II. COMPANY-OWNED AND TRUST-OWNED LIFE INSURANCE

A. Summary

Enron implemented company-owned life insurance ("COLI") and trust-owned life insurance ("TOLI") programs. The discussion below provides background on the structure of COLI and TOLI arrangements, summarizes the present law tax treatment, describes Enron's COLI and TOLI arrangements, and provides discussion and recommendations. COLI generally has been the subject of considerable publicity due to its Federal income tax and financial accounting benefits,[795] and Congress has sought to limit its use as a tax arbitrage mechanism in Federal tax legislation since the 1940's.[796]

B. Background, Present Law, Discussion and Recommendations

1. Background and present law relating to the tax treatment of company-owned life insurance

Structure of COLI and TOLI arrangements historically

The term COLI refers to life insurance contracts owned by a business (whether or not the business is actually in corporate form). The structure of a COLI arrangement generally has been that a business buys life insurance of a type that has a cash value, and after the cash value has built up sufficiently, the business borrows some portion of the cash value. The business can borrow directly from the policy under a loan administered by the insurance company that issued the policy. In such a case, the amounts borrowed with respect to the contracts may be repaid by means of a reduction in the death benefits when the person insured under the contract dies. Alternatively, the business may borrow from a third party lender, perhaps using the life insurance contract as security for the loan, either formally or informally. The life insurance contract or contracts in COLI arrangements typically have covered the life or lives of employees, customers, or other individuals in whom the business has an insurable interest under applicable State law. The type of life insurance contract used for COLI is a type of contract that has cash value, and is often referred to generically as whole life insurance. This type of life insurance can be distinguished from term life insurance, which normally has no cash value. A TOLI arrangement

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[795] See, e.g., Francis, *Bill Seeks Disclosure on Insuring Employees*, Wall St. J., Feb. 5, 2003; Francis, *Insurance Disclosure of S&Ls May Change*, Wall St. J., Jan. 27, 2003; Gettlin, *Tax-Free Earnings: A Life-And-Death Issue*, National J., Oct 26, 2002, at 3140; Clark, *Better Off Dead?*, U.S. News & World Report, May 6, 2002, at 32; Schultz and Francis, *The Economy: Senator to Target Tax Boon to Firms Insuring Workers*, Wall St. J., May 3, 2002; Francis and Schultz, *Big Banks Quietly Pile Up 'Janitors' Insurance,'* Wall St. J., May 2, 2002; Francis and Schultz, *Many Banks Boost Earnings with 'Janitors' Life Insurance,'* Wall St. J., April 26, 2002; Francis and Schultz, *Why Secret Insurance on Employees Pays Off,* Wall St. J., April 25, 2002; Schultz and Francis, *Why Are Workers in the Dark? Most States Don't Force Firms To Disclose 'Janitors' Insurance,' But Congress May Change That*, Wall St. J., April 24, 2002; Schultz and Francis, *Valued Employees: Worker Dies, Firm Profits*, Wall St. J., April 19, 2002.

[796] A description of Federal tax legislation on this subject is below.

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is similar to a COLI arrangement, except that the life insurance contracts are held by a trust that is generally controlled by the business, such as a trust that maintains assets to fund qualified or nonqualified employee benefits.

Use as funding vehicle

COLI policies have been used as an indirect funding vehicle for employee benefits (or for any other cash need of the business). Because the policies are not specifically allocated to fund a particular expenditure, they can be used as a means of providing liquidity when direct funding of a future obligation is not necessary or is undesirable. For example, borrowings under COLI policies have been used to pay employers' obligations under retiree health plans, or to make payments under unfunded deferred compensation arrangements.

Financial statement benefits

COLI policies provide the financial statement benefit that the increase in the cash surrender value (including earnings under the contract) and death benefits received under the policy are treated as income for financial reporting purposes. By contrast, cash value increases and death benefits generally are not included in income for Federal income tax purposes, thus generally resulting in a permanent book-tax difference.[797]

Borrowing in connection with COLI

Patterns of business borrowings with respect to life insurance contracts the business owns have changed over the past several decades. These changes have resulted from growth in the marketing to businesses of life insurance on employees, customers or other individuals, and also from changes in the tax law, and from other factors.

Borrowing by a business with respect to a life insurance contract is attractive because the earnings under the policy ("inside buildup") increase tax-free. The loans permit the borrower to have the current use of income that has not been taxed. Interest paid by the borrower is credited to the policy, which it owns, so the effect is equivalent to paying interest to itself. The amount of the loan reduces the death benefit when the insured person dies, if the loan has not yet been repaid; however, this is not a disadvantage to the borrower if another person (such as an employee's spouse) is the recipient of the death benefit. A further advantage of borrowing with respect to a life insurance policy would arise to the extent the interest on the policy loan is deductible.

Tax treatment

Pattern of COLI legislation

Provisions of tax legislation designed to limit the tax arbitrage of deducting interest on borrowings with respect to a life insurance contract date to the 1940's.[798] The deductibility of

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[797] Premiums and interest associated with the policies, however, are treated as an expense for financial reporting purposes, and are not deductible for Federal income tax purposes.

interest on borrowings that relate to life insurance contracts has been limited most recently by Federal tax legislation in 1986, 1996, and 1997.

In 1986, deductible interest on borrowings under life insurance contracts was capped at debt of $50,000 per contract, to combat the use of life insurance loans as an "unlimited tax shelter."[799] This provision was effective for contracts purchased on or after June 20, 1986. Life insurance contracts purchased before that date were grandfathered; the $50,000 cap did not apply to interest on debt borrowed under such contracts.

A pattern then developed of businesses insuring the lives of thousands of their employees to increase the amount of interest to deduct on borrowings under the contracts.[800] In 1996, a broader limitation on deductibility of interest on debt under a life insurance contract was enacted, generally replacing the $50,000 cap. That rule provided that no deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance, annuity or endowment contracts owned by the taxpayer, and covering the life of any individual who is or has been (1) an officer or employee of, or (2) financially interested in, any trade or business currently or formerly carried on by the taxpayer.[801] A key person insurance exception was provided. The 1996 legislation applied generally to interest paid or accrued after October 13, 1995, with a phase-in rule. However, the grandfather rule for pre-June 20, 1986 contracts was preserved, with a new interest rate cap based on a Moody's rate.[802]

The interest deduction limitation was further expanded in 1997 when Congress became aware of the practice of businesses insuring the lives of customers or debtors (for example, financial institutions insuring the lives of mortgage borrowers while borrowing under the life

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[798] Section 129 of the Revenue Act of 1942 (Pub. L. No. 753, 77th Cong., 56 Stat. 798) added Internal Revenue Code section 24(a)(6), which provided that no deduction was allowed for "any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. For the purposes of this paragraph, if substantially all the premiums on a life insurance or endowment contract are paid within a period of four years from the date on which such contract is purchased, such contract shall be considered a single premium life insurance or endowment contract."

[799] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, at 579. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1003, 100 Stat. 2388 (1986).

[800] *See* Lee Sheppard, "'Janitor' Insurance as a Tax Shelter," *Tax Notes*, Sept. 25, 1995, p. 1526.

[801] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-96), Dec. 18, 1996, p. 365. *See* Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, sec. 510, 110 Stat. 2090 (1996).

[802] Sec. 264(e)(2).

insurance policies, or maintaining other debt, and deducting the interest thereon).[803] The 1997 legislation provided that no deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual. It also provided that, for taxpayers other than natural persons, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values of a life insurance, annuity or endowment contract. An exception is provided under this proration rule for contracts that cover an individual who is a 20 percent owner, officer, director or employee of the taxpayer's trade or business.[804] The pro rata interest deduction limitation applied generally to contracts issued after June 8, 1997. Thus, the phase-in rule under the effective date of the 1996 legislation, and the grandfather rule under the 1986 and 1996 legislation for contracts purchased on or before June 20, 1986, were not affected.

Inside buildup and death benefits under life insurance contracts generally tax-free

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract[805] ("inside buildup").[806] Further, an exclusion from

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[803] *See* "Fannie Mae Designing a Program to Link Life Insurance, Loans," *Washington Post*, Feb. 8, 1997, p. E3; "Fannie Mae Considers Whether to Bestow Mortgage Insurance," *Wall St. Journal*, April 22, 1997, at C1.

[804] This proration rule applies to policies issues after June 8, 1997. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1084, 111 Stat. 951 (1997), and *see* Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), Dec. 17, 1997, p. 272.

[805] By contrast to the treatment of life insurance contracts, if an annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract (sec. 72(u)).

[806] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59 1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[807]

Premium and interest deduction limitations with respect to life insurance contracts

Premiums.–Under present law, no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract.[808]

Interest paid or accrued with respect to the contract.–In addition, no deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual,[809] with a key person insurance exception.[810]

Pro rata interest limitation.–A pro rata interest deduction disallowance rule also applies. Under this rule, in the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values.[811] Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance, annuity and endowment contracts, to (2) the sum of the average unborrowed cash values (or average adjusted bases, for other assets) of all the taxpayer's assets.

Under the pro rata interest disallowance rule, an exception is provided for any contract owned by an entity engaged in a trade or business, if the contract covers only one individual who is a 20-percent owner of the entity, or an officer, director, or employee of the trade or business.

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[807] Sec. 101(a).

[808] Sec. 264(a)(1).

[809] Sec. 264(a)(4).

[810] This provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest under applicable State law when the contract is first issued, except as otherwise provided under special rules with respect to key persons and pre-1986 contracts. Under the key person exception (sec. 264(e)), otherwise deductible interest may be deductible, so long as it is interest paid or accrued on debt with respect to a life insurance contract covering an individual who is a key person, to the extent that the aggregate amount of the debt does not exceed $50,000. The deductible interest may not exceed the amount determined by applying a rate based on Moody's Corporate Bond Yield Average-Monthly Average Corporates. A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) five individuals, or (2) the lesser of five percent of the total number of officers and employees of the taxpayer, or 20 individuals.

[811] Sec. 264(f). This applies to any life insurance, annuity or endowment contract issued after June 8, 1997.

The exception also applies to a joint-life contract covering a 20 percent owner and his or her spouse.

"Single premium" and "4-out-of-7" limitations.–Other interest deduction limitation rules also apply with respect to life insurance, annuity and endowment contracts. Present law provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity or endowment contract.[812] In addition, present law provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, annuity or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise).[813] Under this rule, several exceptions are provided, including an exception if no part of four of the annual premiums due during the initial seven year period is paid by means of such debt (known as the "4-out-of-7 rule").

Judicial decisions relating to COLI

Interest deductions under COLI arrangements have also been limited by recent case law applying general principles of tax law, including the sham transaction doctrine. These cases generally cover taxable years of the taxpayers before the recent 1996 and 1997 legislation took effect. These principles of tax law continue to apply after enactment of the specific interest deduction limitation rules.

The case of *Winn-Dixie Stores, Inc. v. Commissioner*[814] involved the application of the sham transaction doctrine. In 1993, Winn-Dixie entered into a company-owned life insurance (COLI) program on the lives of its 36,000 employees. Under the program, Winn-Dixie purchased whole life insurance policies and was the sole beneficiary. Winn-Dixie borrowed periodically against the policies' account value at interest rates that averaged 11 percent. The 11 percent average interest rate, when coupled with the administrative fees, outweighed the net cash surrender value and benefits paid on the policy. Thus, although Winn-Dixie lost money on the program each year, the tax deductibility of the interest and fees yielded a benefit of several billion dollars over 60 years. In 1997, Winn-Dixie terminated its participation in the COLI program following the enactment of tax law changes in 1996 that limited the deductibility of interest on COLI policy loans. On audit, the IRS disallowed the deductions for interest and administrative fees that Winn-Dixie claimed on its 1993 tax return with respect to its COLI program and COLI policy loans.

On petition to the Tax Court, Winn-Dixie argued that the deductions relating to its COLI program were proper because: (1) the COLI program satisfied the business purpose and economic substance prongs of the sham transaction doctrine, and (2) in any case, the sham

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[812] Sec. 264(a)(2).

[813] Sec. 264(a)(3).

[814] *Winn-Dixie,* 113 T.C. 254 (1999), *aff'd* 254 F.3d 1313 (11th Cir. 2001), *cert. denied,* April 15, 2002.

transaction doctrine was inapplicable because Congress explicitly authorized the deductions in connection with the COLI program. However, the Tax Court sustained the IRS disallowance of the COLI-related deductions claimed by Winn-Dixie, concluding that the COLI program (including the associated policy loans) was a sham.

In arguing that its COLI program had a business purpose and economic substance, Winn-Dixie asserted that it used the earnings from the COLI program to fund the flexible benefits program that it provided to its full time employees.[815] However, the Tax Court determined that the COLI program lost money on a pre-tax basis, and that the program generated positive earnings and cash flow only on an after-tax basis after taking into account the deductions for interest and administrative costs. Thus, the court concluded that the COLI program was a sham:

> Even if we were to accept [the testimony of Winn-Dixie's financial vice president] that he intended to use tax savings to fund [Winn-Dixie's flexible benefits program], that would not cause the COLI plan to have economic substance. If this were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, every sham tax shelter device might succeed. Petitioner's benefit from the COLI plan was dependent on the projected interest and fee deductions that would offset income from petitioner's normal operations. The possibility that such tax benefits could have been used as a general source of funds for petitioner's [flexible benefits program] obligations (or any other business purpose) does not alter the fact that the COLI plan itself had only one function and that was to generate tax deductions which were to be used to offset income from its business and thereby reduce petitioner's income tax liabilities in each year.[816]

With regard to whether Congress sanctioned the deductibility of interest and costs relating to COLI programs, Winn-Dixie argued that the sham transaction doctrine was not pertinent to its COLI program because Congress has repeatedly addressed the treatment of COLI plans over the years and has permitted deductions attributable to certain COLI plans that either satisfied explicit statutory requirements or predated the enactment of legislation to restrict such deductions.[817] However, the Tax Court concluded that any legislative approval of COLI programs was premised upon programs that had economic substance and were not shams:

> It is clear that Congress and the Treasury Department were aware of the problems associated with interest deductions on life insurance loans. However, we are not persuaded that Congress, by enacting and amending section 264 or other related provisions that restrict the deductibility of interest, intended to allow interest deductions under section 163 based on transactions that lacked with economic substance or business

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[815] *Winn-Dixie,* 113 T.C. at 286.

[816] *Id.* at 287-88 [footnote omitted].

[817] *Id.* at 290.

purpose. In *Knetsch*,[818] the Supreme Court noted that nothing in the legislative history of section 264 suggests that Congress intended to protect sham transactions. Similarly, we find nothing in the more recent legislative history of section 264 suggesting that Congress intended to allow deductions arising from sham transactions that lacked economic substance and business purpose.[819]

Accordingly, the Tax Court upheld the disallowance by the IRS of the deductions claimed by Winn-Dixie for interest and administrative costs relating to its COLI program. On appeal, the Eleventh Circuit Court of Appeals adopted the reasoning of the Tax Court and affirmed its decision.[820]

Other recent cases have also upheld the disallowance by the IRS of deductions for interest relating to COLI programs. In *Internal Revenue Service v. CM Holdings, Inc.*,[821] Camelot Music had purchased COLI policies in 1990 covering the lives of 1,430 employees. Camelot borrowed under the policies to pay the first three annual premiums and sought to deduct the interest on the borrowings. Camelot subsequently filed a petition under chapter 11 of the Bankruptcy Code, and the IRS filed proofs of claim based on disallowance of the interest deductions. The District Court held that the interest deductions should be disallowed, and also concluded that the application of accuracy-related penalties was appropriate. The court stated that there were two rationales for the interest deduction disallowance. First, the interest deductions were part of a transaction that was in part a factual sham and therefore did not meet the "4-out-of-7" exception to the interest deduction disallowance rule of Code section 264(a)(3). In addition, the COLI plan lacked economic substance and business purpose, and was a sham in substance.[822] On appeal, the Third Circuit affirmed, "based on the . . . reasoning, that the COLI policies lacked economic substance and therefore were economic shams."[823] The Appellate Court also affirmed the assessment of penalties.

In *American Electric Power, Inc. v. U.S.*,[824] the District Court concluded that interest deductions on policy loans under a COLI program covering the lives of over 20,000 employees should be disallowed. The court concluded that the "plan as a whole was a sham in

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[818] *Knetsch v. United States*, 364 U.S. 361 (1960) (disallowing deduction for prepaid interest on a nonrecourse, riskless loan used to purchase deferred-annuity savings bonds) (footnote supplied).

[819] *Winn-Dixie*, at 293-94.

[820] 254 F.3d 1313 (11th Cir. 2001) (per curiam).

[821] *Internal Revenue Service v. CM Holdings, Inc.*, 254 B.R. 578 (D. Del. 2000).

[822] *Id.* at 583, 654.

[823] *IRS v. CM Holdings, Inc. (In Re: CM Holdings, Inc.)*, 301 F.3d 96 (3d Cir. 2002), at 96

[824] *American Electric Power, Inc. v. U.S.*, 136 F.Supp. 2d 762 (S. D. Ohio 2001).

substance,"[825] as well as concluding that first year policy loans, and the first year and fourth through seventh year loading dividends and corresponding portions of the premiums, were factual shams. The court stated that it had "independently reached many of the same conclusions as the [District] court in *C.M. Holdings*," and that the policies in that case were in all relevant respects identical to those involved in this case.[826]

2. Enron's COLI and TOLI transactions

Brief overview

During the 1980s and early 1990s, Enron bought approximately 1,000 life insurance contracts covering employees. Approximately $178 million had been borrowed under these life insurance contracts at the end of 1994, after which Enron stopped purchasing life insurance contracts covering employees. By late 2001, the amount borrowed under Enron's life insurance contracts had grown to approximately $432 million. In addition to its own contracts, Enron acquired Portland General Electric in 1997, which also owned life insurance contracts covering its employees. As of 1999, Portland General Electric had approximately $79 million worth of such life insurance contracts, and its affiliates owned approximately $59 million worth. Policies covering a total of 2,315 Portland General Electric employees were purchased between 1996 and 1999. Following Enron's bankruptcy filing on December 2, 2001, Enron surrendered its life insurance contracts during 2002. Portland General Electric's life insurance contracts were in the process of being surrendered as of early 2003.

Company-owned life insurance provides tax benefits and financial statement benefits, in addition to providing life insurance coverage of persons in whom the company has an insurable interest (such as officers, managers or other employees). Life insurance is tax favored in that death benefits paid by reason of the death of the insured person generally are excludable from income, and also in that earnings on amounts credited to the policy generally are excluded from the policyholder's income as well. Premiums paid on business-owned life insurance generally are not deductible.

From a financial statement perspective, the untaxed income earned inside the contract and the untaxed death benefits received under the contract can generally be credited as income on the income statement. Accrued interest on borrowings under the contract is treated as an expense for financial statement purposes.

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[825] *Id.* at 795.

[826] *Id.* at 769.

Background[827]

Reported tax and financial statement effects

Enron treated premium payments for its COLI policies as nondeductible for Federal income tax purposes, and excluded from income the inside buildup and death benefits under the contracts.[828]

For financial statement purposes, Enron included the increase of the cash surrender value of the COLI policies as income, included the death benefits received as income, treated the premiums for the policies as an expense, and treated the accrued interest on the COLI loans as an expense.[829]

Development and implementation of COLI and TOLI transactions

Enron's COLI and TOLI contracts.--During the 1980s through the mid-1990s, Enron bought approximately one thousand life insurance contracts on the lives of individuals.[830] These contracts were issued by several different life insurance companies, including Great West,[831] Mass Mutual (formerly Connecticut Mutual), Pacific Life, Security Life of Denver, and CIGNA.

Approximately half of Enron's life insurance contracts covering employees (including a group of 201 contracts purchased June 1, 1986) were purchased before June 20, 1986, the

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[827] The information regarding Enron's COLI and TOLI contracts was obtained from a Joint Committee staff interview of Mr. Hermann, as well as from documents and information provided by Enron and the IRS.

[828] Letter of Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, January 13, 2003, answer 142. Enron made adjustments required under the adjusted current earnings preference of the corporate alternative minimum tax with respect to inclusion of income on life insurance contracts and deductibility of premiums (sec. 56(g)(4)(B)(ii)). *Id.*

[829] *Id.* Enron's net book income adjustment for COLI, per the tax return, was -$19 million for 1996, -$24 million for 1997, -$27 million for 1998, -$35 million for 1999, and -$20 million for 2000, as shown on Enron Corp. & Subsidiaries Reconciliation of Net Income per Annual Report to Taxable Income per Enron's Consolidated Tax Return For the Calendar Years 1996 thru 2000 in Enron Corp. Presentation to Joint Committee on Taxation staff, Washington, D.C., June 7, 2002, at 20. Appendix B, Part I contains this document.

[830] From lists of Enron life insurance contracts as of December 31, 1994, EC2 000038640 - EC2 000038689. One company list shows 1,007 contracts (Sheet 1, Enron Corp., Summary of COLI Values @ 12/31/1995, EC2 000038639). Another company list shows 1,046 contracts (Item 11- Attachment A, dated 5/9/2002, 2:11 PM, EC 000768247).

[831] Also referred to as Great Western Life.

effective date of 1986 legislation limiting the tax deduction for interest on debt under a life insurance contract.[832]

In documents prepared by Clark-Bardes (a COLI broker) for Enron in connection with its 1994 purchase of life insurance contracts from CIGNA, the contracts were described as a funding vehicle for Enron's obligation to pay deferred compensation under a 1994 nonqualified deferred compensation arrangement with approximately 300 executives.[833] The life insurance contracts were to fund the deferral of approximately $3 million of 1994 compensation by 100 of the executives, and also to fund deferrals of compensation elected by the executives for the next seven years. These contracts were held by a trust, rather than directly by the company, and thus can be described as TOLI (trust-owned life insurance) contracts. Enron stopped purchasing contracts covering employees after the purchase of this group of contracts on September 24, 1994.[834]

Enron had borrowed a total of approximately $178 million under its life insurance contracts as of the end of 1994.[835] At that time, these COLI contracts had a total of approximately $226 million of gross surrender value.[836] A 1999 summary by Clark-Bardes showed that interest rates charged on loans under some of the contracts -- those issued by Massachussetts Mutual and Great West -- ranged from 6.75 percent to 11.75 percent during the period 1983 - 1999.[837] As the cash surrender value of the contracts increased, Enron continued to borrow under the contracts. The summary states, "Enron's policy blocks retain 100% loan interest deductibility under current legislation; this deductibility is a commodity that is no longer available in the insurance marketplace."[838]

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[832] Item 11- Attachment A, dated 5/9/2002, 2:11 PM, EC 000768247. Appendix B contains this document.

[833] Attachment D, Enron Corp. 1994 Deferral Plan, Plan Funding Conclusions and Recommendations, Prepared by Corporate Compensation, Corporate Treasury, Clark/Bardes, Inc., EC 000768252. Appendix B contains this document.

[834] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, January 31, 2003, answer 11.

[835] Documents listing COLI contracts as of December 31, 1994, EC2 000038640 - EC2 000038689.

[836] *Id.* Gross surrender value generally is the cash surrender of the contract (the amount that would be received on surrender of the contract to the insurer that issued it), not taking into account fees or other charges, or the amount loaned under the contract.

[837] Attachment B, Enron Corporation Executive Summary, EC 000768248-9. Appendix B contains this document.

[838] *Id.*

PGE's COLI and TOLI contracts.–Enron indirectly acquired COLI and TOLI contracts through the 1997 acquisition of Portland General Electric Company ("PGE") and its affiliates. PGE had purchased life insurance on employees in 1986, approximately 10 years before Enron acquired PGE. The premiums were paid by PGE, and the employees had no interest in the policies. The life insurance contracts were to fund corporate officers' and directors' deferred compensation and pension plans. Policies covering a total of 2,315 Portland General Electric employees were purchased between 1996 and 1999.[839] PGE had approximately $79 million worth of insurance contracts on the lives of its employees, and affiliates held another $59 million worth. These figures represent the contracts' cash surrender value as of 1999.

In preparation for a sale of PGE to Sierra Pacific that was anticipated for 2000, Enron planned during 1999 to acquire the life insurance contracts from PGE. This expected transfer of life insurance contracts from PGE to Enron was named "Project Granite."[840] Enron tax department analysis concluded that transferring the policies would yield an after-tax benefit to Enron of $129 million.[841] The sale of PGE to Sierra Pacific, and the transfer of PGE's life insurance contracts to Enron, never took place.[842]

Role of outside advisors

Clark-Bardes, an insurance broker, was involved with respect to contracts Enron bought in 1983, 1984, 1985, and 1986 and in 1994. Enron also bought life insurance contracts through the Management Compensation Group/Silverstone Group. These brokers also provided management services to Enron, such as preparing statements listing all the life insurance contracts and showing the contracts' values and loan balances.

Subsequent developments

Enron's COLI and TOLI contracts.–In connection with Enron's bankruptcy filing on December 2, 2001, the company filed a statement of contingent and non-contingent interests in certain assets, including life insurance policies.[843] Shortly before Enron's bankruptcy filing,

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[839] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, January 31, 2003, answer 11.

[840] Enron Corp. Project Granite, Executive Compensation/Benefits Trust, October 29, 1999, EC2 000038621 - EC2 000038634.

[841] Interoffice memorandum from J. Anthony Jarrett to File, Subject: Sale of PGE: Options for Trust Owned Life Insurance, August 6, 2002, EC2 000038636 - EC2 000038638. Appendix B contains this document.

[842] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, January 13, 2003, answer 141. The sale of PGE to Sierra Pacific did not take place; Enron listed PGE among its core assets in its bankruptcy filing (Dec. 2, 2001).

[843] "Exhibit B-19, Contingent and non-contingent interests in estate of a decedent, death benefit plan, life insurance policy, or trust," filed August 14, 2002, in the United States Bankruptcy Court, S. D. N.Y. The letter from Enron's counsel (Skadden, Arps) to Lindy L.

Enron held 1,047 life insurance policies, the same number of contracts it had in 1994. The contracts had a gross cash surrender value of approximately $512 million, of which approximately $432 million was borrowed (i.e., was included in the loan balance with respect to the policies).[844]

Since the end of 1994, the loans under Enron's COLI contracts had increased by approximately $254 million (from approximately $178 million to approximately $432 million). During this period, the gross surrender value of the contracts increased by approximately $286 million (from approximately $226 million to approximately $512 million). Approximately half (493 of 1,047 contracts) of Enron's COLI contracts were purchased before June 20, 1986, and were grandfathered under the 1986 and 1996 legislation limiting interest on debt with respect to life insurance contracts.

Enron's life insurance contracts on employees were surrendered during the period May through July, 2002.[845]

PGE's COLI and TOLI contracts.–PGE is listed as a core asset in Enron's December 2, 2001, bankruptcy filing. The sale of PGE to a third party, and the transfer of PGE's life insurance contracts to Enron, did not take place as anticipated.

The life insurance contracts held by Portland General Electric were in the process of being surrendered as of January 31, 2003. At that time, some of the contracts had been surrendered.[846]

Discussion

Enron's COLI and TOLI arrangements were leveraged, showing approximately $432 million of debt on $512 million of life insurance coverage by November, 2001. The purchase of

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Paull, Joint Committee on Taxation, January 31, 2003, answer 11, states that the amount borrowed was approximately $432 million as of November 30, 2001.

[844] *Id.* The values of assets in this filing were required to be stated as of the month-end prior to the December 2, 2001, petition date, that is, as of November 30, 2001.

[845] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, January 31, 2003, answer 11, and Enron Corp. COLI Policies Surrendered in 2002, EC2 000057702. The latter document is contained in Appendix B. According to a company document (Item 11 - Attachment A, EC000768247), by August 9, 2002, 767 of Enron's life insurance contracts covering the lives of individuals, with annual premiums of approximately $12.7 million, had been surrendered. Another 279 life insurance contracts held by Enron on individuals remained in force as of that date, according to the document, and final premium payments were made in 2000 for 78 of the Enron contracts remaining in force, and annual premium payments on the other 201 of the contracts totalled approximately $5.8 million.

[846] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, January 31, 2003, answer 11.

these contracts predated the 1996 and 1997 legislation limiting interest deductions under life insurance contracts and imposing a pro rata reduction on interest deductions in the case of taxpayers that have life insurance contracts but do not borrow directly under the contracts.

The grandfather rule under the 1986 COLI legislation would apply to those contracts Enron purchased on or before June 20, 1986. Under this grandfather rule, neither the 1986 $50,000 per-contract cap on debt, nor the broader 1996 rule disallowing interest on debt under a life insurance contract, applied to contracts Enron purchased on or before June 20, 1986 (although for interest incurred after the 1996 legislation, those contracts were subject to an interest rate cap based on a Moody's rate relating to corporate bond yields).

This grandfather rule continues in effect, allowing the continued deduction of interest on debt under contracts that were purchased on or before June 20, 1986. As years pass from the 1986 date, the value of this tax treatment increases with the growth of the cash surrender value of the grandfathered contracts (assuming they are not treated as materially changed or otherwise ceasing to be pre-June 20, 1986 contracts). This result could be viewed as inconsistent with Congress' repeated legislation limiting interest deductions with respect to life insurance contracts.

Recommendations

In light of the growth of interest on debt incurred under Enron's life insurance contracts that remained deductible due to the grandfather rule applicable to pre-June 20, 1986 contracts, the Joint Committee staff recommends termination of the grandfather rule for such contracts. Even though Enron did not purchase any additional life insurance contracts after 1994, Enron's debt and deductible interest under life insurance contracts continued to increase throughout the 1980s and 1990s (along with the cash surrender value of the contracts). This result is inconsistent with the legislative limitations imposed by Congress in 1986, 1996 and 1997 on interest associated with the tax-free inside buildup of life insurance contracts. If the 1986 grandfather rule was intended to provide transition relief to businesses that had purchased life insurance contracts before the 1986 date, sufficient time has passed that a redeployment of such businesses' assets could have been possible. The grandfather rule can no longer serve any reasonable need for transition relief.