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).

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[10]

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[11]

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[12]

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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[10] 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.

[11] 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.

[12] 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[13]

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[14]

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

[14] 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[15]

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[16]

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[17]

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[18]

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

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

[17] 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.

[18] 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[19]

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[20]

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

[20] 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[21]

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[22]

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

[22] 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[23]

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.

[23] 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[24]

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.

[24] 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[25]

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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[25] 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 recordkeeepers, 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 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 it 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.[26] 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 given to whether rabbi trusts are appropriate for deferred compensation and whether the rules relating to such arrangements

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[26] *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.[27] 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 was11 percent of total compensation).[28] Given Enron's net operating loss carryovers, the

[27] 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.

[28] 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.

nondeductiblity 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.