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**REPORT OF INVESTIGATION OF
ENRON CORPORATION AND RELATED ENTITIES
REGARDING FEDERAL TAX AND COMPENSATION ISSUES,
AND POLICY RECOMMENDATIONS**

VOLUME I: REPORT

**Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION**

**At the Request of
Senator Max Baucus
and
Senator Charles E. Grassley
of the
SENATE COMMITTEE ON FINANCE**



February 2003

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JOINT COMMITTEE ON TAXATION

108TH CONGRESS, 1ST SESSION

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TRANSMITTAL LETTER

Senator Max Baucus
Senator Charles E. Grassley
Senate Committee on Finance
Washington, DC 20510

Dear Senators Baucus and Grassley:

By this letter, I am hereby transmitting to you an official report of the investigation of the staff of the Joint Committee on Taxation relating to Enron Corporation and related entities, which was prepared pursuant to your request dated February 15, 2002. This investigation took nearly a year to complete. The Joint Committee staff spent countless hours reviewing documents and other information, interviewing individuals relevant to the investigation, and preparing this Report, while at the same time continuing to perform the normal legislative duties with which the Joint Committee staff is charged.

Each member of the Joint Committee staff contributed to the investigation. However, special recognition must be given to certain members of the Joint Committee staff who devoted much of their time during the last year to the investigation. Mary Schmitt, Sam Olchyk, and Carolyn Smith coordinated all aspects of the Joint Committee staff work on the investigation and were each primarily responsible for certain aspects of the investigation. Other Joint Committee professional staff members who also had primary responsibility for the investigation include E. Ray Beeman, Nikole Clark, Robert Gotwald, Brian Meighan, David Noren, Cecily Rock, Carol Sayegh, Ron Schultz, and Allison Wielobob. Other professional staff members who contributed to the investigation include Roger Colinvaux, Patrick Driessen, Deirdre James, Laurie Matthews, Patricia McDermott, Pamela Moomau, John Navratil, Oren Penn, and Tara Zimmerman. Recognition is provided to the administrative and support staff who assisted with the investigation, including Jean Best, John Bloyer, Sean Corcoran, Kathleen Dorn, Jayne Gribbin, Debra McMullen, Neval McMullen, Kristine Means, Tracy Nadel, Melissa O'Brien, Lucia Rogers, and Patricia Smith. A special thanks goes to Christine Simmons, whose skill at pulling together an enormous document made the Joint Committee staff's work much easier.

The Joint Committee staff gratefully acknowledges the contribution of Christopher Hanna, Professor of Law, Southern Methodist University, who contributed to the Joint Committee staff investigation as a consultant and was particularly helpful in assisting the Joint Committee staff understand Enron's complex tax transactions. In addition, Claire Merkin who was with the Joint Committee staff for six months under a special fellowship program with the New York University School of Law, also assisted in the investigation.

Sincerely,

Lindy L. Paull
Chief of Staff

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INTRODUCTION

This document,¹ prepared by the staff of the Joint Committee on Taxation (“Joint Committee staff”), is an official report of the Joint Committee staff investigation relating to Enron Corporation and related entities. This investigation began in February 2002 at the request (by letter dated February 15, 2002) of Senator Max Baucus and Senator Charles E. Grassley of the Senate Committee on Finance.

The Joint Committee staff is publishing this Report in three volumes. Volume I contains the Joint Committee staff report of investigation. Volume I is divided into Four Parts: Part One is the general observations, findings, and recommendations; Part Two contains general background information including the methodology and scope of the Joint Committee staff investigation and a history of the company; Part Three provides a detailed discussion of certain of Enron’s tax-motivated business transactions and other business tax issues; and Part Four provides a detailed discussion of Enron’s pension plans and compensation practices.

Volumes II and III contain four Appendices to this Report. Appendix A (general information relating to investigation) and Appendix B (information relating to Enron’s tax-motivated transactions) are contained in Volume II. Appendix C (tax opinion letters with respect to Enron’s tax-motivated transactions) and Appendix D (pension and compensation-related materials) are contained in Volume III.

¹ This document may be cited as follows: Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003.

EXECUTIVE SUMMARY

A. General Overview of the Investigation

1. Scope of Report

In February 2002, at the direction of Senator Max Baucus and Senator Charles E. Grassley of the Senate Committee on Finance (“Senate Finance Committee”), the staff of the Joint Committee on Taxation (“Joint Committee staff”) began its review of Enron Corporation and related entities (“Enron”).² The review focused on two principal areas: (1) Enron’s use of tax shelter arrangements, off-shore entities, and special purpose entities, and (2) the compensation arrangements of Enron employees, including tax-qualified retirement plans, nonqualified deferred compensation arrangements, and other arrangements, in order to analyze the factors that may have contributed to the loss of benefits and the extent to which losses were experienced by different groups of employees. This Report transmits the findings and recommendations of the Joint Committee staff with respect to its review of these areas.

On March 6, 2002, a disclosure agreement was executed by representatives of Enron Corp., the Senate Finance Committee, and the Joint Committee staff. Under the terms of the disclosure agreement, Enron agreed to the disclosure of its tax returns and tax return information that would otherwise be confidential under the Federal tax laws. The Senate Finance Committee and Joint Committee staff agreed that any disclosure of information collected during the investigation would only be disclosed through official reports, meetings, or hearings of either Committee.

2. Methodology and scope of Joint Committee staff investigation

Enron agreed to cooperate with the Joint Committee staff investigation. Enron complied with requests for information from the Joint Committee staff through the voluntary production of documents.

In conducting its investigation, the Joint Committee staff:

- Requested Enron’s tax returns since 1985;³
- Reviewed more than 100 boxes of documents received from Enron in response to seven extensive document requests;

² Except as otherwise indicated, all references to “Enron” in this Report refer to Enron Corporation and its affiliates, and all references to “Enron Corp.” refer specifically to the parent company.

³ Each tax return was thousands of pages in length.

- Reviewed more than 40 boxes of documents from the Internal Revenue Service (“IRS”) relating to Enron;
- Conducted 46 interviews of current and former Enron employees and other individuals with information relevant to the investigation;
- Made four trips to Houston, Texas, to review documents and conduct interviews;
- Reviewed publicly available information relating to Enron, including information made available by various Congressional committees, governmental agencies, the U.S. Bankruptcy Court for the Southern District of New York, and information contained in media reports; and
- Reviewed information provided by the Pension Benefit Guaranty Corporation, the Department of Labor, and the Senate Permanent Subcommittee on Investigations.

The Joint Committee staff faced several limitations in conducting the investigation. The Joint Committee staff had to rely on Enron’s cooperation to make available relevant documents and employees. In many cases, current Enron management could not locate the requested documentation or were unable to answer questions posed by the Joint Committee staff. The individuals interviewed by the Joint Committee staff were not under oath, nor were individuals relevant to the investigation compelled to appear. Many Enron employees who had participated in the transactions or activities reviewed by the Joint Committee staff have since left Enron and, in some cases, could not be located for an interview. Other individuals stated that they recalled little of the specific events or transactions. The Joint Committee staff cannot represent that this Report identifies all relevant facts or analyzes all transactions in which Enron engaged that might be of interest to policymakers or government agencies.

Despite these limitations, the Joint Committee staff believes that its investigation provides valuable analysis of Enron’s structured transactions and compensation structures and provides important recommendations and findings for improvements to the Federal tax system. More generally, the Joint Committee staff believes the Report provides significant insights into a corporation’s tax and compensation activities that typically are unavailable to those outside the company.

The Report identifies financial accounting benefits that Enron claimed in connection with certain tax-motivated transactions, but it was beyond the scope of the investigation to evaluate the validity of these claimed financing accounting benefits. Therefore, the financial accounting benefits are reported as claimed.

This Report is presented in three volumes. Volume I contains the Joint Committee staff report of investigation. Volume I is divided into Four Parts: Part One is the general observations, findings, and recommendations of the Joint Committee staff investigation; Part Two contains general background information, including the methodology and scope of the Joint Committee staff investigation and a history of the company; Part Three provides a detailed discussion of certain of Enron’s tax-motivated business transactions; and Part Four provides a detailed discussion of Enron’s pension plans and compensation practices.

Volumes II and III contain four Appendices to this Report. Volume II contains Appendices A and B. Appendix A contains copies of certain general information relating to investigation, including the letter to the Joint Committee staff from Senators Baucus and

Grassley and the disclosure agreement among Enron, the Senate Finance Committee, and the Joint Committee staff. Appendix B provides detailed documentation relating to Enron's tax-motivated transactions. Volume III contains Appendices C and D. Appendix C reprints copies of the tax opinion letters provided with respect to Enron's tax-motivated transactions. Appendix D contains information relating to Enron's pension plans and other compensation-related materials.

B. Enron's Business Operations and Tax-Motivated Transactions

Enron is a Houston-based energy and commodities trading company currently under Federal bankruptcy reorganization protection. Prior to its bankruptcy, Enron conducted business through approximately 3,500 domestic and foreign subsidiaries and affiliates (though some of these entities were inactive), and operated in diverse markets and industries such as wholesale merchant and commodity market businesses, the management of retail customer energy services, the operation of gas transmission systems, and the management of energy-related assets and broadband services. Enron reported consolidated financial statement revenues of \$101 billion for 2000, and ranked seventh on the Fortune 500 list of the country's largest companies for 2001. As of December 31, 2000, the company had approximately 59,000 shareholders of record with respect to its outstanding shares of common stock. At the time it filed for bankruptcy on December 2, 2001, Enron employed approximately 25,000 employees worldwide.

1. Summary of selected tax information

Federal taxable income

Enron and its affiliates filed a consolidated Federal income tax return for each year from 1985 through 2001. Based on Enron's tax returns without regard to audit adjustments, Enron paid approximately \$325 million in Federal income taxes between the years 1990 and 1995.

Enron paid no Federal income tax for taxable years 1996 through 1999, and reported a net operating loss carryover of \$3.1 billion from 1999 to 2000. Enron reported that it fully utilized its net operating loss carryover in 2000 and paid \$63.2 million of Federal income tax for its 2000 taxable year. Enron filed its 2001 Federal income tax return on September 13, 2002, and reported a net operating loss of \$4.6 billion for its 2001 taxable year.

Table 1, below, lists Enron's Federal tax liability for its taxable years 1996 through 2001.

Table 1.—Enron's Federal Tax Liability, 1996-2001
[millions of dollars]

Year	Regular Tax	Alternative Minimum Tax	Total Tax Per Return
1996	0	0	0
1997	0	0	0
1998	0	0	0
1999	0	0	0
2000	21.3	41.9	63.2
2001	0	0	0*
Totals	21.3	41.9	63.2

Source: Enron's Federal income tax returns

* Enron's tax liability for taxable year 2001 as shown on its return was \$13,331.

The IRS uses a coordinated industry case program to coordinate the examination of large and highly diversified taxpayers. Enron has been in the coordinated industry case program since

January 1989. The IRS has completed its examination of Enron's tax returns through 1995 and is currently examining Enron's 1996 through 2001 tax returns. The IRS adjustments to Enron's taxable years 1988 through 1994 increased Enron's taxable income by \$361 million, which, after taking into account net operating loss carryovers from earlier years, resulted in additional tax payments of \$4.3 million for 1988 through 1994.⁴

It is impossible to fully assess Enron's ultimate tax liability until the IRS examination of Enron's tax returns for 1996 through 2001 is completed and the bankruptcy court has reviewed the IRS proof of claim, which is expected to be filed by March 31, 2003.

Reconciliation of Enron's financial statement net income and Federal taxable income

Enron reported financial statement net income of \$2.3 billion, but tax losses of \$3 billion, for the period 1996 through 1999. For year 2000, Enron reported financial statement net income of \$1.0 billion and taxable income of \$3.1 billion (before net operating loss carryovers from 1999).

Table 2, below, summarizes the significant adjustments from Enron's Form 1120, Schedule M-1, Reconciliation of Financial Statement Income to Taxable Income, for years 1996 through 2000. These reconciliations use Enron's financial statement and tax return information as reported or filed, without regard to restatements or audit adjustments. It should be noted that a complete analysis of Enron's book to tax differences cannot be made prior to determination of Enron's ultimate tax liability, which is under review by the bankruptcy court, and without a restatement of Enron's financial statements for these periods to reflect generally accepted accounting principles.

⁴ The IRS examination of Enron's tax return for 1995 is complete. The impact of any IRS adjustments to Enron's 1995 tax return will not be known until the examination of 1996 through 2001 is complete.

Table 2.—Enron Corp. and Subsidiaries: Reconciliation of Financial Statement Income to Taxable Income 1996-2000
[millions of dollars]

	1996	1997	1998	1999	2000
Net Income Reported in Consolidated Financial Income Statement ¹	584	105	703	893	979
<u>Less Net Income from Entities not Included in Consolidated Tax Return</u>					
Domestic Corporations ²	-96	-189	-149	-152	-345
Foreign Corporations ³	-232	-44	-521	-1,110	-1,722
Partnerships ⁴	-145	-211	-319	-638	-6,899
	-473	-444	-989	-1,900	-8,966
<u>Plus Net Income from:</u>					
Intercompany Elimination Made for Books but not for Tax	1,322	1,300	1,884	3,997	13,625
Entities not Controlled for Financial Accounting Included for Tax ⁵	0	0	14	122	258
	1,322	1,300	1,898	4,119	13,883
Book Income Reported on Consolidated Tax Return	1,433	961	1,612	3,112	5,896
<u>Significant Book to Tax Adjustments⁶</u>					
Federal Income Taxes	159	-35	45	-128	193
Net Partnership Adjustments	-107	-122	-109	-338	-481
Net Mark to Market Adjustments	-118	118	-333	-906	-537
Constructive Sale (section 1259)	0	0	0	0	5,566
Structures Treated as Debt for Tax not for Book (e.g., equity or minority interest)	-2	-24	-3	-12	-149
Company Owned Life Insurance Adjustment	-19	-24	-27	-35	-20
Stock Options Deduction	-113	-9	-92	-382	-1,560
Depreciation Differences	-67	-65	-57	-124	-154
Equity Earnings Reversal Per Tax Return	-1,183	-1,023	-1,688	-2,868	-5,516
All Other Book to Tax Differences	-293	-281	-101	223	-137
Taxable Income Reported on Consolidated Tax Return	-310	-504	-753	-1,458	3,101

Notes:

(1) As originally reported. (2) Corporations not meeting 80 percent vote and value test (sec. 1504(a)(2)). The financial accounting to tax return reconciliation in Appendix A contains additional details of these amounts. (3) Foreign corporations are not eligible for inclusion in consolidated tax return (sec. 1504(b)(3)). (4) Partnerships are required to file separate Federal income tax returns. The financial accounting to tax return reconciliation in Appendix A contains additional details of these amounts. (5) Disregarded entities for Federal tax purposes (Treas. Reg. sec. 301.7701-3) not included in consolidated financial statements. The financial accounting to tax return reconciliation in Appendix A contains additional details of these amounts. (6) Amounts as reported in Enron presentation to the Joint Committee staff, June 7, 2002. Appendix B contains this presentation. In addition, Appendix A contains further details of Enron's book to tax adjustments as reported in the tax return.

2. Enron's development and use of tax-motivated structured transactions

As Enron's management came to realize that tax-motivated transactions could generate financial accounting benefits, Enron looked to its tax department to devise large transactions that would increase its financial accounting income. Enron came to view the role of its tax department as more than managing its Federal income tax liabilities. Rather, Enron's tax department became a source for financial statement earnings, thereby making it a profit center for the company. With an emphasis on short-term profitability and cash flow, Enron used various techniques to generate current financial statement net income and increase cash flows. Enron also used techniques with respect to its tax planning by engaging in 12 large structured transactions during the period from 1995 until it filed for bankruptcy. At their core, Enron's structured transactions were designed to permit Enron to take the position that its long-term tax benefits could be converted to current or short-term financial statement net income. In most of the structured transactions discussed in this Report, the origin of the financial accounting benefits was the reduction in Federal income tax that the transaction was anticipated to provide either currently or in the future.

This Report classifies Enron's business transactions into various categories: (1) structured transactions that raise corporate tax issues; (2) structured transactions that raise partnership tax issues; (3) other structured transactions which implicate international or certain financial products provisions; (4) corporate-owned and trust-owned life insurance arrangements; and (5) structured financings, including tiered preferred securities, investment unit securities, and commodity prepay transactions. Irrespective of the structure used, the structured transactions typically used one of two strategies to achieve their tax and financial statement benefits. Several of the structured transactions (i.e., Projects Tanya, Valor, Steele, and Cochise) were designed to duplicate losses (i.e., deduct the same loss twice) with respect to a single economic loss. The other dominant strategy (i.e., Projects Tomas, Condor, Teresa, Tammy I and Tammy II) was to shift tax basis from a nondepreciable asset to a depreciable asset with little or no economic outlay. One exception was Project Apache, which was designed to generate tax deductions for what was, in essence, the repayment of principal. In two projects (Renegade and Valhalla), Enron received a fee to serve as an accommodation party to another taxpayer who expected to derive tax or financial statement benefits from a structured transaction.

Most of the transactions relied on differences between the tax treatment and financial accounting treatment of various items so that the tax benefits could be used to generate financial statement income. For example, the transactions designed to duplicate losses, i.e., deduct the same tax loss twice, would be recorded on the financial statements as producing income (not loss). Similarly, the transactions designed to shift tax basis from a nondepreciable asset to a depreciable asset would be recorded on the financial statements as producing income.

Table 3, below, summarizes certain tax and accounting information regarding Enron's structured transactions. The table shows that the financial accounting benefits Enron expected to derive from the structured transactions were front loaded to provide immediate reporting of earnings for its financial statements, even though the bulk of the tax benefits would not be derived, if at all, until well into the future. The table lists the promoter of the transaction, the primary tax opinion provider, and project fees paid by Enron with respect to each transaction. The table tells a broader story as well -- from 1995 until Enron filed for bankruptcy, Enron achieved more than \$2 billion in tax and financial accounting benefits and paid approximately \$88 million in fees paid to advisors and promoters.

Table 3.—Benefits and Fees of Enron’s Various Structured Transactions (1995-2001)
(millions of dollars)

Project Name	Financial Accounting Income through 2001¹	Total Projected Financial Accounting Income²	Federal Tax Savings through 2001³	Total Projected Federal Tax Savings⁴	Promoter	Primary Tax Opinion Provider	Total Project Fees⁶
Tanya (1995)	66	66	66	66	Arthur Andersen	Arthur Andersen	0.5
Valor (1996)	---	82	82	82	Arthur Andersen	Arthur Andersen	0.1
Steele (1997)	65	83	39	78	Bankers Trust	Akin, Gump, Strauss, Hauer & Feld	11
Teresa (1997)	226	257	(76)	263	Bankers Trust	King & Spalding	12
Cochise (1998)	101	143	---	141	Bankers Trust	McKee Nelson, Ernst & Young	16
Apache (1998)	51	167	51	167	Chase Manhattan	Shearman & Sterling	15
Tomas (1998)	37	113	95	109	Bankers Trust	Akin, Gump, Strauss, Hauer & Feld	14
Renegade (1998) ⁵	1	1	---	---	Bankers Trust	---	---
Condor (1999)	88	328	---	332	Deloitte & Touche	Vinson & Elkins	10
Valhalla (2000) ⁵	16	64	---	---	Deutsche Bank	Vinson & Elkins	---
Tammy I (2000)	---	406	---	414	Deloitte & Touche	Vinson & Elkins	9
Tammy II (2001)	---	369	---	370	---	---	---
Totals	651	2,079	257	2,022	N/A	N/A	87.6

Notes:

(1) Financial accounting income does not reflect the reversal of many of the reported income amounts due to Enron’s bankruptcy filing; (2) Source information for projected financial accounting income is the November Structured Transactions Group Summary of Project Earnings & Cash Flows, November 2001 contained in Appendix B to this Report, except Project Valor. Due to Enron’s bankruptcy filing, it is likely that many of the financial accounting benefits will not be realized; (3) Federal tax savings computed using a 35 percent tax rate. Because Enron had net operating losses for many of the years the benefits resulted in increased net operating losses rather than an immediate reduction in taxes; (4) Source information for projected Federal income tax savings is the November Structured Transactions Group Summary of Project Earnings & Cash Flows, November 2001 contained in Appendix B to this Report, except Project Valor; (5) Enron was an accommodation party to Bankers Trust and Deutsche Bank (the successor to Bankers Trust) in Projects Renegade and Valhalla, respectively. Enron was paid \$1.375 million for engaging in Project Renegade. Enron’s fee for participation in Project Valhalla was in the form of an interest-rate spread on the offsetting loans; and (6) Project fees are based on contractual agreements between Enron and the counterparty. Due to Enron’s bankruptcy filing, not all payments have been received by the counterparty to each agreement.

3. Enron's foreign subsidiaries and other entities

As of December 31, 2001, Enron's worldwide operations included roughly 250 foreign entities that were associated with ongoing businesses. Enron had a total of approximately 1,300 different foreign entities, including foreign corporations and partnerships that were controlled by Enron, as well as other entities in which Enron owned a significant stake. Approximately 80 percent of Enron's foreign entities were inactive shells that did not hold and were not engaged in or associated with any ongoing business and that were therefore largely irrelevant for tax purposes.

Enron created many entities in jurisdictions that do not impose a tax on such entities. In particular, as of December 31, 2001, the Enron ownership structure included 441 entities formed in the Cayman Islands, a country that has never imposed a corporate income tax. Most of these entities were inactive shells not associated with any ongoing business.

C. Pension and Compensation Arrangements

1. Overview

Enron's compensation arrangements received considerable media attention in the aftermath of the Enron bankruptcy. Some of this attention has focused on the broad-based retirement plans maintained by Enron that receive special tax benefits ("qualified retirement plans"). For many Enron employees, the benefits provided under these plans were the primary source of retirement income. Attention has also focused on the overall compensation arrangements of Enron, particularly the compensation provided to executives. The Report addresses both aspects of Enron's compensation arrangements.

2. Enron's qualified retirement plans

Overview of Enron qualified plans

Enron maintained three main qualified retirement plans: the Enron Employee Stock Ownership Plan ("ESOP"); the Enron Retirement Plan, which was modified and renamed the Enron Cash Balance Plan; and the Enron Savings Plan.

The Enron ESOP was invested primarily in Enron stock.

The Enron Retirement Plan provided a benefit based on a participant's compensation and years of service. The Enron ESOP and Enron Retirement Plan were designed as a floor-offset arrangement, under which benefits earned by a participant under the Enron Retirement Plan were reduced or "offset" by the benefits received by the participant under the Enron ESOP.

The floor-offset arrangement was frozen after 1994 and was phased out over the period 1996 through 2000. During that period, the value of the account balance in the ESOP was locked in, and an offset for benefits accrued under the Enron Retirement Plan during 1987 through 1994 was set permanently based on Enron stock prices at specified times. As a result of the locking in of the offset and the subsequent decline in the value of Enron stock, many plan participants did not receive the same level of benefits they would have received if the offset feature had remained unchanged. The locking in of the offset is currently under review by the IRS.

In 1996, the Enron Retirement Plan was renamed the Enron Cash Balance Plan and the traditional defined benefit plan formula was replaced with a cash balance formula. The Enron Cash Balance Plan has been under review by the IRS National Office since 2000, pursuant to a 1999 directive that all cash balance plan conversions be referred to the IRS National Office pending clarification of applicable rules.

The Enron Savings Plan is a 401(k) plan. Participants could make elective deferrals and after-tax contributions to the Enron Savings Plan, and had a range of investment choices available for their contributions, including Enron stock. In addition, Enron made matching contributions based on employee elective deferrals. The matching contributions were invested in Enron stock pursuant to the plan terms; participants could elect to invest the matching contributions in another investment after attaining age 50.

Many Enron Savings Plan participants lost considerable amounts of retirement savings due to the high level of investment in Enron stock. Significant amounts of plan assets were invested in Enron stock even though the Enron Savings Plan offered approximately 20 investment options other than Enron stock, consisting of a broad range of alternatives offering various risk and return characteristics.

Employee investment in Enron stock was generally encouraged by Enron. Even as the price of Enron stock declined during 2001, management told employees of a bright future for Enron. For example, Kenneth L. Lay was consistently optimistic in his predictions for the future of Enron stock, even when an employee specifically asked about Enron stock in the context of the Enron Savings Plan.

The decline of Enron's stock price and Enron's subsequent bankruptcy has affected the benefits that Enron employees are or may be entitled to under the Enron qualified plans. Most of the media attention regarding the effect of the bankruptcy on employees' benefits related to the significant plan holdings in Enron stock, particularly in the Enron ESOP and the Enron Savings Plan.

Issues reviewed with respect to Enron qualified plans

The Joint Committee staff reviewed in detail certain issues relating to the Enron qualified plans, including: (1) the locking in of the value of the ESOP offset under the Enron Retirement Plan; (2) the conversion of the Enron Retirement Plan into the Enron Cash Balance Plan; (3) investment of the Enron ESOP in Enron stock; (4) a change in recordkeepers under the Enron Savings Plan that resulted in a "blackout" period in October and November 2001 during which plan participants could not make investment changes while the price of Enron stock was falling; (5) the reasons behind the level of investment of Enron Savings Plan assets in Enron stock; and (6) allegations made in early 2002 by Ms. Robin Hosea, a former Enron contract and full-time employee, that payments were made from Enron's employee benefit funds for purposes unrelated to employee benefits. The Report also discusses the issue of whether plan fiduciaries of the Enron ESOP should have acted to remove Enron stock as an investment under the ESOP, despite plan provisions directing such investment.

3. Other compensation arrangements

In general

In addition to the attention given to the Enron qualified retirement plan issues, attention has been focused on the various compensation arrangements of Enron, particularly those of officers and other executives. This focus has been both on the magnitude of compensation paid to certain executives and on the various forms of compensation used by Enron.

Enron had a pay-for-performance compensation philosophy. Employees who performed well were compensated well. Enron's compensation costs for all employees, and especially for executives, increased significantly over the years immediately preceding the bankruptcy.

Enron's executives were paid substantial amounts. In 2000, total compensation for the 200 highest paid employees of Enron was \$1.4 billion. This consisted of \$56.6 million of

bonuses, \$1.06 billion attributable to stock options, \$131.7 million attributable to restricted stock, and \$172.6 million of other income, including base salary.

Overview of Enron's executive compensation arrangements

Executive compensation at Enron was generally comprised of base salary, annual incentives, and long-term incentives. Enron's long-term incentive program was designed to tie executive performance directly to the creation of shareholder wealth. The long-term incentive program provided for awards of nonqualified stock options and restricted stock. Certain executives were eligible to participate in nonqualified deferred compensation arrangements.

Nonqualified deferred compensation plans

Certain executives were given the opportunity to participate in nonqualified deferred compensation arrangements. Participants were eligible to defer all or a portion of salary, bonus, and long-term compensation into Enron-sponsored deferral plans. The plans provided an opportunity to delay payment of Federal and State income taxes and earn a tax-deferred return on deferrals. Many executives took advantage of the opportunity to defer amounts that would otherwise have been included in income currently.

Nonqualified deferred compensation was a major component of executive compensation for Enron. In 1998, the 200 highest paid employees at Enron employees deferred \$13.3 million. By 2000, that amount had risen to \$70 million. For the years 1998 through 2001, a total of \$154 million in compensation was deferred. According to documents provided by Enron, Mr. Lay deferred \$32 million under one of Enron's nonqualified deferred compensation plans.

In late 2001, prior to Enron's bankruptcy filing, early distributions were made to certain participants from two of Enron's nonqualified deferred compensation plans. These distributions totaled more than \$53 million.

Stock-based compensation

Enron used stock-based compensation as a principal form of compensation for executives. Enron's stock-based compensation programs included nonqualified stock options, restricted stock, and phantom stock. Enron's deduction for compensation attributable to the exercise of nonqualified stock options increased by more than 1,000 percent from 1998 to 2000. Enron's directors were also compensated partially in Enron stock.

Pre-bankruptcy bonuses

In the weeks immediately preceding the bankruptcy, Enron implemented bonus programs; one for approximately 60 key traders and one for approximately 500 employees that Enron claimed were critical for maintaining and operating Enron going forward. In order to receive a bonus under one of these programs, the employee had to agree to repay the bonus, plus an additional 25 percent, if the employee did not remain with Enron for 90 days. The combined cost of the programs was approximately \$105 million.

Special compensation arrangements

Enron had certain compensation arrangements for limited groups of people or for specific individuals. For example, Enron had a Project Participation Plan for employees in its international business unit.

Enron also had arrangements for a small number of employees or in some cases just one employee. One executive, Mr. Lou Pai, received the use of a 1/8 fractional interest in a jet aircraft Hawker 800 as part of his compensation. A few employees received loans (or lines of credit) from Enron or split-dollar life insurance arrangements. Enron purchased two annuities from Mr. Lay and his wife as part of a compensation package for 2001. Certain executives were allowed to exchange interests in plans for large cash payments or stock options and restricted stock grants.

Employee loans

From time to time, Enron extended loans to a few executives. Information provided to the Joint Committee staff indicates that loans were made to at least eight Enron employees, including Mr. Lay and Mr. Jeffrey Skilling. Mr. Lay was provided with a \$7.5 million line of credit with the company. The aggregate amount withdrawn pursuant to his line of credit from 1997 through 2001 was over \$106 million. In 2001 alone, Mr. Lay engaged in a series of 25 transactions involving withdrawals under the line of credit totaling \$77.5 million, of which all but \$7.5 million was repaid. Mr. Skilling was loaned \$4 million by Enron in 1997. Half of the loan was repaid in 1999 and the other half in 2001.

Purchase and reconveyance of Mr. Lay's annuity contracts

In September of 2001, the Compensation Committee of the Enron Board of Directors agreed to an "insurance swap transaction" under which Enron agreed to purchase two annuity contracts from Mr. and Mrs. Lay for \$10 million and also agreed to reconvey the annuity contracts back to Mr. Lay if he remained employed with Enron through December 31, 2005. If Mr. Lay left Enron prior to that date, the reconveyance would still take place in four events: (1) retirement with the consent of the Board; (2) disability; (3) involuntary termination (other than termination for cause); or (4) termination for "good reason." Mr. Lay's counsel indicated in a letter to the Joint Committee staff that they could not give a legal opinion about the current status of the annuity contracts and indicated their understanding that the characterization of Mr. Lay's termination with Enron for purposes of severance benefits was still under review.

Split dollar insurance arrangements

Enron entered into split-dollar life insurance arrangements with Mr. Lay (\$30 million and \$11.9 million), Mr. Skilling (\$8 million), and Mr. Clifford Baxter (\$5 million).

D. Summary of General Observations

This Report's detailed analysis of Enron's structured transactions reveals a pattern of behavior showing that Enron deliberately and aggressively engaged in transactions that had little or no business purpose in order to obtain favorable tax and accounting treatment.

A critical component of many of Enron's structured transactions was the involvement of an accommodation party such as an Enron employee or the party promoting the transaction. Enron's activities show that, in general, when transactions can be structured by parties that have the shared goal of obtaining favorable tax treatment, the tax rules do not function as intended and may produce undesirable results.

In transaction after transaction, Enron obtained sophisticated advice, and in most instances received assurances that the proposed transaction "should" comply with technical tax law requirements. Often, these assurances were based on highly technical interpretations of the law even though the transaction produced surprising and questionable outcomes. Many of the opinions hinged on a determination that the transaction had sufficient business purpose. Enron represented the business purpose of the transaction, and Enron's counsel did not bother to look beyond the representation.

For many transactions, Enron picked from the same small pool of outside advisors. In some cases, if one advisor from the pool was not advising Enron in a particular deal, that advisor advised the other party (the promoter) to the transaction. Thus did incestuous relationships evolve among the participants in many of the transactions, with the result that Enron even acted as an accommodation party to deals designed primarily by Enron's advisors to benefit others.

Enron also excelled at making complexity an ally. Many transactions used exceedingly complicated structures and were designed to provide tax benefits significantly into the future. A reviewer of the transaction would be required to parse details from a series of deal documents, make assumptions about the parties' intent in future years, and only then apply technical rules to the transaction to test for legitimacy. Enron had the incentive and the ability to engage in unusually complicated transactions in order to preclude meaningful review.

Corporations like Enron have an inherent advantage over the IRS. Enron relied on advice from sophisticated and experienced lawyers, investment bankers, and accountants. Assertions of attorney-client privilege hinders the ability of the IRS to obtain many of the most instructive documents, which impedes the IRS's ability to audit the transaction. Enron's activities shows that the IRS cannot minimize the importance of loss companies on examination because to do so would ignore a breeding ground for tax-motivated transactions that also could be used by taxpaying companies.

Enron's aggressive interpretation of business purpose, the cooperation of accommodation parties, the protections provided by tax opinions, the complex design of transactions, advantages over the IRS -- all were factors that contributed to Enron's ability to engage in tax-motivated transactions. Until the costs of participating in tax-motivated transactions are substantially increased, corporations such as Enron will continue to engage in transactions that violate the letter or the spirit of the law.

E. Summary of Findings and Recommendations

1. General findings relating to business tax matters

The Joint Committee staff believes that the transactions that are the subject of this Report demonstrate the need for strong anti-avoidance rules to combat tax-motivated transactions that might satisfy the technical requirements of the tax statutes and administrative rules, but that serve little or no purpose other than to generate income tax or financial statements benefits. Accordingly, the Joint Committee staff makes the following general findings with respect to tax-motivated transactions:

- Stronger measures (e.g., the imposition of substantial, punitive penalties) are necessary to increase the costs to taxpayers of engaging in transactions that lack a non-tax business purpose or economic substance;
- Attainment of financial statement benefits based solely on Federal income tax savings is not a valid business purpose for Federal income tax purposes;
- The tax laws should impose severe penalties on the use of accommodation parties such as employees, consultants, or advisors, as parties in a transaction or arrangement to permit a taxpayer to achieve Federal income tax benefits;
- The Treasury Department and IRS should have a broad array of sanctions to impose on advisors who render opinions that rely on representations that the advisor knows, or has reason to believe, are incorrect, incomplete, or inconsistent with the facts; State licensing authorities should be notified when these sanctions are imposed, and the licensing authorities should discipline the advisor as appropriate;
- Many taxpayers are engaging in transactions primarily to obtain financial accounting benefits and those responsible for promulgating the accounting standards should evaluate whether changes to the rules governing accounting for income taxes should be made; and
- The use of multiple entities in connection with tax-motivated transactions, coupled with the inherent complexity of these transactions and the delayed realization of the tax benefits, makes it exceedingly difficult for the IRS to timely identify and properly evaluate these transactions; thus, taxpayers should be required to make a detailed disclosure of any tax-motivated transaction on a timely basis, irrespective of whether the transaction has immediate tax return effect.

2. Specific recommendations relating to business tax issues

In addition to the general recommendations and findings relating to tax-motivated transactions, the Joint Committee staff makes the following specific recommendations:

- The duplication of losses should be curtailed so that a single economic loss is not deducted more than once;
- The rules that prevent corporate acquisitions made to evade or avoid Federal income tax should be strengthened;
- The extraordinary dividend rules should be strengthened;
- Guidance should be provided on the replication of earnings and profits in a consolidated group;
- There should be greater disclosure of partnership disguised sales;
- The partnership allocation anti-abuse rules should be strengthened;
- Guidance should be provided regarding the transfer of partial partnership interests;
- Rules are needed to address the appropriate interaction between the partnership basis rules and the corporate stock nonrecognition rules;
- The rules for allocating subpart F income should include an anti-abuse provision;
- The exception to the passive foreign investment company rules for U.S. shareholders of controlled foreign corporations should relate more closely to the U.S. shareholder's potential taxability under subpart F;
- The earnings stripping rules should be strengthened;
- Annual information reporting should be required with respect to entities that are disregarded pursuant to a check-the-box election;
- The financial asset securitization investment trust provisions should be repealed;
- The pre-June 20, 1986, grandfather rule for certain corporate-owned life insurance contracts should be repealed;

- The rules relating to the characterization and treatment of debt and equity should be modified; and
- The 50-percent related party threshold under the interest expense disallowance rules for disqualified indebtedness should be eliminated.

3. General findings relating to pensions and compensation

This Report's detailed review of Enron's compensation programs reveals a process which rested approval of executive compensation packages almost entirely with internal management. Although the Compensation Committee of the Board of Directors formally approved both the total amount of compensation paid to executives and the form of such compensation, the Committee's approval generally was a rubber stamp of recommendations made by Enron's management.

Underlying Enron's compensation programs was an apparent lack of consistent or centralized recordkeeping with respect to compensation arrangements in general and executive compensation in particular. Enron could not provide documentation relating to many of Enron's special compensation arrangements for its top executives. Although Enron represented that it properly reported income with respect to employee compensation arrangements, the lack of recordkeeping made it impossible to verify whether this was true.

Enron's heavy reliance on stock-based compensation, both with respect to executives and with respect to rank and file employees, caused significant financial loss when Enron's stock price collapsed. Although some executives suffered losses that appear stunning in amount, many executives also reaped substantial gains from their compensation arrangements. Enron's rank and file employees in many cases lost virtually all of their retirement savings because they believed statements made by Enron's top executives up to the very end that Enron was viable and that Enron's stock price would turn around.

4. Findings and recommendations relating to pensions and compensation

Some of the issues examined by the Joint Committee staff with respect to Enron's retirement plans and compensation arrangements raise nontax issues, such as issues of corporate governance and fiduciary responsibility. The Joint Committee staff finds it appropriate to make the following recommendations with respect to these plans and arrangements:

- Clear rules should be adopted with respect to the operations of cash balance plans and the conversion of traditional defined benefit plans into cash balance plans;
- To better protect retirement benefits, legislative changes should be made to reduce the likelihood that defined contribution plan participants will have high concentrations of assets in a single investment, such as employer securities. Such changes include allowing participants greater opportunities to move plan assets out of employer securities and into more diversified investments, and requiring plans to provide notices regarding investment principles. In addition, plan participants should receive investment education consistent with fiduciary rules;

- To help prevent plan participants from being misled with respect to investments in employer securities, fiduciary rules should apply to statements made by company executives regarding investments under participant-directed defined contributions plans, regardless of whether such officials are otherwise plan fiduciaries. The Department of Labor should also make additional efforts to educate plan fiduciaries and company executives regarding fiduciary obligations;
- Changes should be made to the rules relating to nonqualified deferred compensation arrangements to curb current practices that allow for the deferral of tax on compensation income while providing executives with inappropriate levels of security, control, and flexibility with respect to deferred compensation. These changes include repealing the prohibition on the issuance of related Treasury guidance, and providing that certain plan features result in current taxation, including the ability to obtain accelerated distributions, participant directed investments, and subsequent elections.
- Guidance relating to split-dollar life insurance should be finalized; and
- The limitation on the deduction for compensation in excess of \$1 million should be repealed.