D. Other Structured Transactions

1. Project Apache

Brief overview

Project Apache was a financing arrangement in which the Enron group borrowed funds from third-party foreign lenders. By channeling this third party borrowing through an Enron controlled foreign corporation and blending this borrowing with debt that the Enron group owed itself, the Enron group sought to claim U.S. tax deductions not only for interest paid on the third-party debt, but also for the interest paid to itself, without triggering any offsetting income inclusion on the Enron controlled foreign corporation's receipt of such interest. Viewed another way, the transaction was intended to generate deductions on the Enron U.S. consolidated return in an amount roughly equal to the entire cash flow paid by Enron to the third-party lenders -- not only the interest, but also the repayment of principal. The third-party borrowing also was designed to be treated as "mezzanine," or minority interest financing for financial reporting and rating agency purposes, notwithstanding its characterization as debt for U.S. Federal income tax purposes.

In general terms, the transaction involves a U.S. corporation and its unrelated foreign lenders indirectly establishing and funding a Dutch entity that in turn lends its funds indirectly to the U.S. corporation. The U.S. corporation indirectly contributes 60 percent of the cash in exchange for common ownership units representing 60 percent of the value of the entity, and the foreign lenders indirectly contribute 40 percent of the cash in exchange for preferred ownership units representing 40 percent of the value of the entity. The terms of the ownership units ensure that no earnings can be distributed on the U.S. corporation's common units while the foreign lenders' preferred units remain outstanding. The preferred units are redeemable at the option of the Dutch entity and are entitled to cumulative preferred distributions out of retained earnings and to a liquidation preference equal to the foreign lenders' initial investment in the Dutch entity.

The Dutch entity lends nearly all of its funds indirectly to the U.S. corporation, which deducts all of the interest on this debt on its U.S. tax return.[660] In view of the relative cash contributions to the Dutch entity, 60 percent of this debt is effectively owed by the U.S. corporation to itself, and 40 percent represents borrowing by the U.S. corporation from third parties.

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[660] In Enron's case, as explained in further detail below, the bulk of these deductions took the form of factoring deductions arising from purported sales of trade receivables to a financial asset securitization investment trust ("FASIT"). The discounts that generated the factoring deductions may be regarded as equivalent to interest, since the factoring transactions, to the extent that they had any significant non-tax effect, were economically similar to short-term secured borrowings (cf. Treas. Reg. sec. 1.861-9T(b)(3)(i), treating factoring discounts as interest expense for sourcing purposes). As explained below, this form was chosen in an effort to avoid the restrictions of section 163(j).

The Dutch entity is treated as a controlled foreign corporation, which ordinarily would entail current U.S. taxation of the entity's passive type earnings under subpart F. The interest that the Dutch entity receives indirectly from the U.S. corporation is subpart F income, and the Dutch entity's debt investment normally would be subject to the deemed repatriation rules of section 956. However, since the terms of the ownership units and the earnings of the Dutch entity are structured and managed in such a way as to render it impossible for any earnings of the Dutch entity to be distributed to the U.S. corporation, the U.S. corporation takes the position that none of the entity's subpart F income is allocable to the U.S. corporation, and that there is no deemed repatriation of earnings to the U.S. corporation under section 956. In other words, the parties effectively seek to specially allocate all adverse subpart F consequences to the foreign lenders, who are indifferent to it because subpart F does not apply to them.

When the transaction is unwound, the redemption of the foreign lenders' preferred units (i.e., the repayment of their principal) is treated under the terms of the instruments as a distribution of the Dutch entity's remaining undistributed earnings (i.e., the rest of the interest income received indirectly from, and deducted by, the U.S. corporation). The U.S. corporation takes the position that this elimination of the preferred units also eliminates all of the Dutch entity's earnings and profits for U.S. tax purposes, allowing the U.S. corporation to liquidate the entity without any recognition of income.

In sum, by effectively allocating all of the principal repayment on the combined debt to the U.S. corporation's common units and all of the interest payments on the combined debt to the foreign lenders' preferred units, the U.S. corporation ultimately claims U.S. tax deductions approximating the entire cash flow from its group to the foreign lenders -- both interest and principal -- while making no offsetting income inclusions under subpart F or otherwise.

Background[661]

Purported tax and financial statement effects

Project Apache was projected to increase Enron's financial net income by $167 million over the years 1999-2006. Ultimately, according to the company, the transaction increased financial net income by $50.7 million ($11.3 million, $20.6 million, and $18.8 million for 1999, 2000, and 2001, respectively) before the company declared bankruptcy at the end of 2001. This increase in financial net income was attributable to the tax benefit of interest and receivables factoring deductions that were not offset on the company's tax return by subpart F inclusions or other potential tax liabilities.

On its 1999 return, the company claimed $47.6 million of factoring deductions and $33 million of interest deductions on short-term debt, for a total of $80.8 million of deductions for the year in connection with the transaction. On its 2000 return, the company claimed $110.5 million of factoring deductions and $49.9 million of interest deductions on short-term debt, for a

[661] The Joint Committee staff obtained this information through interviews of Robert Hermann, James A. Ginty, and R. Davis Maxey, as well as from documents and materials provided by Enron Corp.

total of $160.5 million of deductions for the year in connection with the transaction. Sixty percent of these amounts were effectively circular -- i.e., paid by the Enron group to itself.

In addition, the Enron group's net borrowing in the amount of $500 million, which was treated as debt for U.S. tax purposes, was treated as minority interest, or "mezzanine" financing, for financial statement and rating agency purposes.

Development of Project Apache

The idea for Project Apache was brought to Enron by Chase Securities, an affiliate of Chase Manhattan Bank, in mid-1998. Mr. Hermann named the transaction after a favorite golf course in Arizona.[662]

As originally proposed, the transaction involved direct lending by the Dutch controlled foreign corporation to Enron.[663] After a concern was raised that interest on a direct loan might be subject to the restrictions of section 163(j), the transaction was redesigned to direct the loan through a FASIT, with the FASIT borrowing from the Dutch controlled foreign corporation and using the borrowed funds to purchase trade receivables from Enron affiliates, effectively loaning the funds to Enron based on the security of the receivables.[664] The transaction was structured to designate a third party as the owner of the FASIT, and Enron was able to take the equivalent of interest deductions largely in the form of receivables factoring deductions.

On September 25, 1998, a presentation was made to management regarding the transaction. The transaction was approved by a corporate officer of Enron, and Enron's Board of Directors' Executive Committee approved the transaction on November 2, 1998. At a meeting on December 8, 1998, Enron's full Board of Directors approved and ratified the transaction. Mr. Maxey and Mike Herman were instructed to execute the transaction.

Implementation of Project Apache

Blending third-party and related-party lending through controlled foreign corporation

In May of 1999, Enron Corp. transferred $748.5 million to Seminole Capital, LLC ("Seminole"), a newly formed Delaware limited liability corporation, in exchange for a 99.8 percent ownership interest in Seminole. The Lucelia Foundation, a New York not-for-profit

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[662] Joint Committee staff interviews.

[663] Memorandum from R. Davis Maxey to Robert J. Hermann, with transaction diagram, June 23, 1998, EC2 000037282, EC2 000037285; Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (*see* Appendix B, Part X to this Report).

[664] Joint Committee staff interviews; Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (with the words "163(j) issue" written by hand on a copy of a diagram showing direct lending by the controlled foreign corporation to Enron) (*see* Appendix B, Part X to this Report).

corporation unrelated to Enron, transferred $1.5 million to Seminole in exchange for a 0.2 percent ownership interest. Seminole was treated as a partnership for U.S. Federal income tax purposes.

Seminole in turn transferred its $750 million to Cheyenne Finance SARL ("SARL"), a newly formed Luxembourg company, in exchange for the entire equity interest in SARL. SARL was treated as a corporation for U.S. Federal income tax purposes and was a controlled foreign corporation as defined in section 957.

Rabo Merchant Bank N.V. ("Rabo"), a Dutch bank unrelated to Enron, transferred $15 million to Choctaw Investors B.V. ("Investors B.V."), a newly formed Dutch company, in exchange for all of the Investors B.V. common stock. Investors B.V. then borrowed $485 million from a syndicate of mostly foreign banks.

SARL and Investors B.V. then formed Cherokee Finance VOF ("Dutch VOF"), a Dutch entity treated as a partnership for tax purposes in both the Netherlands and Luxembourg. SARL transferred its $750 million to Dutch VOF in exchange for all of the "common" ownership units of Dutch VOF (the "Common Units"). Investors B.V. transferred its $500 million to Dutch VOF in exchange for all of the "preferred ownership units of Dutch VOF (the "Preferred Units").[665] The holder of the Common Units had the right to elect two out of the three directors of Dutch VOF, and the holder of the Preferred Units had the right to elect one director. Pursuant to an election under the "check the box" regulations, Dutch VOF was treated as a corporation for U.S. Federal income tax purposes. Dutch VOF also was a controlled foreign corporation as defined in section 957, because Enron Corp. (through Seminole and SARL) indirectly owned more than 50 percent of the Dutch VOF stock.

The Common Units held indirectly by Enron Corp. could not receive any distributions of earnings while any of the Preferred Units remained outstanding. The Preferred Units had an initial liquidation preference of $500 million, as well as the right to a floating-rate cumulative preferred distribution out of retained earnings equal to a percentage of the liquidation preference, as declared by the Board of Directors. The Preferred Units were subject to redemption at a stated date ten years from issuance, at which time any outstanding units would be redeemed for their liquidation preference. Dutch VOF also had the right to redeem the Preferred Units in whole or in part at any time, again for the units' liquidation preference. The initial $500 million liquidation preference would be increased by the amount of any accrued but unpaid preferred distributions and would be decreased by the amount of any redemption proceeds received.

<u>Generating receivables factoring and interest deductions through FASIT transactions</u>

Of the $1.25 billion that Dutch VOF possessed immediately upon its formation by SARL and Investors B.V., Dutch VOF invested $1.23 billion in monthly senior debt obligations (the "Interim Notes") of Sequoia Financial Assets, LLC, a FASIT (the "FASIT"). When each Interim Note matured and was repaid, Dutch VOF would reinvest the proceeds in another Interim Note.

[665] This $500 million represented Enron's net third-party borrowing in the transaction and was treated as minority interest financing for financial accounting purposes.

Dutch VOF earned interest on the Interim Notes in the form of short-term original issue discount. The FASIT in turn effectively loaned the Interim Note proceeds to Enron at the beginning of each month by making discounted purchases of third-party trade receivables from Enron North America and Enron Power Marketing, domestic affiliates of Enron Corp.[666] In cases in which the FASIT received payment on the receivables prior to the end of the month, these funds were used to purchase Enron North America commercial paper from Enron Corp. The transactions between Enron Corp. and its affiliates and the FASIT generated factoring deductions on the Enron consolidated return (reflecting the discount on the sales of the receivables), as well as interest deductions with respect to the commercial paper.

The "owner interest" in the FASIT was held by Ojibway, Inc., a domestic corporation unrelated to the Enron group. Ojibway contributed $2 million to the FASIT for this interest. Enron Corp. contributed $50 million to the FASIT in exchange for a subordinated interest in the FASIT.[667] Enron's interest in the FASIT was treated as a "regular interest" under the FASIT rules. The $1.23 billion Interim Notes held by Dutch VOF also were characterized as "regular interests" under the FASIT rules. Enron Corp. acted as the servicer of the FASIT. In this capacity, Enron Corp. not only handled the accounting, billing, collection, and other administrative functions with respect to the receivables sold by its affiliates to the FASIT, but also held the receivables and other assets of the FASIT and administered the monthly reinvestment program described above.

Intended exit strategy and net effects of transaction

At the time of the transaction, it was anticipated that Dutch VOF would exercise its right to redeem the Preferred Units of Investors B.V. in 2006, and that Dutch VOF and SARL would be liquidated immediately thereafter. Since all of Dutch VOF's earnings and profits (i.e., the interest paid by the FASIT) would have been allocated to the Preferred Units, the company would take the position that the redemption of the Preferred Units eliminated Dutch VOF's earnings and profits, and thus that Dutch VOF and SARL could be liquidated tax-free. In order to achieve this characterization, the redemption of the Preferred Units had to be treated as a dividend for U.S. tax purposes. In furtherance of this goal, Seminole had been granted an option to purchase all of the outstanding shares of Investors B.V. from Rabo. This option was intended to make Enron Corp. the "owner" of all of the stock of Investors B.V. and Dutch VOF under the constructive ownership rules of section 318(a)(4), such that the redemption of Investors B.V.'s Preferred Units would be treated as a dividend under section 302 and would eliminate Dutch VOF's earnings and profits.

Over the 7 years that the project was intended to have been in place, the structure would have generated receivables factoring and interest deductions on the Enron group's U.S.

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[666] The receivables arose primarily from Enron North America's natural gas and electric power businesses. The collection rate on these receivables exceeded 98 percent. "Discussion Material for Sequoia Financial Asset Trust," Mar. 2, 1999, at EC2 000037245.

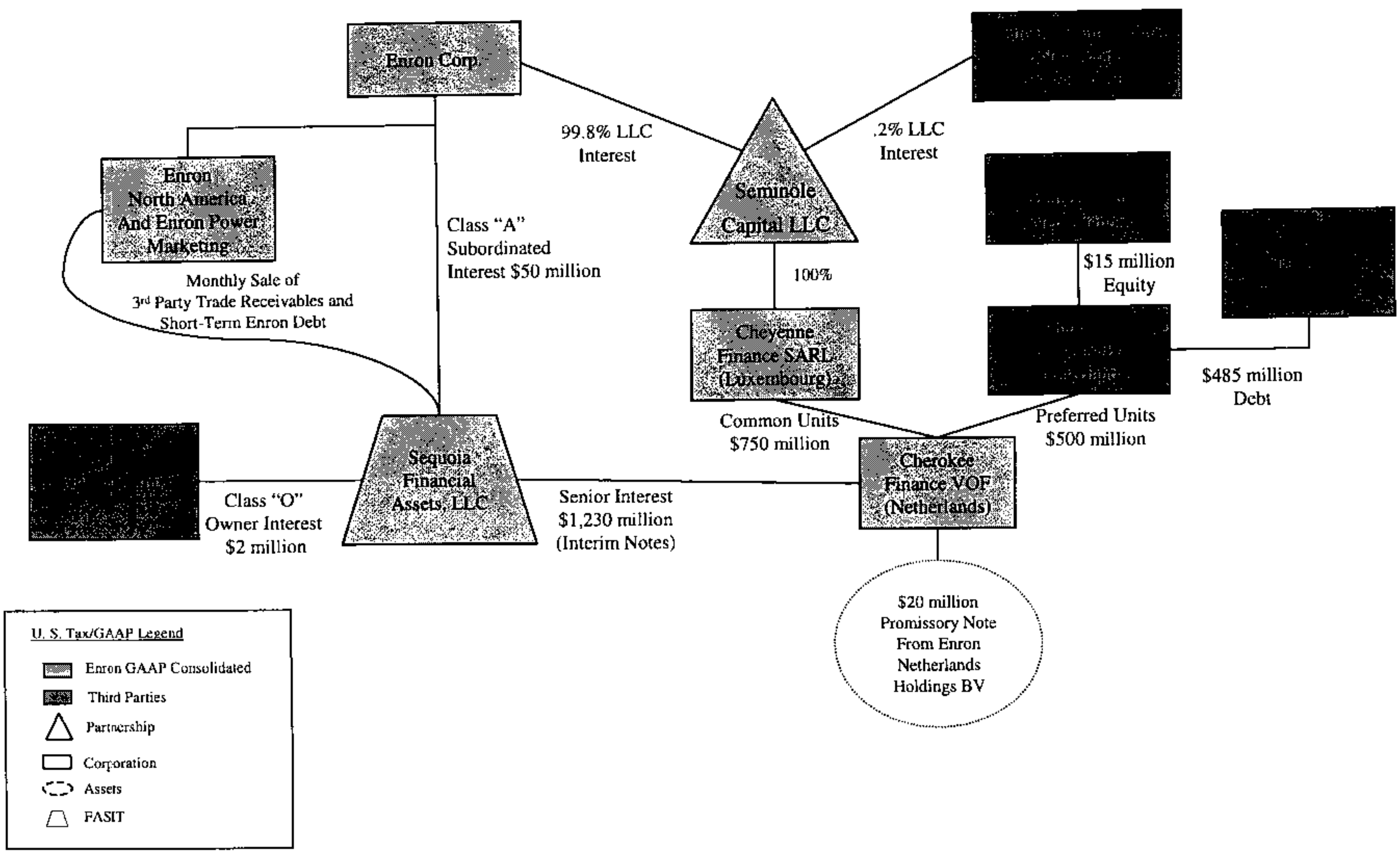
[667] Enron's subordinated interest was intended to insulate Dutch VOF, and hence the third-party foreign lenders, from credit risk on the receivables.

consolidated return approximating the entire cash flow from the Enron group to the unrelated foreign lenders. As it happened, the transaction generated $80.8 million and $160.5 million of such deductions for 1999 and 2000, respectively. These annual deductions were expected to increase gradually through 2006, thus generating deductions at least equal to the principal and interest on the $500 million that the Enron group borrowed from third parties in the transaction. It was intended that this benefit be unmitigated by any offsetting U.S. tax under subpart F or otherwise, despite the fact that 60 percent of the debt in the structure, or $750 million, constituted a circularity in the sense that it was owed by the Enron group to itself.

The diagram on the following page depicts the Project Apache structure.

Confidential

Project Apache
Structure as of May 28, 1999



Role of outside advisors

As noted above, Chase Manhattan Bank promoted the transaction to Enron. Chase Manhattan personnel presented the idea to Messrs. Hermann and Maxey in a meeting and gave them promotional materials.

Shearman & Sterling provided a "should" opinion as to the key intended tax consequences of the transaction, in particular the treatment of the transaction under subpart F, the characterization of various instruments as debt or equity, and the appropriateness of respecting the form of the transaction rather than disregarding it as an economic sham.

Shearman & Sterling also provided a separate tax opinion as to issues relating to the use of the FASIT in the transaction, including qualification as a FASIT ("will" opinion), treatment of Ojibway as the owner of the FASIT ("will" opinion), treatment of the receivables transactions as true sales ("should" opinion), the inapplicability of section 163(j) ("should" opinion), and the inapplicability of U.S. withholding tax on interest paid by the FASIT to Dutch VOF ("should" opinion). This latter opinion letter also included a separate "comments" section that addressed other issues, including the potential treatment of the FASIT as the originator of debt.

As of June 2001, Enron had paid over $14 million in fees in connection with the transaction, including $10,362,038 to Chase Manhattan, $2,070,000 in "syndicate bank fees" relating to various administrative costs of concluding the transaction, $1,108,940 to Shearman & Sterling for its U.S. tax opinions, and $300,000 to Freshfields LLC for a foreign-law opinion, among other fees.[668]

Appendix C, Part IX to this Report contains the tax opinions that Enron received in connection with Project Apache.

Subsequent developments

On January 13, 2003, the company advised the Joint Committee staff that no steps had been taken to unwind the Project Apache transaction structure, but that the parties had stopped cycling cash through the structure since Enron's bankruptcy filing.[669]

Following the bankruptcy filing, JP Morgan Chase Bank (the successor to Chase Manhattan Bank) exercised its right under the Dutch VOF organizing documents to appoint a majority of Dutch VOF's directors. JP Morgan Chase also initiated litigation against Enron on behalf of Dutch VOF and its investors, seeking the turnover of $2.1 billion of accounts receivable, commercial paper, cash, and other property that JP Morgan Chase believes is still

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[668] Enron Estimated Structured Transaction Project Fees as of June 4, 2001, EC2 000036379 (*see* Appendix B, Part I to this Report).

[669] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, Jan. 13, 2003, answer 74.

held by Enron in its capacity as servicer of the FASIT.[670] JP Morgan Chase claims that this property is not part of the Enron bankruptcy estate and fears dissipation of the assets if they remain in Enron's hands.

<u>Discussion</u>

<u>In general</u>

In order for Project Apache to provide the tax benefits intended, a number of different issues would have to be resolved in Enron's favor. First, the transaction would have to survive scrutiny under the judicial doctrines applicable to tax-avoidance transactions, despite the obvious tax motivation and large circular flow of cash at the heart of the transaction.[671] Second, the intended allocation of all of Dutch VOF's earnings and profits to the Preferred Units for subpart F purposes[672] would have to be sustained, in order for Enron to avoid current income inclusions under subpart F. Third, the receivables factoring and interest deductions arising from the FASIT transactions would have to be allowed, despite the tax motivation for the use of the FASIT and its close relationship to Enron.

<u>Judicial doctrines and the circular flow of cash</u>

The intended tax benefits of Project Apache arguably should be denied on the grounds that the bulk of the transaction lacked economic substance and non-tax business purpose. The overall transaction undoubtedly had a significant tax motivation, and in particular the circular flow of cash in the form of $750 million of debt (and the interest thereon) owed by the Enron group to itself appears to have lacked both economic substance and non-tax business purpose. Instead, this self-owed debt seems to have been created solely for the purpose of blending it with the third-party debt through Dutch VOF in order to generate interest and interest equivalent

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[670] Since the assets are under Enron's control, JP Morgan Chase could not be sure of the amount and composition of the assets and thus based its complaint on an estimate. The complaint thus also seeks a full and complete accounting of the assets. Complaint, *JP Morgan Chase Bank v. Enron Corp., et al.*, Chapter 11 Case No. 01-16034 (AJG), Adversary Proceeding No. 01-03637 (Bankr. S.D. N.Y.), Dec. 11, 2001, EC2 000054744.

[671] For detailed information on the present-law rules and judicial doctrines applicable to tax-avoidance transactions and related recommendations and developments, *see e.g.*, Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters* (JCX-19-02), March 19, 2002; Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including provisions relating to Corporate Tax Shelters)* (JCS-3-99), July 22, 1999; Temporary Treasury regulations (T.D. 9017) to section 6011 (October 22, 2002); Temporary Treasury regulations (T.D. 9018) to section 6012 (October 22, 2002); Joint Committee on Taxation, *Description of the "CARE Act of 2003,"* (JCX-04-03), February 3, 2003; Symposium: *Business Purpose, Economic Substance and Corporate Tax Shelters*, 54 SMU L. Rev. 1 (2001).

[672] *See* Treas. Reg. sec. 1.951-1(e)(2).

deductions in excess of those attributable to the third-party debt, while at the same time avoiding any of the offsetting income inclusions that normally apply. To the extent that the receivables factoring and interest deductions claimed by Enron are attributable to this circularity, they arguably should be denied as lacking economic substance and non-tax business purpose. Since this debt accounted for 60 percent of the overall debt in Project Apache, it could reasonably be argued that 60 percent of the deductions claimed by Enron in connection with the structure should be denied.

According to Enron, the non tax business purposes of Project Apache were to raise $500 million of outside financing that would qualify as minority interest financing for financial accounting and rating agency purposes, as well as to manage the trade receivables generated in the course of its affiliates' gas pipeline and electric power wholesale businesses by engaging in factoring transactions.

With respect to the first purpose cited, even if managing financial statement presentation and rating agency evaluations are found to constitute a valid business purpose, this purpose can justify only part of the transaction. This purpose fails to account for the complex and unusual manner in which Enron went about raising $500 million of minority interest financing. Indeed, this purpose fails to account for the majority of the debt involved in the transaction -- the business need to raise $500 million of outside financing does not explain the inclusion of $750 million of intra-group debt in the same structure. The only evident explanation for the use of the intra-group debt relates to the intended tax benefits of the transaction.

The receivables factoring business purpose cited also seems unconvincing. According to Enron tax department personnel interviewed by the Joint Committee staff, Enron did not even consider including trade receivables in the transaction until it concluded that the initial transaction design, which involved a more straightforward loan from Dutch VOF to Enron, was vulnerable to attack under section 163(j), which denies deductions for certain interest on related-party debt.[673] Thus, a tax-motivated transaction structure that did not involve any trade receivables was designed first, and the later inclusion of the receivables and use of the FASIT served the primary purpose of reducing one of the perceived tax risks in the transaction.

Moreover, to the extent that the factoring transactions were ultimately financed 60 percent by intra-group debt, the transactions cannot be said to have achieved the same non-tax effects as factoring transactions with unrelated parties. Factoring transactions generally serve the purpose of accelerating the conversion of trade receivables into cash, thus increasing liquidity and decreasing credit exposure. To the extent that a company effectively advances the bulk of the cash in a factoring transaction to itself and retains an indirect interest in the receivables, these benefits are not realized.

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[673] *See also* Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (with the words "163(j) issue" written by hand on a copy of a diagram showing direct lending by the controlled foreign corporation to Enron) (Appendix B, Part X to this Report).

In sum, while the matter is not free from doubt, the Joint Committee staff believes that a strong argument could be made to deny the intended tax benefits of Project Apache under longstanding judicial doctrines addressing tax-motivated transactions.

Avoidance of subpart F and other potential offsetting tax liabilities

Allocation of subpart F income away from Enron.–The deductions generated by Project Apache would confer no net tax benefit to Enron if they were offset by subpart F inclusions. Under section 951(a), a U.S. shareholder of a controlled foreign corporation generally must include in income its pro rata share of the corporation's subpart F income for the year, as well as its pro rata share of the corporation's deemed repatriations for the year determined under section 956. Enron Corp., as an indirect 60-percent shareholder of Dutch VOF, which was a controlled foreign corporation, ordinarily would have been subject to current U.S. tax with respect to 60 percent of Dutch VOF's subpart F income. Dutch VOF's interest income was treated as subpart F income, and thus, under normal circumstances, it would be expected that Enron Corp. would include 60 percent of this interest income on a current basis for U.S. tax purposes. This of course would have the effect of offsetting 60 percent of the deductions generated in the transaction, thus eliminating the intended tax benefit. This treatment would, however, comport with the overall economics of the transaction, given that 60 percent of the total lending in Project Apache was a self-owed circularity.

Enron sought to avoid these current subpart F inclusions by structuring Dutch VOF's ownership instruments in such a way as to allocate all of the earnings and profits to the Preferred Units held by Investors BV, and none of the earnings and profits to the Common Units held by SARL, and thus indirectly by Enron. In determining a shareholder's pro rata share of subpart F income in cases involving multiple classes of stock, Treas. Reg. section 1.951-1(e)(2) provides that the subpart F income attributable to a class of stock is that proportion of the controlled foreign corporation's total subpart F income that the earnings and profits distributable to such class in a hypothetical year end distribution of all of the corporation's earnings and profits would bear to the corporation's total earnings and profits. Since Dutch VOF's ownership instruments provided that no earnings distributions could be made on the Common Units as long as any Preferred Units remained outstanding, Enron took the position that the Common Units would be entitled to no distribution at all in a hypothetical distribution of all of Dutch VOF's earnings and profits in any particular year, and thus that none of Dutch VOF's subpart F income was allocable to the Common Units (and thus to Enron Corp.) under Treas. Reg. section 1.951-1(e)(2). Even if Dutch VOF's right to redeem the Preferred Units were taken into consideration in this analysis, Enron took the position that the result would not change, on the basis that even a complete redemption of the Preferred Units would be treated as a dividend distribution by reason of the option attribution arrangement described above in connection with Enron's intended exit strategy.

The allocation method applicable to subpart F income also applies in the case of section 956 inclusions, and thus Enron took the same allocation position with respect to both subpart F income and section 956 inclusions.

Enron found support for this allocation position in the case of *Barnette v. Commissioner*,[674] a memorandum opinion of the Tax Court addressing a similar issue that arose under the foreign personal holding company regime.[675] The issue was one of 15 issues decided in the case, which addressed several tax years of an individual who had been convicted of both tax fraud and government contracting fraud in connection with the foreign business arrangements at issue.[676] The present discussion of the case is limited to the issue pertinent to Enron's subpart F position in Project Apache.

Among other tax reduction strategies, the taxpayer in the *Barnette* case arranged for a Panamanian foreign personal holding company that he controlled to issue a new class of preferred stock, with a conceded purpose of deflecting foreign personal holding company income away from himself. As in Project Apache, the terms of the ownership instruments provided that no distributions could be made on the taxpayer's common stock while the preferred stock remained outstanding. Under the applicable Treasury regulation, if a foreign personal holding company has outstanding both preferred and common stock, and the preferred stock is entitled to a specified dividend before any distribution can be made on the common stock, foreign personal holding company income is treated as being distributed first with respect to the preferred shares.[677] Thus, like Enron under the subpart F multiple-classes-of-stock regulation, the taxpayer in *Barnette* took the position that none of the "tainted" foreign income was allocable to the common shares that he held. The IRS, on the other hand, contended that all such income should have been allocated to the taxpayer's common shares, since there was no reason for the creation of the preferred shares other than tax avoidance.

The court ruled in favor of the taxpayer on this issue, sustaining his allocation of foreign personal holding company income away from himself under the regulation, despite the acknowledged tax motivation for the issuance of the preferred stock and related transactions. The court concluded that, even if the sole purpose for creating and transferring the preferred stock were tax avoidance, the stock's existence still could not be ignored. Since the transactions at issue altered the taxpayer's financial position, the court decided that no non-tax business purpose was necessary. In other words, the court seems to have concluded that the foreign personal holding company income allocation regulation was to be applied literally, and its results

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[674] 63 T.C.M. (CCH) 3201 (1992), *reh'g denied*, 64 T.C.M. (CCH) 998 (1992).

[675] The foreign personal holding company regime (secs. 551-558) is an anti-deferral regime that preceded subpart F, and that now has been largely supplanted by it. Under coordination rules applicable for taxable years of U.S. shareholders beginning after July 18, 1984, subpart F generally trumps the foreign personal holding company regime. Sec. 951(d). During the taxable years at issue in the *Barnette* case, however, the foreign personal holding company rules generally trumped the subpart F rules. Sec. 951(d), prior to amendment by P.L. 98-369.

[676] The case also involved several tax years of the individual's company and certain members of his family.

[677] Treas. Reg. sec. 1.551-2(c).

respected, even with respect to a tax-motivated structure entirely lacking any non-tax business purpose.

Given the similarities between the foreign personal holding company issue raised in the *Barnette* case and the subpart F issue raised in Project Apache, the *Barnette* case arguably lends support to Enron's position that none of Dutch VOF's subpart F income should be allocated to Enron, regardless of the tax motivation behind the structuring of the ownership instruments. Nevertheless, if the issue were litigated, a court would approach the issue de novo and accord the *Barnette* case little or no precedential weight. As a memorandum opinion (as opposed to a "regular," or "T.C." opinion) of the Tax Court, the case is not regarded as controlling precedent by any court, including the Tax Court itself.[678] Memorandum opinions are generally limited to their specific facts; if a case raises novel legal issues, the Tax Court generally issues a "regular" opinion, which the court then regards as controlling precedent.

Thus, a court determining how to apply Treas. Reg. section 1.951-1(e)(2) to Enron and Dutch VOF would be free to analyze the issue on its own merits and would not be bound by the earlier memorandum decision of the Tax Court applying Treas. Reg. section 1.551-2(c) to the taxpayer in *Barnette*. On this basis, it is impossible to predict how a court might resolve the issue. A literal application of the regulation to the carefully structured ownership instruments of Dutch VOF appears to yield the results intended by Enron. However, it is possible that a court would sustain an argument along the same lines advocated by the IRS in the *Barnette* case. In other words, a court might conclude that the transaction was structured to generate tax benefits not intended by the Congress, that there was no significant non-tax business purpose for the complex manner in which the transaction was structured, and that the subpart F income allocation sought by Enron would violate the purpose of subpart F and would abuse the rule set forth in Treas. Reg. section 1.951-1(e)(2), thus requiring an allocation of some subpart F income to Enron.

A court might reach this conclusion on a somewhat narrower basis by disregarding Seminole's option to purchase the Investors B.V. stock as lacking any non-tax business purpose. The court then could apply the hypothetical of Treas. Reg. section 1.951-1(e)(2) by treating Dutch VOF's redemption right as exercised, and treating the hypothetical redemption of the Preferred Units as a sale instead of a dividend distribution, which in turn would leave earnings and profits distributable to the Common Units in a hypothetical year-end distribution, thus requiring an allocation of subpart F income to Enron.

<u>Avoidance of other potential offsetting tax liabilities.</u>–Subpart F was the main, but not the only, potential source of U.S. tax that needed to be avoided in order for Project Apache to generate the net tax benefits intended. For example, if the interest paid to Dutch VOF had been subject to U.S. withholding tax, then the transaction would not have been worthwhile, even if the other tax issues raised by the transaction were resolved in Enron's favor. In this regard, Enron took the position that no withholding tax applied, principally because the interest earned by

[678] *See, e.g., Darby v. Comm'r*, 97 T.C. 51, 67 (1991); *Nico v. Comm'r*, 67 T.C. 647, 654 (1977), aff'd in part and rev'd in part on other grounds, 565 F.2d 1234 (2d Cir. 1977); *McGah v. Comm'r*, 17 T.C. 1458 (1952).

Dutch VOF on the Interim Notes took the form of short-term original issue discount, which is exempt from withholding tax.[679]

Another potential U.S. tax problem for the structure, the passive foreign investment company regime,[680] was avoided by reason of Dutch VOF's status as a controlled foreign corporation, and Enron's status as a U.S. shareholder of Dutch VOF. Under section 1297(e), which Congress enacted in 1997 to address the overlap of the passive foreign investment company rules and subpart F, a controlled foreign corporation generally is not also treated as a passive foreign investment company with respect to a U.S. shareholder of the corporation. Thus, even though Enron took the position that it would not be allocated any of Dutch VOF's subpart F income, Enron's status as a U.S. shareholder of Dutch VOF within the meaning of section 951(b) nevertheless exempted Enron from the application of the passive foreign investment company rules in connection with Dutch VOF.

Use of a FASIT to avoid earnings stripping rules

As explained above, Project Apache as originally conceived did not involve the use of a FASIT. Rather, the original transaction design would have used direct lending by Dutch VOF to Enron to cycle funds through the structure and generate the desired deductions.[681] Only after a concern was raised that the interest on such a direct loan might be subject to disallowance under section 163(j) was the transaction redesigned to direct the loan through a FASIT.[682] Since the limits of section 163(j) generally apply only to interest paid between related parties, Enron took the position that interposing an unrelated FASIT between itself and Dutch VOF rendered those limits inapplicable. The FASIT rules[683] in turn made it possible for Enron to place a relatively small "owner interest" in the FASIT with an unrelated party, and thereby to take the position that the FASIT was unrelated to Enron, despite the fact that Enron: (1) was the largest investor in the

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[679] Sec. 871(g)(1)(B). Even if the interest did not qualify as short-term original issue discount, the portfolio debt exception of section 881(c)(2)(B) might have shielded the interest from withholding taxes. In addition, U.S. income tax treaties with the Netherlands and Luxembourg arguably would have provided a further backstop against the imposition of withholding tax.

[680] Secs. 1291-1298.

[681] Memorandum from R. Davis Maxey to Robert J. Hermann, with transaction diagram, June 23, 1998, EC2 000037282, EC2 000037285; Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (*see* Appendix B, Part X to this Report).

[682] Joint Committee staff interviews; Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (with the words "163(j) issue" written by hand on a copy of a diagram showing direct lending by the controlled foreign corporation to Enron) (*see* Appendix B, Part X to this Report).

[683] Secs. 860H - 860L.

FASIT; (2) exercised day-to-day control over the FASIT through the servicing arrangement; and (3) treated the FASIT as an Enron consolidated entity for financial reporting purposes.

Although the Treasury Department has never issued final regulations under section 163(j), a comprehensive set of proposed regulations was issued in 1991.[684] Under these proposed regulations, the IRS would have broad authority to disregard entities created with a principal purpose of avoiding section 163(j). Specifically, the proposed regulations provide that "[a]rrangements, including the use of partnerships and trusts, entered into with a principal purpose of avoiding the rules of section 163(j) and [the proposed regulations] shall be disregarded or recharacterized to the extent necessary to carry out the purposes of section 163(j)."[685]

In the case of Project Apache, it is clear from Joint Committee staff interviews with Enron personnel involved in planning the transaction, as well as from documentary evidence and the structure of the transaction itself, that the FASIT arrangement was established "with a principal purpose of avoiding section 163(j)." In addition, given that the arrangement was used to ensure that no interest or interest-equivalent deductions would be disallowed on what in substance was a related-party borrowing, and that Enron maintained that the payments in question were not subject to any offsetting Federal tax (e.g., withholding tax, or tax arising under subpart F), recharacterizing the transaction would "carry out the purposes of section 163(j)."[686] Thus, if the proposed regulation had applied to the transaction, the conditions for the application of the anti-avoidance rule would have been present.

Proposed regulations do not have the force of law, but taxpayers commonly use them as guidance and as indicators of the government's position on the issues addressed. In this case, Enron disregarded a proposed regulation that was directly on point and contrary to its return position.

The Shearman & Sterling opinion letter that addressed FASIT-related issues briefly discussed the proposed regulations and concluded that "the anti-abuse rule in the proposed regulations should not be applicable to disregard [the FASIT], because no principal purpose of the transaction is to avoid section 163(j)."[687] In light of the evidence that avoiding section 163(j) in fact was the principal purpose for using a FASIT in the first place, the Joint Committee staff finds this statement in the opinion letter troubling.

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[684] Prop. Reg. sec. 1.163(j)-1 *et seq.*

[685] Prop. Reg. sec. 1.163(j)-1(f).

[686] This issue, of course, would not be reached if it were determined that Dutch VOF's subpart F income was taxable to Enron, since the amounts then would be subject to Federal tax, canceling out the benefit of the interest deductions. Sec. 163(j)(3)(A).

[687] Letter from Shearman & Sterling to Enron Corporation and Cherokee Finance VOF c/o Rabobank Management B.V., May 28, 1999, at 10-11 (Appendix C, Part IX to this Report).

Although the analysis of the opinion letter is somewhat elliptical on this point, it implies that avoidance of section 163(j) could not have been a principal purpose of using the FASIT, since payments of interest directly from the obligors on the receivables (i.e., Enron's natural gas and electric power customers) to Dutch VOF would have been payments between unrelated parties, and thus would not have been subject to section 163(j).[688] Of course, the FASIT was not interposed in any larger lending transaction between Enron's customers and Dutch VOF; it was interposed in a larger lending transaction between Enron and Dutch VOF. The purported sales of trade receivables by Enron affiliates to the FASIT may be viewed as secured financings comprising merely one component of the larger financing arrangement -- in other words, Dutch VOF loaned funds to the FASIT, and the FASIT in turn effectively loaned the funds to Enron on the strength of the receivables. Viewed in this manner, the transaction may be understood as avoiding section 163(j), since the interest, if paid directly by Enron to Dutch VOF (and not subjected to Federal tax) potentially would have been subject to section 163(j). The opinion letter raises this possibility, and dismisses it, in a footnote.[689]

The opinion letter's explanation of the transaction is that "the principal purpose of the arrangement is to create a revolving securitization vehicle for accounts receivable generated by [domestic affiliates of Enron]."[690] Again, this declared purpose is implausible, given that the idea to use a FASIT in fact arose as a solution to a perceived section 163(j) problem, and that the structure did not generate the non-tax benefits (increased liquidity, decreased credit exposure) that normally accompany third-party factoring transactions, due to the circularity at the heart of the arrangement. The Joint Committee staff believes that, at a minimum, the opinion letter reflects an unquestioning reliance on company representations as to business purpose, as well as a failure to look beyond isolated parts of an overall transaction to evaluate it in its totality.

Notwithstanding these concerns about the opinion letter's analysis of the proposed regulations, the fact remains that the lack of final regulations on this issue, combined with the availability under the FASIT rules of an entity that Enron could control but treat as unrelated for tax purposes, enabled Enron to take the position that section 163(j) could be avoided through the expedient of interposing an additional entity.[691]

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[688] The opinion letter acknowledges that this reasoning would not apply to the Enron-group commercial paper held by the FASIT. The opinion letter instead downplays the importance of this debt, implying that it could not be significant enough to form "a principal purpose" of avoiding section 163(j). *Id.*, at 10-11.

[689] *Id.*, at 11, n.7.

[690] *Id.*, at 10.

[691] Subsequent to the closing of the transaction, the Treasury Department issued proposed regulations under the FASIT rules, which included a broad anti-abuse rule. Prop. Reg. sec. 1.860L-2 (Feb. 7, 2000). In view of the company's treatment of the anti-abuse rule provided in the proposed regulations under section 163(j), it would seem unlikely that a second anti-abuse rule in proposed form would have caused Enron or its advisors to reach a different conclusion as to the appropriateness of the use of the FASIT.

Recommendations

In general

As discussed above, Project Apache raises a set of familiar concerns encountered in connection with tax-motivated transactions, in particular issues relating to the economic substance and business purpose doctrines. In addition to these general concerns, however, the transaction also raises some specific issues regarding the potential abuse of particular statutory and regulatory provisions. The Joint Committee staff believes that amendments to some of these provisions should be considered in order to render them less prone to abuse in tax-motivated transactions.

Allocation of subpart F income

Project Apache exploited a highly mechanical earnings and profits allocation rule in Treas. Reg. sec. 1.951-1(e)(2) in an effort to achieve results that cannot have been envisioned or intended by the Treasury Department when it issued the regulation. The putative ability to allocate all of the subpart F income of Dutch VOF to tax indifferent foreign parties was critical to Enron's position that it could blend its third-party debt with self-owed debt within Dutch VOF in order to generate inflated interest and interest-like deductions without incurring any offsetting tax liability under subpart F. The transaction thus illustrates that special allocation abuses similar to those that have been encountered in the partnership taxation area[692] are also possible in the context of controlled foreign corporations. Enron took the position that it could specially allocate the subpart F "taint" to tax-indifferent parties, and it was able to find some support for this position under both the regulation and analogous non-subpart-F case law.

The Joint Committee staff believes that this tactic is inconsistent with the purposes of subpart F and that the results that it purports to produce are inappropriate. The Joint Committee staff recommends adding an exception to the subpart F income allocation method set forth in the regulation for cases involving allocations of earnings and profits to tax-indifferent shareholders, if such allocations are made for tax avoidance purposes. If such an exception had been applicable to Project Apache, the transaction would not have been viable.

Passive foreign investment company regime

Another concern raised by Project Apache involves the statutory elimination of the so-called overlap between the passive foreign investment company regime and the subpart F regime. In 1997, Congress enacted section 1297(e) in order to mitigate the complexity and uncertainty that arose when a foreign corporation met the definitions of both the controlled foreign corporation rules of subpart F and the passive foreign investment company rules, thus requiring shareholders to negotiate two sets of anti-deferral rules in connection with the same investment. Section 1297(e) largely eliminates this overlap by providing that a corporation generally is not treated as a passive foreign investment company with respect to a particular shareholder if the corporation is also a controlled foreign corporation, and the shareholder is a

[692] *See, e.g.*, sec. 704(b); Treas. Reg. sec. 1.704-1(b)(2) (addressing special partnership allocations that lack "substantial economic effect").

"U.S. shareholder" as defined in section 951(b). Thus, subpart F is allowed to trump the passive foreign investment company rules, and a U.S. shareholder generally no longer needs to contend with these rules in connection with the ownership of controlled foreign corporation stock.

As applied to Project Apache, section 1297(e) enabled Enron to claim exemption from the passive foreign investment company rules with respect to its ownership of Dutch VOF stock on the basis of Enron's subpart F status as a U.S. shareholder, despite the fact that Enron had implemented a structure designed to render it impossible for Enron to recognize any income under subpart F in connection with the stock. Thus, in a case in which Enron was a 60-percent U.S. shareholder of a foreign corporation with nothing but passive assets and passive income, Enron could take the position that neither subpart F nor the passive foreign investment company rules applied.

The Joint Committee staff believes that the exception to the passive foreign investment company rules for U.S. shareholders of controlled foreign corporations should be geared more closely to the U.S. shareholder's potential taxability under subpart F, as opposed to mere status as a U.S. shareholder under subpart F. Accordingly, the Joint Committee staff recommends adding an exception to section 1297(e) for cases in which the likelihood that a U.S. shareholder would have to include income under subpart F is remote. In such a case, the subpart F rules and the passive foreign investment company rules cannot be said to "overlap" in the manner that the Congress found objectionable in 1997. Rather, allowing the two regimes to "overlap" in these cases would allow the passive foreign investment company rules to serve the useful purpose of providing a backstop to subpart F. If the passive foreign investment company rules had applied to Enron in Project Apache, the transaction as structured would not have been viable, even if Enron's position under subpart F were sustained.

<u>FASIT rules</u>

As explained above, the availability under the FASIT rules[693] of an entity that Enron could control but treat as unrelated for tax purposes enabled Enron to take the position that section 163(j) could be avoided through the expedient of interposing an additional entity. In view of the wide range of rules under the Code that apply special restrictions to transactions between related parties, the ability to treat a FASIT as unrelated for tax purposes while maintaining effective control of it for other purposes renders FASITs prone to abuse in a wide range of situations. Regulatory anti-abuse rules,[694] if issued in final form, might mitigate this potential to some extent, but history suggests that the administration of such rules would be problematic, leaving considerable potential for abuse remaining. Moreover, recent commentary suggests that the FASIT rules, which were first enacted in 1996, are not widely used in the manner envisioned by the Congress and thus have failed to further their intended purposes.[695]

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[693] Secs. 860H - 860L.

[694] *See, e.g.*, Prop. Reg. sec. 1.163(j)-1(f); Prop. Reg. sec. 1.860L-2.

[695] *See, e.g.*, New York State Bar Association, "Report on Securitization Reforms" (Dec. 20, 2002) ("It is clear that the FASIT rules are not being used to any significant degree and

The Joint Committee staff believes that the abuse potential inherent in the FASIT vehicle far outweighs any beneficial purpose that the FASIT rules may serve, and thus recommends that these rules be repealed.

Earnings stripping regulations

The lack of final regulations under section 163(j) has created a void in an area in which more definitive guidance is needed. Project Apache illustrates that taxpayers may treat proposed regulations as a one-way street, to be relied upon when supportive of the desired return position, and to be disregarded when contrary to such position. If the anti-abuse rule of the proposed regulations under section 163(j)[696] had been in final form, Enron might have reconsidered this transaction. As noted above, the administration of such rules is always problematic, but the existence of a finalized anti-abuse rule directly on point would induce at least some change to a company's cost benefit assessment of a transaction like Project Apache. Accordingly, the Joint Committee staff recommends that the regulations implementing an anti-abuse rule to combat the avoidance of section 163(j) should be finalized expeditiously.

2. Project NOLy[697]

Project NOLy was a series of transactions structured to generate sufficient taxable income so that Enron could offset all of its tax losses from earlier years. Enron engaged in this transaction because it would allow Enron to settle and close tax examinations for those years. Project NOLy involved the constructive sale rules and the partnership rules. The following is a discussion of these rules, followed by a detailed discussion of Project NOLy.

Discussion of relevant tax laws

Tax treatment of section 1259 constructive sales

For transactions entered into after June 8, 1997, taxpayers are required to recognize gain (but not loss) upon entering into a constructive sale of any appreciated position in stock, a partnership interest, or certain debt instruments as if such position were sold, assigned or otherwise terminated at its fair market value on the date of the transaction.[698] If the requirements

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accordingly are not achieving their purpose"); New York State Bar Association, "Simplification of the Internal Revenue Code" (March 18, 2002), reprinted in 95 Tax Notes 575 (April 22, 2002) ("In our experience, the FASIT legislation is not being used by those who would be expected to benefit from it and it is unlikely that situation will change"); Letter from James M. Peaslee and David Z. Nirenberg to Assistant Treasury Secretary (Tax Policy) Mark A. Weinberger (June 6, 2001), reprinted in 91 Tax Notes 2079 (June 18, 2001) ("The FASIT legislation has failed").

[696] Prop. Reg. sec. 1.163(j)-1(f).

[697] The project was named for "Molly," a girlfriend of one of the attorneys on the transaction. Joint Committee staff interview.

[698] Sec. 1259, enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1001(a). A "position" is defined as an interest, including a futures or forward contract, short

for a constructive sale are met, the taxpayer recognizes gain in a constructive sale as if the position were sold at its fair market value on the date of the transaction and immediately repurchased.[699]

In general, a taxpayer is treated as making a constructive sale of an appreciated position if and when the taxpayer (or, in certain circumstances, a person related to the taxpayer) does one of the following: (1) enters into a short sale of the same (or substantially identical) property; (2) enters into an offsetting notional principal contract with respect to the same (or substantially identical) property; or (3) enters into a futures or forward contract to deliver the same (or substantially identical) property.[700] In addition, in the case of an appreciated financial position that itself is a short sale, a notional principal contract, or a futures or forward contract, the holder is treated as making a constructive sale when it acquires the same (or substantially identical) property as the underlying property for the position.[701] Finally, to the extent provided in Treasury regulations, a taxpayer is treated as making a constructive sale when it enters into one or more other transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described.[702]

A forward contract results in a constructive sale of an appreciated financial position only if the forward contract provides for delivery, or for cash settlement, of a substantially fixed

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sale, or option. A "position" includes a notional principal contract or other derivative instrument that provides that a taxpayer make or receive payments (or contractual credits) that approximate the economic effect of ownership of stock, a debt instrument or a partnership interest. For example, a contract that provides a right to receive payments (or contractual credits) based on a calculation having the effect of interest on a notional principal amount is treated as a position with respect to a debt instrument.

[699] Sec. 1259(a)(1).

[700] Sec. 1259(c)(1). A constructive sale does not include a transaction involving an appreciated financial position that is mark to market, including positions governed by section 475 (mark to market for securities and commodities dealers and traders) or section 1256 (mark to market for futures contracts, options and currency contracts). Nor does a constructive sale include any contract for sale of an appreciated financial position which is not a "marketable security" (as defined in section 453(f) if the contract settles within one year after the date it is entered into).

[701] *Id.*

[702] Sec. 1259(c)(1)(E). Future Treasury regulations are anticipated to treat as constructive sales other financial transactions that, like those specified in section 1259, have the effect of eliminating substantially all of the taxpayer's risk of loss and opportunity for income and gain with respect to the appreciated financial position. It is anticipated that the Treasury regulations, when issued, will provide specific quantitative standards for determining whether several common transactions will be treated as constructive sales. H.R. Rep. No. 105-148, at 442-443 (1997).

amount of property and a substantially fixed price.[703] Thus, a forward contract providing for delivery of property, such as shares of stock, the amount of which is subject to significant variation under the contract terms does not result in a constructive sale.[704]

Tax treatment of partnership formation

Generally, a partner does not recognize gain or loss on the exchange of property for a partnership interest[705] and a partner's basis in a partnership interest acquired by contribution of property to a partnership is the amount of money plus the partner's adjusted basis of the property contributed.[706] In Rev. Rul. 80-235[707] the IRS held that if the property contributed to a partnership is an obligation of the contributing partner, that partner's basis is not increased to reflect the partner's obligation because the partner has no basis in its own obligation under certain circumstances. Treasury regulations provide that if parties enter into an off-market swap with significant nonperiodic payments, the contract is treated for Federal income tax purposes as two separate transactions, an on-market swap and a loan.[708] Consequently, it could be argued that the loan part of the swap transaction would be within the holding of Rev. Rul. 80-235 and the contributing partner would receive no basis in its partnership interest as a result of contributing its own obligation.

Liquidation of a partnership

Gain is not recognized to a partner as a result of a distribution from a partnership except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution.[709] No loss generally will be recognized to a partner upon receipt of a distribution from a partnership except upon a distribution in complete liquidation of a partner's interest in the partnership if no property other than money, unrealized receivables and inventory is received.[710] If the criteria for recognizing a loss are met, the loss is recognized to the extent of the excess of the adjusted basis of the partner's interest in the partnership over the sum of the money distributed and the basis to the distributee, as determined

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[703] *See* Sec. 1259(d)(1).

[704] H.R. Rep. No. 105-148, at 442 (1997).

[705] Sec. 721.

[706] Sec. 722.

[707] 1980-2 C.B. 229. *See* also, *Gemini Twin Fund III v. Commissioner*, T.C. Memo 1991-315 (1991) *aff'd without published opinion*, 8 F3d 26 (9th Cir. 1993).

[708] Treas. Reg. sec. 1.446-3(g)(4).

[709] Sec. 731.

[710] Sec. 731(a)(2).

under section 732, of any unrealized receivables and inventory distributed.[711] Gain or loss recognized as a result of a distribution pursuant to section 731 is treated as gain or loss from the sale or exchange of the partnership interest of the distributee partner[712] and is generally treated as gain or loss from the sale of a capital asset.[713] If a distribution is made to a partner of the partner's obligation received by the partnership in exchange for a partnership interest, there is no direct authority as to how this should be treated.[714] Commentators have indicated that this should be treated as a nonevent for tax purposes.[715] As a result the loss on the liquidation would be recognized to the extent basis exceeds the amount of cash distributed plus the basis to the distributee of any unrealized receivables and inventory received.[716]

Capital loss carryback

Capital losses are required to be carried back three years and, if not used in the carryback years, carried forward five years.[717] A capital loss carryback cannot increase or produce a net operating loss for the year to which it is carried back.[718] Treasury regulations provide ordering rules for capital loss carrybacks in situations when there are also net operating losses at issue.[719] Generally, the capital loss carryback would offset capital gains in the carryback year to the extent a net operating loss is not created or increased in the carryback year. To the extent a net operating loss from a year prior to the year that produced the capital loss was carried into the carryback year and offset capital gains, that net operating loss is freed up to be carried to a subsequent year.[720]

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711 *Id.*

712 *Id.*

713 Sec. 741.

714 Treas. Reg. sec. 1.731-1(c)(2) and Rev. Rul. 93-7, 1993-1 C.B. 125, involve partner obligations that were either a loan or were acquired from a third party.

715 McKee, Nelson & Whitmire, Federal Income Taxation of Partnerships and Partners, Para. 19.02[5] (1997).

716 Sec. 731(a)(2).

717 Sec. 1212(a)(1)(A) and (B).

718 Sec. 1212(a)(1)(A)(ii).

719 Treas. Reg. sec. 1.1212-1(a)(3).

720 *See* Examples 4 and 5 of Treas. Reg. sec. 1.1212-1(a)(3).

Statute of limitations on NOL carryover years and adjustment of NOL carryover

Generally tax must be assessed within three years from the date a return for that year is filed.[721] Courts have held that, although the period of limitations for the year a net operating loss carryover arose is not open, the amount of net operating loss carryover from a barred year can be recalculated when determining a deficiency for an open year.[722]

IRS Appeals' "no immediate tax consequence" policy

If a taxpayer does not agree with adjustments made by an examiner, generally a taxpayer has the opportunity to take that dispute to Appeals, a dispute resolution function within the IRS. Most cases considered by Appeals involve disputed tax liability and as a general rule Appeals will not consider cases when there is "no immediate tax consequence."[723] However, cases can arise in which there is no disputed tax liability for the period under consideration. In such cases, if required by law, IRS policy, regulation, ruling or procedure, Appeals will consider issues that do not have an immediate tax consequence.[724] Appeals has indicated that one example of such a case is a year in which a net operating loss carryover arises and the carryforward year has not yet been examined.[725] The IRS has recently established other dispute resolution procedures and at least one of these might be available in no immediate tax consequence situations.[726]

Brief overview of Project NOLy

Project NOLy was a series of transactions structured to "soak up" losses generated in the 1996 through 2000 taxable years so that Enron could settle and close tax examinations for those years. The transactions involve using limited liability companies ("LLCs") taxed as partnerships and the constructive sale rules of section 1259 to generate capital gains that can be offset by NOL carryovers to and losses incurred in 2000. Because the exact amount of the losses for 2000 was not known, Enron used two techniques to try to match the amount of gain as closely as possible to the ultimately determined losses. First, it set up 14 different LLCs, each with a different amount of potential gain available, so that when the amount of the losses was finally determined, it could be matched as closely as possible by using a combination of LLCs. Also,

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[721] Sec. 6501(a).

[722] *Hill v. Commissioner*, 95 T.C. 437, 440 (1990) and *Stiebling v. Commissioner*, 1994 T.C. Memo 233, *aff'd without published opinion* 113 F3d 1242 (9th Cir. 1997). *See* also Rev. Rul. 56-285, 1956-1 C.B. 134.

[723] IRM 8.1.2.2.3(1) (February 2, 1999). Apparently one reason for this position is that Appeals resources should not be used in cases when there is no tax currently at issue.

[724] IRM 8.1.2.2.3(2) (February 2, 1999).

[725] *Id.*

[726] Internal IRS correspondence indicates that early referral might be available in such a situation. See Rev. Proc. 99-28, 1999-2 C.B. 109, for a description of the early referral program.

Enron used certain technical provisions of the constructive sale rules to delay determining how much gain to report in 2000 until the end of March 2001.[727] Enron intended to recognize the corresponding loss in a subsequent year.

Background[728]

Reported tax and financial statement effects

Enron reported a capital gain of $5.6 billion on its 2000 consolidated tax return as a consequence of Project NOLy and paid taxes of $63 million in that year. The partnerships were liquidated in late 2001, causing recognition of a capital loss of $5.6 billion.[729] That capital loss was carried back to 2000, offsetting capital gain that resulted from the constructive sale in that year.[730] Pursuant to the ordering rules, NOLs would be freed up allowing them to be carried to subsequent years.[731] Enron anticipated that application of the capital loss carryback would also result in a refund of the $63 million in taxes paid in 2000.[732]

For financial purposes, this transaction was considered to be neutral.[733]

Development of Project NOLy

Project NOLy was initially developed internally within Enron. Enron wanted to close out examinations on back years from which there were loss carryovers and believed that to do so they needed to trigger enough gain so that there was tax liability for 2000. The Managing Director and General Tax Counsel asked one of the directors in the Tax Department to devise a plan to accomplish this. A plan was developed that utilized the constructive sale rules of section 1259 to generate gain in 2000 by segregating the gain portion of existing financial contracts into partnerships so that the gain could be recognized. Pursuant to section 1259, a taxpayer is deemed to have sold an appreciated financial asset if derivatives or short sales are used to lock in the gain. The gain part of the project had to be completed by the end of 2000. However, by

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727 Sec. 1259(c)(3) discussed in more detail below.

728 The information regarding Project NOLy was obtained from Joint Committee staff interviews of Robert J. Hermann, Greek L. Rice, and Stephen H. Douglas as well as from documents and information provided by Enron and the IRS.

729 Enron Presentation to the Joint Committee on Taxation Staff, June 7, 2002, at 15. The General Background Materials in Appendix B contain this document.

730 *Id.*

731 Treas. Reg. sec. 1.1212-1(a)(3).

732 EC2 000038222. Part of a document entitled, "Chiricahua Partnerships and Related Transactions ("Project NOLY")" provided to the Joint Committee staff by Enron.

733 Joint Committee staff interview.

using 14 different LLCs taxed as partnerships and certain technical requirements of section 1259(c)(3), determining the exact amount of the gain to be recognized was postponed until late March 2001.

The business purpose of Project NOLy was stated to be to economically segregate the "in-the-money" portion of the financial trading book of Enron North America, Corp., a wholly owned subsidiary of Enron Corp. ("ENA").[734] The reason 14 LLCs were needed to do this was not given.

Implementation of Project NOLy[735]

ENA routinely entered into positions, including swaps, futures contracts, options and forward contracts with third parties relating to the price of natural gas and other commodities. Usually ENA would enter into offsetting positions with its wholly owned subsidiary Risk Management and Trading Corp. ("RMT") pursuant to an ISDA Master Agreement[736] dated March 31, 1997, and periodic confirmations executed in association with that agreement ("ENA Master Swap). This served to place the risks for these types of transactions in one entity, RMT, which made managing the risk easier.

On December 20, 2000, 14 Delaware LLCs were formed by RMT and FS 360 Corp., a wholly owned subsidiary of RMT ("FS 360").[737] These 14 LLCs, which elected to be taxed as partnerships, were named RMT Chiricahua I[738] through RMT Chiricahua XIV ("Chiricahuas"). FS 360 owned a .01 percent interest in the capital, profits and losses of each partnership, which it acquired in exchange for a cash contribution to that entity. RMT acquired a 99.99 percent

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[734] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 114. The answer references a memorandum to Robert J. Hermann from Stephen H. Douglas dated August 29, 2001. Appendix B, Project NOLy contains this document.

[735] This section is based in large part on an opinion letter from Vinson & Elkins to Enron Corp. dated February 26, 2001, contained in Appendix C, Part X to this Report; a draft opinion letter from Vinson & Elkins to Enron Corp. dated December 17, 2001, also contained in Appendix C, Part X to this Report; summaries of the transaction provided to the Joint Committee staff by Enron at EC2 000038199-206 and a memorandum from Stephen H. Douglas to Robert J. Hermann dated August 29, 2001. Appendix B, Project NOLy contains this memorandum.

[736] An ISDA Master Agreement is a standard form agreement copyrighted by the International Swap Dealers Association that sets forth the terms and conditions governing any specific swaps made pursuant to the agreement among the parties to it.

[737] Current Management is not aware of any internal approval process for Project NOLy. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 110.

[738] The Chiricahua partnerships were named for a golf course at the Desert Mountain Golf Club in Scottsdale, Arizona. Joint Committee staff interviews.

interest in the capital, profits and losses of each entity, in exchange for a cash contribution and its agreement to enter into an ISDA Master Agreement dated December 20, 2000, between RMT and the Chiricahuas and the associated confirmation dated December 27, 2000 ("RMT Swaps"), which represented offsetting positions with respect to certain of the contracts held by RMT. All of the RMT Swaps were substantially in the money at the time of execution and represented a transfer of value from RMT to the Chiricahuas. The amount of the net cash payments required to be made under each of the RMT Swaps to each Chiricahua was based upon the specific terms set forth in the associated confirmation based on the notional volumes and prices set forth therein. It was anticipated that a substantial net payment would be made by RMT to each Chiricahua over the life of the RMT Swaps rather than requiring a payment to be made by the Chiricahuas to RMT. None of the Chiricahuas was required, under the terms of the RMT Swaps, to make any net payments in the aggregate to RMT in excess of the amounts actually received by such entity from RMT.

Tularosa LLC was a Delaware LLC whose members were ENA and Mangas I Corp., a wholly owned subsidiary of ENA ("Mangas"). ENA owned a 99.99 percent interest in Tularosa and Mangas owned the remaining .01 percent interest. Subsequent to the execution of the RMT Swap, RMT entered into an ISDA Master Agreement dated December 20, 2000 with Tularosa and an associated confirmation dated December 27, 2000, for a total return swap ("Tularosa Swap") with respect to RMT's membership interest in each Chiricahua. Under the terms of the Tularosa Swap, RMT was entitled to receive from Tularosa on the settlement date, a fixed sum equal to the fair market value of RMT's membership interests in the Chiricahuas on the initial contract date and RMT was required to pay Tularosa the fair market value of the membership interests in the Chiricahuas on the settlement date, plus the amount of any distributions from the Chiricahuas during the term of the contract. The Tularosa Swap was effective December 27, 2000, and the settlement date was January 2, 2002. Enron Corp. guaranteed Tularosa's obligation under the Tularosa Swap. By entering into the Tularosa Swap, RMT became subject to the constructive sale rules of section 1259, causing it to recognize $5.6 billion in gain (the difference between its basis in the Chiricahuas and the fair market value of its interest in the Chiricahuas) in the 2000 taxable year.

Because it would take a few months to determine precisely the amount of losses at the end of its 2000 taxable year, Enron sought to use technical rules contained in section 1259(c)(3) to delay final determination of the amount of gain until the end of March 2001. There is an exception to constructive sale treatment for any transaction that is closed before the end of the 30th day after the close of the taxable year in which it was entered into.[739] This exception to the constructive sale rules is only available if the taxpayer holds the appreciated financial position to which the transaction relates throughout the 60-day period beginning on the date such transaction is closed and at no time during such 60-day period is the taxpayer's risk of loss reduced (under the principals of section 246(c)(4)) by holding positions with respect to substantially similar or related property.[740]

[739] Sec. 1259(c)(3).

[740] *Id.*

To this end, less than 30 days after the end of the taxable year, on January 29, 2001, RMT and Tularosa entered into an early settlement of the Tularosa Swap. This early settlement triggered a $701.8 million termination payment by Tularosa to RMT (because gas prices had declined since December 27, 2000) and was considered to be a closed transaction, nullifying the constructive sale, provided the 60-day rule was not applicable.[741] However, Enron intended to use the 60-day rule to further extend the time for determining how much gain was needed to offset the losses. By March 27, 2001, Enron's Tax Department had concluded that the entire $5.6 billion gain should be recognized in 2000. In order to ensure that the entire gain was recognized, RMT and Tularosa entered into a new total return swap within 60 days of termination of the termination of the original Tularosa Swap. This brought the transactions within the 60-day rule[742] with the result that the $5.6 billion gain was deemed to be recognized in 2000. RMT's basis in the Chiricahuas was increased by the same amount.

At the time Project NOLy was developed and implemented, it was assumed that it would be unwound in January 2002.[743] However, due to Enron's financial deterioration in 2001, a decision was made to unwind Project NOLy in 2001 by liquidating the Chiricahuas thereby triggering the offsetting $5.6 billion capital loss. The Chiricahuas were liquidated in December 2001.[744]

The following consequences resulted from the liquidation of the Chiricahuas.[745] FS 360 redeemed its original $500,000 investment and all other assets and liabilities were transferred to RMT. The only assets of the Chiricahuas were accounts receivable from RMT, the RMT Swaps and cash. When the liquidation occurred, RMT was distributed cash and the RMT Swaps. RMT's basis now included the $5.6 billion gain recognized in 2000. Because it received relatively little cash and its own liability, the RMT Swaps, on which it recognized no gain or loss, a large capital loss, essentially equal to the $5.6 billion capital gain in the previous year, was recognized. The recognition of this loss and the resultant carryback to earlier years was projected to result in a refund of the $63 million of tax paid in 2000. Because the capital loss carryback from 2001 cannot increase or produce an NOL, the approximately $2.5 billion of operating losses that arose in 2000 would continue to offset capital gains of that amount in 2000.

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741 *Id.*

742 *Id.*

743 Opinion letter from Vinson & Elkins to Enron Corp. dated February 26, 2001, at 2. Appendix C, Part X to this Report contains this letter.

744 Enron Corp. Presentation to the Joint Committee on Taxation Staff, June 7, 2002, at 15. The General Background materials in Appendix B contain this document.

745 Draft opinion letter from Vinson & Elkins dated December 17, 2001, at 4-10. Appendix C, Part X to this Report contains this letter.

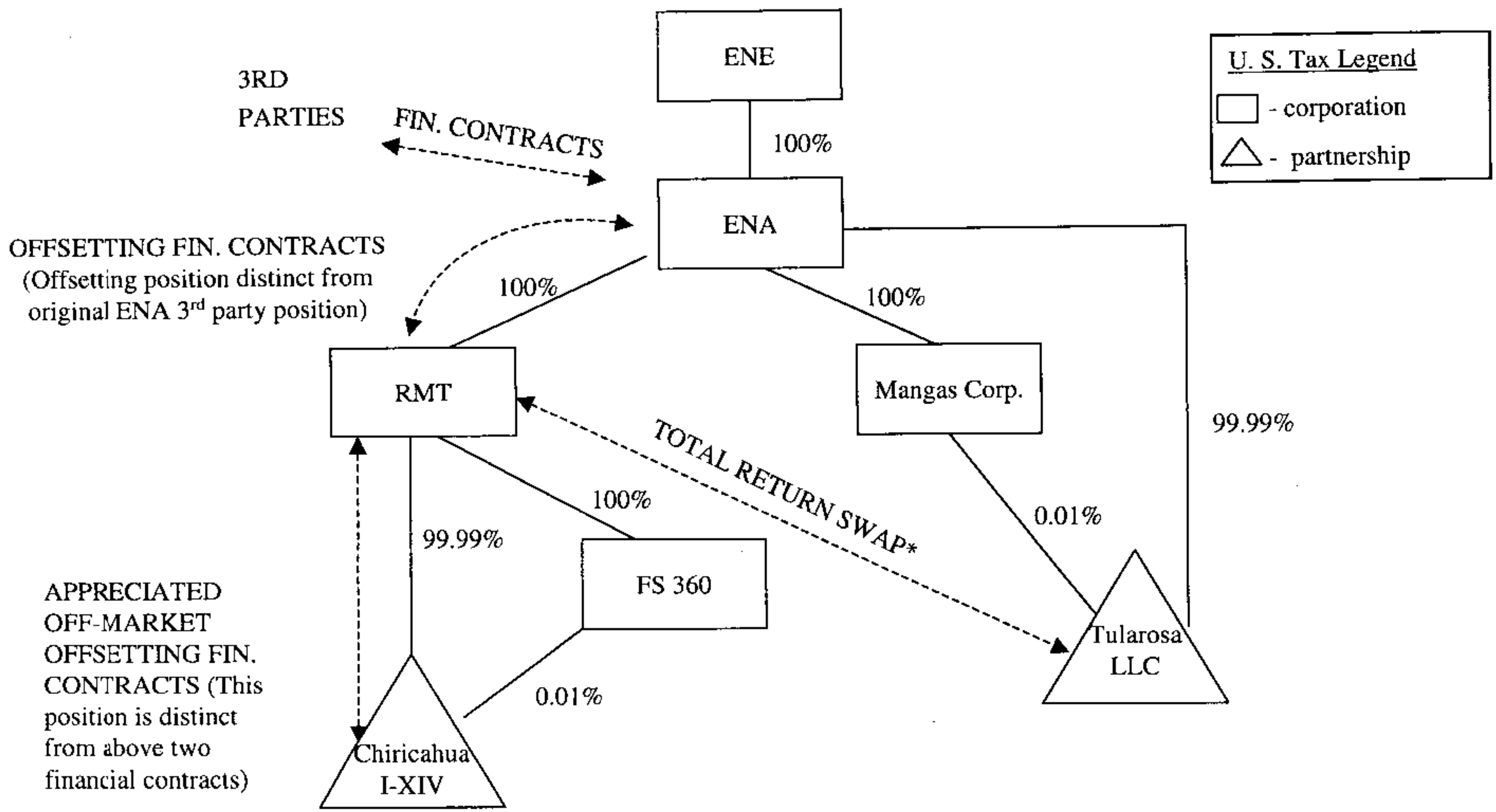
However, the pre-2000 NOL carryovers would be freed up and available to be carried to subsequent years.[746]

The diagram on the next page depicts the Project NOLy structure as of December 2000.

[746] EC2 000038222. Part of a document entitled, "Chiricahua Partnerships and Related Transactions (Project NOLy)" provided by to the Joint Committee staff by Enron.

Confidential

Project NOLy – December 2000



*Total return swap contract whereby Tularosa LLC agrees to pay RMT $5.556 billion in return for RMT's obligation to pay to Tularosa LLC all returns related to RMT's interest in Chiricahua LLC. Net cash settlement of difference between (i) FMV of Chiricahua interest at settlement date + distributions on such interest, and (ii) $5.556 billion fixed payment.

Role of outside advisors

Although the plan that became Project NOLy originated within the Enron Tax Department, Vinson & Elkins became involved during the development stage. Arthur Andersen was involved on the accounting side of the transaction and concluded that it was a "neutral" transaction for financial accounting purposes.[747]

In an opinion letter dated February 26, 2001, Vinson & Elkins opined that the transactions should result in the following: (1) a constructive sale of RMT's membership interest in Chiricahua under section 1259; (2) the recognition of gain in an amount equal to the excess of the fair market value of RMT's member interest in Chiricahua over its basis in such interest; and (3) an increase in RMT's basis in its interest in Chiricahua in an amount equal to the gain recognized as a result of the constructive sale.[748] An important element in conclusion (2) was that RMT did not receive any basis for its interest in any of the Chiricahuas as a result of its agreement to enter into the RMT Swap because it was an obligation of a partner in which the partner had no basis.

In a separate letter, Vinson & Elkins opined with regard to the tax consequences of the liquidation of all of the Chiricahuas concluding the liquidation should generate capital losses that Enron would be able to carry back to 2000. Vinson & Elkins also concluded that RMT's basis in the Chiricahuas would be increased by the amount of gain recognized on the constructive sale in 2000. When the partnerships were liquidated, RMT received only cash and the RMT Swaps. Vinson & Elkins concluded that for the same reasons it was viewed as a nonevent in the formation of the Chiricahuas, it should be viewed as a nonevent in the liquidation. Consequently, RMT should be regarded as receiving only cash in the liquidation enabling it to recognize a loss in the amount its basis exceeded the cash received.

Appendix C, Part X to this Report contains the tax opinions Enron received in connection with Project NOLy.

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[747] Joint Committee staff interviews and letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 107, which indicates that current management of Enron is unaware of "any documents relating to the financial accounting for Project NOLy, other than a passing comment in a document Bates stamped EC2 000038207." The Project NOLy materials in Appendix B contain this document -- a memorandum to Robert J. Hermann from Stephen H. Douglas dated August 29, 2001. The document states "[t]he transaction will not result in negative accounting consequences for ENA because the tax gain resulting at the outset of the transaction will be offset with subsequently recognized tax losses in an equal amount..."

[748] Enron indicated that the February 26, 2001 opinion letter was a final opinion. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 111. However, the copy bears numerous hand-written changes, and therefore does not appear to be the final version.

Fees billed by Vinson & Elkins for project NOLy totaled approximately $90,000.[749] Enron's current management is not aware of any fees paid to Arthur Andersen in connection with services that may have been performed with respect to Project NOLy.[750]

Subsequent developments

By mid-October of 2001, IRS was close to completing the examination cycle involving the losses that were to be carried forward. At that time, it was likely that the examination would be agreed with the exception of one issue. IRS appears to have been concluded that the Appeals Office could take jurisdiction of the remaining disputed issue in the years the NOLs arose.[751] If the disputed issue were resolved, this would allow the examination cycle for those years to be closed.

The IRS is in the process of examining Enron's tax returns for years 1995 through 2001.

Discussion

Enron had loss carryovers from the 1996 through 1999 taxable years into the 2000 taxable year of approximately $3 billion.[752] Based on operations in 2000, it was anticipated that additional operating losses of more than $2 billion would be generated in that year.[753] The Enron Tax Department wanted to close out the earlier loss years to finalize the tax treatment of items in those years, but believed that they needed to use up the loss carryovers and pay some tax in order to do so. Project NOLy was designed to generate sufficient gains to soak up all of the NOLs and losses so that Enron paid some tax in 2000.

The IRS has provided exceptions to its general policy that the Appeals Office will not accept cases unless there is tax at issue.[754] One of the exceptions to this no immediate tax consequence policy is for adjustments made to an NOL carryforward when the carryforward year has not yet been examined. By mid-October of 2001, IRS was close to completing its

[749] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 113. The answer indicates that Enron has paid $77,228.62 of this amount. The remainder, $13,363.75, was billed in the fall of 2001 and related to the liquidation of the Chiricahua entities, but may not have been paid due to the bankruptcy filing.

[750] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 108.

[751] Internal IRS correspondence.

[752] Opinion letter from Vinson & Elkins to Enron Corp. dated December 17, 2001. Appendix C, Part X to this Report contains this letter.

[753] *Id.*

[754] IRM 8.1.2.2.3(2) (February 2, 1999).

examination of a cycle including years in which the net operating loss carryforwards arose with only one issue remaining unagreed. IRS appears to have concluded that an Appeals forum would be available to Enron in that situation to resolve the unagreed issue.[755]

The stated reason for Project NOLy was to finalize the treatment of items in the years the net operating losses were generated, 1996 through 1999. These were the years in which Enron implemented a number of the structured transactions described in this Report. It appears that the purpose behind Enron's implementation of Project NOLy was to use technical tax rules to manipulate its tax situation in order to put the IRS in the position that it would have to sign off on years in which Enron implemented other structured transactions.

Project NOLy is also another example of the disparity between financial statement treatment of a transaction and tax treatment of the same transaction. For financial statement purposes, Project NOLy was neutral. However, for tax purposes, the taxpayer recognized $5.6 billion of capital gains in one year and an essentially equal amount of capital losses in the next year.

[755] IRS internal correspondence.