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]

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

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

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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.[4]

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.

[4] 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]

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

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

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

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)

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

Notes:
(1) Financial accounting income does not reflect the reversal of many of the reported income amounts due to Enron's bankruptcy filing; (2) Source information for projected financial accounting income is the November Structured Transactions Group Summary of Project Earnings & Cash Flows, November 2001 contained in Appendix B to 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.