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.[5] 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.[6] 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.[7]

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[5] 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.

[6] 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.

[7] 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.

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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.[8] 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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[8] 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.[9] 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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[9] 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).