Sale of Executive Options Technique – Advantages and Disadvantages
(Privileged Information – Do Not Disseminate)

Associated Advantages of Using the Sale of Executive Options Technique

Executive

1. The executive gets the opportunity to diversify his/her portfolio without having an immediate tax payment due from exercising the options.

2. The executive keeps approximately 80% of the benefits from deferring associated taxes for 15 years.

3. Income from the options is "locked-in" at the sale price.

4. The technique does not have to be reported to the IRS as a tax shelter.

5. The downside risk is limited as Arthur Andersen's opinion letter should eliminate tax penalties imposed by the IRS for disallowing the technique.

Enron

1. Enron may generate goodwill from its top executive staff for introducing such a large potential benefit to its executives.

2. The technique helps serve as an NOL tax refresher for Enron.

Associated Disadvantages of Using the Sale of Executive Options Technique

Executive

1. The executive must pay Arthur Andersen the entire fee by the time the technique is implemented while the benefits will accrue over 15 years.

2. The executive must capitalize the Limited Partnership with non-personal assets in value approximately equal to 10% of the sale price of the options.

3. If the value of the Limited Partnership portfolio drops by a significant amount, then the Limited Partnership could have trouble repaying the "promise to pay" back to the executive. However, this debt must be repaid. In the case of executive death, the debt must be repaid to his/her estate.

4. If tax rates change significantly over the next 15 years, the value of the benefit could be significantly lessened.

Enron

1. Could potentially, significantly reduce executive ownership in Enron. ?

2. Enron must wait until the executive claims income in order to receive the compensation tax deduction for the option. If all goes as planned, Enron will postpone its tax benefit for 15 years.

3. If the executive leaves Enron within the next 15 years, Enron will require some sort of procedure to receive its tax deduction when principal is repaid to the executive from the Limited Partnership.

4. Enron will require guidance from Arthur Andersen as the executive's tax advisor to operationalize manually overriding the payroll system to legally keep income off of the executive's W-2 statement.

5. How will Enron's role in letting Arthur Andersen show the technique to executives be perceived by tax and legal authorities? Enron would prefer not to have involvement.

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Discuss

Sale of Executive Options Technique
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Steps Involved in the Transaction

I. The Executive forms a Limited Partnership (LP) with family ownership approximately as follows:

Executive	79% Limited Partner (also General Partner)
Executive Spouse	18% Limited Partner (also General Partner)
Children	3% Limited Partners

Maintain beneficial ownership (indirect

Executive makes a capital contribution to the LP roughly equal to 10% of the value of the options that will be sold to the LP.

Capitalization should be comprised of non-personal assets.

II. Executive sells options to the LP for an amount equal to the appraised value of the options.

Discuss w/ Mary – cannot be unvested

Generally, nonqualified options will be used (vested ~~or unvested~~).

LP gives to the executive, an unfunded, unsecured, 15 year, balloon promise to pay with a marketable interest rate which is payable yearly. The principal is to be repaid in 15 years.

All income to be recognized concerning the options will now be fixed at the option sale price.

Income recognition is deferred until principal is repaid (15 year principal repayment defers the taxable recognition of income for 15 years). An amortizing debt would recognize income incrementally as the principal is returned to the lender.

Employee income recognition and Enron compensation expense recognition, for tax purposes, must occur at the same time. This means that Enron will not be able to receive a tax deduction for the options (or portions of them) unless the principal on the note (or portions of it) is repaid.

(sale -- for value; occ, insider maintains control/beneficial ownership (he has sold to himself, in effect.)

III. While the partnership may exercise the options within the time frame permitted under the relevant option plan, most partnerships exercise the options and sell the underlying shares immediately. – Note.

Effect of Transaction on Executive

- Can ~~but~~ rely on S-8
- Must report sale by P/S as sale by insider (or family P/S).

Cash

Initial outflow of 10% of the transferred asset value to fund the LP.

The executive must expend the greater of $150,000 or 20% of the NPV of the deferred benefit as compensation to Arthur Andersen.

The executive will receive interest payments annually from the LP. For tax purposes, the amount is reduced by the amount of the pass through interest expense by the LP.

Income

The executive will defer the income from the sale of the options until principal is received.

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It is recommended that the LP exercise the options immediately after the sale transaction. If the options are exercised immediately after the sale, then the net effect of an IRS disallowed deduction would be to accelerate taxes due from a 15 year deferral period to present. AA's "more likely than not" opinion is intended to shield the executive from penalties for understating income should the transaction be challenged.

Enron must override the payroll system at exercise. Since all income will be deferred, override is necessary to ensure that no income will be attributable to the executive from exercise.

Income is also recognized by the executive for interest received on the note receivable. This is partialy offset by the interest expense passed through by the LP.

SEC Reporting

No additional SEC reporting is required.

Discuss - When P/S exercises option, Ken Lay files a Form 4.

Effect of Transaction on LP

Cash

The LP will have an initial capitalization of approximately 10% of the transaction value.

The LP will take possession of the stock options and simultaneously exercise the options.

Will be reported on Ken Lay's Form 4. (i.e., he maintains beneficial ownership -- not a "gift" to family member.

Income

Interest payments will be an interest expense to the LP while the investment income will be income.

Both interest expense and investment income will be passed through to the partners of the LP.

16a-13 Transaction - Without change in pecuniary interest Exempt from Sec 16

SEC Reporting

Upon sale, Form 4 (Family Controlled Entity) is filed by Enron while S-8 should continue to suffice.

? Filed by Ken Lay (not Enron, not Family Controlled Entity)

Effect of Transaction on Enron

Cash

Upon exercise, Enron will recieve the strike price times the number of options exercised.

Since Enron is allowed a compensation expense deduction as the executive recognizes income, a compensation expense (and corresponding the tax deduction) will be taken when principal is returned. This has an effect of reducing cash flow (vis-à-vis a normal exercise) in the year of exercise if Enron is in a positive NOL situation.

is loss of deduction for 15 year. Value in excess of $60,000?

If the sale of options transaction is disallowed by the Service, Enron will be allowed an accelerated compensation expense deduction for the income related to the exercise of the options.

Income

As mentioned above, a slight decrease in the tax deduction will effect a small decrease in net income.

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Tax

The transaction has the net effect of increasing tax expense in the year of exercise and decreasing the expense when principal is returned.

If the deferral transaction does not work, all income from exercise will be accelerated to the date of exercise allowing Enron a corresponding immediate deduction.

Accounting

must be immaterial

For Financial Accounting purposes, the net effect of the transaction is a small indirect reduction in net income through a lower tax deduction in the year of exercise.

Discuss w/ Cauley ~~Also~~ ENE is not a party to this so no proxy disclosure

The deferred tax asset will be maintained on Enron's books without an NPV adjustment.

SEC Reporting

Upon sale, Form 4 (Family Controlled Entity) is filed by Enron while S-8 should continue to suffice.

Ken Lay

Other

This transaction could be put in place by an executive without approval by Enron, however proper approval may be warranted as Enron's involvement may require overriding the payroll systems concerning W-2 income recognition.

But ENE is not a party (Proxy issue)

There is a small chance that an equity analyst could figure out the transaction.

Enron Plan Allowance for the Transaction

Arthur Andersen requires that plan documents permit "transfers" for the transaction to be permitted. The 1991 Plan currently has that language with the 1994 plan to contain that language beginning August 2000.

Does Plan provide for "sales". I thought what was contemplated was "gifts" (transfers to family members) Have Pat Martin look at this.)

Should be limited # of executives that get grants for from '94 Plan

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