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").[184] 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.[185]

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.[186] 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.[187] In some of the structured transactions,

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[184] The commodity prepay transactions are discussed in more detail later in this Part of the Report.

[185] 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.

[186] 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.

[187] 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,

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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.[188] 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.[189]

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.

[188] 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 in 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).

[189] 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.[190] 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.[191]

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.[192] 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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[190] 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.

[191] 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.

[192] 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[193] 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.[194]

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."[195] 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.[196] 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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[193] 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.

[194] The "should" level requirement was added after the first two structured transactions. Those transactions received "more likely than not" tax opinions.

[195] 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.

[196] 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.[197]

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."[198]

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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[197] 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.

[198] 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]

Project Name	Financial Accounting Income through 2001	Total Projected Financial Accounting Income	Federal Tax Savings through 2001	Total Projected Federal Tax Savings	Promoter	Primary Tax Opinion Provider	Total Project Fees
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	---	---	---
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, 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.