vinson & Elkins to the Department of Labor in support of its application for an Advisory Opinion. *See* Department of Labor Adv. Op. 94-42A (Dec. 9, 1994). Enron represented that it would amend the Retirement Plan to provide that the benefits accrued by such adversely affected participants on an after January 1, 1995, will be equal to the greater of (1) benefits under the Cash Balance formula increased by certain allocations to the ESOP or (2) benefits under the Retirement Plan's formula as in effect on December 31, 1994.

<sup>1446</sup> Letter dated October 25, 1994, from Enron's outside counsel to the Department of Labor in support of its application for an advisory opinion.

<sup>1447</sup> The Plan provided (1) that a Transition Participant's accrual service will generally be increased for the period of employment January 1, 1995, to January 1, 2002, by crediting the participant with one month of accrual service for each calendar month of employment service with Enron and (2) that a Transition Participant's final average pay will be computed on the basis of a period consisting of the sixty consecutive months of employment within the last one hundred twenty months of employment with Enron prior to January 1, 2002, which yield the highest average compensation. Additionally, a Transition Participant who becomes disabled after January 1, 1995, will be credited with full and partial years of accrual service for each

accrual service with Enron under the final average pay formula through January 1, 2002, and by considering compensation earned up to such date.<sup>1448</sup> The Enron Cash Balance Plan also includes a special provision for Transition Participants who terminate employment with Enron before attaining age 55.<sup>1449</sup>

The Enron Cash Balance Plan was amended effective November 1, 2001, to eliminate the requirement that the Transition Participant terminate employment prior to January 1, 2002, to qualify for the special provision.<sup>1450</sup>

### **Information provided to participants**

The decision to convert the Enron Retirement Plan to the Enron Cash Balance Plan was communicated to participants in *EnSight*, Enron's "all-employee publication dedicated to benefits education". The November 1994 edition of *EnSight* described "the decision to change benefits [as] an effort to align Enron's retirement program with the company's approach to business." It explained that "[w]hile economics were considered, cost is not the driving factor. In fact, these enhancements will mean an increase in Enron's costs over the next decade. But as Enron continues to thrive in a culture built on change and built to respond positively to change, the company is committed to retirement benefits that are: Fair...Portable...Simple...and Valuable."<sup>1451</sup>

Enron also described the conversion to participants in the *Enron Retirement Program Guide*.<sup>1452</sup> The *Program Guide* includes an example that estimates a participant's benefit under the Enron Cash Balance Plan.<sup>1453</sup> Materials reviewed by Joint Committee staff do not contain an example provided to participants of the special provision for Transition Participants.

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period between January 1, 1995, and January 1, 2002, during which the participant was disabled. Enron Cash Balance Plan sec. 13.2 (effective Jan 1, 1996).

<sup>1448</sup> Exhibit V to the Enron Cash Balance Plan is an example of the calculation of regular and transition benefits under the Plan. The exhibit is included in Appendix D to this Report.

<sup>1449</sup> Enron Cash Balance Plan sec. 13.2(a) (Jan. 1, 2001, restatement).

<sup>1450</sup> Fifth Amendment to Enron Corp. Cash Balance Plan (effective Jan. 1, 1996).

<sup>1451</sup> *EnSight*, November 1994, EC000020206.

<sup>1452</sup> *Enron Retirement Program Guide*, included in Appendix D to this Report.

<sup>1453</sup> *Id.*

## **IRS technical advice pending**

An IRS examination of the Enron Cash Balance Plan's 1996 year resulted in a request by IRS examiners for technical advice from the IRS National Office.<sup>1454</sup> The technical advice raised the concern that as a result of the floor-offset arrangement, in some instances, the final average pay benefit was completely offset so that participants are offered no qualified joint and survivor annuity, notwithstanding Code requirements that benefits accrued under the final average pay formula be offered in the form of a qualified joint and survivor annuity.<sup>1455</sup> IRS examiners also asked the IRS National Office to review the effect of the conversion of the Enron Retirement Plan to a cash balance formula, in accordance with the September 15, 1999, directive that all open cases involving conversions of defined benefit plans to cash balance plans be submitted for review by the National Office.<sup>1456</sup>

The request arrived in National Office of the IRS on March 17, 2000, and is currently under review. On April 12, 2000, Enron submitted to the IRS a request for a determination of the tax-qualified status of the Enron Cash Balance Plan.<sup>1457</sup> The IRS notified Enron that its request for a determination letter would be associated with the request for technical advice from IRS examiners. The request is currently pending.

### **Discussion of Issues**

Changes in retirement plan design, including significant changes in benefit structure and formulas, are not uncommon. Plan design changes can occur for a variety of reasons, including employer cost considerations, employer views regarding appropriate retirement benefits, the popularity of an alternative plan design among employees, and mergers of plans with disparate provisions due to corporate transactions. The timing of any particular plan design changes may also depend on a variety of factors, including administrative convenience to the employer and others involved in the change.

During the 1990s, conversions of typical defined benefit plans to cash balance formulas were common among mid- to large-size employers. There was considerable media attention regarding such conversions, particularly in cases in which the plan contained a "wearaway" or in which older or longer-service employees close to retirement were denied the opportunity to

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<sup>1454</sup> The advice requested from the IRS National Office concerned a technical issue that arose with respect to the examination of the Enron Cash Balance Plan, as described in Part II.B.6.

<sup>1455</sup> At the time the technical advice was requested, the Enron Corp. ESOP did not offer benefits in the form of a joint and survivor annuity.

<sup>1456</sup> Announcement 2003-1, 2003-2 I.R.B. 281, <http://www.irs.gov/pub/irs-drop/a-03-1.pdf>

<sup>1457</sup> As described above at Part II.B.6., an application for determination of the tax-qualified status of the Enron Cash Balance Plan was also submitted on February 15, 2002.

continue to accrue benefits under the old plan formula.<sup>1458</sup> While perhaps complying with the law, such plan designs were viewed by many as unfair to certain participants. There was concern that some employers were adversely affecting participants in order to reduce costs. There was also concern that participants might not understand the effect of the conversion on their benefits (including future benefits the participant may have accrued under the old formula).<sup>1459</sup>

The conversion to a cash balance plan may be motivated by a variety of factors. From the employer's perspective, the change may result in reduced pension costs. Because the level of contributions and earnings under a cash balance plan are predetermined, a cash balance plan may also make it easier for employers to manage pension liabilities. Some employers are concerned about the level of contributions that may be required to fund typical defined benefit plans and cash balance plans can provide an attractive alternative.

Cash balance plans may also have advantages for employees. Unlike typical defined benefit plans, which tend to benefit long-service participants who remain with a company until retirement, cash balance plans often benefit shorter service, more mobile workers. Thus, cash balance plans may be popular in industries or markets in which workers are relatively mobile or among groups of workers who go in and out of the workforce. Cash balance plans also provide a more portable benefit than the typical defined benefit plan. Some participants also find cash balance plans easier to understand than a typical defined benefit plan--their benefit statement shows an account balance.

In Enron's case, the conversion to a cash balance formula appeared to be motivated primarily by a desire to provide a more attractive plan for most of its workers. Enron executives viewed the future of the Enron as consisting of a highly trained, mobile workforce. In many cases, such workers would find a cash balance plan more attractive than in a typical defined benefit plan. In addition, converting to a cash balance plan was consistent with Enron's image as an innovator; at the time, cash balance plans were viewed as an emerging, new type of benefit plan. While Enron benefit costs may be reduced due to the conversion over time, materials prepared by Enron indicate that, at least initially, the conversion would result in increased pension costs.

In effecting the conversion, Enron did not adopt the plan design features that garnered most of the media attention. Enron did not adopt a wearaway, but rather used a "sum of" approach in protecting accrued benefits. In addition, Enron took steps to protect the expectations of workers who were nearing retirement by providing that they would, in effect, receive benefits under whichever formula gave the greatest benefit.

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<sup>1458</sup> See, e.g., Albert B. Crenshaw, *Companies Embrace New Pension Plan*, THE WASHINGTON POST, Jan. 31, 1999, at H1; Richard A. Opiel, Jr., *Companies Cash in on New Pension Plan; But Older Workers Can Face Penalties*, N.Y. TIMES, Aug. 20, 1999, at C1; Ellen E. Schultz & Elizabeth MacDonald, *Retirement Wrinkle: Employers Win Big with a Pension Shift; Employees Often Lose*, WALL ST. J., Dec. 4, 1998, at A1.

<sup>1459</sup> As mentioned above, these concerns led to the enactment of the present-law notice requirements regarding future reductions in benefit accruals. Sec. 4980F.

Enron's cash balance plan is under review by the IRS National Office pursuant to the IRS directive regarding cash balance plan conversions. The Plan has been pending in the National Office since March 2000. The Enron Cash Balance Plan conversion does not appear to raise any issues other than those that generally arise with respect to such plans, particularly in the absence of definitive guidance with respect to such issues. As mentioned above, given the Enron plan design, the Enron conversion may raise fewer issues than many cash balance conversions.

### **Recommendations**

Present law is not clear with respect to many issues that may be raised under cash balance plans. During the 1990s when conversions were receiving considerable attention, there was significant debate in Congress and elsewhere as to whether cash balance plans should be permitted as a plan design and, if so, what rules should apply (e.g., whether the wearaway approach should be permitted). While some thought that strict limits should be placed on such plans, others were concerned that strict limits would have a harmful effect on the voluntary retirement plan system. Under present law, employers are not required to adopt qualified plans for employees, and whenever new restrictions on plan design or other aspects of plan operation are considered, there is generally an issue of whether the changes will cause employers to reduce or eliminate qualified plan benefits. Thus, in the retirement plan area, there is often a tension between providing adequate safeguards for employees and allowing employers freedom to adopt the type of plan they deem appropriate.

Under the current state of the law with respect to cash balance plans, including the proposed Treasury regulations, cash balance plan conversions will be permitted, subject to certain requirements, unless statutory changes are made. While the proposed regulations answer certain questions regarding cash balance plans, there are other issues still outstanding.

The Joint Committee staff believes that both employers and employees would benefit from certainty in the law regarding cash balance plans and that the Congress or the Treasury Department should adopt appropriate rules. Thus, the Joint Committee staff recommends that specific rules be provided with respect to cash balance plan conversions and cash balance plans generally.

### **3. Enron ESOP Investment in Enron Stock**

#### **Present Law**

ESOPs are defined contributions plans which are designed to invest primarily in qualifying employer securities. This generally refers to securities issued by the employer sponsoring the ESOP. Like other investments in securities, benefits under ESOPs are subject to the risks inherent in investing.

ERISA imposes broad duties governing all plan fiduciaries. Among them are the requirements that plan fiduciaries discharge their duties with respect to plans solely in the interest of plan participants and beneficiaries for the exclusive purpose of providing benefits and that such fiduciaries act with reasonable care, skill, prudence, and diligence under the circumstances. A fiduciary must also diversify plan investments so as to minimize the risk of

large losses unless, under the circumstances, it is clearly not prudent to do so.<sup>1460</sup> Under ERISA, fiduciaries must also refrain from engaging in prohibited transactions.

Fiduciaries of ESOPs, like fiduciaries of other retirement plans subject to ERISA, are subject to ERISA's broad fiduciary duties.<sup>1461</sup> However, ESOP fiduciaries are generally not subject to the ERISA rule that plan investments must be diversified so as to minimize the risk of large losses.<sup>1462</sup> Specifically, under an ESOP, the diversification requirement and the prudence requirement (only to the extent that it requires diversification) is not violated by acquisition or holding of qualifying employer securities.<sup>1463</sup>

Notwithstanding, participants in ESOPs have challenged the actions of ESOP fiduciaries for failure to diversify ESOP investments. Courts have attempted to delineate the duties of ESOP fiduciaries under ERISA while remaining mindful of the purposes of ESOPs. In some instances, courts have acknowledged that ERISA's strict fiduciary standards could override plan provisions directing the investment of ESOPs in employer securities.<sup>1464</sup>

The difficulty of determining the ERISA responsibilities of ESOP fiduciaries has been acknowledged by courts facing this issue.<sup>1465</sup> In part, the difficulty arises, according to one court, because ESOPs are basically trusts created to invest in the stock of a single company.<sup>1466</sup>

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<sup>1460</sup> ERISA sec. 404(a)(1)(C).

<sup>1461</sup> See, e.g., *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5<sup>th</sup> Cir. 1983); *Kuper v. Iovenko*, 66 F.3d 1447, 1457 (6<sup>th</sup> Cir. 1995); *Moench v. Robertson*, 62 F.3d 553, 566 (3d Cir. 1995); *Eaves v. Penn*, 587 F.2d 453, 459-60 (10<sup>th</sup> Cir. 1978).

<sup>1462</sup> See ERISA sec. 404(a)(2)

<sup>1463</sup> ERISA sec. 404(a)(2).

<sup>1464</sup> See, e.g., *Moench v. Robertson*, 62 F.3d 553, 556 (3d Cir. 1995) (The court said “[I]n limited circumstances, ESOP fiduciaries can [breach ERISA's fiduciary duty requirements] for continuing to invest in employer stock according to the plan's direction.” In *Moench*, the court vacated the district court's grant of summary judgment in favor of defendant, ESOP fiduciaries, and remanded the case. The court concluded that in limited circumstances, ESOP fiduciaries could be liable under the ERISA for continuing to invest in employer securities according to the plan's direction. Ultimately, the parties reached a settlement agreement which was approved by the court.) *Moench v. Robertson*, 1996 U.S. Dist. LEXIS 21898 (D.N.J. 1996). Also see *Kuper v. Iovenko*, 66 F.3d 1447, 1458 (6<sup>th</sup> Cir. 1995).

<sup>1465</sup> See *Moench v. Robertson*, 62 F.3d at 569 (noting the difficulty in “delineating the responsibilities of ESOP trustees.”); *Kuper v. Iovenko*, 66 F.3d at 1458.

<sup>1466</sup> *Id.* at 568-69.

Nonetheless, there may be a point at which investments in employer securities no longer are justified under the purposes of the trust.<sup>1467</sup>

In cases dealing with the ERISA-imposed duties of ESOP fiduciaries, courts have recognized that because ESOPs are generally designed to invest primarily in the stock of the employer, “an ESOP fiduciary who invests the assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision.”<sup>1468</sup> That presumption does not, however, foreclose review of the actions of ESOP fiduciaries.<sup>1469</sup> While an ESOP fiduciary may be released from certain per se violations on investments in employer securities, ERISA requires that in making an investment decision of whether or not to invest a plan’s assets in employer securities, an ESOP fiduciary is governed by ERISA’s “solely in interest” and “prudence” tests.<sup>1470</sup>

Under ERISA, directed trustees may also have fiduciary responsibility for ESOP investments in certain limited circumstances.<sup>1471</sup> Generally, a directed trustee is a person who has custody of the plan assets but is not charged with discretionary authority over the disposition or management of those assets. Usually, a directed trustee follows instructions of a plan fiduciary with discretion over plan assets. A directed trustee’s liability for a fiduciary breach generally is limited because the directed trustee lacks the requisite authority over the plan or its assets. Nonetheless, if a directed trustee has actual knowledge of the named fiduciary’s breach

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<sup>1467</sup> *Kuper v. Iovenko*, 66 F.3d 1447, 1457 (6<sup>th</sup> Cir. 1995) (The court said that a plan provision that completely prohibits diversification of ESOP investments violates ERISA. Accordingly, fiduciaries who continue to invest in employer securities even when the plan sponsor’s value is declining should not rely on ERISA’s requirement that fiduciaries discharge their duties in accordance with plan provisions that are not inconsistent with ERISA for protection. ERISA exempts ESOPs from its diversification requirements but the purpose of an ESOP “cannot override ERISA’s goal of ensuring the proper management and soundness of employee benefit plans” imposed by ERISA’s prudence and loyalty standards).

<sup>1468</sup> *Moench v. Robertson*, 62 F.3d 553.

<sup>1469</sup> *See, e.g., Kuper v. Iovenko*, 66 F.3d 1447 (The court said that a proper balance between the purpose of ERISA and the nature of ESOPs requires review of an ESOP fiduciary’s decision to invest in employer securities for an abuse of discretion.); *also see In re McKesson HBOC, Inc. ERISA Litigation*, 2002 U.S. Dist. LEXIS 19473 (N.D. Cal. 2002) (The court said that while fiduciaries of ESOPs “may not blindly follow an ESOP plan’s directive to invest in company stock,” the plaintiffs needed to establish that the fiduciaries of the ESOP abused their discretion in permitting a high level of investment in employer securities.)

<sup>1470</sup> *See Eaves v. Penn*, 587 F.2d 453, 459 (10<sup>th</sup> Cir. 1978).

<sup>1471</sup> *See FirstTier Bank v. Zeller*, 16 F.3d 907 (8<sup>th</sup> Cir. 1994). *See also* 29 CFR sec. 2509.75-8, FR-14.

of fiduciary duty, the directed trustee may have a duty to determine that the instructions it receives and carries out are proper.<sup>1472</sup>

### **Factual Background**

The terms of the Enron ESOP provide that each year, Enron will contribute directly to the trustee for the Enron ESOP the amount, if any, authorized by Enron's Board of Directors. Enron's contributions to the Enron ESOP were payable in cash or in shares of Enron stock, as determined by the Board. To date, Enron has never made a direct contribution to the Enron ESOP.<sup>1473</sup>

Participants in the Enron ESOP were neither required nor permitted to make contributions to the Enron ESOP.

The Enron ESOP provides that plan assets are to be invested primarily in shares of Enron stock. For purposes of complying with the Code requirement that such assets are invested "primarily" in shares of such stock, the Enron ESOP provides that plan assets will be deemed to be so invested if 80 percent or more of the aggregate plan assets are invested in Enron stock. However, plan assets attributable to Enron stock which was purchased with the proceeds of the reversion transferred to the Enron ESOP when it was created in 1986 must be 100 percent invested in Enron stock to qualify for the exception to the excise tax on reversions.

The Enron ESOP provides that the duties, obligations, and responsibilities of the Enron ESOP trustee are governed by the trust agreement. The trust article entitled "Investment of Trust Fund" provides that the named fiduciary under the Enron ESOP has all discretionary authority for the management and control of the trust fund and is responsible for determining the diversification policy and for monitoring adherence by the investment manager to such policy. Under the trust agreement, the named fiduciary generally is the plan administrator, in this case, the Administrative Committee.

Materials presented by Enron's ERISA counsel to members of the Administrative Committee at the March 9, 2000, meeting generally describe the Administrative Committee's trustee duties. For example, the materials explain the general rules pertaining to appointment, removal and replacement of the plan trustee and the payment of plan expenses. In a section on the Enron ESOP's special provisions, the materials state that the trustee may invest up to 100 percent of the trust in Enron stock but that the Administrative Committee determines the extent to which the trust fund will be invested in Enron stock and determines the price at which the stock will be bought or sold.<sup>1474</sup>

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<sup>1472</sup> See *FirstTier Bank v. Zeller*, 16 F.3d 907 (8th Cir. 1994), *Ershick v. United Missouri Bank of Kansas City*, 948 F.2d 660 (10<sup>th</sup> Cir. 1991), *Newton v. Van Otterloo*, 756 F. Supp. 1121 (N.D. Ind. 1991).

<sup>1473</sup> The assets of the ESOP are attributable to the stock purchased with the 1986 loan and 1987 reversion.

<sup>1474</sup> These materials are included in Appendix D to this Report.



As discussed above,<sup>1475</sup> the Administrative Committee generally did not evaluate Enron stock as an appropriate investment under the Enron ESOP. As described by one Administrative Committee member, the Enron ESOP plan terms provided for investment of plan assets in Enron stock, so there was no need to review that investment. The Administrative Committee questioned for the first time whether it should be examining Enron stock as an investment under any of the Enron qualified plans on November 1, 2001.<sup>1476</sup>

Documents provided by Enron indicate that, due to the volatility of Enron's stock and the fiduciary responsibility of the Administrative Committee, a special meeting of the Administrative Committee was held on November 1, 2001, to discuss the prudent steps that the Administrative Committee might need to consider with respect to the Enron Savings Plan, as well as other Enron qualified plans.

The Administrative Committee was presented with a snapshot of the current Enron stock holdings in the Enron Savings Plan and Enron ESOP as of October 26, September 30, and January 1, 2001. The Administrative Committee was advised that it had no duty to issue cautionary advice on the value or risk of holding Enron stock because the Administrative Committee does not act in the capacity of an investment advisor, but is charged with administering the plans in accordance with the terms of the plan documents and in compliance with ERISA. It was decided that the Administrative Committee should hire an independent investment advisor to monitor Enron stock, and a member of Enron's treasury department was directed to conduct the search.

With respect to the Enron ESOP, it was determined that the Administrative Committee had no duty to take action since adequate communication has been given to participants over the years. The Administrative Committee would review the recommendations of the investment advisor as to what, if any, action might be required.

**Table 3** shows the number of active, retired, or separated participants with account balances and the number of beneficiaries of deceased participants entitled to benefits under the Enron ESOP during the period 1990 to 2000.<sup>1477</sup> Additionally, it shows how many shares were held by the Enron ESOP and the total value of the Enron ESOP assets during each year of the period. At the end of 2000, the total value of the ESOP assets exceeded \$1 billion. As a result of the bankruptcy, the value of the ESOP assets was minimal.

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<sup>1475</sup> Part II. B.3.

<sup>1476</sup> Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001), EC000001847.

<sup>1477</sup> 1990 was the first year for which Joint Committee staff reviewed data.

**Table 3.–The Enron ESOP–Number of Participants,  
and Shares Held and Total Value of Assets**

<b>Year</b>	<b>Number of Active, Retired, or Separated Participants with Account Balances or Beneficiaries of Deceased Participants Entitled to Benefits at End of Year</b>	<b>Shares of Enron Stock at End of Year (millions)</b>	<b>Total Value of ESOP Assets at End of Year (millions of dollars)</b>
1990	9,396	17.2	469.2
1991	10,111	25.6	602.4
1992	10,664	33.8	788.0
1993	11,463	49.6	952.7
1994	11,262	32.5	827.6
1995	11,172	20.1*	797.1
1996	11,056	36.9*	689.9
1997	10,826	29.5	562.8
1998	10,585	**	624.6
1999	8,209	18.1	807.3
2000	6,920	12.8	1,062.9

Source: Forms 5500 for the Enron ESOP for the applicable years, unless otherwise indicated.

\*Source: *Tittle v. Enron Corp.*, S.D. Texas, No. H-01-3913, First Consolidated and Amended Complaint (filed April 8, 2002), at paragraphs 173-174.

\*\*No data available.

### **Discussion of Issues**

The precipitous decline in the value of Enron stock raises the question of whether, at some point, plan fiduciaries have an obligation to question whether employer securities is an appropriate investment for a plan despite plan provisions directing such investment. As noted above, courts have sometimes found this issue to be difficult, because ERISA's general fiduciary standards and the policies underlying the present-law rules relating to employer securities have some inherent conflict. The questions raised in this regard in the case of the Enron ESOP are similar to those raised in other cases in which this issue has arisen.

These issues may include questions of law as well as fact, including: who are the relevant plan fiduciaries and what were their respective roles under the terms of the Enron ESOP and the related trust; the specific terms of the Enron ESOP and trust regarding investment authority and the types of investments that could be made; and at what point fiduciaries should have acted. These issues are being addressed in litigation. A discussion of the Enron ESOP and the relevant law has been provided here in order to provide a more complete picture of Enron qualified plans.

In addition to the issues raised specifically with respect to the Enron ESOP, the overall structure of Enron's qualified plans raises issues regarding appropriate levels of diversification in retirement plans, and ways to achieve such levels. These issues are addressed in Part II.C.5., below.

## 4. Change of recordkeepers under the Enron Savings Plan

### Present Law

#### In general

The selection and change of third party service providers to qualified retirement plans are subject to ERISA's general fiduciary provisions.<sup>1478</sup> At the time of the Enron bankruptcy, there were no specific rules addressing blackout periods, so the general fiduciary rules were the only governing provisions. Advance notice of blackouts with respect to plans, i.e., periods during which participants are unable to engage in certain transactions due to a change in recordkeepers or other reasons, is now required under the Sarbanes-Oxley Act of 2002.<sup>1479</sup> These specific notice provisions now apply in addition to the general fiduciary rules. Even though the notice requirement did not apply at the time of the Enron blackout, a description is provided here for completeness.

In addition to the notice requirement, the Sarbanes-Oxley Act also included a provision prohibiting a director or executive officer of a publicly traded corporation from trading in the stock of the employer during a blackout period in certain circumstances.<sup>1480</sup>

#### Notice of blackout periods under the Sarbanes-Oxley Act

##### In general

The Sarbanes-Oxley Act amended ERISA to require the plan administrator of an individual account plan<sup>1481</sup> to provide advance notice of a blackout period (a "blackout notice") to plan participants and beneficiaries to whom the blackout period applies.<sup>1482</sup> Generally, notice must be provided at least 30 days before the beginning of the blackout period. In the case of a blackout period that applies with respect to employer securities, the plan administrator must also provide timely notice of the blackout period to the employer (or the affiliate of the employer that issued the securities, if applicable).

##### Definition of blackout period

A blackout period means any period during which any ability of participants or beneficiaries under the plan, which is otherwise available under the terms of the plan, to direct or

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<sup>1478</sup> These provisions are discussed in Part II.A.4., above.

<sup>1479</sup> Pub. L. No. 107-204, enacted July 30, 2002.

<sup>1480</sup> *Id.* at sec. 306(a).

<sup>1481</sup> An "individual account plan" is the term generally used under ERISA for a defined contribution plan. The notice requirement does not apply to one-participant plans.

<sup>1482</sup> ERISA sec. 101(i), as enacted by section 306(b) of the Sarbanes-Oxley Act of 2002.

diversify assets credited to their accounts, or to obtain loans or distributions from the plan, is temporarily suspended, limited, or restricted if the suspension, limitation, or restriction is for any period of more than three consecutive business days. However, a blackout period does not include a suspension, limitation, or restriction that (1) occurs by reason of the application of securities laws, (2) is a change to the plan providing for a regularly scheduled suspension, limitation, or restriction that is disclosed through a summary of material modifications to the plan or materials describing specific investment options under the plan, or changes thereto, or (3) applies only to one or more individuals, each of whom is a participant, alternate payee, or other beneficiary, under a qualified domestic relations order.

#### Timing of notice

Notice of a blackout period is generally required at least 30 days before the beginning of the period. The 30-day notice requirement does not apply if (1) deferral of the blackout period would violate the fiduciary duty requirements of ERISA and a plan fiduciary so determines in writing, or (2) the inability to provide the 30-day advance notice is due to events that were unforeseeable or circumstances beyond the reasonable control of the plan administrator and a plan fiduciary so determines in writing. In those cases, notice must be provided as soon as reasonably practicable under the circumstances unless notice in advance of the termination of the blackout period is impracticable.

Another exception to the 30-day period applies in the case of a blackout period that applies only to one or more participants or beneficiaries in connection with a merger, acquisition, divestiture, or similar transaction involving the plan or the employer and that occurs solely in connection with becoming or ceasing to be a participant or beneficiary under the plan by reason of the merger, acquisition, divestiture, or similar transaction. Under the exception, the blackout notice requirement is treated as met if notice is provided to the participants or beneficiaries to whom the blackout period applies as soon as reasonably practicable.

The Secretary of Labor may provide additional exceptions to the notice requirement that the Secretary determines are in the interests of participants and beneficiaries.

#### Form and content of notice

A blackout notice must be written in a manner calculated to be understood by the average plan participant and must include (1) the reasons for the blackout period, (2) an identification of the investments and other rights affected, (3) the expected beginning date and length of the blackout period, and (4) in the case of a blackout period affecting investments, a statement that the participant or beneficiary should evaluate the appropriateness of current investment decisions in light of the inability to direct or diversify assets during the blackout period, and (5) other matters as required by regulations. If the expected beginning date or length of the blackout period changes after notice has been provided, the plan administrator must provide notice of the change (and specify any material change in other matters related to the blackout) to affected participants and beneficiaries as soon as reasonably practicable.

Notices provided in connection with a blackout period (or changes thereto) must be provided in writing and may be delivered in electronic or other form to the extent that the form is

reasonably accessible to the recipient. The Secretary of Labor is required to issue guidance regarding the notice requirement and a model blackout notice.

#### Penalty for failure to provide notice

In the case of a failure to provide notice of a blackout period, the Secretary of Labor may assess a civil penalty against a plan administrator of up to \$100 per day for each failure to provide a blackout notice. For this purpose, each violation with respect to a single participant or beneficiary is treated as a separate violation.

#### **Factual Background**

In 2001, Enron Corp. changed recordkeepers under the Enron Savings Plan from Northern Trust Retirement Consulting (“Northern Trust”) to Hewitt Associates (“Hewitt”). As part of this change, there was a period of approximately 2-½ weeks during which plan participants could not make investment changes (the “blackout”). During the blackout, the price of Enron stock fell.

#### **Background--prior recordkeeper searches**<sup>1483</sup>

During the period which was the subject of the Joint Committee staff review, Enron undertook a number of searches for new third party service providers for various benefit plans, including the Enron Retirement Plan, the Enron Savings Plan, and health and welfare benefit plans (i.e., plans other than retirement plans). In some, but not all cases, these searches resulted in a change of recordkeeper. Some of these searches related to efforts by Enron to outsource more of its benefit plan administration. For example, the Enron Retirement Plan had been administered in-house and was outsourced in 2000. Enron also looked for new third party service providers with respect to all its benefit plans, in 2000, including pension and welfare plans, but decided not to change recordkeepers for the Enron Savings Plan at that time.

With respect to the Enron Savings Plan specifically, a new recordkeeper search was begun in 1998 as a result of the acquisition by Enron of Portland General Electric (“PGE”) in 1997. PGE also had a 401(k) plan, and Enron wanted to merge the two plans. While similar in many respects, the two plans had a number of differences. For example, the PGE match was at a higher level than the match in the Enron Savings Plan; the Enron Savings Plan had daily valuations, whereas PGE had monthly valuations. Many other plan features also varied.

The plans also had different recordkeepers. The Enron Savings Plan had Northern Trust Retirement Consulting (“Northern Trust”) as recordkeeper, and the PGE plan recordkeeper was

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<sup>1483</sup> Background information relating to prior searches for recordkeepers is based primarily on documents provided by Enron in response to the Joint Committee staff requests for information. Documents relating to prior recordkeepers encompasses almost an entire box of information. Relevant document numbers include a range of documents from EC000022700-23700. Information was also obtained from minutes of Administrative Committee meetings, interviews with Enron employees, and the Timeline Presented to the Administrative Committee (EC000001909-16), which is included in Appendix D to this Report.

Towers Perrin. While merging the two plans did not necessarily require hiring a new recordkeeper, in mid-1998, Enron engaged Watson Wyatt Worldwide (“Watson Wyatt”) to assist in the search for a new recordkeeper. A letter to Enron from Watson Wyatt regarding the search process states the understanding that Enron was not at that time dissatisfied with the services being provided by Northern Trust, but would like to “test the waters” to see what other options might be available for the combined Enron/PGE plan.<sup>1484</sup> At that time, Enron records indicate the goal was to have the search completed by October 31, 1998, with a proposed implementation date of July 1, 1999.

According to documents provided by Enron, requests for information were sent out to 33 vendors in July 1998. The requests for information sought responses to a variety of questions relevant to the plans, such as the ability to perform daily valuations and administer self-directed accounts. Enron received responses from 17 vendors (10 of whom declined to provide service if assets did not change to their respective funds), seven vendors declined to participate, and nine vendors did not respond. Watson Wyatt compiled the responses and provided analysis and evaluations to Enron.

During the next few months, requests for proposals were sent to a number of vendors, with follow-up questions in some cases. Watson Wyatt again compiled and analyzed the responses in a number of areas. A weighted quantitative evaluation of the responses was provided. This process led to site visits by Enron to the top two candidates Fidelity Institutional Retirement Services Company (“Fidelity”)--Fidelity and Northern Trust. Documents provided by Enron indicate that the decision to hire Fidelity was made at the end of October 1998. However, as described in more detail below, it was then decided to postpone any change in recordkeepers until after the merger of the two plans.

The merger of the plans went forward starting in June 1999. The merger resulted in a blackout period for PGE plan participants that was expect to last about 8-12 weeks, during the period from June 15 through September 3. Documents provided by Enron indicate there was a trust reconciliation issue that caused the blackout period to extend until September 15, 1999. Plan participants were apparently notified of the change in the blackout period by mail. Enron plan participants also had a blackout period that lasted from August 30, 1999, to September 3, 1999, even though they did not have a trustee or recordkeeper change. The blackout was said to be necessary in order to complete the merger of the approximately 3,400 PGE participants into the plan.

The involvement of the Enron Savings Plan Administrative Committee in the search for the new recordkeeper and the merger of the two plans is unclear. The first reference to the merger appears in the Administrative Committee meeting minutes of September 17, 1998, wherein it was reported that a member of the Enron Benefits Department updated the Administrative Committee on the work being done by the Enron and PGE Human Resources and Treasury Departments relating to the merger of the two plans. At that time, a joint meeting of

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<sup>1484</sup> Enron Corp. Service Provider Vendor Search RFI Teleconference notes prepared by Watson Wyatt, EC000022724-27.

the Administrative Committees of both plans on savings plan issues was scheduled for November 11, 1998.

According to Enron, there are no minutes of Enron Savings Plan Administrative Committee meetings from October 19, 1998, through October 26, 1999. However, a document prepared by Enron employees and provided to the Administrative Committee in connection with the recordkeeper search in 2001, indicates that the Administrative Committee was briefed on the transition on November 4, 1998. This document says that in November 1998, the “[d]ecision [to change recordkeepers] was reviewed for impact to Non-Qualified Deferral (NQ) Plans wherein it was determined that the recent vendor change for the NQ plans was to go live 3/99 at Northern Trust. A new recommendation was made to not move the 401(k) recordkeeping until after the PGE plan merger and [Enron’s] Qualified and Non-Qualified plans were stabilized.” The document also says that on November 4, 1998, “Presentations were given to both the PGE and [Enron’s] administrative committees notifying both of the recommendation. In subsequent meetings, the recommendation to stay with Northern Trust was approved until the plans were stable. At this point, there was no more work on the move away from Northern Trust until after the PGE plan had been merged.”<sup>1485</sup>

Documents provided by Enron to the Joint Committee staff include a document dated November 1998 titled: “Presentation to the Administrative Committees: The 1999 Enron/Portland General Savings Plan.” This document includes a schedule of events, which indicates that in November 1998 there would be “presentation to the Committees for approval.” The document also includes information relating to differences between the two plans, background on the recordkeeping search (including a list of possible service providers and their rankings based on responses to requests for information), the recommendation to hire Fidelity and background information regarding why, fee comparison information, discussion of adding a self-directed account, and implementation issues. It is unclear whether this document was presented to the Administrative Committee. Despite the fact that Administrative Committee minutes do not reflect discussion of this process, one committee member interviewed by the Joint Committee staff described the merger process as one of two major events that occurred during his tenure on the Administrative Committee.

## **2001 search process**

### **Reasons for looking for new recordkeeper**

Enron personnel and records indicate that the search for a new recordkeeper stemmed from customer service issues with respect to the prior recordkeeper (Northern Trust), such as difficulty dealing with the number of employees and transactions and data issues with respect to government filings. Enron personnel also felt that the level of technology services provided by Northern Trust in connection with the Savings Plan was not sufficient to satisfy the demands of Enron employees. Northern Trust personnel have testified regarding Enron comments on customer service issues and stated that Northern Trust had been working with Enron to correct

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<sup>1485</sup> Timeline Prepared for Administrative Committee, EC000001869-EC000001875. This document is included on Appendix D to this Report.

identified problems, such as responses to telephone inquiries, and that progress in correcting problems had been made. Northern Trust personnel also testified to their understanding that Enron prided itself on its own technology and that Enron felt that the Northern Trust trading desk was not as advanced as the Hewitt operations.<sup>1486</sup> Enron personnel told the Joint Committee staff that although they had been working with Northern Trust to correct problems, they eventually determined that it would be appropriate to look for a change of recordkeepers.

Selection process for new recordkeeper (Enron stock price: \$78.79 on February 1, 2001; \$68.68 on March 1, 2001; \$56.57 on April 2, 2001; \$63.41 on May 1, 2001)

Enron employees told the Joint Committee staff that Enron had a task force consisting of four to five employees involved in the process of engaging a new recordkeeper for the Enron Savings Plan. While much of the detail work was handled by a single person, Enron personnel have stated that the decision-making process was a joint process. At the same time, Enron was also interested in a new recordkeeper with respect to the 1994 Deferral Plan and Expat Deferral Plan. According to Enron personnel, they had been experiencing customer service issues with respect to the 1994 Deferral Plan for some time. However, the volume of business generated by that plan was low so that most companies were not willing to bid for that plan alone, they would bid only in conjunction with a larger plan such as the Enron Savings Plan. When a decision was made to go forward with a change in recordkeepers for the Enron Savings Plan, personnel responsible for the 1994 Deferral Plan and Expat Plan were also involved and the search was a joint search.<sup>1487</sup>

As they had before, Enron engaged Watson Wyatt to assist in the search process and to update the work from the earlier searches. The search process began in early 2001.<sup>1488</sup> Watson Wyatt did a research screening of at least six companies, including Northern Trust and Hewitt. As part of this process, they sent a list of questions to companies that might be interested in bidding. They rated each of the companies in a variety of areas, such as administration, background, customer service, communication and education, implementation, investments, reporting, legal and compliance, and systems and technology. The rating was based on responses to questions in all of these areas.<sup>1489</sup> This process narrowed down the number of firms considered in the search process.

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<sup>1486</sup> Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 51 (Feb. 5, 2002).

<sup>1487</sup> The change in recordkeepers under the deferral plans is also discussed in Part III.C.1., below.

<sup>1488</sup> Letter from Watson Wyatt to Cynthia Barrow, dated January 26, 2001, EC000022055-58.

<sup>1489</sup> Pre Screen Vendors, EC00022066-78. Pre Screen Vendors, EC000022110-28.



A request for proposal was sent to four vendors in 2001, with an initial date for the response of March 9, 2001.<sup>1490</sup> The date was extended to March 13, 2001, due to adverse weather conditions in the Northwest United States.<sup>1491</sup> The 16-page request for proposal included a statement of objectives, requirements for the service provider, plan summary information, and questions to be answered with respect to a variety of administrative and investment issues. For example, the request for proposal indicates a need for daily valuation, interactive voice response systems, transactional and information web access, and a brokerage investment option. The request for proposal indicated July 1, 2001, as the date the conversion was to be completed and the system operational. The request for proposal asked respondents to describe the blackout period that was expected to occur during the conversion process.<sup>1492</sup>

The process was similar to the process for the 1998 recordkeeper search. Watson Wyatt evaluated responses and provided quantitative weighted ratings overall and in specific areas. Follow-up questions were provided in some cases. Specific questions were asked with respect to concerns Enron had identified with the current recordkeeper. After Watson Wyatt consolidated responses, an Enron task force met to evaluate the responses from a cost and service standpoint. This led to the selection of two finalists--Hewitt<sup>1493</sup> and another company.<sup>1494</sup> Enron employees made site visits to both potential recordkeepers. Among other things, they looked at the computer capabilities and customer service. They listened to customer service calls to monitor the quality of responses.

Enron personnel told the Joint Committee staff that, after making the site visits, the team working with the Enron Savings Plan met with the group working with the 1994 Deferral Plan and Expat Deferral Plan and a joint decision was made. Documents provided by Enron say that the last firm, other than Hewitt, was eliminated due to cost to the program for the nonqualified deferred compensation plans.

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<sup>1490</sup> EC000022082. Other documents indicate requests for proposals were sent to six companies. Timeline prepared for Administrative Committee, EC000001872.

<sup>1491</sup> EC000022099.

<sup>1492</sup> Enron Corp. Savings Plan Request for Proposal, EC000022083-98.

<sup>1493</sup> Enron was seeking a service provider for both recordkeeping and trust services. Because Hewitt does not provide trustee services, Hewitt obtained a quote from Wilmington Trust Company, and Hewitt and Wilmington Trust Company made submissions in response to the Enron request for proposal. Wilmington Trust Company was chosen as the new trustee to replace Northern Trust Company. Committee on Governmental Affairs, United States Senate. *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 107 (Feb. 5, 2002).

<sup>1494</sup> See Summary of All Proposals Total Weighted Score Comparison, EC000022164-66.

The Administrative Committee was notified on May 3, 2001, of the decision to hire Hewitt as the new recordkeeper. Northern Trust was notified in July 2001 that Enron would transfer recordkeeping services for the Enron Savings Plan to Hewitt.<sup>1495</sup>

The response to the request for proposal submitted by Hewitt contains the following regarding the blackout period:

There will be a blackout period while the final valuation is performed on the prior recordkeeping system, balances are reconciled, and accounts are established on the system. The duration of the blackout is dependent on the prior valuation cycle and the timeliness of final balances from the prior recordkeeper. Typically, Hewitt does not require a blackout period of longer than two weeks (this includes one week the prior recordkeeper needs to send us the conversion data and reports)[.]<sup>1496</sup>

### **The 2001 transition process**

Deciding on the blackout dates (Enron stock price: \$53.04 on June 1, 2001; \$48.30 on July 1, 2001; \$45.61 on August 1, 2001; \$29.15 on September 1, 2001)

According to testimony of Hewitt, Hewitt and Enron signed a letter of intent in June 2001. The letter of intent contemplated that Hewitt would begin work immediately, and would be compensated for the work it performed if a final contract was not agreed to. Pursuant to the letter of intent, during June 2001, Enron and Hewitt worked on what Hewitt refers to as the “Delivery Model,” which describes the services Hewitt would normally expect to provide as a recordkeeper, additional services they would provide to Enron, and services that Hewitt would not provide.<sup>1497</sup>

During July 2001, Hewitt began what they refer to as the “Requirements Process.” They describe this as a “detailed and comprehensive” process intended to identify precisely the services to be performed and how and when they would be provided. Transition issues with respect to the change of recordkeepers was addressed at this time as well. Hewitt stated that Enron had proposed a “live date” of October 23, 2001, and that Hewitt identified all work needed to effect the transition and target dates for completion in order to meet the proposed live date.<sup>1498</sup>

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<sup>1495</sup> Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 101 (Feb. 5, 2002).

<sup>1496</sup> Hewitt Associates, Request For Proposal - Savings Plan Enron Corporation (March 12, 2001). EC000022242-91, at EC000022246.

<sup>1497</sup> Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 107-08 (Feb. 5, 2002).

<sup>1498</sup> *Id.* at 108.

During this time, there were discussions involving Enron and the old and new trustees and recordkeepers. After discussion, Enron decided on a blackout period that would begin on September 14, 2001, and end on the live date of October 23, 2001. The planned blackout period was two-tiered: (1) participants would be restricted from taking loans or withdrawals or making rollover contributions, and making similar transactions from the close of trading on September 14, 2001, to October 23, 2001; and (2) participants would be restricted from changing investments from the close of trading on September 26, 2001, through October 23, 2001. Under this schedule, the asset transfer from Northern Trust to Wilmington Trust Company was to take place on October 1.<sup>1499</sup>

According to Hewitt, transition issues were revisited in mid-August 2001. Hewitt says they were informed that Enron had decided to make some plan design changes that would affect recordkeeping requirements and of which Hewitt was not previously aware. These changes included (1) replacing three Vanguard investment funds with Fidelity funds, and (2) eliminating Enron Oil and Gas Stock Fund as an investment option.<sup>1500</sup>

Enron personnel told the Joint Committee staff that they wanted to eliminate the Enron Oil and Gas Stock Fund because Enron Oil and Gas (“EOG”) had been sold and was no longer part of the Enron group. Since Enron had no further connection with EOG, it was not believed to be an appropriate fund. Enron benefits department personnel determined that plan amendments needed to be made to eliminate the fund, and did not want to proceed until the Administrative Committee had acted on the amendments. These issues were initially discussed at the May 3, 2001, meeting of the Administrative Committee,<sup>1501</sup> and were approved at the Administrative Committee meeting on August 15, 2001.<sup>1502</sup>

Hewitt indicated that they would need approximately two to three weeks of additional time to make the necessary adjustments to their systems to reflect these changes. Enron decided to provide more time, and moved the proposed target dates back by about one month. Under the revised timetable, the new live date was November 23, 2001. The asset transfer to the new trustee was scheduled for November 1, 2001. The blackout period was now as follows: (1) participants would be restricted from taking loans or withdrawals or making rollover contributions or making similar transactions from the close of trading on October 19, 2001, to

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<sup>1499</sup> *Id.* at 109-110.

<sup>1500</sup> *Id.*

<sup>1501</sup> At that meeting, the Administrative Committee requested additional information with respect to the change from Vanguard Funds to Fidelity funds, including further information regarding comparability of the funds.

<sup>1502</sup> Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 110 (Feb. 5, 2002); interviews by Joint Committee staff of Enron employees.

November 19, 2001: and (2) participants would be restricted from changing investments from the close of trading on October 26, 2001, to November 19, 2001.<sup>1503</sup>

October 4, 2001: initial notice of blackout periods mailed to plan participants (Enron stock price \$33.10)

Hewitt representatives testified that, at Enron's request, they prepared a draft communication to employees regarding the change in trustee, recordkeeper, and certain changes in investment options. This draft was reviewed by Enron and Hewitt incorporated changes from Enron into their draft. The communication was mailed to participants by Hewitt on October 4, 2001, using address lists provided by Enron and Northern Trust. Hewitt testified that at this point it had not received the data necessary to prepare mailing labels. Hewitt personnel have testified that Hewitt did not participate in the preparation of mailing of any other communications materials regarding the blackout, although they are aware that other communications were sent.<sup>1504</sup>

This initial communication, titled "Enron Corp. Savings Plan Changes, Money in Motion" a six-page document.<sup>1505</sup> It includes the following under "What's New?"

"In late November, Hewitt Associates will become our new administrator for the Enron Corp. Savings Plan, providing improved customer service and quicker processing of your requests." It states that on November 20, the Fidelity Freedom Funds will replace the Vanguard LifeStrategy Funds. The communication also states that all investment funds will now be listed by asset class in order of risk factor, from the least risky to the most risky. It shows the mapping of the Vanguard funds to the Fidelity funds, i.e., the comparable Vanguard funds to which assets in each of the Fidelity funds will be transferred.<sup>1506</sup>

Under "Transaction Action Items" the document includes the following. "During the transition period, you will NOT have access to your funds. Your fund balances will remain invested in the market based on your fund choices as of 3:00 PM October 26."<sup>1507</sup> The document states that all activity must be completed by the dates indicated and explains that the reason for this transition is that fund balances of approximately \$1.4 billion for 24,000 participants will be moved and balanced and that each record must be correct. It explains that once the records are balanced, investment returns and November payroll contributions will be added.<sup>1508</sup>

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<sup>1503</sup> *Id.*

<sup>1504</sup> *Id.* at 110.

<sup>1505</sup> This document is included in Appendix D. EC000021560-65.

<sup>1506</sup> *Id.*

<sup>1507</sup> EC000021564. (Emphasis in original.)

<sup>1508</sup> *Id.*

The document includes the following as blackout dates:

- October 19, 3:00 PM CST as the last date for loan requests, in-service withdrawals and distributions, hardship withdrawals, loan payoffs, rollovers into the plan and SDA Schwab Fund Liquidation;
- October 26 3:00 PM CST as the last date for investment fund balance transfers/allocation changes and contribution rate changes;
- November 20 8:00 AM CST as the date transition ends. Savings plan system opens with all the great new features.<sup>1509</sup>

The document also describes changes that will take place, including a new online investment education and advice tool that is described as helping to turn financial dreams into reality.<sup>1510</sup>

October 16, 2001: Enron reports a loss (Enron stock price \$33.84)

On October 16, 2001, Enron reported that it had lost \$618 million for the quarter ended September 30, 2001, after taking into account after-tax nonrecurring charges of \$1.01 billion. Enron also announced it was making a \$1.2 billion reduction to shareholders' equity.

October 16, 2001, 11:10 PM: electronic mail to employees (Enron stock price \$33.84)

An electronic mail message was sent to "All Enron Employees United States Group @ Enron."<sup>1511</sup> stating that, for all Enron Savings Plan participants, Friday, October 19 at 3:00 p.m. will be the last day to request a loan or a loan payoff or requests an in-service or hardship withdrawal. For self-directed account participants, Friday, October 19, 3:00 p.m. is given as the last day to make trades in the brokerage account to move holdings in kind.

The message states that other transactions, such as contribution rate changes and investment fund transfers, will continue until 3:00 p.m. on October 26.

October 19, 2001: blackout period with respect to distributions begins (Enron stock price \$26.05)

On October 19, 2001, the blackout period with respect to loans and distributions began as scheduled.<sup>1512</sup>

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<sup>1509</sup> *Id.*

<sup>1510</sup> EC000021562.

<sup>1511</sup> EC000021573. A copy of this message is included in Appendix D to this Report.

<sup>1512</sup> Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 111 (Feb. 5, 2002). Timeline provided to

October 22, 2001, 10:28 pm: electronic mail message sent to employees (Enron stock price \$20.65)

On October 22, 2001, an electronic mail message was sent to same group as the October 16 electronic mail message.<sup>1513</sup> The message cautioned that “October 26 is fast approaching,” and reminded plan participants that Friday October 26 at 3:00 p.m. will be the last day to transfer investment fund balances and make contribution allocation changes, change the contribution rate for the November 15<sup>th</sup> payroll deductions, and enroll if the employee was hired before October 1.

The message contains a reminder regarding the change in investment funds from Vanguard to Fidelity, and states that funds will remain invested in the funds chosen as of 3:00 p.m. October 29 until 8:00 a.m. November 20, when the Enron Savings Plan reopens with “great new features.”

The message provides contact information for those needing help during the transition.

October 25, 2001: Reconsideration of decision to move forward with blackout period for investment changes; electronic mail reminding employees of pending blackout (Enron stock price \$16.35)

On the eve of the beginning of the blackout period for investment changes, there was concern in the benefits department about the timing of the blackout and the falling stock price. Mikie Rath, Benefits Manager, Enron Corp., testified that one employee had commented that the timing on the blackout was horrible, and that she tended to agree, but that the process had been well underway for some time.<sup>1514</sup> In addition, an employee had submitted an advance question for an all employee meeting to be asked Mr. Lay, “Now that I have lost all my retirement, what do I do? I have been here 20 years.” Ms. Rath also indicated that there had been an all employee meeting in October and the facts had started to come out regarding problems of Enron.<sup>1515</sup>

In response to these concerns, Ms. Rath contacted Northern Trust on October 25, 2001, regarding the possibility of postponing the blackout date for investments until January 2002. Northern Trust personnel responded (on that date) that the date could be postponed, but that a January date could be problematic due to year-end demands on recordkeepers. They suggested as an alternative March 31, 2002.<sup>1516</sup>

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Administrative Committee, EC000001913. This timeline is included in Appendix D to this Report.

<sup>1513</sup> EC000021574. A copy of this message is included in Appendix D to this Report.

<sup>1514</sup> Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 55-56 (Feb. 5, 2002).

<sup>1515</sup> *Id.* at 50, 56-57.

<sup>1516</sup> *Id.* at 101-102.

Ms. Rath also contacted Hewitt on October 25, 2001, regarding either postponing the blackout date or shortening the period of the blackout. Hewitt responded on the same day that accelerating the live date would present a number of risk issues, including adverse effects of plan participants of restarting plan activities in the event the shortened period resulted in accurate plan records and possible compromising of the services that Hewitt could provide. They also pointed out a number of factors that Enron should consider in determining whether to delay the blackout, including extra cost, staffing implications, and the inability to predict when Enron stock would be less volatile.<sup>1517</sup>

After discussions with Hewitt and Northern Trust, Ms. Rath consulted her superior, the Senior Director of Benefits, Cynthia Barrow. They consulted their superior, Cindy Olson, the Executive Vice President, Human Resources, Employee Relations and Building Services as to whether to go forward with the blackout. Ms. Olson consulted two other Human Resources Vice Presidents and another Enron employee, and also contacted Enron's ERISA counsel. Ms. Olson said that she consulted with the other Human Resources Vice Presidents because of their general experience and that she consulted with the other Enron employee because that person had made comments regarding the timing of the blackout. All of these persons thought that the blackout should go forward. The ERISA counsel advised that they should go forward with the blackout because of the difficulty of notifying all plan participants of the postponement, particularly the inactive employees who did not have access to electronic mail. One employee suggested that another electronic mail be sent reminding participants about the blackout.<sup>1518</sup>

The decision was made to go forward with the blackout as planned and Enron notified Hewitt and Northern Trust by telephone that a decision had been made to go forward with the blackout period as planned.<sup>1519</sup>

According to documents provided by Enron, on October 25, at 11:44 p.m. another electronic mail message was sent to the same group of active employees reminding them that the blackout was going to take place. Enron personnel indicated that no additional communication was sent to other plan participants at that time.

The electronic mail message contained the following notice: "If you are a participant in the Enron Corp. Savings Plan, please read this very important message." The message indicated that there had been concern about the timing of the move to a new administrator and the restricted access to funds during the transition period. The message stated "We have been working with Hewitt and Northern Trust since July. We understand your concerns and are

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<sup>1517</sup> *Id.* at 54-55, 111-112; interviews of Enron employees by Joint Committee staff.

<sup>1518</sup> Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 55-58; interviews of Enron employees by Joint Committee staff.

<sup>1519</sup> Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 102, 112. (Feb. 5, 2002).

committed to making this transition period as short as possible without jeopardizing the reconciliation of both the Plan in total or your account in particular.”<sup>1520</sup>

The message also included “reminders” that “the Enron Corp. Savings Plan is an investment vehicle for your **long-term** financial goals” and that “the Enron plan will continue to offer a variety of investment opportunities with different levels of risk.”<sup>1521</sup> The message reminds participants to review their overall investment strategy and weigh the potential earnings of each investment choice against its risks before making decisions.

The message concludes: “For that reason, it is critical that **ALL** trades among your investment funds be completed by **3:00 PM CST Friday, October 26 before the transition period begins.**”<sup>1522</sup>

October 26, 2001: 11:58 AM; electronic mail message to Enron employees<sup>1523</sup> (Enron stock price \$15.40)

On the morning of October 26, 2001, an electronic mail message was sent to same group as the earlier electronic mail messages. The message contained a “final reminder” of the October 26 blackout date and said that investment funds would be frozen as of 3:00 p.m. on that date for the duration of the transition period.<sup>1524</sup>

October 30, 2001: Hewitt requested to come to meeting of Administrative Committee (Enron stock price \$11.16)

A Hewitt representative testified that she was contacted by the Enron Benefits Department on October 30, 2001, and asked to come to a meeting of the Administrative Committee on November 1, 2001. She said Hewitt was asked to be prepared to discuss the feasibility of shortening the blackout period and accelerating the live date to November 13, 2001.<sup>1525</sup>

November 1, 2001: Administrative Committee meeting (Enron stock price \$11.99)

Documents provided by Enron indicate that, due to the volatility of Enron’s stock and the fiduciary responsibility of the Administrative Committee, a special meeting of the

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<sup>1520</sup> EC000021575. A copy of this message is included in Appendix D to this Report.

<sup>1521</sup> *Id.*

<sup>1522</sup> *Id.*

<sup>1523</sup> EC000023713.

<sup>1524</sup> EC000021576. A copy of this message is included in Appendix D to this Report.

<sup>1525</sup> Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 113 (Feb. 5, 2002).



Administrative Committee was held on November 1, 2001, to discuss the prudent steps that the Administrative Committee might need to consider with respect to the Enron Savings Plan, as well as other Enron qualified plans. Minutes of the meeting indicate that it was attended by four of the Administrative Committee members, a newly engaged attorney representing the Administrative Committee,<sup>1526</sup> Benefits Department personnel, three representatives from Hewitt, and Enron's ERISA counsel.

The Administrative Committee was presented with a snapshot of the current Enron stock holdings in the Enron Savings Plan and Enron ESOP as of October 26, September 30, and January 1, 2001. The Administrative Committee was advised that it had no duty to issue cautionary advice on the value or risk of holding Enron stock because the Administrative Committee does not act in the capacity of an investment advisor, but is charged with administering the plans in accordance with the terms of the plan documents and in compliance with ERISA. It was decided that the Administrative Committee should hire an independent investment advisor to monitor Enron stock, and a member of the Enron Treasury Department was directed to conduct the search.<sup>1527</sup>

At the Administrative Committee meeting, Hewitt summarized the decision to move forward with the Enron Savings Plan transfer and discussed the implications of attempting to unwind the transaction, i.e., have Northern Trust return to their prior role and postpone the date of transferring recordkeeping to Hewitt. Hewitt indicated that the asset transfer from Northern Trust to the new trustee had already taken place, and the old trustee would have to be contacted if that were to be undone. Hewitt stated that unwinding would extend the blackout period beyond November 20.

Hewitt was asked if it were possible to speed up the process to grant limited access to accounts by all participants by November 13. Hewitt stated that it was to receive data from Northern Trust on November 7, and that it would take five days to review and that the ability to shorten the blackout period was dependent on the quality of data received.<sup>1528</sup>

Administrative Committee minutes state that the Administrative Committee agreed that it was most prudent to move forward with the transition and asked the Benefits Department to set up an external website and to mail a postcard to all participants informing them to check for updates on the transition. It was decided that this was the most prudent and reasonable action to take under the circumstances. The minutes also state that, with respect to the Enron ESOP, it was determined that the Administrative Committee had no duty to take action since adequate

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<sup>1526</sup> The previous legal counsel for the Administrative Committee had had to resign due to conflicts of interest that had developed. It was agreed that the November 1, 2001, Administrative Committee meeting that the new attorney would represent the Administrative Committee at this meeting and the next pending a further agreement regarding his services.

<sup>1527</sup> Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001).

<sup>1528</sup> *Id.* Committee on Governmental Affairs, United States Senate, *Retirement Insecurity; 401(k) Crisis at Enron*, S. Hrg. 107-378, at 113 (Feb. 5, 2002).

communication has been given to participants over the years. The Administrative Committee would review the recommendations of the Investment Advisor as to what, if any, action might be required.

The Administrative Committee also determined that weekly meetings should be held during the transition period, and the next meeting date was scheduled for November 6. At that time, candidates for investment advisor to the Administrative Committee would be presented.

November 6, 2001: Administrative Committee meeting<sup>1529</sup> (Enron stock price \$9.67)

The November 6, 2001, meeting of the Administrative Committee was attended (by person or via phone) by five members of the Administrative Committee, Benefits Department personnel, Enron ERISA counsel, counsel for the Administrative Committee, and two representatives from Hewitt.

The Administrative Committee discussed retaining an investment advisor to give guidance to the Administrative Committee on Enron stock in relation to the blackout period as well as current market conditions surrounding Enron stock.

Benefits Department personnel provided an update of the status of participant communications and the transition process. It was reported that the website for participants to check for updates was operational as of the time of the Administrative Committee meeting, and that a notification postcard would be mailed to all participants on November 8. Hewitt informed the Administrative Committee that the transition was on target and that Hewitt would make every prudent effort possible to shorten the blackout period.

Pending lawsuits were also discussed.

November 7, 2001: data transfer from Northern Trust to Hewitt (Enron stock price \$9.05)

On November 7, 2001, Hewitt received the data transfer from Northern Trust.<sup>1530</sup>

November 8, 2001: post card mailed to plan participants (Enron stock price \$8.41)

At the request of Enron, Hewitt mailed a post card to plan participants on November 8, 2001. Hewitt says that they used participant address lists provided by Northern Trust and Enron in making the mailing.<sup>1531</sup> The post card stated that “Enron and Hewitt are committed to making this period as short as possible so we have established a phone number and a web address that

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<sup>1529</sup> See Minutes of Administrative Committee Meeting (Nov. 6, 2001).

<sup>1530</sup> Committee on Governmental Affairs, United States Senate, *Retirement Insecurity; 401(k) Crisis at Enron*, S. Hrg. 107-378, at 37 (Feb. 5, 2002).

<sup>1531</sup> *Id.* at 113-114.

enables you to get current information in a timely manner.” The postcard also stated: “Stay connected to watch for an earlier access date.”<sup>1532</sup>

November 13, 2001: blackout ends, Administrative Committee meeting (Enron stock price \$9.98)

Enron and Hewitt report that the plan went “live” on November 13, 2001, at 8:00 am.

An Administrative Committee meeting was held on November 13, 2001, at which the Administrative Committee received an update of the status of the Enron Savings Plan transition. Benefits Department personnel reported that the Enron Savings Plan was “live” as of 8:00 am that morning and that the transition update website and phone line reflected this information. It was noted that the blackout had ended five days earlier than originally planned.

It was reported that on that day prior to the time of the Administrative Committee meeting, the plan website had experienced 200-250 hits and that the plan had not seen large movements in accounts.

The Administrative Committee chair requested that another electronic mail message be sent to employees to remind them that the transition period had ended.

An update on the investment advisor search was also provided at that time. It was reported that the selection process was expected to be finished by Friday, November 16, 2001.

Pending lawsuits were also discussed.

November 14, 2001, 9:07 PM:<sup>1533</sup> electronic mail to Enron employees notifying them that the blackout had ended on November 13 (Enron stock price \$10.00)

An electronic mail message dated November 14, 2001, at 9:07 p.m. was sent to the same group of employees as previous electronic mail messages. The message announces an early end to the transition period and says that the internet site went live as of 8:00 a.m., November 13, the previous morning. It tells employees to log on to [benefits.enron.com](http://benefits.enron.com), to enjoy the new features.

This notice was sent 36 hours after the blackout had ended. Enron personnel interviewed by the Joint Committee staff were not able to specifically explain the delay. Joint Committee staff were told that the process for sending electronic mails to all employees was to send the message to a center for transmittal, and they were sent when they got around to them.

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<sup>1532</sup> *Id.* at 122.

<sup>1533</sup> EC000023719.

## **Miscellaneous employee communications**

Documents provided to the Joint Committee staff by Enron include additional employee communications that are not dated. These appear to be printouts from a website. They are as follows.

### Undated web printout<sup>1534</sup>

This document tells people to stay connected to watch for an earlier access date.

### Undated web printout<sup>1535</sup>

This document appears to be printout from a web page. Heading: “Welcome to your Enron Corp. Savings Plan Transition Update Site”--a website designed to bring you the most up-to-date news on the progress of the Savings Plan move to Hewitt Associates.

The document says: Update November 13, 2001, “The Savings Plan system is up and live as of 8:00 AM!” Provides web address and telephone number to check on account, check out the new website or make changes.

The document also contains the following (historical) information:

- November 7: All participant information for approximately 24,000 participants will transfer.
- Activities for week ending 11/2/01:
  - a. November 1: Savings Plan and ESOP balances transferred to new trust, remaining assets in the three Vanguard LifeStrategy funds mapped to the new Fidelity Freedom Funds;
  - b. October 26: 187 investment transfers completed by the 3:00 PM deadline;
  - c. October 22: The self-directed brokerage account began its migration from Schwab to CSFBdirect. With the exception of some mutual funds, no holdings were liquidated.

## **Involvement of the Administrative Committee**

The first mention of a search for a new recordkeeper specifically for the Savings Plan appears in the Administrative Committee meeting on May 3, 2001. The minutes state that Ms. Rath reviewed the reasons for and status of the Enron Savings Plan recordkeeper and trustee vendor search.<sup>1536</sup> Ms. Rath presented the decision for the move to Hewitt Associates as

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<sup>1534</sup> EC000023718.

<sup>1535</sup> EC000023721.

<sup>1536</sup> The minutes refer to an Attachment III for this agenda item. The documents supplied by Enron in response to Joint Committee staff request do not label Attachment III or describe either the reasons for or the status of the search. The Joint Committee staff has been unable to determine whether we have the complete documents provided to the Administrative

recordkeeper and Wilmington Trust as trustee. She recommended that the Administrative Committee approve the elimination of the Enron Oil and Gas Stock Fund and the switch from Vanguard LifeStrategy Funds to Fidelity Freedom Funds. The Administrative Committee requested Ms. Rath to work with another Enron employee to determine whether the Fidelity Funds are a comparable class and optimal fee structure. It was decided that these matters would be brought back to the committee at the August 15<sup>th</sup> meeting for a vote.

The materials provided to the Administrative Committee in connection with this agenda item are:

- (1) A one-page paper titled "Vendor Search" which says "Revised 1998 request for proposal and sent to": **Hewitt Associates, Fidelity**, Prudential, PaineWebber/Putnam, Merrill Lynch, Invesco, Citistreet, JP Morgan/American Century (emphasis in original).
- (2) A one-page paper titled "Investment Offerings" which refers to the elimination of the Enron Oil and Gas Stock Fund and the recommended investment switch from Vanguard to Fidelity Funds. Also says "Increase rebate from Fidelity by \$59,172.57/qtr."
- (3) A one-page paper titled "Enron Corp. Savings Plan Fund Performance Average Annual Total Returns For The Period ended March 31, 2001," which compares certain Vanguard funds with Fidelity funds.
- (4) Four pages of materials which describe the Fidelity Freedom Funds.
- (5) Three pages of materials describing Vanguard LifeStrategy Funds.

While not clear, the first document referenced above appears to mean that, in making the search, the 1998 request for proposal was revised and sent to the listed service providers. The two bolded names were the two final providers considered in the process, with Hewitt being chosen.

As discussed above, the Administrative Committee discussed the status of the blackout at the November 6, 2001, meeting.

### **Subsequent Administrative Committee meetings**

Issues relating to the change of recordkeeper were discussed at some subsequent Administrative Committee meetings. At the Administrative Committee meeting on November

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Committee on this matter. The materials described here were included with the minutes and relate to this item, so it is assumed they were provided for this item.

20, 2001, a timeline of the events leading to the change of recordkeepers was discussed.<sup>1537</sup>

At the Committee meeting on December 11, 2001, copies of the following were provided to the Committee: employee communications and an updated timeline documenting the sequence of events relating to the blackout; a copy of the prior presentation by in-house counsel regarding the roles and responsibilities of the Administrative Committee; and a copy of a draft analysis by of the history of the stock price and the transition period.

### **Enron Savings Plan holdings of Enron stock and transactions in Enron stock**

According to information provided by Ms. Rath to the Senate Committee on Governmental Affairs, at the time the blackout of investments began under the Enron Savings Plan on October 26, 2001, approximately 26 percent of the assets of the Enron Savings Plan were invested in Enron stock. At this time, approximately 58 percent of the Enron Savings Plan investment in Enron stock was due to participant investment elections with respect to participant contributions and 42 percent was due to Enron matching contributions. Approximately 22 percent of plan participants at that time were eligible to reinvest the matching contributions in something other than Enron stock.<sup>1538</sup>

For the two weeks preceding October 26, 2001, Enron Savings Plan participants were net buyers of Enron stock. During this period, Enron Savings Plan participants purchased \$15.770 million of Enron stock and sold \$11.553 worth of Enron stock. Also during this period, the number of Enron Savings Plan participants who bought Enron stock (501 participants) outnumbered plan participants who sold Enron stock (224 participants) by more than a two to one margin.<sup>1539</sup>

In contrast, for the two week period after the blackout period ended on November 13, 2001, Enron Savings Plan participants were net sellers of Enron stock.<sup>1540</sup>

### **Enron Savings Plan provisions relating to third party service providers**

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<sup>1537</sup> EC000001909-16. An updated copy of this timeline was presented at the December 11, 2001, Administrative Committee Meeting. A copy of this document is included in Appendix D to this Report.

<sup>1538</sup> Responses to questions for the record submitted on behalf of Mikie Rath by Swidler Berlin Shereff Friedman, LLP, *Retirement Insecurity: 401(k) Crisis at Enron*, Hearing before the Committee on Governmental Affairs, United States Senate, S.Hrg. 107-378, at 188-89 (Feb. 5, 2002).

<sup>1539</sup> Responses to questions for the record submitted by Northern Trust Retirement Consulting, LLC, *Retirement Insecurity: 401(k) Crisis at Enron*, Hearing before the Committee on Governmental Affairs, United States Senate, S.Hrg. 107-378, at 191 (Feb. 5, 2002).

<sup>1540</sup> Responses to questions for the record submitted by Hewitt Associates, *Retirement Insecurity: 401(k) Crisis at Enron*, Hearing before the Committee on Governmental Affairs, United States Senate, S.Hrg. 107-378, at 200 (Feb. 5, 2002).

Section XV.6 of the Enron Savings Plan (as amended and restated effective July 1, 1999) provides as follows:

Notwithstanding any provision of the Plan or the Trust Agreement to the contrary, the Company may, in its sole discretion, engage any service provider which is not an employee or a subsidiary of the company to perform identified administrative services with respect to the Plan (“Third-Party Administrative Services”). In the event that the Company so engages any such service provider to perform Third-Party Administrative Service, then notwithstanding any provision of the Plan to the contrary, the Company shall be fully responsible and accountable for selecting, credentialing, overseeing, and monitoring such service provider, including without limitation, evaluating the quality of performance, determining whether the fees charged are reasonable, and removing or replacing such service provider, as the Company deems to be necessary or appropriate in its discretion. Upon engaging a service provider to perform Third-Party Administrative Services, the Company shall advise the Committee in writing regarding such engagement identifying the service provider and the Third-Party Administrative Services which are to be performed by such service provider. Thereafter the Committee shall have not power, duty, or responsibility with respect to such Third-Party Administrative Services and shall have no power, duty or responsibility to monitor the performance of such service provider.

#### **Discussion of Issues**

Changes in third party service providers, including plan recordkeepers, are a normal part of qualified plan operation. Changes in recordkeepers may be made for a variety of reasons, including mergers of plans due to corporate transactions, problems with a current recordkeeper, fee differences between comparable providers, and investment or other plan changes. A change in recordkeepers generally will involve some interruption or blackout of normal plan operations; the extent and duration of the interruption will depend on a variety of factors, including the nature of services provided, plan features (e.g., whether loans are permitted and how often investment changes can be made), the number of plan participants and accounts, and the accuracy of the information being transferred. Some recordkeepers have commented that the latter feature is often a key element determining the length of any blackout period, because if the transferred data is not accurate, then the reconciliation process will take longer.

The decision of when to implement a change, i.e., when to impose a plan blackout, may also depend on a variety of factors, including when a change is likely to have the least effect on plan operations and administrative convenience for the new and old recordkeeper and others involved in plan administration. Once chosen, blackout dates may be changed due to necessity or convenience. For example, as described above, the blackout for the Enron Savings Plan was originally scheduled to begin on September 14, 2001. The date was deferred (prior to the time participants were notified of the change) because of a perceived need to make additional plan amendments. In some cases, unanticipated problems discovered either before a blackout has begun or during a blackout may result in a delay in implementing the blackout or a delay in restarting full normal plan operations.

Actions relating to a change in plan recordkeepers are subject to ERISA's general fiduciary provisions. Thus, if ERISA's fiduciary standards are not met in connection with a change in recordkeepers, including implementation of any blackout period, fiduciary liability for losses may be imposed.

The blackout associated with the Enron Savings Plan in November 2001 has received considerable attention due to the timing of the blackout and the decline in the value of Enron stock during this period. At the beginning of the blackout, Enron stock was \$15.40 per share, compared to \$9.98 per share at the end of the blackout. This is a 35 percent loss in value during the blackout period. However, Enron's stock price was falling before the blackout, and participants who wished to could have sold stock previously. For example, on February 1, 2001, Enron stock price was \$78.79, and on October 25, 2001, the day before the blackout began, Enron stock price was \$15.35. During this period, the price of the stock fell 81 percent. Until the blackout, there is some indication that Enron employees viewed Enron stock as a good investment. As described above, Enron Savings Plan participants were net buyers of Enron stock just before the blackout. During the blackout, attitudes regarding the future of the company may have changed; Enron Savings Plan participants were net sellers of Enron stock.

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, thereby possibly allowing plan participants to reduce their losses. In hindsight, the blackout was ill-timed. However, the actions of plan fiduciaries should be evaluated based on what was known (or should have been known) at the time.

One issue is whether the Administrative Committee (or other plan fiduciaries) should have acted to postpone the blackout. The Administrative Committee, although informed about matters related to the change in recordkeepers, did not become actively involved until the blackout was underway. At that point, the Administrative Committee became concerned with the possibility of accelerating the end of the blackout period.

On the eve of the blackout, the possibility of postponing the blackout due to volatility of Enron stock was considered by Enron personnel. Although the Administrative Committee was not formally involved in this decision, Cindy Olson, a member of the Administrative Committee and also, at the time, Executive Vice President, Human Resources and Community Relations, Enron Corp., was involved. In deciding to go forward with the blackout, she consulted with two other human resources vice presidents and Enron's ERISA counsel.<sup>1541</sup>

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<sup>1541</sup> Committee on Governmental Affairs, United States Senate. *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 57. (Feb. 5, 2002); interview of Cindy Olson by Joint Committee staff.



According to Ms. Olson, the blackout was not postponed due to the difficulty of providing notice of the postponement to all plan participants.<sup>1542</sup> Part of this reasoning appears to be a concern that different groups of participants not be treated differently, and part of this appears to be due to the thought that if not all participants could be notified, the blackout would go into effect as a practical manner in any case for some participants. The first concern is undermined somewhat by the fact that during the transition process to the new recordkeeper, Enron routinely provided different notices to different groups of plan participants.

Issues involving possible fiduciary liability relating to the blackout are being addressed in litigation.

Another issue that arises with respect to the blackout is 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 notices to plan participants regarding the blackout. The Joint Committee staff did not undertake to determine whether all plan participants received notice of the blackout; however, the Joint Committee staff determined that various groups of plan participants received different notices regarding the blackout. In particular, active plan participants (i.e., those currently employed by Enron) were sent numerous electronic mail messages regarding the blackout. Inactive plan participants (i.e., those not currently employed by Enron) were not sent such electronic messages, nor comparable messages regarding the blackout. Thus, active employees received more reminders of the blackout than other plan participants. The exact group of employees to whom the messages were sent is unclear, as Enron did not respond to the Joint Committee staff request to explain the group electronic mail address.

Even active employees did not all receive the same notices. In particular, it appears that PGE employees did not receive all the electronic mail messages addressed to Enron employees generally.<sup>1543</sup> Enron employees indicated to the Joint Committee staff that this was due to technical error, and that it was not uncommon for electronic mail links to break down between Enron and its related companies.

## **5. Investments under the Enron Savings Plan**

### **Present Law**

#### **ERISA**

As discussed above,<sup>1544</sup> ERISA generally provides that a person is a plan fiduciary to the extent the fiduciary exercises any discretionary authority or control over management of the plan or exercises authority or control over management or disposition of its assets, renders investment

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<sup>1542</sup> *Id.*

<sup>1543</sup> A note from a PGE employee to Ms. Rath states that PGE employees did not receive the electronic mail messages of October 16, October 22, and October 26, 2001. EC000021566.

<sup>1544</sup> *See* Part II.A.3., above.

advice for a fee or other compensation, or has any discretionary authority or responsibility in the administration of the plan. Under ERISA, the person deciding how to invest the assets of a pension plan or selecting an investment manager generally is a fiduciary by virtue of those actions. ERISA imposes a number of specific fiduciary obligations on that person or entity, including the duty to diversify plan investments. Limited exceptions permit certain defined contribution plans to hold an unlimited amount of plan assets in employer securities.<sup>1545</sup>

Additionally, ERISA requires that plan assets be held in trust and that the trustee (or the named fiduciary that directs the trustee) have “exclusive authority and discretion to manage and control the assets of the plan.”<sup>1546</sup>

Under a so-called safe harbor rule, ERISA fiduciary liability does not apply to investment decisions made by plan participants if plan participants control the investment of their individual accounts.<sup>1547</sup> Many employers design plans to meet the safe harbor in order to minimize fiduciary responsibilities. If the safe harbor applies, a plan fiduciary may be liable for the investment alternatives made available, but not for the specific investment decisions made by participants. This includes investments in employer securities made at the direction of a participant. Failure to satisfy the safe harbor rule means that plan fiduciaries may be held liable for the investment decisions of participants.

In order for the safe harbor to apply:

- the plan must provide at least three different investment options, each of which is diversified and has materially different risk and return characteristics;
- the plan must allow participants to give investment instructions with respect to each investment option under the plan with a frequency that is appropriate in light of the reasonably expected market volatility of the investment option;
- at a minimum, participants must be allowed to give investment instructions at least every three months with respect to at least three of the investment options, and those investment options must constitute a broad range of options (the three-month minimum rule);
- participants must be provided with detailed information about the investment options, information regarding fees, investment instructions and limitations, and copies of financial data and prospectuses; and
- specific requirements must be satisfied with respect to investments in employer securities to ensure that employees’ buying, selling, and voting decisions are confidential and free from employer influence.<sup>1548</sup>

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<sup>1545</sup> See Part II.A.4., above.

<sup>1546</sup> ERISA sec. 403(a).

<sup>1547</sup> ERISA sec. 404(c).

<sup>1548</sup> Additional limitations on the safe harbor include that it generally does not apply to any investment instruction of a participant which, if implemented, would result in an acquisition or sale of any employer security except to the extent that the securities are publicly traded and

In addition, the safe harbor applies only with respect to a transaction if a participant exercises independent control in fact with respect to the assets in his or her account. Whether a participant has exercised independent control in fact with respect to a transaction depends on the facts and circumstances of the particular case. However, a participant's exercise of control is not independent in fact if:

- the participant is subjected to improper influence by a plan fiduciary or the employer
- with respect to the transaction;
- a plan fiduciary has concealed material nonpublic facts regarding the investment from
- the participant, unless the disclosure of the information by the plan fiduciary to the
- participant would violate other law not preempted by ERISA; or
- the participant is legally incompetent and the responsible plan fiduciary accepts the participant's instructions knowing this.

If the safe harbor is being relied upon, then participants must be permitted to change investment decisions in a manner consistent with that safe harbor or the safe harbor will not apply. Unless the safe harbor is being relied upon, there are no specific rules regarding how often a plan must permit participants to change investments.

#### **Rules relating to investments in employer securities**<sup>1549</sup>

In general, the assets of either a defined contribution plan or a defined benefit plan may be invested in employer securities. The rules relating to such investments differ for defined benefit plans and defined contribution plans. ERISA rules applicable to defined benefit plans prohibit such plans from acquiring employer securities if, after the acquisition, more than 10 percent of the assets of the plan would be invested in employer securities. Most defined contribution plans, such as profit-sharing plans, stock bonus plans, pre-ERISA money purchase plans, 401(k) plans and ESOPs, generally are not subject to this limitation. In general, there is no limit on the amount that an employee can choose voluntarily to invest in employer securities in a defined contribution plan.

A defined contribution plan can generally require that some or all plan contributions must be invested in employer securities, with no opportunity to change investments. It is common for 401(k) plans to require that the employer match be invested in employer securities.

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are traded with sufficient frequency and in sufficient volume to assure that participant and beneficiary directions to buy or sell the security may be acted upon promptly and efficiently. ERISA reg. sec. 2550.404c-1(d)(2)(ii). In connection with such an acquisition or sale, the regulations also include requirements pertaining to the provision of information about such securities to participants and beneficiaries as well as voting, tender, and similar rights with respect to such securities. *Id.*

<sup>1549</sup> For a more detailed discussion of these rules, *see* Part II.A.4., above.

## Factual Background

### In general

Under the Enron Savings Plan, participants generally may contribute from one to 15 percent<sup>1550</sup> of their base pay in any combination of elective deferrals<sup>1551</sup> or after-tax contributions, subject to the limits prescribed by the Code. Materials reviewed by Joint Committee staff showed that participants generally could change the amount of their contributions monthly and could stop their contributions at any time.<sup>1552</sup> Such changes generally would be effective within one month.<sup>1553</sup>

Participants may also roll over amounts from other plans to the Enron Savings Plan in certain circumstances (“rollover contributions”).

Enron contributed as matching contributions amounts equal to a percentage of participants’ contributions to the Enron Savings Plan to participants’ company contribution accounts.<sup>1554</sup> Enron’s matching contributions under the Enron Savings Plan historically were invested “primarily” in Enron Corp. common stock and could not be reinvested by employees in another investment until they turned age 50.<sup>1555</sup>

The amount of Enron’s matching contribution varied over time. Under the 1994 version of the Enron Savings Plan, Enron contributed 100 percent of participants’ elective deferrals and after-tax contributions, up to six percent of their base pay, depending on the participant’s years

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<sup>1550</sup> At one point, 14 percent was the maximum permitted contribution. Summary of Enron Savings Plan (undated), at 118. The Enron Savings Plan provides that the contribution amount must be an integral percentage. Sec. 3.2, Enron Savings Plan (July, 1, 1999, restatement).

<sup>1551</sup> For a description of elective deferrals, *see* Part II.A.2., above.

<sup>1552</sup> *See The Enron Retirement Program Guide*, included in Appendix D to this Report.

<sup>1553</sup> Changes made to the amount of a participant’s contribution before the 15<sup>th</sup> of any month would be effective within one to two payroll periods following the change. Changes made after the 15<sup>th</sup> would be effective the following month. *Money in Motion - 401(k) Plan Details*, DOL020522.

<sup>1554</sup> Additionally, in November 1996, Enron announced a special \$300 contribution to the Enron Savings Plan on behalf of regular full-time Enron employees. Participants would automatically be 100 percent vested in the contribution, which would be made in mid-January 1997 and would be invested in Enron stock. *EnSight* (Nov. 1996), EC000020134-EC000020137.

<sup>1555</sup> The Enron Savings Plan provides that matching contributions to the accounts of participants who are Enron Oil & Gas employees are to be invested primarily in shares of Enron Oil & Gas stock. Sec. 5.1(a) of Enron Savings Plan (July 1, 1999, restatement).

of service.<sup>1556</sup> Effective January 1, 1998, the Enron Savings Plan was amended to provide that notwithstanding participants' years of service, for 1998, Enron would contribute a matching contribution equal to 50 percent of a participant's elective deferrals, up to two percent of base pay. The January 1, 1999, version of the Enron Savings Plan provides that Enron's matching contribution for 1999 was equal to 50 percent of participants' elective deferrals up to four percent of base pay. For 2000 and 2001, the limit was six percent of compensation. These contributions were discontinued effective November 28, 2001.<sup>1557</sup>

### **Role of the Administrative Committee**

The Enron Savings Plan Administrative Committee is the plan administrator and named fiduciary for purposes of ERISA,<sup>1558</sup> except with respect to the investment of assets of the trust fund, for which the plan trustee is the named fiduciary.<sup>1559</sup> The trust agreement under the Enron Savings Plan provides that the named fiduciary thereunder is the organization, entity, or other person responsible for benefit administration under the Enron Savings Plan.<sup>1560</sup> Further, it provides that the named fiduciary is responsible for management and control of the Enron Savings Plan trust fund and is responsible for determining the "diversification policy."<sup>1561</sup> The trust agreement also provides that the named fiduciary may delegate discretionary authority for the management and control of all or any portion of the trust to investment managers.<sup>1562</sup>

As discussed above in Part II.B.3., above, the Administrative Committee generally did not evaluate Enron stock as an appropriate investment under the Enron Savings Plan. The Administrative Committee questioned for the first time whether it should be examining Enron stock as an investment under the Enron qualified plans at a special meeting of the Administrative

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<sup>1556</sup> Sec 3.4. Enron Corp. Savings Plan (Jan. 1, 1994, restatement).

<sup>1557</sup> Third Amendment to Enron Corp. Savings Plan (July 1, 1999, restatement), DOL020351-DOL020354.

<sup>1558</sup> Sec. 13.1 of Enron Savings Plan (July 1, 1999, restatement).

<sup>1559</sup> Sec. 14.1(a) of Enron Savings Plan (July 1, 1999, restatement).

<sup>1560</sup> Sec. 1.1 of the Trust Agreement between Enron Corp. and the Wilmington Trust Company, as Trustee (effective Nov. 1, 2001) ("Trust Agreement"). The Trust Agreement between Enron and Wilmington Trust was effective November 1, 2001. Documents reviewed by Joint Committee staff indicate that The Northern Trust Company previously served as trustee to the Enron Savings Plan. The trust agreement also allocates the authority of the named fiduciary to the organization, entity, committee or other person who has authority to perform the functions allocated to it under the trust agreement. *Id.*

<sup>1561</sup> *Id.*

<sup>1562</sup> *Id.* at sec. 4.1.

Committee on November 1, 2001.<sup>1563</sup> Documents provided by Enron indicate that, due to the volatility of Enron's stock and the fiduciary responsibility of the Administrative Committee, the special meeting was called to discuss the prudent steps that the Administrative Committee might need to consider with respect to the Enron Savings Plan, as well as other Enron qualified plans. Minutes of the meeting indicate that it was attended by four of the Administrative Committee members, a newly engaged attorney representing the Administrative Committee,<sup>1564</sup> Benefits Department personnel, three representatives from Hewitt, and Enron's ERISA counsel.

The Administrative Committee was presented with a snapshot of the current Enron stock holdings in the Enron Savings Plan on January 1, September 30, and October 26, 2001. The Administrative Committee was advised that it had no duty to issue cautionary advice on the value or risk of holding Enron stock because the Administrative Committee does not act in the capacity of an investment advisor, but is charged with administering the plans in accordance with the terms of the plan documents and in compliance with ERISA. It was decided that the Administrative Committee should hire an independent investment advisor to monitor Enron stock.

At a November 6, 2001, meeting, the Administrative Committee discussed retaining an investment advisor to give guidance to the Administrative Committee on Enron stock in relation to the Administrative Committee's operation of the plans.<sup>1565</sup> Minutes of the meeting indicate that the Administrative Committee agreed that the role of the advisor would be to give advice on Enron stock and to assist the Administrative Committee in operating the plans in the best interests of its participants.<sup>1566</sup> Additionally, it was decided that the Administrative Committee should select an independent investment advisor to monitor Enron stock, and an Enron Treasury Department employee was directed to conduct the search.<sup>1567</sup>

### **Investment authority and investment decisions under the Enron Savings Plan**

Upon enrolling in the Enron Savings Plan, participants select the fund or funds in which they want to invest their contributions. The Plan provides that participants' elective deferrals and after-tax contributions may be invested into any combination of funds offered by the

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<sup>1563</sup> Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001), EC000001847-EC000001855.

<sup>1564</sup> The previous legal counsel for the Administrative Committee had had to resign due to conflicts of interest that had developed. It was agreed that the November 1, 2001, Administrative Committee meeting that the new attorney would represent the Administrative Committee at this meeting and the next pending a further agreement regarding his services.

<sup>1565</sup> Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001), EC000001858-EC000001860.

<sup>1566</sup> *Id.*

<sup>1567</sup> *Id.*

Plan.<sup>1568</sup> Participants' rollover contributions may also be invested in any combination of investments available under the Plan.<sup>1569</sup>

The Enron Savings Plan provides that participants may change their investment selections prospectively as well as with respect to amounts already invested under the Plan.<sup>1570</sup> The Plan provides that the manner and frequency of such changes are subject to procedures established by the Enron Savings Plan Administrative Committee.<sup>1571</sup>

Participants generally can make changes in investment choices for future contributions and transfer current balances from one fund to another on any business day.<sup>1572</sup> Participants wishing to make a change from one fund to another could call a phone line for the Enron Savings Plan or make the change electronically, through a website for the Plan.<sup>1573</sup> Participants would receive written confirmations of transactions.<sup>1574</sup>

With respect to Enron's matching contributions, the Enron Savings Plan generally provided that upon turning 50, participants may elect to reallocate their company contribution account balances among other investment options offered under the Enron Savings Plan. For this purpose, participants could designate one investment fund for all the amounts allocated or may split the investment of such amounts between investment funds. However, effective November 28, 2001, the Enron Savings Plan was amended to provide that notwithstanding their age, participants could reinvest the amounts in their company contribution accounts in the investment funds offered under the Plan.

Effective February 15, 2002, the Plan was amended to provide that the portion of a rollover contribution including Enron stock or other "employer securities" will continue to be so invested until the participant elects to convert it into another investment under the Plan.<sup>1575</sup> Effective March 15, 2002, the Plan was amended to provide that participants may not elect to

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<sup>1568</sup> Participants can invest in any or all funds offered under the Plan as long as the investment allocations are made in one percent increments and total 100 percent. *See The Enron Retirement Program Guide.*

<sup>1569</sup> Sec. 5.3 Enron Savings Plan (July 1, 1999, restatement); *Money in Motion*, DOL 020252.

<sup>1570</sup> Sec. 5.2 Enron Savings Plan (July 1, 1999, restatement); *Money in Motion*, DOL 020252.

<sup>1571</sup> *Id.*

<sup>1572</sup> *Money in Motion*, DOL020252.

<sup>1573</sup> *Id.*

<sup>1574</sup> *Id.*

<sup>1575</sup> Sixth Amendment to Enron Corp. Savings Plan (July 1, 1999, restatement).

convert any investment of any portion of their accounts under the Plan into an investment in Enron stock or any other “employer security.”<sup>1576</sup>

### **Plan investment options available to participants**

During the period reviewed by Joint Committee staff, participants could invest their contributions to the Enron Savings Plan in up to 20 investment options<sup>1577</sup> as long as the whole percentages chosen totaled 100 percent.<sup>1578</sup> The options included several mutual funds, Enron stock, and beginning in 1999, a Schwab account that functioned like a self-directed brokerage account,<sup>1579</sup> through which participants could invest in almost any individual stock or mutual fund.

The particular funds available under the Enron Savings Plan varied over time. During the period covered by the Joint Committee review, they included Enron stock as well as funds sponsored by a variety of financial institutions.<sup>1580</sup>

### **Information provided to participants**

Enron produced a variety of employee benefit education materials for Enron Savings Plan participants. These included periodic newsletters, occasional special newsletters, electronic communications, and materials designed to meet legal requirements, such as summary plan descriptions.<sup>1581</sup> Materials provided to the Joint Committee staff show that Enron also periodically produced publications for participants which describe the investment options under the Enron Savings Plan. Examples of prospectuses for the funds available under the Enron Savings Plan were provided to Joint Committee staff.

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<sup>1576</sup> *Id.*

<sup>1577</sup> The number of investment options varied over time.

<sup>1578</sup> *See generally* “Enron Savings Plan summary description.”

<sup>1579</sup> SEC 1999 Form 11-K. Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 33 (Feb. 5, 2002).

<sup>1580</sup> See Table 4 through Table 9, below, for the identity of the various investment options under the Enron Savings Plan for 1996 through 2000.

<sup>1581</sup> *Money in Motion - 401(k) Plan Details*, a summary plan description for the Savings Plan, describes for participants the Plan features and details, as well as their rights under the Plan. DOL020532. In a section called “ERISA Rights,” *Money in Motion* tells participants that ERISA requires the individuals responsible for managing the plan to act prudently and in their best interests. *Id.*



For example, Enron produced *Only You - Enron Retirement Planning - Tools and Information for Your Future*.<sup>1582</sup> *Only You* includes information to assist employees with determining how much to contribute to the Enron Savings Plan and how to invest their contributions.<sup>1583</sup> Additionally, an accompanying *Resource Guide*<sup>1584</sup> identifies resources through which employees could learn about investing. The *Resource Guide* lists the following types of assistance as provided by Enron:

- Information about Enron retirement benefits so that employees know what to expect when they retire;
- The “Wealthy Barber” video which provides advice about saving and investing;
- *FutureSaver*, interactive retirement planning software, customized for Enron’s benefit plans; and
- “Investing in Your Future” workbooks, emphasizing the importance of saving for retirement and focusing on the fundamentals of investing and the relationship between risk and return, the importance of diversification and the impact of time on investment results.

### **Employee meetings and company culture**

Enron held periodic “all-employee” meetings. Depending on the location of the meetings, employees could attend the meetings in person. In addition, the meetings were typically broadcast to all employee locations. While the purpose of these meetings generally was not to discuss investment options under the Enron Savings Plan, the future of Enron and projected prices of Enron Corp. common stock were discussed.

The Joint Committee staff reviewed videotapes of nine employee meetings for the period February 1, 1999, to October 23, 2001. The meetings had a common format. Information regarding the most recent financial information, the future of the company, and any current changes or planned changes were addressed. The discussion was typically led by the Chairman (either Mr. Lay or Mr. Skilling, depending on the time frame) and two or three other high-ranking Enron officials, such as Mr. Skilling, Joseph Sutton and Mark Frevert. A question and answer session followed the presentations by such individuals. In many cases, the questions had been submitted in advance of the meeting.

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<sup>1582</sup> *Only You - Enron Retirement Planning - Tools and Information for Your Future*, EC000020214-EC000020237.

<sup>1583</sup> For example, the *Only You Resource Guide* states that there is “no better way to save money than on a before-tax basis through payroll deduction. Thanks to the plans’ tax advantages and wide variety of investment options, it simply can’t be beat...Make the most of your investment options. Most of us are long-term investors and can take advantage of the more aggressive investment funds. Enron has also recently introduced three new “Lifestyle” investment funds designed to fit a variety of investor profiles,” EC000020241.

<sup>1584</sup> *Only You Resource Guide*, EC000020238-EC000020257.

With two exceptions, described below, Enron stock was not discussed in the employee meetings specifically in the context of the Enron Savings Plan. However, the future of Enron and the projected value of Enron stock was always addressed. A positive picture of the future was generally presented. The view that all employees should be owners of Enron was also frequently addressed.

For example, at the employee meeting on July 13, 1999, Mr. Lay told employees that “[w]e think it’s critical that every body has an ownership position in the company” and that it is “very possible before year end” that the stock price would reach \$100 per share and that “there is a fairly good chance we could see the stock price double again in the next year to 18 months...Do that math on your Enron stock.”<sup>1585</sup> On August 16, 2001, Mr. Lay explained to employees, “we think we’re at the bottom of the cycle and want you [the employees] to enjoy the ride back up. And more importantly, we want you to work hard so we get that ride back up.”<sup>1586</sup> The previous day, Enron stock closed at \$40.25. Mr. Lay added, “we are a deep value stock” and “the company is doing extremely well.” Also on August 16, 2001, Mr. Lay told Enron employees that “the next several months, the next few years are going to be great for Enron, great for Enron’s employees...And that’s all starting now.” Enron stock closed at \$36.85 that day.

As mentioned above, Enron stock was addressed in the context of the Enron Savings Plan at two employee meetings. At the February 1, 1999, meeting, Cindy Olson, Enron’s Executive Vice President for Human Resources and Community Relations was asked to join Mr. Lay, and respond to the question “Should we invest all of our 401(k) in Enron stock?,” submitted by an employee. She replied, “Absolutely!”<sup>1587</sup>

According to Ms. Olson, the question was impromptu and her reply, which was intended to be humorous, was “greeted with laughter by those running the meeting and by the audience.”<sup>1588</sup> In her view, when taken in the context of the meeting, it is clear that this was not

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<sup>1585</sup> July 13, 1999, employee meeting.

<sup>1586</sup> Mr. Lay was explaining to Enron employees that an additional issuance of stock options would be made to them. The options would vest in one year, instead of over five years as under previous similar programs.

<sup>1587</sup> In an interview with Joint Committee staff, Ms. Olson said she had no “on-the-ground detailed knowledge” of the Savings Plan despite the fact that she served on the Administrative Committee from January 2001 to March 2002. According to Ms. Olson, her responsibilities were more in the nature of customer service: to ensure that the Savings Plan was administered properly “in accordance with the culture” and that participants “got the services they needed.” She said that she was not involved with the Savings Plan from a technical standpoint.

<sup>1588</sup> Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 182-183 (Feb. 5, 2002).

intended as a serious statement. She also stated that she generally stressed diversification of investments.<sup>1589</sup>

At an employee meeting on October 23, 2001, Mr. Lay directly answered employee questions. To the question “I’m showing little in my 401(k). Any speculation on whether there will be any guarantee of pensions for those with 10 or 20 years of service?”, Mr. Lay included as part of his answer, “Enron stock--we’ll bring it back. We’re gonna bring it back.”

A few weeks following the meeting, on November 8, 2001, Enron announced its intention to file restated financial statements for the years December 31, 1997, through 2000, and for the first and second quarters of 2001.<sup>1590</sup>

Current and former employees interviewed by the Joint Committee staff indicated that there was a general culture encouraging employee ownership of Enron stock and that it was part of the Enron philosophy that all employees should also be owners of the company. Employees interviewed by the Joint Committee staff generally expressed continued loyalty to Enron, despite their own financial losses. One former employee of an Enron subsidiary gave the following testimony at a Congressional hearing:

Throughout my time with Enron, the top management of the company constantly encouraged us to invest our savings in Enron stock. I took the fact that the company matched our savings only with Enron stock as a further endorsement of the stock as a safe retirement investment. More recent statements made by Enron’s top management, including e-mails from Ken Lay, about the company’s stock also caused me to keep investing my savings into the stock. I remember, in the Fall of 2000, Enron’s top executives telling us at an employee meeting and by company e-mail that Enron’s stock price was going to increase to at least \$120 per share. When Mr. Skilling resigned last

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<sup>1589</sup> Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 40, 44 (Feb. 5, 2002). Additionally, Ms. Olson provided Joint Committee staff with examples of her responses to questions e-mailed to her by Enron employees about their benefits. In answering one such question, Ms. Olson wrote: “We encourage employees to discuss these questions with a financial advisor or tax expert. Because everyone’s situation, risk tolerance and diversification goals are different, there is no one solution that works for everyone.” Printout of *Enron Options, Featuring Cindy Olson, executive vice president, Human Resources & Community Affairs* (Nov. 2, 2000). Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 177-78 (Feb. 5, 2002).

<sup>1590</sup> SEC Form 8-K, filed with the Securities and Exchange Commission on November 8, 2001.

August, Mr. Lay told us that the company was stronger than it had ever been....Our stock ownership was encouraged by Enron's top management.<sup>1591</sup>

The Joint Committee staff was told that Enron employees were constantly aware of the price of Enron stock, and that, until the bankruptcy filing, the current stock price was displayed on a monitor in the lobby of the Enron building.

### **Historical information regarding distribution of plan investments by type of investment**

Table 4 through Table 9, below, show the general distribution of investments under the Enron Savings Plan by type of investment for the years 1996 to 2000 and as of October 26, 2001. The source of the data for 1996 to 2000 is the Forms 11-K<sup>1592</sup> as filed with the SEC for those years. The source of the data for 2001 is an attachment to minutes of the November 1, 2001, meeting of the Administrative Committee.<sup>1593</sup>

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<sup>1591</sup> Committee on Education and the Workforce, United States House of Representatives, *The Enron Collapse and Its Implications for Worker Retirement Security*, H. Hrg. 107-42, at 100-101 (Feb. 7, 2002).

<sup>1592</sup> The Form 11-K is an annual report for employee stock purchase, savings, and similar plans, interests in which constitute securities registered under the Securities Act of 1933. The Form 11-K is required to be filed pursuant to section 15(d) of the Securities Act of 1933 even though the issuer of the securities offered to employees under the plan also files annual reports in accordance with the Securities Exchange Act of 1934. The Form 11-K is generally due to the Securities Exchange Commission within 180 days after the end of an ERISA plan's fiscal year. See 17 CFR 249.311.

<sup>1593</sup> *Enron Corp. Savings Plan Fund Information*, attachment to Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001), EC000001854.

**Table 4.—Distribution of Enron Savings Plan Investments  
by Type of Investment for 1996**

Investment	Year-End Value (millions of dollars)	Total Year-End Value (millions of dollars)
<b>Short-Term Investments:</b>		
Northern Trust Collective Stock Index Fund	7.8	
SEI Stable Asset Fund	0.0	
<b>Total</b>		7.8
<b>Stock:</b>		
Enron Corp. Common Stock	308.1	
Enron Corp. Cumulative Second Preferred Convertible Stock	41.2	
Enron Oil & Gas Company Common Stock	24.0	
<b>Total</b>		373.3
<b>Investment Funds:</b>		
Fidelity Investments Equity Income Stock	27.6	
Fidelity Investments OTC Fund	9.2	
Fidelity Investments Balanced Fund	3.7	
Fidelity Investments Growth & Income Fund	19.6	
Fidelity Investments Magellan Fund	15.9	
Fidelity Investments Growth Company Fund	16.3	
Fidelity Investments Overseas Fund	6.1	
Vanguard Growth Portfolio	2.4	
Vanguard Moderate Growth Portfolio	0.9	
Vanguard Conservative Growth Portfolio	1.4	
<b>Total</b>		103.1
<b>Fixed Income Deposit Contracts:</b>		
Allstate #GA-5826	4.4	
Canada Life Contracts #P-45770	12.3	
J.P. Morgan Enron-02	3.7	
John Hancock Mutual Life Insurance Co. #GAC 7374	7.1	
Lincoln National #GA-9597	7.2	
New York Life #GA-30282	4.9	
Peoples Security BDA00149TR-1	8.0	
Peoples Security BDA00149TR-2	3.9	
Peoples Security BDA00149TR-5	3.8	
Peoples Security BDA00437FR	8.3	
Principal Mutual #4-20383	4.3	
Protective Life #GA-1206	4.2	
Provident Life and Accident Insurance #627-5578	5.0	
Sun Life of Canada Insurance #S-0885-G	10.0	
Transamerica Occidental Life #51362	0.0	
Transamerica Occidental #51313-00	3.3	
<b>Total</b>		90.6

Note: Items may not sum to total due to rounding.

Source: 2000 SEC Form 11-K for the Enron Corp. Savings Plan, Schedule of Assets Held for Investment Purposes, available at [www.sec.gov](http://www.sec.gov).

**Table 5.—Distribution of Enron Savings Plan Investments  
by Type of Investment for 1997**

Investment	Year-End Value (millions of dollars)	Total Year-End Value (millions of dollars)
<b>Short-Term Investments:</b>		
Northern Trust Collective Stock Index Fund	9.6	
SEI Stable Asset Fund	5.2	
<b>Total</b>		14.8
<b>Stock:</b>		
Enron Corp. Common Stock	276.9	
Enron Corp. Cumulative Second Preferred Convertible Stock	39.7	
Enron Oil & Gas Company Common Stock	28.4	
<b>Total</b>		345.0
<b>Investment Funds:</b>		
Fidelity Investments Equity Income Stock	39.7	
Fidelity Investments OTC Fund	10.7	
Fidelity Investments Balanced Fund	5.4	
Fidelity Investments Growth & Income Fund	31.8	
Fidelity Investments Magellan Fund	20.8	
Fidelity Investments Growth Company Fund	20.1	
Fidelity Investments Overseas Fund	8.3	
Vanguard Growth Portfolio	4.8	
Vanguard Conservative Growth Portfolio	1.5	
Vanguard Moderate Growth Portfolio	2.0	
<b>Total</b>		145.1
<b>Fixed Income Deposit Contracts:</b>		
Allstate #GA - 5826	4.7	
J.P. Morgan Enron-#02	3.8	
John Hancock Mutual Life Insurance Co. GAC # 7374	7.6	
New York Life #GA-30282	5.2	
Peoples Security BDA00149TR-1	8.0	
Peoples Security BDA00149TR-2	3.9	
Peoples Security BDA00149TR-5	3.8	
Peoples Security BDA00437FR	4.5	
Principal Mutual #4-20383	4.6	
Protective Life GA-#1206	4.2	
Provident Life and Accident Insurance #627-5578	5.2	
State Street Bank #97053	8.0	
Sun Life of Canada Insurance #S-0885-G	10.6	
Transamerica Occidental Life #51362	0.0	
Transamerica Occidental #51313-00	1.7	
<b>Total</b>		75.8

Note: Items may not sum to total due to rounding.

Source: 1997 SEC Form 11-K for the Enron Corp. Savings Plan, Schedule of Assets Held for Investment Purposes, available at [www.sec.gov](http://www.sec.gov).

**Table 6.—Distribution of Enron Savings Plan Investments  
by Type of Investment for 1998**

Investment	Year-End Value (millions of dollars)	Total Year-End Value (millions of dollars)
<b>Short-Term Investments:</b>		
Morgan Stanley Stable Value II	6.2	
Northern Trust Collective Stock Index Fund	14.0	
SEI Stable Asset Fund	21.2	
<b>Total</b>		41.4
<b>Stock:</b>		
Enron Corp. Common Stock	311.1	
Enron Corp. Cumulative Second Preferred Convertible Stock	54.5	
Enron Oil & Gas Company Common Stock	38.9	
<b>Total</b>		404.5
<b>Investment Funds:</b>		
Fidelity Investments Equity Income Fund	45.1	
Fidelity Investments OTC Fund	17.0	
Fidelity Investments Balanced Fund	10.1	
Fidelity Investments Growth & Income Fund	55.9	
Fidelity Investments Magellan Fund	33.2	
Fidelity Investments Growth Company Fund	26.2	
Fidelity Investments Overseas Fund	9.4	
The Vanguard Group Growth Portfolio	9.6	
The Vanguard Group Conservative Growth Portfolio	3.1	
The Vanguard Group Moderate Growth Portfolio	3.4	
<b>Total</b>		213.0
<b>Fixed Income Deposit Contracts:</b>		
John Hancock Mutual Life Insurance Co. #GAC 7374	8.1	
John Hancock Mutual Life Insurance Co. #14447	6.0	
Peoples Security BDA00149TR-1	9.7	
Peoples Security BDA00149TR-8	3.9	
Peoples Security BDA00149TR-6	3.6	
Peoples Security BDA00437FR	4.8	
Peoples Security BDA00149TR-11	3.4	
Principal Mutual #4-20383	4.9	
Provident Life and Accident Insurance #627-5578	5.5	
State Street Bank 97-053B	7.8	
Sun Life of Canada Insurance #S-0885-G	11.1	
Transamerica Occidental Life #51362-00	0.0	
Transamerica Occidental Life #51313-00	1.9	
<b>Total</b>		70.7

Note: Items may not sum to total due to rounding.

Source: 1998 SEC Form 11-K for the Enron Corp. Savings Plan, Schedule of Assets Held for Investment Purposes, available at [www.sec.gov](http://www.sec.gov).

**Table 7.—Distribution of Enron Savings Plan Investments  
by Type of Investment for 1999**

Investment	Year-End Value (millions of dollars)	Total Year-End Value (millions of dollars)
<b>Short-Term Investments:</b>		
Northern Trust Company Short-Term Investment Fund	8.8	
SEI Trust Company Stable Asset Fund	23.1	
Morgan Stanley Dean Witter Stable Value II	12.5	
<b>Total</b>		44.4
<b>Stock:</b>		
Enron Corp. common stock	662.1	
Enron Corp. Cumulative Second Preferred Convertible Stock	84.8	
Enron Oil & Gas Resources, Inc. Common Stock	25.2	
Charles Schwab Self-Directed Brokerage Account	16.1	
<b>Total</b>		788.2
<b>Investment Funds:</b>		
Fidelity Investments Equity Income Fund	43.2	
Fidelity Investments OTC Funds	43.4	
Fidelity Investments Balanced Fund	13.8	
Fidelity Investments Growth & Income Fund	55.0	
Fidelity Investments Magellan Fund	52.1	
Fidelity Investments Growth Company Fund	66.1	
Fidelity Investments Overseas Fund	15.5	
Morgan Stanley Dean Witter International Equity Portfolio	12.9	
Morgan Stanley Dean Witter Institutional Fund	69.1	
The Vanguard Group Growth Portfolio	59.5	
The Vanguard Group Conservation Growth Portfolio	15.1	
The Vanguard Group Moderate Growth Portfolio	56.5	
The Vanguard Group Index Trust 500 Portfolio	17.4	
The Vanguard Group Windsor II Fund	39.3	
T. Rowe Price Small Cap Fund	20.9	
PIMCO Total Return Fund	12.0	
PIMCO Low Duration Fund	10.2	
PIMCO Total	6.3	
UAM Trust Company Dwight Target 2 Fund	24.8	
UAM Trust Company Dwight Target 5 Fund	44.0	
<b>Total</b>		677.1
<b>Fixed Income Deposit Contracts:</b>		
John Hancock Mutual Life Insurance Co. GAC #7374	4.3	
John Hancock Mutual Life Insurance Co. #14447	6.4	
Principal Mutual Life Insurance Co. #4-20383	5.2	
Sun Life of Canada Insurance #S-0885-G, 5.42 percent	11.7	
Transamerica Occidental Life #51362-00, 6.10 percent	0.0	
Allstate Insurance Co. #5926P	4.3	
Allstate Insurance Co. #6229	6.0	
GE Life & Annuity Assurance Co. #3322	5.1	
John Hancock Mutual Life Insurance Co. #3322	5.0	
Monumental Insurance Co. #ADA00757FRP	6.6	
New York Life Insurance Co. #30505P	5.2	



**Table 7.—Distribution of Enron Savings Plan Investments  
by Type of Investment for 1999**

<b>Investment</b>	<b>Year-End Value (millions of dollars)</b>	<b>Total Year-End Value (millions of dollars)</b>
New York Life Insurance Co. #31036	32.7	
CDC Financial Synthetic #1032-01-P	0.7	
Transamerica Life Insurance Co. #76644-P	1.0	
<b>Total</b>		94.2

Note: Items may not sum to total due to rounding.

Source: 1999 SEC Form 11-K for the Enron Corp. Savings Plan, Schedule of Assets Held for Investment Purposes, available at [www.sec.gov](http://www.sec.gov).

**Table 8.—Distribution of Enron Savings Plan Investments  
by Type of Investment for 2000**

Investment	Year-End Value (millions of dollars)	Total Year-End Value (millions of dollars)
<b>Short-Term Investments:</b>		
Northern Trust Company Short-Term Investment Fund	17.8	
SEI Trust Company Stable Asset Fund	18.3	
Morgan Stanley Dean Witter Stable Value II	13.4	
<b>Total</b>		49.5
<b>Stock:</b>		
Enron Corp. Common Stock	1,157.5	
Enron Corp. Cumulative Second Preferred Convertible Stock	158.9	
Enron Oil & Gas Resources, Inc. common stock	26.4	
Charles Schwab Self-Directed Brokerage Account	30.8	
<b>Total</b>		1,373.6
<b>Investment Funds:</b>		
Fidelity Investments Equity Income Fund	34.9	
Fidelity Investments OTC Funds	37.6	
Fidelity Investments Balanced Fund	12.2	
Fidelity Investments Growth & Income Fund	43.3	
Fidelity Investments Magellan Fund	46.5	
Fidelity Investments Growth Company Fund	84.0	
Fidelity Investments Overseas Fund	14.8	
Morgan Stanley Dean Witter International Equity Portfolio	11.7	
Morgan Stanley Dean Witter Institutional Fund	45.9	
The Vanguard Group Life Strategy Growth	44.9	
The Vanguard Group Conservation Growth Portfolio	12.6	
The Vanguard Group Moderate Growth Portfolio	41.1	
The Vanguard Group Index Trust 500 Portfolio	23.2	
The Vanguard Group Windsor II Fund	28.0	
T. Rowe Price Small Cap Fund	25.5	
PIMCO Total Return Fund II Institutional	8.0	
PIMCO Low Duration Fund	11.0	
PIMCO Total Return Fund	7.0	
UAM Trust Company Dwight Target 2 Fund	27.1	
UAM Trust Company Dwight Target 5 Fund	49.6	
<b>Total</b>		608.9
<b>Fixed Income Deposit Contracts:</b>		
John Hancock Mutual Life Insurance Co. #14447	6.8	
Canada Life Investment #P46067	12.5	
Canada Life Investment #P46058	13.8	
People's (Aegon) Life Co. #NDA0017SFR	10.2	
People's Benefit Life Investment #173FR	10.4	
Allstate Insurance Co. #5926P	4.6	
Allstate Insurance Co. #6229	6.5	
GE Life & Annuity Assurance Co. #3322	5.5	
John Hancock Mutual Life Insurance Co. #9600P	5.0	
New York Life Insurance Co. #31036	5.9	
CDC Financial Synthetic #1032-01-P	0.2	

**Table 8.—Distribution of Enron Savings Plan Investments  
by Type of Investment for 2000**

<b>Investment</b>	<b>Year-End Value (millions of dollars)</b>	<b>Total Year-End Value (millions of dollars)</b>
Transamerica Occidental Life Insurance Co. #76644-P	(0.4)	
State Street Bank Synthetic #97053	0.3	
Monumental Insurance Co. #BDA00390TR	(0.1)	
<b>Total</b>		81.2

Note: Items may not sum to total due to rounding.

Source: 2000 SEC Form 11-K for the Enron Corp. Savings Plan, Schedule of Assets Held for Investment Purposes, available at [www.sec.gov](http://www.sec.gov).

**Table 9.—Enron Savings Plan Fund Information at  
October 26, 2001, as Reported at the November 1, 2001,  
Meeting of the Administrative Committee**

<b>Investment</b>	<b>Value (millions of dollars)</b>	<b>Total Value (millions of dollars)</b>
Enron Corp. Stock	246.7	
EOG Resources	16.3	
Self-Directed Account	26.5	
SEI Trust Company Stable Asset Fund	223.5	
Fidelity Investments Equity Income Fund	31.4	
Fidelity Investments OTC Funds	22.8	
Fidelity Investments Balanced Fund	15.1	
Fidelity Investments Growth & Income Fund	36.7	
Fidelity Investments Magellan Fund	37.1	
Fidelity Investments Growth Company Fund	49.9	
Fidelity Investments Overseas Fund	10.4	
Morgan Stanley Dean Witter International Equity Portfolio	10.6	
Morgan Stanley Dean Witter Equity Growth	34.2	
The Vanguard Group Life Strategy Growth	36.3	
The Vanguard Group Conservation Growth Portfolio	9.9	
The Vanguard Group Moderate Growth Portfolio	36.2	
The Vanguard Group Index Trust 500 Portfolio	26.7	
The Vanguard Group Windsor II Fund	31.1	
T. Rowe Price Small Cap Fund	27.7	
PIMCO Total Return Fund II Institutional	17.0	
<b>Total</b>		946.1

Note: Items may not sum to total due to rounding.

Source: *Enron Corp. Savings Plan Fund Information*, attachment to Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001), EC000001854.

Based on the data reported on the SEC Forms 11-K for the Enron Savings Plan for 1996 to 2000, as shown in Table 4 through Table 8, the portion of the assets under the Enron Savings Plan that was invested in Enron stock was 65 percent in 1996, 59 percent in 1997, 55 percent in 1998, 48 percent in 1999, and 62 percent in 2000.<sup>1594</sup> In 2000, these securities were valued at over \$1.3 billion.<sup>1595</sup>

According to an attachment to the minutes of the November 1, 2001, meeting of the Administrative Committee, as of October 26, 2001, as shown in Table 9, 28 percent, or \$246.7 million, of the assets under Enron Savings Plan were invested in Enron stock. Of this amount, \$102 million was attributable to Enron's matching contribution and \$144.7 million was attributable to participants' contributions.<sup>1596</sup>

### **Discussion of Issues**

Enron stock was a significant portion of the assets held under the Enron Savings Plan in the period before Enron's bankruptcy. As a result, many Enron Savings Plan participants lost considerable amounts of retirement savings when Enron's stock price plummeted.<sup>1597</sup> There are a variety of factors which may have contributed to such significant investment in Enron stock, including plan design, a company culture that may have induced participants to invest in (and keep assets invested in) Enron stock, statements by high ranking Enron officials even as the Enron stock price fell regarding the bright future for Enron, a lack of understanding of the importance of diversification, and the actions (or inactions) of plan fiduciaries, including the Administrative Committee.

The design of the Enron Savings Plan is not atypical. Many defined contribution plans allow participants to direct the investment of their account balances, particularly elective deferrals under a 401(k) plan. Participants' varying tolerances for investment risk can be accommodated if plans offer a variety of investment options. It is not uncommon for stock of the employer sponsoring a plan to be offered as an investment option under a defined contribution plan.

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<sup>1594</sup> For purposes of these calculations, because Enron Oil & Gas ("EOG") was established as a public company independent of Enron in 1999, investment in EOG is not considered in determining the overall amount of assets invested in Enron stock beginning in 2000. See Part II of Part Two of this Report; also see Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 45 (Feb. 5, 2002). Notwithstanding, EOG was retained as an investment option under the Enron Savings Plan. *Id.*

<sup>1595</sup> 2000 SEC Form 11-K for the Enron Corp. Savings Plan, Schedule of Assets Held for Investment Purposes.

<sup>1596</sup> *Enron Corp. Savings Plan Fund Information*, attachment to Minutes of the Meeting of the Administrative Committee (Nov. 1, 2001), EC000001854.

<sup>1597</sup> Many participants also lost their jobs. *Tittle v. Enron Corp.*, S.D. Texas, No. H-01-3913, First Consolidated and Amended Complaint (filed Apr. 8, 2002), at paragraph 20.

Some employers make all or part of their contributions to defined contribution plans in employer securities.<sup>1598</sup> Many employers favor contributing their stock to their defined contribution plans because newly-issued stock and treasury stock generally do not reduce the employer's cash flow. Many employers also believe that contributing company stock to a retirement plan places the stock in the hands of persons who are more likely to retain their shares through the company's downcycles and vote with current management. However, employees whose defined contribution account balances are heavily invested in employer securities are vulnerable to losing both their job and their retirement security if the company's fortunes decline. Employees often like the opportunity to have an ownership interest in the company they work for, having the opportunity to share directly in profits of the company.

When an employee chooses to allocate a large percentage of his or her defined contribution plan assets to a single investment such as employer securities, that employee is generally assuming more risk than under a diversified asset allocation. The level of employee investment in Enron stock under the Enron Savings Plans and the losses in retirement savings resulting from the decline in Enron's stock price emphasizes the importance of prudent investment principles such as diversification. Diversification helps to mitigate investment risk by reducing excessive exposure to any one source.

The high concentration of Enron Savings Plan investments in Enron stock resulted from both employee investment choice and Enron's matching contributions being made in the form of Enron stock.<sup>1599</sup> Enron Savings Plan participants clearly did not invest their elective deferrals in Enron stock due to a lack of other alternatives. 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, including a self-directed brokerage account. Overall losses experienced by Enron employees may have been limited if employees had diversified their elective deferral and after-tax contribution accounts and if the plan permitted them to diversify their company contribution accounts earlier than age 50. However, even if Enron Savings Plan participants had had this opportunity, it is not clear that many participants would have taken advantage of it, given the overall level of voluntary Enron Savings Plan investment in Enron stock. Current and former Enron employees interviewed by the Joint Committee staff demonstrated a tremendous loyalty to Enron, despite the bankruptcy and their own personal financial losses and experiences. While this loyalty certainly may not be universal, the degree to which many of the individuals interviewed by the Joint Committee staff still had faith in Enron was striking.

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<sup>1598</sup> Many plans require that at least some portion of any employer contribution be in stock.

<sup>1599</sup> However, the high level of investment in Enron stock under the Enron Savings Plan was not altogether anomalous. One study of 401(k) plans with company stock showed that 25 out of 219 plans had more than 60 percent of their assets invested in company stock. *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).

Investment in Enron stock by employees was generally encouraged by Enron, both through plan design and statements by management. During the period reviewed by the Joint Committee staff, Enron employees could acquire Enron stock through several company-sponsored arrangements, including the Enron Savings Plan, the Enron ESOP, and stock options. This variety of opportunities to purchase company stock is not uncommon among large employers.

In addition, Enron officials and Enron's "company culture" actively encouraged employee ownership of Enron stock, both through the Enron Savings Plan and in general. A central premise of Enron's philosophy seemed to be that all employees should be company owners.

Even as the price of Enron stock declined during 2001, management told employees of a bright future for Enron. For example, Mr. Lay was 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. Similarly, Enron's Executive Vice President for Human Resources and Community Relations, Cindy Olson, said that employees should "Absolutely!" invest their contributions to the Enron Savings Plan in Enron stock. Even if management's positive predictions to employees about the future of Enron stock were not intended to be anything more than inspirational company pep talks, statements regarding Enron stock--especially in the context of the Enron Savings Plan--could have been understood by some employees to be an endorsement that a significant portion of their assets should be invested in Enron stock.

Additionally, the Administrative Committee may have played a role in the ultimate losses sustained by participants under the Enron Savings Plan. The Administrative Committee was the named fiduciary under the plan with responsibility for plan assets and had the power to direct the trustee, which held the plan assets.<sup>1600</sup> Under the Enron Savings Plan and the accompanying trust agreement, the Administrative Committee was responsible for selecting the investment alternatives available to participants in the Enron Savings Plan.<sup>1601</sup> While the trust agreement included Enron stock as an investment fund alternative, it also stated that the Administrative Committee had the authority to terminate any existing investment alternatives at any time.<sup>1602</sup> Notwithstanding, the Administrative Committee did not seem to view its role as including the obligation to review the suitability of Enron stock as an investment under the Enron Savings Plan. Minutes of Administrative Committee meetings show that the first time the Administrative Committee undertook such a review was at their meeting on November 1, 2001.

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<sup>1600</sup> Sec. 15.2 of the Enron Savings Plan (July 1, 1999, restatement).

<sup>1601</sup> *Id.*; see Trust Agreement, Art. 4.

<sup>1602</sup> Trust Agreement, Art. 4; Under the Trust Agreement, the Committee has discretion to eliminate an investment option at any time. Additionally, the Committee is authorized to direct the Trustee as to the level of investment in Enron stock "as the Committee may deem appropriate." Enron Savings Plan, Article VIII, 7(j) (July 1, 1999, restatement).

If the Administrative Committee had acted sooner, losses under the Enron Savings Plan may have been limited. Provisions of the plan could be interpreted to give them the authority to act in this regard. These issues are currently the subject of litigation.<sup>1603</sup>

### **Recommendations**

The Joint Committee staff believes that the main principle that can be drawn from the Enron experience is that the importance of diversification of retirement savings assets cannot be overemphasized. The Joint Committee staff recommends that a variety of legislative changes should be made to reduce the likelihood that plan participants in plans that allow participant directed investments will have high concentrations of assets in a single investment.

The Joint Committee staff also recommends that plans should provide participants with investment education in a manner consistent with fiduciary standards. This should include notices describing sound investment practices, with a focus on the importance of diversification. The notice might include, for example: (1) information regarding diversification of investments; (2) information on the essential differences, in terms of risk and return, of available investments, including stocks, bonds, mutual funds and money market investments; (3) information on how investment fees may affect the return on an investment; and (4) a description of the factors that may be relevant to determining the appropriate investment allocations under the plan, such as an individual's age and years to retirement.

The Joint Committee staff also recommends that plan participants should be notified when plan assets are over concentrated in a single asset. The notification could include a statement that the participant should review their plan investments to make sure they are properly diversified.

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. In adopting specific rules, the Congress should consider the scope of any new diversification requirement as applied to employer contributions, for example, whether it should be limited to contributions related to elective deferrals (such as matching and nonelective employer contributions used to satisfy applicable nondiscrimination requirements) or whether it should have a broader application.

Finally, the Joint Committee staff recommends certain changes with respect to ERISA fiduciary rules. The experience at Enron pointed out the difficulties that may arise when plan

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<sup>1603</sup> Some participants in the Enron Savings Plan have alleged that the plan's administrators violated their fiduciary duties by allowing participants to continue investing in Enron stock and continuing to make matching contributions in Enron stock even after they knew or should have known that Enron faced difficult financial straits. As discussed above, several Enron Savings Plan participants have filed suit against Enron in federal court seeking relief for losses sustained to their balances under the Plan. *See* Part II.B.2., above.



fiduciaries play more than one role, particularly a role as a fiduciary and a role as an employee or executive of the employer. These two roles may conflict and cause confusion among plan participants. In addition, fiduciaries may not fully understand their dual roles.

In Enron's case, senior management, including Mr. Lay, made numerous statements in employee meetings and in electronic mail messages to employees regarding the future of Enron and the price of Enron stock. Most of these statements were not made specifically in the context of the Enron qualified plans; however, in at least two instances statements were made in the context of the Enron Savings Plan as to the appropriateness of Enron stock as an investment. In one case, Cindy Olson replied to the question "Should we invest all of our 401(k) in Enron stock?" by saying "Absolutely." In the other case in response to a question regarding the Enron Savings Plan and whether Enron would act to replace lost retirement benefits, Mr. Lay said "Enron stock, we'll bring it back."

There are legal and factual questions as to whether Ms. Olson and Mr. Lay were plan fiduciaries at the time of these statements and, if they were, whether they were acting in a fiduciary capacity. These issues are the subject of litigation.

Regardless of the outcome of this litigation, the statements were at best ill advised and certainly may have created the impression on the part of Enron Savings Plan participants that Enron stock was a safe investment. Corporate executives may generally be expected to present a positive view of the company, and should be free to do so. However, in the context of qualified retirement plans, the Joint Committee staff believes that senior executives, whether or not they are otherwise plan fiduciaries, should not make statements regarding the plan or plan investments, particularly employer securities, that are not in accord with generally accepted investment principles or general fiduciary standards. Thus, the Joint Committee staff recommends that fiduciary rules should apply to such statements.

Enron also demonstrates that plan fiduciaries may have difficulty determining what actions are consistent with their dual roles. The Congress should direct the Department of Labor to assist in this effort, including for example, making additional efforts to educate plan fiduciaries who are also employees regarding their duties, particularly in the context of real life situations. The materials could include, for example, a description of actions that might make a company executive a plan fiduciary, even if the individual is not named a fiduciary under plan documents.

While these recommendations may help prevent future losses such as those experienced by Enron employees, given the factors in Enron's case, particularly the culture that encouraged Enron stock ownership, it is not clear that the situation would have been any different if these measures had been in place prior to the bankruptcy. Further, Enron is not alone in the 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.<sup>1604</sup>

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<sup>1604</sup> 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).

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.

Enron also illustrates a general shift away from defined benefit plans toward defined contribution plans, particularly defined contribution plans that provide for participant directed investments. This shift can reduce retirement income security for plan participants, both because participants bear the risk of investment loss in defined contribution plans and because plan participants may not make appropriate investment decisions, regardless of the level of investment education they receive. Thus, the Congress may wish to consider broader approaches to addressing retirement income security under defined contribution plans. A range of options are possible; some suggestions that have been proposed by commentators include providing a Federal government guarantee of a minimum rate of return on defined contribution plan assets and placing some restrictions on the ability of plans to require that participants direct investments.

## **6. Allegations of misuse of benefit funds**

### **Present Law**

A number of present-law rules may be relevant with respect to misuse of pension plan assets by an employer or plan fiduciary.

Under the Code, a qualified retirement plan must be maintained for the exclusive benefit of the employees (the "exclusive benefit rule").<sup>1605</sup> In particular, the trust established in connection with the plan must prohibit the diversion of assets for purposes other than exclusive benefit of employees and their beneficiaries.<sup>1606</sup>

Through similar provisions of ERISA, the exclusive benefit rule applies to all employee benefit plans subject to ERISA without regard to their tax-qualified status. ERISA prescribes that plan fiduciaries shall discharge their duties with respect to a plan solely in the interest of the beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries.<sup>1607</sup>

ERISA also contains a "noninurement" rule which requires that, subject to certain exceptions, the assets of a plan shall never inure to the benefit of any employer and shall be held in a trust for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries.<sup>1608</sup> For this purpose, the assets of the plan include contributions that are withheld

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<sup>1605</sup> Sec. 401(a).

<sup>1606</sup> Sec. 401(a)(2).

<sup>1607</sup> ERISA sec. 404(a)(1).

<sup>1608</sup> ERISA sec. 403(c)(1).

from a participant's wages, which must be contributed to the plan as soon as they can reasonably be segregated from the employer's general assets.<sup>1609</sup> Employers who fail to promptly transmit participant contributions, and plan fiduciaries who fail to make diligent efforts to collect those amounts in a timely manner, may violate the requirement that plan assets be held in trust and may be engaging in prohibited transactions.<sup>1610</sup>

Under criminal law provisions of the U.S. Code, embezzlement, conversion, abstraction, or stealing of "any of the moneys, funds, securities, premiums, credits, property, or other assets of any employee welfare benefit plan or employee pension benefit plan, or any fund connected therewith" is a criminal offense punishable by fine, imprisonment, or both.<sup>1611</sup>

### **Factual Background**<sup>1612</sup>

In early 2002, Robin Hosea, a former Enron contract employee and full-time employee, publicly alleged that payments were made from Enron's employee benefit funds for purposes unrelated to employee benefits. Specifically, Ms. Hosea alleged that, during 2000, approximately \$15 million was improperly paid out of Enron Benefits Department accounts for purposes unrelated to employee benefits. She also claimed that her superiors at Enron told her that the payments were made to friends of executives and that she should not pursue the issue. Ms. Hosea's claims were reported in the national media, including in an interview on the television program, the *CBS Evening News*, which aired on February 4, 2002.

Because Ms. Hosea's allegations are under investigation by Federal government enforcement agencies, the Joint Committee staff has not attempted to independently investigate their veracity.

Ms. Hosea was hired by Enron in August 2000 on a contract basis to work in the Enron Benefits Department. Jobs she previously held with other employers included human resource, payroll, and accounting positions. In November 2000, Ms. Hosea was hired for the full-time position of Senior Benefits Specialist in the Enron Benefits Department. This was her only position while at Enron. While working for Enron, Ms. Hosea assisted with benefit compliance and budgeting work. Her specific responsibilities included accounting for employee benefit plans and the Benefits Department compliance and budgeting work.

Ms. Hosea reported to Enron's Senior Director of Benefits and one other manager at different times during her employment at Enron. Ms. Hosea took medical leave from Enron beginning May 24, 2001. She did not return to Enron and was laid off on December 5, 2001, as part of a general layoff following Enron's bankruptcy filing.

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<sup>1609</sup> 29 C.F.R. 2510.3-102.

<sup>1610</sup> See Preamble to regulations at 29 C.F.R. 2510.3-102.

<sup>1611</sup> 18 U.S.C. sec. 664.

<sup>1612</sup> Unless otherwise indicated, the background information described herein is based on an interview of Ms. Robin Hosea conducted by Joint Committee staff on September 20, 2002.

According to Ms. Hosea, a general ledger account for the Enron Benefits Department was composed of several subaccounts, including subaccounts for medical benefits, dental benefits, life insurance, the Savings Plan, and vision benefits. Each month, Ms. Hosea would receive a statement of the account (including subaccounts) from Enron's Finance Department. The statement included a line for unallocated or unrecognized payments. These were payments that came out of the general account but were not assigned to a subaccount. According to Ms. Hosea, the unallocated payments were not initiated by the Benefits Department.

Sometime before taking medical leave, Ms. Hosea started to review the unallocated payments. She tracked two to three items that appeared in the accounts each month for three or four months running and determined that the payments had been made over a period of a few years. She obtained copies of the check requests but was unable to determine the purpose of the requisition. She showed them to her supervisor as well as the Benefit Department's administrative assistant, who did not recognize them. She also showed them to the Senior Director of Benefits, who did not recognize them. On instructions from the Senior Director of Benefits, Ms. Hosea contacted the person who approved the payments and learned that the payments originated in the Legal Department. According to Ms. Hosea, the Senior Director of Benefits told Ms. Hosea that she vaguely remembered the payments, and instructed Ms. Hosea to disregard the issue.

Additionally, in May 2001, Ms. Hosea identified a payment that originated with the Benefits Department and had the approval of the Department. A check in the amount of approximately \$1,000 to \$5,000 payable to an individual as a "consulting fee" was paid out of the medical or dental subaccount. Ms. Hosea's supervisor and the Benefits Department administrative assistant told Ms. Hosea that the fee was not unusual and that the payee was a friend of a highly-placed Enron executive. Ms. Hosea stated that she was again instructed to disregard the issue.

Former Enron Executive Vice President for Human Resources and Community Relations Cindy Olson, and former Enron Benefits Manager Mikie Rath were asked about Ms. Hosea's claims in hearings before the Senate Governmental Affairs Committee and the House Education and the Workforce Committee which were held in February 2002.<sup>1613</sup> Ms. Olson testified that she did not have first hand knowledge of Ms. Hosea's claims. Ms. Rath, who handled day-to-day administration of Enron's retirement plans, testified that no funds were diverted from the Savings Plan. Further, Ms. Rath explained that any payment from the Savings Plan trust would be reported in the plan's annual filing with the Department of Labor, the Form 5500, which requires a listing of payments from the plan. According to Ms. Rath, those audited financial statements appended to the Form 5500 showed no payments to individuals.

Ms. Hosea contacted the Department of Labor about these issues at the end of November or the beginning of December 2001. After contacting the Department of Labor, Ms. Hosea

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<sup>1613</sup> Committee on Governmental Affairs, United States Senate, *Retirement Insecurity: 401(k) Crisis at Enron*, S. Hrg. 107-378, at 59 (Feb. 5, 2002); Committee on Education and the Workforce, United States House of Representatives, *The Enron Collapse and Its Implications for Worker Retirement Security*, H. Hrg. 107-42, at 121-22 (Feb. 7, 2002).

claimed that she began to receive threats “almost daily” in the form of “threatening” phone calls and “hang up calls.” Although she could not remember the callers’ exact words, she perceived the threats to be physical. Ms. Hosea’s stated that her husband answered a call to their home in which the caller admonished Ms. Hosea to “be quiet.” Ms. Hosea also stated that she was being followed but did not report it to the police because she perceived “no real physical threat” or destruction of property.

Ms. Hosea feels that the threats she alleges she received were connected to her actions in relation to Enron. She claims that, at the time she received the calls, she had contacted the Department of Labor, but that contact had not been made public. Because of this timing, she believes that the threats could only have originated with Enron. She contacted the press about one month later.

Mr. Mark Lindsey, Enron’s Vice President for Corporate Accounting and Planning told Joint Committee staff that he first learned of Ms. Hosea’s allegations from a television program.<sup>1614</sup> He said that he recognized a schedule displayed during the program. The Corporate Accounting and Planning staff approached Mr. Lindsey about Ms. Hosea’s allegations. They discussed her allegations and looked into them. According to the Mr. Lindsey, the allegations related to monthly reconciliations of benefits liabilities accounts for welfare benefits as well as for Enron’s qualified plans. The staff, together with the Benefits Department, assembled an analysis of 14 to 15 subaccounts as part of their review.

In looking into her allegations, the Corporate Accounting and Planning staff did not speak directly with Ms. Hosea or attempt to contact her. Mr. Lindsey said there was “no reason” to contact her. He also said that the facts did not warrant speaking with anyone else about Ms. Hosea’s claims. In the wake of Enron’s bankruptcy filing, he explained, numerous allegations surfaced, many of which were sensationalized. Against this backdrop, he said, Ms. Hosea’s claims were not compelling. Mr. Lindsey stated that he does not believe Ms. Hosea’s claims that amounts allocated to other departments were diverted. He also said that there was no evidence that benefits funds were misused or that consulting fees were paid to friends of Enron executives but noted that consultants were occasionally retained by Enron in connection with special hiring initiatives.

Enron’s Accounting Department responded to a subpoena issued by the Department of Labor in February 2002 in its investigation of Ms. Hosea’s claims. According to Mr. Lindsey, the Department of Labor sent three or four investigators to audit Enron’s employee benefits accounts during March or April of 2002. Mr. Lindsey and his staff spoke with the auditors and reviewed a reconciliation of employee benefits accounts with them.

Ms. Hosea’s allegations were reported to the Administrative Committee of the Enron Qualified Plans by Enron’s Director of Benefits at a February 12, 2002, meeting of the Committee. The Director of Benefits told the Committee that Ms. Hosea’s allegations appeared to relate to accounting reserves for welfare benefit plans maintained by Enron, rather than assets

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<sup>1614</sup> Joint Committee staff interviewed Mr. Mark Lindsey, Enron’s Vice President for Corporate Accounting and Planning, on January 23, 2002.

of any of the plans. He reported that the Department of Labor recently concluded a review of certain plans maintained by Enron and found no irregularities.

The Department of Labor is investigating Ms. Hosea's allegations.

### **Discussion of Issues**

The allegations made by Ms. Hosea, if established as true, might have serious legal consequences for Enron officials, Enron itself, and certain Enron employee benefit plans. Specifically, violations of the exclusive benefit rule of the Code and ERISA could lead to plan disqualification or the imposition of prohibited transaction penalties. However, the allegations, even if true, do not necessarily represent an illegal or improper diversion of funds. Payments from unallocated subaccounts do not, taken alone, constitute improper or illegal payments.

Further, any violations of ERISA fiduciary responsibility provisions could result in the imposition of penalties by the Department of Labor. Criminal sanctions could be imposed. Additionally, participants, beneficiaries, or cofiduciaries could make legal claims against responsible persons for which they would be personally liable for plan losses or other court-ordered relief including punitive and extracontractual damages.<sup>1615</sup>

Based on interviews conducted by Joint Committee staff as well as the staff review of the media reports regarding Ms. Hosea's claims, there appear to be a variety of interpretations of what may have happened with respect to accounting practices of the Enron Benefits Department. The unallocated or unrecognized payments from the general ledger account identified by Ms. Hosea may have been legitimate entries consistent with the Benefits Department's bookkeeping practices. When she made the allegations in early 2001, Ms. Hosea was barely six months into her employment with Enron. It is possible that she was not yet familiar with the legitimate accounting practices of her employer.

When asked about her claims during an interview with Joint Committee staff, Ms. Hosea's answers to questions about the specifics of her allegations were vague. She stated that she could not recall the specific accounts from which the alleged improper payments were made nor could she recall the amounts involved. When asked about the threats she alleged were made against her, she could not provide any specific details.

Because there is an ongoing Federal investigation into Ms. Hosea's claims, the Joint Committee staff did not pursue Ms. Hosea's allegations issues further.

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<sup>1615</sup> See *Mass. Mut. Life Ins. Co. v. Russell*, 473 U.S. 134 (1985).

### III. OTHER COMPENSATION-RELATED ISSUES

#### A. General Overview of Compensation

##### In general

Enron had a pay for performance compensation philosophy. Employees who performed well were compensated well. The amount of compensation that Enron paid to employees, especially executives, increased significantly over the years immediately preceding the bankruptcy. The amounts of compensation paid in 2000, the year immediately preceding the bankruptcy, are extraordinary.

Tax return data for Enron Corp. and its subsidiaries shows how compensation of officers, salaries and wages, and employee benefit program expenses increased. Table 10, below, shows the deduction taken by Enron Corp. and its subsidiaries for such expenses on its Federal income tax returns for 1998, 1999, and 2000.<sup>1616</sup> Enron's total compensation deduction dramatically increased from 1998 to 2000. The increase in compensation expense was, in part, due to the substantial increase in Enron's deduction attributable to stock options.<sup>1617</sup>

The deduction for compensation of officers increased exponentially. The compensation of officers doubled from 1998 to 1999 and tripled from 1999 to 2000. As shown in Table 10, in 2000 the deduction for compensation of officers was almost twice the deduction for salaries and wages.<sup>1618</sup>

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<sup>1616</sup> The deductions for 1998 and 2000 are from the originally-filed returns. The deduction from 1999 is from Enron's amended return. The Joint Committee staff is not aware of amended returns for 1998 or 2000.

<sup>1617</sup> Upon exercise of a nonqualified stock option, the difference between the fair market value of the stock and the option price is generally includible in the gross income of the employee. This amount is also deductible as a business expense by the employer.

<sup>1618</sup> It is unclear how many employees were considered officers for purposes of the compensation deduction.

**Table 10.—Enron Compensation Deductions for 1998, 1999, and 2000<sup>1619</sup>**

	<b>1998</b>	<b>1999, as amended</b>	<b>2000</b>
Compensation of officers <sup>1620</sup>	\$149,901,000	\$313,312,000	\$952,492,000
Salaries and wages <sup>1621</sup>	\$499,746,000	\$702,725,000	\$557,550,000
Pension, profit-sharing, etc., plans <sup>1622</sup>	\$628,000	\$834,000	\$20,000
Employee benefit program <sup>1623</sup>	\$344,676,000	\$569,278,000	\$1,456,796,000
Total <sup>1624</sup>	\$994,951,000	\$1,586,149,000	\$2,966,858,000

As discussed below in further detail, executives of Enron were extremely highly compensated. Table 11, 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.<sup>1625</sup> Compensation for the top-200 increased over recent years, particularly in the area of stock options.

Appendix D includes a list of compensation paid to the top-200 highly compensated employees for 1998 through 2001, which was provided by Enron. As in many instances, the data provided by Enron to the IRS and to the Joint Committee staff does not reconcile.

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<sup>1619</sup> Amounts are rounded.

<sup>1620</sup> Includes deductible officers' compensation. Instructions for Forms 1120 (U.S. Corporation Income Tax Return) and 1120-A (U.S. Corporation Short Form Income Tax Return).

<sup>1621</sup> Includes salaries and wages paid for the tax year, reduced by certain employment credits. *Id.*

<sup>1622</sup> Includes deduction for contributions to qualified pension, profit-sharing, or other funded deferred compensation plans. *Id.*

<sup>1623</sup> Includes contributions to employee benefit programs not claimed elsewhere on the return (e.g., insurance, health and welfare programs) that are not an incidental part of a pension, profit-sharing, etc., plan deducted in the previous line. *Id.*

<sup>1624</sup> This is not a line item on the tax return, but was computed for purposes of this table.

<sup>1625</sup> The compensation of the top-200 does not reconcile with the deduction for the officers as shown in Table 10, as the group of employees included in each category is different. For example, an employee could be one of the top-200 highly compensated employees, but not be an officer for purposes of the compensation deduction. Additionally, the compensation of the top-200 also includes nondeductible compensation.



**Table 11.—Compensation Paid to the Top-200 Highly Compensated Employees for 1998-2000<sup>1626</sup>**

<b>Year</b>	<b>Bonus</b>	<b>Stock options</b>	<b>Restricted stock</b>	<b>Wages</b>	<b>Total</b>
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

Enron used a market pricing approach to compensation. Enron frequently used outside consultants, principally Towers Perrin, to determine compensation practices in the market place. The role of outside consultants is discussed below. Total compensation was determined based on job level, job type, individual performance, and company performance. Total compensation targets were established using external benchmarking practices. The components of compensation generally included base pay, bonus, special programs, and long-term incentive compensation. These components are discussed below in further detail.

Enron used a variety of forms of compensation in recent years, including cash, stock, stock options, restricted stock, phantom stock, performance units, and participation interests. Enron also offered employees standard benefits such as participation in retirement plans (as previously discussed) and health and life insurance. Executives were also offered special compensation arrangements, including nonqualified deferred compensation, employee loans, and split-dollar life insurance.

Enron used stock-based compensation as a principle form of compensation. As discussed below in further detail, Enron compensated executives through stock options, restricted stock and phantom stock. All-employee stock option grants were also periodically made. Enron did not grant qualified stock options (i.e., incentive stock options or options under employee stock purchase plans). Stock appreciation rights were granted in the past, but were not granted in recent years.

As shown in Table 12, below, tax return information demonstrates that Enron's stock option deduction dramatically increased over recent years.<sup>1627</sup> The deduction in 2000 was more than 1,000 percent greater than the deduction taken just two years prior.

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<sup>1626</sup> The information provided by the IRS includes some inconsistencies. In reproducing the summary data, the Joint Committee staff attempted to reconcile inconsistencies and include the data that appears to be accurate. Amounts are approximates.

<sup>1627</sup> Information from Schedule M1. See Table 11, below, for summary information from the IRS stating that stock option income resulting from the exercises of nonstatutory stock options for the top-200 most highly compensated employees was \$62 million for 1998, \$244.6 million for 1999, and \$1,063.5 million for 2000.

**Table 12.--Enron Stock Option Deductions for 1998, 1999, and 2000<sup>1628</sup>**

<b>1998</b>	<b>1999</b>	<b>2000</b>
\$125,343,000	\$585,000 (as filed)	\$1,549,748,000
	\$367,798,000 (as amended)	

### **Enron's revised compensation system**

Enron's compensation system was revised in the late 1990's.<sup>1629</sup> Prior to 1999, each operating company had its own base pay, annual incentive, long-term incentive, and employment contract arrangements. It was seen as beneficial for Enron for there to be more fungibility between the various operating companies and business units. The new structure was implemented to create one centralized compensation structure for all business units so that employees could move easily between the business units. The new compensation structure was designed with the intention to decrease competition within the various business units for employees resulting from differing compensation structures and plans.

The new compensation structure consisted of standardized base salary, bonus, and long-term incentive. Suggested compensation ranges for each executive by job type and performance rating were developed. In connection with the new structure, Enron developed standardized performance measures and ratings of individual executive performance across business units. The new compensation structure also included buyouts of certain business units' equity plans. Buyouts generally were done in order to move executives out of the older business unit plans and into centralized Enron plans and programs.

Enron had an incentive structure in place for middle and upper management. The revised compensation structure brought a long-term incentive plan that was used throughout the entire company. Before implementation of the new process, business units had their own version of long-term incentives. For example, the international group used the Project Participation Plan, while Enron Capital & Trade Corp. and Enron Energy Services, LLC, each used their own phantom equity plans.

In connection with the new compensation structure, the Compensation Committee also approved the creation and delegation of authority to an administrative committee consisting of

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<sup>1628</sup> Amounts are rounded.

<sup>1629</sup> The possibility of changing Enron's compensation structure was first presented at the May 3, 1999, meeting of the Compensation Committee. The changes were again presented by Mr. Skilling at the June 28, 1999, Compensation Committee meeting and were approved by the Compensation Committee on August 9, 1999. The status of the program was reviewed by the Compensation Committee throughout 1999. The Compensation Committee minutes show that the status of the program was reviewed at the October 11, 1999, and November 16, 1999, Compensation Committee meetings.

Mr. Skilling and Mr. Lay,<sup>1630</sup> to make grants under the long-term incentive program, except for grants to Section 16 officers.<sup>1631</sup>

The new compensation structure was intended to result in uniform compensation packages.<sup>1632</sup> Nevertheless, after the implementation of the new compensation structure, individualized compensation arrangements for executives did exist. For example, the minutes to the Compensation Committee meeting of February 14, 2000, show that an officer of recently reorganized Enron Broadband Services was to receive short-term stock options as compensation in lieu of salary and bonus. As discussed below, one executive was compensated with a fractional interest in an airplane. Despite these individualized arrangements, the new compensation structure did result in a more uniform compensation system.

The new compensation system introduced the new performance evaluation process (referred to as “PEP”) for employees, which was a web-based performance evaluation system.<sup>1633</sup> The new performance evaluation process introduced the performance review committee (“PRC”) process throughout Enron. Before it was implemented on a company-wide basis, the performance review committee process was used by Enron Capital & Trade Resources. Subject to a few exceptions, the performance review committee process was generally used for all Enron employees.<sup>1634</sup>

At the initial stage of the performance review process, employees were able to choose individuals who were familiar with their work to be reviewers of their performance, subject to the approval of their supervisors. Feedback forms would be completed on-line by the selected reviewers. Performance criteria included business skills, innovation/entrepreneurship, communication/vision and values, team work/interpersonal, leadership, analytical/technical, and

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<sup>1630</sup> In August 2001, the Compensation Committee approved changing the administrative committee to be composed of Mr. Lay and one member of the Compensation Committee.

<sup>1631</sup> Throughout this document, “Section 16 officers” refers to individuals subject to the requirements of section 16 of the Securities Exchange Act of 1934. These requirements include disclosure requirements and restrictions on short-swing profits.

<sup>1632</sup> See Attachments to the February 9, 1998, Compensation Committee meeting which outline the executive compensation structures used by the various operating companies.

<sup>1633</sup> Joint Committee staff discussed the performance review process in an interview with Mr. Skilling, who was responsible for establishing the process on a company-wide basis.

<sup>1634</sup> In an interview with Joint Committee staff, Mr. Skilling said that the performance review committee process was not used for non-executives of the pipeline organization. Enron documents state that the following job groups were not required to participate in a formal performance review committee meeting, but would be reviewed at the business unit’s discretion. This included junior specialists, specialists, senior specialists, and non-exempt positions. PEP Performance Management HR Guide Year End 2001. ECU000077031. Documents for the 2001 Midyear review state that all active exempt employees are rated in a performance review committee meeting. ECU000077115.

professional and career development.<sup>1635</sup> Performance would be rated in one of the following categories: highly effective, effective, acceptable, and ineffective.<sup>1636</sup> It appears that before 2001, the performance ratings were superior, excellent, strong, satisfactory, needs improvement, and issues.<sup>1637</sup> Supervisors would develop a preliminary rating for their employees based on the reviewers' feedback, which would be used by the performance review committee. Employees were allowed to submit self-assessments to be considered in a performance review committee meeting.<sup>1638</sup>

After the preliminary review was complete, a performance review committee would meet to evaluate individual employee performance. According to Mr. Skilling, there were approximately 30 performance review committees throughout Enron.<sup>1639</sup> Each employee was ranked from one to five, with a ranking of five being the lowest.<sup>1640</sup> According to Mr. Skilling, there was a target distribution of how many employees should fall within each category. Enron documents for the 2001 review state that there was no preferred distribution for performance review committee meetings, but that each unit was required to submit their top 10 percent and bottom 10 percent of employees.<sup>1641</sup> Earlier dated documents state that there was a preferred distribution.<sup>1642</sup>

According to Enron documents, the purpose of the performance review committee meeting was to identify the top 10 percent and bottom 10 percent of performers of each job level based on the intrinsic skills, competencies and potential of employees relative to their peers.<sup>1643</sup> According to documents provided by Enron, the placement of each employee would provide a guide for compensation decisions for year-end bonuses, but the purpose was not to determine compensation, but to determine employee performance and potential.<sup>1644</sup>

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<sup>1635</sup> PEP Process Guide 2001. ECU000077160.

<sup>1636</sup> PEP Performance Management HR Guide, Year End 2001. ECU000077031.

<sup>1637</sup> ECU000077017; ECU000077063.

<sup>1638</sup> PEP Performance Management HR Guide, Year End 2001. ECU000077031.

<sup>1639</sup> Enron documents show that there would be no more than 30 meetings in total. ECU000077162.

<sup>1640</sup> PEP Performance Management Midyear 2001 HR Guide. ECU000077129.

<sup>1641</sup> PEP Performance Management Midyear 2001 HR Guide. ECU000077031.

<sup>1642</sup> PEP Performance Management Midyear 2001 HR Guide. ECU000077130.

<sup>1643</sup> PEP Performance Management HR Guide, Year End 2001. ECU000077032.

<sup>1644</sup> PEP Performance Management HR Guide, Year End 2001. ECU000077032.

According to Mr. Skilling, after employees were ranked into the five categories, matrixes were developed. The theory was that all employees in a certain category at a particular job level should be compensated similarly, subject to some modification. According to Mr. Skilling, employees with a ranking of category five were encouraged to “look elsewhere.”<sup>1645</sup> Enron documents state that there was no prescribed action for employees in the bottom 10 percent, but that managers would identify which employees need to be part of a performance improvement plan.<sup>1646</sup> According to Mr. Skilling, this group was the only group of Enron employees who did not receive annual bonuses. As part of the revised compensation structure, all other employees received annual bonuses. According to Enron documents, typically promotion candidates typically would come from the top 10 percent, but discretion was given to promote candidates outside of the top 10 percent.

The performance review committees met twice per year, once in June or July and once in January. The January review determined compensation. According to Mr. Skilling, the mid-year review allowed employees to know how they were ranked so that they would have time to improve before the January review. After the completion of the performance review committee process, employees would receive one-to-one feedback from their supervisors. There have been media reports that some employees viewed the performance review committee process as harsh or unfair. One former Enron executive interviewed by the Joint Committee staff indicated that the process may have created tension among employees.

### **Enron’s Compensation Committee**

#### **In general**

The Compensation Committee of the Board of Directors<sup>1647</sup> (the “Compensation Committee”) was responsible for developing the Enron executive compensation philosophy.<sup>1648</sup> The Compensation Committee’s focus was stated to be on ensuring that there is a strong link between the success of the shareholder and the rewards of the executive.<sup>1649</sup> According to interviews with Compensation Committee members, the charge of the Committee was to make sure that the executive officers of Enron were adequately compensated in a way to increase shareholder wealth. The Compensation Committee believed in “pay for performance.” The

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<sup>1645</sup> The media has reported that employees in the lowest ranking group were fired. Enron executives interviewed by Joint Committee staff stated that employees in category five were not fired, but were advised of the ranking they received and may have been encouraged to leave.

<sup>1646</sup> PEP Performance Management HR Guide, Year End 2001. Ecu000077032.

<sup>1647</sup> In some years, the Committee was named the Compensation and Management Development Committee.

<sup>1648</sup> 2001 Enron Corp. Proxy Statement.

<sup>1649</sup> 2001 Enron Corp. Proxy Statement.

Compensation Committee also believed that a great deal of executive compensation should be at risk; if shareholders did not profit, executives would not profit.

As stated in the 2001 proxy, the responsibility of the Compensation Committee “is to establish Enron’s compensation strategy and ensure that the senior executives of Enron and its wholly-owned subsidiaries are compensated effectively in a manner consistent with the stated compensation strategy of Enron, internal equity considerations, competitive practice and the requirements of appropriate regulatory bodies.”<sup>1650</sup> In the proxies, the Compensation Committee stated its mission as follows:

The basic philosophy behind executive compensation at Enron is to reward executive performance that creates long-term shareholder value. This pay-for-performance tenet is embedded in each aspect of an executive’s total compensation value. Additionally, the philosophy is designed to promote teamwork by tying a significant portion of compensation to business unit and Enron performance. Base salaries, annual incentive awards and long-term incentive awards are reviewed periodically to ensure consistency with Enron’s total compensation philosophy.<sup>1651</sup>

#### Compensation Committee charter

The Board of Directors established the Compensation Committee with authority, responsibility, and specific duties as described in the Compensation Committee charter.<sup>1652</sup> The charter provided that the Committee is to consist of directors who are independent of management and free from any relationship that, in the opinion of the Board of Directors, as evidenced by its election of the Committee members, would interfere with the exercise of independent judgment as a Committee member. Under the charter, the Compensation Committee’s basic responsibility is “to assure that the senior executives of Enron and its wholly-owned affiliates are compensated effectively in a manner consistent with the stated compensation strategy of Enron, internal equity considerations, competitive practice, and the requirements of the appropriate regulatory bodies. The charter provided that the Committee is to communicate to shareholders Enron’s policies and the reasoning behind such policies as required by the Securities and Exchange Commission.”<sup>1653</sup>

The charter dated 1998 provides that the Committee was also responsible, in connection with the Chief Executive Officer, for management development and succession planning for key

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<sup>1650</sup> 2001 Enron Corp. Proxy Statement.

<sup>1651</sup> 2000 Enron Corp. Proxy Statement; 2001 Enron Corp. Proxy Statement.

<sup>1652</sup> On February 9, 1998, the charter was approved to the Board by the Compensation Committee. In response to Joint Committee staff requests for the most recent Compensation Committee charter, Enron provided a copy of the Compensation Committee charter from October 4, 1994. The 1994 and 1998 charters are almost identical.

<sup>1653</sup> Enron Corp. Compensation Committee Charter. EC 002634700 - EC 002634702.

top level management positions. The charter lists other responsibilities of the Compensation Committee, including reviewing Enron's stated compensation strategy, reviewing and determining Chief Executive Officer and senior management compensation, and assuring that Enron's executive incentive compensation program is administered consistent with Enron's compensation strategy. Under the charter, the Compensation Committee was also responsible for approving all new equity-related incentive plans for senior management, approving annual retainer, meeting fees and stock compensation for the Board of Directors, approving executive salary range structures, reviewing Enron's employee benefit programs and approving all changes, hiring executive compensation experts to assist the Committee with its reviews, and such other duties and responsibilities as may be assigned to the Committee from time to time.

The charter provided that the Committee would meet as often as necessary to carry out its responsibilities. Meetings could be called by the Chairman of the Committee and/or management of Enron. All meetings of the Committee were required to be held pursuant to the bylaws of Enron with regard to notice and waiver, and written minutes of each meeting were required to be filed with Enron records. According to the charter, reports of the meetings of the Compensation Committee were required to be made to the Board of Directors at its next regularly scheduled meeting following the Committee meeting accompanied by any recommendation to the Board of Directors approved by the Committee.

#### Activities of the Compensation Committee

The Compensation Committee made decisions on a wide variety of compensation issues. While the Compensation Committee was principally involved with executive compensation, the duties of the Compensation Committee were not limited to executive compensation. The Compensation Committee approved all qualified retirement plan documents and amendments. They also approved medical and dental plans, severance pay plans, and flexible compensation plans. The Compensation Committee also approved all stock plans, bonus plans, and deferral plans and approved grants of stock options and other equity compensation. The Compensation Committee was also responsible for authorizing bonus pools and often approved accelerated vesting of options and other equity-based compensation. Selected employment agreements were approved by the Compensation Committee.

While the Compensation Committee had responsibility for a wide range of issues, they were not deeply involved in most issues. Members of the Compensation Committee interviewed by Joint Committee staff were not fully aware of all of the issues for which they were responsible and often made decisions. For example, even though changes to the nonqualified deferred compensation plans were approved by the Compensation Committee, one former member of the Compensation Committee interviewed by Joint Committee staff did not know whether Enron offered nonqualified deferred compensation. Even though reflected in the minutes, one former member of the Compensation Committee interviewed by Joint Committee staff could not recall whether the Committee approved qualified retirement plans issues, while another Committee member did not know what a qualified retirement plan was. The Compensation Committee did not scrutinize proposed arrangements, but basically approved whatever compensation arrangements were presented to them by management.

According to interviews with former Compensation Committee members, the Compensation Committee reviewed the compensation of the 30 to 45 senior positions annually. There was special concentration on the Chief Executive Officer and Chief Operating Officer and any other position in the Office of the Chairman. Most meetings of the Compensation Committee included an executive session in which the salaries of the top executives were discussed. Generally, the executive sessions were not recorded in the meeting minutes. The attachments to the minutes show that during the executive sessions, the Committee periodically reviewed executive committee compensation summary charts.<sup>1654</sup> These charts summarized the compensation of the top executives and included information on employment end date, years of service, age, base salary, cash bonus, stock owned, long-term value realized, vested and unvested options, restricted stock, performance units, outstanding long-term value, and five-year projection of outstanding long-term values.

In each annual proxy, the Compensation Committee issued a report regarding executive compensation. The report outlined the responsibility of the Committee and its basic philosophy. The report did not change much, if at all, from one year to the next.

In recent years, the Compensation Committee was composed of a Chairman and three or four members of the Board. According to the Chairman of the Committee during the period reviewed by the Joint Committee staff, the members of the Committee were selected by a nominating committee as the members who were most independent; and then members would be elected by the full Board.<sup>1655</sup> The Compensation Committee met at least once before each Board meeting and also held telephone meetings when issues arose. The Committee formally met ten times in 2000. Until the restructuring following the bankruptcy filing, the members of the Committee were Charles A. LeMaistre, Norman Blake, Jr., John H. Duncan, Robert K. Jaedicke and Frank Savage.<sup>1656</sup> The Board members have been replaced in connection with reorganization of Enron.

### **Role of outside consultants**

The Compensation Committee relied on outside consultants in making a variety of decisions. The annual proxy statements described the Compensation Committee's reliance on outside consultants. According to the 2001 proxy, all decisions regarding executive compensation were made based upon performance, measured against preestablished objectives and competitive practice, as determined by utilizing multiple public and private compensation surveys. The proxy stated that Enron utilized the services of Towers Perrin to conduct an

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<sup>1654</sup> In older years, the charts were labeled "Executive Compensation Value."

<sup>1655</sup> Interview with Dr. LeMaistre.

<sup>1656</sup> Messrs. Blake and Jaedicke were appointed to the Compensation Committee in 1996, replacing Robert A. Belfer and Joe E. Foy. *See* Enron Corp. 1996 and 1997 Proxy Statements. Mr. Savage is first listed as being on the Compensation Committee in the 2000 proxy statement.



executive compensation study covering executives in the top corporate and business unit positions.<sup>1657</sup> Additional studies performed by Towers Perrin are discussed below.

The 2001 proxy states that competitive compensation rates are developed using published and private compensation survey sources for companies of comparable size and, as appropriate, in comparable industries. According to the proxy, data from the sources represent similar positions in general industry and industry specific companies as appropriate.

Towers Perrin advised the Compensation Committee that “under most circumstances, Compensation Committee actions are governed by the Business Judgment Rule. Under this rule, Compensation Committee (and full Board) decisions are not to be second-guessed if good processes have been used in making decisions, even if the impact of the decisions turn out to be unfavorable. A helpful condition for demonstrating sound business judgment is the use of reputable professional experts (such as compensation consultants in the case of making compensation decisions).”<sup>1658</sup>

The minutes of the Compensation Committee meeting on April 30, 2001, discuss the consulting services provided to Enron and the Compensation Committee by Towers Perrin. The services included: (1) providing analysis and recommendation with respect to base, bonus, and long-term compensation for the Office of the Chairman and the Board of Directors; (2) providing updates and opinions relative to trends in executive compensation; (3) reviewing, validating, and recommending executive compensation program design alternatives; (4) providing consultation with respect to governmental regulations and shareholder perspectives on certain issues; (5) reviewing and validating management’s executive job pricing analysis and pay target recommendations; (6) providing Black-Scholes stock option valuations on request; and (7) conducting consultations and special studies as requested by management and/or the Compensation Committee.<sup>1659</sup>

Enron frequently obtained analysis from consultants, particularly Towers Perrin, to ensure that the executive compensation program was within its stated philosophy and goals. Towers Perrin periodically issued opinion letters to Enron regarding their compensation programs in general and on specific compensation issues. For example, in December 2001, the Compensation Committee received an opinion letter from Towers Perrin regarding the

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<sup>1657</sup> The compensation studies were said to evaluate total direct compensation, defined as base salary plus most recent actual annual incentive earned plus the estimated annualized present value of long-term incentive grants.

<sup>1658</sup> Letter from Towers Perrin to Dr. Charles LeMaistre dated November 14, 2001. EC2 000028647. This letter is included in Appendix D. Towers Perrin also advised that once a company is in a merger or other similar situation, a higher standard of decision-making could apply.

<sup>1659</sup> Minutes of the meeting of the Compensation Committee, at 4 (April 30, 2001). EC 000102176.

competitiveness of the executive compensation programs at Enron.<sup>1660</sup> Additionally, Towers Perrin issued a letter to Enron dated November 14, 2001, addressing potential strategies Enron might want to consider in dealing with 2001 bonus allocations and possible ways to retain key employees during the period before the anticipated merger with Dynegy was expected to be completed.<sup>1661</sup> The letter outlined how Enron's Compensation Committee was impacted by the announced merger and provided suggested compensation decision parameters.

General compensation studies were frequently performed. For example, a comparative analysis of Enron's executive compensation levels was conducted in November 2000.<sup>1662</sup> In January 2001, the Compensation Committee approved the performance of a study by Towers Perrin to analyze the relationship between pay and performance.<sup>1663</sup> Towers Perrin presented to the Compensation Committee that they concluded that the basic structure of the program was consistent with Enron's stated philosophy and that the program was appropriately tied to performance. Towers Perrin recommended that Enron not make any broad-based programmatic changes to its executive pay programs since pay-for-performance systems work when pay rises and falls according to the gains realized by shareholders.

While Towers Perrin concluded that the basic structure of the program was consistent with Enron's philosophy, the findings of the study show that pay elements were higher than the stated philosophy.<sup>1664</sup> The study looked at the specific compensation of approximately 60 executives. The results of the study showed that the base compensation, base plus bonus, long-term incentives, and total compensation for many executives were considerably above the stated target. The finding showed that for base salaries, Enron was 91 percent of market median.<sup>1665</sup> For total cash, Enron was 140 percent of market 75th percentile.<sup>1666</sup> For long-term incentives, Enron was 97 percent of market 75th percentile,<sup>1667</sup> and for total direct pay was 113 percent of

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<sup>1660</sup> The letter provided an overview of Enron's executive compensation programs and is included in Appendix D. EC2 00028641 - EC2 000028645.

<sup>1661</sup> Letter from Towers Perrin to Dr. Charles LeMaistre dated November 14, 2001. EC2 000028647. This letter is included in Appendix D.

<sup>1662</sup> The results indicated Enron's 2000 actual total direct compensation to be at the 75<sup>th</sup> percentile of the market, which met Enron's stated philosophy relative to pay and performance.

<sup>1663</sup> The findings of the study, dated April 20, 2001, were presented to the Compensation Committee on May 1, 2001. EC 002634703 - EC 002634756. The findings of the study, as presented to the Compensation Committee, are included in Appendix D.

<sup>1664</sup> *Id.* at EC 002634712.

<sup>1665</sup> *Id.*

<sup>1666</sup> *Id.*

<sup>1667</sup> *Id.*

market 75th percentile.<sup>1668</sup> Still, Towers Perrin concluded that the program was consistent with Enron's philosophy.

Towers Perrin also provided opinions on individual compensation arrangements. At the request of Enron, Towers Perrin prepared a letter to document the results of marketplace compensation analysis for the top two executives at Enron (Mr. Lay and Mr. Skilling) dated November 16, 2000.<sup>1669</sup> On January 18, 2001, Towers Perrin prepared a letter for Enron providing alternative compensation arrangements for Mr. Lay, given his shift in responsibilities to Executive Chairman of the Board, with Mr. Skilling becoming CEO of Enron.<sup>1670</sup>

From Joint Committee staff interviews with many former members of the Compensation Committee, it appears that many members made decisions relying on the opinions of consultants without fully understanding the underlying issue. For example, former Compensation Committee members interviewed by Joint Committee staff could not explain why Enron purchased two annuities from Mr. Lay and his wife in 2001, but knew that Towers Perrin issued an opinion providing justification for the transaction.

### **Employment agreements**

Several employees had employment agreements with Enron. There were no set rules for determining which employees entered into employment agreements, but generally agreements were executed for top executives and traders. Employment agreements were often used in the commercial areas, or other areas in which skills were in high demand. In many of these cases Enron wanted to have a contract with noncompetition clauses. Employment agreements were generally used for members of the management committee, managing directors and some vice presidents. Documents provided by Enron show that as of February 9, 1998, there were 425 employment contracts in place throughout the various business units and affiliated companies. Enron documents show that as of April 30, 2001, 225 executives, not including traders, below the Vice President level had employment agreements with Enron.<sup>1671</sup>

Employment agreements were individually negotiated, but generally included certain standard terms. Agreements generally included an appendix listing the employee's base salary, bonus and long-term incentive and generally included a signing bonus. Employment agreements were often renegotiated before expiration. Terms were typically two to three years. Some contacts included noncompete provisions. Selected employment agreements were approved by the Compensation Committee. The Compensation Committee generally approved the agreements for the top executives only.

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<sup>1668</sup> *Id.*

<sup>1669</sup> Letter from Towers Perrin to Pam Butler dated November 16, 2000. EC 000102297 - EC 000102306. The letter is included in Appendix D.

<sup>1670</sup> Letter from Towers Perrin to Dr. Charles LeMaistre dated January 18, 2001. EC 000102234 - EC 000102238. The letter is included in Appendix D.

<sup>1671</sup> EC 000102476.

## B. Overview of Executive Compensation Arrangements

### 1. In general

#### Overview

Enron's stated executive compensation philosophy was to provide executives with rewards that reflect their impact on Enron's total shareholder returns and creation of long-term shareholder value.<sup>1672</sup> As previously discussed, each year, the Compensation Committee established total compensation targets based on an assessment of external trends and market data. According to Enron employee materials, the key tenets of the executive compensation program were: (1) to tie executive compensation to the creation of shareholder value; (2) to deliver a significant portion of total compensation in a combination of short-term and long-term incentives so that executives have the opportunity to earn at the 75th percentile of the external marketplace or higher, subject to the achievement of Enron financial and nonfinancial goals and individual performance objectives; and (3) to promote teamwork and support movement of key talent to opportunities as they arise throughout the organization.<sup>1673</sup>

Executive compensation at Enron was generally comprised of base salary, annual incentives, and long-term incentives. Executives had the opportunity to earn at the 75<sup>th</sup> percentile or higher level, subject to obtaining performance at the 75<sup>th</sup> percentile or higher.<sup>1674</sup> In addition to the three principal components of executive compensation (base salary, annual incentive and long-term incentive), certain executives also participated in special compensation arrangements, such as nonqualified deferred compensation programs, split-dollar insurance arrangements, and employee loans. Individualized compensation arrangements were also used for certain executives. For example, as discussed below, as a form of compensation, Enron purchased two annuities from Kenneth L. Lay and his wife. Another executive, Mr. Lou Pai, received a fractional interest in an airplane as part of his compensation.

#### Base salary

Base salary levels were targeted at the 50th percentile of the external marketplace. An annual salary increase budget was set to maintain Enron's position relative to the market. Base pay was reviewed and adjusted at Enron's discretion and in relation to market conditions, but was also reflective of individual performance. Base pay was generally reviewed and adjusted on February 1 of each year, if appropriate. Base salary increases were typically approximately four percent per year.<sup>1675</sup>

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<sup>1672</sup> Enron Compensation Program 2001 (employee brochure). EC2 000019710.

<sup>1673</sup> Enron Compensation Program 2001 (employee brochure). EC2 000019710.

<sup>1674</sup> Report from Compensation Committee, 2001 Enron Corp. Proxy Statement.

<sup>1675</sup> The minutes of the May 3, 1999, meeting of the Compensation Committee show that Messrs. Lay and Skilling requested that the Committee not increase their respective salaries for

## **Annual incentive awards**

Annual bonuses were a major component of Enron's executive compensation structure. Annual bonuses were targeted at the 75<sup>th</sup> percentile level compared to the market and could often be larger than base salary for some employees.

According to the 2001 proxy, the primary objective of the annual incentive plan was to promote outstanding performance by Enron in absolute terms, as well as in comparison to its peer companies. The plan was funded as a percent of recurring after-tax net income as approved by the Compensation Committee each year.

Competitive annual incentive targets were established by the Compensation Committee each year based on external trends and market data.<sup>1676</sup> Payments were based upon Enron's performance against preestablished goals, as well as business unit and individual performance. According to the 2001 proxy, annual bonus payments were based upon Enron's performance measured against Enron's operating plan as approved by the Board of Directors. Key performance criteria such as funds flow, return on equity, debt reduction, earnings per share improvements, and other relevant factors could be considered at the option of the Committee. Proxy statements from recent years state that a Performance Review Report was presented to the Compensation Committee in January, which summarized management's view regarding whether and to what extent the key performance criteria were attained. The Performance Review Report also discussed any other significant, but unforeseen factors that positively or negatively affect Enron's performance. The Compensation Committee verified Enron's actual recurring after-tax net income, reviewed management's funding level recommendation, and approved the resulting award fund.

The Performance Review Committee process and resulting employee ranking significantly influenced the actual incentive awards paid. The Annual Incentive Plan was used for bonuses for Section 16 officers. The Annual Incentive Plan for Section 16 officers was funded as a percentage of after-tax net income, not to exceed five percent. Officers other than Section 16 officers were paid annual bonuses, but not through the Annual Incentive Plan.

Annual incentives are discussed in detail in Part III.B.2., below.

## **Long-term incentives**

According to the 2001 proxy, Enron's long-term incentive program was designed to tie executive performance directly to the creation of shareholder wealth. The long-term incentive

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1999. The Committee reluctantly agreed to honor the request on the condition that the minutes reflect the Committee's judgment that during 1998 Messrs. Lay and Skilling had performed their respective duties superbly, that Enron's shareholders had benefited significantly from such performance, and that, in the absence of the specific request they had made, each would have received a salary increase for 1999.<sup>1675</sup> Joint Committee staff asked several interviewees about this and no one, including Mr. Skilling, could recall the reason for the request.

<sup>1676</sup> 2001 Enron Corp. Proxy Statement.

program provided for awards of nonqualified stock options and restricted stock. Awards were one-half stock options and one-half restricted stock. In the past, the Compensation Committee utilized other long-term compensation vehicles. Option grants generally vested over a five-year term. The number of options to be awarded was determined based on the approved Black-Scholes value as determined by the Compensation Committee. Restricted stock grants generally vested over four years, but could be accelerated based on Enron's performance relative to the S&P 500 index.

Participation in the long-term incentive plan was available to employees in the vice president job group and above.<sup>1677</sup> Long-term incentive target values were to be established by the Compensation Committee each year based on assessment of external trends and market data.<sup>1678</sup> Actual grants were determined each January based on the year-end performance review committee assessments and were subject to the approval by the Office of the Chairman. Award agreements providing the terms and provisions of the awards were typically presented to recipients during the first quarter of the year. Grants for section 16(b) officers required Compensation Committee approval.

Before the changes to Enron's compensation structure in 1999, some business units had their own long-term incentive programs. For example, Enron Capital & Trade Resources had its own long-term compensation program for stock options and phantom stock units, which were granted under the Enron Capital & Trade Resources Corp. Phantom Stock Unit Plan.

Long-term incentives are discussed in detail in Part III.C.2., below.

### **Nonqualified deferred compensation**

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 tax-deferred return on deferrals. Many executives took advantage of the opportunity to defer amounts that would otherwise be included in income currently. The specific nonqualified deferred compensation plans and programs offered by Enron are discussed below in more detail.

### **Miscellaneous**

Enron maintained a FlexPerq program for Managing Directors and above. Under the program, certain expenses were covered by an allowance rather than required to be submitted for reimbursement on an expense report. These included income tax preparation, investment counseling/estate planning, legal counseling, country club and health club membership, luncheon club membership, airline VIP club membership, car/cell phone, in-home long-distance service, and "premium" credit cards. In materials provided to executives, Enron explained that all FlexPerq allowance amounts would be reported as compensation on the participant's Form W-2.

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<sup>1677</sup> Enron Corp. Executive Compensation Program brochure. EC 002634797.

<sup>1678</sup> Enron Corp. Executive Compensation Program brochure. EC 002634797.

Eligible participants would be given an annual FlexPerq allowance equal to three percent of their salary.

**Top-200 most highly compensated**

Appendix D shows the compensation paid to each of the top-200 highest paid employees for the years 1998, 1999, 2000, and 2001.<sup>1679</sup> Compensation attributable to bonus, stock options, restricted stock, deferred payout, and other compensation is separately stated. As shown in Appendix D, the top executives were extremely highly compensated, especially in the years immediately preceding Enron’s bankruptcy. The range of total compensation paid to the top-200, as provided by Enron, is shown in Table 13, below.

**Table 13.—Range of Total Compensation Paid to the Top-200 Most Highly Compensated Employees for 1998-2001<sup>1680</sup>**

Year	Range of Total Compensation Paid to the Top-200
1998	\$152,000 to \$20,621,000
1999	\$325,000 to \$56,541,000
2000	\$1,270,000 to \$168,741,000
2001	\$1,104,000 to \$56,274,000 <sup>1681</sup>

In 2000 and 2001, each one of the top-200 employees was paid over \$1 million. In 2001, the year of Enron’s bankruptcy, at least 15 executives were paid over \$10 million. One executive was paid over \$56 million.<sup>1682</sup> In 2000, three executives were paid over \$100 million, with the top-paid executive receiving \$169 million. In 2000, at least 26 executives were paid over \$10 million.

Table 14, below, shows information obtained from the IRS, which is based on information provided by Enron, on the total compensation for the top-200 employees for 1998 through 2000.

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<sup>1679</sup> This information was provided to the Joint Committee staff by Enron.

<sup>1680</sup> Amounts are rounded.

<sup>1681</sup> For 2001, \$56.274 million is the highest compensation which is separately listed. There are eight separate listings for Chairman and CEO, but because names are not provided it is unclear whether compensation to some individuals is separately stated in more than one line entry.

<sup>1682</sup> As mentioned above, there are eight separate listings for Chairman and CEO, but because names are not provided it is unclear whether compensation paid to the most highly compensated individual is included in more than one line entry, which is likely the case.

**Table 14.—Total Compensation Paid to the Top-200 Highly Compensated Employee for 1998-2000<sup>1683</sup>**

Year	Total Compensation paid to the Top-200
1998	\$193,281,000
1999	\$401,863,000
2000	\$1,424,442,000

As in many other cases, the information provided by the Company to the IRS does not reconcile with the information provided by Enron to the Joint Committee staff.

**Executive compensation White Papers**

In general

During 1986, the Compensation Committee, with the assistance of Hewitt Associates, developed the compensation philosophy, objectives, and comprehensive executive compensation program for senior Enron executives to be implemented January 1, 1987.<sup>1684</sup> With the merger of HNG and InterNorth, Enron needed to reconcile the different executive compensation philosophies and programs. With the help of Board members and management, Hewitt Associates developed a suggested philosophy and objectives for the compensation program. Based on these suggestions, the Management Committee developed a comprehensive executive compensation program based upon the agreed-to philosophy and objectives. The Compensation Committee approved the program (with modification), as did the full Board of Directors on December 8, 1986, subject to ongoing review and change. Approximately 60 Enron executives (less than 1 percent of the total Enron employee population) participated in the original program, including management committee members, operating company presidents, corporate officers, and selected key line and staff officers in the operating companies.

The Enron Executive Compensation Program “White Paper” provides a summary of Enron’s executive compensation policies. The White Paper was periodically revised to incorporate changes agreed to by the Compensation Committee. The White Paper was distributed by management to the executives who were participants in the program. The original White Paper was dated August 1987, and was revised August 1990, May 1993, January 1996, January 1997, and January 1998. The changes between the various versions are relatively minor. In most cases, the only changes from one version to the next are the peer companies used for performance comparison and the number of executives participating in the program. The following discussion summarizes the executive compensation White Paper.

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<sup>1683</sup> The information provided by the IRS includes some inconsistencies. In reproducing the summary data, the Joint Committee staff attempted to reconcile inconsistencies and include the data that appears to be accurate. Amounts are rounded.

<sup>1684</sup> EC 001934641 - EC 001934656.



### Compensation philosophy and objectives

Throughout the various versions of the White Paper, Enron's stated compensation philosophy for its senior management remained the same and included the following:

- Total compensation will consist of base pay, annual bonus, long-term incentive pay, benefits, and perquisites.
- Individuals will have an opportunity to earn at the 75th percentile or higher level relative to peer companies, subject to obtaining performance at the 75th percentile or higher. Higher achievement provides higher payouts, while lesser achievement decreases total compensation. In order to assure that individual compensation is tied to performance, more dollars of total compensation will be placed at risk, tied to Enron absolute performance, and performance relative to its peers.
- Program design will promote teamwork by tying a significant portion of compensation to subsidiary and Enron Corp. performance.

### White Paper Updated, January 1998

The most recent version of the White Paper appears to be January 1998,<sup>1685</sup> which is almost identical to all other older versions, as Enron's compensation philosophy has generally been the same since 1986. The January 1998 White Paper is included in Appendix D. The major components of the most recent White Paper, January 1998, are summarized below. Joint Committee staff asked Enron whether the White Paper had been revised since the January 1998 version. In response to this request, Enron provided an undated Enron Corp. Executive Compensation Program brochure.<sup>1686</sup> The brochure is summarized below and is included in Appendix D. It is unclear whether the brochure replaced the White Paper.

According to the White Paper, the executive compensation program would be reviewed biannually for market competitiveness and was reviewed periodically to determine if changes in philosophy, targets or compensation vehicles were necessary. The White Paper lists the companies that would be considered the "market" in making compensation comparisons.

Compensation Objectives.—The compensation objectives were stated as shown in Table 15 below.<sup>1687</sup>

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<sup>1685</sup> EC 001934688.

<sup>1686</sup> EC 002634796 - EC 002634799.

<sup>1687</sup> This table lists the compensation objectives exactly as stated in the January 1998 White Paper. EC 001934689.

**Table 15.–Enron “White Paper” Compensation Objectives**

<b>Component</b>	<b>Enron Target</b>
Base Salary	50th Percentile
Target Annual Bonus for Outstanding Performance	“Gap” between Total Direct Target and Base Salary
Total Direct Compensation	Commensurate with Enron Performance - Target of 75th Percentile
Long-Term Incentive Pay	Grants at 75th Percentile - Payouts Commensurate with Enron Performance
Benefits	Same as All-Employee Benefits Target
Perquisites	50th Percentile

Participation.—According to the 1998 White Paper, approximately 78 Enron executives participated in the program. These 78 executives included management committee members, operating company presidents, corporate officers, and selected key line and staff officers in the operating companies. These 78 executives represent approximately one percent of the total Enron employee population. The participation is an increase from 60 in 1987, which at that time was less than one percent of the employee population.

Base salary.—The target for base salary was the 50th percentile of the market. The salary midpoints were set at the 50th percentile for the executive positions. The annual merit increase budget was set to maintain Enron’s market position.

Annual Incentive Plan.—The primary objective of the annual incentive plan was to promote outstanding performance by Enron in absolute terms, as well as in comparison to its peer companies. The plan was funded as part of a percent of after-tax net income as approved by the Compensation Committee each year. Payouts under the program would be made in the year following the year of performance. The payout would be based upon Enron’s performance against preestablished goals, as well as subsidiary and individual performances.

Long-term incentives.—Enron’s long-term incentive program was designed to tie executive performance directly to the creation of stockholder wealth over a four-year period. Payout was based upon how well Enron’s stock price performed absolutely and how well it performed against the stock process of its peer companies.

Each participant would be assigned a “Targeted Grant Value” coincident with selection for participation in the program and in December each year thereafter. The “Targeted Grant Value” would be determined by the results of the Hewitt Compensation Survey.

Grants were targeted at the 75th percentile. One half of the grants would be paid in nonqualified stock options to foster shareholder return. The remaining one half would be granted in the form of performance units to be paid within six weeks after the close of books for

the fourth year. The Compensation Committee had the option to substitute any other long-term compensation vehicles that they deemed appropriate (e.g., restricted stock).

Enron Corp. Executive Compensation Program brochure

In general.—As discussed above, the Joint Committee staff asked Enron whether the White Paper had been revised since the January 1998 version. In response to this request, Enron provided an undated Enron Corp. Executive Compensation Program brochure.<sup>1688</sup> It is unclear whether the brochure replaced the White Paper. The brochure is included in Appendix D. According to the brochure, the “central philosophy of Enron’s executive compensation program is to provide executives with rewards which reflect their impact on Enron’s total shareholder returns and creation of long-term shareholder value. The Program is targeted at Enron’s senior management team, which is approved each year by the Compensation and Management Development Committee . . . of the Enron Board of Directors.”<sup>1689</sup> The key tenets of the program, as stated in the brochure, are:

- To deliver market competitive total compensation targets as determined through comprehensive market studies.
- To deliver a significant portion of total compensation in a combination of short-term and long-term incentives so that executives have the opportunity to earn at the 75th percentile of the external marketplace or higher, subject to the achievement of company financial and nonfinancial goals and individual performance objectives.
- To tie executive compensation to the creation of shareholder value.
- To promote teamwork and support Enron’s desire for a transferable workforce.

The brochure states that the Enron Corp. Executive Compensation Program is “designed to promote excellence in both team and individual performance and to attract and retain key talent.” The program is revised annually for market competitiveness. It is also reviewed periodically to determine if changes in philosophy, targets or compensation vehicles are necessary to help attract, motivate and retain executive talent.”<sup>1690</sup>

The various components of the executive compensation program are discussed in the brochure and include base salary, annual incentives, long-term incentives, executive deferral plans, and benefits. The components of the program as explained in the brochure are discussed below. These are essentially the same as described in the White Paper for prior years.

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<sup>1688</sup> EC 002634796 - EC 002634799.

<sup>1689</sup> Enron Corp. Executive Compensation Program brochure. EC 002634796.

<sup>1690</sup> Enron Corp. Executive Compensation Program brochure. EC 002634799.

Base salary.—Base salary was targeted at the 50th percentile of the external marketplace. An annual salary increase budget was set to maintain Enron’s market position. Base pay was reviewed and adjusted on February 1 of each year.

Annual incentives.—Competitive annual incentive targets were established by the Committee each year based on an assessment of external trends and market data. Cash awards were determined each January based on company and business unit performance as determined by the Committee. Individual performance, as determined through year-end performance review committee process had a significant influence on actual incentive awards paid.

Long-term incentives.—Long-term incentives were composed of stock options and restricted stock. Options grants provided time-based vesting. Restricted stock grants were made with a future vesting date, which could be accelerated based on Enron’s performance relative to the S&P 500. The brochure describes how restricted stock vesting could be accelerated based on Enron’s annual cumulative shareholder return relative to the S&P 500. Participation in the long-term incentive program was available to employees in the vice present job group and above. Actual grants were determined each January based on the year end performance review committee assessments and were subject to approval by the Enron Corp. Office of the Chairman. Awards are presented to each recipient during the first quarter of the year. Grants to Section 16 officers required Compensation Committee approval.

Executive deferral plans.—Long-term incentive plan participants were eligible to defer all of a portion of salary, bonus and long-term compensation into Enron-sponsored deferral plans.

Benefits.—Executives typically had the same benefit plans as other Enron employees.

## **2. Bonuses**

### **In general**

As discussed above, the components of executive compensation at Enron included base salary, annual incentive awards (cash bonus) and long-term incentive. Bonuses were targeted at the 75 percent level. There has been much media attention on the magnitude of bonuses paid to Enron executives. In many cases, bonuses were the principal compensation component. Appendix D shows the bonuses received by each of the top-200 highest paid employees for the years 1998, 1999, 2000, and 2001.<sup>1691</sup> Bonuses paid in 2001, the year of Enron’s bankruptcy, were as high as \$5 and \$8 million dollars in some cases. In 2001, at least 48 executives received bonuses of \$1 million or greater. Table 16, below, shows bonuses for the top-200 employees according to information obtained from the IRS.<sup>1692</sup> Enron’s bankruptcy filing Exhibit 3b.2 shows that bonuses to 144 insiders (managing directors and above) paid during the year preceding the bankruptcy totaled approximately \$97 million.

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<sup>1691</sup> This information was provided to the Joint Committee staff by Enron.

<sup>1692</sup> The data is based on information provided by Enron to the IRS. As in other cases, information regarding bonuses provided by Enron to the Joint Committee staff does not reconcile with similar information provided by Enron to the Joint Committee staff and to the IRS.

**Table 16.—Total bonuses for the top-200 highly compensated employees<sup>1693</sup>**

<b>Year</b>	<b>Total bonuses for the top-200</b>
1998	\$41,193,000
1999	\$51,195,000
2000	\$56,606,000

The Joint Committee staff asked Enron to provide the average employee bonus for employees other than the top-paid 200, for each of the years 1999 - 2001. Enron provided information on managers and above only.<sup>1694</sup> For such group, the average bonus paid in 2000 (earned in 1999) was \$37,396, which was an average of 43.6 percent of base salary and 19.5 percent of total compensation. The average bonus paid in 2001 (earned in 2000) was \$61,543, which was an average of 70.7 percent of base salary and 27.4 percent of total compensation.

According to materials provided to employees, the primary objectives of Enron's annual incentive plan were to provide cash awards aligned with Enron's achievement of preestablished financial and nonfinancial operating goals and to reward individual contributions to Enron's success.<sup>1695</sup> In recent years, the Annual Incentive Plan was used for bonuses for certain executives.<sup>1696</sup> Prior to 1999, the Annual Incentive Plan was also used for bonuses to non-executives. According to Enron, generally all employees were eligible for incentive/variable pay consideration unless excluded due to union contracts, local labor laws, etc.<sup>1697</sup> Payment of bonus, however, was contingent on company an individual performance; therefore, less than 100 percent of employees actually received bonuses.<sup>1698</sup> Employees interviewed by Joint Committee staff stated that all employees, other than those receiving a performance review committee ranking of category five, received annual bonuses.

Prior to the modification of Enron's compensation structure in 1999, some business units maintained their own bonus plans. For example, the Enron International, Inc. Project Participation Plan was used for international developers. The Project Participation Plan has received a considerable amount of attention because of the large bonuses that were paid from the plan and because of the way that bonus amounts were determined. For a discussion of the Project Participation Plan, see Part III.B.3., below.

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<sup>1693</sup> Amounts are rounded.

<sup>1694</sup> EC 002690459. Because Enron did not provide the specific data requested, the averages are not true indicators of typical employee bonuses.

<sup>1695</sup> Executive Compensation Program brochure. EC2 00019710.

<sup>1696</sup> Enron's bonus program is generally referred to as its "annual incentive plan," which includes the Enron Corp. Annual Incentive Plan, as approved in 1999.

<sup>1697</sup> EC 002679698.

<sup>1698</sup> EC 002679698.

## Annual Incentive Awards

### Annual Incentive Plan

The most recent version of the Enron Corp. Annual Incentive Plan (the “Annual Incentive Plan”) was executed as of May 4, 1999, and was effective as of January 1, 1999. The Plan was “designed to recognize, motivate, and reward exceptional accomplishment toward annual corporation objectives; to attract and retain quality employees; and to be market competitive.”<sup>1699</sup>

The Annual Incentive Plan was approved by the shareholders at the May 1999 Annual Meeting. Before the approval of the plan in 1999, an older version of the Annual Incentive Plan had been approved by the shareholders in 1994. The older version of the plan was somewhat different from the plan approved in 1999, as eligibility under the 1994 plan included all full-time and part-time employees, while eligibility under the more recent version is limited to Section 16 officers. With the change in class of eligible employees under the Plan, employees other than Section 16 officers still received annual bonuses, but not through the Annual Incentive Plan.

The Annual Incentive Plan was administered by the Compensation Committee of the Board of Directors, who had the sole discretion to interpret the plan, approve preestablished, objective, annual performance measures, certify the level to which the performance measures were attained prior to any payment under the Plan, approve the amount of awards made under the Plan, and determine who is to receive payments under the Plan.<sup>1700</sup>

The Annual Incentive Plan has an annual award fund of five percent of recurring after-tax net income of Enron. “Recurring after-tax net income” is after-tax net income subject to downward adjustment by the Compensation Committee in its discretion for what the Committee considered extraordinary or nonrecurring items of after-tax net income and other items or events, including, but not limited to financial impact on Enron resulting from changes in law or regulation pertaining to Federal corporate taxes. The maximum individual target award level that may be established under the Plan is one percent of the recurring after-tax net income of Enron. This is an increase from the Annual Incentive Plan in effect prior to 1999, which had a maximum individual award level of .5 percent.

According to the Plan document, at the end of each plan year, the Compensation Committee would verify the actual recurring after-tax net income of Enron, if any, and the resulting award fund (taking into consideration any downward adjustments made by the Committee). The Committee would then determine which participants would receive payments under the Plan and the amounts of the payments. Payments made under the Plan could be made in cash or other property having equivalent value, including shares of Enron Corp. common stock. Cash payments under the Plan could be deferred according to the terms of Enron’s deferral plans. Eligible recipients of an Annual Incentive Plan bonus payment could defer up to 100 percent of bonus into one or more of the Enron Corp. 1994 Deferral Plan, the Enron Corp. Bonus Stock Option Program and/or the Enron Corp Bonus Phantom Stock Program.

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<sup>1699</sup> Enron Corp. Annual Incentive Plan.

<sup>1700</sup> Enron Corp. Annual Incentive Plan.

### Bonus determinations

Bonuses for individuals would be determined after the approval of bonus pools. Preliminary bonus pools were generally approved at the close of the current year as were preliminary funding for the following year. Exact bonus amounts would be determined and approved in the beginning of the following year. The year-end Performance Review Committee process significantly influenced the annual incentive paid to an employee.<sup>1701</sup>

According to the 2001 Proxy, annual bonus payments were based upon Enron's performance measured against the Enron Operating Plan as approved by the Board of Directors. Key performance criteria such as funds flow, return on equity, debt reduction, earnings per share improvements, and other relevant factors were considered at the option of the Compensation Committee.<sup>1702</sup> A Performance Review Report, which summarized management's view regarding whether and to what extent the key performance criteria were attained, would be presented to the Compensation Committee in January.<sup>1703</sup> The report also discussed other significant, but unforeseen factors that positively or negatively affected Enron's performance. The Compensation Committee would verify Enron's actual recurring after-tax net income, review management's funding level recommendation and then approve the resulting award fund.<sup>1704</sup>

After the Board of Directors determined the overall funding level, the Office of the Chairman determined the allocations for each operating group based on performance. Individual payouts were based on business unit performance (or corporate financial performance for corporate executives) and the employee's individual performance as determined through the Performance Review Committee process. The Compensation Committee would review the individual recommendations for key executives and the Office of the Chairman would approve the recommendations for all other participants.<sup>1705</sup> In an interview with Joint Committee staff, the former chairman of the Compensation Committee stated that bonuses for executives were generally proposed by management and then recommended to Compensation Committee, who would basically approve what management had proposed. According to interviews with current and former Enron employees, bonuses for nonexecutive level employees were generally determined by market data and then ultimately approved by management.

### Funding

Before 2000, Enron's bonuses were funded as a percentage of each specific business unit's net income. Maintaining separate bonus funding created problems for business units,

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<sup>1701</sup> Executive Compensation Program brochure. EC2 00019710.

<sup>1702</sup> 2001 Enron Corp. Proxy Statement.

<sup>1703</sup> *Id.*

<sup>1704</sup> *Id.*

<sup>1705</sup> *Id.*

especially new business units, that had little or no net income, but significant total shareholder value. As discussed below, to help ensure continued employee fungibility, a single corporate-wide funding pool was established.

Before the 1999 restatement of the Annual Incentive Plan, a bonus pool for all Enron Corp. Section 16 officers and corporate staff would be determined annually. The Annual Incentive Plan as adopted in 1994 did not have a specific bonus target, but allowed the Compensation Committee to set a target based on after-tax net income. For 1996, the Annual Incentive Plan fund for Enron Corp. was 11 percent of after-tax net income. For 1997 and 1998, the Annual Incentive Plan fund for bonuses was 15 percent of after-tax net income.

At Enron's request, Towers Perrin prepared a letter, dated July 27, 1998, providing information about the percentage of after-tax net income allocated to management annual incentives.<sup>1706</sup> Towers Perrin commented that Enron's annual bonus spending cap of 15 percent of after-tax net income for Section 16 officers and corporate staff was relatively high.<sup>1707</sup> However, Towers Perrin noted that most companies are well advised to set high bonus caps because the limits exist only to preserve the tax deductibility of compensation paid to the top-five highest paid officers.<sup>1708</sup> Beginning in 1999, with the effectiveness of the restated Annual Incentive Plan, which limited eligibility for payments under the Plan, there was a five-percent bonus pool for Section 16 officers. Bonuses of corporate staff were not paid from the five-percent pool.

As discussed above, until 2000, Enron funded bonus pools for each business unit and for corporate staff based on market levels of incentive funding by business line.<sup>1709</sup> In 2000, senior management expressed concern that this bonus funding structure discouraged key commercial employees from leaving profitable units to take critical positions in less profitable units (since funding was based on a percentage of net income for each unit).<sup>1710</sup>

To address that concern, at the recommendation of Towers Perrin, the Compensation Committee adopted a new bonus funding scheme under which bonuses throughout Enron would be funded with one pool. At its December 11, 2000, meeting, the Compensation Committee approved a change in the compensation scheme to utilize a single corporate-wide bonus funding pool for 2000 which would be set at up to 27 percent of after-tax income. Individual employee

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<sup>1706</sup> EC 000104381.

<sup>1707</sup> The Towers Perrin survey showed that most companies pay management annual incentives from two percent to 10 percent of net income. EC 000104381.

<sup>1708</sup> See the discussion of the \$1 million limit on deductibility of executive compensation in Part III.C.6, below.

<sup>1709</sup> Letter from Towers Perrin to Dr. Charles LeMaistre dated December 3, 2001. EC2 000028641. This letter is included in Appendix D.

<sup>1710</sup> *Id.*



bonus allocations from the pool would be made using discretion, but considering the value of the individual's position using market data and individual performance.

At the January 22, 2001, Compensation Committee meeting, the 2000 bonus pool as a percentage of after-tax net income up to 27 percent was adopted.<sup>1711</sup> This pool included Enron Corp. and all business units. The pool as a percentage of earnings before interest and taxes was up to 15 percent. Pursuant to the Annual Incentive Plan, the pool allocated under the Plan (for Section 16 officers) was five percent of recurring after-tax net income. Towers Perrin advised Enron that its annual incentive plan design was consistent with market 75th percentile practices for energy trading and marketing entities.<sup>1712</sup>

#### Annual bonuses for employees other than executives

As of January 1, 1999, even though payments under the Annual Incentive Plan were limited to Section 16 officers, other employees were paid annual bonuses under the general bonus pool of Enron. The bonuses were determined similar to the determination of executive bonuses and were market driven. Consulting firms, such as Towers Perrin, would be involved in determining bonuses for both executives and nonexecutives.

#### Bonus deferral programs

##### In general

Enron had two bonus deferral programs, the Bonus Stock Option Program and the Bonus Phantom Stock Deferral Program. The bonus deferral programs gave participants an opportunity to receive stock options and/or phantom stock in lieu of cash bonus payments.<sup>1713</sup> It appears that these programs were open to all employees receiving a cash bonus, with the exception of certain employees working outside of the United States. These programs were considered deferral programs because Federal and State income taxes associated with bonus deferrals, plus appreciation on such amounts, were not incurred until stock options were exercised or phantom shares were released. Participants were required to enroll in the programs in the year prior to the scheduled bonus payment. Participation in the programs did not guarantee that a participant would receive a bonus. The minutes of meetings of the Compensation Committee show that the Committee approved the issuance of stock options and phantom stock that Section 16 officers elected to receive pursuant to the bonus deferral programs.<sup>1714</sup>

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<sup>1711</sup> The letter from Towers Perrin to Dr. Charles LeMaistre dated December 3, 2001, states that the bonus pool approved was 24.5 percent of recurring net income. The Compensation Committee minutes reflect approval of a bonus pool of 27 percent.

<sup>1712</sup> Letter from Towers Perrin to Dr. Charles LeMaistre dated December 3, 2001. EC2 000028641.

<sup>1713</sup> EC2 0000018944.

<sup>1714</sup> See, e.g., Minutes of Compensation Committee meetings held January 24, 2000, and January 22, 2001.

### Bonus Stock Option Program

The Bonus Stock Option Program provided employees with an opportunity to purchase stock at a fixed price, over a specified period of time. Under the Bonus Stock Option Program, participants could elect to defer up to 50 percent of bonus (in 5 percent increments) to purchase stock options.<sup>1715</sup> For every dollar deferred into the program, the participant would receive \$1.50 in expected value (employees would receive a 50 percent premium). The size of the grant was determined using a Black-Scholes ratio. Before 2001, a fixed dollar value was used. Bonus stock options were fully vested immediately upon grant. Beginning with 2001 deferrals, options had a five-year term.<sup>1716</sup> Before 2001, options had a seven-year term. The change was meant to be in sync with an overall trend in moving toward shorter stock option grants.<sup>1717</sup> Company documents show that when the options were exercised, all taxes (Federal and state income taxes and FICA and Medicare) were due.

Employee materials emphasized that there is risk in choosing to receive a portion of bonus in stock options.<sup>1718</sup> Employees were informed that if the stock price did not appreciate to the break-even point before exercise, the participant would receive less than the amount deferred and could lose the entire deferred bonus amount if the stock price did not increase above the grant price. According to documents provided by Enron to the IRS, in 2000, approximately 1,121 employees participated in the Bonus Stock Option Program, deferring amounts ranging from \$75 to \$300,000.

### Bonus Phantom Stock Program

The Bonus Phantom Stock Program was established in 1997 to allow Enron employees the opportunity to take a one for one exchange of cash for phantom stock for up to 50 percent of any cash bonus received.<sup>1719</sup> A participant electing to defer a percentage of bonus could select a holding period from one to five years and would receive a premium of five percent for each year holding the shares.<sup>1720</sup> Phantom stock mirrored the performance of Enron Corp. common stock and was used so that employees would not be considered to be in receipt of actual shares at the time of grant, thereby allowing deferral of taxes until the shares were released. Dividend equivalents accrued during the holding period.

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<sup>1715</sup> Bonus Stock Option Program employee materials. EC2 000019129.

<sup>1716</sup> EC2 000018959.

<sup>1717</sup> Letter from Kim Bolton describing deferral programs dated October 12, 2000. EC2 000018424.

<sup>1718</sup> EC2 000018968.

<sup>1719</sup> EC 000104582.

<sup>1720</sup> Employee election form. EC2 000018971.

Beginning in 2001, Company documents show that FICA and Medicare taxes were due on the bonus shares (deferred amounts) on the bonus payment date, and would be deducted from the remaining bonus or from subsequent paychecks until fully collected.<sup>1721</sup> It appears that prior to 2001, FICA and Medicare taxes on the deferred bonus would be paid when the shares were released. FICA and Medicare on premium shares would be paid when the phantom shares were released. Federal and State income taxes were imposed when phantom shares are released.<sup>1722</sup> At the end of the holding period, shares would be sold to cover the tax liability and remaining shares would be released into the employee's brokerage account.<sup>1723</sup> An employee could also choose to pay withholding taxes in cash.

Information provided by Enron states that in the initial year of the Bonus Phantom Stock Program, 1998, there were approximately 620 participants.<sup>1724</sup> Information provided by Enron also shows that there were approximately 610 participants in 1999, 1,140 in 2000 and 681 in 2001. According to documents provided by Enron to the IRS, in 2000, approximately 1,673 employees participated in the program and deferred amounts ranging from \$166 to \$282,000.<sup>1725</sup>

### **Pre-bankruptcy bonuses**

#### **In general**

In the weeks immediately preceding the bankruptcy, Enron implemented two bonus programs for (1) approximately 60 key traders and (2) approximately 500 employees that Enron claimed were critical for maintaining and operating Enron going forward. The combined cost of the programs was approximately \$104.9 million.<sup>1726</sup> The minutes of the Board of Directors meetings and Compensation Committee meetings in which such payments were approved, discussed below, are included in Appendix D.

#### **Bonuses for traders**

At the November 16, 2001, meeting of the Compensation Committee, Lawrence Gregory ("Greg") Whalley reported concerns of key employees that annual bonuses either would not be

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<sup>1721</sup> Power-point presentation explaining the bonus deferral programs. EC2 000018950.

<sup>1722</sup> Power-point presentation explaining the bonus deferral programs. EC2 000018951.

<sup>1723</sup> Power-point presentation explaining the bonus deferral programs. EC2 000018952.

<sup>1724</sup> Information provided September 4, 2002. EC 001872010.

<sup>1725</sup> As stated previously, information provided by Enron to the Joint Committee staff and to the IRS does not reconcile in many cases.

<sup>1726</sup> Attachment to the December 20, 2001, Compensation Committee meeting. EC2 000028654.

awarded or, if awarded, might not be funded by Enron.<sup>1727</sup> Mr. Whalley reviewed the terms of a proposed grantor trust of Enron North America to fund the payment of 2001 performance bonuses to certain key personnel of Enron North America as well as Enron Energy Services and Enron Canada. The bonus trust was approved by the Compensation Committee on November 16, 2001, and was approved by the Board of Directors on November 18, 2001.<sup>1728</sup> Pursuant to this approval, Enron established a 2001 annual bonus pool of \$50 million to be paid to up to 100 key commercial employees (referred to as traders).<sup>1729</sup> Towers Perrin advised that such funding equaled about 2.5 percent of Enron Americas' earnings before income taxes, which was dramatically less than market median funding of 15 percent of earnings before income taxes for energy trading units.<sup>1730</sup>

Originally, it was approved that payments to the traders would be made as long as the employee was actively employed on the designated payment dates of January 4, 2002, and February 5, 2002. After the payment of pre-bankruptcy bonuses to the nontrader key employee group, discussed below, Enron decided to make payments from the trust in 2001 and impose the same restrictions required for payments to the nontrader group.

#### Pre-bankruptcy payments to key employees

In connection with Dynegy's withdrawal from the proposed merger with Enron, Enron established a 2001 bonus pool of approximately \$54 million for approximately 528 critical noncommercial staff (i.e., persons other than traders). On November 28, 2001, the Board of Directors approved the establishment and adoption of the Enron Corp. Bonus Plan for calendar year 2001.<sup>1731</sup> While not stated specifically in the Bonus Plan, Enron documents show that it was Enron's intent to pay 2001 bonus payments to key and critical employees as soon as

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<sup>1727</sup> Minutes of the Meeting of the Compensation Committee, at 1 (Nov. 16, 2001). EC2 000026922 - EC2 000026925. At the October 24, 2001, Special meeting of the Board of Directors, the Board approved the guarantee of minimum bonuses to be paid to key commercial personnel in January of 2002. EC2 000027260- EC2 000027262.

<sup>1728</sup> *Id.* Minutes of the Meeting of the Board of Directors, at 8 (Nov. 18, 2001). EC2 000028074 - EC2 000028081. The trust document is dated November 16, 2001. EC 001506928.

<sup>1729</sup> Letter from Towers Perrin to Dr. Charles LeMaistre dated December 3, 2001. EC2 000028641. The letter is included in Appendix D.

<sup>1730</sup> *Id.*

<sup>1731</sup> Minutes of the Special Meeting of the Board of Directors, at 5 (Nov. 28, 2001). EC2 000028296 - EC2 000028306; EC2 000028310 - EC2 000028314. The minutes of the November 25, 2001, meeting of the Special Committee of the Board of Directors show that the Board approved the Enron Corp. Retention Plan to retain critical and key employees through the transitional period. EC2 000027122 - EC2 000027128. The number of employees to be included in such plan was 1,350 and the value was capped at \$115 million. It is unclear whether this plan was implemented or whether the Enron Corp. Retention Plan was the predecessor of the Enron Corp. Bonus Program.

practicable after approval of the Bonus Plan.<sup>1732</sup> The payments would be made pursuant to the new Enron Corp. Bonus Plan and the Enron Corp. Annual Incentive Plan. The new bonus plan was needed to pay bonuses to key employees who were not eligible to participate in the Enron Corp. Annual Incentive Plan.<sup>1733</sup> It was also contemplated that remaining eligible employees would receive bonus payments at the end of calendar year 2001. It is unclear whether additional payments were made.

The Enron Corp. Bonus Plan was executed as of November 28, 2001. The stated purpose of the Enron Corp. Bonus Plan was to recognize, motivate, and reward exceptional accomplishment of annual corporation objectives during calendar year 2001.<sup>1734</sup> Employees of Enron and its subsidiaries and affiliated companies who were not eligible to participate in the Enron Corp. Annual Incentive Plan, and who were designated by the Compensation Committee, were eligible to participate in the plan. Employees eligible for payments under the Performance Bonus Trust, the grantor trust established by Enron North America, discussed above, were not eligible to participate in the Enron Corp. Bonus Plan.

The Enron Corp. Bonus Plan had an award fund in the amount of not more than \$60 million, subject to downward adjustment by the Compensation Committee. Payments under the plan could be made in cash or in property having equivalent value. As a condition to receive payments under the plan, participants were required to execute an agreement requiring repayment of any amounts received if the participant voluntarily terminated employment prior to the expiration of 90 days following the receipt of any payment. Additionally, the agreement under the plan required a participant who makes repayments to Enron to pay an additional 25 percent of any payment as liquidated damages for terminating employment prior to the expiration of ninety days following receipt of payment. It appears that traders who received pre-bankruptcy payments were also required to execute such agreement. Sample agreements are included in Appendix D. Enron employees interviewed by Joint Committee staff maintained that a number of employees did not want to remain with Enron for the 90-day period and did not accept the bonus payment. The Plan was unfunded (i.e., no trust was created under the Plan).

The Bonus Plan and recommended payments were presented to the Compensation Committee on November 29, 2001. A total of up to \$60 million of payments pursuant to the Enron Corp Bonus Plan and the Enron Corp. Annual Incentive Plan were approved.<sup>1735</sup> It was also approved that management was authorized to modify the list of employees and payment amounts as deemed appropriate, and it was confirmed that any awards to employees subject to

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<sup>1732</sup> Attachment to the minutes of the November 28, 2001, Special Meeting of the Board of Directors. EC2 000028310. The attachment is included in Appendix D.

<sup>1733</sup> Payments under the Enron Corp. Annual Incentive Plan could only be made to Section 16 executives.

<sup>1734</sup> EC2 000019658 - EC2 000019660.

<sup>1735</sup> Minutes of the Compensation Committee, at 1 (Nov. 29, 2001). EC2 000026930 - EC2 000026946.

Section 16 of the Securities Exchange Act of 1934 would be presented for approval by the Committee prior to such awards being made. At the November 29, 2001, meeting, payment to one Section 16 officer was approved.

The Board of Directors was advised that Weil, Gotshal, and Manges commented that it was not a legal decision to implement this type of plan, but that it was an issue of business judgment that could be second-guessed.<sup>1736</sup> Weil Gotshal thought, that based on Enron's analysis of the criticality of personnel and the need to protect key personnel, it was a compensation design for which reasonable justification existed.<sup>1737</sup> The minutes of the November 29, 2001, Compensation Committee meeting state that Towers Perrin confirmed that the approved payments were consistent with industry practices and with the past practices of Enron to retain key employees.

According to Towers Perrin, awards were equal to about 90 percent of the bonus for the prior year.<sup>1738</sup> Many current and former employees interviewed by Joint Committee staff stated that payments were 100 percent of the year 2000 bonus.

Recipients of these bonus payments interviewed by Joint Committee staff stated that the bonus payments to the nontraders were made in cashier's checks (net of payroll taxes) and were paid on the Friday preceding Enron's bankruptcy filing. The comments of one individual interviewed by the Joint Committee staff indicated that there was an air of secrecy involving the payments. Other individuals who received bonuses said that it became known that the payments were forthcoming and individuals waited in the office for the payments. The Joint Committee staff asked Enron why the payments were made in cashier's checks. According to Enron, the bonuses were paid in cashier's checks "to effect the retention strategy approved by the Compensation Committee as soon as possible."<sup>1739</sup>

#### Enron's response for requests for information

The Joint Committee staff asked Enron several questions about the pre-bankruptcy payments, including how it was determined who would be entitled to the payments and the amount of the payments. Enron responded that various management team(s) of each business unit reviewed the critical efforts that would need to be maintained to increase value for creditors going forward.<sup>1740</sup> Enron stated that the "90 Day Payments" to certain key management and employees were based on the following criteria: the extent to which the employees' skills were

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<sup>1736</sup> Attachment to the minutes of the November 28, 2001, Special Meeting of the Board of Directors. EC2 000028310. The attachment is included in Appendix D.

<sup>1737</sup> *Id.*

<sup>1738</sup> Letter from Towers Perrin to Dr. Charles LeMaistre dated December 3, 2001. EC2 000028641. The letter is included in Appendix D.

<sup>1739</sup> EC 002679699.

<sup>1740</sup> Ecu000077383. Company response received January 13, 2003.

critical to business, marketable skills, trust factor with Enron, specialized skills, replaceability/cost of outside procurement (by consultants, etc.), multiskilled, and institutional knowledge.<sup>1741</sup> Enron provided a list of employees who received payments.<sup>1742</sup> See Appendix D for the list. The list included approximately 584 employees for payments totaling approximately \$104.6 million. Additional information provided by Enron states that 490 employees received key employee bonuses totaling \$50.404 million, which were paid from general company assets.<sup>1743</sup> Trader/Dynegy bonuses were paid to 67 employees totaling \$46.074 million, which were made from the trust discussed above.<sup>1744</sup> In addition, 27 Canadian employees received bonuses totaling \$8 million, which were paid by Enron Canada Corp.<sup>1745</sup> The payments ranged from \$2,500 to \$8 million. It appears that three employees terminated employment with Enron before the end of the 90-day retention period.<sup>1746</sup> In each of the three cases, Enron indicated that repayment of the bonus has been demanded, but the employee disputes the obligation and has not repaid.

### **Post-bankruptcy bonuses**

Bonuses have been awarded after Enron's bankruptcy filing.<sup>1747</sup> With the approval of the Bankruptcy Court, Enron implemented the Key Employee Retention Program ("KERP") to provide an employment incentive for certain existing and newly hired employees deemed essential to the successful liquidation of Enron assets, divestiture of certain non-core businesses, restructuring of profitable core businesses, and management of litigation and government investigations.<sup>1748</sup> As approved by the court, the KERP provides for the following: retention

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<sup>1741</sup> Ecu000077383. Company response received January 13, 2003.

<sup>1742</sup> Ecu000077384 - Ecu000077395. Company response received January 13, 2003.

<sup>1743</sup> EC 002679698.

<sup>1744</sup> EC 002679698.

<sup>1745</sup> EC 002679698.

<sup>1746</sup> Ecu000077396. Company response received January 13, 2003. Information regarding individuals who terminated employment with Enron before completing the 90-day service requirement is included in Appendix D.

<sup>1747</sup> On December 20, 2001, the Compensation Committee ratified a retention program to be used for bankrupt companies. Minutes to the Meeting of the Compensation Committee, at 3 (Dec. 20, 2001). EC2 000028575 - EC2 000028578; EC2 000028654. The Joint Committee staff was not provided minutes of meetings held after December 2001; therefore, it is unclear whether other post-bankruptcy retention plans were considered.

<sup>1748</sup> Enron's motion for approval of the KERP, dated March 29, 2002, and the Bankruptcy Court's order approving the KERP, dated May 8, 2002. The motion and order also provided for indemnification of officers and directors for claims related to their post-bankruptcy-petition services, to the extent not covered by insurance, and treatment of costs related thereto as priority administrative expenses.

payments, liquidation incentive payments, and severance benefits.<sup>1749</sup> Employees are not permitted to participate in the retention payment program and the liquidation incentive program simultaneously. The KERP is effective March 1, 2002, through February 28, 2003.

Under the retention payment program, employees are entitled to payments of a percentage of base salary for continued employment during each quarter ending May 31, 2002, August 31, 2002, November 30, 2003, and February 28, 2003, as long as the employee neither resigns nor is involuntarily terminated for cause during the quarter. The program was expected to cover up to 1,285 employees. Payments up to a total of \$40 million can be made under the program.

The liquidation incentive program is intended to correlate incentive payments to performance for employees involved in the liquidation of Enron's trading assets and certain non-core businesses between March 1, 2002, and February 28, 2003. The amount payable under the program is determined as a percentage of \$1 billion increments of the cash collected from the liquidation of assets, with a threshold collection amount of \$500 million. The percentage is .5 percent of collections from \$500 million to \$3 billion, 1 percent of collections over \$3 billion up to \$6 billion and 1.5 percent of collections over \$6 billion up to \$9 billion, for a maximum amount of \$90 million. The minimum aggregate amount payable is \$7.4 million.

The severance benefit program provides severance benefits for about 850 employees not eligible to participate in either of the other programs and about 700 employees eligible under the retention payment program, whose severance benefits will be offset by any retention payments received. Severance benefits consist of two weeks of base salary for each year or partial year of the employee's total service, with a minimum of \$4,500 and a maximum of eight weeks of base salary. The maximum amount of severance benefits for employees not eligible for the other programs is \$7 million; the maximum amount of severance benefits for employees also covered by the retention is \$500,000. The KERP was later amended to reduce the amount available for severance benefits by \$1.3 million in order to pay divestiture bonuses to certain employees in connection with the sale of the Enron Metals and Commodity Corporation.

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<sup>1749</sup> In addition to approval of the KERP, the motion also requested approval to waive the right to seek recovery from 237 potential KERP participants (150 retention participants, 37 liquidation incentive participants, and 50 severance benefit participants) of payments made before the filing of Enron's bankruptcy petition, which were scheduled to vest on February 28, 2002. These payments were subject to challenge as preference payments or fraudulent transfers under bankruptcy law. Enron proposed to release any claim for disgorgement of these payments by a participant if the participant would agree to remain employed by Enron until August 31, 2002 (or an earlier termination of employment without cause).



### **3. Special compensation arrangements**

#### **In general**

While executive compensation at Enron generally included base pay, bonus and long-term incentive, 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. The Project Participation Plan is discussed below.

Enron also had arrangements for a small number of employees or in some cases just one employee. For example, 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.<sup>1750</sup> A few employees received loans from Enron and had split dollar life insurance policies. These arrangements are discussed in further detail below. As discussed below in further detail, Enron purchased two annuities from Kenneth L. Lay and his wife as a part of his compensation package for 2001. Certain executives were allowed to exchange interests in plans for large cash payments or stock options and restricted stock grants.

#### **Project Participation Plan**

##### **In general**

On September 23, 1993, Enron Development Corporation adopted the Enron Development Corp. Project Participation Plan. The Project Participation Plan was used for international developers and other employees working on international projects. The Enron Development Corp. Project Participation Plan was amended and restated effective January 1, 1996; this restatement replaced the prior plan originally effective January 1, 1993.<sup>1751</sup> All projects were not subject to the restated plan. Generally, projects for which an incentive payment was made with respect to an event occurring on or before December 31, 1995, were not subject to the restated plan, but continued to be governed by the terms of the plan in effect prior to the January 1, 1996, restatement. The Project Participation Plan was principally used in the 1990's when Enron was competing for various international projects. According to the terms of the plan, the plan terminated as of December 31, 2000; however, payments for awards granted before 2001 could be made from the plan after such date.

One former Enron executive told the Joint Committee staff that the Project Participation Plan was terminated because it was viewed as not in the interests of the shareholders. He indicated that if someone had an interest in a project, and the project was not likely to be a good project, it was hard to move people off the project, because they had a stake in it. Every time

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<sup>1750</sup> As part of the executive's separation from Enron, he assumed and became financially responsible for the 1/8 fractional interest in the jet aircraft Hawker 800. EC 002634790.

<sup>1751</sup> The Project Participation Plan was amended as of February 1, 1997, and as of January 1, 1998.

Enron wanted to move someone off a project, compensation had to be renegotiated. He said that the Project Participation Plan made staffing inflexible, time consuming, and difficult.

In the late 1990's, the name of the Project Participation Plan and all references to "Enron Development Corp." were changed to "Enron International, Inc.,"<sup>1752</sup> thus changing the name of the plan to the Enron International, Inc. Project Participation Plan. The stated purpose of the plan was to provide a means whereby certain selected employees could develop a sense of proprietorship and personal involvement in the development and financial success of Enron International, Inc., to attract and retain employees of outstanding competence and ability, and to encourage them to devote their best efforts to the business of Company, and to reward them for outstanding performance benefiting Enron and its stockholders.<sup>1753</sup>

Projects under the Project Participation Plan included:<sup>1754</sup>

- Bitterfeld;
- Centragas - Columbia Pipeline;
- Dabhol India - Phase I;
- Latvian Storage;
- Mostransgaz - Optical Disk Imaging;
- Severnaya Compressor Station;
- Subic Bay Power Plant;
- Yucatan (Merida);
- YPFB - Joint Venture;
- Volgograd Compressor;
- Italy - Saras;
- Poland;
- Puerto Rico;
- Panama;
- Puerto Caldera - Costa Rica;
- Sao Paulo - Brazil;
- Ecuador;
- CEMIG - Brazil;
- YPFB - Capitalization;
- CEMAT-Mato Grosso - Bolivia;
- Enersul-Mato Grosso Do Sul;
- LNG Commercial Development;

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<sup>1752</sup> The change was executed in August 1999, to be effective February 1, 1997. By error or omission, the Board did not adopt the First Amendment on or about February 1, 1997, which would have changed the name of the plan. EC2 000019327.

<sup>1753</sup> Project Participation Plan document. EC 000767561.

<sup>1754</sup> This is not intended to be an inclusive list. Other projects may have also been under the Project Participation Plan.

- Israel Marketing;
- Mozambique - Integrated;
- Oman;
- Qatar;
- Jordan Marketing;
- E. Java - Indonesia;
- Ilijan Philippines Gas;
- China-Hainan;
- Vietnam;
- E. Kalamantan;
- Thailand IPP LPG;
- Song Yu;
- Hainan LPG Storage Terminal;
- Dong Fong Natural Gas Reserve;
- Dabhol India - Phase II;
- Multan - Pakistan;
- Dabhol India - Phase I - Implementation;
- India Marketing; and
- Dominican Republic.<sup>1755</sup>

All employees were eligible to be selected for participation in the Project Participation Plan. Under the plan, employees would be granted participation interests in particular projects. Participation interests would be expressed as a percentage of the value of the project. Payments with respect to a project would be triggered upon the occurrence of a plan payment date, which generally occurred upon (1) financial closure of the project, (2) operation of the project, or (3) the sale or transfer of the project. The incentive payment generated upon a payment date would be allocated among the participants who had a participation interest in the project at such time based upon the relative size of their participation interests.

Typically, awards would be paid 50 percent upon financial closure of the project and 50 percent upon operation of the project, as defined by the Project Participation Plan. The plan also included provisions which provided how participants would be compensated in the event that the particular project was sold or transferred before the achievement of financial closure or commercial operation. Under the Project Participation Plan, the total participation interests in any given projects could not exceed 10 percent. The financial closure payment would generally be five percent of the net project value; the commercial operation payment would generally be 10 percent of net project value reduced by any prior financial closure payment paid or payable. Some projects were specifically excluded from the Project Participation Plan and certain projects had special features under the plan. The plan defined how the value of the project was determined and included provisions for cases in which the value was disputed.

Payments would be made in cash, in shares of common stock, or in a combination of cash and shares. The amendment to the Project Participation Plan effective January 1, 1998, allowed

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<sup>1755</sup> EC 000767596 - EC 000767597.

participants in certain projects (Italy and Poland) to elect to receive payments in cash and stock options. Such options were granted under the 1994 Stock Plan.

The Project Participation Plan was administered by a committee which was charged with selecting participants in the plan and determining the participation interests to be awarded each participant. According to the plan document, the plan constituted an unfunded, unsecured obligation of Enron to make payments of incentive compensation from its general assets in accordance with the plan.

Awards under the Project Participation Plan could vary greatly. Attention has been given to the plan because of the large amounts that were awarded under the plan and because the method used to determine award amounts, a percentage of the estimated project value, could create an incentive to overstate the value of projects. Awards for top developers could be as high as \$5 million or \$7 million for single projects.<sup>1756</sup>

Former and current employees interviewed by Joint Committee staff regarding the magnitude of the payments responded that such large payments could be attributable to years of work on a particular project. While many executives greatly benefited from Project Participation Plan awards, all awards under the plan were not very large; some awards were less than \$10,000.<sup>1757</sup>

### Deferrals

The Project Participation Plan was amended effective February 1, 1997, to allow deferral of payments under the plan from the time they would otherwise be paid. A participant could elect to defer receipt of a portion of any plan payment that was to be made in cash to a date that is after the participant's termination of employment with Enron. Up to 100 percent of payments could be deferred. Payments deferred by a participant would be credited to the participant's deferral account as of the date that the participant would have received such payment under the plan had such payment not been deferred.

Deferrals were credited with Enron's mid-term cost of capital for the period. For 2001, deferrals were to earn a 7.4 percent annual rate of return.<sup>1758</sup> Deferral accounts would be paid to participants in the event of retirement, disability, death, or termination of employment. Payments could also be requested in the event of a hardship.

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<sup>1756</sup> EC 000102338 (Project Puerto Rico); EC2 000032354 (Project Puerto Rico). The Joint Committee staff does not have a list of all payments, so it is not clear whether these were the highest awards.

<sup>1757</sup> EC2 000032354.

<sup>1758</sup> Participant election form for 2001 deferrals. EC2 000018648.

Documents provided by Enron show that there were 11 participants who deferred amounts under the Project Participation Plan.<sup>1759</sup> Enron documents show that as of December 31, 1999, there were five participants with total account balances of \$450,054.<sup>1760</sup> As of December 31, 2000, there were 10 participants with accounts balances totaling \$7.9 million.<sup>1761</sup> As of December 31, 2001, the Project Participation Plan had 11 participants with account balances totaling \$9.4 million.<sup>1762</sup>

#### Project Participation Plan trade-outs

In 1997, Enron allowed certain participants in the Project Participation Plan to trade their interests in the plan for stock options and restricted stock, thus allowing their compensation to grow as Enron's stock price increased. On February 10, 1997, the Compensation Committee approved the trade-out of fixed interests owned by five Enron International executives in the Project Participation Plan by providing \$10 million in stock options and \$10 million in restricted stock. The trade-out was reported by the Board of Directors on February 11, 1997. According to IRS information, in addition to the five executives referred to above, seven other employees agreed to trade-out their participation interests in the Project Participation Plan for grants of stock options and restricted stock later in August 1997.<sup>1763</sup>

According to IRS documents, the value of the stock options and restricted stock conveyed to the 12 employees totaled approximately \$22 million at the date of grant.<sup>1764</sup> Also according to IRS information, the fair market value of the options granted to two executives totaled 74 percent of the total value conveyed. Stock options were valued using the Black-Scholes valuation method. Restricted stock was assigned a value equal to the closing price of the stock on the date of the exchange.

Enron treated the stock options and restricted stock attributable to the trade-out of the Project Participation Plan interests the same as options and restricted stock are treated generally for Federal tax purposes. That is, no income was reported to employees at the time of the trade-out/grant. Rather, income was reported at the time of exercise (in the case of options) and when

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<sup>1759</sup> EC 000768136. This list is not all participants in the Project Participation Plan, but only those who elected to defer payments.

<sup>1760</sup> EC 000768234.

<sup>1761</sup> EC 000768234.

<sup>1762</sup> EC 000768234.

<sup>1763</sup> The additional trade-outs do not appear to be reflected in the Compensation Committee meeting minutes.

<sup>1764</sup> Other IRS documents state that the fair market value of the stock options and restricted stock conveyed to the 12 employees totaled approximately \$26.8 million; \$11.6 million on the February 10, 1997, grant date, and \$15.2 million on the August 11, 1997, grant date. While these two amounts do not reconcile either amount is substantial.

the restrictions lapse (in the case of restricted stock). Similarly, Enron had a corresponding income tax deduction at such times. In the case of restricted stock, the deduction is equal to the fair market value of the stock multiplied by the number of shares with respect to which restrictions lapsed. In the case of options, the deduction is equal to the difference between the fair market value of the stock at the time of exercise and the exercise price.

Because the compensation expense was deducted when the options were exercised and the restrictions lapsed, and the stock price continued to rise, Enron's deduction was much larger than the deduction would have been if Enron had paid the awards in cash or unrestricted stock as originally contemplated by the arrangement. According to IRS documents, due to the increase in Enron stock, amounts deducted by Enron, and reported as compensation to the individuals, were about \$82 million more than the value at the grant dates.<sup>1765</sup> According to the IRS, two individuals reported more than 90 percent of the spread.<sup>1766</sup> The Joint Committee staff did not discover any information indicating whether the potential increase in the deduction was a motivating factor behind the trade-outs.

#### **4. Board of Directors compensation**

##### **In general**

Nonemployee director compensation at Enron was composed of annual fees and equity grants. For the years 1999 through 2001, each nonemployee director received an annual service fee of \$50,000 for serving as a director. This was an increase from the \$40,000 fee paid in 1995 through 1998. In 1994 and the beginning of 1995, the annual service fee was \$22,000. Additional fees for serving on committees were eliminated effective May 2, 1995. Prior to the elimination of such fees, nonemployee directors were paid \$4,000 for serving on committees.

Committee chairs received an additional \$10,000 annually in 1999 through 2001, which was an increase from \$5,000 paid in 1995 through 1998, and \$4,000 paid in prior years. Meeting fees were \$1,250 for each Board of Directors and committee meetings attended. Before 1999, meeting fees for committee meetings were \$1,000. Enron periodically hired compensation

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<sup>1765</sup> Internal IRS Memorandum regarding EDC Participation Plan Stock Trade-Out dated February 22, 2002. An earlier IRS correspondence (dated January 25, 2002) stated that the deduction could exceed \$70 million.

<sup>1766</sup> In connection with the 1997 audit, IRS international examiners raised issues with respect to the trade-outs, including whether the grant or exercise date should be used for valuing the compensation for purposes of deductions, capitalizing costs by Enron, and determining service fee income to be reported by Enron Development Corp. The IRS concluded that there was authority for the taxpayer to use the grant date in determining the value of the trade-outs for certain purposes. The IRS also raised other issues related to the Project Participation Plan trade-outs, including whether the stock-based compensation spread was an ordinary and necessary business expense under section 83(h). For a discussion of international issues relating to the Project Participation Plan, see Part IV.D. of Part Three, above.

consultants, particularly Towers Perrin, to perform studies to determine if the level of compensation for nonemployee directors was competitive with market practices.

Directors' fees could be paid in cash, deferred under the Enron Corp. 1994 Deferral Plan, or received in a combination of phantom stock and stock options in lieu of cash under the Enron Corp. 1991 Stock Plan. As discussed below, beginning in 1997, directors were required to defer 50 percent of their annual service fee into the Phantom Stock Account of the 1994 Deferral Plan.

For 2000, total directors' fees (whether paid in cash, deferred, or paid in the form of phantom stock or stock options) were \$1.1 million, or an average of \$79,107 per nonemployee director. The average fee for nonemployee directors was \$86,829 in 1999 and \$63,500 in 1998. These averages do not include the value of stock options and phantom stock units annually granted to directors. Table 17 below shows totals fees paid in cash, deferred, or received in a combination of phantom stock units and stock options in lieu of cash for the years 1993 through 2000 for all nonemployee directors.<sup>1767</sup>

**Table 17.—Total Directors Fees for All Nonemployee Directors 1993 - 2000  
(Thousands of Dollars)**

<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>
\$551	\$481	\$601	\$701	\$813	\$889	\$1,172	\$1,107

### Deferrals

Beginning January 1, 1997, nonemployee directors were required to defer 50 percent of their annual service fee into the Phantom Stock Account of the 1994 Deferral Plan. Directors could elect to receive remaining fees (i.e., annual service fee has less mandatory deferrals) in cash, defer receipt of the fees to a later specified date under the 1994 Deferral Plan, or receive the fees in a combination of phantom stock units and stock options in lieu of cash under the 1991 Stock Plan.<sup>1768</sup> Before the mandatory deferral requirement was adopted in 1997, directors could elect to receive fees in cash, defer receipt of the fees to a later specified date under Enron's 1994 Deferral Plan, or receive the fees in a combination of phantom stock units and stock options in lieu of cash under Enron's 1991 Stock Plan. Prior to 1997, restricted stock was used instead of phantom stock units.

In some countries, deferrals into the 1994 Deferral Plan could create adverse tax consequences for the director. In August 1999, the Compensation Committee approved a change that upon notification by Enron management of the applicable international tax laws, a director could receive an award of phantom stock units under the 1991 Stock Plan in lieu of mandatory

<sup>1767</sup> 1994 through 2001 Enron Corp. Proxy Statements.

<sup>1768</sup> December 11, 2000, letter to members of the Board of Directors regarding deferral program opportunities. EC2 000018652.

deferrals into the Phantom Stock Accounts of the 1994 Deferral Plan. After such change, Lord Wakeham was allowed to receive phantom stock units in lieu of deferrals into the Phantom Stock Account.

Directors were required to annually complete election forms to make their deferral plan choices.<sup>1769</sup> Directors could elect to defer compensation annually in December prior to the year in which the compensation was earned and payable. Voluntary deferrals could be placed into the Flexible Deferral Account and/or the Phantom Stock Account at the director's discretion.<sup>1770</sup> Earnings on amounts invested in the Flexible Deferral Account or the Phantom Stock Account would be determined in the same way as all other 1994 Deferral Plan participants. Earnings on deferrals into the Flexible Deferral Account would be credited with cumulative appreciation and/or depreciation based on the market price of the chosen investments. Investments in the Phantom Stock Account were treated as if the participant purchased shares of Enron Corp. common stock at the closing price on the date of deferral. Deferral accounts would be paid as specified in the participant's election form during the first quarter of the year following the termination event (retirement, death, disability or termination).<sup>1771</sup> The 1994 Deferral Plan also provided an opportunity for in-service distributions.

Under the 2001 annual election form, in electing stock in lieu of fees, a director could choose a vesting period for phantom stock units between six and 60 months. Stock options (in lieu of the annual retainer fee) would be 100 percent vested on the grant date and have a ten-year term. Regular and special purpose deferrals could be elected.

Nonemployee directors were also eligible to participate in the deferral of stock options gains and deferral of restricted stock programs. The deferral of stock option gains program allowed deferrals to the 1994 Deferral Plan in lieu of receiving financial gains upon the exercise of stock options granted under an Enron Corp. stock plan. The deferral of restricted stock program allowed deferrals under the 1994 Enron Corp. Deferral Plan in lieu of the release of shares of restricted stock granted under an Enron Corp. stock plan. The programs are discussed in more detail in the nonqualified deferred compensation section of this Report.<sup>1772</sup>

During 2000, eight of the 13 eligible directors elected to defer fees under the 1994 Deferral Plan. In 2000, four directors elected to receive stock in lieu of fees in a combination of phantom stock units and stock options under the 1991 Stock Plan. In 1999, nine directors elected to defer fees under the 1994 Deferral Plan, while one director elected to receive stock in lieu of fees in a combination of phantom stock units and stock options according to the terms of the 1991 Stock Plan.

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<sup>1769</sup> *Id.*

<sup>1770</sup> *Id.*

<sup>1771</sup> *Id.*

<sup>1772</sup> *See* Part III.C.1, below.



In prior years, Enron maintained “Directors Deferral Plans.” Documents provided by Enron show that the Director Deferral Plans included HNG, InterNorth, and Enron.<sup>1773</sup> Documents provided by Enron show that there were approximately 29 participants in such plans. In prior years, directors also deferred into the HNG Deferral Plan and the 1985 Deferral Plan.

**Directors’ account balances**

On December 11, 2001, Enron sent letters to the Board members advising them of the status of their nonqualified deferred compensation.<sup>1774</sup> Distributions to deferral plan participants who were in pay status ceased as of November 30, 2001. Enron stated that after the first phase of the bankruptcy, it would begin to explore options with its creditors to seek approval to reinstate deferral plan payments, or to somehow otherwise restore the value lost to deferral plan participants. In general, claims under the deferral plans have the same status as Enron’s other unsecured general creditors, which are paid after the claims of secured creditors. Board members were informed that claims for deferral plan benefits should be made against Enron’s bankruptcy estate.

Nonemployee director balances in nonqualified deferred compensation plans as of November 30, 2001, are provided in Table 18, below.<sup>1775</sup>

**Table 18.–Nonemployee Director Balances in Nonqualified  
Deferred Compensation Plans (November 30, 2001)  
(Thousands of Dollars)**

	<b>Enron Corp. 1988 Deferral Plan</b>	<b>Enron Corp. 1994 Deferral Plan</b>	<b>Enron Directors Deferral Plan</b>	<b>HNG Deferred Income Plan</b>	<b>Total</b>
Robert Belfer	3,894	485	1,708		6,087
Norman Blake, Jr.		250	39		288
Ronnie Chan		2*			2*
John Duncan		*			*
Wendy Gramm		686			686
Robert Jaedicke		220	1,068	175	1,463
Charles LeMaistre		92			92
John Mendelsohn		3*			3*
Paulo Pereira		4*			4*

<sup>1773</sup> EC 000758146.

<sup>1774</sup> It is unclear whether such letters were sent to all nonqualified deferred compensation participants or just to Board members.

<sup>1775</sup> The information in the table was obtained from letters sent to directors by Enron informing them of their bankruptcy rights and the status of their deferred compensation. EC 000171608 - EC 000171674.

	<b>Enron Corp. 1988 Deferral Plan</b>	<b>Enron Corp. 1994 Deferral Plan</b>	<b>Enron Directors Deferral Plan</b>	<b>HNG Deferred Income Plan</b>	<b>Total</b>
William Powers		18			18
Frank Savage		3*			3*
Lord John Wakeham		*			*
Herbert Winokur		*			*
Joe Foy		176	484	46	706
Jerome Meyer		58			57
<b>Total</b>					9,411

\* Denotes that balance is relatively minimal because 100% invested in the Phantom Stock Account (value of Enron common stock at \$.26 per share).

### **Equity grants**

In addition to the fees discussed above, nonemployee directors were annually granted stock options and phantom stock units. Under the Enron Corp. 1991 Stock Plan, nonemployee directors were granted shares of phantom stock units and nonqualified options to purchase stock effective the Monday following the annual meetings of the shareholders. The number of shares of phantom stock units was equal to 50 percent of the prior year's average retainer fee divided by the stock price on the date of grant rounded to the next highest increment of ten. The number of stock options was equal to four times the number of shares of phantom stock units. In some years, additional stock options were granted.<sup>1776</sup> For 2001, each nonemployee director was granted 460 phantom stock units and 11,175 stock options.<sup>1777</sup> The awards were based on an average 2000 retainer fee of \$52,871 and a May 7, 2001, closing stock price of \$58.04. During 2000, each nonemployee director received 360 phantom stock units and options to purchase 10,775 shares according to the terms of the 1991 and 1994 Stock Plans. Phantom stock units and options granted in 2000 and 2001 vest over a five-year period. The Senate Permanent Subcommittee on Investigations computed that for 2000, total stock/option value when granted was \$250,626 per director.<sup>1778</sup> Table 19, below, shows the number of restricted stock shares, phantom stock units, and stock options received by directors in the years 1993 through 2001.

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<sup>1776</sup> In most recent years (2000 and 2001), nonemployee directors were granted stock options equal to four times the number of phantom stock units plus 9,335 options.

<sup>1777</sup> Letter from Mary K. Joyce to Charles A. LeMaistre dated May 11, 2001, regarding May 2001 director awards. EC 000257935.

<sup>1778</sup> Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate, *The Role of the Board of Directors in Enron's Collapse*, May 7, 2002, Exhibit #35a.

**Table 19.—Directors’ Restricted Stock, Phantom Stock, and Stock Options  
(1993-2001)**

	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
Restricted stock shares	480	490	450						
Phantom stock units				480	510	400	560	360	460
Stock options	1,920	1,960	1,800	1,920	2,040	1,600	8,240	10,775	11,175

The 1991 Stock Plan permitted nonemployee directors whose ownership of Enron Corp. common stock would result in a materials conflict of interest for business, employee, or professional purposes, to submit an opinion of counsel of such fact to the Compensation Committee with a request that such nonemployee director not be eligible to receive further grants under the 1991 Stock Plan and to forfeit all outstanding grants made to such nonemployee director until such time as the Committee is satisfied that such conflicts have been removed or no longer apply. In December 1998, Dr. Gramm provided to the Compensation Committee a written opinion of counsel indicating that her continued participation in the 1991 Stock Plan could be considered a conflict of interest. Dr. Gramm chose not to receive further grants under the 1991 Stock Plan, and therefore, did not receive stock options or phantom stock units in 1999 or 2000. Instead, on behalf of Dr. Gramm, Enron contributed the value of phantom stock units and stock options into her Flexible Deferral Account under the 1994 Deferral Plan.

Table 20, below, represents the value of directors compensation as of August 21, 2002, and July 31, 2001, from documents provided by Enron.<sup>1779</sup> The top number shows the value as of August 21, 2000 (when the stock value was \$86), while the bottom number shows the value as of July 31, 2001 (when the stock value was \$45).

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<sup>1779</sup> EC 000257928 - EC 000258305. The values as of August 21, 2000, were published by the Permanent Subcommittee on Investigations. Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate, *The Role of the Board of Directors in Enron’s Collapse*, May 7, 2002, Exhibit #35b.

**Table 20.—Value of Directors Compensation as of August 21, 2000 and July 31, 2001  
(Thousands of Dollars)**

	<u>Stock Option</u> as of 8/21/00 as of 7/31/01	<u>Restricted/ Phantom Stock</u> as of 8/21/00 as of 7/31/01	<u>Total Equity Value</u> as of 8/21/00 as of 7/31/01	<u>Deferral Plan Account Balance</u> <sup>1780</sup> as of 6/30/00 as of 6/30/01
Charles LeMaistre	\$3,111 860	\$162 72	\$3,273 932	\$263 242
Robert Jaedicke	3,111 860	162 72	3,273 932	1,670 1,809
Wendy Gramm	N/A	N/A	N/A	699
John Duncan	3,111 860	162 72	3,273 932	170 149
Ronnie Chan	1,295 N/A	213 N/A	1,508 N/A	357 N/A
Norman Blake	2,809 330	266 142	3,074 472	449 409
Robert Belfer	2,479 860	162 72	2,641 932	5,900 6,414
John Mendelsohn	516 61	69 49	586 110	113 141
Jerome Meyer	852 N/A (resigned)	178 N/A	1,030 N/A	247 N/A
John Urquhart	2,479 N/A	162 N/A	2,641 N/A	962 N/A
Lord Wakeham	1,472 413	208 119	1,680 532	149 115
Herbert Winokur, Jr.	2,479 860	162 72	2,641 932	170 149
Paulo V. Ferraz Pereira	140 0	53 45	193 45	39 74
Frank Savage	140 0	31 49	170 49	46 65

**Miscellaneous**

Liability insurance was provided to directors with a maximum indemnification of \$300 million for sums that they become legally obligated to pay for claims made because of a wrongful act for which Enron does not provide reimbursement. Directors were also provided

<sup>1780</sup> The deferral account balances are reflected as of June 30, 2000, and June 30, 2001. The top number is the value as of June 30, 2000; the bottom number is the value as of June 30, 2001. The account balance reflects combined balances under the 1994 Deferral Plan, 1985 Deferral Plan and Director's Deferral Plans.

coverage in the case of an accident resulting in death on a company aircraft and could participate in Enron's matching gift program under which Enron would match charitable contributions by employees.

## C. Discussion of Specific Issues

### 1. Nonqualified deferred compensation plans

#### Present law

##### In general

Deferred compensation occurs when the payment of compensation is deferred for more than a short period after the compensation is earned (i.e., the time when the services giving rise to the compensation are performed). Payment is generally deferred until some specified event, such as the individual's retirement, death, disability, or other termination of service, or until a specified time in the future. Nonqualified deferred compensation plans do not receive the favored tax treatment afforded to qualified retirement plans under the Code.<sup>1781</sup>

ERISA contains exemptions from its requirements for certain nonqualified deferred compensation arrangements. Most nonqualified deferred compensation arrangements are designed to fall within these ERISA exemptions.

A "top-hat plan" is the term generally used for certain nonqualified deferred compensation plans that are exempt from most ERISA requirements. The ERISA exemption applies to a plan that is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees. ERISA does not provide statutory definitions of "select group," "management," or "highly compensated employees," and the Department of Labor has not issued regulations defining these terms.<sup>1782</sup> Employees sometimes claim ERISA protection (such as vesting or funding) for benefits under a nonqualified deferred compensation plan. However, most nonqualified deferred compensation arrangements are intended to fall under the top-hat exemption.

A top-hat plan is exempt from the ERISA requirements relating to participation and vesting, funding, and fiduciary responsibility.<sup>1783</sup> A top-hat plan is not exempt from the reporting and disclosure requirements or the administration and enforcement provisions under ERISA. However, under Department of Labor regulations, the reporting and disclosure requirements are satisfied by (1) a one-time filing with the Secretary of Labor of a statement that includes the name and address of the employer, the employer's tax identification number, a declaration that the employer maintains a plan or plans primarily for the purpose of providing

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<sup>1781</sup> This favorable treatment includes: (1) a current deduction for the employer's contributions; (2) assets of the plan set aside in a trust for the exclusive benefit of the employees; (3) tax-exempt status of the trust; and (4) no income inclusion by employees until distributions are received (i.e., constructive receipt does not apply).

<sup>1782</sup> The Code definition of "highly compensated employee" (sec. 414(q)) has not been applied for this purpose.

<sup>1783</sup> ERISA secs. 201(2), 301(a)(3), and 401(a)(1).

deferred compensation for a select group of management or highly compensated employees, and a statement of the number of such plans and the number of employees in each, and (2) providing plan documents, if any, to the Secretary of Labor upon request.<sup>1784</sup>

### **Types of nonqualified deferred compensation arrangements**

Nonqualified deferred compensation arrangements are contractual arrangements between the employer and the employee, or employees, covered by the arrangement. Such arrangements are structured in whatever form achieves the goals of the parties; as a result, they vary greatly in design. Considerations that may affect the structure of the arrangement are the current and future income needs of the employee, the desired tax treatment of deferred amounts, and the desire for assurance that deferred amounts will in fact be paid.

In the simplest form, a nonqualified deferred compensation arrangement is merely an unsecured, unfunded promise to pay a stated dollar amount at some point in the future. However, in most cases, such a simple arrangement does not meet the needs of the parties to the arrangement; thus, the typical nonqualified defined compensation arrangement is more complicated and may involve a funding vehicle or other mechanism to provide security to the employee.

Some nonqualified deferred compensation arrangements are structured as formal plans with formal governing documents. In such cases, the plan generally specifies the employees covered by the plan. In other cases, nonqualified deferred compensation may be provided for under the terms of an individual's employment contract and apply only to that particular individual.

A nonqualified deferred compensation arrangement may provide for the deferral of base compensation (i.e., salary), incentive compensation (e.g., commissions or bonuses), or supplemental compensation. The arrangement may permit the employee to elect, such as on an annual basis, whether to defer compensation or to receive it currently, similar to a salary reduction or cash-or-deferred arrangement under a qualified employer plan. Alternatively, the arrangement may provide for mandatory deferral of compensation.<sup>1785</sup>

A nonqualified deferred compensation arrangement may be structured as an account for the employee (similar to a defined contribution or individual account plan) or may provide for specified benefits to be paid to the employee (similar to a defined benefit pension plan). Under an account structure, depending on whether the arrangement is unfunded or funded, a hypothetical or actual account is maintained for the employee, to which specified contributions and earnings are credited. The benefits to which the employee is entitled are based on the amount in the account. Under a defined benefit structure, the terms of the nonqualified arrangement specify the amount of benefits (or formula for determining benefits) to be paid to the employee.

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<sup>1784</sup> 29 CFR 2520.104-23.

<sup>1785</sup> Such plans are discussed in Part II.A., above.

## **Timing of income inclusion for the individual -- in general**

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine,<sup>1786</sup> the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts and nonqualified annuities.<sup>1787</sup>

The following general rules regarding the taxation of nonqualified deferred compensation result from these provisions. In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received (i.e., when it is paid or otherwise made available). If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

## **Timing of income inclusion under an unfunded arrangement**

### **In general**

As mentioned above, in the case of an unfunded nonqualified deferred compensation arrangement, amounts are includible in gross income when the amount is actually or constructively received.

An amount is constructively received if it is credited to an individual's account, set apart, or otherwise made available to the individual so that he or she can draw on it at any time, even if the individual has not actually received the income.<sup>1788</sup> Income is not constructively received if there is a substantial limitation or restriction on the individual's ability to withdraw it. A requirement that the individual provide advance notice in order to withdraw (or receive) the income is not considered a substantial limitation on the ability to withdraw it. However, a requirement that the individual relinquish a valuable right in order to withdraw the income is a substantial limitation.

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<sup>1786</sup> See, e.g., *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174.

<sup>1787</sup> Secs. 402(b) and 403(c). For a detailed discussion of the background of the taxation of nonqualified deferred compensation, see Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation* (JCX-29-02), April 7, 2002.

<sup>1788</sup> Treas. Reg. sec. 1.451-2(a).



For years before 1982, the constructive receipt doctrine applied to amounts payable under a qualified retirement plan.<sup>1789</sup> Various IRS revenue rulings held that amounts held within a qualified retirement plan were not constructively received if, in order to receive a distribution, the participant was required to discontinue participation in the plan (either permanently or for a period of at least six months), forfeit a portion of his or her benefits, or lose past service credits or job retention rights in the case of reemployment.

A variety of methods are used under nonqualified deferred compensation arrangements to provide some flexibility to individuals covered by the arrangement in obtaining distributions while attempting to avoid constructive receipt. For example, nonqualified deferred compensation arrangements frequently provide that distributions can be made in the event of financial hardship. Another technique sometimes used is to provide that the employer, plan administrative committee, or similar body can make distributions in its sole discretion. Another mechanism is to provide that withdrawals can be made at any time, but that a portion of the amount withdrawn, such as 10 percent, is forfeited to the employer if the distribution is made before some stated time or event. Other ways to try to avoid constructive receipt may also be used.

### Subsequent elections

While it is generally accepted that, to avoid constructive receipt, the election to defer compensation must be made before the performance of services giving rise to the compensation, the required timing of subsequent elections to avoid constructive receipt is unclear. Revenue Procedure 71-19 sets guidelines for obtaining an advance ruling from the IRS regarding the application of the doctrine of constructive receipt to unfunded nonqualified deferred compensation arrangements.<sup>1790</sup> Under the revenue procedure, a ruling letter will be issued only if the plan meets certain requirements. If the plan provides for an election to defer payment of compensation, such election must be made before the beginning of the period of service for which the compensation is payable, regardless of the existence in the plan of forfeiture provisions. In addition, if any elections, other than the initial election may be made by an employee subsequent to the beginning of the service period (i.e., a “subsequent election”), the plan must set forth substantial forfeiture provisions that must remain in effect throughout the entire period of deferral.<sup>1791</sup> Revenue Procedure 92-65 amplified Revenue Procedure 71-19 and clarified that the period of service is generally the employee’s taxable year for cash basis, calendar year taxpayers, with exceptions for new plans and new participants in existing plans.<sup>1792</sup>

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<sup>1789</sup> Before 1982, amounts were includible in income when distributed or made available. Since 1982, qualified retirement plan benefits are includible in income when distributed.

<sup>1790</sup> 1971-1 C.B. 698, amplified by Rev. Proc. 92-65, 1992-2 C.B. 428.

<sup>1791</sup> Revenue Procedure 71-19 provides that a substantial forfeiture provision will not be considered to exist unless its condition imposes upon the employee a significant limitation or duty which will require a meaningful effort on the part of the employee to fulfill and there is a definite possibility that the event which will cause the forfeiture could occur.

<sup>1792</sup> Rev. Proc. 92-65, 1992-2 C.B. 428.

Revenue Procedure 92-65 further provides that, for an advance ruling, the plan must define the time and method for payment of deferred compensation for each payment event and also states that a plan may provide for the payment of benefits in the case of an unforeseeable emergency.<sup>1793</sup> Courts have sometimes taken a more lenient approach than the IRS ruling position in allowing subsequent elections.

Various courts that have dealt with the issue of subsequent elections have held that a subsequent election to change the timing or manner of payment of deferred compensation does not result in constructive receipt. Because each decision is fact specific, there is no case which can be cited for the rule that, unequivocally, constructive receipt does not result from the making of a subsequent election. While the holding of each case legally applies only to its specific facts, there are several cases that are principally cited for support of permitting subsequent elections without triggering constructive receipt.

In *Veit v. Commissioner* (known as “*Veit I*”), a subsequent election made after the performance of services was complete did not result in constructive receipt.<sup>1794</sup> At the time of the subsequent election, however, the amount due was not ascertainable. Additionally, the election was bilateral and was mutually beneficial to both the employer and the employee. In *Commissioner v. Oates*, constructive receipt did not apply when the taxpayer was given the right to elect to receive payments as provided in an original contract or to have them paid in monthly installments over a period not to exceed 15 years.<sup>1795</sup> While all services necessary to earn the payments had been performed, the final amount to be paid was not determinative. *Veit I* and *Oates* are relied upon by taxpayers for the position that constructive receipt does not result when a subsequent election is made before payment is due and the amount of compensation to be paid is ascertainable.<sup>1796</sup>

Taxpayers also rely on other decisions for the position that subsequent elections do not result in constructive receipt. In *Martin v. Commissioner*, a change in the payment schedule did not result in constructive receipt.<sup>1797</sup> In *Martin*, however, the election to receive either a lump-sum distribution or installment payments could only be made before the amounts became due and fully ascertainable. In *Veit v. Commissioner* (known as “*Veit II*”), a subsequent election

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<sup>1793</sup> The other requirements for an advance ruling are that the plan must provide that participants have the status of general unsecured creditors of the employer and that the plan constitutes a mere promise by the employer to make benefit payments in the future. If the plan refers to a trust, it must conform to the terms of Revenue Procedure 92-64, 1992-2 C.B. 422, *modified in part by* Notice 2000-56, 2000-2 C.B. 393.

<sup>1794</sup> *Veit v. Commissioner*, 8 T.C. 809 (1947).

<sup>1795</sup> *Commissioner v. Oates*, 207 F.2d 700 (7<sup>th</sup> Cir. 1953).

<sup>1796</sup> The IRS acquiesced in both *Veit I* and *Oates*.

<sup>1797</sup> *Martin v. Commissioner*, 96 T.C. 814 (1991).

made after the amount of payments was determinable, but before payment was due, did not result in constructive receipt.<sup>1798</sup> In *Veit II*, the subsequent election was bilaterally negotiated.

Even though the IRS has attempted to enforce its position on constructive receipt, it appears that courts generally have been hesitant to apply the doctrine of constructive receipt. Many practitioners rely on case law for the position that subsequent elections to change the timing and manner of payment do not result in constructive receipt. It is not uncommon for plans to allow participants to make some type of subsequent election to change the time or manner of payment.

### **Income inclusion under a funded arrangement**

As stated above, if a nonqualified deferred compensation arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture. An arrangement is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property.<sup>1799</sup>

Under section 83, the excess of the fair market value of property received in connection with the performance of services over the amount, if any, paid for the property is includible in the income of the person performing the services. Income is generally includible for the year in which the service provider's right to the property is either transferable or is not subject to a substantial risk of forfeiture. The amount includible in income is based on the fair market value of the property at that time.<sup>1800</sup>

Section 83 applies to a transfer of property to any service provider; its application is not limited to employees or even to individuals. A transfer of property occurs for purposes of section 83 when a person acquires a beneficial ownership interest in such property.

The term "property" is defined very broadly for purposes of section 83.<sup>1801</sup> Property includes real and personal property other than money or an unfunded and unsecured promise to

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<sup>1798</sup> *Veit v. Commissioner*, 8 T.C.M. 919 (1949).

<sup>1799</sup> The application of section 83 to a funded nonqualified deferred compensation arrangement is based in part on the broad scope of section 83 (i.e., section 83 applies to any transfer of property in connection with the performance of services) and the broad definition of property under section 83. Depending on the design of a particular nonqualified deferred compensation arrangement (e.g., if it covers only employees), either the economic benefit doctrine or Code provisions dealing with nonexempt employee trusts and nonqualified annuities may be relevant as legal authority for this tax treatment in addition to section 83.

<sup>1800</sup> Under a special rule, if property is either nontransferable or is subject to a substantial risk of forfeiture when transferred, the service provider may elect within 30 days to apply section 83 as of the time of the transfer.

<sup>1801</sup> Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83.<sup>1802</sup>

Property is subject to a substantial risk of forfeiture if the individual's right to the property is conditioned on the future performance of substantial services (such as full-time services for two years or more) or on the nonperformance of services (such as a noncompete requirement). In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services and there is a substantial possibility that the property will be forfeited if the condition does not occur.<sup>1803</sup> Under a special rule, property is considered to be subject to a substantial risk of forfeiture if sale of the property at a profit could subject the person to suit under section 16(b) of the Securities Exchange Act of 1934 (relating to short-swing profits).

Risks that do not fall within this legal definition, such as the risk that the property will decline in value, do not result in a substantial risk of forfeiture. Whether a substantial risk of forfeiture exists depends on the facts and circumstances, including whether the service requirement or other condition will in fact be enforced. Property that is subject to a substantial risk of forfeiture is referred to as nonvested property; property that is not (or is no longer) subject to a substantial risk of forfeiture is referred to as vested property.

Property is considered transferable if a person can transfer his or her interest in the property to anyone other than the transferor from whom the property was received. Property is not considered transferable if the transferee's rights in the property are subject to a substantial risk of forfeiture. A temporary restriction on the transferability of property (called a "lapse" restriction) is disregarded in determining the value of the property for purposes of section 83. A permanent restriction on the transferability of property (a "nonlapse" restriction) is taken into account in determining the value of the property.

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<sup>1802</sup> In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, only the cash surrender value is considered to be property. Where rights in a contract providing life insurance protection are substantially nonvested, the cost of the current life insurance protection thereunder (i.e., the reasonable net premium cost as determined by the Commissioner) is includible in income.

<sup>1803</sup> For example, if contributions are made to a trust exclusively for the purpose of reimbursing employees for education expenses, but reimbursement is available only if an employee takes a course and earns a passing grade, the employee's interest in the trust is subject to a substantial risk of forfeiture until he or she takes and passes a course.

## **Section 132 of the Revenue Act of 1978**

Section 132 of the Revenue Act of 1978<sup>1804</sup> was enacted in response to proposed Treasury regulations published in the Federal Register for February 3, 1978.<sup>1805</sup> These regulations provided that, if a payment of an amount of a taxpayer's compensation is, at the taxpayer's option, deferred to a taxable year later than that in which such amount would have been payable but for the taxpayer's exercise of such option, the amount is treated as received by the taxpayer in such earlier taxable year.<sup>1806</sup> Section 132 of the Revenue Act of 1978 provides that the taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan is determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978.

The term, "private deferred compensation plan" means a plan, agreement, or arrangement under which the person for whom service is performed is not a State or a tax-exempt organization and under which the payment or otherwise making available of compensation is deferred. However, the provision does not apply to certain employer-provided retirement arrangements (e.g., a qualified retirement plan), a transfer of property under section 83, or an arrangement that includes a nonexempt employees trust under section 402(b). Section 132 of the Revenue Act of 1978 was not intended to restrict judicial interpretation of the law relating to the proper tax treatment of deferred compensation or interfere with judicial determinations of what principles of law apply in determining the timing of income inclusion.

### **Attempts to provide security for nonqualified deferred compensation**

#### In general

Because amounts deferred that are funded are includible in gross income in the year the amount is transferable or is no longer subject to a substantial risk of forfeiture, funded arrangements can result in the imposition of tax even when no amount is actually received. For example, suppose a nonqualified deferred compensation plan provides that an employer will pay an employee (or the employee's beneficiary) \$500,000 when the employee attains age 55 or dies. Further suppose that the plan is funded and provides that the employee's right to the \$500,000 vests after five years of employment. Because the arrangement is funded, the employee must include the present value of \$500,000 in income after he or she completes five years of employment, even if that is many years before the employee attains age 55. Given this type of result, individuals covered under nonqualified deferred compensation arrangements typically prefer for such arrangements not to be funded for tax purposes.

Nevertheless, such individuals are often interested in providing some security with respect to payment of the deferred compensation. Unfunded status presents the risk that the

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<sup>1804</sup> Pub. L. No. 95-600 (1978).

<sup>1805</sup> Prop. Treas. Reg. 1.61-16, 43 Fed. Reg. 4638 (1978).

<sup>1806</sup> *Id.*

employee will not receive his or her deferred compensation payments when due.<sup>1807</sup> Thus, a goal of many plans is to maximize the security that can be provided for the individual without incurring current income tax consequences, i.e., without having the arrangement being considered funded for tax purposes. Various arrangements have been developed in an effort to provide employees with security for nonqualified deferred compensation, while still allowing deferral of income inclusion.

### Rabbi trusts

A “rabbi trust” is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made.<sup>1808</sup> The trust or fund is generally irrevocable<sup>1809</sup> and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation. However, the terms of the trust or fund provide that the assets are subject to the claims of the employer’s creditors in the case of bankruptcy or insolvency.

As discussed above, for purposes of section 83, property includes a beneficial interest in assets set aside from the claims of creditors, such as in a trust or fund, but does not include an unfunded and unsecured promise to pay money in the future. In the case of a rabbi trust, terms providing that the assets are subject to the claims of creditors of the employer in the case of bankruptcy or insolvency have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.<sup>1810</sup> As a result, no amount is currently included in the income of a beneficiary of a rabbi trust by reason of the rabbi trust; income inclusion occurs as the deferred compensation is paid or made available.

The IRS has issued guidance setting forth model rabbi trust provisions.<sup>1811</sup> Revenue Procedure 92-64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. The model trust language requires that the trust provide that all assets of the trust are subject to the claims of the general creditors of the company in the event of the company’s insolvency or bankruptcy.

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<sup>1807</sup> This risk is not a substantial risk of forfeiture as defined under section 83.

<sup>1808</sup> A rabbi trust is generally a grantor trust of the employer for tax purposes, so trust earnings are treated as income to the employer.

<sup>1809</sup> Some trusts provide that the trust is funded or irrevocable only upon the occurrence of a certain events, such as a change in control of the employer.

<sup>1810</sup> This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence the popular name “rabbi trust.” Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).

<sup>1811</sup> Rev. Proc. 92-64, 1992-2 C.B. 422, *modified in part* by Notice 2000-56, 2000-2 C.B. 393.

Since the concept of a rabbi trust was developed, other techniques have been developed that attempt to protect the assets from creditors despite the terms of the trust. For example, the trust or fund may be located in a foreign jurisdiction, making it difficult or impossible for creditors to reach the assets. In such a case, the existence of the assets may be unknown or the assets may be protected from creditors under the laws of the jurisdiction where the trust is located.

### Secular trusts

In contrast to a rabbi trust, a “secular” trust is a trust established by an employer exclusively for the purpose of providing nonqualified deferred compensation; assets are not subject to claims of creditors. A secular trust constitutes a funding of a nonqualified deferred compensation arrangement, so that vested amounts are includible in income by the employees (i.e., such amounts are not tax-deferred).<sup>1812</sup> A secular trust provides security for the employees, but also causes current taxation. In some cases, under the terms of the nonqualified deferred compensation arrangement, the employer pays the taxes attributable to the deferred compensation by grossing up the employees’ current compensation by a corresponding amount.

### Other forms of security

Other methods are sometimes used in an attempt to provide employees with security that deferred compensation payments will be made when due, such as third party guarantees, letters of credit, and surety bonds. There is little specific guidance as to how these arrangements should be treated for tax purposes. In addition, the tax treatment depends on the facts of the particular arrangement.

### **Timing of employer income tax deduction**

Special statutory provisions govern the timing of the deduction for nonqualified deferred compensation, regardless of whether the arrangement covers employees or nonemployees and regardless of whether the arrangement is funded or unfunded.<sup>1813</sup> Under these provisions, the amount of nonqualified deferred compensation that is includible in the income of the individual performing services is deductible by the service recipient for the taxable year in which the amount is includible in the individual’s income.

### **Payroll taxes and wage reporting**

#### In general

In the case of an employee, nonqualified deferred compensation is generally considered wages both for purposes of income tax withholding and for purposes of taxes under the Federal Insurance Contributions Act (“FICA”), consisting of social security tax and Medicare tax.

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<sup>1812</sup> A secular trust is generally structured as a separate entity for tax purposes, and earnings are includible in the income of the trust.

<sup>1813</sup> Secs. 404(a)(5), (b) and (d) and sec. 83(h).

However, the income tax withholding rules and social security and Medicare tax rules that apply to nonqualified deferred compensation are not the same.

### Income tax withholding

Nonqualified deferred compensation is generally subject to income tax withholding at the time it is includible in the employee's income as discussed above. In addition, such amounts must be reported as wages on a Form W-2. Income tax withholding and Form W-2 reporting are required even if the employee has already terminated employment. For example, if nonqualified deferred compensation is includible in income only as payments are made after retirement, income taxes must be withheld from the payments and the payments must be reported on a Form W-2.

Income tax withholding and Form W-2 reporting are required when amounts are includible in income even if no actual payments are made to the employee. For example, if nonqualified deferred compensation is provided by means of vested contributions to a funded arrangement, the amount of the contributions is includible in the employee's income and is subject to income tax withholding<sup>1814</sup> and Form W-2 reporting. Additional income tax withholding and reporting may be required when payments are made from the funded arrangement to the extent a portion of the payments are includible in income (i.e., amounts in excess of the employee's basis). Such amounts are subject to the income tax withholding rules that apply to pensions and are reported on a Form 1099R.

Generally, the employer is responsible for income tax withholding and Form W-2 reporting (or Form 1099R, if applicable) with respect to nonqualified deferred compensation. However, if nonqualified deferred compensation payments are made by a third party, such as the trustee of a trust, and are not under the control of the employer, the payor is responsible for income tax withholding and reporting.

### Social security and Medicare taxes

The Code provides special rules for applying social security and Medicare taxes to nonqualified deferred compensation. In general, nonqualified deferred compensation is subject to social security and Medicare tax when it is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). This treatment is not affected by whether the arrangement is funded or unfunded, which, as described above, is relevant in determining when amounts are includible in income (and subject to income tax withholding). Because nonqualified deferred compensation arrangements generally cover only highly paid employees, the other compensation paid to the employee during the year generally exceeds the social security wage

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<sup>1814</sup> The required income tax withholding is accomplished by withholding income taxes from other wages paid to the employee in the same year.



base. In that case, nonqualified deferred compensation amounts are subject only to Medicare tax.

## **Factual Background**

### **Executive deferral programs in general**

In recent years, Enron had two principal active deferral plans: the Enron Corp. 1994 Deferral Plan (the “1994 Deferral Plan”) and the 1998 Enron Expat Services, Inc. Deferral Plan (the “Expat Deferral Plan”). The 1994 Deferral Plan was the principal deferral plan used by Enron. The 1994 Deferral Plan and the Expat Deferral Plan had almost identical terms and features, with the principal difference that the Expat Deferral Plan was used for employees of Enron Expat Services Inc., while the 1994 Deferral Plan was used for all other employees. Enron also had several older deferral plans, which did not allow current deferrals, but pursuant to which participants had made deferrals in previous years. In addition, Enron had a Project Participation Plan for international developers, which was put in place in the early 1990’s. The Project Participation Plan was terminated December 31, 2000, except that payments could be made after that date with respect to awards made before such date. The Project Participation Plan allowed participants to defer receipt of payments that would otherwise be made.<sup>1815</sup>

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.<sup>1816</sup> Amounts deferred in these years are shown in the following table.

**Table 21.–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 <sup>1817</sup>
2001	54.4

### **1994 Enron Corp. Deferral Plan**

#### **In general/background**

Enron adopted the Enron Corp. 1994 Deferral Plan effective January 1, 1994. The stated purpose of the Plan is to allow key employees and outside directors of Enron Corp. to reduce current compensation and thereby reduce their current taxable income, earn an attractive, tax-free rate of growth on monies deferred, and accumulate funds on a tax-favored basis which can be

<sup>1815</sup> The Project Participation Plan is discussed in Part III.B.3., above.

<sup>1816</sup> EC 000599639 - EC 000599654(1998); EC 000599620 - EC 000599638 (1999); EC 001872078 - EC 001872081 (2000); and EC 000599599 - EC 000599619 (2001).

used for retirement planning or other future financial objectives. The summary of the 1994 Deferral Plan for participants states that the “Plan provides you with an opportunity to delay payment of federal and state income taxes, and earn tax-deferred returns on your deferrals. You have the flexibility of choosing an investment strategy and payment schedule to meet your financial needs.”<sup>1818</sup>

Participation in the 1994 Deferral Plan was originally offered to approximately 300 executives and key employees.<sup>1819</sup> Approximately 100 individuals<sup>1820</sup> elected to defer 1994 compensation, including salary, bonus, and long-term incentive for total deferrals of \$3 million in 1994.<sup>1821</sup> Enron anticipated offering the same deferral opportunity for seven consecutive years, subject to further renewal after that time, according to the value of the 1994 Deferral Plan.<sup>1822</sup> To provide a level of security to executives and an asset to cover Enron’s future payment liabilities, a rabbi trust was approved for the 1994 Deferral Plan.<sup>1823</sup> The rabbi trust is discussed below in further detail.

Many executives participated in Enron’s deferral programs. Information provided by Enron shows that for the years 1999-2001, there were approximately 340 participants in the 1994 Deferral Plan.<sup>1824</sup> As of December 2000, there were approximately 295 participants in the 1994 Deferral Plan, with account balances totaling \$153.4 million. As of December 2001, there were approximately 304 participants in the 1994 Deferral Plan, with account balances totaling approximately \$51.6 million. The decrease in account balances was principally due to the decline in the value of Enron Stock and the accelerated distributions, discussed below, that were made immediately preceding Enron’s bankruptcy filing.

The 1994 Deferral Plan was amended and restated several times. The original plan, after being amended seven times, was restated as of August 11, 1997. The 1994 Deferral Plan,

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<sup>1817</sup> According to the documents provided by Enron, in 2000, Mr. Lay deferred \$32 million under the 1994 Deferral Plan in 2000. EC 001872080.

<sup>1818</sup> Added Value for your Future (a participant brochure). EC 000768171.

<sup>1819</sup> Plan Funding Conclusions and Recommendations prepared by Clark/Bardes, Inc. EC 000768252.

<sup>1820</sup> When the 1994 Deferral Plan filed notification of its effectiveness with the Department of Labor, the plan covered 104 highly compensated employees.

<sup>1821</sup> Plan Funding Conclusions and Recommendations prepared by Clark/Bardes, Inc. EC 000768252.

<sup>1822</sup> *Id.*

<sup>1823</sup> *Id.*

<sup>1824</sup> EC 000768148.

restated as of August 11, 1997, was amended three times and was restated again as of October 6, 2000.<sup>1825</sup> The 1994 Deferral Plan was amended August 14, 2001.<sup>1826</sup>

In connection with Enron's financial situation, the 1994 Deferral Plan was amended November 28, 2001, to suspend deferrals under the Plan, effective at the end of business on November 29, 2001, until such time that the Board of Directors removed such suspension.

### Eligibility

Under the 1994 Deferral Plan, key management and highly compensated employees of Enron, as determined by the Deferral Plan Committee,<sup>1827</sup> and outside directors of Enron Corp. and participating subsidiaries were eligible to be designated participants under the 1994 Deferral Plan. The 1994 Deferral Plan allowed Enron to determine which executives would be eligible for participation. Over time, Enron changed participation eligibility requirements.

For 2001, the following employees were eligible to participate in either the 1994 Deferral Plan or the Expat Deferral Plan, whichever was applicable: (1) vice president level and above employees of Enron Corp. or a participating subsidiary who were eligible for stock awards under the Executive Long-Term Incentive program, on the executive pay structure (job level structure), and on local payroll; and (2) lower than vice president level employees who were making current (year 2000 for 2001 eligibility) deferrals under one of the plans.<sup>1828</sup> Enron believed that linking deferral plan eligibility to job level and participation in another Enron-sponsored program was a

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<sup>1825</sup> This is the most recent version of the plan. In the October 6, 2000, restatement of the 1994 Deferral Plan, certain amendments were made. On October 6, 2000, the Compensation Committee approved a restatement of the 1994 Deferral Plan which included amendments to: (1) clarify provisions relative to deferral of gains realized upon the exercise of options utilizing a stock swap and the deferral of restricted stock that would otherwise be released; (2) provide consistency with respect to Enron's definition of retirement; (3) clarify current administrative processes; and (4) eliminate a reference that the plan may be adopted by other employing companies due to multiemployer trust issues.

<sup>1826</sup> The 1994 Deferral Plan as restated October 6, 2000, was first amended August 14, 2001, to: (1) allow daily investment changes instead of only once a month; (2) allow participants to make an election covering all future aggregate deferrals and to have the ability to change past and future elections by submission of a revised payout election; and (3) allow participants the ability to submit a beneficiary designation via an electronic process.

<sup>1827</sup> The "Deferral Plan Committee" refers to the committee established under the 1994 Deferral Plan to administer the plan. The duties and authority of the Deferral Plan Committee are discussed below.

<sup>1828</sup> Interoffice memorandum from Executive Compensation Department to unspecified distribution list regarding deferrals, dated October 12, 2000. EC2 000018424.

very straight-forward and thoughtful approach to determining the eligible group for executive deferrals.<sup>1829</sup>

In the few years preceding the bankruptcy, the group of eligible participants had changed. For 1999, employees with a September 15, 1998, salary of \$130,000 or above, who were employees of Enron Corp. or a participating subsidiary, were eligible to participate in the 1994 Deferral Plan.<sup>1830</sup> For 2000, there was a change in eligibility for the 1994 Deferral Plan. Each business unit had the ability to select the executive and management employees who would be eligible to participate. The number of eligible participants was determined based on the numbers in each group that had been eligible to participate in the past at the advice of legal counsel. For 2000, all managing directors, executive vice presidents, business unit heads, and employees participating in the Plan during 1999 were automatically eligible to participate. Up to 43 additional employees in a group could be selected to participate based on specified criteria. In order to participate, an employee had to earn a minimum base salary of \$120,000.

#### Regular deferrals

Under the 1994 Deferral Plan, a participant could defer up to 35 percent of base salary, up to 100 percent of annual bonus payments and up to 100 percent of select long term incentive payments. Prior to the Third Amendment to the 1994 Deferral Plan (as amended and restated effective as of August 11, 1997) dated August 8, 2000, participants could defer only up to 25 percent of base salary. The minimum deferral for each category of compensation was \$2,000 for any deferral year.

Deferral elections were to be made in writing. Elections to defer compensation were irrevocable and were required to be made prior to the first day of the calendar year in which the compensation to be deferred was earned and payable.<sup>1831</sup> As discussed below, the 1994 Deferral Plan also allowed for stock option deferral and restricted stock deferral for certain employees. Enron could also make company deferral contributions on a participant's behalf.

Under the 1994 Deferral Plan, Enron would establish a deferral account in the name of each participant on its books and records. The account would carry the amount of the deferrals made, plus any earnings thereon, as a liability of Enron to the participant. Participant materials state that the account would be utilized solely as a device for the measurement and determination of the amount to be paid to the participant pursuant to the Plan.

Participants could choose to have their deferrals treated as having been invested in two types of investment accounts -- the Phantom Stock Account and the Flexible Deferral Account. A percentage of deferred compensation could be allocated to either account or the entire deferral could be allocated to only one account.

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<sup>1829</sup> *Id.*

<sup>1830</sup> Interoffice memorandum from Corporate Compensation Department regarding 2000 deferrals, dated October 21, 1999. EC2 000018664.

<sup>1831</sup> A special rule applied for deferral elections of new employees.

Deferrals invested in the Phantom Stock Account were treated as if the participant purchased shares of Enron Corp. common stock at the closing price on the date of deferral. Under the Plan, credits for dividends declared for Enron Corp. common stock would be made quarterly to the Participant's Phantom Stock Account Deferral Account, and would be administered as though reinvested in Enron Corp. common stock.

During 1994 and 1995, deferrals into a participant's Flexible Deferral Account earned a fixed annual return of nine percent. Beginning in 1996 and thereafter, participants were allowed to select investment funds for the crediting of earnings to their account balances, and returns on Flexible Deferral Accounts were based on the performance of the participant's investment choices, less an administrative fee. Investment options were to include different levels of risk and return such as growth, balanced asset and bond funds, and fixed interest accounts. In 1999, in connection with a change to the Enron Savings Plan's recordkeeper, the investment options under the Flexible Deferral Account were changed to mirror those of the Enron Savings Plan. For 2001, participants could allocate among 17 investment choices that mirrored funds available in the Enron Savings Plan.<sup>1832</sup> The account would be credited with cumulative appreciation and/or depreciation based on the market price of chosen investments.

It appears that participants' deferrals were not actually invested to match participants' investment elections, but that participants' investment elections may have been followed generally in investing the assets of the rabbi trust associated with the 1994 Deferral Plan. According to Enron, only initially did Enron direct investments to generally correspond with participant elections.<sup>1833</sup> The investment of the trust's assets is discussed in further detail below. According to Enron's summary of the 1994 Deferral Plan,<sup>1834</sup> because of constructive receipt rules, Enron could credit a participant deferral account with earnings that tracked a chosen mix of investment funds, but the actual investments were required to be made by Enron Corp. or by the Trustee appointed by Enron Corp. at the direction of Enron Corp.

A participant could not transfer balances between the Phantom Stock Account and the Flexible Deferral Account, but could change investment choices within the Flexible Deferral Account once each calendar month. The First Amendment to the 1994 Deferral Plan dated August 14, 2001, allowed for daily changes in election choices instead of monthly changes.

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<sup>1832</sup> For 2001, the Flexible Deferral Account investment choices were: Stable Asset Fund, Fidelity Balanced Fund, Fidelity Equity-Income Fund, Fidelity Growth & Income Portfolio, Fidelity Magellan Fund, Fidelity Growth Company Fund, Fidelity OTC Portfolio, Fidelity Overseas Fund, MSDW Institutional International Equity Fund, MSDW Institutional Equity Fund Growth Portfolio, PIMCO Total Return Fund II, T. Rowe Price Small Cap Stock Fund, Vanguard Index Trust 500, Vanguard Windsor II, Vanguard Conservative Growth Portfolio, Vanguard Moderate Growth Portfolio, and Vanguard Growth Portfolio.

<sup>1833</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

<sup>1834</sup> EC2 000018443.

Under the 1994 Deferral Plan, within 120 days after the close of each plan year, each participant was to be provided a statement setting forth the participant's balance in the deferral accounts.

### Distributions

Distributions from the 1994 Deferral Plan could be made upon the participant's retirement, disability, death or termination of employment. The 1994 Deferral Plan provides how retirement benefits, disability benefits, death benefits and termination benefits would be triggered and paid.

The 1994 Deferral Plan originally provided that elections with respect to payment options had to be made annually at the time the election to defer was made. Participants could elect to receive payments in a lump sum or up to 15 annual installments. Payments from an account could be received beginning the first quarter of the year following retirement, death, disability or termination. Payment elections could be revised at any time, but would not be effective until one full calendar year after receipt of the revised payment election form. Only one installment payment option could apply at any given time, e.g., an employee could not elect to have certain deferrals payable over 10 years and other deferrals payable over 15 years. If a participant was terminated for cause, the participant would receive deferrals only, with no earnings, in a lump sum during the first quarter of the year following termination.

The First Amendment to the 1994 Deferral Plan (as amended and restated October 6, 2000) dated August 14, 2001, changed the Plan to allow participants to make an election covering all future aggregate deferrals, rather than requiring payment option elections to be made annually, and to have the ability to change past and future elections by submission of a revised payout schedule. The 1994 Deferral Plan provided specific rules for beneficiary designations and the First Amendment allowed beneficiary designations by electronic processes.

In addition to distributions on account of retirement, death, disability or termination, the 1994 Deferral Plan allowed for hardship withdrawals. Participants were required to petition the Deferral Plan Committee, described below, in writing for such distributions, which could be granted, in the sole discretion of the Deferral Plan Committee, on account of unforeseeable circumstances causing urgent and severe financial hardship for the participant. According to the 1994 Deferral Plan, the types of circumstances that usually met the criteria were accidents and illness, large theft and fire losses, severe financial reversals, and large personal judgments. The distribution amount was limited to a reasonable, necessary amount to eliminate the hardship. The 1994 Deferral Plan was amended in 1996 to prohibit hardship distributions from the Phantom Stock Account for participants subject to section 16(b) of the Securities Exchange Act of 1934.

For circumstances other than financial hardship, an accelerated withdrawal of all or a portion of the account balance was also available, subject to the consent of the Deferral Plan Committee. The accelerated distribution provision was added to the plan in the First Amendment to the 1994 Deferral Plan (as restated effective August 11, 1997) dated October 13, 1997. If a participant elected an accelerated withdrawal, 10 percent of the elected distribution amount was required to be forfeited and 90 percent of the elected distribution would be paid to

the participant. Upon such distribution, a participant would not be eligible to participate in the 1994 Deferral Plan for at least 36 months following the distribution. The account balance distributed would be determined as of the last day of the month preceding the date on which the Deferral Plan Committee received the written request of the participant.

Deferrals into the Phantom Stock Account would be paid out in shares of Enron Corp. common stock, with the exception of pre-1998 deferrals, which would be paid out in cash unless the participant signed a waiver to receive stock. The plan provides that the value of the shares, and resulting payment amount, would be based on the closing price of Enron Corp. common stock on the January 1 before the date of payment. Dividends would be credited to a participant's Phantom Stock Account and would be administered as if reinvested in Enron Corp. common stock.

Payments from the Flexible Deferral Account would be made in cash over the payment period selected. Earnings/losses would be applied to the Flexible Deferral Account during the payout period, based upon the investment choices made. Earnings on the declining account balance would be paid annually. Losses, if any, would be subtracted from the remaining account balance, which could shorten the payment period. Payments would begin during the first quarter of the year following the termination event.

#### Special purpose deferrals

The Second Amendment to the Enron 1994 Deferral Plan (as restated effected August 11, 1997) dated October 12, 1998, changed the Plan to allow participants to elect to make special purpose deferrals beginning in 1999. Participants could receive special purpose deferral payments while remaining actively employed. Special purpose deferral payments could be received as soon as three years following the deferral in a lump sum or up to five annual installments. Special purpose deferrals were intended to assist with anticipated expenses, such as a child's college expenses.

#### Taxes

Participant information states that Federal and State income taxes associated with deferrals were not incurred until the receipt of payments. FICA and Medicare taxes on amounts deferred were due at the time of deferral. Such amounts were said to be subtracted from compensation that was not deferred.

Information supplied to the IRS by Enron states that, for all deferrals of compensation made to the various plans, FICA tax was withheld at the time the deferral was made and deposited along with other payroll taxes for the pay period in which the deferral was made.

#### Enron deferral contributions

The Second Amendment to the 1994 Deferral Plan (as restated effective August 11, 1997) dated October 12, 1998, allows for deferral contributions by Enron. Under the amendment, Enron could make contributions on a participant's behalf in any amount as Enron determined in its sole discretion and to any investment account under the 1994 Deferral Plan. Such contributions could be made on behalf of some participants to the exclusion of others, and

could vary among individual participants in amount and/or with respect to the investment account in which they may be credited. Such Enron deferral contributions were said to be cash bookkeeping credits made to the records of the 1994 Deferral Plan.

Documents obtained from the IRS show that, as part of one executive's employment agreement, Enron agreed to make contributions to the 1994 Deferral Plan in the amount of \$500,000 to be deposited each February 15th of calendar years 2000, 2001, 2002, and 2003. It is unclear to what extent Enron made deferral contributions on behalf of other employees.

#### Deferral of stock option gains and deferral of restricted stock

The 1994 Deferral Plan allowed for deferral of income attributable to stock options and restricted stock. The Stock Option Deferral Account was established by the Fifth Amendment to the 1994 Deferral Plan, dated December 10, 1996. The Restricted Stock Deferral Account was established by the Sixth Amendment to the 1994 Deferral Plan, dated May 5, 1997.

Under the deferral of stock option gains program, participants designated by the Deferral Plan Committee could make an advance written election to defer the receipt of shares of Enron Corp. common stock from the exercise of a stock option granted under a stock plan sponsored by Enron, when such exercise was made by means of a stock swap using shares owned by the participant.<sup>1835</sup> The deferral election applied to the number of shares that the employee was due to receive in addition to the shares exchanged in the stock for stock exercise.

In 2001, nonemployee directors and members of the Enron Executive and Policy Committees were eligible to participate in the deferral of stock option gains program. An election to defer stock was required to be made prior to the end of the tax year preceding the year in which the option was exercised and at least six months prior to the exercise. The election was irrevocable, remained in effect for all tax years subsequent to the year the election was made, and remained in effect until the Phantom Stock Account was to be paid out.

If an executive made a deferral election, Enron would credit share units to the Stock Option Deferral Account under the 1994 Deferral Plan, to be payable in stock upon death, disability, retirement or termination as elected by the executive (over a period of one to fifteen years) instead of delivering shares to the executive upon exercise of the option. Credits for dividends would be accrued in a separate account and paid in cash pursuant to the distribution provisions under the 1994 Deferral Plan. Phantom stock units derived through deferral counted for purposes of meeting Enron stock ownership requirements for executives. The tax issues associated with this program are discussed below.

Under the deferral of restricted stock program, participants designated by the Committee could make an advance written election to defer the receipt of shares of Enron Corp. common stock to be released according to a grant of restricted shares under a stock plan sponsored by Enron Corp. In 2001, nonemployee directors and executives who were current deferral plan participants or who met criteria for deferral in accordance with ERISA regulations for top-hat

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<sup>1835</sup> Issues relating to stock-for-stock exercises are discussed in detail in Part III.C.2, below.



plans, as determined by the Deferral Plan Committee, were eligible to participate in the deferral of restricted stock program under the 1994 Deferral Plan. Eligible holders of shares of restricted stock could make an advance election, in the nature of a deferred compensation election, prior to the end of the tax year preceding the release date, and at least six months prior to release date, to defer receipt of shares which would otherwise vest and be released. Instead of delivering shares of restricted stock upon vesting, Enron would credit the value of such shares of restricted stock to the participant's Phantom Stock Account under the 1994 Deferral Plan, to be payable in shares of Enron Corp. common stock upon death, disability retirement or termination, as selected by the participant, over a period from one to fifteen years. Credits for dividends would be accrued in a separate account and paid in cash pursuant to the distribution provisions under the 1994 Deferral Plan.

### Administration

According to the plan document, the 1994 Deferral Plan was to be administered by a committee of not more than three people appointed by the Chief Executive Officer of Enron ("Deferral Plan Committee"). The Deferral Plan Committee had the authority to make, amend, interpret and enforce all appropriate rules and regulations for the administration of the 1994 Deferral Plan and decide or resolve any and all questions, including interpretations of the 1994 Deferral Plan. In addition to other enumerated powers, the Deferral Plan Committee had the right, power, authority and duty to determine the amount, manner and time of payment of any benefits under the 1994 Deferral Plan and to prescribe procedures to be followed in obtaining benefits.

Effective October 26, 2001, Kenneth L. Lay appointed Lawrence Gregory ("Greg") Whalley to serve as the sole member of the Deferral Plan Committee. Mr. Whalley accepted the appointment October 29, 2001. Even though eligible, Mr. Whalley was not a participant in the 1994 Deferral Plan. There is no record of a Deferral Plan Committee before October 2001. Enron employees interviewed by Joint Committee staff said that an informal administrative committee would be formed when an issue arose, which was infrequently. Informal committees may have been composed of the head of Human Resources, compensation staff members, and legal counsel.

### Claims procedures

Under the 1994 Deferral Plan, any claim for benefits was required to be submitted to the Deferral Plan Committee. The Deferral Plan Committee was responsible for deciding whether such claim was within the scope provided by the 1994 Deferral Plan. Notice of a decision by the Deferral Plan Committee with respect to a claim was required to be furnished to the claimant within 90 days following the receipt of the claim. If a claim was wholly or partially denied, notice was required to be in writing and worded in a manner to be understood by the claimant.

### Rights of participants

The 1994 Deferral Plan provides that compensation deferred is part of the general assets of Enron. Enron was not required to segregate, set aside or escrow compensation deferred, nor earnings credited thereon. With respect to benefits payable under the 1994 Deferral Plan,

participants have the status of general creditors of Enron. Participants could look only to Enron and its general assets for payment of their account balances.

#### Establishment of rabbi trust

Under the 1994 Deferral Plan, Enron, in its sole discretion, could acquire insurance policies or other financial vehicles for the purpose of providing future Enron assets to meet its anticipated liabilities under the 1994 Deferral Plan. Such policies or other investments would at all times remain unrestricted general property and assets of Enron. Participants in the 1994 Deferral Plan would have no rights, other than as general creditors, with respect to such policies or other acquired assets. As discussed below, Enron did acquire insurance policies on the lives of certain participants in the 1994 Deferral Plan.

The 1994 Deferral Plan provides that, notwithstanding any other provision or interpretation of the plan, Enron shall establish a trust in which to hold cash, insurance policies or other assets to be used to make or reimburse Enron for payments to participants of the benefits under the plan, provided that the trust assets shall at all times remain subject to the claims of general creditors of Enron in the event of Enron's insolvency. The 1994 Deferral Plan further provides that Enron, and not the trust, shall be liable for paying the benefits under the 1994 Deferral Plan. On April 5, 1994, Enron Corp. established an irrevocable rabbi trust for the executive nonqualified deferred compensation program.<sup>1836</sup> The provisions of the trust document were incorporated in the 1994 Deferral Plan.

The use of variable life insurance products was approved for investment of trust assets, because such products provided tax-free buildup of earnings.<sup>1837</sup> Upon the establishment of the trust, 100 trust-owned life insurance ("TOLI") policies were purchased through Cigna on the lives of 100 participants in the Plan. It was also approved that the assets for the 1992 Deferral Plan, which credited deferrals with Enron's mid-term cost of capital, be included in the rabbi trust and used to purchase life insurance.<sup>1838</sup>

Documents obtained from Enron<sup>1839</sup> show that a new grantor trust agreement was entered into with Wachovia Bank, N.A. as trustee dated January 1, 1999.<sup>1840</sup> Even though approved by

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<sup>1836</sup> In response to questions asked by the Joint Committee staff, Enron responded that the trust was established April 5, 1995. This appears to have been an error; because several documents provided by Enron state that the trust was established in 1994.

<sup>1837</sup> Plan Funding Conclusions and Recommendations prepared by Clark/Bardes, Inc. EC 000768252.

<sup>1838</sup> *Id.*

<sup>1839</sup> Trust under the Enron Corp. 1994 Deferral Plan. EC2 000030938.

<sup>1840</sup> The Trust Agreement dated January 1, 1999, was actually executed in August 2000. The minutes of the August 7, 2000, Compensation Committee meeting show that executive compensation staff, in-house and outside legal advisors, and trust experts from Wachovia conducted a thorough review of the trust document dated April 5, 1994, to make sure that it

the Compensation Committee, members of the Compensation Committee interviewed by the Joint Committee staff did not know whether Enron had such a trust.

The January 1, 1999, trust replaced the prior trust dated April 5, 1994, and the assets from the prior trust were transferred to the 1999 trust.<sup>1841</sup> The 1999 trust was established with \$1,000, plus the transfer of the assets from the 1994 trust.<sup>1842</sup> Enron could make additional deposits of assets, but according to Enron, other than the contribution in 1994 of the trust-owned life insurance policies, no additional funding other than a pay-as-you go mechanism was established (i.e., current deferrals funded current benefit obligations).<sup>1843</sup> According to Enron, the assets of

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incorporated sufficient protection to plan participants in the event of a change in control. Several changes were recommended and were incorporated into a replacement trust document. The new trust included several changes relating to the following areas: (1) the establishment and funding of a new trust (under the new trust, all income received by the trust could be returned to Enron upon request at any time prior to a change in control); (2) the trustee's responsibility regarding payments (the new trust provides a process for confirming the insolvency or alleged insolvency of Enron, and for tax or payment claims handling); (3) provisions regarding payments if a short fall of the trust assets occurs (the new trust described how payments would be handled in the event of a short fall of trust assets that could result if Enron were to become insolvent); (4) insurance contracts to provide an irrevocable trust (the new trust confirmed the trustee as owner of life insurance policies, and beneficiary of death proceeds); and (5) provisions regarding the resignation and removal of the trustee (the new trust allowed for removal or termination of the trustee with majority consent of participants following a change in control). EC 000101470.

<sup>1841</sup> The Third Amendment to the 1994 Deferral Plan (as amended and restated effective as of August 11, 1997) dated August 8, 2000, amended the plan to incorporate provisions of the new trust document in order to link the replacement trust to the 1994 Deferral Plan.

<sup>1842</sup> Minutes from the February 12, 1996, Compensation Committee meeting report that the deconsolidation of Enron Oil & Gas ("EOG") in December 1995, resulted in EOG establishing a 1996 Oil & Gas Deferral Plan which included the assumption of deferral plan liabilities for active participants. It was anticipated that EOG would assume the deferred compensation obligations attributable to EOG and that there would be a separation of the trust under the 1994 Deferral Plan into an Enron trust and an EOG trust. The minutes note that as of December 31, 1995, the assets to be placed in the EOG trust equaled \$2.085 million, with all trust assets totaling \$11.480 million. Evidently, the transfer did not take place when originally contemplated, as the minutes of the May 3, 1999, meeting of Compensation Committee state that they approved, for recommendation to the Board, a proposed amendment to the 1994 Deferral Plan to allow the transfer of assets to the EOG trust. It is unclear whether such transfer eventually took place.

<sup>1843</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

the trust were not intended to be sufficient to entirely pay for the nonqualified deferred compensation obligations under the 1994 Deferral Plan.<sup>1844</sup>

Under the trust document, a change in control would trigger funding of the trust so that the trust would contain assets necessary to meet the liability for benefits credited under the plan.

Under the trust document, in the event that a participant or beneficiary was determined to be subject to Federal income tax on any amount credited under the 1994 Deferral Plan prior to the time of payment, whether or not due to the establishment of or conditions to the trust, a portion of the taxable amount equal to the Federal, state and local taxes owed would be, at the direction of Enron, distributed by the trustee as soon thereafter as practicable to such participant or beneficiary. Enron would reimburse the trust for such distributions. Enron would also bear the expenses to defend any tax claims (related to deferred amounts) asserted by the IRS against any participant or beneficiary.

Under the trust document, the trustee was to cease any payment of benefits if Enron were insolvent. The trust provides that, all times during the continuance of the trust, all principal and income of the trust is subject to the claims of all of the general creditors of Enron.<sup>1845</sup> The trust was to be used as a source of funds to assist Enron in satisfying its obligations under the 1994 Deferral Plan. No assets held by any trust established were to constitute security for the performances of obligations under the 1994 Deferral Plan.

The trust document provides that the trustee has the power to invest and reinvest the assets of the trust in its sole discretion. It also provides, however, that prior to a change in control, Enron shall have the right to direct the trustee with respect to the investment of all or any portion of the assets of the trust. One former Enron employee interviewed by the Joint Committee staff stated that the trust assets were invested in a manner to correspond to participant investment selections. In response to questions asked by the Joint Committee staff, Enron responded that only initially<sup>1846</sup> were investments of trust assets directed so as to correspond generally to participant elections.

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<sup>1844</sup> One former employee interviewed by Joint Committee staff said that the assets of the trust were intended to be sufficient to satisfy obligations under the 1994 Deferral Plan.

<sup>1845</sup> At the February 12, 1996, Compensation Committee meeting, it was reported that Vinson & Elkins informed Enron that if one of Enron's subsidiaries were to file bankruptcy, the creditors of that company would not be able to obtain access to amounts in the trust because the trust was held at the corporate level. To prevent current taxation of deferred amounts, Enron management recommended, and the Compensation Committee approved, that all employees deferring compensation into the 1994 Deferral Plan be transferred into Enron Corp., with their payroll costs charged back to the original subsidiaries.

<sup>1846</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

Employees were notified of the existence of the trust and were notified that they did not have any interest or ownership in the trust assets. Employee information<sup>1847</sup> regarding security of deferrals stated that the 1994 Deferral Plan was secured by a rabbi trust to hold assets that would be used to make payments directly to participants in the event that Enron Corp. defaults on its obligation to make payments, but that benefits were contractually payable by Enron. Participant information explained that the trust would secure deferrals in the event of a change in control, or for any other circumstances, except bankruptcy. Participants were informed that in the event of bankruptcy, trust assets would be subject to the claims of creditors in bankruptcy proceedings.

Distributions to participants were not made from the trust, but were made from the general assets of Enron. The 1994 Deferral Plan trust is still in existence. According to Enron, the cash surrender value of the 78 policies with CIGNA was \$25 million as of October 28, 2002 (the latest valuation report received from the insurance company).<sup>1848</sup> According to Enron, the general ledger of Enron Corp. reflected a trust value of \$31.1 million as of December 2001.<sup>1849</sup> According to Enron, earnings from the trust were included in income when information was received from a third party recordkeeper.<sup>1850</sup>

### **1998 Enron Expat Service, Inc. Deferral Plan**

The 1998 Enron Expat Services Inc. Deferral Plan (“Expat Deferral Plan”) is very similar to the 1994 Deferral Plan and was established to allow key employees of Enron Expat Services Inc. to reduce current compensation and thereby reduce current taxable income, earn an attractive, tax-free rate of growth on monies deferred, and accumulate funds on a tax-favored basis which could be used for retirement planning or other financial objectives.<sup>1851</sup> The Expat Deferral Plan was established for expatriates who were ineligible to participate in the 1994 Deferral Plan because they were employed by Enron Expat Services Inc.<sup>1852</sup> A participant was eligible for either the 1994 Deferral Plan or the Expat Deferral Plan. Following repatriation,

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<sup>1847</sup> 2000 Deferral Plan Choices. EC2 000018665.

<sup>1848</sup> Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002. In a subsequent response, Enron stated that Wachovia is the owner of the TOLI policies and Enron is the beneficiary. EC 002680494 - EC 002680495.

<sup>1849</sup> EC 002680493. Enron Corp.’s general ledger reflected a balance of \$33.5 million as of November 2000; \$32 million as of December 1999; \$24.7 million as of November 1998; \$18.4 million as of December 1997; \$12.8 million as of December 1996; and \$8.5 million as of December 1995.

<sup>1850</sup> EC 002680496.

<sup>1851</sup> Attachment to May 4, 1998, Compensation Committee meeting minutes. EC 000104257.

<sup>1852</sup> Attachment to May 4, 1998, Compensation Committee meeting minutes. EC 000104257.

compensation of participants in the Expat Deferral Plan would be deferred under the 1994 Deferral Plan.

The most recent version of the Expat Deferral Plan was restated as of September 1, 2001,<sup>1853</sup> and has most of the same features as the 1994 Deferral Plan. The Expat Deferral Plan mirrored the 1994 Deferral Plan in that it provided executives the benefit of having their deferral balances track a chosen mix of investment funds. Under the Expat Deferral Plan, participants could defer up to 35 percent of base salary, up to 100 percent of annual incentive plan bonus payments, and up to 100 percent of select long-term incentive payments into the Expat Deferral Plan. Deferrals could be allocated into the Phantom Stock Account or the Flexible Deferral Account. The 17 investment options in the Flexible Deferral Account were the same as those for the 1994 Deferral Plan. The Expat Deferral Plan also included the deferral of stock option gains and deferral of restricted stock programs.

Unlike the 1994 Deferral Plan, a trust or other funding mechanism was not established in connection with the Expat Deferral Plan. The Plan provides that Enron could acquire insurance policies or other financial vehicles for the purpose of providing future assets to meet its anticipated liabilities under the Expat Deferral Plan. However, documents provided by Enron show that because there were only a few eligible participants (approximately 25 in 1998), the Expat Deferral Plan was established on an unfunded basis.<sup>1854</sup> Enron Corp. periodically agreed to serve as guarantor of benefit payments from the Expat Deferral Plan.<sup>1855</sup>

Information provided by Enron shows that there were approximately 55 total participants in the Expat Deferral Plan.<sup>1856</sup> As of December 2000, there were approximately 45 participants in the Expat Deferral Plan, with account balances totaling \$14 million.<sup>1857</sup> As of December 2001, there were approximately 48 participants in the Expat Deferral Plan, with account balances totaling \$5.4 million.<sup>1858</sup>

In connection with Enron's financial situation, the Expat Deferral Plan was amended November 28, 2001, to suspend deferrals, effective at the end of business November 29, 2001, until such time that the Board of Directors removed such suspension.

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<sup>1853</sup> There was a 1997 Expat Services Inc. Deferral Plan, which appears to have been merged into the 1998 Expat Deferral Plan.

<sup>1854</sup> Attachments to the May 4, 1998, Compensation Committee meeting minutes. EC 000104257.

<sup>1855</sup> In 1997, the Compensation Committee approved Enron Corp. as the guarantor of payments made from the 1997 Enron Expat Services Inc. Deferral Plan. Attachments to the May 4, 1998, Compensation Committee meeting minutes. EC 000104257.

<sup>1856</sup> EC 000768135.

<sup>1857</sup> EC 000768209.

<sup>1858</sup> EC 000768210.

The Expat Deferral Plan was also administered by a committee. As with the 1994 Deferral Plan, it appears that no formal committee was ever established.

One Enron employee told the Joint Committee staff that the Executive Vice President, Human Resources and Community Relations had been appointed to the Expat Deferral Plan committee. The Joint Committee staff interviewed this individual, and she said she had no recollection of such an appointment. Enron employees interviewed by Joint Committee staff stated that, as with the 1994 Deferral Plan, an informal committee would be formed when an issue arose, which was infrequently. It was suggested that the committee could be composed of the head of human resources, compensation department staff members, or legal counsel. An accelerated distribution from the Expat Deferral Plan in April 2001 was approved by three compensation staff members.<sup>1859</sup> When asked whether these individuals were the committee for the Expat Deferral Plan, Enron responded that although there is no documentation which reflects the appointment of a formal committee, plan administrators responsible for securing approvals of Expat Deferral Plan amendments and Expat Deferral Plan administration collectively approved the accelerated distribution in accordance with plan provisions.<sup>1860</sup>

### **Change in recordkeeper**

In connection with the change in recordkeeper for the Enron Savings Plan, the recordkeeper for the 1994 Deferral Plan and the Expat Deferral Plan was changed from Northern Trust Retirement Consulting to Hewitt Associates. The change in recordkeeper occurred at the same time for the 1994 Deferral Plan, Expat Deferral Plan, and the Enron Savings Plan.<sup>1861</sup> The change was completed on November 13, 2001, which was an accelerated date. The originally scheduled date for completion of the change was November 20, 2001. In interviews with the Joint Committee staff, Enron employees who worked on the change in recordkeeper stated that there had been problems with the old recordkeeper for some time, but that because the deferral plans were relatively small plans, vendors generally were interested in recordkeeping only in conjunction with other, larger Enron plans. Thus, they had to wait until a change in recordkeeper was made for the Enron Savings Plan. Enron Compensation Department staff stated that they had minimal involvement in selecting the new recordkeeper. They stated that the Benefits Department staff, who were handling the change in recordkeeper under the Enron Savings Plan, took the principal role in selecting the criteria and making the final decision regarding the new recordkeeper.

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<sup>1859</sup> The document provided by Enron lists three Enron Human Resources employees as the committee approving the accelerated distribution from the Expat Plan as of April 2001. EC2 00032287.

<sup>1860</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

<sup>1861</sup> The change in recordkeeper under the Enron Saving Plan is discussed in Part II.C.4., above.

Because the investment accounts in the deferral plans mirrored those in the Enron Savings Plan, Enron employees interviewed by Joint Committee staff stated that Enron believed that there was an advantage to having the same recordkeeper for both the Enron Savings Plan and the 1994 Deferral Plans and Expat Deferral Plan. In 1999, when investment options for the 1994 Deferral Plan and the Expat Deferral Plan were changed to match those of the Enron Savings Plan, the recordkeeping services for the 1994 Deferral Plan and the Expat Deferral Plan were transitioned from Clark/Bardes to Northern Trust Retirement Consulting, who was the recordkeeper for the Enron Savings Plan at that time. For the future, Enron intended to keep the same recordkeepers for the Enron Savings Plan and the 1994 Deferral Plans and Expat Deferral Plan, as having one recordkeeper would be easier and more efficient for participants.

In connection with the change in recordkeeper of the 1994 Deferral Plan and Expat Deferral Plan, there was a blackout period from November 1, 2001, through November 13, 2001. During this period, reallocation of balances and changes to investment choices were restricted. According to Enron, participants were notified of the change in recordkeeper and blackout period through a notification, which was mailed with the notification sent regarding the Enron Savings Plan blackout.<sup>1862</sup> Information provided by Enron states that participants were mailed a brochure providing the first notice of the change in recordkeeper on October 4, 2001, and were mailed a transition date update postcard on November 8, 2001.<sup>1863</sup> Information provided by Enron shows that the notifications were mailed to 303 participants in the 1994 Deferral Plan and 48 participants in the Expat Deferral Plan.<sup>1864</sup> The notification informed participants that October 31, 2001, would be the last day to access account information.

Even though there was a blackout period for the 1994 Deferral Plan and the Expat Deferral Plan, the blackout did not result in a major interruption of activities for participants. Under the 1994 Deferral Plan and Expat Deferral Plan, participants were not allowed to change investments from the Phantom Stock Account. Other changes in investment could be made daily in the Flexible Deferral Account.<sup>1865</sup> Unlike participants in the Enron Savings Plan, participants in the 1994 Deferral Plan and Expat Deferral Plan received distributions during the blackout. The 1994 Deferral Plan and Expat Deferral Plan provide that a participant's account balance is determined as of the last day of the month preceding the date on which the Deferral Plan Committee received the written request of the participant. Therefore, the participants' account balances as of October 31, 2001 (which was the last day on which account information could be accessed), could be used for distribution requests submitted during the blackout.

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<sup>1862</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

<sup>1863</sup> *Id.*

<sup>1864</sup> *Id.*

<sup>1865</sup> As noted above, participant investment elections had the result of directing the source of investment returns, rather than directing actual investments.



## Other deferred compensation plans

### In general

Enron also had other deferral plans that were the predecessor programs to the active plans. These included the: InterNorth, Inc. Director's Unfunded Deferred Income Plan; InterNorth Deferral Plan; Houston Natural Gas Corporation Deferred Income Program for Directors; HNG Deferred Income Plan; HNG/InterNorth Deferral Plan; Enron Corp. Deferral Plan; Enron Corp. 1988 Deferral Plan; Enron Corp. 1992 Deferral Plan; Enron Corp. Director's Deferral Plan; Enron Deferral Repatriation Plan; Portland General Holdings, Inc. Management Deferred Compensation Plan; and Portland General Holding, Inc. Outside Directors' Deferred Compensation Plan.<sup>1866</sup>

Information provided by Enron shows that there were approximately 200 participants in the InterNorth, HNG/InterNorth, and 1988 Deferral Plans.<sup>1867</sup> As of December 31, 2000, there were approximately 87 participants in the HNG Deferral Plan, with account balances totaling \$7.5 million.<sup>1868</sup> The account balances totaled \$7 million as of December 31, 2001.<sup>1869</sup> According to Enron, no trusts or other funding arrangements were used in connection with any deferral plans other than the 1994 Deferral Plan.<sup>1870</sup>

### 1992 Deferral Plan

The 1992 Deferral Plan preceded the 1994 Deferral Plan. Enron filed the 1992 Deferral Plan with the Department of Labor on January 20, 1992, and stated that there were 76 employees participating in the Plan.<sup>1871</sup> Rather than allowing participants to select investments, account earnings under the 1992 Deferral Plan were based on Enron's midterm cost of capital. The 1992 Deferral Plan allowed distributions in the event of hardship, but did not permit the accelerated distributions (i.e., distributions with a 10 percent forfeiture) like the 1994 Deferral Plan and the Expat Deferral Plan. The 1992 Deferral Plan was amended in 1995 to allow Enron to establish a trust which would fund obligations of plans of deferred compensation of Enron provided that

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<sup>1866</sup> Enron also had a deferred compensation agreement, which appears to have been a nonqualified deferred compensation plan for one individual.

<sup>1867</sup> EC 000768139 - EC 000768145.

<sup>1868</sup> EC2 000031598 - EC2 000031600.

<sup>1869</sup> EC2 000031601 - EC2 000031603.

<sup>1870</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

<sup>1871</sup> Enron letter to the Department of Labor dated January 20, 1992. Documents provided by Enron show that there were 18 participants in the 1992 Deferral Plan. EC 000768147.

trust assets at all times remain subject to the claims of general creditors of Enron. According to Enron, no trust was established.

#### Directors' deferral opportunities

As discussed in the section of this report describing of Board of Directors compensation,<sup>1872</sup> beginning January 1, 1997, it was mandatory that 50 percent of the annual retainer fee of directors be deferred into the Phantom Stock Account under the 1994 Deferral Plan, which, as discussed above, tracked the performance of Enron Corp. common stock. Directors could elect to receive their remaining fees (less mandatory deferrals) in cash, elect to defer remaining fees into the 1994 Deferral Plan, and/or elect to receive Enron Corp. phantom stock units or stock options in lieu of remaining fees.<sup>1873</sup>

Before the use of the 1994 Deferral Plan, there were separate plans maintained for director deferrals. These included the InterNorth, Inc. Director's Unfunded Deferred Income Plan, the Houston Natural Gas Corporation Deferred Income Program for Directors, and the Enron Corp. Director's Deferral Plan. Information provided by Enron shows that there were approximately 29 participants in the Director Deferral Plans (HNG, InterNorth, and Enron).<sup>1874</sup> In prior years, directors also deferred into the 1985 Enron Corp. Deferral Plan and the HNG Deferral Plan.

As discussed above,<sup>1875</sup> Enron sent letters to directors on December 11, 2001, informing them of the status of their nonqualified deferred compensation in connection with the bankruptcy and provided them with a statement of their account balances.<sup>1876</sup> Documents provided by Enron show that nonemployee director account balances in the deferral plans as of November 30, 2001, totaled \$9.4 million.<sup>1877</sup>

#### The Enron Deferred Repatriation Incentive Plan

The Enron Deferred Repatriation Incentive Plan ("EDRIP") was a plan designed for U.S. employees on long-term assignment to the United Kingdom.<sup>1878</sup> The stated purpose of the

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<sup>1872</sup> See Part III.B.4., above.

<sup>1873</sup> Letter to the Enron Board of Directors regarding deferrals, dated December 11, 2002. EC2 000018654.

<sup>1874</sup> EC 000768146.

<sup>1875</sup> See Part III.B.4.

<sup>1876</sup> It is unclear whether all deferral plan participants received such notification.

<sup>1877</sup> The account balance of one individual, Robert Belfer, totaled \$6.086 million. See Part III.B.4.,above, for a table of individual director balances.

<sup>1878</sup> Added Value for your Future (a participant brochure). EC2 000018643.

EDRIP was to promote the success of Enron by providing a means of securing and retaining the continued success of key personnel on foreign assignments through their initial period of repatriation to the United States.<sup>1879</sup> Enron would nominate selected key personnel for participation in the EDRIP while on overseas assignments. Only those selected could choose to participate. Under the EDRIP, Enron made discretionary payments into a U.S.-based escrow account, which would pay out the total accrued balance, including interest, approximately six months after repatriation to the United States. In connection with the EDRIP, Enron would make discretionary bonus payments that were less than they would otherwise be. The employee could express a preference between an EDRIP payment and a bonus, but such preference would not be binding on Enron.

Documents provided by Enron show that the advantages of the EDRIP depended on four assumptions: (1) the U.K. Inland Revenue would not tax a payment that relates to future services; (2) the IRS would allow an election under section 83(b) to recognize earnings currently that may not be paid until some point in the future; (3) in using this election, the earnings were effectively treated as having been earned while on foreign assignment and became eligible for offset by foreign tax credits; and (4) traditionally the level of U.K. taxes has been higher than U.S. taxes and consequently there is often a surplus of foreign tax credit that could be used.<sup>1880</sup>

According to documents provided by Enron, the EDRIP was advantageous to employees because Enron would not withhold U.S. hypothetical taxes at their marginal rate (possibly 39.6 percent) on payments into the EDRIP. Instead Enron would take a flat (15 percent) special hypothetical tax on any deferrals. According to documents provided by Enron, an employee would benefit to the extent of the difference between his or her marginal U.S. tax rate and 15 percent.<sup>1881</sup> The EDRIP balance, including the accrued interest, from the escrow amount would therefore be paid to the employee, contingent on certain factors, free of any further U.S. or U.K. tax liability, except on the accrued interest income. Any earnings deferred into the EDRIP were subject to forfeiture in the event that the individual was not still in the employment of Enron approximately six months after returning to the United States.

### **Early distributions from deferral plans**

#### Accelerated distributions<sup>1882</sup>

In general.—In the months preceding Enron’s bankruptcy, early distributions from the 1994 Deferral Plan and the Expat Deferral Plan were made to certain participants. As discussed

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<sup>1879</sup> EC 002634805.

<sup>1880</sup> Added Value for your Future (a participant brochure). EC2 000018643.

<sup>1881</sup> EC2 000018842.

<sup>1882</sup> The amounts discussed herein as accelerated distribution are approximate amounts. Documents provided by Enron regarding early distributions do not exactly reconcile. The information summarized is from the document most recently provided by Enron, which is included in Exhibit D. EC 002634761 - EC 002634769.

above, the 1994 Deferral Plan and the Expat Deferral Plan had a special feature which allowed participants to request early withdrawals of their account balances subject to a 10-percent forfeiture. The request was subject to approval at the discretion of each plan's committee. Upon an early withdrawal, participants were also prohibited from participating in the plan for a period of three years. The plan was presumably designed this way to attempt to avoid constructive receipt.

In the fall of 2001, participants began to make requests for early distributions from their accounts in the 1994 Deferral Plan and Expat Deferral Plan. Documents provided by Enron show that, in the last quarter of 2001, there were a total of approximately 211 requests for accelerated distributions from the 1994 Deferral Plan and the Expat Deferral Plan.<sup>1883</sup> There have been reports in the media that certain employees were notified that they should make distribution requests; however, the participants interviewed by the Joint Committee staff stated that they were not notified that they should make an early distribution request. Several current and former employees mentioned that there were general rumors regarding the financial status of Enron circulating at the time the requests for early distribution were made.

The Joint Committee staff interviewed several current and former Enron employees regarding the early distribution requests. The Joint Committee staff also interviewed the sole member of the 1994 Deferral Plan Committee,<sup>1884</sup> who was responsible for making the determination of whether distribution requests from the 1994 Deferral Plan should be approved.

1994 Deferral Plan.—Documents provided by Enron show that there were approximately 181 requests for early distributions from the 1994 Deferral Plan.<sup>1885</sup> According to interviews with current and former Enron employees, accelerated distributions had not been made in the past from the 1994 Deferral Plan. Information provided by Enron shows that there were no accelerated distributions made in 1998, 1999, or 2000. In interviews with Joint Committee staff, Enron employees stated that in the fall of 2001, Enron had to create a form and process for handling early distribution requests, because such requests had not been made in the past. After the creation of a form to be used, requests for early distributions were accepted by the Enron Compensation Department, forwarded to the Deferral Plan Committee for consideration, and then, if payment was approved, were processed for payment by the Compensation Department.

Some current and former employees interviewed by Joint Committee staff, including one employee who was involved with administering the early distribution requests, stated that they believed the only early distribution requests approved were those made by active employees.

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<sup>1883</sup> EC 002634761 - EC 002634769. At that time, there were approximately 350 participants in the plans.

<sup>1884</sup> As discussed above, Mr. Whalley was appointed as the Deferral Plan Committee as of October 26, 2001.

<sup>1885</sup> EC 002634761 - EC 002634769.

Documents provided by Enron show that while many requests made by inactive employees were not approved, some early distribution requests made by inactive employees were approved.<sup>1886</sup>

In an interview with Joint Committee staff, the sole member of the 1994 Deferral Plan Committee explained the procedure that was used in making the determination of whether requests for early distributions should be approved. This process was arrived at after discussions with several people, including legal advisors. According to the Deferral Plan Committee, participants with account balances were treated as unsecured creditors of Enron. Three possible primary operating conditions of Enron were identified and decisions were made as to whether distribution requests would be granted or not, depending on the operating condition.

- (1) The first condition was when Enron was considered a going concern. Under such condition, all bills would be paid when due. Thus, if Enron was operating as a going concern, all requests for early distributions would be approved.
- (2) The second condition was when Enron was operating as a going concern, but there were cash flow issues. Under the second condition, Enron would pay distribution requests made by active employees only, because active employees were needed to keep Enron operating, while inactive participants were providing no current service to Enron. The Deferral Plan Committee stated that Enron made similar assessments in handling other unsecured creditors.
- (3) The third condition was when Enron was in bankruptcy or insolvent, in which case no early distribution requests would be paid.

According to the Deferral Plan Committee, in late October and early November, Enron was operating under the second condition (going concern with cash flow issues); therefore, the Deferral Plan Committee approved payments to all of the active employees who had made requests. On November 9, 2001, Enron closed the Dynegy deal and on November 12, 2001, received a large cash payment. At that time, Enron was operating under the first condition (going concern); therefore, all requests were approved. This included requests by inactive participants that had not been approved originally.<sup>1887</sup> This operating condition lasted approximately one week. According to the Committee, during the week of November 19, 2001, there were questions as to whether the Dynegy deal would go through and Enron was eventually downgraded below investment grade. The Committee did not believe that the inactive participants were paid after November 19, 2001.<sup>1888</sup>

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<sup>1886</sup> *Id.* According to Enron and Mr. Whalley, no requests were formally denied, but amounts subject to a request were either paid or not paid. For simplicity, “approved” is used here for those distributions that were made, and “not approved” refers to distributions that were not made.

<sup>1887</sup> Documents provided by Enron show that requests by inactive participants made in October and early November 2001, were approved on November 14, 2001. EC 002634763.

<sup>1888</sup> Minutes from the November 28, 2001, meeting of the Board of Directors show that the Board had authorized management to pay bills selectively to maximize the value of Enron.

Documents provided by Enron detailing the timing of the approval of payments of early distributions requests are not inconsistent with the approval system discussed above as described by the Deferral Plan Committee. While most employees interviewed by the Joint Committee staff believed that all requests made by active employees were approved, and that requests by inactives were not, documents provided by Enron show that accelerated distribution requests made by active employees on November 30, 2001, were not approved.<sup>1889</sup> Documents provided by Enron show that while some requests made by inactive participants were approved, no such requests were approved after November 14, 2001, which was the last approval date before November 19, 2001.<sup>1890</sup> No requests made after the bankruptcy filing were approved.

Of the approximately 181 participants who requested early distributions from the 1994 Deferral Plan, approximately 109 participants received distributions from the Flexible Deferral Accounts totaling \$46.2 million.<sup>1891</sup> Payments were made from the general funds of Enron and not from the 1994 Deferral Plan rabbi trust. In addition to the cash distributions from the Flexible Deferral Accounts, stock distributions from the Phantom Stock Account equal to \$502,452 were made to participants.<sup>1892</sup> In the case of a distribution from the Phantom Stock Account, shares were withheld to cover taxes owed.<sup>1893</sup>

Expat Deferral Plan.—As discussed above, like the 1994 Deferral Plan, subject to the discretion of the Expat Deferral Plan Committee, the Expat Deferral Plan also allowed an accelerated withdrawal of all or a portion of a participant’s account balance, with 10 percent of the elected distribution amount forfeited. An accelerated distribution had been approved from the Expat Deferral Plan in April 2001. In the fall of 2001, approximately 30 participants in the Expat Deferral Plan made requests for early distributions. The committee for the Expat Deferral Plan was responsible for determining whether early distribution requests should be granted.<sup>1894</sup>

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<sup>1889</sup> EC 000768237.

<sup>1890</sup> EC 002634761 - EC 002634769.

<sup>1891</sup> EC 002634761. Approval of one request for distribution of an account balance of \$4.8 million is listed as “pending.” Distributions to 11 participants in the aggregate amount of \$2.1 million were approved, but were not wired. Two distribution requests were withdrawn. One request was approved, but the check bounced. EC 002634761 - EC 002634769.

<sup>1892</sup> EC 002634761 - EC 002634769. Payments from the Phantom Stock Account were paid in shares of Enron Corp. common stock, with the exception of pre-1998 deferrals, which would be paid out in cash unless the participant signed a waiver to receive stock. Documents provided by Enron show varying amounts in participants’ Phantom Stock Accounts. The amount cited above is from the document most recently provided by Enron, which is included in Appendix D.

<sup>1893</sup> According to Enron, Exhibit 3b.2 to the bankruptcy filing incorrectly considered the net value of the share distribution in the calculation of deferral payments.

<sup>1894</sup> As discussed above, there does not appear to have been a formal committee under the Expat Deferral Plan.

Distributions from the Flexible Deferral Account were made to approximately 18 participants in the amount of \$6.9 million.<sup>1895</sup> In addition, distributions of stock equal to \$52,342 were made from Phantom Stock Accounts.<sup>1896</sup>

### Hardship requests

Three participants in the 1994 Deferral Plan and one participant in the Expat Deferral Plan made requests for hardship distributions in the weeks immediately preceding the bankruptcy.<sup>1897</sup> There were no hardship requests granted in 2001. Participants submitted distribution requests for both hardship distributions and early distributions. In at least one case, after an accelerated distribution was made, the participant requested the 10 percent forfeited as a hardship. The request was denied.

From Joint Committee staff interviews with Enron employees, it appears that the process for evaluating hardship withdrawal requests was more complicated and time consuming than the process for accelerated distribution requests. In the case of a hardship request, the participant had to prove hardship and necessary documentation was required. In an interview with Joint Committee staff, one Enron employee stated that Enron filed for bankruptcy before there was sufficient time to process the hardship withdrawal requests. Another former employee stated that none of the requests qualified for hardship under the terms of the plans. Many of the reasons for the requested hardship distributions claimed by participants were tied to the financial situation of Enron.

The older deferred compensation plans did not allow accelerated distributions, but did allow for hardship distributions. Documents provided by Enron show that hardship withdrawal requests were made in November 2001 from participants in the 1988 Deferral Plan, the 1992 Deferral Plan, the Project Participation Plan, the 1994 Deferral Plan and the Expat Deferral Plans totaling \$5.9 million.<sup>1898</sup> There were 11 requests from the 1998 Deferral Plan, one request from the 1992 Deferral Plan, and three requests from the Project Participation Plan.<sup>1899</sup> As mentioned above, no hardship requests were granted. Although infrequent, hardship withdrawals had been made in the past. Documents provided by Enron show that one hardship request was granted from the 1992 Deferral Plan in 1998.

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<sup>1895</sup> EC 002634761. Three distributions in the aggregate amount of \$283,027 were approved for payment, but were not wired.

<sup>1896</sup> EC 002634763 - EC 002634769. Documents provided by Enron show varying amounts in participants' Phantom Stock Accounts. The amount cited above is from the document most recently provided by Enron.

<sup>1897</sup> EC2 000018410 - EC2 000018411.

<sup>1898</sup> EC2 000018404.

<sup>1899</sup> EC2 000018404 - EC2 000018411.

## Discussion of Issues

### In general

Nonqualified deferred compensation is a common form of executive compensation. From the executive's perspective, the desire to save taxes is generally the key motivating factor behind deferred compensation. Individuals may want to defer compensation to a future date because they believe that their tax burden will be lower in the future than it is currently, thus resulting in payment of lower taxes than if the compensation had been received currently. Individuals may defer compensation in order to provide a future income stream in retirement. Employers may structure deferred compensation arrangements to induce or reward certain behavior. In many cases, the desire to accommodate the compensation wishes of an individual that a company wants to attract or retain as an employee may be a sufficient motivating factor to provide a deferred compensation arrangement. In some cases, a company may require the deferral of certain amounts of compensation, e.g., salary in excess of \$1 million, in order to comply with the limitation on the deductibility of compensation in excess of \$1 million.<sup>1900</sup> ERISA's exemptions for nonqualified deferred compensation arrangements allow great flexibility in designing plans and individual arrangements.

Nonqualified deferred compensation arrangements are often compared and contrasted to qualified retirement plans. Qualified retirement plans are subject to rules that do not apply to nonqualified arrangements, including nondiscrimination rules designed to ensure that the plans cover a broad group of employees. The benefits of qualified plans include tax advantages for the employer and the employee,<sup>1901</sup> security for the employee,<sup>1902</sup> and flexibility regarding payment.<sup>1903</sup>

Some argue that nonqualified deferred compensation arrangements are necessary because of the limits on qualified plans.<sup>1904</sup> The structure of some nonqualified deferred compensation arrangements is similar to qualified plans without the restrictions imposed by the Code. In many

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<sup>1900</sup> Sec. 162(m). This limitation is discussed in Part III.C.6., below.

<sup>1901</sup> In the case of a qualified plan, the employer receives a current deduction, while in the case of a nonqualified plan, the deduction is postponed until the time at which the employee includes the amount in income.

<sup>1902</sup> Assets of a qualified plan cannot be reached by creditors of the employer, and are set aside for the sole purpose of paying plan benefits. In addition, as described above, within limits, the PBGC guarantees benefits under defined benefit plans.

<sup>1903</sup> Constructive receipt rules do not apply to qualified retirement plans. In some cases, however, the Code may restrict the earliest point at which benefits may be paid.

<sup>1904</sup> The maximum benefit that can be payable out of a qualified defined benefit plan is \$160,000 a year (sec. 415(b)). This is far less than the annual salary of many Enron executives. In addition, the *annual* limit on contributions to qualified defined contributions plans, \$40,000 for 2003, (sec. 415(c)) is far less than the *monthly* salary of many Enron executives.



cases, nonqualified deferred compensation offers even greater advantages for executives than qualified plans. For example, while qualified plan distributions are subject to a 10-percent additional tax on early withdrawals,<sup>1905</sup> Enron executives could defer amounts under the 1994 Deferral Plan and structure the arrangement so that payment would be made in as little as three years from the time of deferral (i.e., special purpose deferrals). To the extent that nonqualified deferred compensation arrangements have features more like qualified plans, there may be less incentive for employers to adopt broad-based qualified retirement plans.

As discussed above, neither the Code nor ERISA limit the amount of nonqualified deferred compensation. Because the employer is denied a deduction for deferred compensation until the employee includes the compensation in income, there is often said to be a tension between the interests of the employer and the employee that will result in an appropriate limit on deferred compensation.

In Enron's case, the deferral of its tax deduction was not a paramount concern, and the supposed "tension" between the interests of the employer and the employee from a tax perspective did little, if anything, to limit the amount of deferred compensation. Many Enron executives participated in Enron's nonqualified deferred compensation programs. As discussed above, from 1998 through 2001, over \$154 million in compensation was deferred.

In connection with Enron's financial problems, many executives lost a considerable amount of compensation that had been deferred. Participants who had balances remaining in the deferral plans as of the bankruptcy may recover some of those amounts as unsecured creditors in the bankruptcy proceeding. This would include participants in plans that did not allow early distributions (e.g., the 1998 Deferral Plan), participants who could have but did not request an early withdrawal, or participants whose requests for early withdrawals were not approved. In addition, the value of Phantom Stock Accounts is currently minimal, because the account balances were treated as if invested in Enron stock.

On the other hand, many executives were able to access their deferred compensation, primarily by means of the early withdrawal provisions under the 1994 Deferral Plan and the Expat Deferral Plan. In the few months immediately preceding the bankruptcy, approximately 117 people received distributions totaling over \$53 million.

As described above, there are no clear rules governing many aspects of deferred compensation arrangements. As a result, taxpayers may design deferred compensation arrangements based on varying interpretations of authority that may not be strictly applicable to the situation in question. Under present law, a variety of practices have developed with respect to deferred compensation arrangements which are intended to achieve the desired tax deferral, while at the same time attempting to provide some sense of security to executives as well as some degree of flexibility regarding time of payment and other plan features. In order to make such arrangements more attractive to the employee, some taxpayers may push the limits of present law.

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<sup>1905</sup> Sec. 72(t).

While deferred compensation arrangements vary greatly, many of the plan features used by Enron are not uncommon. Even though certain aspects of the plans may be within common practices, some issues may be raised with respect to whether they meet the requirements necessary to obtain the desired tax deferral. In addition, even if the present-law rules are satisfied, certain of the arrangements Enron maintained raise broader questions of whether they fall within the spirit of the present-law rules or whether they should, as a policy matter, result in tax deferral. Particular issues raised under the Enron deferral arrangements are addressed below.

### **Funding issues**

It appears that Enron may have intended the rabbi trust used in connection with the 1994 Deferral Plan to comply with the safe harbor requirements of Revenue Procedure 92-64.<sup>1906</sup> It was certainly intended that the trust not result in current income taxation; Enron employees and counsel interviewed by Joint Committee staff stated that it was intended that current taxation not result from the structure of the deferred compensation arrangements. Even if the trust were a valid rabbi trust when evaluated solely on the basis of the trust document, there is an issue as to whether other provisions under the 1994 Deferral Plan would cause the trust to be considered funded for tax purposes.

As discussed above, in the case of a rabbi trust, trust terms providing that the assets are subject to the claims of creditors of the employer in the case of bankruptcy or insolvency have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes. In the case of Enron, even though the trust document provided that the assets of the trust were subject to the claims of creditors, because participants had the ability to obtain early distributions, there is an argument that the rights of such employees were effectively greater than the rights of the creditors, making the trust funded for tax purposes. If, in fact, the arrangement was not subject to the claims of creditors, the arrangement should be considered funded, and income inclusion should have occurred when there was no substantial risk of forfeiture.

It may be argued that the ability to obtain the money did not give the participants rights greater than general creditors. Under the terms of the 1994 Deferral Plan and the rabbi trust, participants had no interest in any particular assets of Enron. In addition, Enron employees told the Joint Committee staff that the decisions whether to approve requests for distributions were made in the same way as Enron would treat the claims of other unsecured creditors.

However, because of the early distribution provisions in the 1994 Deferral Plan and the Expat Deferral Plan, plan participants received over \$53 million under the Plans within approximately two months preceding the bankruptcy, precluding such amounts from being available to the claims of creditors. They would not have been able to obtain this amount in the absence of the withdrawal provisions. The financial condition of Enron appears to have been a

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<sup>1906</sup> Because the revenue procedure describes a “safe harbor,” a trust may be a valid rabbi trust without satisfying the safe harbor. However, the IRS will not rule on trusts that do not satisfy the safe harbor, except in rare and unusual circumstances.

motivating factor behind the requests for distribution; such requests had not previously been received under the Plans.

## **Constructive receipt**

### In general

Income is constructively received in the taxable year during which it is credited to the taxpayer's account, set apart, or otherwise made available so that the taxpayer may draw on it at any time. Income is not constructively received if the taxpayer's control of the income is subject to substantial limitations or restrictions. While the 1994 Deferral Plan and the Expat Deferral Plan were designed to impose restrictions or limitations on the participant's control of amounts deferred, such restrictions or limitations could be seen as illusory. While under present law the plan provisions may not result in constructive receipt, there is an issue as to whether the existence of such features should result in the application of the constructive receipt doctrine. When viewed collectively, the existence of the opportunities for accelerated distributions, participant-directed investment, and change in participant elections lend credence to the argument that the doctrine of constructive receipt should apply.

### Accelerated distributions

Even if the 1994 Deferral Plan is considered unfunded, there is an issue as to whether participants should have been considered in constructive receipt of deferred amounts. A participant's unfettered right to withdraw amounts deferred results in constructive receipt. As discussed above, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Enron's treatment of deferred amounts reflects the view that even though participants could receive accelerated distributions under the 1994 Deferral Plan and Expat Deferral Plan, the 10-percent forfeiture, the inability to participate in the Plan for three years following an accelerated distribution, and the requirement subjecting distributions to the discretionary authority of the plan committee were substantial limitations or restrictions on the right to receive deferred amounts.

The IRS has not explicitly authorized the use of forfeiture provisions (i.e., "haircuts") in nonqualified deferred compensation plans. Many nonqualified deferred compensation plans utilize a 10-percent forfeiture limitation preventing constructive receipt, based on the 10-percent early withdrawal tax applicable to distributions from qualified retirement plans and IRAs.<sup>1907</sup>

Some may argue that the fact that some participants made requests for early distributions, but such requests were not granted supports the argument that the discretionary authority of the plan committee was a substantial limitation or restriction on the right to receive the deferred amounts, which should prevent the application of constructive receipt.

As a practical matter, the 10-percent forfeiture provision did not appear to impose much of a deterrent for 1994 Deferral Plan participants in requesting distributions. As noted above, many participants requested distributions. One former Enron executive who did not request a

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<sup>1907</sup> Sec. 72(t).

distribution indicated that he did not make a request because he did not want to contribute to the already bad financial position of Enron.

#### Participant-directed investment

An issue may also exist due to the ability of participants to direct investments of amounts deferred. As discussed above, participants in the 1994 Deferral Plan and Expat Deferral Plan were able to direct investments of amounts deferred into the Flexible Deferral Account. More precisely, they were able to direct how earnings on deferred amounts should be credited.

According to Enron, only initially did Enron direct investments to track generally with participant elections.<sup>1908</sup> According to Enron's summary of the 1994 Deferral Plan,<sup>1909</sup> because of constructive receipt rules Enron could credit an employee's deferral account with earnings that tracked a chosen mix of investment funds, but the actual investments were required to be made by Enron Corp. or by the Trustee appointed by Enron Corp. at the direction of Enron Corp.

The model rabbi trust safe harbor under Revenue Procedure 92-64 only requires that the trustee must be given some investment discretion, such as the authority to invest within broad guidelines established by the parties. It does not provide precise guidelines on how trust assets must be invested. The IRS has ruled, in the case of one taxpayer, that no amount would be considered made available as a result of the fact that the participant has a right to designated deemed investments.<sup>1910</sup> Some commentators have noted that allowing participant directed investments presents no tax issues and should be allowed in plans.<sup>1911</sup>

#### Change in participant elections

Participants in the 1994 Deferral Plan were allowed to change payout elections at any time. Elections would be effective one year after being received by Enron. As previously discussed, under present law, courts have generally been lenient in applying the constructive receipt doctrine with respect to subsequent elections. While no single case can be relied upon for the position that subsequent elections will not result in constructive receipt, given the case law in the area, the position that the ability to make a subsequent election has some support.

Nevertheless, allowing participants to change payout elections gives them control over the amounts deferred. Changing payout elections allows participants to control the timing and

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<sup>1908</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002.

<sup>1909</sup> EC2 000018443.

<sup>1910</sup> Priv. Ltr. Rul. 200148054. (The private letter ruling involved a qualified governmental excess benefit arrangement under section 415.)

<sup>1911</sup> See SMITH, ET. AL, NONQUALIFIED DEFERRED COMPENSATION ANSWER BOOK (3rd ed. 1996).

amount of payment, which is the basis for the general principle of constructive receipt. Thus, the ability to make subsequent elections arguably should result in constructive receipt.

### **Fairness concerns relating to early distributions**

Nontax issues have been raised regarding the pre-bankruptcy accelerated distributions made from the 1994 Deferral Plan and the Expat Deferral Plan. Media reports allege that distributions were wrongfully allowed. While it may seem unfair for some participants to receive their account balances while other participants' requests were not approved, the 1994 Deferral Plan and the Expat Plan documents clearly state that accelerated distributions are made subject to the consent of the relevant plan committee. The plans provide that the committee has 60 days to approve or deny a request, but do not discuss what criteria must be used by the committee in approving or denying requests. Furthermore, the plans provide generally that all determinations provided for in the plan shall be made in the absolute discretion of the committee and that determinations shall be binding on all persons.

Employees were aware that the committee had discretion regarding accelerated distribution payments. Employee materials state that the committee was to interpret the plans, including but not limited to decisions regarding suspension of deferrals, hardship withdrawals, accelerated distributions, and other matters that would arise under the terms of the plans.<sup>1912</sup> There appears to be no obvious violation of the terms of either plan.

While there may be some perceived inequity, modifying the rules relating to nonqualified deferred compensation arrangements to eliminate any perceived inequities in the treatment of active and inactive employees would be counter to tax policy because such a modification would give participants in nonqualified deferred compensation arrangements greater control over their deferred amount.

### **Deferral of stock option gains program**

As discussed above, Enron amended the 1994 Deferral Plan in 1996 to provide for the deferral of stock options gains program, which established a Phantom Stock Account to which gains realized from stock-for-stock exercises of options could be deferred. Under the program, executives were able to pay the exercise price of options with already-owned Enron stock, transfer their basis in the old stock to an equal amount of new stock, and transfer the additional stock that would otherwise be received into the Phantom Stock Account.

The deferral credited to the participant's stock option deferral account was an amount equal to the number of shares deferred multiplied by the current per share market price, and was treated as if the amount of the deferral had been used to purchase shares of Enron Corp. common stock at such per share market price. Credits for dividends would be accrued in a separate account and paid in cash, pursuant to the normal payment terms of the 1994 Deferral Plan.

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<sup>1912</sup> Deferral plan questions and answers (brochure for participants). EC2 000018440.

The 1994 Deferral Plan includes an example of how the stock option gain deferral works:

- Executive optionee holds an option for 20,000 shares at \$50 per share (an aggregate exercise price of \$1 million).
- Optionee makes an advance election to defer receipt of the additional shares received in a stock-for-stock exercise until a fixed time in the future (from one to 15 years beginning at death, disability, retirement or termination).
- Optionee owns 12,500 previously acquired mature shares (held at least six months) with a current market price of \$80 per share (an aggregate market value of \$1 million).
- Optionee exercises the 20,000-share option in a stock-for-stock exercise (either by actual delivery of already-owned share or by “attestation,” i.e., instead of delivering shares to Enron, the executive simply provides an affidavit of ownership of the shares).
- Enron credits 7,500 share units to a Phantom Stock Account under the Plan (executive retains the already-owned 12,500 shares at the original cost basis). During the deferral period, dividend equivalents would be credited in the form of cash.<sup>1913</sup>
- Upon death, disability, retirement or termination, the share units are converted to shares which are issued to the executive according to the payment election made by the executive at the time of the deferral election (i.e., if at termination there are 1,000 share units in the account and the executive chose 10 annual payments, 100 shares would be distributed each year, in addition to credits attributable to dividends on such shares which will be paid out in cash).

While this type of program may be commonly used, there are questions whether it should result in effective income deferral.<sup>1914</sup> There is no authority clearly addressing stock option gain deferrals.<sup>1915</sup> The program does not fit within the IRS ruling guidelines on the application of

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<sup>1913</sup> Absent the deferral, the executive would include in income the fair market value of the 7,500 additional shares, i.e., \$600,000 (7,500 x \$80). Rev. Rul. 80-244, 1980-2 C.B. 234.

<sup>1914</sup> See Geer, “*Why not just pay the tax?*,” FORBES (March 10, 1997) at 156.

<sup>1915</sup> Some taxpayers may attempt to rely on Priv. Ltr. Rul. 199901006 in taking the position that the IRS has approved the transaction. In addition to the fact that private letter rulings may not be used or cited as precedent, the ruling cannot be relied upon, as the facts of the ruling are different from that those of the stock option gains program. For example, in the ruling, the election to exchange options for deferred compensation was made before the options were vested. Additionally, distributions of the amounts deferred would generally be made at the time that the employee’s options would have vested. Further deferral was not allowed at the election of the employee.

constructive receipt to nonqualified deferred compensation.<sup>1916</sup> The principles used are a combination of the rules relating to a stock-for-stock exercise and nonqualified deferred compensation.

As discussed above,<sup>1917</sup> upon a stock-for-stock exercise, the employee is taxed on the fair market value on the additional shares received. Under the deferral of stock option gains program, the employee would not be taxed on the shares, but would defer the gain recognition to some time in the future. Enron took the position that the Phantom Stock Account would amount to an unfunded promise to pay, thereby avoiding inclusion of the gain amount.<sup>1918</sup> Upon exercise, the employee would be treated as receiving the number of already-owned shares that he or she used for payment (in a tax-free exchange) and the employer's promise to deliver additional shares in the future. It appears that the timing of income inclusion is deferred by having the employer and employee alter the terms of the original option agreement so that the employee's right to receive the additional shares is delayed until a specific time in the future.

To avoid possible constructive receipt, Enron required that the exercise occur six months or more after the deferral election was made. Deferrals were required to be made prior to the end of the preceding tax year and at least six months prior to exercise. The timing of the election is different from the timing that is typically required for an election to effectively defer compensation. In order to obtain a ruling concerning the application of constructive receipt to unfunded deferred compensation arrangements, generally elections must be made before the beginning of the period of service for which the compensation is payable.<sup>1919</sup> In the case of option gain deferral in Enron's plan, the election could be made after the options are vested and after services have been performed with respect to such compensation, as long as it is made at least six months prior to exercise.

The tax position taken with respect to the deferral of stock options gains is similar to that of the exercise of an option for stock which is restricted. If an individual were to engage in a stock-for-stock exercise receiving stock subject to a substantial risk of forfeiture, the stock would not be included in income until the substantial risk of forfeiture expires. In the deferral of stock option gains, taxation is not postponed by imposing restrictions on the stock, but by having the employee's right to receive the shares delayed until a specified time in the future. Because the employee only has an unfunded promise to pay, which is not property under section 83, income inclusion is postponed.

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<sup>1916</sup> Rev. Proc. 71-19, 1971-1 C.B. 698; Rev. Proc. 92-65, 1992-33 I.R.B. 16.

<sup>1917</sup> See Part III.C.2., above.

<sup>1918</sup> The company's deduction is postponed until the amounts are distributed and included in the employee's income.

<sup>1919</sup> Rev. Proc. 71-19, 1971-1 C.B. 698; Rev. Proc. 92-65, 1992-33 I.R.B. 16.

Documents provided by Enron show that Mr. Lay participated in the deferral of stock option gains program.<sup>1920</sup> It is unclear to what extent other employees participated in the program. Enron-provided documents show that spread at exercise was subject to FICA/FUTA and Medicare taxes. Documents provided by Enron show that upon a stock-for-stock exercise where shares were deferred, shares were withheld for Medicare taxes.<sup>1921</sup>

## **Recommendations**

### **In general**

The experience with Enron demonstrates that the theoretical tension between the employer's interest in a current tax deduction and the employee's interest in deferring tax from a tax perspective has little, if any, effect on the amount of compensation deferred by executives. In Enron's case, because of net operating loss carryovers, denial of the deduction did not have a significant impact on its tax liability. Despite any possible effect on its tax deduction, Enron's deferred compensation arrangements allowed executives to defer millions of dollars in compensation that would otherwise be currently includible in income.

Enron's nonqualified deferred compensation arrangements contained a variety of features which serve to blur the distinction between nonqualified deferred compensation and qualified plans. Enron's nonqualified deferred compensation plans included features that to some extent provided the advantages of a qualified plan, such as security for and access to benefits without current income inclusion, despite not meeting the qualified plan requirements. Because nonqualified arrangements have features like qualified plans, there may be less incentive from employers to adopt broad-based qualified retirement plans. If executives are able to fulfill their retirement needs through the use of nonqualified plans, for some employers there would be no incentive to offer qualified plans to rank and file employees.

While there are a number of reasons why nonqualified deferred compensation arrangements are adopted, a primary factor is the desire by the executive to defer payment of income tax. For example, a stated purpose of the 1994 Deferral Plan and Expat Deferral Plan was to allow executives to reduce current compensation and thereby reduce their current taxable income and earn returns on a tax-favored basis. Without the tax benefit of deferral, it is unlikely that nonqualified deferred compensation arrangements would exist, and certainly would not exist to the extent they do under present law.

Some argue that nonqualified deferred compensation is merely an avoidance of current income taxation, and that rules should be adopted to prevent inappropriate deferral. For

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<sup>1920</sup> EC 000769187 - EC 000769197. The election to defer was made August 4, 1999. Shares were credited to the Phantom Stock Account in the 1994 Deferral Plan in February 2000. The stock-for-stock exercises were done through attestation. Shares were withheld to pay Medicare taxes.

<sup>1921</sup> Mr. Lay's compensation generally would have been over the maximum amount subject to FICA and FUTA taxes (i.e., the taxable wage base); therefore, only Medicare (HI) taxes would apply to these amounts.



example, some have suggested rules that compensation should be includible in income when earned or, if later, when there is no substantial risk of forfeiture of the rights to such compensation.<sup>1922</sup> In the case of Enron executives, this would have resulted in earlier income inclusion, as amounts deferred would have been included in income when earned and vested. The Joint Committee staff believes that this approach would result in a better measure of income than under present-law rules in which an unfunded promise to pay, even if vested, is not currently taxable. However, this approach would represent a significant change in policy.

The Joint Committee staff believes that some changes to the present-law rules regarding the taxation of deferred compensation are appropriate. Following are some specific options relating to deferred compensation which would preserve the ability to obtain tax deferral, but would reduce the use of practices which give executives control over amounts deferred. This is not intended as an exhaustive list of possible alternatives. Other options should also be considered. The options mentioned here would affect current practices, but would have less impact on current practices than would a broad change in policy.

In evaluating changes to the rules relating to deferred compensation, one factor to keep in mind is that taxpayers are likely to change their behavior to adapt to any given set of rules. For example, if the law were changed to restrict the use of one particular practice, it is likely that, over time, taxpayers would develop other ways to achieve the intended result.

### **Section 132 of the Revenue Act of 1978**

As discussed above, section 132 of the Revenue Act of 1978 was enacted in response to proposed Treasury regulation 1.61-16, and provides that the taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan is determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978. The restriction imposed by section 132 of the Revenue Act of 1978 may have prevented Treasury from issuing more guidance on nonqualified deferred compensation and may have contributed to aggressive interpretations of present law.

Section 132 of the Revenue Act of 1978 should be repealed. Repealing section 132 would allow Treasury to provide more guidance to taxpayers and may also help to stem abusive practices. Especially given the lack of statutory rules in this area, the lack of administrative guidance in this area allows taxpayers latitude to create and promote arrangements which push the limit of what is allowed under the law. Because of the lack of rules and guidance in this area, the current state of practice has, to a great extent, evolved from variations of private letters ruling issued by the IRS to various taxpayers. Because there are no clear rules or guidance, taxpayers continue to create new variations of arrangements that, in their basic form, are generally perceived as allowed by the IRS.

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<sup>1922</sup> This would be similar to the rule under Code section 457(f) relating to deferred compensation of employees of tax-exempt organizations and governments. Another alternative would be to impose a tax on the investment income. See Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 YALE L.J. 506 (1986).

### **Accelerated distributions**

Under present law, a requirement of surrender or forfeiture of a valuable right is a sufficient restriction to preclude constructive receipt of income. The Joint Committee staff recommends that under nonqualified deferred compensation arrangements, plan provisions allowing accelerated distributions at the request of the participant, should trigger constructive receipt rather than resulting in deferral. Distributions made to executives in the period immediately preceding the bankruptcy drained Enron's cash by over \$53 million that would have been available to the creditors and raises questions regarding whether, in fact, a substantial limitation existed.

As part of any specific proposal, consideration should be given to the circumstances under which withdrawals should be permitted without triggering constructive receipt. Distribution options under current arrangements include: financial hardship, death, disability, retirement, the passage of a period of time specified by the employee (e.g., three years), and change in control.

### **Rabbi trusts**

Enron had a rabbi trust to provide some security with respect to deferred amounts. Rabbi trusts are common arrangements. Arrangements have developed which appear to fit within the technical guidelines for a valid rabbi trust, but which provide security to executives. For example, as discussed above, even though the trust document stated that participants' rights were not greater than those of general creditors, the fact that millions of dollars in distributions were made immediately before the bankruptcy supports the conclusion that the rights of participants were greater than those of general creditors. Consideration should be given as to whether rabbi trusts are appropriate for deferred compensation, or whether additional requirements should be imposed with respect to such trusts.

### **Participant-directed investment**

Allowing participants to direct investment of amounts deferred gives participants control over the earnings on the amounts deferred. The Joint Committee staff recommends that the ability of participants to direct investments of amounts deferred should result in current inclusion of income.

### **Subsequent elections**

While the rules regarding subsequent elections are not clear under present law, many taxpayers take the position that subsequent elections allowing participants to change the payout term of their deferred compensation do not result in constructive receipt.

The Joint Committee staff recommends that plan provisions allowing participants to make subsequent elections should trigger constructive receipt. Subsequent elections allow taxpayers to control the timing and amount of their distributions. Allowing participants to accelerate or postpone the payment of their accounts should result in constructive receipt.

Alternatively, limited opportunities to change elections could be provided for in the law. If limited opportunities to make subsequent elections are allowed, the time that such elections are allowed to be made should be specified.

### **Deferral of stock option gains and restricted stock**

As described above, Enron provided opportunities for executives to defer gains that would otherwise have been taxable due to the exercise of stock options and the vesting of restricted stock. The deferral of stock option gains program can be viewed as a manipulation of the rules for deferred compensation and stock-for-stock exercise, which were not intended to be combined, thus resulting in an unintended and inappropriate result for taxpayers. The Joint Committee staff believes that it is inappropriate to allow deferral of stock option gains and restricted stock.

### **Reporting**

Other than an initial plan filing with the Department of Labor, until amounts are includible in income, there is no required reporting of nonqualified deferred compensation. Requiring reporting of amounts deferred to the IRS, even if the taxpayer takes the position that such amounts are not currently includible in income, could provide the IRS greater information regarding such arrangements. In most cases, the IRS does not have any information regarding amounts deferred, and therefore, no indication that a particular arrangement should be examined.

## **2. Stock-based compensation**

### **Present Law**

#### **General background**

Stock-based compensation is a commonly used form of compensation for employees and may be also provided as compensation for service providers who are not employees, such as outside directors. Commonly used forms of stock-based compensation include stock options, restricted stock, stock appreciation rights, and phantom stock arrangements.

Similar to nonqualified deferred compensation arrangements, an employer may have a formal plan that provides stock-based compensation to employees on a regular basis. For example, the employer may have a plan under which stock or stock options are granted to employees annually. Alternatively, or in addition, an individual's employment contract may provide for stock-based compensation for that individual. In some cases, stock-based plans are a means of providing nonqualified deferred compensation.

Stock-based compensation is often used in connection with incentive compensation. For example, bonuses may be paid in the form of stock; grants of stock or stock options may depend on corporate performance; or the rate at which restrictions on stock lapse or the rate at which stock options become exercisable may be accelerated if certain corporate earnings targets are met.

Some argue that the use of stock-based compensation is an appropriate means of compensation because it aligns the interests of the shareholders and corporate executives and rewards performance. On the other hand, some argue that an increase in stock price or corporate earnings alone is not an appropriate measure of performance because such an increase may not be directly linked to an individual's performance and may encourage executives to inappropriately inflate earnings and focus on short-term earnings.

### **Compensatory stock (including restricted stock)**

#### In general

Stock may be granted to an employee (or other service provider) without restrictions in the sense that the stock is fully vested and transferable. In some cases, the employee is granted "restricted" stock in the sense that the stock must be forfeited or sold back to the company in certain circumstances. For example, an employee may receive stock that is subject to a substantial risk of forfeiture because of a requirement that the stock be forfeited if the employee terminates employment within some stated number of years. As another example, restricted stock may be granted pursuant to a five-year vesting schedule, pursuant to which 20 percent of the stock granted becomes available to the employee for each year of service. In this example, if the employee were to leave after three years of service, 60 percent of the shares of restricted stock would have vested and 20 percent would be forfeited.

Restricted stock (i.e., stock that is subject to a substantial risk of forfeiture) is often referred to as nonvested stock; stock that is not (or is no longer) subject to a substantial risk of forfeiture is often referred to as vested stock. Restrictions that no longer apply are often said to have "lapsed." Shares that vest are sometimes referred to as being "released."

#### Tax treatment

Stock that is granted to an employee (or other service provider) is subject to the rules that apply under section 83 to transfers of property in connection with the performance of services. Accordingly, if vested stock is transferred to an employee, the excess of the fair market value of the stock, over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which the transfer occurs.

If nonvested stock is transferred to an employee, no amount is includible in income as a result of the transfer unless the employee elects to have income inclusion in the year of transfer.<sup>1923</sup> Otherwise, the excess of the fair market value of the stock at the time of vesting, over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which vesting occurs.

In the case of an employee, the amount includible in income under section 83 is also subject to income tax withholding and to social security tax (subject to the social security wage

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<sup>1923</sup> Sec. 83(b).

base) and Medicare tax and must be reported on a Form W-2.<sup>1924</sup> The amount includible in the income of the employee (or other service provider) is generally deductible by the employer for the taxable year of the employer in which the recipient's taxable year of inclusion ends.<sup>1925</sup>

## **Compensatory stock options**

### **In general**

A stock option is the right to purchase stock at a specified price (or at a price determined under a specified formula) at a specified time or during a specified period. Stock options granted to employees or other service providers are considered to be compensation for services. There are two general types of compensation-related stock options under the Code: nonqualified options and statutory options.

Statutory options include incentive stock options<sup>1926</sup> and options provided under an employee stock purchase plan.<sup>1927</sup> Nonqualified options are any other options granted in connection with the performance of services.

### **Nonqualified options**

The income taxation of a nonqualified option is determined under section 83 and depends on whether the option has a readily ascertainable fair market value when granted. A nonqualified option has a readily ascertainable fair market value if (1) the option is actively traded on an established market, or (2) the option is transferable, it is immediately exercisable in full, the stock subject to the option is not subject to any restriction or condition that has a significant effect on the value of the option, and the fair market value of the option privilege is readily ascertainable. The option privilege is the opportunity to benefit from increases in the value of the stock during the option period without risking capital.

If an individual receives a nonqualified option that has a readily ascertainable fair market value at the time the option is granted, the excess of the fair market value of the option over the amount, if any, paid for the option is includible in the recipient's gross income as ordinary income in the first taxable year in which the option is either transferable or is not subject to a substantial risk of forfeiture (or, if the taxpayer elects, in the taxable year in which the option is

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<sup>1924</sup> Because there is no transfer of cash upon the vesting of the stock, the withholding requirements may present administrative issues. Enron utilized several methods for handling withholding in such cases, as described below.

<sup>1925</sup> The employer must comply with applicable reporting requirements in order to claim the deduction. Treas. Reg. sec. 1.83-6(a)(2). The amount of any deduction may also be limited by the \$1 million limitation on the deduction of compensation of the top-five executives. Sec. 162(m). This limitation is discussed in Part III.C.6., below.

<sup>1926</sup> Sec. 422.

<sup>1927</sup> Sec. 423.

granted). No amount is includible in the gross income of the option recipient due to the exercise of the option.

If the nonqualified option does not have a readily ascertainable fair market value at the time of grant, no amount is includible in the gross income of the recipient with respect to the option until the recipient exercises the option. The transfer of stock on exercise of the option is subject to the general rules of section 83. That is, if vested stock is received on exercise of the option, the excess of the fair market value of the stock over the option price is includible in the recipient's gross income as ordinary income in the taxable year in which the option is exercised. If the stock received on exercise of the option is not vested, the excess of the fair market value of the stock at the time of vesting over the option price is includible in the recipient's income for the year in which vesting occurs unless the recipient elects to apply section 83 at the time of exercise. In most cases, compensatory stock options do not have a readily ascertainable fair market value.

In the case of an employee, the amount includible in income under section 83 with respect to nonqualified stock options is also subject to income tax withholding and to social security tax (subject to the social security wage base) and Medicare tax and must be reported on a Form W-2.

The amount includible in the income of the employee (or other service provider) is generally deductible by the employer for the taxable year of the employer in which the recipient's taxable year of inclusion ends.<sup>1928</sup>

#### Statutory options

The Federal tax rules applicable to statutory options are not discussed in detail here because Enron did not utilize such options.<sup>1929</sup>

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<sup>1928</sup> The employer must comply with applicable reporting requirements in order to claim the deduction. Treas. Reg. sec. 1.83-6(a)(2). The amount of any deduction may also be limited by the \$1 million limitation on the deduction of compensation of the top-five executives. Sec. 162(m). This limitation is discussed in Part III.C.6., below.

<sup>1929</sup> The following general rules apply to statutory options. No amount is includible in the gross income of the option recipient on the grant or exercise of a statutory option. No compensation expense deduction is allowable to the employer with respect to the grant or exercise of a statutory option. If an employee disposes of stock acquired upon exercise of a statutory option, the employee generally is taxed at capital gains rates with respect to the excess of the fair market value of the stock on the date of disposition over the option price, and no compensation expense deduction is allowable to the employer, unless the employee fails to meet a holding period requirement. For a detailed description of the rules relating to statutory options, see Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation*, JCX-29-02, at 41-44 (April 17, 2002).

## Special techniques for exercising options

### Cashless exercise of stock options

Stock option plans may allow employees to exercise their options through a cashless exercise program generally operated by a company-designated broker. In a cashless exercise, on behalf of the employee, the broker exercises the option and sells some of the stock acquired pursuant to the option in one transaction. The amount of stock sold generally is sufficient to generate cash in an amount needed to cover the exercise price and any taxes that the employer is required to withhold upon exercise of the option. The remaining stock is then transferred to the employee.<sup>1930</sup>

The funds required to exercise the options may be provided either by the issuer (e.g., by advancing shares to the broker) or by the broker (by making a loan to the option holder and then deducting the amount loaned from the proceeds of the sale). If the funds for the exercise of the options are provided by the issuer, the broker transfers the exercise price along with tax withholdings back to the issuer.<sup>1931</sup>

### Stock-for-stock exercise of stock options

Employers often allow optionees to pay the amount due on the exercise of an option with already owned stock of the employer (a “stock-for-stock” exercise) rather than requiring executives to pay cash. An IRS revenue ruling,<sup>1932</sup> addresses the use of employer stock to exercise stock options. Under the ruling, if stock of a corporation is exchanged for similar stock in the same corporation, the transfer qualifies as a nontaxable transaction and the taxpayer is not required to recognize the gain realized in the exchange.<sup>1933</sup> Instead, the taxpayer’s basis in the stock exchanged is transferred to an equal amount of new shares.<sup>1934</sup> Shares received by the employee that are in addition to the number of shares exchanged are treated as compensation for

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<sup>1930</sup> For purposes of section 83, in a cashless exercise, the employee is treated as having received all the stock subject to the option, followed by a separate sale of stock. The amount includible in the gross income of an employee as a result of the exercise of the option is not affected by a cashless exercise.

<sup>1931</sup> Some have suggested that cashless exercise programs may be affected by the prohibition on loans to executives in the Sarbanes-Oxley Act of 2002, because such programs involve the extension of credit (or the arranging of credit) by the employer. Pub. L. No. 107-204, sec. 402 (2002).

<sup>1932</sup> Rev. Rul. 80-244, 1980-2 C.B. 234.

<sup>1933</sup> Sec. 1036.

<sup>1934</sup> Sec. 1031.

services under section 83(a).<sup>1935</sup> The employee is required to include in gross income the fair market value of the additional shares received.

The stock-for-stock exercise effectively allows an employee to use the untaxed appreciation in already owned shares on a tax-free basis to purchase new shares. Upon a stock-for-stock exercise, taxes can be satisfied with already-owned shares or cash. The participant does not incur a brokerage fee because the swap does not involve a sale on the open market. A plan may provide that the employee does not have to physically surrender the previously owned shares. Delivery of the shares may be accomplished through “attestation,” in which case the executive provides an affidavit of ownership of the shares.

A stock-for-stock exercise can be illustrated by the following example:

An employee exercises an option to purchase 200 shares of stock with a fair market value of \$100 per share at an exercise price of \$50 per share. To pay for the exercise price, the employee exchanges 100 previously-owned shares, with a fair market value of \$100 per share, and a basis of \$30 per share. The basis in the previously-owned 100 shares would transfer to 100 new shares. The fair market value of the additional 100 shares received (\$10,000) is includible in income.

The use of a stock-for-stock exercise provides more favorable tax results to the executive than would be the case if the executive first sold previously owned shares and then used the cash to pay the purchase price. With a stock-for-stock exercise, the executive can postpone the recognition of gain on the previously-owned shares.<sup>1936</sup>

### **Gift of stock options**

Some employer plans permit the executive to transfer options to family members or others as a gift. The IRS issued guidance on the gifting of options in 1998, which concludes that the gratuitous transfer of a stock option is a completed gift at the later of: (1) the date of transfer, or (2) when the right to exercise the option is no longer conditioned on the performance of services by the transferor.<sup>1937</sup> Upon exercise of the option by the transferee, the income tax is generally required to be paid by the transferor.

The IRS guidance describes how an unexercised compensatory stock option is valued for gift or estate tax purposes.<sup>1938</sup>

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<sup>1935</sup> Rev. Rul. 80-244.

<sup>1936</sup> In a stock-for-stock exercise, the amount includible in income is the same amount that would be includible in income if the employee paid the exercise price with cash, although the amounts are arrived through different analyses.

<sup>1937</sup> Rev. Rul. 98-21, 1998-18 I.R.B. 7.

<sup>1938</sup> Rev. Proc. 98-34, 1998-18 I.R.B. 34.



## Accounting for stock options

### In general

The accounting rules for treatment of stock based compensation generally are governed by Accounting Principles Board Opinion 25, Accounting for Stock Issued to Employees, (“APB 25”) and Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (“FAS 123”). FAS 123 is the preferred accounting method, but is not mandatory. If a company accounts for options using APB 25, disclosure of the impact of FAS 123 on the income statement is required.

### APB 25 treatment of stock options

APB 25 requires compensation costs for stock-based employee compensation plans to be recognized based on the difference, if any, between the quoted market price of the stock and the amount an employee must pay to acquire the stock. No increase in value is ascribed to the right to purchase the stock at a fixed price for a period of years. Correspondingly, no decrease in value is ascribed to restrictions on the option. The comparison of the market price to the exercise price is generally done on the grant date.<sup>1939</sup> The approach is effectively a snapshot of the difference between the market price and exercise price at a specific date.

As a result of these rules, under APB 25, generally no compensation cost is recorded in financial statements for stock options issued to employees if the exercise price is equivalent to or greater than the market price on the grant date.

### FAS 123 treatment of stock options

FAS 123, issued in 1995, defines a fair value method of accounting for employee stock options. Under FAS 123, except in extremely rare situations, the fair value determination of an option is made on the grant date.

The fair value of stock options is determined using an option-pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock and the expected dividends on it, and the risk-free interest rate over the expected life of the option. The fair value of an option estimated at the grant date is not subsequently adjusted for changes, such as in the price of the underlying stock, its volatility, or the life of the option.

The total amount of compensation cost recognized for an award of stock options is based on the number of options that eventually vest. No compensation cost is recorded for options that do not vest. If compensation cost has been recorded in a prior period and the employee does not vest, such cost is reversed in the current period. Once an option vests no reversal of cost is permitted if the option is forfeited or expires.

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<sup>1939</sup> An exception applies to certain variable plans, a type of stock option plan that is not very common.

## **Other types of stock-based compensation**

### **Stock appreciation rights**

A stock appreciation right (“SAR”) is an arrangement under which the employee has the right to receive the amount of the increase in the value of stock of the employer during a specified period. The employee receives the increase in value by cashing out or exercising the SAR. For example, the employee may be granted stock appreciation rights with respect to 1,000 shares of employer stock at a time when the stock is valued at \$100 a share, and the SAR may be exercisable for three years. As a result, the employee has the right at any time during the three years to receive cash in the amount of the increase in value of 1000 shares of stock since the time the SAR was granted. Variations in the terms of an SAR may include limitations on the exercisability of the SAR until (or unless) certain stock value goals are met or allowing the proceeds of the SAR to be paid in the form of stock rather than cash.

Because the employee has the right to receive on request the increase in stock value that has already occurred (i.e., the current increase in stock value), SARs raise constructive receipt issues. However, under IRS revenue rulings, a substantial limitation on the employee’s ability to receive the current increase in stock value results from the fact that the employee must forego the right to benefit from additional increases in stock value during the SAR period (i.e., the employee must surrender a valuable right) in order to exercise the SAR.<sup>1940</sup> Therefore, the current increase in stock value is not considered constructively received. The amount received on exercise of the SAR is includible in income and wages for employment tax purposes at that time.

### **Phantom stock**

A phantom stock unit is a contractual obligation of the company equal in value to one share of the company which, until paid, is an unfunded bookkeeping credit on the records of the company. Upon the vesting of phantom stock units, the holder is generally entitled to payment in cash or in shares of common stock at the rate of one share of common stock for each phantom stock unit, plus dividends that have accrued from the grant date until vesting. Payments made in cash under a phantom stock plan are includible in gross income and wages when received. Payments made in the form of stock are includible in income as provided under section 83.

## **Factual Background**

### **In general**

Enron utilized various types of programs to provide its employees with compensation tied to the equity or long-term performance of the company. Included in these programs were stock-based plans such as the 1991, 1994 and 1999 Stock Plans,<sup>1941</sup> as well as one-time stock or option

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<sup>1940</sup> Rev. Rul. 80-300, 1980-2 C.B. 165.

<sup>1941</sup> Other stock-based plans, such as the 1978, 1984 and 1988 Stock Option Plans were no longer active during the 1990s.

grants such as the All-Employee Stock Option Program, the 2001 Special Stock Grant, and “Project 50.” Long-term compensation programs that were not based on Enron stock included the Performance Unit Plan, which was terminated in 1999.

In recent years, Enron used stock options and restricted stock as the long-term component for executive compensation.<sup>1942</sup> Various documents provided by Enron show that participation in the long-term incentive program was limited to employees in the vice president job group and above.<sup>1943</sup> An employee involved in compensation matters interviewed by Joint Committee staff stated that restricted stock was limited to executives. The Joint Committee staff asked Enron whether nonexecutive level employees (i.e., employees below the vice president level) were granted stock options and restricted stock other than through all-employee programs. Enron responded that stock options and restricted stock/phantom stock were also granted to nonexecutive level employees.<sup>1944</sup>

As part of its compensation package, Enron provided its executives with long-term incentives designed to “encourage and reward...the enhancement of stockholder wealth.”<sup>1945</sup> According to the proxy statements, the value of the long-term incentives, like base salary and annual incentives, was targeted at the 75th percentile of Enron’s industry peer group.

Prior to 1999, long-term incentive grants were given in performance units under the Performance Unit Plan<sup>1946</sup> and in stock options.<sup>1947</sup> Occasionally, restricted stock was granted for specific reasons, such as: (1) individual performance; (2) company performance; (3) to accommodate special situations such as promotions; (4) in lieu of other benefits; or (5) to remain

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<sup>1942</sup> According to Enron, options were never repriced.

<sup>1943</sup> *See, e.g.*, Enron Corp. Executive Compensation program brochure. EC 002634796.

<sup>1944</sup> Letter from Enron’s counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated December 20, 2002. Joint Committee staff asked Enron for data regarding stock options and restricted stock granted to nonexecutives. In providing the data, Enron stated that there is some overlap in grants to executives, so that data does not clearly indicate the amount of options and restricted stock provided to nonexecutives. Because the data provided does not provide the requested information, it is not included here.

<sup>1945</sup> 1992 Enron Corp. Proxy Statement.

<sup>1946</sup> See the discussion below for an explanation of this long-term incentive program.

<sup>1947</sup> According to the proxy statements, the value of an Enron stock option was based upon the value of Enron stock at the time of the grant and other factors, including stock price volatility, dividend rate, option term, vesting schedule, termination provisions and long-term interest rates. In 2000, stock options were granted with a seven-year term, 25 percent vesting on date of grant and 25 percent vesting each anniversary date thereafter. In 2001, the term of stock options was changed to five years and the portion of the grant vesting each year was increased to 30 percent.

market competitive.<sup>1948</sup> Aggregate stock holdings of the executives had no bearing on the size of long-term incentive grants.

In 1999, citing difficulties in identifying an appropriate peer group for comparison and the tenuous connection between peer group performance and executive management, Enron ceased giving long-term incentive grants under the Performance Unit Plan. Consequently, for the years 1999 to 2001, long-term grants to executives consisted of fifty percent nonqualified stock options and fifty percent performance-based restricted stock with a performance accelerated vesting feature.<sup>1949</sup> According to the 1999 proxy statement, the ultimate value of the performance based restricted stock awards made to executives was to depend upon the achievement of recurring after-tax net income targets established by the Compensation Committee for the years 1999, 2000, and 2001 and Enron's stock price.

During the 1990s, Enron had two principal stock plans: the 1991 Stock Plan and the 1994 Stock Plan. In 1999, Enron approved the 1999 Stock Plan as a funding mechanism for the issuance of common stock in connection with special circumstances. The plans are described below.

## **1991 Stock Plan**

### History

The 1991 Stock Plan was created in 1991 as an unfunded plan with the purpose of encouraging Enron employees and other eligible persons to “develop a proprietary interest in the growth and performance of the Company . . . generate an increased incentive to contribute to the Company's future success and prosperity . . . and enhance the ability of the Company to retain key individuals.”<sup>1950</sup> The Plan was restated and approved by the shareholders in 1994, 1997, 1999, and 2001. Various amendments that did not require shareholder approval were approved throughout the years.

### Eligibility

When the 1991 Stock Plan was created in 1991, eligible participants included all employees of Enron Corp. and its affiliates as well as nonemployee directors of Enron Corp. or an affiliate.<sup>1951</sup> Nonemployee contractors were added as eligible participants in 1994. In 1999,

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<sup>1948</sup> 1998 Enron Corp. Proxy Statement.

<sup>1949</sup> 2000 Enron Corp. Proxy Statement. According to the proxy statement, restricted stock was subject to four-year cliff vesting from the date of grant. However, vesting could be accelerated based upon Enron's annual cumulative shareholder return relative to the S&P 500. For example, if Enron's cumulative shareholder return exceeded the 90<sup>th</sup> percentile, 100 percent would vest on the date of grant.

<sup>1950</sup> 1991 Stock Plan, section 1.

<sup>1951</sup> 1994 Enron Corp. Proxy Statement.

however, the entire class of eligible participants in the 1991 Stock Plan was changed to include only employees who were residents of the United Kingdom or members of the Management Committee of Enron, and nonemployee directors. The change in eligibility decreased the number of individuals eligible to receive benefits under the 1991 Stock Plan from approximately 7,000<sup>1952</sup> to 500.<sup>1953</sup>

#### Grants under the 1991 Stock Plan

Initially, the 1991 Stock Plan provided for grants of (1) stock options,<sup>1954</sup> including incentive stock options meeting the requirements of section 422 of the Code,<sup>1955</sup> and stock options with a grant price that is discounted from the fair market value to be used only in lieu of cash bonus payments, (2) stock appreciation rights (“SARs”), and (3) restricted stock.<sup>1956</sup>

In 1996, the 1991 Stock Plan was amended to provide that phantom stock units would be given to Enron directors in lieu of restricted stock and to permit the grant of phantom stock units interchangeably with restricted stock to eligible persons other than directors.<sup>1957</sup> According to documents provided by Enron, the decision to grant phantom stock units in lieu of restricted stock was motivated by the desire to avoid constructive receipt for employees who met the 1991 Stock Plan’s definition of retirement.<sup>1958</sup> Under the 1991 Stock Plan, vesting of restricted stock was to be accelerated when an employee met the plan’s definition of retirement. Employees who

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<sup>1952</sup> 1997 Enron Corp. Proxy Statement.

<sup>1953</sup> 1999 Enron Corp. Proxy Statement.

<sup>1954</sup> The 1991 Stock Plan provided that exercise price of a stock option could not be less than the fair market value of the stock on the date of grant.

<sup>1955</sup> Although the 1991 Stock Plan provided for incentive stock options, Enron did not grant such options.

<sup>1956</sup> The 1991 Stock Plan provided that restrictions placed on restricted stock would remain in place for at least three years in the case of restricted stock and, in the case of performance-based restricted stock, for least one year. Dividends or credits associated with the restricted stock were to be withheld during that period but credited to the participant’s account. When shares became vested, all accumulated credits and dividends were to be distributed to the participant. The Plan provided that non-vested restricted stock would be forfeited if the participant terminated service for any reason other than death, disability, retirement, or involuntary termination. On the occurrence of certain events such as such as a merger, dissolution, sale of assets and consolidation, the Plan provided for the accelerated vesting of restricted stock and stock options.

<sup>1957</sup> Minutes of the meeting of the Compensation Committee (May 6, 1996).

<sup>1958</sup> EC 000102953. While documents provided by Enron state that there was an issue of constructive receipt, the actual issue appears to be a section 83 issue regarding a transfer of property.

met the definition of retirement but who remained employed with Enron would be vested in restricted stock and could be subject to taxation before actual receipt of the shares. To defer taxation until the payout of the shares, the plan was amended to grant phantom stock units instead of restricted stock, on the theory that phantom stock is considered an unfunded promise to pay stock which would be taxable when actually or constructively received, rather than section 83 property, which would be taxed upon vesting.

In 1997, Enron eliminated the availability of discounted options under the 1991 Stock Plan, and the plan was amended to provide that the exercise price of options would not be less than fair market value of the stock on the date of grant. In 1999, stock appreciation rights were eliminated from constituting an option for award under the 1991 Stock Plan.

#### Performance-based compensation

In 1994, in order for awards under the 1991 Stock Plan to qualify as performance-based compensation for purposes of the \$1 million limitation on the deduction of certain executive compensation,<sup>1959</sup> the 1991 Stock Plan was amended to provide that: (1) the issuance of awards was contingent upon attainment of preestablished performance criteria; (2) restrictions would lapse contingent upon attainment of preestablished performance criteria, and (3) the issuance was in lieu of cash payments under the Annual Incentive Plan or Performance Unit Plan, based upon attainment of the performance criteria established under the terms of those stockholder approved plan. Likewise, limitations were placed on the number of options, stock appreciation rights and performance-based restricted stock that could be given to any one individual during a calendar year. The limit on options and stock appreciation rights was set at one million, while the number of performance-based restricted stock was capped at 100,000.<sup>1960</sup>

#### Shares available

When the 1991 Stock Plan was first approved in 1991, the number of shares available for grant under the plan was 11 million.<sup>1961</sup> The number of shares authorized for granting awards under the 1991 Stock Plan was increased by 10 million in each of the years 1994, 1997, and 1999. In 2001, an additional 21 million shares (reflecting a two-for-one stock split that took place in 1999) were added to the 1991 Stock Plan. No more than an aggregate of 25 percent of the shares available under the 1991 Stock Plan could be granted as restricted stock or phantom stock units.<sup>1962</sup>

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<sup>1959</sup> This limitation is discussed in Part III.C.6., below.

<sup>1960</sup> As a result of the stock split, the caps were set at 2 million for both restricted stock and stock appreciation rights and at 200,000 for performance-based restricted stock.

<sup>1961</sup> This is equal to 2.75 million shares, adjusted for stock splits in December 1991 and August 1993.

<sup>1962</sup> 1996 Enron Corp. Proxy Statement.

### Assignability and transferability of awards

Originally, the 1991 Stock Plan contained an antialienation provision prohibiting the assignment or transfer of awards (with the exception of transfer pursuant to a qualified domestic relations order.) In 1996, the 1991 Stock Plan was amended to allow the transfer of stock options to immediate family members, family trusts, and family partnerships.<sup>1963</sup> This transfer program is discussed in more detail, below.

On October 9, 2000, the 1991 Stock Plan was amended to allow the transfer by an eligible participant of options to a private charitable foundation described in 501(c)(3), the assets of which are controlled by the participant and one or more members of his or her immediate family.<sup>1964</sup>

### Nonemployee directors

Nonemployee directors were eligible to receive awards under the 1991 Stock Plan, except for incentive stock options. Under the 1991 Stock Plan, nonemployee directors were to receive each year an amount equal to half of their retainer fee in restricted stock or stock options.<sup>1965</sup> In 1994, the 1991 Stock Plan was amended to allow non-employee directors to elect to receive a portion or all of their retainer fees in restricted stock and stock options.

Pursuant to the terms of the 1991 Stock Plan, nonemployee directors were required to defer fifty percent of their annual retainer fee into the 1994 Deferral Plan. On August 11, 1999, the 1991 Stock Plan was amended to allow nonresident, nonemployee directors whose deferral was regarded as the receipt of taxable income in their country of residence, to elect to waive the portion of the retainer fee required to be deferred and receive an award of phantom stock units under the 1991 Stock Plan.<sup>1966</sup>

On August 14, 2001, the 1991 Stock Plan was amended to provide that if a nonemployee director resigned with the approval of the board, the Compensation Committee could fully vest

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<sup>1963</sup> 1997 Enron Corp. Proxy Statement. This change followed the 1996 amendments to the short-swing profit liability rules under section 16(b) of the Securities Exchange Act of 1934, which eliminated the requirement that stock options be nontransferable.

<sup>1964</sup> Sixth amendment to the 1991 Stock Plan (as amended and restated May 4, 1999). According to documents provided by Enron, the change would allow employees to claim charitable contribution deductions on the transfers to private charities.

<sup>1965</sup> Only 20 percent of the options granted could be exercised on the date of grant, with an additional 20 percent becoming exercisable in each of the following four years. On May 2, 2000, the 1991 Stock Plan was amended to provide that the 20 percent portions of the options granted were to become exercisable only upon the completion of a full term of service by the nonemployee director. Fourth Amendment to the 1991 Stock Plan, as amended and restated May 4, 1999.

<sup>1966</sup> First Amendment to the 1991 Stock Plan (as amended and restated May 4, 1999).

grants of restricted stock made to the director and extend the time in which he or she could exercise options after resignation.<sup>1967</sup>

### Other provisions

The 1991 Stock Plan was amended to allow for broker cashless exercise of stock options. As mentioned above, in a cashless exercise, the broker loans money to exercise the options, sells the shares, deducts taxes and commissions from the sales proceeds, and sends the participant the remaining proceeds.

Under the 1991 Stock Plan, the payment of the exercise price and applicable tax withholding amounts was required to be made at the time of option exercise and could be made by delivery of cashier's checks, shares of stock, or other property, which allowed participants to use stock-for-stock exercises. Prior to 1996, shares could not be used to satisfy tax withholding obligations.

## **1994 Stock Plan**

### History

The 1994 Stock Plan was created in 1994 to provide long-term incentives to employees in a similar way to the 1991 Stock Plan. The purpose of the 1994 Stock Plan was "to enable all employees employed by Enron Corp. . . . and its Affiliates and other eligible persons to develop a proprietary interest in the growth and performance of the Company, to generate an increased incentive to contribute to the Company's future success and prosperity, thus enhancing the value of the Company for the benefit of its stockholders, and to enhance the ability of Enron and its Affiliates to attract and retain employees who are essential to the progress, growth and profitability of Enron."<sup>1968</sup> The 1994 Stock Plan was amended several times and restated on October 12, 1999.

### Eligibility

Eligible participants in the 1994 Stock Plan included any employee of Enron or of an affiliate, any nonemployee director of an affiliate, and any nonemployee contractor performing services for Enron. Originally, any person who was subject to section 16(b) of the Securities Exchange Act of 1934 or any officer or director of Enron who was covered by the New York Stock Exchange listing requirements was not eligible to be designated a participant. This participation restriction was subsequently removed.<sup>1969</sup>

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<sup>1967</sup> First Amendment to 1991 Stock Plan (as amended and restated May 1, 2001).

<sup>1968</sup> Enron Corp. 1994 Stock Plan.

<sup>1969</sup> June 28, 1999.



## Grants

When originally enacted, stock options and restricted stock could be awarded under the 1994 Stock Plan. The 1994 Stock Plan was later amended to allow the grant of phantom stock units.<sup>1970</sup> Grants of incentive stock options could not be made under the 1994 Stock Plan.<sup>1971</sup> The number of shares of restricted stock available for grant under the 1994 Stock Plan was limited to not more than 25 percent of the total number of shares available under the 1994 Stock Plan.

On February 7, 2000, the 1994 Stock Plan was amended to provide that bookkeeping credit for phantom stock units given to individuals who were subject to the tax laws of specified countries would be made in cash rather than Enron stock.<sup>1972</sup>

## Shares available

When the 1994 Stock Plan was created, the number of shares approved for awards was three million. On May 3, 1994, the number of shares under the Plan was increased to 11 million.<sup>1973</sup> The number of shares was further increased to 18 million, 26.5 million and then to 30 million between the years 1994 and 1997. In June of 1999, additional shares were added for a total of 45 million (updated to 90 million after the 1999 two-for-one stock split). Finally, in February and December of 2000, the number of shares available was increased to 104 million and 124 million, respectively.<sup>1974</sup>

## Antialienation provisions

Under the 1994 Stock Plan as originally enacted, no rights under the 1994 Stock Plan could be pledged, alienated, attached or encumbered, except pursuant to a domestic relations order.

On August 8, 2000, the antialienation provision was amended to allow for the transfer of awards under the 1994 Stock Plan by a participant to: (1) a member of his or her immediate family; (2) a trust solely for the benefit of the participant and his or her immediate family; or (3)

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<sup>1970</sup> December 12, 1997.

<sup>1971</sup> Enron Corp. 1994 Stock Plan (as amended and restated in October, 1999).

<sup>1972</sup> The change was made in response to the tax laws of China. Second Amendment to the 1994 Stock Plan (as amended and restated effective October 12, 1999).

<sup>1973</sup> First amendment to 1994 Stock Plan.

<sup>1974</sup> Second and Fifth Amendments to the 1994 Stock Plan (as amended and restated effective October 12, 1999).

a partnership or limited liability company whose only partners are the participant and his or her immediate family.<sup>1975</sup> This transfer program is discussed in more detail, below.

On October 9, 2000, the provisions were further amended to allow transfers of awarded options by a participant to a section 501(c)(3) charitable foundation the assets of which are controlled by the participant and/or one or more of his or her immediate family members.<sup>1976</sup>

#### Other provisions

The 1994 Stock Plan was amended to allow for broker cashless exercise of stock options. As mentioned above, in a cashless exercise, the broker loans the money to exercise the options, sells the shares, deducts taxes and commissions from the sales proceeds, and sends the participant the remaining proceeds.

Under the 1994 Stock Plan, the payment of the exercise price and applicable tax withholding amounts was required to be made at the time of exercise and could be by delivery of cashier's checks, shares of stock, or other property, which allowed participants to use stock-for-stock exercises. Prior to 1996, shares could not be used to satisfy tax withholding obligations.

#### **1999 Stock Plan**

The 1999 Stock Plan was created to “provide a funding source for the issuance of common stock of Enron Corp. in connection with special situations, including, but not limited to divestitures, outsourcing, remuneration payable under compensatory programs sponsored by Enron and its affiliates, and any other circumstance deemed, by the Compensation Committee of the Board of Directors as such a special situation.”

Eligible participants included all employees of Enron Corp. and its affiliates, nonemployee directors, nonemployee contractors, and any individual who had accepted an offer of employment with Enron Corp. or an affiliate.

Under the 1999 Stock Plan, awards could be given in restricted stock, stock options, or phantom stock units. No grants of incentive stock options could be made under the 1999 Stock Plan. The number of shares available for grant under the 1999 Stock Plan was initially 3 million. Awards granted were inalienable with the exception of a transfer pursuant to a qualified domestic relations order.

Under the 1999 Stock Plan, the payment of the exercise price and applicable tax withholding amounts were required to be made at the time of exercise by delivery of cashier's checks, shares of stock, or other property, thus allowing stock-for-stock exercises.

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<sup>1975</sup> Third Amendment to the 1994 Stock Plan (as amended and restated effective October 12, 1999).

<sup>1976</sup> Fourth Amendment to the 1994 Stock Plan (as amended and restated effective October 12, 1999).

## **Stock option transfer program**

After amending the 1991 and 1994 Stock Plans to allow for the transfer of options to family members or family controlled entities, Enron instituted the stock option transfer program. In 2000, the 1991 and 1994 Stock Plans were amended to allow transfers to private charitable foundations controlled by participants or their immediate family members. Originally, eligibility for participation in the program was limited to nonemployee directors and Management Committee members. In August 2000, eligibility was expanded to include all employees who received grants from the 1991 or 1994 Stock Plans.

Pursuant to the stock option transfer program, employees could irrevocably gift stock options granted under the 1991 and 1994 Stock Plans to family members or certain family-controlled entities.<sup>1977</sup> Transfers could be made to immediate family members, to a trust for the exclusive benefit of immediate family members, or to a partnership in which immediate family members are the only partners. As mentioned above, the plans were later amended to allow transfers to private charitable foundations controlled by a participant or his or her immediate family.<sup>1978</sup> The employee would pay gift tax on the present value of the options, subject to the annual gift-tax exclusion or the lifetime unified tax credit. Enron advised employees against gifting unvested stock options given the IRS' position<sup>1979</sup> that the transfer of unvested options would not be considered a completed gift, the result being that gift tax would be assessed on the value of the options on the date of vesting rather than the date of the gift.

When the transferee exercised the options, the employee would be responsible for income tax payments on the gains realized.<sup>1980</sup> No additional payment of gift tax or estate tax would be required on the death of the employee since the options were already removed from the employee's estate by the transfer.

As stated in materials given to employees explaining the program "[t]he gifting technique allows you, with little or no additional tax, to pass on stock option gains that would have been in the estate and subject to estate rates of up to 55 percent."<sup>1981</sup> In addition, for transfers to family charitable foundations, the employee could be eligible for a charitable deduction.

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<sup>1977</sup> In February 2001, the Compensation Committee approved administrative procedures to be followed under the stock option transfer program.

<sup>1978</sup> Even though allowed by the plans, program information given to participants does not include transfers to private charitable foundations as a permissible under the program.

<sup>1979</sup> Rev. Rul. 98-21, 1998-18 I.R.B. 7.

<sup>1980</sup> Documents provided to participants state that upon exercise of an option by the transferee, Federal income tax withholding was required to be paid to the Company by the executive for the amount of withholding tax imputed to the executive.

<sup>1981</sup> Memorandum to Executive Committee Members regarding the stock option transfer program. EC2 000019353.

Enron used the Black-Scholes option pricing method to value options transferred.<sup>1982</sup> Employees were advised that more recent grants would have the lowest estimated value and would create the lowest gift tax liability and the greatest benefit.

As stated in employee materials provided by Enron, benefits to the transferor included: (1) the ability to pass on stock options that would have otherwise been in the estate and subject to estate taxes; (2) the ability to gift vested stock options immediately after vesting at a discounted theoretical value which reduces the gift tax when the gifting occurs; (3) the ability to provide a benefit that appreciates over time and is tax free to heirs upon exercise; and (4) the ability to maximize the benefits to heirs by utilizing the \$10,000 per recipient annual gift tax exclusion and/or the \$675,000 lifetime unified tax credit.<sup>1983</sup>

The Compensation Committee was required to be notified of the terms and conditions of any transfer and was required to determine that the transfer complied with the requirements of the applicable plan. Documents provided by Enron indicate that transfers by at least five persons, including Ken Lay and two members of the Board of Directors, were approved by the Compensation Committee.<sup>1984</sup>

### **Stock option tax shelter**

The materials provided in response to the Joint Committee staff's general request for information regarding Enron compensation arrangements included documents describing a technique purporting to defer inclusion of income upon the exercise of an employee's stock options.<sup>1985</sup> The documents indicate that Enron apparently considered whether to have a role in facilitating the technique and in letting Arthur Andersen show the technique to employees. The

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<sup>1982</sup> Documents provided by Enron show that in some years, multiple valuations were considered. For an assumed transfer date of November 15, 2000, one set of valuations that conforms strictly to Revenue Procedure 98-34 and qualified for safe harbor treatment was considered, as was another set of valuations which Enron believed conformed to Revenue Procedure 98-34, but took a more aggressive approach.

<sup>1983</sup> Enron informed participants that the possible drawbacks are: the inability to control the timing of the exercise, which must be relinquished to the transferee; the income tax that the executive must pay; income tax consequences to the transferee if the executive dies before the options are exercised; and if the executive pays gift tax upon the transfer and the stock does not appreciate, tax would be paid on income never realized.

<sup>1984</sup> The documents indicate that the Compensation Committee approved transfers during 1997-1998 to family members, family partnerships, and trusts of executives. EC 000104417; EC 000102332; EC2 000019444 - EC2 000019470; EC 002634789.

<sup>1985</sup> Sale of Executive Options Techniques, EC 000770979 – EC 000770981, and Sale of Executive Options Technique – Advantages and Disadvantages, EC 000770978. Enron also received a draft opinion letter for employees from Arthur Andersen (1999) (EC2 000038589 – EC2 000038616), but it is not known whether Enron ever supplied the letter to any employees. These materials are included in Appendix D of this Report.

technique involves the purported sale of the option to a partnership consisting of the employee's family members, followed by the partnership's exercise of the option and possible sale of the stock. In order for the technique to be effective, it would require Enron not to report gain on the exercise of the stock option on the employee's W-2 statement.<sup>1986</sup>

In an interview with Joint Committee staff, Mr. Hermann indicated that he understood that the technique was considered to be of interest to one employee. He declined to name this individual. He also told the Joint Committee staff that the tax department had reviewed the technique and had advised that Enron was required to withhold. Thus, the technique would not achieve the intended result. Mr. Hermann stated that he believed that Enron had not facilitated this type of transaction. From the materials received by the Joint Committee staff, it is not clear whether or not any Enron executives entered into a transaction of this type.

### **Performance Unit Plan**

The Performance Unit Plan was created to provide long-term incentive compensation tied to increases in stockholder value to key Enron executive employees.<sup>1987</sup> According to the Performance Unit Plan, eligible participants included employees of Enron Corp. and its subsidiaries who participated in the Enron Executive Compensation Program. Dr. Charles LeMaistre, the Chairman of the Compensation Committee, submitted written testimony to the Permanent Subcommittee on Investigations on May 7, 2002, regarding, among other things, the Performance Unit Plan.<sup>1988</sup> In his statement, Dr. LeMaistre stated that Enron granted performance units to corporate and certain operating company executives who were not in an Enron long-term incentive plan. These operating company executives were, for the most part, in commercial support and pipeline businesses. Dr. LeMaistre stated that he believed that performance unit awards were granted pursuant to the Performance Unit Plan between 1987 and 1998.

Prior to the beginning of each calendar year, the Compensation Committee would designate the employees that were eligible to receive performance units during that year and the number of performance units to be given to each individual. Each performance unit had a value at the time of grant of \$1. No single individual could be granted more than 3 million performance units in one calendar year.

Pursuant to the Performance Unit Plan, the total shareholder return of Enron was compared to that of a selected peer group comprised of 11 publicly held companies over a four-

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<sup>1986</sup> Sale of Executive Options Technique – Advantages and Disadvantages, EC 000770978. This document states, “Enron will require guidance from Arthur Andersen as the executive’s tax advisor to operationalize manually overriding the payroll system to legally keep income off of the executive’s W-2 statement.”

<sup>1987</sup> 1994 Enron Corp. Proxy Statement.

<sup>1988</sup> *Hearing on The Role of the Board of Directors in Enron’s Collapse before the Permanent Subcommittee on Investigations of the Committee on Government Affairs*, 107th Cong. (May 7, 2002) (testimony of Dr. Charles LeMaistre).

year period. The value of the performance units was then determined with reference to the ranking of Enron's shareholder return relative to its peer group as shown in Table 22, below.

**Table 22.—Performance Unit Adjusted Values**

<b>Enron's Total Shareholder Return Ranking Position</b>	<b>Adjusted Value</b>
1	\$2.00
2	\$1.50
3	\$1.00
4	\$0.75
5	\$0.50
6	\$0.25
7 through 12	\$0.00

Additionally, irrespective of the ranking position of Enron's shareholder return, if the total return for the period did not exceed the cumulative percentage return for 90-day U.S. treasury bills, the performance unit would have no value.

In 1995, the Plan was restated and approved by shareholders to comply with the requirements of section 162(m) for deductions of performance-based compensation.<sup>1989</sup>

### **All-employee stock option arrangements**

#### In general

Enron periodically made stock option grants to all employees. These grants were made to allow all employees to become shareholders of Enron.

#### All-Employee Stock Option Program

Under the All-Employee Stock Option Program, participants were entitled to receive a one-time up-front grant of Enron stock options. The six-year program was created in 1994 and was offered to all full-time Enron employees and part-time employees who completed at least 1,000 hours of service. The grants were made under the 1991 Stock Plan for Section 16 officers and under the 1994 Stock Plan for all other employees.

Initial grants under the program were made in 1994 and were equal in value to 30 percent of the annual base salary of each employee. For those joining the All-Employee Stock Option Program in subsequent years, the benefit was reduced by five percent for each year. For example, so that those joining in 1999 received a grant equal to five percent of their annual benefits. The grant was awarded on the last business day of the calendar year in which the employee was hired. Stock options awarded under the All-Employee Stock Option Program vested ratably over five years or over the remaining years of the program, whichever was shorter.

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<sup>1989</sup> 1995 Enron Corp. Proxy Statement.

Enron documents indicate that the program was implemented in lieu of a company match under the Enron Savings Plan because of the cost savings that could be achieved by Enron. Documents provided by Enron show that a 401(k) match would have cost the Enron \$43.9 million more than the All-Employee Stock Option Program.<sup>1990</sup> Documents provided by Enron show that if options would have been held to a \$75 stock price, they would have delivered \$1.77 billion in option value, while a 401(k) match, if implemented, would have delivered only \$359.2 million in value.<sup>1991</sup> The Compensation Committee decided to repeat the program in 2000 through 2005.

#### One Enron - "Project 50" Stock Option Program

Eligible employees on the payroll as of December 31, 1999, participated in "Project 50." Under the program, employees were given a one-time grant of 50 stock options on January 18, 2000, in recognition of Enron's stock price reaching \$50 after the 1999 two-for-one stock-split. Included in the Project 50 informational materials provided by Enron to participants is a message from Mr. Lay thanking the employees' contributions to Enron's success. In his words, "I look forward to working with you as we continue to make Enron a successful global energy and communications company. And it would not surprise me if our stock continued to \$50 milestones after two-for-one splits on an even more frequent basis. In fact, anything is possible, if we are focused, if we work together, as a team, as One Enron."<sup>1992</sup>

#### EnronOptions

In May 2000, Enron approved a new all-employee stock option program called "EnronOptions - Your Stock Option Program" which was to commence in 2001 and continue for a five-year period. Pursuant to the program, all full-time and part-time employees on the payroll of Enron as of December 29, 2000, were awarded a one-time grant of stock options equal in value to 25 percent of their annual base salary.<sup>1993</sup> Employees joining after 2001 were to receive the annual grant in the year they were hired equal in value to five percent of their annual base salary multiplied by the number years remaining in the program. Stock options awarded under the program were to vest ratably on June 30 of each year remaining in the program.

Pursuant to bankruptcy rules, the EnronOptions program was terminated effective with the December 20, 2001, Compensation Committee meeting.<sup>1994</sup>

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<sup>1990</sup> EC 000101777.

<sup>1991</sup> EC 000101777.

<sup>1992</sup> EC2 000019565.

<sup>1993</sup> 2001 Enron Corp. Proxy Statement.

<sup>1994</sup> Compensation Committee Meeting Minutes, December 20, 2001.

## 2001 Special Stock Grant

In the summer of 2001, when Enron's financial problems were getting much attention, Enron made an all-employee stock grant. The 2001 Special Stock Grant was made to most eligible Enron employees; some Enron companies' employees were not eligible due to legal, accounting, tax, labor or business issues.<sup>1995</sup> Grants were made to eligible employees who were active, regular employees of participating companies on August 13, 2001. Such employees received options equal to five percent of their annual base salary, as of August 13, 2001. Most employees were granted options on August 21, 2001, with an exercise price equal to the closing price of Enron stock (\$36.88) on that date. The number of options that an eligible employee would receive was based on five percent of an employee's annualized base salary, as of August 13, 2001, and a theoretical stock option value of \$15 (the Black-Scholes value for Enron stock on the grant date). The grant date for some non-U.S. locations was made at a later time due to pending legal/business issues. The grant price for grants made to eligible employees after August 21, 2001, was determined on the date of grant.

Options granted through the 2001 Special Stock Option Grant were 100 percent vested on the date of grant. Eligible employees who received the grant had five years to exercise the stock options unless they terminated employment. Although examples in employee communications assumed that the stock price would increase, Enron noted that there was no assurance that Enron common stock would increase in value.

Enron employees interviewed Joint Committee staff stated that the grant was done for goodwill and morale reasons on account of concerns that the stock price continued to decline. In connection with the 2001 Special Stock Grant, Mr. Lay circulated an electronic mail message to employees stating "one of my highest priorities is to restore investor confidence in Enron. This should result in a significantly higher stock price . . . I ask for your continued help and support as we work together to achieve this goal."<sup>1996</sup>

## Miscellaneous

As discussed in Part III.B.2., above, Enron had two bonus deferral programs. Under the Bonus Phantom Stock Program and the Bonus Stock Option Program, participants were given the opportunity to receive stock options and/or phantom stock in lieu of cash bonus.

In addition, Enron offered the deferral of stock options gains and deferral of restricted stock programs in which participants could defer taxation attributable to such compensation. The deferral of stock option gains program allowed executives to exercise options without outlaying cash or incurring any current income tax liability. The program would be particularly useful for options due to expire. These programs are discussed in Part III.C.1.

Before Enron revised its compensation system in 1999, many other stock/equity plans existed throughout the various business units. These included the: Enron Capital & Trade

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<sup>1995</sup> EC2 000019566.

<sup>1996</sup> EC 000851236.



Resources Corp. Phantom Stock Unit Plan; Enron Energy Services, LLC Phantom Equity Plan; Enron Power Corp. Phantom Equity Plan, Enron International Stock Plan; Enron Renewable Energy Corp. Tandem Option Program; Northern Plains Natural Gas Company Phantom Stock Unit Plan; and Azurix Corp. Stock Option Plan. Miscellaneous stock-related programs may have also existed for various groups of employees or business units.<sup>1997</sup>

### Discussion of Issues

#### In general

Enron used considerable amounts of stock-based compensation, and the amount of compensation generated from such arrangements increased dramatically in the years immediately preceding the bankruptcy, particularly in 2000.

Table 23, below, shows the Enron's deduction attributable to stock options for 1998 through 2000.<sup>1998</sup>

**Table 23.—Enron Deduction Attributable to Stock Options 1998-2000**

Year	Amount of Deduction
1998	\$125,343,000
1999	\$585,000 as filed \$367,798,000 as amended
2000	\$1,549,748,000

Table 24, below, shows the amount of income attributable to stock options for the highest paid 200 employees for 1998, 1999, and 2000. This is summary information provided by the IRS, based on information provided by Enron to the IRS.

**Table 24.—Income Attributable to Stock Options for Top-200 Most Highly Paid Enron Employees (1998-2000)**

Year	Amount of Compensation
1998	\$61,978,000
1999	\$244,579,000
2000	\$1,063,567,000

Table 25, below, shows the income generated from the release, i.e., vesting, of stock options for the top-200 most highly paid Enron employees for 1998-2000. This information is also summary information provided by the IRS based on information provided by Enron to the IRS.

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<sup>1997</sup> Minutes of the Compensation Committee show that the committee approved two other miscellaneous programs, the Key Performer Stock Option Retention Program and the NationsBank OptionPlus Program. It is unclear whether such programs were implemented.

<sup>1998</sup> Information from Schedule M1.

**Table 25.—Income Attributable to the Vesting of Restricted Stock for Top-200 Most Highly Paid Enron Employees (1998-2000)**

Year	Amount of Compensation
1998	\$23,966,000
1999	\$21,943,000
2000	\$131,701,000

Enron’s stock-based compensation programs can be analyzed both from a Federal tax perspective and from a nontax perspective. As discussed below, while Enron took advantage of tax planning opportunities in implementing its stock-based compensation programs, with two exceptions, the issues raised by these programs are not primarily tax-related.

**Federal tax issues, in general**

From a Federal tax perspective, Enron structured its stock-based compensation arrangements with an eye toward tax planning, sometimes from the point of view of Enron, sometimes from the point of view of the executive. For example, the use of nonqualified stock options resulted in tax deductions for Enron that would not have been available if Enron had used qualified stock options.<sup>1999</sup>

Enron also made use of techniques that benefited the executives from a tax perspective. For example, the use of stock-for-stock exercises provided a more favorable tax result for the executive than would have resulted if the executive sold Enron stock and used the cash proceeds to exercise options. In addition, the stock option transfer program, which allowed the gifting of stock options to family members and certain other persons, was clearly an estate planning device and was described to employees as such. However, both of these programs appeared to operate in accordance with published IRS rulings.<sup>2000</sup> In these cases, Enron appeared to do little more than take advantage of tax planning opportunities provided clear IRS authority.

There are two aspects of Enron’s stock-based compensation programs that raise Federal tax issues. The first is the ability to defer gain on the exercise of options and restricted stock, which is discussed in Part III.C.1., above. The second is the sale of executive stock options tax shelter technique, which, if utilized by Enron executives, would raise significant tax issues. As mentioned above, it is unclear whether Enron executives engaged in this transaction. Issues with respect to this technique are discussed below.

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<sup>1999</sup> There may be other reasons Enron did not use qualified options, including the restrictions placed on those options under applicable Code requirements.

<sup>2000</sup> It also appears that Enron attempted to comply with withholding requirements for stock-based compensation.

## Stock option tax shelter technique

Recent news articles have drawn attention to attempts to defer inclusion of income upon the exercise of employees' stock options.<sup>2001</sup> Publicity has focused on the question of whether the sale of the option to the partnership can be an arm's length transaction.<sup>2002</sup>

Enron received a copy of a draft opinion letter (not addressed to any particular individual) from Arthur Andersen that could be provided to individuals who utilize the technique.<sup>2003</sup> In the transaction contemplated in the draft Arthur Andersen opinion letter, an employee who holds stock options sells the options to a family partnership owned 79 percent by himself, 17 percent by his wife, and one percent by each of his two sons. The partnership is capitalized with cash contributed by the option holder and his family (\$180,000 by the employee, and \$20,000 by the other family members). The purchase price of the options is set at \$2 million as determined by an appraisal performed by Arthur Andersen. Upon the sale of the stock options to the partnership, the option holder takes back an unfunded and unsecured promissory obligation to repay the purchase price after 20 years, at 8 percent interest. The terms of the purchase agreement are described as "designed to be comparable to similar commercial transactions."<sup>2004</sup>

The draft opinion letter concludes it is more likely than not that: (1) the partnership will be recognized as a valid partnership for Federal income tax purposes; (2) the sale of options to the partnership will be respected as a valid sale between two separate taxable entities; (3) the assignment of income doctrine will not apply to the sale; (4) a disposition of options at fair market value under commercially reasonable terms satisfies the arm's length standard of section 83; (5) once the options are disposed of at arm's length under section 83, thereby triggering the realization of ordinary income, any subsequent exercise of the options by the partnership does not invoke the re-application of section 83; (6) the transferor's receipt of the partnership's unfunded and unsecured promise to pay the appraised value of the options plus interest will not constitute the "receipt of property" for purposes of section 83, so recognition of compensatory ordinary income should be delayed until the transferor receives principal payments under the promissory obligation; and (7) the timing and amount of the grantor corporation's deduction for compensation paid correspond to the timing and amount of compensation included in the transferor's gross income.

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<sup>2001</sup> Johnston, *Costly Questions Arise on Legal Opinions for Tax Shelters*, N.Y. Times, Feb. 9, 2003, at A15; Glater and Labaton, *Auditor Role in Working for Executives is Questioned*, N.Y. Times, Feb. 8, 2003, at B1; Johnston and Glater, *Tax Shelter Is Worrying Sprint's Chief*, N.Y. Times, Feb. 6, 2003, at C1; Blumenstein, Lublin and Young, *Sprint Forced Out Top Executives Over Questionable Tax Shelter*, Wall St. J., Feb. 5, 2003, at A1.

<sup>2002</sup> *Id.*

<sup>2003</sup> Draft opinion letter to Mr. Client from Arthur Andersen, dated 1999 (EC2 000038589 – EC2 000038616). Appendix D contains this document.

<sup>2004</sup> EC2 000038591.

One element of the draft opinion letter is the conclusion that, more likely than not, the note received from the partnership does not constitute property for purposes of section 83, because the note is unfunded and unsecured. The opinion letter relies on the regulations under section 83 providing that an “unfunded and unsecured promise to pay” is not “property.”<sup>2005</sup>

The conclusion that the partnership’s obligation is “unfunded and unsecured” is arguably not directly contrary to the conclusion that the obligation is at “arm’s length,” as discussed below. However, whether this obligation is unfunded and unsecured could be challenged based on the practical meaning and application of the “unsecured and unfunded” language of the section 83 regulation in the context of a third party note as opposed to an obligation of an employer.

The draft opinion letter concludes that it is more likely than not that sale of options to the partnership will be respected as being at arm’s length. In discussing this issue, the draft opinion letter relies on the assumed facts that the partnership may not make distributions other than to meet its partners’ tax obligations, which is similar to security arrangements required by commercial lenders; this restriction helps to assure that the partnership will be able to meet its obligation to pay after 20 years. The draft opinion letter also relies on the fact that the partnership’s primary activity is investing, so its exposure to liabilities or creditors’ claims is likely to be small.

The draft opinion letter does not mention or alert the transferor to any possible economic risk of the transfer. For example, if the payments are in fact unsecured and unfunded, then it is possible that the value of the options (or of the optioned stock) in the hands of the partnership could decline. To the extent this can occur and the transferor is not protected except by the value of the options (or stock, if the options are exercised) in the partnership and by the cash contribution largely funded by the transferor, it could be argued that he did not in fact transfer the risk of loss of value of the options or underlying stock to the partnership, a key element of a “sale.” Thus, it could be the conclusion that the transaction would be a contribution to capital rather than a sale, or perhaps even a “sham” transaction that did not actually shift the benefits and burdens of option ownership significantly to the partnership.<sup>2006</sup>

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<sup>2005</sup> The draft opinion letter refers to Treas. Reg. Sec. 1.83-3(e). The draft opinion letter recognizes that the authorities it cites interpreting that regulation involve a promissory obligation of an employer rather than a third party, but concludes that there is no special rule limited the provision to employers and that the theoretical support should apply equally to a third party. EC2 000038611.

<sup>2006</sup> Although the draft opinion letter does make reference to concepts such as the common law “sham transaction” and “substance over form” doctrines, it relies in large part on its conclusion that the transfer is more likely than not an “arm’s length” sale to distinguish cases in which such doctrines have been applied. EC 000038599.

For detailed information on the present law rules and judicial doctrines applicable to tax avoidance transactions and related recommendations and developments, *see e.g.*, Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters* (JCX-19-02),

The draft opinion letter also takes the position that the sale of the options is at arm's length, even though the transaction is between an individual and a partnership whose partners are the members of his immediate family. In discussing the issue, the draft opinion letter concludes that the state of the law is merely ambiguous, and that the sale between related parties can be considered at arm's length. This conclusion fails to take into account the absence of any adverse interest between the parties.

The draft opinion letter relies entirely upon the application of specific regulations under section 83, and does not consider whether any other provisions of the tax law might apply. For example, the letter does not mention section 453(e), generally applicable to installment sales between parties that are related but otherwise respected as independent. Section 453(e) provides that if a sale of property occurs between related parties and, within two years of the first sale, the transferee makes a second disposition of the transferred property, then the original transferor is not entitled to use the installment method of reporting income to defer recognition of income from the sale until payments are received, but rather must include all gain in income at the time of the second disposition. The opinion letter does not address whether this provision might have relevance to the transaction, or whether an exercise of the option (or a sale of the optioned stock) by the partnership might invoke this section.<sup>2007</sup>

### **Nontax issues**

A noticeable aspect of Enron's stock-based compensation programs is the emphasis placed on stock as a form of compensation. Enron used stock-based compensation as a principle form of compensation for executives. Management believed that executive compensation should be tied to company performance. There was a stock ownership requirement for certain executives, the stated purpose of which was to align the interests of executives and stockholders. A stated focus of the Compensation Committee was ensuring that there was a strong link between the success of the shareholder and the rewards of the executive. The Compensation Committee believed that a great deal of executive compensation should be dependent on company performance.

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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).

<sup>2007</sup> Some published discussion of similar structures has discussed section 453, both by way of exploring possible beneficial capital gain treatment of a sale of options and also by way of exploring whether there might be risks in the case of transfers to related parties. *See, e.g.,* Hammill and Lusby, *Intrafamily Installment Sales of Nonqualified Stock Options*, 31 Tax Advisor 494 (July 2000).

As noted elsewhere, the Enron culture also Enron stock ownership by employees. For example, Joint Committee staff were told that there was a monitor in the lobby of the Enron headquarters in Houston so that the performance of Enron stock could be viewed by all who entered the building. Even up to the months immediately preceding the bankruptcy, employees were encouraged that the company was in strong financial shape. Stock-based compensation was used for all employees in a variety of forms, including as an investment in the Enron Savings Plan and Enron ESOP, in addition to the all-employee stock option programs. Stock was used as a form of compensation for nonemployee directors.

While some argue that linking shareholder and executive success is beneficial for shareholders, conflicts may arise. Linking compensation of executives to the performance of the company can result in executives taking measures to increase short-term earnings instead of focusing on longer-term interests.

The use of stock options by Enron brings renewed attention to discussions regarding the proper treatment of stock options for accounting purposes, and the difference between the treatment of options for tax and accounting purposes. As discussed above, under APB 25, which Enron followed, generally no compensation cost is required to be recorded in financial statements for stock options issued to employees if the exercise price is equivalent to or greater than the market price on the grant date. FAS 125, the “preferred,” but optional, approach, would require stock option costs to be taken into account when options are granted, based on a determination of the value of the option.

Because of the differences between accounting rules and tax rules, the amount shown on financial statements as a cost attributable to stock options, even under FAS 125, can be substantially less than a company’s tax deduction for stock options. Accounting rules and tax rules have somewhat different purposes, and it may be appropriate for different rules to apply in order to achieve the differing purposes. For example, under the tax laws, one principle is the proper matching of income and deductions; in the case of stock options, the corporation is not allowed a deduction until an amount is includible in gross income, which is generally upon exercise. This is an appropriate rule from a tax perspective; however, accounting rules might reasonably take the approach that options should be recorded earlier for financial reporting purposes.

Nevertheless, the sheer magnitude of the amount of corporate deductions and executive income generated by the exercise of stock options in some cases, such as Enron’s, may appropriately focus attention on whether proxy disclosure rules and accounting rules are sufficient to properly inform shareholders.

### 3. Employee loans

#### Present Law

##### Overview

It is not uncommon for employers to make loans to some employees, particularly executives. From a Federal income tax perspective, a question that may arise is whether the arrangement is in fact a loan or a payment of compensation.

The tax treatment of loans is different from the tax treatment of compensation for both the employer and the employee. Compensation is generally currently includible in the gross income of the employee, and includible in wages for employment tax purposes. Compensation is generally deductible by the employer as an ordinary and necessary business expense,<sup>2008</sup> subject to the \$1 million limitation on the deduction of compensation for certain executives.<sup>2009</sup>

On the other hand, a loan is not includible in the gross income of the employee (or in wages for employment tax purposes). Similarly, no deduction is allowed the employer with respect to the making of a loan to an employee. Interest payments may in some circumstances be deductible by the employee;<sup>2010</sup> accrued interest is includible in the gross income of the employer.

Under present law, a loan that provides for the payment of interest at a rate below the applicable Federal rate (a “below-market-rate loan”) between certain parties is recharacterized as a transaction in which the lender made a loan to the borrower in exchange for a note requiring the payment of interest at the applicable Federal rate. In the case of loans in the employment context, the rule results in the parties being treated as if: (1) the borrower paid interest to the lender at the applicable Federal rate which is includible in income by the lender; and (2) the lender paid compensation to the employee in the amount of imputed interest.<sup>2011</sup> Because of these rules, the stated interest rate on loans to executives is often the applicable Federal rate.

If an employer makes a bona fide loan to an employee and subsequently forgives any outstanding debt, the amount forgiven is includible in gross income as compensation in the year forgiven and subject to employment taxes. The employer is generally entitled to a compensation deduction upon such forgiveness, subject to the general rules applicable to deduction of compensation expenses.

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<sup>2008</sup> Sec. 162.

<sup>2009</sup> Sec. 162(m). This limitation is discussed in Part III.C.6., below.

<sup>2010</sup> Sec. 163.

<sup>2011</sup> Sec. 7872.

Determining whether an arrangement is a loan to an employee or compensation is generally based on all the facts and circumstances. Present-law rules applicable in making this determination are discussed below.

Laws other than tax laws may also affect the structure of employee loan transactions. Federal securities laws regarding reporting of stock transactions by corporate executives have influenced the decision of whether to use stock of the company to repay a loan. These rules are discussed in brief, below.

### **Definition of a bona fide loan**

#### **In general**

A transfer of funds from one taxpayer to another may constitute a loan, a gift, compensation for services, a contribution to capital, or something else.<sup>2012</sup> Whether the transfer will be treated as a loan for tax purposes depends on the intentions of the parties as well as the objective facts and circumstances of the transaction.<sup>2013</sup>

In general, in order for a loan to exist, at the time the transfer of funds takes place, there must be an unconditional obligation on the part of the transferee to repay the funds coupled with an unconditional intention on the part of the transferor to secure repayment.<sup>2014</sup> In analyzing whether there is an unconditional obligation to repay on the part of the payee, courts have examined whether, under the loan agreement, the obligation to repay the loan is contingent upon a future event.<sup>2015</sup> If the obligation to repay is conditional if the condition of repayment may be easily satisfied by the borrower<sup>2016</sup> or is under the borrower's control, the transfer of funds generally will not be regarded as a bona fide loan.<sup>2017</sup>

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<sup>2012</sup> For example, a transfer by a corporation to a shareholder employee may be a dividend.

<sup>2013</sup> *Haber v. Commissioner*, 52 T.C. 255, 266 (1969) *aff'd*, 422 F.2d 198 (5th Cir. 1970).

<sup>2014</sup> *Id.*; *Haag v. Commissioner*, 88 T.C. 604, 615-616 (1987), *aff'd* 855 F.2d 855 (8th Cir. 1988).

<sup>2015</sup> *See, e.g., Frierdich v. Commissioner*, T.C. Memo 1989-103, *aff'd*, 925 F.2d 180 (7th Cir. 1991); *also see Bouchard v. Commissioner*, T.C. Memo 1954-243, *aff'd*, 229 F.2d 703 (7th Cir. 1956)

<sup>2016</sup> *Saunders v. Commissioner*, 720 F.2d 871, 874 (5th Cir. 1983) (holding that where agreement contained "exceedingly generous" forgiveness clauses and the recipients of the loans could easily qualify for cancellation of the loan, no creditor-debtor relationship was established).

<sup>2017</sup> *Milenbach v. Commissioner*, 106 T.C. 184, 197 (1996). In *Milenbach*, repayment was to be made out of future profits generated from residential suites the borrower was to construct at a time in its "reasonable discretion." The borrower never constructed the suites and thus never repaid the loan. The Tax Court held that because the agreement provided for only a



Courts have often looked beyond the intentions of the parties to objective factors that may indicate whether a creditor-debtor relationship has been created.<sup>2018</sup> Frequently cited factors include (1) the existence of a promissory note or other evidence of indebtedness, (2) the existence of a specified repayment schedule including interest, (3) the presence of a collateral or security for the loan, and (4) the payee's ability to repay.<sup>2019</sup> Additional factors include whether repayments were made, and the manner in which the loan was treated in the taxpayers' books.<sup>2020</sup>

### Loans in the employment context

Loans to employees may be subject to challenge on the ground that they constitute compensation for services rather than a true debt. Two factors, in addition to the general rules for determining whether a bona fide loan exists, have been applied in the employment context.

First, the manner in which the loan is to be repaid--whether through the provision of services or monetary payments--has been a significant indicator of whether a bona fide loan exists in the employment context. Generally, loans made with the expectation that they would be repaid through the provision of future services have been held not to create a creditor-debtor relationship between the employer and the employee and to constitute advance compensation rather than loans.<sup>2021</sup> The same result has been reached even if employment was ultimately terminated and monetary repayment ensued.<sup>2022</sup>

Second, if under the loan agreement repayment is to be satisfied with monetary payments, the focus has been on whether the repayment is to be satisfied solely from the future

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conditional obligation to repay the loan, the satisfaction of which was under the sole control of the borrower, it did not constitute a true loan.

<sup>2018</sup> *Geftamn v. Commissioner*, 154 F.3d 61, 68 (3rd Cir. 1998); *Haag*, 88 T.C. at 616; *Morgan v. Commissioner*, T.C. Memo 1997-132.

<sup>2019</sup> *Geftamn*, 154 F.3d at 68; *Morgan*, T.C. Memo 1997-132.

<sup>2020</sup> *Haag*, 88 T.C. at 616.

<sup>2021</sup> *Beaver v. Commissioner*, 55 T.C. 85, 91 (1970) ("in the case of a loan, satisfaction is to be made by making monetary payments pursuant to the parties' agreement. In such case a debtor-creditor relationship is established at the outset. In the case of compensation for future services, satisfaction is to be made by actually performing such services. Only when such services are not rendered does there arise a debtor-creditor relationship requiring satisfaction by monetary repayment."); *see also Morgan*, T.C. Memo 1997-132 ("an intent to repay a purported loan by the performance of services...[renders the loan] nothing more than an advance salary or other payment for services"); and *Friedrich*, T.C. Memo 1989-103 (holding that a loan to an attorney by his client, the repayment of which was due upon the occurrence of a future event and which could be offset by legal fees owed to the attorney, was not a loan but advance payment for legal services).

<sup>2022</sup> *See Beaver*, *supra*.

earnings of the employee during the period of employment or whether the obligation to repay continues after the employment relationship is terminated. Thus, in cases in which the loan agreement provided that repayment was to be made out of the future earnings of the employee but that the obligation would continue to exist after termination of employment, the transfer was treated as a true loan.<sup>2023</sup> Conversely, when repayment of the loan was limited to the future earnings of the employee during employment and could not be enforced against the employee after termination, the transfer was deemed to constitute compensation rather than a loan.<sup>2024</sup> Further, if there existed a high probability that, in fact, repayment would not be enforced against the employee or would be forgiven by the employer the transfer was not regarded as a loan but as compensation for services.<sup>2025</sup>

In a private letter ruling, the IRS ruled that advances made pursuant to an arrangement whereby they had to be repaid, in effect, only if the employee left the employment prior to the end of a required period of service constituted advance compensation for services rather than true loans.<sup>2026</sup> Under the loan agreement in the ruling, the employees had to work five years throughout which portions of the debt were forgiven on a yearly basis. The IRS reasoned that the fact that the obligation to repay would only arise if the employee's employment terminated prematurely rendered the repayment a conditional obligation "not sufficient to characterize the transfer as a loan." Any repayment obligation that would arise would be, according to the IRS, "liquidated damages for breach of the employment contract."<sup>2027</sup>

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<sup>2023</sup> Rev. Rul. 68-337, 1968-1 C.B. 417 (holding that advance payments made to employees which were to be repaid out of future earnings, but which included an acknowledgment of the debt and had to be repaid even if employment was terminated, were true loans rather than compensation); *see also Rosario v. Commissioner*, T.C. Memo 2002-70 (holding that payments made pursuant to an income guarantee agreement which were to be repaid during the term of employment from excess earnings were loans rather than compensation, if any balance remaining after termination of employment was to be repaid to the employer).

<sup>2024</sup> Rev. Rul. 68-239, 1968-1 C.B. 414 (holding that loans made to employees to be paid out of future earnings but which would not be enforced if employment were terminated were "wages" for income tax purposes); *see also Kinzy v. United States*, 87-2 USTC ¶ 9520, 60 AFTR 2d 5770 (N.D. Ga. 1987), (holding that when an employee received an advance payment which would be charged off as long as he remained employed and which had to be repaid only if employment terminated prior to the discharge and even then only out of earned commissions, the liability was contingent rather than an unconditional obligation to pay the advances and, therefore, the payment was compensation rather than a loan).

<sup>2025</sup> Rev. Rul. 83-12, 1983-1 C.B. 99 (holding that advance payments made to insurance agents which were to be repaid out of earned commissions and for which the agent was personally liable beyond the employment relationship, did not constitute true loans where the employer had a practice of forgiving and not enforcing the debt).

<sup>2026</sup> Priv. Ltr. Rul. 200040004 (June 12, 2000).

<sup>2027</sup> *Id.*

## **Nontax laws relating to employee loans**

### **SEC reporting requirements regarding insider sales of securities**

In some cases, Enron executives used stock to repay loans from Enron. Such transactions are affected by SEC reporting rules. Generally, any sale or purchase of the stock of a publicly held by its officers and directors is subject to reporting requirements under the Securities Exchange Act of 1934.<sup>2028</sup> In general, these rules require that purchases or sales of a company's stock in public markets must be reported within 10 days of the close of the month in which the transaction occurs.

However, during the time period covered by the Joint Committee staff review, in the case of transactions between officers and directors and the company itself, if certain requirements were satisfied, the transaction did not have to be disclosed until 45 days after the close of the company's fiscal year.<sup>2029</sup> Among the requirements that may apply in order for a transaction to qualify for delayed reporting is a requirement that the transaction be approved by the Board of Directors of the company or a committee of the Board consisting solely of two or more nonemployee directors. For example, if the applicable requirements are met, then transfers of stock by a corporate insider to the company in order to make payments on a loan from the company would qualify for delayed reporting.

Following the recent exposures of significant volumes of undisclosed insider-issuer dispositions and pursuant to section 403 of the Sarbanes-Oxley Act of 2002, the Securities and Exchange Commission has adopted new disclosure rules relating to transactions between the issuer and its officers and directors.

### **Prohibition on loans to executives**

The Sarbanes-Oxley Act of 2002,<sup>2030</sup> enacted in the aftermath of the Enron bankruptcy, contains a prohibition on the provision of personal loans to executives of companies with securities registered under the Securities Exchange Act of 1934.<sup>2031</sup> Subject to certain exceptions, the provision prohibits such a company from directly or indirectly (including through a subsidiary) extending or maintaining credit, arranging for the extension of credit, or renewing an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of the company.

If certain requirements are satisfied, the prohibition on loans does not apply to:

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<sup>2028</sup> 15 U.S.C. sec. 78p(a).

<sup>2029</sup> See Rule 16b-3 of the Securities Exchange Act of 1934; 17 CFR § 240.16b-3 which exempted transaction with the issuer from Rule 16(b).

<sup>2030</sup> Pub. L. No. 107-204 (2002).

<sup>2031</sup> Sec. 402(a) of the Sarbanes-Oxley Act of 2002.

- Home improvement and manufactured home loans as defined in the Home Owners' Loan Act,<sup>2032</sup>
- Consumer credit as defined in the Truth in Lending Act,<sup>2033</sup>
- any extension of credit under an open end credit plan or a charge card,<sup>2034</sup> or
- certain extensions of credit by a broker or dealer registered under the Securities Exchange Act of 1934 to any employee of that broker or dealer to buy, trade, or carry securities.

In order for one of these exceptions to apply, the following requirements must be satisfied. The loan must be:

- made or provided in the ordinary course of the consumer credit business of the company,
- of a type that is generally made available by the company to the public, and
- made by the company on market terms, or terms that are no more favorable than those offered by the company to the general public for such extensions of credit.

The prohibition also does not apply to loans made or maintained by an insured depository institution if the loan is subject to the insider lending restrictions of the Federal Reserve Act.

The provision is generally effective on the date of enactment of the Sarbanes-Oxley Act (July 30, 2002), but does not apply to extensions of credit maintained on that date if there is no material modification to any term of the arrangement or any renewal of the arrangement on or after that date.

## **Factual Background**

### **In general**

Enron did not have a general policy or program relating to executive loans. However, from time to time Enron extended loans to various executives. These loans were individually designed arrangements, and varied considerably. In Enron documents, most of the loans are described as personal loans. Interviews with current and former Enron personnel indicate that there was no single person or department that kept track of loan information, and that in some cases only one or two people within Enron may have been aware of the loan arrangements. Some of these arrangements have received considerable media attention, particularly the loans extended to Kenneth L. Lay.

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<sup>2032</sup> 12 U.S.C. 1464(c)(1)(J).

<sup>2033</sup> 15 U.S.C. 1602.

<sup>2034</sup> These terms are as defined in section 103 of the Truth in Lending Act (15 U.S.C. 1602) and section 127(c)(4)(e) of the Truth in Lending Act (15 U.S.C. 1637(c)(4)(e), respectively).

In repose to requests for information, Enron provided to the Joint Committee staff account reconciliation statements regarding executive loans. These statements show the amount of loans, payments made, and interest accrued with respect to loans to Mr. Lay, Jeffrey Skilling, Rebecca Mark, Rodney Gray, Clifford Baxter, and Mark Frevert. These account reconciliation statements are included in Appendix D to this Report. Other documents provided by Enron describe loans to Mark Pickering, and David Oxley. The loans to each of these individuals are discussed below.<sup>2035</sup> The loan arrangements of Mr. Lay and Mr. Skilling are highlighted, due to the amounts involved, the position they held within Enron (both served as Chief Executive Officer at different times), and the attention garnered by these particular arrangements. All of these arrangements were treated by Enron as loans for Federal tax purposes.

### **Kenneth L. Lay**

On September 1, 1989, Mr. Lay entered into a loan agreement with Enron. Under the agreement, Enron provided him with a revolving line of credit in the amount of \$2.5 million.<sup>2036</sup> Mr. Lay also received an advance of \$5 million to be used to purchase shares of Enron common stock, which were used as collateral.<sup>2037</sup> Mr. Lay signed a promissory note and pledged as collateral certain deferral benefits under the Deferral Plan, death benefits, Enron stock granted under the 1988 Stock Plan, financed stock held by Enron, and any severance remuneration payable.<sup>2038</sup> Mr. Lay was responsible for paying the full amount of interest which was to accrue at the applicable Federal rate. Mr. Lay repaid the entire principal of the \$2.5 million loan and the \$5 million advance, plus accrued interest, in 1994.<sup>2039</sup>

On March 25, 1994, Mr. Lay's employment agreement was renewed to provide him with a noncollateralized,<sup>2040</sup> interest-bearing revolving line of credit in the amount of \$4 million.<sup>2041</sup>

On May 3, 1999, the Compensation Committee approved an amendment to the loan agreement that allowed Mr. Lay to repay his loans with Enron stock, and the loan agreement was accordingly amended. Compensation Committee minutes indicate that the approval of the new

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<sup>2035</sup> All of these loan arrangements are also described in proxy materials, except those to Mr. Frevert, Mr. Pickering, and Mr. Oxley.

<sup>2036</sup> The 1996 proxy characterizes the line of credit as a one-time loan. The loan agreement, however, suggests that the loan was in the form of a line of credit.

<sup>2037</sup> The shares were pledged as collateral.

<sup>2038</sup> See Loan Commitment Agreement, September 1, 1989 (EC000752817).

<sup>2039</sup> The renewed employment agreement signed in 1994 provided that Mr. Lay had to pay all outstanding balances within 30 days of its execution.

<sup>2040</sup> The proxy statements indicate that the loan was not collateralized.

<sup>2041</sup> 1996 Enron Corp. Proxy Statement.

repayment option was intended as evidence of compliance with the exemption from reporting under applicable securities laws.<sup>2042</sup>

On August 13, 2001, the amount available to Mr. Lay under the line of credit was increased to \$7.5 million.<sup>2043</sup> Mr. Lay resigned on January 23, 2002, with a remaining unpaid principal balance of \$7.5 million. According to Enron, the total outstanding amount, plus accrued interest, is \$7.794 million.<sup>2044</sup>

The account reconciliation statements for Mr. Lay's loans show that the aggregate amounts withdrawn pursuant to his line of credit from 1997 through 2001, was over \$106 million.<sup>2045</sup> In 2001 alone, Mr. Lay engaged in a series of 25 transactions involving withdrawals under the line of credit. The total amount of withdrawals for 2001 was \$77.525 million (of which all but \$7.5 million was repaid). The account reconciliation statements also show that during 1997 through 2001, Mr. Lay repaid principal amounts of \$99.3 million. Over \$94 million of this amount was repaid with 2.1 million shares of Enron stock.<sup>2046</sup>

The Joint Committee staff sent a series of written questions to Mr. Lay's counsel, Piper Rudnick, regarding Mr. Lay's compensation arrangements. In response to a question regarding Mr. Lay's use of stock to repay loans, Mr. Lay's counsel stated that it was their understanding that in 2001 Mr. Lay drew down on the Enron line of credit and then repaid it with stock principally because he needed funds to avoid or, if unavoidable, to pay margin calls on secured lines of credit Mr. Lay had established with certain banks and brokerage firms. These lines were secured primarily by Enron stock, the price of which was falling. Mr. Lay's counsel also stated it was their understanding that, because Mr. Lay's holdings in Enron stock represented a high percentage of his liquid assets, he used Enron stock to repay the Enron loan.

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<sup>2042</sup> Minutes of the Meeting of the Compensation Committee, at 10 (May 3, 1999).

<sup>2043</sup> EC2000026955.

<sup>2044</sup> EC002679852.

<sup>2045</sup> See Appendix D to this Report. The total outstanding principal amount at any one time varied, but did not exceed \$7.5 million.

<sup>2046</sup> In the account reconciliation statements, the use of Enron stock to repay an outstanding loan is referred to as "swapping in" Enron stock. See, e.g., EC002680500 in Appendix D.

**Jeffrey K. Skilling**<sup>2047</sup>

On October 13, 1997, Mr. Skilling's employment agreement was amended to incorporate a loan provision, allowing Mr. Skilling to borrow \$4 million. Interest was to accrue at the applicable Federal rate until maturity on December 31, 2001. Under the agreement, Mr. Skilling was responsible for paying the interest. The loan agreement further provided that if Mr. Skilling remained in the employ of Enron until December 31, 2001, 50 percent of the loan principal would be forgiven. If, however, he voluntarily terminated his employment prior to that or was terminated for cause, the entire amount of the loan would become due. As collateral, Mr. Skilling pledged his Enron restricted stock and the right to receive certain deferral benefits under the 1994 Deferral Plan.<sup>2048</sup>

Mr. Skilling borrowed \$4 million from Enron on October 23, 1997, and signed a promissory note. On May 3, 1999, the Compensation Committee approved an amendment to the loan agreement that allowed him to repay his loans with Enron stock and, on that date, he made a partial repayment in the form of \$2 million worth of Enron shares.<sup>2049</sup> Compensation Committee minutes indicate that the approval of the new repayment option was intended as evidence of compliance with the exemption from reporting under applicable securities laws.<sup>2050</sup> Mr. Skilling resigned from his position (then as Chief Executive Officer of Enron) on August 14, 2001. On September 15, 2001, he repaid in cash the remaining \$2 million balance due on the loan.<sup>2051</sup> Mr. Skilling recalled that he paid accrued interest on the loan. According to Enron, Mr. Skilling still owes \$88,679 of accrued interest and payment has been requested.<sup>2052</sup>

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<sup>2047</sup> Jeffrey K. Skilling was appointed President and Chief Operating Officer of Enron Corp. on December 10, 1996. Prior to his appointment as Chief Operating Officer of Enron, Mr. Skilling served as the Chairman and Chief Executive Officer of Enron Gas Services Corp. Mr. Skilling entered into several loan transactions with Enron during that time: he received a \$1.4 million loan in 1991 and another \$100,000 loan in 1992. The 1991 loan was collateralized with pledged personal property. In 1993, Mr. Skilling repaid the principal and interest of both loans with the proceeds of a newly-issued nonrecourse debt in the amount of \$1,606,719, which was collateralized with Enron stock options and phantom equity in Enron Gas Services. The loan was repaid in full on July 1, 1993. *See* 1993 and 1994 Enron Corp. Proxy Statements.

<sup>2048</sup> The 1999 Enron Corp. Proxy Statement indicates that the collateral given included Enron common stock, EOG stock and 1994 Deferral Plan benefits.

<sup>2049</sup> EC002680500. The 1999 Enron Corp. Proxy Statement indicates that he had paid the total amount of interest that accrued until September 1998 for a total of \$215,664. According to the 2000 Enron Corp. Proxy Statement, the total accrued interest for 2000 was \$126,747, which was paid by Mr. Skilling.

<sup>2050</sup> Minutes of the Meeting of the Compensation Committee, at 9 (May 3, 1999).

<sup>2051</sup> Enron Corp. Account Reconciliation Officers' Loans as of September 30, 2001, EC002680504.

<sup>2052</sup> EC002679852.

## Other executive loans

### Rebecca Mark

Rebecca Mark held numerous positions with Enron, including chairman and Chief Executive Officer of Enron International, Chairman and Chief Executive Officer of Azurix, and Chairman and Chief Executive Officer of Enron Development Corp.

Ms. Mark received two loans from Enron. First, Ms. Mark received a loan in the amount of \$900,000 on May 7, 1997. The loan bore interest at the mid-term applicable Federal rate and was collateralized with 24,899 shares of Enron common stock.<sup>2053</sup> In May 1998, the entire principal of the loan plus the accrued interest, totaling \$955,343, were forgiven.<sup>2054</sup> The 1999 proxy statement states that the loan forgiveness was “in consideration of Ms. Mark’s increased responsibilities.”<sup>2055</sup> The precise nature of these increased duties are not described.<sup>2056</sup>

Second, on May 4, 1998, Ms. Mark received a loan in the amount of \$2.5 million.<sup>2057</sup> The loan bore interest at the short-term applicable Federal rate and was collateralized with Enron stock. In the beginning of 1999, \$700,000 of the principal amount was forgiven due to Ms. Mark’s performance in 1998. In February 1999, Ms. Mark repaid \$550,000 on the loan.<sup>2058</sup> The remaining amount of \$1.25 million as well as the accrued interest (in the amount of \$171,099) was repaid by February 25, 2000.<sup>2059</sup>

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<sup>2053</sup> 1998 Enron Corp. Proxy Statement, at 26. As of December 1997, accrued interest totaled \$37,367. *Id.*

<sup>2054</sup> 1999 Enron Corp. Proxy Statement, at 25.

<sup>2055</sup> *Id.*

<sup>2056</sup> *Id.* Enron Corp. billed \$450,000 of the loan amount to Enron International and amortized the remaining \$450,000 plus the relevant portion of the accrued interest during 2000. *See* Account Reconciliation of Officer’s Loans Chart as of December 31,2000 (EC001709350). It is noted on the chart that Enron Corp. would attempt to shift the remaining \$450,000 to Water Co., and would write it off before year-end if it did not succeed.

<sup>2057</sup> According to the 1999 proxy statement, the loan was issued “due to revised vesting provisions that triggered constructive receipt for tax purposes.” 1999 Enron Corp. Proxy Statement, at 25.

<sup>2058</sup> According to Enron, on the same date Ms. Mark paid \$206,150 representing taxes on the \$700,000 that was forgiven. EC002679704.

<sup>2059</sup> 1999 Enron Corp. Proxy Statement, at 25. (EC001709350).



Enron said that it reported both amounts forgiven as income on Ms. Mark's Form W-2.<sup>2060</sup>

### Richard Kinder

Pursuant to his 1989 employment agreement, Richard Kinder received an advance of \$3 million to purchase shares of Enron Corp. common stock,<sup>2061</sup> and a loan in the amount of \$1.5 million. The loan and advance were to mature on February 8, 1999.<sup>2062</sup> In February of 1994, Mr. Kinder's employment agreement was renewed to provide that if he and Enron would "not be able to reach mutually satisfactory terms relating to his future employment," the loan and the advance would be forgiven.<sup>2063</sup> In November of 1996, Mr. Kinder entered into an agreement with Enron whereby he would resign from his position as an officer and director of Enron effective December 31, 1996, and would terminate his employment with Enron effective February 15, 1997. The outstanding principal and interest balances on his loan and advance -- totaling \$3.8 million -- were forgiven as of February 7, 1997.<sup>2064</sup>

### Rodney Gray

Rodney Gray received a loan from Enron in the amount of \$250,000 on August 1, 1994. Enron Corp. common stock was pledged as collateral and Mr. Gray was responsible for payment of interest, which accrued at the applicable Federal rate.<sup>2065</sup> Mr. Gray terminated employment as an executive officer with Enron in November 1997. According to documents provided by Enron, Mr. Gray repaid the loan on August 24, 1999.<sup>2066</sup>

### Clifford Baxter

Clifford Baxter received a loan from Enron in the amount of \$200,000 on September 15, 1995. The loan bore interest at the short-term applicable Federal rate. According to the terms of the loan agreement as described in proxy materials, if Mr. Baxter remained employed by Enron

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<sup>2060</sup> EC002680476.

<sup>2061</sup> The stock was pledged as collateral. 1996 Enron Corp. Proxy Statement, at 21.

<sup>2062</sup> *Id.* at 21-22.

<sup>2063</sup> *Id.*

<sup>2064</sup> 1997 Enron Corp. Proxy Statement, at 25. A former member of the Board of Directors of Enron told the Joint Committee staff that Mr. Kinder had anticipated succeeding Mr. Lay as Chief Executive Officer, and that when that failed to occur, Mr. Kinder resigned.

<sup>2065</sup> *Id.* at 24.

<sup>2066</sup> EC002680449. According to the 1997 and 1998 proxy statements, Mr. Gray made interest payments of \$15,426 in 1996 and \$15,874 in 1997. 1997 Enron Corp. Proxy Statement, at 24; 1998 Enron Corp. Proxy Statement, at 26.

during March 15, 1996, and March 15, 1997, 50 percent of the loan would be forgiven on each date. In 1996, \$100,000 of the principal was forgiven<sup>2067</sup> and in 1997 the remaining balance was forgiven.<sup>2068</sup>

#### Mark Frevert

Enron filings with the bankruptcy court indicate that Enron made a \$2 million loan to Mark Frevert.<sup>2069</sup> Documents provided by Enron indicate that this loan was made in October 2001, the loan bore interest at the applicable Federal.<sup>2070</sup> According to Enron, the loan is still outstanding and repayment has been requested. The outstanding amount, including principal and interest is \$2.093 million.

#### Mark Pickering

According to documents provided by Enron as well as interviews with Enron employees, Enron made a loan to Mark Pickering in connection with his relocation to the United States. It was explained that because Mr. Pickering had no credit in the United States, he was required to pay a substantial down payment on the purchase of a home and that Enron loaned him the money for this reason. The loan was made on June 13, 2001, for \$400,000 and, according to Enron, is still outstanding.<sup>2071</sup>

#### David Oxley

According to information provided by Enron, a loan was made to David Oxley<sup>2072</sup> on August 15, 2001, in the amount of \$500,000. The loan agreement provided that the loan was to

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<sup>2067</sup> 1997 Enron Corp. Proxy Statement, at 24-25.

<sup>2068</sup> 1998 Enron Corp. Proxy Statement, at 26-27. According to the 1997 and 1998 proxy statements, Mr. Baxter paid the accrued interest on the loan, totaling \$6,000 in 1996 and \$5,788 in 1997. 1997 Enron Corp. Proxy Statement, at 25; 1998 Enron Corp. Proxy Statement, at 27. While a loan to Mr. Baxter was described in proxy statements, in response to request for information made by the Joint Committee staff, Enron stated that current staff was unable to determine what loans were made to Mr. Baxter, and that there may have been two loans. EC002679704; EC002680476.

<sup>2069</sup> *In re Enron Corp.*, Case No. 01-16034, Statement of Financial Affairs, Exhibit 3b.2 (Payments to Insiders).

<sup>2070</sup> EC000752675.

<sup>2071</sup> EC002679704; EC002679766.

<sup>2072</sup> According to a services agreement entered into between Enron and Mr. Oxley on August 28, 2000, 2001, he was Vice President of Enron Europe Limited. EC002679832-844. Pursuant to an amendment to the services agreement dated November 28, 2001, his agreement was assumed by Enron North America and he was placed on the payroll of Enron North America. Assignment and Second Amendment Agreement, EX002679848.

be repaid within 120 days.<sup>2073</sup> On November 28, 2001, the services agreement between Mr. Oxley and Enron was amended to provide that the loan would be forgiven if: (1) Mr. Oxley remained employed by Enron until February 5, 2002; or (2) if earlier, Mr. Oxley were terminated involuntarily before February 5, 2002.<sup>2074</sup> The loan was forgiven on November 29, 2001.<sup>2075</sup>

### **Discussion of Issues**

Although Enron had no formal policy regarding loans, there was a practice of making loans, particularly to key executives. Not counting the loans to Mr. Lay, Enron made loans to eight executives totaling over \$17 million. Enron forgave over \$6 million of these loans, including both principal and interest.

The loans to Mr. Lay stand out from the others by virtue of the total amount involved over time. The structure of his loans was also different. In other cases the loans, even if characterized as a line of credit, involved lending on single occasions, whereas Mr. Lay engaged in a series of transactions in which he borrowed, repaid, and borrowed again. As described above, the total amount withdrawn by Mr. Lay under his line of credit was over \$106 million (over \$77 million of which was in 2001 alone). During the period 1999-2001, Mr. Lay used stock to repay a portion of his loans; a total of over 2 million shares of Enron stock with a total value of \$94.267 million was given to Enron as repayment for loans.

The loans made by Enron to employees raise both tax and nontax questions. From a Federal income tax perspective, Enron treated all these arrangements as loans for Federal tax purposes. That is, no amount was reported as income with respect to the loans, unless the loan was forgiven. A key issue raised by the various loans to Enron executives is whether certain loans should have been treated as compensation to the executive rather than a loan. The arrangements all carried the indicia of loans; there was generally a loan agreement and/or promissory note, interest was accrued (and in some cases paid), and in some cases there was collateral for the loan. Two aspects of the various loans raise the question of whether the loans were in fact compensation when entered into: (1) loan agreements that provide that the loan will be forgiven if the executive works for a specified period of time; and (2) forgiveness of loans (without an explicit forgiveness clause in the loan).

Two loans reviewed by the Joint Committee staff, one of Mr. Skilling's loans and a loan to Mr. Baxter, contained provisions providing that if the executive remained with Enron until a specified date, the loan would be forgiven.<sup>2076</sup> Mr. Baxter remained employed until the date specified in his agreement and, as a result, a \$200,000 in indebtedness was forgiven. Mr.

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<sup>2073</sup> Loan Agreement between Enron North America Corp. and David Oxley (EC002679827-831).

<sup>2074</sup> First Amendment to the Services Agreement, at 2 (EC002679845-847).

<sup>2075</sup> EC002680476; EX002679849.

<sup>2076</sup> As described above, Mr. Baxter's loan agreement provided for forgiveness in two stages.

Skilling did not remain with Enron until the date specified in his loan agreement, and he repaid the loan, with interest, after leaving Enron.

As described above, income results to the executive when a loan is forgiven. However, these loans raise the question of whether they were really in the nature of compensation for services and should have been treated as taxable compensation when entered into. It can be argued that the loan is to be satisfied solely from the performance of future services, and therefore is really compensation for services. From a factual standpoint, at the time the loan was made, the arrangement is not unlike the pre-bankruptcy bonuses paid by Enron in November 2001, which required the employee to repay the bonus, with a 25 percent penalty, if the employee did not remain with Enron for a certain period of time. These bonuses were treated by Enron as compensation and were subject to withholding.

In other cases, Enron forgave loans to executives when the loan agreement did not require forgiveness. Loans to Ms. Mark and Mr. Kinder were of this type. In these cases, the question is whether the forgiveness was contemplated at time of the agreement, which would cast doubt on the intent of the parties to enter into a loan. In order for these arrangements to be considered compensation, it would have to be shown that it was the understanding of the parties that repayment was not in fact anticipated.

In addition to tax issues raised, the loan transactions also raise questions of corporate governance. In particular, some view the use of loans, particularly when substantial amounts are involved over time or in particular instances, as a use of corporate funds for personal purposes. From this perspective, some argue that such loans are inappropriate. This view is reflected in the prohibition on executive loans contained in the Sarbanes-Oxley Act.

The use of stock to repay loans also raises corporate governance issues. Some commentators have argued that Enron executives used stock to repay loans in order to take advantage of exceptions to securities laws reporting requirements, thereby allowing the executives to defer reporting on sales of Enron stock during the months before the Enron bankruptcy. As described above, the loan agreements for Mr. Lay and Mr. Skilling were amended in 1999 to allow for payment with the use of stock; the changes were specifically structured to come within the reporting exceptions.

### **Recommendations**

The Sarbanes-Oxley Act contains a prohibition on executive loans. If this prohibition had been in effect in prior years, it is likely that the loans reviewed by the Joint Committee staff in this case would not have been made. Thus, the Joint Committee staff is not recommending further legislative changes at this time.

#### 4. Purchase and reconveyance of Kenneth L. Lay's annuity contracts

##### Present Law

##### Taxation of annuity contracts

###### In general

Present law provides favorable tax treatment for annuity contracts held by individuals. While no deduction is allowed for the purchase of an annuity contract, income credited to an annuity contract (i.e., "inside buildup") generally is not currently includible in the gross income of the owner of the contract. The extent to which payments received under the contract are includible in gross income depends on when the payments are received and the taxpayer's investment in the contract.<sup>2077</sup>

In general, for amounts received as an annuity, an "exclusion ratio" is provided for determining the taxable portion of each payment.<sup>2078</sup> The portion that represents recovery of the taxpayer's investment in the contract is not taxed. The exclusion ratio is the ratio of the taxpayer's investment in the contract to the expected return under the contract, that is, the total of the payments expected to be received under the contract. The ratio is determined as of the taxpayer's annuity starting date. Each annuity payment is multiplied by the exclusion ratio, and the resulting portion of each payment is treated as nontaxable recovery of the investment in the contract. Once the taxpayer has recovered his or her investment in the contract, the entire amount of all further payments are included in income. If the taxpayer dies before the full investment in the contract is recovered, a deduction is allowed on the final return for the remaining investment in the contract.

Amounts not received as an annuity generally are included in income if received on or after the annuity starting date. If amounts not received as an annuity are received before the annuity starting date, such amounts generally are included in income to the extent allocable to income on the contract (i.e., as income first).

A 10-percent additional income tax is imposed on certain early withdrawals under an annuity contract. This additional tax does not apply to any distribution made after the owner of the contract attains age 59-1/2, made after the owner dies or becomes disabled, made in the form of certain periodic payments, or that satisfies certain other requirements.

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<sup>2077</sup> Sec. 72. Section 72 uses the term "investment in the contract" in lieu of the general tax notion of basis. Investment in the contract is defined (as of the annuity starting date) as the aggregate amount of premiums or other consideration paid for the contract, minus the aggregate amount already received under the contract (to the extent it was excludable from income).

<sup>2078</sup> Special rules apply to variable annuity contracts. Treas. Reg. sec. 1.72-4(d)(3).

### Annuities held by nonnatural persons

In general, if an annuity contract is held by a person that is not a natural person, such as a corporation, then the income on the contract is treated as ordinary income currently received or accrued during the taxable year. Thus, under this rule, no deferral is permitted to the holder of the contract. The contract is not treated as an annuity contract for Federal income tax purposes (except with respect to the insurance company issuing the contract).<sup>2079</sup>

### Sale or disposition of annuity contracts

In general, a sale or disposition of an annuity contract is subject to the normally applicable gain recognition rules. That is, the seller of the contract recognizes gain to the extent that the amount received for the contract exceeds his or her investment in the contract. A number of courts have held that gain on the sale of an annuity contract is taxed as ordinary income to the seller.<sup>2080</sup> In general, if an annuity contract is transferred by an individual for less than full and adequate consideration, the individual is treated as receiving the difference between the cash surrender value of the annuity over the investment in the contract as an amount not received as an annuity.<sup>2081</sup>

### Receipt of property for services

Property transferred in connection with the performance of services generally is includible in gross income of the person performing the services for the year in which the service provider's right to the property is either transferable or is not subject to a substantial risk of forfeiture.<sup>2082</sup> The amount includible is the excess of the fair market value of property received in connection with the performance of services over the amount, if any, paid for the property.

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<sup>2079</sup> Sec. 72(u). For purposes of this rule, the holding an annuity contract by a trust or another entity as an agent for a natural person is not taken into account. Section 72(u) provides several narrow exceptions to the rule of inclusion in the case of an annuity contract that: (1) is acquired by the estate of a decedent; (2) is held under certain types of retirement plans or arrangements; (3) is a qualified funding asset for a structured settlement arrangement; or (4) is purchased by an employer upon termination of certain types of retirement plans and meets certain other requirements.

<sup>2080</sup> *First National Bank of Kansas City v. Commissioner*, 309 F.2d 587 (8<sup>th</sup> Cir. 1962); *Roff v. Commissioner*, 304 F.2d 450 (3<sup>rd</sup> Cir. 1962); *Commissioner v. Phillips*, 275 F.2d 33 (4<sup>th</sup> Cir. 1960).

<sup>2081</sup> Sec. 72(e)(4)(C).

<sup>2082</sup> Sec. 83. Under a special rule, if property is either nontransferable or is subject to a substantial risk of forfeiture when transferred, the service provider may elect within 30 days to apply section 83 as of the time of the transfer.

The person for whom the services were performed is entitled to a deduction equal to the amount includible in the service provider's gross income<sup>2083</sup> (subject to the \$1 million cap on the deductibility of executive compensation).<sup>2084</sup> The deduction generally is allowable in the taxable year in which the amount is included in the income of the person performing the services. If the property is substantially vested upon transfer, the deduction is allowable in accordance with the method of accounting used by the taxpayer.<sup>2085</sup>

### **Factual Background**

On September 14, 2001, the Compensation Committee of the Enron Board of Directors approved what the Committee minutes<sup>2086</sup> refer to as an "insurance swap transaction" as part of the compensation to be provided to Mr. Lay in connection with the resumption of his duties as Chief Executive Officer following the resignation of Mr. Skilling in August of 2001.<sup>2087</sup> According to documents provided by Enron, this transaction involved two annuity insurance contracts that had been purchased by Mr. Lay and his wife, one in each of their names. Mr. Lay's contract was purchased on September 30, 1999, and Mrs. Lay's contract was purchased on February 8, 2000. The contracts were to mature after approximately 30 years. As stated in the contracts, the initial premium made on each of the contracts was \$2.5 million.<sup>2088</sup>

Under the transaction,<sup>2089</sup> Enron purchased the annuity contracts from the Lays for \$5 million each (a total of \$10 million)<sup>2090</sup> and also agreed to reconvey the annuity contracts to Mr.

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<sup>2083</sup> Sec. 83(h).

<sup>2084</sup> Sec. 162(m).

<sup>2085</sup> Treas. Reg. sec. 1.83-6(2).

<sup>2086</sup> Minutes of the Meeting of the Compensation and Management Development Committee, September 14, 2001, at 4. EC2 000026740-41.

<sup>2087</sup> Mr. Skilling became Chief Executive Officer in February 2001. Prior to that time, Mr. Lay was both Chairman of the Board and Chief Executive Officer. When Mr. Skilling became Chief Executive Officer, Mr. Lay retained the title of Chairman.

<sup>2088</sup> Mrs. Lay's insurance contract is EC 000897921-50. Mr. Lay's is EC 000897964-99. Other internal Enron documents indicate that the amount of the initial investment was \$5 million for each contract. "Inter Office Memorandum to Annuity Contracts, Liquidation for Compensation - Tax Issues, September 25, 2001," EC 002680472.

<sup>2089</sup> Documents regarding the transaction were executed by the Lays and Enron on September 21, 2001. Purchase, Sale, and Reconveyance Agreement, EC 000752808-814.

<sup>2090</sup> Information provided to Joint Committee staff indicated that Mr. Lay and Mrs. Lay each had a \$5 million basis in their respective contracts. However, it is not clear from reviewed documents whether the Lays made payments in addition to the initial \$2.5 million payments.

Lay if he remained employed with Enron through December 31, 2005.<sup>2091</sup> If Mr. Lay were to leave Enron prior to that date, reconveyance still would take place on the occurrence of one of four events: (1) retirement with the consent of the Board; (2) disability; (3) involuntary termination (other than a termination for cause); or (4) termination for “good reason.”<sup>2092</sup> If Mr. Lay were to leave Enron prior to December 31, 2005, for a reason other than those provided, then Enron would have no further obligation to Mr. Lay with respect to the annuity contracts. The agreement regarding the transaction also provided that if either of the Lays died while Enron owns the contracts and continues to have a potential obligation to reconvey them to Mr. Lay, Enron will pay all proceeds received under the contracts to Mr. Lay if the decedent is Mrs. Lay and to Mr. Lay’s estate if he is the decedent.

At the September 14, 2001, meeting, the Compensation Committee was presented with two different possible transactions involving the annuity contracts.<sup>2093</sup> The first alternative was the one adopted by the Committee. The second was the same as the first, except that the contracts would be purchased for their current market value (for a total of \$4.691 million for both contracts combined). Both alternatives indicated that the Lays’ basis in the contracts was \$5 million each (for a total of \$10 million) and that the current floor value of the policies was a total of \$11.240 million. The presentation included a comparison of the each alternative with providing Mr. Lay with additional Enron stock, in terms of issues for Enron (deductibility of the payment, dilution to common shares outstanding, and taxes) and issues for Mr. Lay (liquidity at various time frames and vesting).

In addition to the material presented at the Compensation Committee meeting, the Committee requested a letter from Towers Perrin regarding the transaction. The letter is dated November 2, 2001, and states that it reflects discussions with Enron that occurred prior to the date of the Committee meeting.<sup>2094</sup> The letter indicates that the transaction grew out of a desire

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<sup>2091</sup> Technically, only one of the annuity contracts would be reconveyed. The contract originally owned by Mrs. Lay would be not be reconveyed to her but conveyed to Mr. Lay. The term a “reconveyance” is used here because that is how the transaction is described in the relevant agreements.

<sup>2092</sup> “Good reason” is defined by reference to Mr. Lay’s employment contract, and generally refers to a constructive termination by reason of the occurrence of certain events, such as a change in his duties or a material reduction in salary without his consent.

<sup>2093</sup> Attachment to Minutes of the Meeting of the Compensation and Management Committee, (Sept. 14, 2001). Committee meeting minutes indicate that this analysis was presented by employees of Enron, and was prepared in consultation with lawyers at Vinson & Elkins and others. Mr. Lay was present while the proposed transaction was being discussed, but was reported as not present when the decision to go forward with the transaction was made. Minutes of the Meeting of the Compensation and Management Committee, at 4 (EC 2000026740) (Sept. 14, 2001).

<sup>2094</sup> Letter from Charles E. Essick, Principal, Towers Perrin to Dr. Charles A. LeMaistre (Nov. 2, 2001). EC 000897960-EC 000897961.



by Enron to provide an incentive for Mr. Lay to remain with Enron for a period of years. Members of the Compensation Committee also indicated in interviews with the Joint Committee staff that the motivation for the transaction was to provide a retention device. The documents executed in connection with the transaction also state that Mr. Lay's services have been and are expected to be of substantial value to Enron and that Enron wishes to encourage Mr. Lay to remain in the employment of Enron.

The Towers Perrin letter states that a retention incentive typically is handled by issuing restricted stock, but that Mr. Lay had indicated that he currently had large holdings in Enron stock and wanted more liquidity. The letter makes a number of points with respect to the transaction. First, the letter states that the transaction, while involving a current cash flow drain for Enron, will be beneficial to Enron overall because the \$10 million payment to the Lays for the contracts is less than the current net present value floor value of the contracts of \$11.240 million. That is, the letter indicates that the fair value of the contract is more than \$10 million. Second, the letter states that the feature of the arrangement which allows Mr. Lay to earn the contracts back over four years is similar to the way a restricted stock award would be structured and thus should serve as a similar retention device.<sup>2095</sup> Third, the letter recommends that because the arrangement is in lieu of restricted stock, the \$10 million value of the payment to Mr. Lay should be subtracted from future stock or stock option awards that would otherwise be granted to Mr. Lay over the next four years (at a rate of \$2.5 million per year).<sup>2096</sup> Finally, the letter states the understanding that an alternative structure that was suggested was to pay Mr. Lay a cash signing bonus and to purchase his annuity, but not his wife's. The letter concludes that the structure adopted by the Committee is preferable to this alternative because it provides a meaningful retention incentive.

As of January 23, 2002, Mr. Lay was no longer with Enron. Thus, whether he is entitled to have the annuity contracts reconveyed to him depends on whether his termination meets the requirements as set forth in the agreement with the Enron. It is unclear whether the contracts have been or will be reconveyed to Mr. Lay. During the course of interviews, the Joint Committee staff was informed by counsel for former Compensation Committee members that the issue of whether Mr. Lay was entitled to receive the annuity contracts given the terms of his departure was under review by Enron and various legal counsel. At the time of publication, Enron stated it was unable to give the Joint Committee staff any further information regarding the status of the annuity contracts and whether they had been or would be reconveyed to Mr. Lay.

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<sup>2095</sup> The letter refers to Mr. Lay as being able to "earn back the annuities over 4 years." This phraseology implies that Mr. Lay earned the contracts back ratably over the 4-year period, much as restricted stock might vest over a period of years. However, under the terms of the purchase, sale, and reconveyance agreement, Mr. Lay had no rights with respect to the annuity contracts unless he stayed through December 31, 2005 (or was terminated before then for one of the stated reasons).

<sup>2096</sup> The letter states that the Compensation Committee agreed to this reduction. However, the minutes from the meeting at which the transaction was approved do not mention this transaction. Thus, it is not clear whether this was the intent of Enron at the time.

The Joint Committee staff submitted written questions to Mr. Lay's counsel, Piper Rudnic, regarding his compensation arrangements. As part of these questions, the Joint Committee staff asked if the annuity contracts had been reconveyed to Mr. Lay (or if they would be) and, if they had been reconveyed, when this occurred. Mr. Lay's counsel did not respond directly to the question, but stated that "We are not in a position to give a legal opinion about the current status of the annuity contracts." They also stated their understanding that the characterization of Mr. Lay's termination for purposes of severance benefits was still under review.

### **Discussion of Issues**

The purchase and reconveyance arrangement involving the Lays' annuity contracts can be analyzed both from the perspective of whether it would accomplish the stated objective of the arrangement, and from a Federal income tax perspective.<sup>2097</sup>

As described above, the stated purpose of the arrangement was to provide an attractive retention package to Mr. Lay upon his resumption of duties as Chief Executive Officer. The total range of options considered by Enron is not clear, but appears to have included (1) giving Mr. Lay a \$5 million cash bonus, and purchasing and possibly reconveying one of the Lays' annuity contracts to Mr. Lay, and (2) the issuance of restricted stock. The first alternative would have provided a retention incentive but arguably not as significant an incentive as the arrangement Enron approved, because the value of the conditional benefit under the first alternative was less (i.e., the value of one annuity contract versus the value of both the annuity contracts). The use of restricted stock, an arrangement frequently used by Enron, would provide a retention incentive, but was not attractive to Mr. Lay because of his interest in more liquidity in his financial portfolio. Thus, the purchase and reconveyance arrangement provided liquidity to Mr. Lay, as well as serving as a more significant retention incentive.

In addition to other perceived benefits, from a tax perspective, use of the annuity purchase and reconveyance arrangement had advantages both for Enron and Mr. Lay when compared to other arrangements considered by Enron. The tax effects can be analyzed separately for the purchase aspect of the transaction and the reconveyance.

The purchase of the annuity contracts had current tax advantages for Mr. Lay compared to payment of a cash bonus (or any arrangement including a cash bonus). If he had been paid a cash bonus, the amount of the bonus would have been currently includible in gross income and subject to employment taxes. On the other hand, Mr. Lay would recognize gain on the sale of the annuity contracts to Enron only to the extent the amount received exceeded the Lays' basis in the contracts.

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<sup>2097</sup> The focus of the Joint Committee staff review is Enron, not individuals. Thus, examination of the Federal tax consequences to the Lays arising from this transaction is beyond the scope of this review. Some general discussion is provided in order to give a full picture of the transaction.

Viewing the tax consequences of the purchase of the annuity contracts compared to payment of a cash bonus from Enron's perspective, as a practical matter, no deduction would be allowable with respect to either type of transaction. Enron would not be entitled to a deduction for the amount of the cost of the contracts; the amount paid would be basis in the contracts. If Enron paid a cash bonus, given Mr. Lay's total compensation package, the bonus would not be deductible due to the \$1 million dollar cap on deductibility of compensation of certain executives.<sup>2098</sup> A key difference, however, is that if a cash bonus had been paid, Enron would be liable for its share of employment taxes;<sup>2099</sup> no employment taxes would be due as a result of the purchase of the annuity contracts. Another important difference is that, as a nonindividual holder of annuity contracts, Enron would be required to include in income each year the amount of the income on the contracts. This income inclusion would apply as long as Enron held the contracts. Thus, from Enron's perspective the current tax consequences of the annuity purchase and reconveyance arrangement were less favorable than the payment of a cash bonus or the payment of restricted stock.

The use of restricted stock would have provided some tax advantage to Mr. Lay compared to an arrangement involving a cash bonus, depending in part on the specifics of the arrangement. In general, restricted stock is includible in gross income when no longer subject to a substantial risk of forfeiture. Thus, for example, if Enron had granted Mr. Lay \$10 million of restricted stock that vested over four years, the value of one fourth of the stock would be includible in income in each year (and subject to employment taxes). This is more favorable to Mr. Lay from a tax perspective than a current payment of \$10 million, but less favorable than the annuity purchase arrangement agreed to by Enron which would result in income in excess of basis.

If restricted stock had been used, Enron theoretically would have been entitled to a compensation deduction when the stock was includible in Mr. Lay's income. However, as with a cash bonus, the deduction likely would be limited by the \$1 million cap on deductibility of executive compensation.

With respect to whether Enron treated the purchase properly from a tax perspective, a key issue is whether Enron paid fair market value for the contracts. If Enron paid the Lays more than the fair market value for the contracts, then the question would arise as to whether the excess of the amount paid over such value was disguised compensation. If so, Enron would have had employment tax obligations.<sup>2100</sup> According to documents provided by Enron, three different purchase price alternatives were presented to the Compensation Committee: (1) a total of \$4.692 million, which was described as the market value of the contract investments; (2) a total of \$10 million, which was described as the Lays' basis in the contracts; and (3) a total of \$11.240

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<sup>2098</sup> Sec. 162 (m).

<sup>2099</sup> There is no dollar cap on the amount of compensation subject to the Hospital Insurance (Medicare) portion of employment taxes.

<sup>2100</sup> There also could be tax consequences for the Lays.

million, which was described as the net present value floor value of the annuities (i.e., the minimum amount the annuities were expected to be worth at maturity).<sup>2101</sup>

While the documents supplied by Enron do not clearly indicate a fair market value, the net present value floor value appears to represent the current value of the future payments in the policy. If this is accurate, the amount paid by Enron did not exceed the fair market value of the contracts, and there would be no question as to whether some amount should have been treated as taxable compensation.

If the annuity contracts are reconveyed to Mr. Lay, then the fair market value of the policies should be treated as compensation by Enron for reporting purposes, and would be subject to withholding and employment taxes. Enron's deduction would be limited by the \$1 million cap on the deduction of executive compensation.<sup>2102</sup>

## **5. Split-dollar insurance arrangements**

### **Present Law**

#### **Background**

##### Overview

The term “split-dollar life insurance” refers to splitting the cost and benefits of a life insurance contract. The cost of premiums for the contract often is split between two parties. One party typically pays the bulk of the premiums, and is repaid in the future from amounts received under the contract. The other party often pays a small portion of the premiums, but has the right to designate the recipient of the bulk of the benefits under the contract. This type of arrangement transfers value from one party to the other party.

Split-dollar life insurance arrangements have been used for several purposes. A principal use has been by employers to provide low-cost life insurance benefits or to provide funds for other compensatory benefits (such as nonqualified deferred compensation) for employees on a tax-favored basis. Split-dollar life insurance arrangements are also used in other contexts. For example, such an arrangement can be used to fund a buy-sell agreement between shareholders or owners of a business, or to provide estate liquidity (sometimes with a trust as the owner of the contract).

The type of life insurance generally used in a split-dollar life insurance arrangement is referred to as whole life insurance. This does not refer to the period for which the insurance contract is in effect, but rather, to the fact that the contract has a “cash value,” as well as providing a death benefit upon the death of the insured person. The cash value arises because the premiums paid to the insurer for the contract are invested, and some of this investment income is

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<sup>2101</sup> Attachment in the Minutes of the Compensation and Management Committee, at 7-8 (Sept. 14, 2001). EC 000026744 - EC 000026750.

<sup>2102</sup> Sec. 162(m).

credited to the contract. The amount of the future death benefit payable under the contract is funded both by premium payments and by investment earnings on the premium payments. The amount of the cash value at any point in time generally is the sum of the premiums paid plus the earnings on premiums that are credited to the policy, reduced by the cost of death benefit coverage for the current period, fees, and other charges imposed by the insurer. The amount of the cash value generally is zero or small at first, and increases over the duration of the contract.

The cash value of a whole life insurance contract may be borrowed or withdrawn by the contract holder (reducing the amount that will be paid as a death benefit under the contract). A whole life insurance contract can be contrasted with a term life insurance contract, which pays a death benefit upon the death of the insured person, but has no cash value. Under a term life insurance contract, the death benefit coverage applies only for a set term (e.g., one year or five years), and the premium payments are set at a level to fund the death benefit only during that period. The contract holder does not have the right to borrow or withdraw cash under a term life insurance contract, because it has no “cash value.”

#### Methods for splitting the cash value and death benefits of a life insurance contract

The benefits that are split under a split-dollar life insurance arrangement generally are the death benefit (the amount paid upon the death of the insured person) and the cash value (which includes the earnings under the contract). Because the arrangement is by contract, the parties can split these features of the life insurance contract in whatever manner they agree upon. Over the past 50 years, a variety of split-dollar life insurance products have been developed.

One form of split-dollar life insurance arrangement is known as the endorsement method. Under this arrangement, as applied, for example, between an employer and an employee, the employer is the owner of the contract and pays the bulk of the premiums. The employee generally is the insured person, and pays a smaller amount of the premiums. The employer endorses over to the employee the right to designate the beneficiary of the death benefit under the contract. The employer’s premium payments are repaid from the cash value of the contract or from the death benefit when the insured employee dies. Under some arrangements, ownership of the contract is turned over, or “rolled out,” to the employee at a contractually agreed time, such as upon retirement, after the employer has recouped its premium payments.

Another common type of split is referred to as the collateral assignment method. Under this arrangement, as applied, for example, between an employer and an employee, the employee (or sometimes a trust he or she establishes) owns the policy and pays the premiums with amounts loaned by the employer, assigning the life insurance contract as collateral for the loans. The employer has the right to the portion of the cash value of the contract funded by its premium loans, but the employee (or trust) has the right to designate the beneficiary of the death benefits. The employee (or trust) may also have the right to the portion of the cash value of the contract that exceeds the employer’s share of the cash value, if any.

Other types of splits, in which ownership of the cash value, the right to death benefits, or both, are split between the parties (e.g., between the employer and employee (or trust)), are also possible. Arrangements in which the cash value is split between the parties are sometimes referred to as equity split-dollar arrangements. Another variation, sometimes referred to as a

reverse split-dollar arrangement, is created when the owner of the contract and its cash value is the employee; the employee pays premiums with amounts loaned or reimbursed by the employer. The employee endorses or assigns to the employer the right to the death benefit under the contract, and perhaps also a portion of the cash value.

## **Tax treatment of split-dollar life insurance arrangements between employer and employee**

### Transfers of property to employees

Under present law, compensation of an employee generally is included in the employee's income when it is received (or constructively received). If property is transferred to a person in connection with the performance of services, the fair market value of the property (reduced by the amount, if any, that is paid for the property) generally is included in income at the time the interest in the property is transferable, or is not subject to a substantial risk of forfeiture (whichever is sooner).<sup>2103</sup>

### Life insurance

Present law provides that no Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup"). Amounts paid by reason of the death of the insured under the contract ("death benefits") are also generally excluded from income of the recipient.<sup>2104</sup>

Other favorable rules apply to amounts paid out or borrowed under a life insurance contract. Distributions from the contract prior to the death of the insured generally are taxed only to the extent they exceed the taxpayer's investment in the contract; that is, the distributions are first treated as tax-free recovery of the investment in the contract, and then the excess is included in income.<sup>2105</sup>

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<sup>2103</sup> Sec. 83. The rules of section 83 are discussed in greater detail in Parts III.C.1. and III.C.2.

<sup>2104</sup> Sec. 101(a). An exception is provided to this general rule of exclusion for death benefits, in the case of a transfer of a life insurance contract for valuable consideration. The amount of the death benefit includible in the beneficiary's income under this exception is the amount that exceeds the premiums and other consideration paid for the contract by the transferee. However, this rule of inclusion does not apply in certain cases, including when the transfer is to the insured or to a corporation in which the insured is a shareholder or officer. Sec. 101(a)(2).

<sup>2105</sup> Sec. 72. These favorable distribution rules do not apply to certain types of high-initial-premium policies (those funded more rapidly than seven annual level premiums); for those contracts, known as modified endowment contracts, distributions (and loans) are treated as income first, then tax-free recovery of investment in the contract.

Present law provides that no deduction is allowed for premiums on any life insurance contract if the taxpayer is directly or indirectly a beneficiary under the contract.<sup>2106</sup>

#### 1960s rulings: cost of current term insurance protection

Until 2001, IRS guidance as to the Federal income tax treatment of split-dollar arrangements was limited. In the 1960s, the IRS published rulings<sup>2107</sup> providing that the amount includible in an employee's income under a split-dollar insurance arrangement is the cost of current term insurance protection (less the amount, if any, paid by the employee). Any policyholder dividends paid to, or benefiting, the employee are also includible in income.

In determining the cost of current term insurance protection, the employee may use either the cost as determined under an actuarial table known as the "P.S. 58 table," or the insurer's published rates for one-year term life insurance coverage. This election arguably permitted the parties to the arrangement to choose the lower rate for determining the amounts includible in the employee's income, or the higher rate for determining the employer's share (as in a reverse split-dollar arrangement).

#### Notice 2001-10: loan or compensation

In January 2001, the IRS issued Notice 2001-10.<sup>2108</sup> It provided interim guidance for the tax treatment of split-dollar life insurance, including types of split-dollar life insurance arrangements between an employer and employee in which the employee has an interest in the cash value of the contract (equity split-dollar arrangements) that were not addressed by the 1960s rulings. The IRS has issued subsequent guidance that continues to apply the general concepts of Notice 2001-10.

Notice 2001-10 provided that the IRS generally would accept the parties' characterization of a split-dollar life insurance arrangement in either of two ways. The first way is to treat the employee as the owner of the contract, and treat the employer's payments for premiums as loans to the employee. Foregone interest on the loans is included in the employee's income under the rules of present law.<sup>2109</sup>

The second way is to treat the employer as owning the contract by reason of paying its share of premiums. The employee includes compensation income equal to the value of the life insurance protection. This approach is similar to the requirement under the 1960s rulings that the cost of current insurance protection be included in income. Notice 2001-10 also specifically provided that the present-law rules taxing transfers of property to employees<sup>2110</sup> apply to split-

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<sup>2106</sup> Sec. 264(a)(1).

<sup>2107</sup> Rev. Rul. 64-328, 1964-2 C.B. 11, and Rev. Rul. 66-110, 1966-1 C.B. 12.

<sup>2108</sup> 2001-5 I.R.B. 459, Jan. 9, 2001.

<sup>2109</sup> Sec. 7872.

<sup>2110</sup> Sec. 83.

dollar life insurance arrangements in which the employer transfers the cash value of the life insurance contract to the employee. If the contract is “rolled out” to the employee, he or she would generally include the cash value in income at that time.

Notice 2001-10 provided a new table, Table 2001, to replace the P.S. 58 table for valuing the cost of current life insurance protection. The Notice also provided that, after 2003, taxpayers would no longer be permitted to choose to determine the value of current life insurance protection by using the insurer’s lower published premium rates (as under the 1960s rulings). Rather, if an insurer’s published premium rate were used for this purpose, it would have to be a premium rate at which the insurer regularly sells term insurance (so long as the insurer does not more commonly sell standard-risk term insurance at higher premium rates).

#### Notice 2002-8

A year after Notice 2001-10 was issued, it was revoked by Notice 2002-8.<sup>2111</sup> Notice 2002-8, however, applies the general concepts of the earlier Notice, and provides that Table 2001 generally applies for valuation purposes for arrangements entered into after January 28, 2002 (the date Notice 2002-8 was issued). It also provides that for valuation purposes under arrangements entered into after January 28, 2002, the taxpayer may continue to choose the insurer’s lower published premium rates; however, for such arrangements, after 2003, these rates must be rates at which the insurer regularly sells term insurance (not just published rates).

Notice 2002-8 specifically provides that the proposed regulations addressing the Federal tax treatment of split-dollar life insurance arrangements will be effective for arrangements entered into after the date of publication of final regulations.

#### Proposed split-dollar life insurance regulations

In general.--The IRS issued proposed regulations on split-dollar life insurance arrangements on July 5, 2002.<sup>2112</sup> The proposed regulations provide guidance on the income, employment, and gift tax treatment of split-dollar life insurance arrangements. Somewhat like the earlier notices, the proposed regulations generally provide two mutually exclusive regimes for taxing split-dollar arrangements, one taking an economic benefit approach,<sup>2113</sup> and the other applying loan treatment.<sup>2114</sup>

A central feature of the proposed regulations is to treat one party as the owner of the policy, even if more than one party has an interest in the policy. Whether the split-dollar arrangement comes under the economic benefit approach or the loan approach generally depends

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<sup>2111</sup> 2002-4 I.R.B. 398.

<sup>2112</sup> REG-164754-0, July 5, 2002. Regulations are proposed under Code sections 61, 83, 301, 1402, 7872, 3121, 3231, 3306, and 3401.

<sup>2113</sup> Sec. 61.

<sup>2114</sup> Sec. 7872 (or secs.1271-1275, if the loan is not below-market).



on which party is considered the owner. The loan approach generally applies if the party who is not the owner is making payments (premiums) and is reasonably expected to be repaid from the contract's cash value or death benefits. Otherwise, the economic benefit approach generally applies for income, employment, and gift tax purposes.

The preamble to the proposed regulations states that the economic benefit approach generally will govern endorsement split-dollar arrangements, and the loan approach generally will govern collateral assignment split-dollar arrangements.<sup>2115</sup> Special rules provide that the economic benefit approach always applies to a split-dollar arrangement in connection with the performance of services if the service provider's only benefit is current life insurance protection (a "non-equity" split dollar arrangement).<sup>2116</sup> The economic benefit approach applies to certain "non-equity" collateral assignment arrangements (if the employee or donee is the listed owner of the contract), as well as to endorsement arrangements (the employer or donor is the listed owner).

The proposed regulations would be effective for arrangements entered into after the final regulations are published in the Federal Register. However, taxpayers may rely on the proposed regulations if all parties treat the arrangement consistently.

Owner of the contract.—Generally, under the proposed regulations, the owner named in the contract is treated as the owner or, if more than one is listed, the first one is treated as the owner.<sup>2117</sup> An employer is treated as the owner if the employee's only benefit at any time is current life insurance protection (no cash value or possible future ownership of the contract, for example).

Split-dollar life insurance arrangement defined.—The proposed regulations define a split-dollar life insurance arrangement broadly, with especially inclusive definitions in the case of arrangements between service providers and recipients, and between corporations and shareholders.<sup>2118</sup>

Economic benefit approach.—Under this approach, the value of economic benefits under the life insurance contract is treated as being transferred from the contract owner to the nonowner (reduced by any consideration paid by the nonowner to the owner). The tax

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<sup>2115</sup> REG-164754-0, preamble at 11 (under the heading mutually exclusive regimes), July 5, 2002.

<sup>2116</sup> Prop. Treas. Reg. 1.61-22(b)(3)(ii). The economic benefit approach also applies to a split-dollar arrangement between a donor and donee (e.g., a life insurance trust) if the donee's only benefit is the value of current life insurance protection.

<sup>2117</sup> However, if multiple listed owners each have an undivided interest in every right under the contract, the contract is treated as two or more separate contracts that are not part of a split-dollar arrangement. Prop. Treas. Reg. sec. 1.61-22(c)(1).

<sup>2118</sup> Prop. Treas. Reg. sec. 1.61-22(b)(2).

consequence of the transfer depends on the relationship of the owner and nonowner;<sup>2119</sup> in the employment context, compensation for services.

The proposed regulations distinguish between equity split-dollar (in which the nonowner also has a right to some or all of the cash value of the contract), and non-equity split-dollar (in which the nonowner has no such right and has only the right to current insurance protection).

In the non-equity split-dollar arrangement, the nonowner includes in income (and also in wages for employment tax purposes) the cost of current insurance protection. Unlike under the 1960s rulings, the proposed regulations provide that the amount of current insurance protection is measured as the excess of the average death benefit under the contract over the total amount payable to the owner (including outstanding policy loans). The cost of this is determined as the amount of current insurance protection times the “premium factor” published by the IRS in separate guidance.<sup>2120</sup>

In the equity split-dollar arrangement, the nonowner is also required to include in income (and for employment tax purposes) the value of any interest in the contract— for example, the value of any interest in the cash value of the contract provided during the year.<sup>2121</sup>

Under the economic benefit approach, in the event of transfer of a contract by the owner to a nonowner (a “rollout” of the contract by the employer to the employee), the fair market value of the contract is included in the nonowner’s income (less any portion on which he has already paid tax). In the service provider context, applicable present-law rules<sup>2122</sup> permit deferral of income inclusion (and also the employer’s deduction) if the transferee’s rights in the contract are not yet substantially vested.

Loan approach.—Under the loan approach, the owner and nonowner are treated as borrower and lender, respectively, if the nonowner (e.g., employer) paying premiums is reasonably expected to be repaid from the contract’s cash value or death benefits. If the loan does not provide sufficient interest, then interest is imputed under the rules of section 7872. In general, such interest is not deductible by the borrower, but is includible in the income of the deemed lender in the arrangement. If sufficient interest is provided for, then the general rules for debt instruments apply (including OID rules). The proposed regulations provide rules for treatment of term, demand, and contingent payment split-dollar loans.

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<sup>2119</sup> E.g., depending on the relationship, the arrangement may be a payment of compensation, dividend distribution under section 301, gift under the gift tax rules, or other transfer. Prop. Treas. Reg. sec. 1.61-22(d)(1).

<sup>2120</sup> Prop. Treas. Reg. sec. 1.61-22(d)(2). This separate guidance had not yet been published as of February 5, 2003.

<sup>2121</sup> The proposed regulations do not provide specific guidance for determining the value of the includible economic benefit. Prop. Treas. Reg. 1.61-22(d)(3)(ii).

<sup>2122</sup> Sec. 83.

## Guidance on valuation

After the issuance of the proposed regulations, the IRS issued further guidance, Notice 2002-59, specifically on valuation of benefits under certain types of reverse split-dollar life insurance arrangements.<sup>2123</sup> This Notice provides that the IRS will challenge the use of high current term insurance rates, prepayment of premiums, or other arrangements to understate the value of benefits under the life insurance policy that are to be included in income in a reverse split-dollar life insurance arrangement.

## Factual Background

### Overview of Enron's split-dollar insurance arrangements

Enron entered into split-dollar life insurance arrangements with three of its top management: Mr. Lay, Mr. Skilling, and John Clifford Baxter.<sup>2124</sup>

Enron entered into two split-dollar life insurance arrangements with Mr. Lay.<sup>2125</sup> Enron entered into a split-dollar arrangement with Mr. Lay on April 22, 1994, with respect to a life insurance contract with a face amount of \$30 million.<sup>2126</sup> Mr. Lay's position was chairman and chief executive officer of Enron Corp.<sup>2127</sup> Enron entered into another split-dollar arrangement with Mr. Lay on December 18, 1996. The face amount of the life insurance contract under the 1996 agreement was \$11.9 million.

Another split-dollar life insurance agreement with Mr. Lay for \$12.75 million of life insurance coverage was later approved by the Compensation Committee of the Board of Directors on May 3, 1999, at Mr. Lay's request, to trade out his Executive Supplemental Pre-Retirement Death Benefit under the Houston Natural Gas Corporation Executive Supplemental

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<sup>2123</sup> Notice 2002-59, 2002-36 I.R.B. 1, Aug. 16, 2002.

<sup>2124</sup> Enron's split-dollar arrangements with employees appear to be individualized, rather than part of a larger plan or arrangement to enter into split-dollar arrangements with employees.

<sup>2125</sup> Appendix D contains Enron's split-dollar life insurance agreements with Mr. Lay.

<sup>2126</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 143.

<sup>2127</sup> Mr. Lay had been chairman and chief executive officer since February 1986. Enron Form 10-K for 1996, as filed with the Securities and Exchange Commission.

Benefit Agreement.<sup>2128</sup> Although Enron purchased the life insurance contract in 2000, Enron and Mr. Lay did not enter into the split-dollar arrangement.<sup>2129</sup>

Mr. Skilling entered into a split-dollar arrangement with Enron on May 23, 1997, with respect to an \$8 million life insurance contract.<sup>2130</sup> Mr. Skilling's position was then president and chief operating officer of Enron Corp.<sup>2131</sup> Mr. Skilling said in an interview with Joint Committee staff<sup>2132</sup> that his insurance broker noticed Mr. Lay's split-dollar arrangement in proxy materials issued by Enron, and the broker suggested that Mr. Skilling should ask Enron to enter into a similar agreement with him.

Mr. Baxter's split-dollar arrangement with Enron was dated January 26, 2000, for \$5 million of life insurance coverage. At that time, Mr. Baxter's position was chairman and chief executive officer of Enron North America Corp.<sup>2133</sup>

### **Specific split-dollar arrangements**

#### **Split-dollar arrangements with Mr. Lay**

**1994 arrangement.** On April 22, 1994, Enron entered into a split-dollar arrangement with Mr. Lay and the KLL & LPL Family Partnership, a Texas limited partnership.<sup>2134</sup> KLL and LPL are the initials of Mr. Lay and his wife, Linda. The life insurance contract covered the joint lives of Mr. Lay and his wife, Linda. The life insurance contract had a face amount of \$30 million<sup>2135</sup>

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<sup>2128</sup> Agenda Item No. 8(d), Split Dollar Policy, EC 000752761, and Minutes, Meeting of the Compensation and Management Development Committee of the Board of Directors, Enron Corp., May 3, 1999, EC 000752759-EC 000752760.

<sup>2129</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 31, 2003, answer 12.

<sup>2130</sup> Appendix D contains Enron's split-dollar life insurance arrangement with Mr. Skilling.

<sup>2131</sup> Mr. Skilling took this position in January, 1997. Enron Form 10-K for 1996, as filed with the Securities and Exchange Commission.

<sup>2132</sup> Interview of Mr. Skilling by Joint Committee on Taxation staff on November 13, 2002.

<sup>2133</sup> Enron Form 10-K for 2000, as filed with the Securities and Exchange Commission.

<sup>2134</sup> Appendix D contains the Split Dollar Life Insurance Agreement (dated April 22, 1994) (EC 000752803 - EC 000752807) and the Collateral Agreement (dated April 22, 1994) (EC 000752801 - EC 000752803).

<sup>2135</sup> Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 143.

and was issued by Transamerica Occidental Life Insurance Company. The arrangement was a “collateral assignment,” whereby the family partnership was the owner of the contract, but Enron agreed to pay each of the nine annual premiums of \$280,265. The family partnership assigned the life insurance contract to Enron as collateral, giving Enron an interest in the cash surrender value of the policy to secure the repayment of amounts Enron paid as premiums. The family partnership agreed not to withdraw, surrender, borrow against, or pledge as security for a loan any portion of the cash value of the policy.

The agreement provided that upon Mr. Lay’s death while the agreement remained in force, Enron would be entitled to receive, from the death benefit proceeds, the amount of the premiums that Enron had paid. The beneficiary designated by the family partnership would be entitled to the balance of the death benefit proceeds. Enron would not be entitled to recoup its premium payments in the event of Mr. Lay’s death after the termination of the agreement.

The 1994 agreement would be terminated by: (1) payment to Enron of the amount of premiums it had paid; (2) surrender of the life insurance contract; (3) death of the second of Mr. Lay and his wife, Linda, to die; or (4) 30 days after the ninth anniversary of the date the contract was issued or upon Mr. Lay’s retirement from Enron, whichever is later. If the split-dollar agreement is terminated by the passage of nine years or Mr. Lay’s retirement, Enron relinquishes the right to recoup its premium payments (unlike the other terminating events).

1996 arrangement.—Effective December 13, 1996, Enron entered into a similar “collateral assignment” split-dollar arrangement with Mr. Lay and the same family trust.<sup>2136</sup> The life insurance contract had a face amount of \$11.9 million, and was also issued by Transamerica Occidental Life Insurance Company.<sup>2137</sup> The family partnership was the owner of the contract, but Enron paid each of the five annual premiums of \$250,000. The family partnership assigned the life insurance contract to Enron as collateral, giving Enron an interest in the cash surrender value of the policy to secure the repayment of amounts Enron paid as premiums. The family partnership had no right to sell, assign, transfer, borrow against or withdraw from the cash surrender value of the policy.

The agreement provided that upon Mr. Lay’s death, Enron would have the right to receive \$1.25 million of the death benefit (the total of the five annual premiums of \$250,000), or the amount of premiums paid by Enron to date if Mr. Lay died before all five premiums were paid. The balance of the death benefit under the life insurance contract would be paid to the beneficiaries under the contract, as designated by the family partnership.

The 1996 agreement could be terminated by the family partnership at any time during Mr. Lay’s life by a lump sum cash payment to Enron of \$1.25 million (or, if less, the amount of premiums Enron had paid by the time Mr. Lay’s employment terminated). In addition, the

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<sup>2136</sup> Appendix D contains the Split Dollar Agreement (dated December 18, 1996) (EC 000752792 - EC 000752798). The agreement stated that it was to be effective as of December 13, 1996.

<sup>2137</sup> The effective date of the life insurance contract was October 14, 1996.

agreement would be automatically terminated by bankruptcy, receivership, dissolution, or cessation of business of Enron, or by mutual written agreement of the parties. In the event of an automatic termination, the family partnership could acquire Enron's interest in the life insurance contract by paying to Enron, within 60 days of the terminating event, the amount of the aggregate premiums Enron had paid (less any outstanding debt incurred by Enron that is secured by the policy). Alternatively, Enron could enforce its right to be repaid the amount of the premiums it had paid.

#### Split-dollar arrangement with Mr. Skilling

On May 23, 1997, Enron entered into a split-dollar arrangement with Mr. Skilling and the trustee of the Jeffrey Keith Skilling Family 1996 Trust.<sup>2138</sup> The trustee of this trust was Mark David Skilling. The life insurance contract had a face amount of \$8 million, and was issued by Massachusetts Mutual Life Insurance Company.<sup>2139</sup> The arrangement was a "collateral assignment," whereby the Skilling family trust was the owner of the contract, but Enron paid most of the five annual premiums of \$115,250 for each of the five years 1997 – 2001.

The trustee of the Skilling family trust agreed to pay a portion of the annual premium (amounts between approximately \$4,400 and \$7,600) for each of the five years.<sup>2140</sup> The agreement provided that these amounts were "equal to the annual cost of current life insurance protection on the life of the employee [Mr. Skilling], measured by the Insurer's current published minimum premium rate for standard risks."<sup>2141</sup> Enron agreed pay the balance of each of the five annual premiums. The Skilling family trust assigned the life insurance contract to Enron as collateral, giving Enron an interest in the cash surrender value of the contract to secure the repayment of amounts Enron paid as premiums. The Skilling family trust had no right to sell, assign, transfer, borrow against or withdraw from the cash surrender value of the policy.

The agreement provided that upon Mr. Skilling's death, Enron would have the right to receive a portion of the death benefit in cash equal to the aggregate premium payments made by Enron. The balance of the death benefit under the life insurance contract would be paid to the beneficiaries under the contract, as designated by the trustee of the Skilling family trust.

The agreement could be terminated by the trustee of the Skilling family trust at any time during Mr. Skilling's life upon written notice to Enron by a lump sum cash payment to Enron in the amount of the aggregate premiums Enron had paid. In addition, the agreement would be

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<sup>2138</sup> Appendix D contains the Split Dollar Agreement (dated May 23, 1997) (EC 000752568 - EC 7525574), the Assignment of Life Insurance Policy as Collateral (dated June 25, 1997, effective as of May 23, 1997) (EC 000752563 0 EC 000752566), and the Jeffrey K. Skilling Split Dollar Premium Payment Schedule (EC 000752567).

<sup>2139</sup> The effective date of the life insurance contract was May 23, 1997.

<sup>2140</sup> Jeffrey K. Skilling Split Dollar Premium Payment Schedule, EC 000752567. Appendix D contains this document.

<sup>2141</sup> Split Dollar Agreement at 2 (dated May 23, 1997) (EC 000752569).

automatically terminated by bankruptcy, receivership, dissolution, or cessation of business of Enron, by termination of Mr. Skilling's employment with Enron for any reason, by failure of the trustee of the Skilling family trust to pay its portion of the premium (unless Enron agreed to pay), or by mutual written agreement of the parties. In the event of an automatic termination, Mr. Baxter's trust could acquire Enron's interest in the life insurance contract by paying to Enron, within 60 days of the terminating event, the amount of the aggregate premiums Enron had paid (less any outstanding debt incurred by Enron that is secured by the policy). Alternatively, Enron could enforce its right to be repaid the amount of the premiums it had paid.

#### Split-dollar arrangement with Mr. Baxter

On January 26, 2000, Enron entered into a split-dollar arrangement with Mr. Baxter and his insurance trust, of which Margo Baxter was trustee. The life insurance contract had a face amount of \$5 million, and was issued by Transamerica Occidental Life Insurance Company.<sup>2142</sup> Under the terms of the agreement, the arrangement, like Enron's other split-dollar arrangements, was a "collateral assignment," whereby Mr. Baxter's trust was the owner of the contract, but Enron paid the annual premium of \$50,565. Mr. Baxter's trust assigned the life insurance contract to Enron as collateral, giving Enron an interest in the cash surrender value of the policy to secure the repayment of amounts Enron pays as premiums. Mr. Baxter's trust had no right to sell, assign, transfer, borrow against or withdraw from the cash surrender value of the policy.

The agreement provided that upon Mr. Baxter's death, Enron would have the right to receive a portion of the death benefit in cash equal to the aggregate premium payments made by Enron. The balance of the death benefit under the life insurance contract would be paid to the beneficiaries under the contract, as designated by Mr. Baxter's trust.

The agreement could be terminated by Mr. Baxter's trust at any time during Mr. Baxter's life by a lump sum cash payment to Enron in the amount of the aggregate premiums Enron had paid. In addition, the agreement would be automatically terminated by bankruptcy, receivership, dissolution, or cessation of business of Enron, or by mutual written agreement of the parties.<sup>2143</sup> In the event of an automatic termination, Mr. Baxter's trust could acquire Enron's interest in the life insurance contract by paying to Enron, within 60 days of the terminating event, the amount of the aggregate premiums Enron had paid (less any outstanding debt incurred by Enron that is secured by the policy). Alternatively, Enron could enforce its right to be repaid the amount of the premiums it had paid.

#### Subsequent developments

Enron filed for bankruptcy under chapter 11 on December 2, 2001. Bankruptcy of Enron was one of the events giving rise to automatic termination of the split-dollar arrangements with

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<sup>2142</sup> The effective date of the life insurance contract was January 26, 2000.

<sup>2143</sup> Unlike the agreement with Mr. Skilling, the agreement with Mr. Baxter was not automatically terminated upon the termination of his employment with Enron.

Mr. Lay, Mr. Skilling, and Mr. Baxter. Mr. Baxter died on January 25, 2002.<sup>2144</sup>

### Discussion of Issues

Enron's split-dollar life insurance arrangements with Mr. Lay, Mr. Skilling, and Mr. Baxter were entered into between 1994 and 2000, before the issuance of the series of recent IRS guidance starting with Notice 2001-10 in January, 2001. Under the limited guidance issued by the IRS prior to Notice 2001-10, the cost of current term insurance protection would be includible in income of the owner of the life insurance contract (less the amount paid by the owner).<sup>2145</sup> Enron would not be permitted to deduct the premiums.<sup>2146</sup>

Under the two split-dollar life insurance arrangements with Mr. Lay and the arrangement with Mr. Baxter, Enron paid the entire amount of the premiums under the life insurance contracts. The portion of this premium that constituted the cost of current term insurance protection would have been includible in income by the employee.

Under Mr. Skilling's arrangement, the Skilling family trust paid a portion of each annual premium under the life insurance contract, while Enron paid the balance of the annual premium. The terms of the split-dollar agreement provide that the amounts paid by the Skilling family trust are intended to constitute the full cost of current insurance protection, based on the insurer's "published minimum premium rate for standard risks." Under the 1960s rulings, taxpayers were permitted to choose to determine the amount includable in income on this basis. Because the Skilling family trust, rather than Enron, paid this portion of the premiums, no amount would have been includible in income. Each of the five annual premiums on the \$8 million life insurance contract was \$250,000, but the "cost of current insurance protection" was determined to be an amount between \$4,400 and \$7,600 each year. This disparity in amount illustrates the valuation issues that arise from permitting the use of insurers' "published" premium rates to set the amount includable in an employee's income.

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<sup>2144</sup> His death was alleged to be a suicide. Paul Duggan and Lois Romano, *Enron Official Shaken In Days Before Suicide*, Washington Post, Feb. 9, 2002, at A1.

<sup>2145</sup> Examination of the Federal tax consequences of the split-dollar life insurance arrangements to the individual Enron employees is beyond the scope of this Report. Some general discussion is provided in order to illustrate the issues relating to the tax treatment of split-dollar life insurance arrangements into which Enron entered.

<sup>2146</sup> Section 264(a)(1) provides that no deduction is allowed for premiums on any life insurance contract if the taxpayer is directly or indirectly a beneficiary under the contract. Prior to amendment in 1997, the rule provided that no deduction was allowed for premiums on a life insurance contract covering any officer or employee, if the taxpayer is directly or indirectly a beneficiary under the contract. Enron generally had the right to recoup all of its premium payments from the death benefits paid by the life insurance contracts, by the terms of the split-dollar life insurance arrangements. The premium deduction denial rules are discussed in more detail in Part Three, section IV of this Report, relating to company-owned and trust-owned life insurance.



Enron employees' split-dollar insurance arrangements were entered into prior to the issuance of the 2002 proposed regulations. Further, the regulations are in proposed form, and would become effective generally for arrangements entered into after the date final regulations are published. However, if the rules of the proposed regulations applied, the tax treatment probably would be conceptually similar to the treatment under the pre-Notice 2001-10 letter rulings published by the IRS, in that the value of the economic benefit would be includible in income. However, the analysis of whether to apply this approach or the proposed regulations' loan approach would be new, and the process of determining the amount of this cost would differ from under prior law.

Under the proposed regulations, the tax treatment of the non-equity collateral assignment split-dollar arrangements that Enron entered into with Mr. Lay, Mr. Skilling and Mr. Baxter would likely be subject to the "economic benefit" approach. The proposed regulations provide a special rule that the economic benefit approach always applies to a split-dollar arrangement in connection with the performance of services if the service provider's only benefit is current life insurance protection (a "non-equity" split dollar arrangement). Because the partnership and the trusts that were the owners of the contracts in these collateral assignment arrangements did not have the right to borrow or otherwise gain access to the cash value of the life insurance contracts,<sup>2147</sup> the contracts would be treated as non-equity split dollar arrangements under the proposed regulations. In this circumstance, the proposed regulations would provide that the owner of the contract<sup>2148</sup> would include in income the cost of current insurance protection. Valuation of this cost would be an issue, as the proposed regulations do not provide new guidance.<sup>2149</sup>

Alternatively, if the arrangements were subject to the loan approach under the proposed regulations, they would be treated as loans of each premium payment made by Enron. The borrower under this analysis would be the person deemed to be the owner of the life insurance contracts.<sup>2150</sup> The foregone interest on these deemed loans would be included in the income of the partnership or trust.

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<sup>2147</sup> Under each agreement described, the employee's family partnership or trust had no right to sell, assign, transfer, borrow against or withdraw from the cash surrender value of the policy.

<sup>2148</sup> Under the proposed regulations, the owner may be the partnership or trust. However, in the employment context, it could be argued that attribution or look-through to the employee would be appropriate, because the income is in the nature of compensation for his services.

<sup>2149</sup> Notice 2002-8 provides that until final regulations are published, the P.S. 58 rates, or the insurer's lower published premium rates for standard risks as permitted under the 1960s rulings, may be used to determine the value of current life insurance protection for split-dollar life insurance arrangements entered into before January 28, 2002.

<sup>2150</sup> Under the proposed regulations, the owner may be the Lay family partnership, the Skilling family trust, or Mr. Baxter's trust, respectively.

The enactment of the Sarbanes-Oxley Act of 2002, relating to corporate governance, has raised the issue of whether a split-dollar life insurance arrangement between an employer and an employee is characterized as a loan, for purposes of that Act's prohibition of certain loans to executives.<sup>2151</sup> The resolution of that question is not necessarily related to whether the arrangement is characterized as a loan, or otherwise, under Federal tax rules.<sup>2152</sup>

Until the issuance of Notice 2001-10 in 2001, the IRS had issued very little guidance on split-dollar life insurance since the 1960s. During this period, the use of split-dollar life insurance became more widespread, and variations on the product proliferated. In the absence of guidance, some taxpayers may have taken a variety of positions as to the includability in income of benefits under the arrangements, and as to the timing or amount of items that are includible. From a tax policy perspective, taxpayers' failure to include in income the appropriate value of an economic benefit received by an employee from an employer indicates a need for guidance as to the proper tax treatment of split-dollar life insurance arrangements.

More recently, since 2001, the IRS has issued far more detailed guidance, both as general statements published in Notices, and as more specific rules published as proposed regulations. In addition, the IRS has superceded the previous valuation table, known as the P.S. 58 table, and supplanted it with Table 2001 for new split-dollar arrangements. The effect has been to treat the economic benefit received in a split-dollar life insurance arrangement more like other economic benefits received by employees, specifying the tax treatment in greater detail than previously in an area in which practices that may not accurately measure income had become increasingly common.

### **Recommendations**

Requiring taxpayers to include in income the economic value of the benefit received in a split-dollar life insurance arrangement (or to treat the arrangement as a loan, if that treatment reflects the nature of the transaction) is consistent with the goal of the income tax system to accurately measure income. The Notices and proposed regulations generally serve the tax policy goal of improving accurate income measurement in the case of split-dollar life insurance arrangements. The Joint Committee staff recommends that guidance relating to split-dollar life insurance should be finalized.

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<sup>2151</sup> Sarbanes-Oxley Act of 2002, sec. 402, Pub. L. No. 107-204. The Sarbanes-Oxley Act is discussed in more detail in Part Four, section III.C.3., relating to employee loans.

<sup>2152</sup> Postal, *Will SEC Exempt Split-Dollar From Ravages Of Sarbanes-Oxley Loan Rules?*, Insurance Chronicle, Jan. 13, 2003, at 1.

## 6. Limitation on deduction of certain executive compensation in excess of \$1 million

### Present Law

#### In general

Present law allows a deduction for ordinary and necessary business expenses, including a reasonable allowance for salaries and other compensation for personal services actually rendered.<sup>2153</sup> The reasonableness standard has been used primarily to limit payments by closely-held companies in cases in which nondeductible dividends may be disguised as deductible compensation. The reasonableness standard has rarely, if ever, been applied in the context of compensation paid to an employee of a large publicly held corporation, where the question of whether a payment is really a return to capital is generally not an issue.

Under present law, compensation in excess of \$1 million paid by a publicly held company to the company's "covered employees" generally is not deductible.<sup>2154</sup> Covered employees are the chief executive officer and the four other most highly compensated employees of the company as reported in the company's proxy statement.

Subject to certain exceptions, the deduction limitation applies to all otherwise deductible compensation of a covered employee for a taxable year, regardless of the form in which the compensation is paid, whether the compensation is for services as a covered employee, and regardless of when the compensation was earned. The deduction limitation applies when the deduction would otherwise be taken. Thus, for example, in the case of a nonqualified stock option, the deduction is normally taken in the year the option is exercised, even though the option was granted with respect to services performed in a prior year.

Certain types of compensation are not subject to the deduction limitation and are not taken into account in determining whether other compensation exceeds \$1 million. With respect to compensation paid to Enron executives, the most relevant exception to the deduction limitation is for performance-based compensation. In general, performance-based compensation is compensation payable solely on account of the attainment of one or more performance goals and with respect to which certain requirements are satisfied, including a shareholder approval requirement.<sup>2155</sup>

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<sup>2153</sup> Sec. 162(a)(1).

<sup>2154</sup> Sec. 162(m). The \$1 million limit is reduced by any amount of excess parachute payments that are not deductible for the year (as determined under sec. 280G). The deduction limitation applies for purposes of the regular income tax and the alternative minimum tax.

<sup>2155</sup> In addition, the following types of compensation are not subject to the deduction limitation and are not taken into account in determining whether other compensation exceeds \$1 million: (1) compensation payable on a commission basis; (2) payments to a tax-qualified retirement plan (including salary reduction contributions); and (3) amounts that are excludable from the individual's gross income (such as employer-provided health benefits). In addition,

## **Performance-based compensation: In general**

The deduction limitation does not apply to any compensation payable solely on account of the attainment of one or more performance goals, but only if: (1) the performance goals are determined by a compensation committee of the board of directors of the publicly held company which is comprised solely of two or more outside directors; (2) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such compensation; and (3) before payment of such compensation, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied.<sup>2156</sup>

Compensation generally does not satisfy the requirements for performance-based compensation if the facts and circumstances indicate that the employee would receive all or part of the compensation regardless of whether the performance goal is attained. However, compensation does not fail to be performance-based merely because the compensation may be paid upon death, disability or change of ownership or control, although compensation actually paid on account of those events prior to the attainment of the performance goal would not satisfy the requirements of the exception.<sup>2157</sup>

## **Performance goal requirement**

### **Preestablished objective performance goal**

In order to qualify for the exception for performance-based compensation, the compensation must be paid to the covered employee pursuant to a preestablished objective goal. A performance goal generally is considered preestablished if it is established in writing by the compensation committee not later than 90 days after the commencement of the period of service to which the performance goal relates, provided that the outcome is substantially uncertain at the time the compensation committee actually establishes the goal.<sup>2158</sup> A performance goal is considered objective if a third party having knowledge of the relevant facts could determine whether the goal is met.<sup>2159</sup>

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under a transition rule, compensation is not subject to the limitation and is not taken into account in determining if other compensation exceeds \$1 million if the compensation is payable under a written binding contract in effect on February 17, 1993, and at all times thereafter before such compensation is paid and which was not modified thereafter in any material respect before such compensation is paid. Sec. 162(m)(4).

<sup>2156</sup> Sec. 162(m)(4)(C).

<sup>2157</sup> Treas. Reg. sec. 1.162-27(e)(2)(v).

<sup>2158</sup> In no event will a performance goal be considered to be preestablished if it is established after 25 percent of the period of service (as scheduled in good faith at the time the goal is established) has elapsed. Treas. Reg. sec. 1.162-27(e)(2)(i).

<sup>2159</sup> *Id.*

The term performance goal is broadly defined. A performance goal can be based on one or more business criteria that apply to the individual, a business unit, or the corporation as a whole. Treasury regulations provide that such business criteria could include, for example, stock price, market share, sales, earnings per share, return on equity, or costs. A performance goal need not, however, be based upon an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses (measured, in each case, by reference to a specific business criterion). A performance goal does not include the mere continued employment of the covered employee. Thus, for example, a vesting provision based solely on continued employment does not constitute a performance goal.<sup>2160</sup>

A preestablished performance goal must state, in terms of an objective formula or standard, the method for computing the amount of compensation payable to the employee if the goal is attained. A formula or standard is objective if a third party having knowledge of the relevant performance could calculate the amount to be paid to the employee. In addition, a formula or standard must specify the individual employees or class of employees to which it applies.<sup>2161</sup>

### Discretion

The terms of an objective formula or standard must preclude discretion to increase the amount of compensation payable that would otherwise be due upon attainment of the performance goal. A performance goal is not discretionary merely because the compensation committee reduces or eliminates the compensation or other economic benefit that was due upon attainment of the goal. That is, negative discretion to reduce the amount payable to a covered employee is generally permitted, as long as such discretion does not result in an increase in the amount payable to another employee. A formula or standard is not considered discretionary merely because the amount of compensation to be paid upon attainment of the performance goal is based on a percentage of base pay or salary and the dollar amount of the salary is not fixed at the time the performance goal is established if the maximum dollar amount to be paid is fixed at that time.<sup>2162</sup>

Changes in the timing of payments can affect the amount being paid and thus raise the question of whether the change involves impermissible discretion. As described below, Treasury regulations provide guidance on what types of timing changes are or are not considered increases in the amount payable.<sup>2163</sup>

If compensation is payable upon or after the attainment of a performance goal, and a change is made to accelerate the payment of compensation to an earlier date after the attainment of the goal, the change will be treated as an increase in the amount of compensation unless the

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<sup>2160</sup> *Id.*

<sup>2161</sup> Treas. Reg. sec. 1.162-27(e)(2)(ii).

<sup>2162</sup> Treas. Reg. sec. 1.162-27(e)(2)(iii)(A).

<sup>2163</sup> Treas. Reg. sec. 1.162-27(e)(2)(iii)(B).

amount of compensation paid is discounted to reasonably reflect the time value of money. If compensation is payable upon or after the attainment of a performance goal, and a change is made to defer the payment of compensation to a later date, any amount paid in excess of the amount that was originally owed to the employee will not be treated as an increase in the amount of compensation if the additional amount is based either on a reasonable rate of interest or on one or more predetermined actual investments (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return of a specific investment (including any decrease as well as any increase in the value of an investment).<sup>2164</sup>

If compensation is payable in the form of property, a change in the timing of the transfer of that property after the attainment of the goal will not be treated as an increase in the amount of compensation. Thus, for example, if the terms of a stock grant provide for stock to be transferred after the attainment of a performance goal and the transfer of the stock also is subject to a vesting schedule, a change in the vesting schedule that either accelerates or defers the transfer of stock will not be treated as an increase in the amount of compensation payable under the performance goal.<sup>2165</sup>

#### Stock option and stock appreciation rights

Compensation attributable to a stock option or a stock appreciation right is deemed to satisfy the performance goal requirement if: (1) the grant or award is made by the compensation committee; (2) the plan under which the option or right is granted states the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee; and (3) under the terms of the option or right, the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant or award.

Conversely, if the amount of compensation the employee will receive under the grant or award is not based solely on an increase in the value of the stock after the date of grant or award (e.g., in the case of restricted stock, or an option that is granted with an exercise price that is less than the fair market value of the stock as of the date of grant), none of the compensation attributable to the grant or award is considered performance-based compensation.<sup>2166</sup> The rule that the compensation attributable to a stock option or stock appreciation right must be based solely on an increase in the value of the stock after the date of grant or award does not apply if the grant or award is made on account of, or if the vesting or exercisability of the grant or award is contingent on, the attainment of a performance goal that satisfies the applicable requirements.

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<sup>2164</sup> *Id.*

<sup>2165</sup> *Id.*

<sup>2166</sup> Treas. Reg. sec. 1.162-27(e)(2)(vi). Whether a stock option grant is based solely on an increase in the value of the stock after the date of grant is determined without regard to any dividend equivalent that may be payable, provided that payment of the dividend equivalent is not made contingent on the exercise of the option.

Compensation attributable to a stock option or stock appreciation right does not satisfy the requirements of the exception for performance-based compensation to the extent that the number of options granted exceeds the maximum number of shares for which options may be granted to the employee as specified in the plan.<sup>2167</sup>

### **Outside director requirement**

The performance goal under which compensation is paid must be established by a compensation committee comprised solely of two or more outside directors. A director is an outside director if the director:

- Is not a current employee of the publicly held corporation;
- Is not a former employee of the publicly held corporation who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year;
- Has not been an officer of the publicly held corporation; and
- Does not receive remuneration from the publicly held corporation, either directly or indirectly, in any capacity other than as a director. For this purpose, remuneration includes any payment in exchange for goods or services.<sup>2168</sup>

Specific rules apply in determining whether a director falls within any of these categories.<sup>2169</sup>

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<sup>2167</sup> If an option is canceled, the canceled option continues to be counted against the maximum number of shares for which options may be granted to the employee under the plan. If, after grant, the exercise price of an option is reduced, the transaction is treated as a cancellation of the option and a grant of a new option. In such case, both the option that is deemed to be canceled and the option that is deemed to be granted reduce the maximum number of shares for which options may be granted to the employee under the plan. *Id.*

<sup>2168</sup> Treas. Reg. sec. 1.162-27(e)(3)(i).

<sup>2169</sup> For example, the determination of whether an individual was an officer of the publicly held corporation is based on the facts at the time that the individual is serving as a member of the compensation committee. A director is not precluded from being an outside director solely because the director is a former officer of a corporation that was previously within the affiliated group of the publicly held corporation but is no longer within the group when the individual is serving on the compensation committee. As another example, specific rules apply, including certain rules disregarding de minimis remuneration, in determining whether and when the individual is receiving remuneration from the publicly held corporation in a capacity other than as a director. Treas. Reg. sec. 1.162-27(e)(3)(ii) - (viii).

## Shareholder approval requirement

### In general

The material terms of the performance goal under which the compensation is to be paid must be disclosed to and subsequently approved by the shareholders of the publicly held corporation before the compensation is paid. The shareholder approval requirement is not satisfied if the compensation would be paid regardless of whether the material terms are approved by shareholders.<sup>2170</sup>

The material terms that must be disclosed to shareholders include: (1) the employees eligible to receive compensation; (2) a description of the business criteria on which the performance goal is based; and (3) either the maximum amount of compensation that could be paid to any employee or the formula used to calculate the amount of compensation to be paid to the employee if the performance goal is attained (except that, in the case of a formula based, in whole or in part, on a percentage of salary or base pay, the maximum dollar amount of compensation that could be paid to the employee must be disclosed).<sup>2171</sup> To the extent not otherwise specifically provided in Treasury regulations, whether the material terms of a performance goal are adequately disclosed to shareholders is determined under the same standards as apply under the Securities Exchange Act of 1934.<sup>2172</sup>

### Eligible employees

Disclosure of the employees eligible to receive compensation need not be so specific as to identify the particular individuals by name. A general description of the class of eligible employees by title or class is sufficient.<sup>2173</sup>

### Business criteria

Disclosure of the business criteria on which the performance goal is based need not include the specific targets that must be satisfied under the performance goal. For example, if a bonus plan provides that a bonus will be paid if earnings per share increase by 10 percent, the 10-percent figure is a target that need not be disclosed to shareholders. However, in that case, disclosure must be made that the bonus plan is based on an earnings-per-share business criterion. In the case of a plan under which employees may be granted stock options or stock appreciation

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<sup>2170</sup> Treas. Reg. sec. 1.162-27(e)(4)(i).

<sup>2171</sup> *Id.* The disclosure requirement may be satisfied even though information that otherwise would be a material term of a performance goal is not disclosed to shareholders if the compensation committee determines that the information is confidential commercial or business information, the disclosure of which would have an adverse effect on the publicly held corporation. Treas. Reg. sec. 1.162-27(e)(4)(iii)(B).

<sup>2172</sup> Treas. Reg. sec. 1.162-27(e)(4)(v).

<sup>2173</sup> Treas. Reg. sec. 1.162-27(e)(4)(ii).



rights, no specific description of the business criteria is required if the grants or awards are based on a stock price that is not less than current fair market value.<sup>2174</sup>

#### Compensation payable under a performance goal

Disclosure as to the compensation payable under a performance goal must be specific enough so that shareholders can determine the maximum amount of compensation that could be paid to any employee during a specified period. If the terms of the performance goal do not provide for a maximum dollar amount, the disclosure must include the formula under which the compensation would be calculated. Thus, for example, if compensation attributable to the exercise of stock options is equal to the difference in the exercise price and the current value of the stock, disclosure would be required of the maximum number of shares for which grants may be made to any employee and the exercise price of those options (e.g., fair market value on date of grant). In that case, shareholders could calculate the maximum amount of compensation that would be attributable to the exercise of options on the basis of their assumptions as to the future stock price.

#### Other rules

Once the material terms of a performance goal are disclosed to and approved by shareholders, no additional disclosure or approval is required unless the compensation committee changes the material terms of the performance goal. If, however, the compensation committee has authority to change the targets under a performance goal after shareholder approval of the goal, material terms of the performance goal must be disclosed to and reapproved by shareholders no later than the first shareholder meeting that occurs in the fifth year following the year in which shareholders previously approved the performance goal.<sup>2175</sup>

The material terms of a performance goal are approved by shareholders if, in a separate vote, a majority of the votes cast on the issue (including abstentions to the extent abstentions are counted as voting under applicable state law) are cast in favor of approval.<sup>2176</sup>

### **Factual Background**

#### **Statement of Enron policy regarding deduction limitation**

Since the enactment of the \$1 million deduction limitation,<sup>2177</sup> Enron has expressed the intent to structure certain compensation arrangements to qualify as performance-based

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<sup>2174</sup> Treas. Reg. sec. 1.162-27(e)(4)(iii).

<sup>2175</sup> Treas. Reg. sec. 1.162-27(e)(4)(vi).

<sup>2176</sup> Treas. Reg. sec. 1.162-27(e)(4)(vii).

<sup>2177</sup> The \$1 million deduction limitation was enacted in 1993, effective for amounts that would otherwise be deductible for taxable years beginning on or after January 1, 1994. Pub. L. No. 103-66, sec. 13211(a) (1993).

compensation not subject to the \$1 million limit. The 1994 Enron Corp proxy statement contains this initial statement regarding the limitation:<sup>2178</sup>

[The deduction limitation], enacted in 1993, generally disallows a tax deduction to public companies for compensation over \$1 million paid to the company's Chief Executive Officer and four other most highly compensated executive officers, as reported in the proxy statement. Qualifying performance-based compensation will not be subject to the deduction limit if certain requirements are met. Enron intends to structure the performance-based portion of the compensation of its executive officers (which currently consists of stock option grants, certain restricted stock grants, performance unit grants and annual incentive awards) in a manner that complies with the new statute, including presentation of each of these plans to stockholders for approval. Occasionally, Enron may grant restricted stock for specific reasons which would not qualify as performance-based.

Subsequent annual proxy statements continued to indicate the general intent to structure most, but not necessarily all, compensation arrangements so as to meet the requirements for performance-based compensation. For example, the proxy statement for the annual shareholder meeting in 2001 contains the following statement as part of the "Report from the Compensation and Management Development Committee Regarding Executive Compensation:"<sup>2179</sup>

Section 162(m) of the Internal Revenue Code, as amended (the "Code"), generally disallows a tax deduction to public companies for compensation over \$1,000,000 paid to a company's CEO and four most highly compensated executive officers, as reported in its proxy statement. Qualifying performance-based compensation is not subject to the deduction limit if certain requirements are met. Enron has structured **most** aspects of the performance-based portion of the compensation for its executive officers (which includes stock option grants, performance units, and performance based annual incentive awards) in a manner that complies with the statute. The Amended and Restated Enron Corp. 1991 Stock Plan, the Amended and Restated Performance Unit Plan, and the Enron Corp. Annual Incentive Plan were presented to and approved by shareholders at the 1999 [sic], 1995 and 1999 Annual Meetings of Shareholders, respectively.<sup>2180</sup> (emphasis added)

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<sup>2178</sup> 1994 Enron Corp. Proxy Statement, at 11.

<sup>2179</sup> 2001 Enron Corp. Proxy Statement, at 16.

<sup>2180</sup> Similar statements were included in previous proxy statements. For example, the 2000 proxy statement contained the same language, except that dates given as to when shareholder approval was obtained are different. The 2000 proxy contains the following dates of shareholder approval: 1994, 1997, and 1999 for approval of the Amended and Restated 1991 Stock Plan; 1994 and 1995 for approval of the Amended and Restated Performance Unit Plan; and 1994 and 1999 for the Annual Incentive Plan. 2000 Enron Corp. Proxy Statement, 15.

Other proxy statements clarify which portions of the 1991 Stock Plan were intended to qualify as performance-based compensation (as Amended and Restated Effective May 4, 1999). For example, the 1999 proxy contains the following:<sup>2181</sup>

[E]nron believes that the income generated in connection with the exercise of stock options granted under the 1991 Stock Plan should qualify as performance-based compensation and, accordingly, Enron's deductions for such compensation should not be limited by [the deduction limitation]. The 1991 Stock Plan has been designed to provide flexibility with respect to whether restricted stock awards will qualify as performance-based compensation under [the deduction limitation]. Enron believes that certain awards of restricted stock under the 1991 Stock Plan will so qualify and Enron's deduction with respect to cash awards should not be limited by [the deduction limitation]. However, certain awards of restricted stock and all awards of phantom stock units will not qualify as performance-based compensation and, therefore, Enron's compensation expense deductions relating to such awards will be subject to the ... deduction limitation.<sup>2182</sup>

## **Shareholder approval**

### In general

As noted in the proxies, three plans, the 1991 Stock Plan, the Performance Unit Plan, and the Annual Incentive Plan<sup>2183</sup> were submitted for shareholder approval (and subsequently approved) so that compensation provided under these plans would qualify as performance based. As discussed in more detail below, with respect to certain plans, Enron initially took the position that the plans would be considered performance-based even if the plans would be effective absent shareholder approval. Treasury regulations made clear that this was not the case.<sup>2184</sup>

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<sup>2181</sup> 1999 Enron Corp. proxy statement, at 16. Similar statements were included in other proxy materials. *See, e.g.*, 2001 Enron Corp. Proxy Statement, at 32.

<sup>2182</sup> The terms of the 1991 Stock Plan (as Amended and Restated Effective May 4, 1999), which the 1999 proxy describes, distinguished between restricted stock (secs. 5.2(i)-(v) of the Plan), performance-based restricted stock (sec. 5.2(vi) of the Plan), and phantom stock units (sec. 5(vi) of the Plan). According to these plan provisions only the performance-based restricted stock is specifically designed to qualify for the performance-based exemption to the deduction limitation.

<sup>2183</sup> The 1991 Stock Plan and the Performance Unit Plan are discussed in more detail in Part III.C.2., above. The Annual Incentive Plan is discussed in Part III.B.2., above.

<sup>2184</sup> Treas. Reg. sec. 1.162-27(e)(4)(i).

### 1991 Stock Plan

The 1991 Stock Plan initially was approved by the shareholders in 1991. Amendments to the Plan 1991 Stock were presented to the shareholders in 1994, including amendments determined necessary by Enron to meet the requirements for performance-based compensation under the deduction limitation.<sup>2185</sup> The 1994 proxy materials state that shareholder approval of the amendment was required so that certain awards under the 1991 Stock Plan would qualify as performance-based compensation under the compensation deduction limitation.<sup>2186</sup>

The proxy materials do not state what happens if the amendment is not approved by the shareholders, and the 1991 Stock Plan amendment submitted with the proxy materials is silent on the issue. The only reference to an effective date in the amendment is the following:

“NOW, THEREFORE, the Plan is amended as follows:

“1. The plan name will be changed to ‘ENRON CORP. 1991 STOCK PLAN (AS AMENDED AND RESTATED EFFECTIVE MAY 3, 1994),’ and the Plan shall be restated to incorporate this and all prior amendments.”<sup>2187</sup>

An amended and restated 1991 Stock Plan was submitted to shareholders for approval in 1997. The plan submitted for approval says that it is effective upon approval of the shareholders.

The 1991 Stock Plan (as Amended and Restated Effective May 4, 1999) was again submitted for shareholder approval in 1999, and again (as Amended and Restated Effective May 1, 2001) in 2001. These versions of the 1991 Stock Plan provided that it is not effective unless shareholder approval is obtained.<sup>2188</sup>

### Performance Unit Plan

The Performance Unit Plan was initially presented for approval by the shareholders for the purpose of meeting the requirements for performance-based compensation under the deduction limitation in 1994. The proxy materials in 1994 stated that, if shareholder approval

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<sup>2185</sup> The amendments were also submitted to the shareholders in order to comply with an exemption under the short-swing profit recovery provisions of the applicable securities laws. 1994 Enron Corp. Proxy Statement, at 31.

<sup>2186</sup> 1994 Enron Corp. Proxy Statement, at 31.

<sup>2187</sup> 1994 Enron Corp. Proxy Statement, Exhibit C. The Joint Committee staff was unable to obtain a copy of the 1991 Stock Plan as originally adopted; it is possible the Plan had separate effective date provisions.

<sup>2188</sup> Sec. 9 of the Enron Corp. 1991 Stock Plan (as Amended and Restated Effective May 4, 1999); sec. 9 of the Enron Corp. 1991 Stock Plan (as Amended and Restated Effective May 1, 2001). The Plans are included as Exhibit B of the 1999 and 2001 Enron Corp. Proxy Statements.

was not obtained, the Performance Unit Plan would continue but payments made on or after January 1, 1994, would not be deductible by Enron.<sup>2189</sup> The Performance Unit Plan document submitted with the proxy did not contain a provision conditioning the effectiveness of the Plan on shareholder approval.

An amended and restated Performance Unit Plan was presented for approval by the shareholders in 1995. The amended and restated Performance Unit Plan was substantially the same plan that was approved in 1994. Proxy materials explain that the Performance Unit Plan was being resubmitted to shareholders in order to comply with the requirements of the compensation deduction limitation. The proxy states that Treasury Regulations under the compensation cap, issued after the proxy materials had been finalized, made it clear that compensation was not performance based if it would be paid regardless of whether the terms are approved by the shareholders. The Performance Unit Plan presented in 1995 provided that, if shareholder approval was not obtained, the Plan would not be continued and grants made in 1994 and 1995 would be cancelled. The proxy materials state that, “Upon further guidance from legal counsel after consultation with the Internal Revenue Service, the clarification contained herein now complies with the Internal Revenue Service’s interpretation of this provision.”<sup>2190</sup> In addition, the Performance Unit Plan document provided with the 1995 proxy materials expressly provides that:

Upon approval by the stockholders of the Company at the 1995 annual meeting, the Plan shall be considered effective for Performance Periods beginning on or after January 1, 1994. In the event that the Plan is not approved by the stockholders of the Company at the 1995 annual meeting, all Performance Units granted prior to such meeting with respect to Performance Periods beginning on or after January 1, 1994, shall be cancelled without the payment of any amount to the holders thereof and no Performance Units shall thereafter be granted under the Plan.<sup>2191</sup>

#### Annual Incentive Plan

The Annual Incentive Plan was initially presented for approval by the shareholders for the purpose of meeting the requirements for performance-based compensation under the deduction limitation in 1994. The 1994 proxy materials state that, if the requisite shareholder approval is not obtained, the Annual Incentive Plan will continue, but payments made on or after January 1, 1994, will not be tax deductible if compensation to executives exceeds \$1 million.<sup>2192</sup> However, the Annual Incentive Plan document provides that “Upon approval by the stockholders

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<sup>2189</sup> 1994 Enron Corp. Proxy Statement, at 28.

<sup>2190</sup> 1995 Enron Corp. Proxy Statement, at 27.

<sup>2191</sup> Section X.G. of the Enron Corp. Performance Unit Plan (As Amended and Restated Effective May 2, 1995), the Plan is included as Exhibit A to the 1995 Enron Corp. Proxy Statement.

<sup>2192</sup> 1994 Enron Corp. Proxy Statement, at 30.

of the Company at the 1994 Annual Meeting, the Plan shall be considered effective as of January 1, 1994,” indicating that the Plan would not be effective unless approved by the shareholders.<sup>2193</sup>

A new Annual Incentive Plan was presented for shareholder approval at the 1999 annual meeting. The proxy materials for this meeting state that approval of the shareholders is required in order for the payments from the Plan to be tax deductible as performance-based compensation and that the Plan will not become effective unless approved by the shareholders.<sup>2194</sup> The Annual Incentive Plan document submitted with the proxy materials provides that “upon approval by the shareholders of the Company at the 1999 Annual Meeting, the Plan shall be considered effective as of January 1, 1999.”<sup>2195</sup>

## **Role of the Compensation Committee**

### Composition of the Committee

During the period of the Joint Committee staff review, the Compensation Committee consisted of a chairman, Charles A. LeMaistre, and three or four other directors. In 1993, 1994, and 1995, the other members of the Compensation Committee were Robert A. Belfer, John H. Duncan, and Joe H. Foy. In 1996, Mr. Foy and Mr. Belfer were replaced by Norman P. Blake and Robert K. Jedicke. Frank Savage joined the Compensation Committee at the end of 1999.

The 1997 proxy states that changes were made in the composition of the Compensation Committee in order to comply with the requirements of the \$1 million deduction limitation.<sup>2196</sup> The proxy does not describe the precise reason for the change. As discussed above, in order to meet the requirements for performance-based compensation, the compensation must be approved by a committee consisting of at least two outside directors. Thus, it appears probable that the change was related to this requirement.

### 1991 Stock Plan

The 1991 Stock Plan provides that the plan is to be administered by a committee of the Board of Directors of Enron Corp. designated by the Board and composed of not less than two nonemployee directors, as defined in Rule 16b-3 of the Securities Exchange Act of 1934. The Compensation Committee acted as the administrator of the 1991 Stock Plan. The 1991 Stock

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<sup>2193</sup> Sec. XIV of the Enron Corp. Annual Incentive Plan. The Plan is included in as Exhibit B to the 1994 Enron Corp. Proxy Statement.

<sup>2194</sup> 1999 Enron Corp. Proxy Statement, at 29.

<sup>2195</sup> Sec. XIV of the Enron Corp. Annual Incentive Plan. The Plan is included as Exhibit A to the 1999 Enron Corp. Proxy Statement.

<sup>2196</sup> 1997 Enron Corp. Proxy Statement, at 15-16.

Plan<sup>2197</sup> provides that, subject to applicable law and the terms of the 1991 Stock Plan, the Committee has the sole power, authority and discretion to:

- Designate participants,
- Determine the types of awards to be granted to a participant,
- Determine the number of shares to be covered by or with respect to which payments, rights, or other matters are to be calculated in connection with awards,
- Determine the terms and conditions of any award,
- Determine whether, to what extent, under what circumstances and how awards may be settled or exercised in cash, Enron Corp. common stock, other securities other awards, or other property, or may be canceled, forfeited, or suspended, determine whether, to what extent, and under what circumstances cash, shares, other securities, other awards, other property, and other amounts payable with respect to an award under the Plan shall be deferred either automatically or at the election of the holder thereof or of the Committee,
- Interpret, construe, and administer the Plan and any instrument or agreement relating to an award made under the Plan,
- Establish, amend, suspend, or waive such rules and regulations and appoint such agents as it shall deem appropriate for the proper administration of the Plan,
- Make a determination as to the right of any person to receive payment of an award or other benefits,
- Except for awards made to persons subject to Section 16 of the Securities Exchange Act of 1934, delegate to individuals in specified officer positions of the company the authority to make and issue awards for a specified number of shares subject to the terms and provisions of the Plan,<sup>2198</sup> and
- Make any other determination and take any other action that the Committee deems necessary or desirable for the administration of the Plan.

The Plan provides that a majority of the Committee constitutes a quorum and that the acts of a majority of the members present at any meeting at which a quorum is present or acts approved in writing by all members of the Committee are considered acts of the Committee.<sup>2199</sup>

#### Performance Unit Plan

The Performance Unit Plan provides that the Compensation Committee of the Board of Directors<sup>2200</sup> is responsible for the administration of the Plan. The Compensation Committee is

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<sup>2197</sup> Except as otherwise described, Plan provisions are included in both the 1999 and 2001 Restatements of the 1991 Stock Plan.

<sup>2198</sup> This provision was not in the 1999 Restatement of the 1991 Stock Plan.

<sup>2199</sup> The authority of the Committee to make plan amendments was added in the 2001 restatement; it was not in the 1999 restated Plan.

<sup>2200</sup> In some years, the Compensation Committee was called the Compensation and Management Committee.

granted certain specific authority under the Plan, as described below, and also has such other powers and authority necessary or proper for the administration of the Plan, as determined from time to time by the Compensation Committee. Notwithstanding that the Compensation Committee is the Plan administrator, day-to-day administration of the Plan is the responsibility of the Vice President of Human Resources, who in carrying out such day-to-day administrative activities is acting as the Committee's delegate. The Compensation Committee may also delegate to any person designated by the Compensation Committee any power or duty granted to it under the Plan. The Compensation Committee may adopt such rules for the administration of the Plan as it deems necessary.

As part of the specific authority granted to the Compensation Committee under the Performance Unit Plan, the Committee is responsible for designating, in its sole discretion, which eligible employees will receive an award of performance units for the year. Prior to the Compensation Committee making its designation, the Office of the Chairman of the Company is to present a nomination list to the Compensation Committee of those eligible employees, if any, recommended to the Committee for consideration as recipients of performance units. The Performance Unit Plan provides that the Compensation Committee is to make its designation after "giving due consideration to the nomination list." The Compensation Committee is not bound by the nomination list, and may include any, all, or none of the eligible employees on the nomination list and may include other eligible employees as the Compensation Committee considers appropriate. The Compensation Committee is to provide each designated eligible employee with a written notice of any performance units granted to the employee during the year. The Committee also determines, in its sole discretion, the number of performance units to be granted to any eligible employee, subject to the terms of the Plan.

The Compensation Committee is to maintain, or is to cause to be maintained, accounts reflecting each participant's interest in the Performance Unit Plan. The Compensation Committee has the authority, in its discretion, to determine whether benefit payments with respect to performance units are made in cash, Enron Corp. common stock, or both.

The Plan provides that the Board, or the Compensation Committee acting on behalf of the Board, may amend or modify the Performance Unit Plan at any time and in any manner, except that no change in any grant previously made may be made which would impair the rights of the recipient of a grant without the consent of the recipient. In addition, no amendment may be made without the approval of stockholders if the amendment would:

- Change the class of eligible employees who may be designated to receive an award under the Performance Unit Plan,
- Change the criteria used to determine the adjusted value to a performance measure other than total shareholder return,
- Change the schedule used to determine adjusted value,
- Increase the maximum grant of performance units that any eligible employee may receive in a year, or
- Otherwise modify the material terms of the Performance Unit Plan.



## Annual Incentive Plan<sup>2201</sup>

The Compensation Committee of the Board is responsible for administering the Annual Incentive Plan and has a variety of duties and responsibilities under the Annual Incentive Plan. It has the sole discretion to: (1) interpret the Annual Incentive Plan; (2) approve preestablished, objective annual performance measures; (3) certify the level to which the performance measures were attained prior to any payment under the Annual Incentive Plan; (4) approve the amount of awards made under the Annual Incentive Plan; and (5) determine who is to receive any payment under the Annual Incentive Plan. The Annual Incentive Plan provides that decisions of the Compensation Committee are conclusive and that the Compensation Committee shall have no liability for any action taken or decision made in good faith relating to the Annual Incentive Plan or any award made under the Annual Incentive Plan.

The Annual Incentive Plan as approved by shareholders in 1994 provided that the Compensation Committee was to establish annually an award fund, expressed as a percentage of after-tax net income, prior to the beginning of the year (or such later date as permitted under applicable law). The Annual Incentive Plan as restated in 1999 provides that the maximum annual award fund is five percent of recurring after-tax net income of Enron and eligible employees are limited to Section 16 officers. Recurring after-tax net income means after-tax net income subject to downward adjustment by the Compensation Committee in its sole discretion for what it considers unordinary or nonrecurring items of after-tax net income and other items or events, including, but not limited to, financial impact on Enron resulting from changes in law and/or regulations pertaining to Federal taxes imposed on corporations.

The maximum permitted individual target award under the 1994 Plan was one-half of one percent (.5 percent) of the after-tax net income of Enron. The 1999 Annual Incentive Plan provides that, for eligible participants subject to the deduction limitation (and officers subject to section 16 of the Securities Exchange Act), the Compensation Committee is to establish an individual target award level, expressed as a percentage of recurring after-tax net income. The maximum individual target award level that can be established under the Annual Incentive Plan is one percent of the recurring after-tax net income of Enron.

Under the 1999 Annual Incentive Plan, the Compensation Committee is to verify the actual recurring after-tax net income of the Company, if any, and the resulting award fund, taking into consideration any downward adjustments that the committee may make at its sole discretion. The Compensation Committee then determines which participants will receive payments under the Plan, and the amount of such payments. Discretionary upward adjustment of the actual award level above the target award level is not allowed.<sup>2202</sup>

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<sup>2201</sup> Unless otherwise indicated, this description is based on the 1999 Annual Incentive Plan.

<sup>2202</sup> The Compensation Committee had similar responsibilities under the 1994 Annual Incentive Plan.

The 1994 Annual Incentive Plan provided that the Compensation Committee has the authority to modify or terminate the plan at any time, except that, without prior approval of the shareholders, no amendment may be made that would: (1) change the class of participants eligible to receive awards under the plan. (2) base the award on a performance measure other than after-tax net income. (3) base the award fund on a performance measure other than recurring net after-tax income. (4) increase the maximum individual target award level under the plan, or (5) modify any other material terms of the plan. The 1999 Annual Incentive Plan contains similar authority, except that, consistent with plan terms in effect at the time, provides that the Compensation Committee cannot change the total fund to an amount greater than five percent of recurring after-tax net income or base an award on a performance measure other than net after-tax income without the consent of the shareholders.

#### Information from third-party consultants

In 1998, Towers Perrin was asked to provide information regarding how other companies address the \$1 million deduction limitation. Towers Perrin provided a letter which was presented to the Compensation Committee at the February 9, 1998, meeting.<sup>2203</sup> The report says that in May 1997, Towers Perrin conducted a survey of 275 companies regarding annual incentive plan design issues. The survey showed that about 45 percent of the survey participants have sought shareholder approval of their annual incentive plans because of the deduction limitation. Towers Perrin suspected that this was relatively low because many companies either do not have cash compensation in excess of \$1 million for covered employees or manage the deduction limitation by deferring compensation in excess of \$1 million. The latter technique was reportedly used by about 10 percent of surveyed companies.

Towers Perrin did not have data regarding how companies structure annual incentive plans to comply with the deduction limitation, but stated that it was their understanding that companies often establish a “soft” incentive funding target for covered employees which makes it likely that the total amount the company desires to pay such employees will be within the cap. Towers Perrin explained that this is done because the deduction limitation permits bonuses to be less than the shareholder-approved target.

Towers Perrin reported that they conducted a survey in August 1997 of 150 large U.S. companies. This survey showed that annual bonuses for management employees represent from two percent to 10 percent of after-tax profit, with a median of five percent. They suggested that, if a company were attempting to leave room for a reduction in the target amount, it would be common to set the funding pool approved by shareholders somewhat above these levels.

Towers Perrin also described a second approach of having shareholders approve the maximum dollar payouts to individuals under the Plan, with a laundry list of possible performance measures that can be used. The compensation committee could then select the performance measures to be used under the Plan each year, subject to the dollar limits. Towers Perrin commented that this approach would give the Compensation Committee considerable

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<sup>2203</sup> Letter from Towers Perrin to Vice President, Compensation and Benefits, Enron Corp., (April 21, 1998). EC000104240 - EC000104241.

latitude, but that some shareholder groups recommend against approval of this type of Plan because the standards of performance are not revealed.

As described above, Enron adopted an approach that gave an overall target based on after-tax net earnings.

#### Other actions of the Compensation Committee

Proxy statements included an annual report from the Compensation Committee. These reports typically discussed the overall Enron philosophy regarding executive compensation and the activities of the Compensation Committee regarding executive compensation, including the methods for determining appropriate levels and components of executive compensation.<sup>2204</sup> In years since the enactment of the \$1 million deduction limitation, this report has included a section regarding compliance with the deduction limitation. As reflected above, this portion of the report typically stated the intent to structure certain compensation arrangements in order to meet the exception to the \$1 million limitation for performance-based compensation.<sup>2205</sup>

Despite the apparent attention paid by the Compensation Committee to the deduction limitation, as reflected in Compensation Committee meetings and reports, one member of the Committee interviewed by the Joint Committee staff indicated that he was not aware that there was such a limitation.

#### Data

Table 26, Table 27, and Table 28, below, show the aggregate amount of total compensation, performance-based compensation, additional deductible compensation, and nondeductible compensation for Enron's covered employees for 1998, 1999, and 2000.

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<sup>2204</sup> See, e.g., 1999 Enron Corp. Proxy Statement, at 13-16.

<sup>2205</sup> 1994 Enron Corp. Proxy Statement, 12; 1995 Enron Corp. Proxy Statement, at 14-15; 1996 Enron Corp. Proxy Statement, at 13-14; 1997 Enron Corp. Proxy Statement, at 15-16; 1998 Enron Corp. Proxy Statement, at 15; 1999 Enron Corp. Proxy Statement, at 16; 2000 Enron Corp. Proxy Statement, at 15; 2001 Enron Corp. Proxy Statement, at 16.

**Table 26.—Application of \$1 Million Deduction Limitation for 1998**  
(Millions of Dollars)

<b>Employee</b>	<b>(1) Total Compensation</b>	<b>(2) Performance- Based Compensation</b>	<b>(3) Additional Deductible Compensation**</b>	<b>(4) Nondeductible Compensation [(4)=(1)-(2)-(3)]</b>
Employee 1	14.942	13.570	1.0	.372
Employee 2	8.214	3.336	1.0	3.878
Employee 3	16.700	2.148	1.0	13.552
Employee 4	8.651	1.884	1.0	5.767
Employee 5	Information not provided by Enron	Information not provided by Enron	Unknown	Information not provided by Enron
<b>Total*</b>	48.505	20.937	4.0	23.568

\*Details may not add to totals due to rounding.

\*\*Additional deductible compensation is the amount of total compensation, minus performance-based compensation, not in excess of \$1 million.

**Table 27.—Application of \$1 Million Deduction Limitation for 1999**  
(Millions of Dollars)

<b>Employee</b>	<b>(1) Total Compensation</b>	<b>(2) Performance- Based Compensation</b>	<b>(3) Additional Deductible Compensation**</b>	<b>(4) Nondeductible Compensation [(4)=(1)-(2)-(3)]</b>
Employee 1	48.478	47.058	1.000	.420
Employee 2	54.322	48.680	1.000	4.642
Employee 3	7.204	2.832	1.000	3.372
Employee 4	6.874	6.517	.357	0
Employee 5	7.324	6.484	.839	0
<b>Total*</b>	124.202	111.572	4.100	8.434

\*Details may not add to totals due to rounding.

\*\* Additional deductible compensation is the amount of total compensation, minus performance-based compensation, not in excess of \$1 million.

**Table 28.—Application of \$1 Million Deduction Limitation for 2000  
(Millions of Dollars)**

<b>Employee</b>	<b>(1) Total Compensation</b>	<b>(2) Performance- Based Compensation</b>	<b>(3) Additional Deductible Compensation**</b>	<b>(4) Nondeductible Compensation</b>
Employee 1	105.990	104.376	1.000	614.153
Employee 2	81.988	66.894	1.000	14.094
Employee 3	29.897	30.022	0.0	0.0
Employee 4	21.427	18.631	1.000	1.796
Employee 5	21.597	21.077	.520	0.0
<b>Total*</b>	260.899	241.00	.520	16.504

\*Details may not add to totals due to rounding.

\*\*Additional deductible compensation is the amount of total compensation, minus performance-based compensation, not in excess of \$1 million.

The amounts shown in these tables are from information provided by Enron to the IRS in connection with the IRS' review of Enron's tax returns for 1998, 1999, and 2000. The information was provided in response to specific questions regarding the deduction limitation. The Joint Committee staff has compared this information with other information provided by Enron to the IRS and the Joint Committee staff, as well as proxy information. This comparison yielded a number of inconsistencies that stem from a variety of sources. In some cases Enron has provided information which was later modified by Enron, in other cases there are internal inconsistencies with the information provided, and in other cases it is difficult to reconcile various pieces of information. These inconsistencies may raise questions as to the accuracy of the information provided. For example, seemingly straightforward and simple information such as the job title of a particular individual varies between proxy statements and information provided to the IRS. In one case, shown on Table 28, performance-based compensation of an individual was more than the individual's total compensation.

Some of the inconsistencies discovered could have a significant impact on the amount of compensation subject to the \$1 million cap. As shown in Table 28, above, based on information provided by Enron to the IRS, in 2000, the top-five highest paid officers received total compensation of \$261 million. However, based on information relating to total the highest paid 200 employees for 2000 provided by Enron to the Joint Committee staff, the five highest paid employees received compensation of over twice that amount--\$573 million.<sup>2206</sup> On the top-200 list for 2000, the highest paid employee is listed as having the title Chairman and Chief Executive Officer of Enron (the list does not include names) and as having total compensation of \$169 million. This amount of compensation does not correspond to any amount provided to the IRS for 2000.

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<sup>2206</sup> The information relating to the highest paid 200 employees provided by Enron to the Joint Committee staff for 1998 through 2001 is in Appendix D to this Report.

In interviews with the Joint Committee staff, IRS personnel also indicated that they had discovered inconsistencies with information provided by Enron and expressed difficulty in obtaining complete compensation information. The IRS attributed this, in part, to Enron's recordkeeping system. According to the IRS, Enron personnel stated to the IRS that Enron did not maintain a centralized file for each executive reflecting total compensation for that executive.

The IRS informed the Joint Committee staff that, as part of its examination of Enron's returns for 1998, 1999, and 2000, it is investigating discrepancies of this nature. The Joint Committee staff has not attempted to duplicate this work. While the information provided below may not be completely accurate, it is the best information available.

### Discussion of Issues

The \$1 million limitation on the deductibility of certain executive compensation does not appear to have had a substantial impact on either the amount of compensation paid by Enron or the structure of its compensation arrangements.

Table 29, below, shows total compensation, performance-based compensation, additional deductible compensation, and nondeductible compensation for 1998 through 2000. This is the combined information contained in Table 26, Table 27, and Table 28.

**Table 29—Application of \$1 Million Deduction Limitation for 1998-2000  
(Millions of Dollars)**

Year	(1) Total Compensation of Covered Employees	(2) Performance- Based Compensation	(3) Additional Deductible Compensation**	(4) Nondeductible Compensation
1998	48.5	20.9	4.0	23.6
1999	124.2	111.6	4.2	8.4
2000	260.9	241.0	3.5	16.5
<b>Total 1998-2000*</b>	433.6	373.5	11.7	48.5

\* Details may not add to totals due to rounding.

\*\* Additional deductible compensation is the amount of total compensation, minus performance-based compensation, not in excess of \$1 million.

It appears evident that the existence of the \$1 million deduction limitation had no effect on the total compensation provided to Enron executives. Based on information provided by Enron to the IRS, as shown in Table 29, above, total compensation for the top-five executives for 1998-2000 was \$433.6 million.<sup>2207</sup>

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<sup>2207</sup> Enron also paid compensation in excess of \$1 million to many employees not subject to the deduction limitation. The information regarding the top-200 most highly compensated employees provided by Enron to the Joint Committee staff indicates that 46 employees, 93

Enron intended certain of its compensation arrangements to qualify as performance-based for purposes of the deduction limitation, and treated substantial amounts of compensation as meeting this requirement. Based on information provided by Enron to the IRS, as shown in [link to table 4], above, performance-based compensation for 1999 and 2000 was comparable, 90 percent and 92 percent, respectively. In those years, seven percent and six percent, respectively, of total compensation of covered employees was not deductible. In the case of certain individuals, the amount of performance-based compensation was so great compared to total compensation that less than \$1 million of compensation was potentially subject to the deduction cap.

For 1998, however, performance-based compensation was only 43 percent of total compensation of covered employees, and 49 percent of the total compensation of covered employees was not deductible. This is due in large part to the compensation provided to two covered employees. The nondeductible compensation for those two employees was 82 percent of the total nondeductible compensation of all five covered employees. Seventy-six percent of the total compensation for those two employees was not deductible.

Although Enron treated substantial amounts of compensation as performance-based, the \$1 million deduction limitation does not appear to have had a significant impact on the overall structure of Enron's compensation arrangements. The arrangements that Enron considered to provide performance-based compensation were generally utilized prior to the enactment of the deduction limitation. Enron made certain modifications to its compensation arrangements in order to meet the Code's definition of performance-based compensation; however, these modifications were generally limited to relatively minor changes needed to meet the requirements rather than changes to the overall structure of its compensation arrangements. For example, in the case of bonuses, the Compensation Committee was advised by its outside consultants to establish a high enough "soft" target that could be approved by the shareholders so that whatever level of bonuses Enron ultimately paid would be within the target and thus would not fail to be performance based. It is possible that certain arrangements might not have been submitted for shareholder approval had this not been required in order to meet the requirements for performance-based compensation.

The Compensation Committee was required to take certain actions in order for compensation to qualify as performance-based. A review of the Compensation Committee minutes indicates that the deduction limitation was discussed from time to time, and the role of the Compensation Committee with respect to approval of performance targets was mentioned.<sup>2208</sup> In addition, the annual report of the Compensation Committee in proxy statements discussed the deduction limitation. While the deduction limitation was discussed in Compensation Committee meetings, it appears that more time was spent on broader compensation issues, such as overall

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employees, and all 200 top-paid employees received compensation in excess of \$1 million in 1998, 1999, and 2000 and 2001, respectively. This information is included in Appendix D to this Report.

<sup>2208</sup> See, e.g., Minutes of the Meeting of the Compensation Committee, at 2 (Feb. 9, 1998).

compensation targets. One former member of the Compensation Committee interviewed by the Joint Committee staff indicated he had no knowledge of the deduction limitation and did not remember it ever being discussed. This may be an indication that the limitation was not a significant concern for Enron.

The existence of the \$1 million deduction limitation did not prevent Enron from paying nondeductible compensation. From 1998 through 2001, \$48.5 million of nondeductible compensation was paid to covered employees.<sup>2209</sup>

Another aspect of the deduction limitation that can be observed from the review of Enron is the discrepancy between the operation of the limitation, which is based on generally applicable tax rules, and compensation as reported in Federal proxy statements. Proxy statements include a summary compensation table for covered employees (referred to as “named officers” under the securities laws) as well as other information regarding executive compensation.

Because of timing differences and other factors, compensation as reported for proxy purposes can vary significantly from compensation subject to the \$1 million deduction limitation. For example, because the deduction limitation applies when amounts would otherwise be deductible, compensation may be taken into account for purposes of the limitation at a different time that it is reported for proxy purposes. Restricted stock is an example of such a timing difference. For proxy purposes, the value of restricted stock is shown in the year the stock is granted,<sup>2210</sup> whereas restricted stock is taken into account for purposes of the deduction limitation when it is includible in income, i.e., as it vests. Salary and certain other compensation that is deferred may also be reported at a different time for proxy purposes than when it is taken into account under the deduction limitation. Income attributable to the exercise of stock options is also treated differently for proxy reporting purposes and tax purposes.

The securities laws requiring that certain compensation information be reported in the proxy statement and the Federal income tax laws have different purposes. Thus, each set of laws may appropriately treat items of compensation differently in order to accomplish their respective purposes. However, the difference in the treatment may cause confusion for persons who are attempting to determine the amount of nondeductible compensation from publicly available sources; it is not possible to make this determination based on proxy information.

The IRS is reviewing the application of the \$1 million deduction limitation to Enron for the years 1998 through 2001. Determining whether the requirements for performance-based compensation were in fact met involves extensive, labor intensive factual determinations. The Joint Committee staff has not attempted to duplicate the efforts of the IRS. Issues that would need to be addressed include an analysis of the total compensation of covered employees, terms of all plans and arrangements and individual compensation agreements, examining materials provided to shareholders for approval, and determining whether the Compensation Committee took required actions with respect to the compensation. As described above, there are a number

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<sup>2209</sup> See Table 29, above.

<sup>2210</sup> See e.g., 1998 Enron Corp. Proxy Statement, at 20.



of inconsistencies in the information provided by Enron regarding compensation, making the examination more difficult in this case.

### **Recommendations**

The Joint Committee staff believes that the \$1 million deduction limitation is ineffective at accomplishing its purpose, overrides normal income tax principles, and should be repealed. The concerns reflected in the limitation can be better addressed through laws other than the Federal tax laws.

The \$1 million deduction limitation reflects corporate governance issues regarding excessive compensation, rather than issues of tax policy.<sup>2211</sup> It is often difficult for tax laws to have the desired effect on corporate behavior.<sup>2212</sup> Taxpayers may simply choose to incur the adverse tax consequences rather than change their behavior. In Enron's case, due to the existence of net operating losses, the denial of the deduction may not have been an issue.

In Enron's case, the \$1 million deduction limitation appeared to have little, if any, effect on the overall level of compensation paid to Enron executives or the structure of compensation arrangements. To the extent that performance-based compensation is viewed as being a preferable form of compensation, some may argue that the \$1 million limitation was effective in the Enron case, because such a large part of compensation was structured to be performance-based. However, as noted above, the deduction limitation did not appear to be a motivating factor in the structure of Enron's compensation and the arrangements that it treated as performance-based (or similar arrangements) generally predated the enactment of the limitation. In addition, some may question whether the compensation was truly performance based, particularly given Enron's financial decline; to the extent the limitation affected Enron's compensation arrangements, it may have merely placed more emphasis on the desire to increase reported earnings.<sup>2213</sup>

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<sup>2211</sup> H.R. Rep. No. 103-111, at 646 (1993).

<sup>2212</sup> Another example of tax laws that are aimed at corporate governance issues are the golden parachute rules that limit the compensation that may be paid to certain employees due to the change of control of a company. Sec. 280G. Failure to comply with these rules results in a denial of the deduction to the company and the imposition of a 20 percent excise tax, payable by the employee. Sec. 4999. Commentators generally observe that the golden parachute rules have done little to affect the amount of compensation payable upon a change of control. Rather, the rules are often thought of as providing a road map as to how to structure compensation arrangements. It is not uncommon for employment agreements to provide that, in the event the employee is subject to the excise tax, the tax will be paid by the company, with a gross up to reflect the income tax payable as a result of the employer's payment of the tax.

<sup>2213</sup> See Part I. of Part One of this Report.