B. Transactions That Raise Corporate Tax Issues

Beginning in 1995, Enron, in consultation with outside tax advisors, engaged in a series of structured transactions that were designed to satisfy the literal requirements of the corporate tax laws, yet produce results that were not contemplated by Congress and not warranted from a tax policy perspective. Several of the projects were structured to duplicate and accelerate tax deductions. The reported tax benefits (and corresponding financial statement benefits) were predicated on the interaction of the corporate tax-free transfer rules and the basis rules that apply to such transfers. For example, Projects Tanya (done in 1995) and Valor (done in 1996) relied on these rules, along with the rules regarding the treatment of contingent liabilities, to duplicate losses in connection with a widely-marketed transaction known as the "contingent liability" tax shelter. Projects Steele (done in 1997) and Cochise (done in 1999) also relied on these rules to duplicate losses in connection with certain built-in loss assets owned by Bankers Trust.

Project Teresa (done in 1997) relied on the interplay between the corporate redemption and dividends received deduction rules (while avoiding the extraordinary dividend rules), in concert with the partnership basis rules, to purportedly increase Enron's tax basis in its building by approximately $1 billion.

This section of the Report begins with a brief discussion of relevant corporate tax rules and then describes in detail Projects Tanya, Valor, Steele, Cochise, and Teresa.[199]

1. Discussion of relevant corporate tax laws

In general, the Federal income tax laws treat a corporation as a separate entity apart from its shareholders. Corporations and shareholders generally are each subject to tax on distributed corporate income. A corporation pays income tax on its income (regardless of whether such income is distributed to its shareholders), while its shareholders include in their income amounts that the corporation distributes to them.

Tax-free transfers to controlled corporations

A transferor that transfers appreciated (or depreciated) property to a corporation in exchange for stock in the corporation, and immediately after the transfer is in "control" of the corporation, generally does not recognize gain (or loss) on the exchange.[200] However, a transferor does recognize gain to the extent the transferor receives money or other property as part of the exchange.[201]

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[199] The next section of this Report discusses the general partnership tax rules (which is relevant to Project Teresa).

[200] Sec. 351(a). For this purpose, section 368(c) defines "control" as the ownership of stock possessing at least 80 percent of the combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

[201] Sec. 351(b)(1).

If an exchange satisfies the requirements of a tax-free transfer, then the transferor's basis in the stock received in the exchange is the same as the transferor's basis in the property transferred, decreased by (1) the amount of any money or other property received by the transferor and (2) any loss recognized by the taxpayer on the exchange, and increased by the amount of gain (or dividend) recognized by the transferor on the exchange.[202] The transferee corporation's basis in the property received in the exchange generally equals the transferor's basis in such property, increased by any gain recognized by the transferor on the exchange.[203]

Assumption of liabilities

A corporation's assumption of a liability in connection with a transfer of property does not prevent a transaction from qualifying for tax-free treatment, nor is such assumption generally treated as a receipt of money by a transferor.[204] The assumption of a liability does reduce the transferor's basis in the stock received in the exchange,[205] and it may result in the recognition of gain by the transferor to the extent the liabilities assumed exceed the total amount of the adjusted basis of the property transferred.[206] In addition, if it appears that the principal purpose of the transferor with respect to the assumption of the liability was to avoid Federal income tax (or was not a bona fide business purpose), then the assumption is considered to be money received by the transferor on the exchange.[207]

Treatment of certain contingent liabilities

An exception to the basis reduction and gain recognition requirements applies with respect to a liability, the payment of which would give rise to a deduction (and that has not resulted in the creation or increase of basis of any property). A liability that falls within this exception is not treated as money received by the transferor and does not reduce the transferor's basis in the stock received in the exchange.[208] This exception was enacted in 1978 to protect a cash basis taxpayer from having to recognize gain on the transfer of its accounts payable on the incorporation of a going business concern.[209] Although this rule was enacted primarily with cash

[202] Sec. 358(a).

[203] Sec. 362(a).

[204] Sec. 357(a).

[205] Sec. 358(d)(1).

[206] Sec. 357(c)(1).

[207] Sec. 357(b)(1).

[208] Secs. 357(c)(3)(A) and 358(d)(2).

[209] S. Rep. No. 95-1263, 95th Cong., 2d Sess. 184, *reprinted in* 1978-3 C.B. 482 (1978).

method taxpayers in mind,[210] accrual method taxpayers also have properly relied on the exception. In some cases, however, taxpayers have utilized the exception to achieve tax benefits not envisioned by Congress. Eventually, Congress revisited the tax treatment of assumed liabilities and enacted section 358(h) in 2000.[211] This provision reduces the basis in stock received by a transferor in connection with a tax-free transfer (but not below its fair market value) by the amount of any liability that is assumed in the exchange if such liability was not treated as money received by the taxpayer.[212] For this purpose the term "liability" includes any fixed or contingent obligation, without regard to whether the obligation is otherwise taken into account for tax purposes.

Deduction of liabilities by transferee corporation

In general, a transferee corporation may be entitled to a deduction of an assumed liability as appropriate under its method of accounting.[213] In this regard, the IRS has ruled that a transferee corporation may deduct certain environmental liabilities assumed in a tax-free transaction.[214]

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[210] The reasons for change states that "[t]he committee therefore believes that it is appropriate to resolve the ambiguity as to whether for purposes of sections 357(c) and 358(d) the term liabilities includes deductible liabilities of a cash basis taxpayer."

As part of the Technical Corrections Act of 1979, Congress changed the requirement that only cash basis taxpayers could exclude certain liabilities for purposes of sections 357(c) and 358(d). *See* S. Rep. No. 96-498, 96th Cong., 1st Sess. 62 (1979).

[211] Section 358(h), added by The Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, sec. 1(a)(7) (Dec. 21, 2000).

[212] Sec. 358(h)(1). This rule does not apply to any liability if (1) the trade or business with which the liability is associated is transferred to the person assuming the liability, or (2) substantially all of the assets with which the liability is associated are transferred to the person assuming the liability. Sec. 358(h)(2).

[213] This has not always been the government's position. *See, e.g., Holdcroft Transp. Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1948) (in a transfer to which the predecessor of section 351 applied, the transferee corporation could not deduct payments made in satisfaction of tort claims even though the transferor would have been entitled to the deductions if it had made the payments). Over the years, however, the IRS generally has refrained from asserting a *Holdcroft*-type argument.

[214] Rev. Rul. 95-74, 1995-2 C.B. 36. In the ruling, an accrual-basis taxpayer ("P") operated a manufacturing plant on land it owned. When P purchased the land, it was not contaminated by any hazardous waste (but the land became contaminated as a result of P's operations). P transferred all of the assets of the manufacturing business (including the plant and the land) to a newly-formed subsidiary ("S") in exchange for stock. S also assumed the liabilities of the business (including the environmental liabilities) as part of the exchange. Two years later, S began soil and groundwater remediation efforts.

Acquisitions made to avoid income taxes

If a taxpayer engages in certain transactions for the principal purpose of evading or avoiding Federal income tax by securing the benefit of a deduction, credit, or other allowance that would not otherwise have been available, the Secretary of the Treasury (the "Secretary") has the authority to disallow the resulting benefits.[215] The Secretary may only exercise this special authority with respect to three defined transactions: (1) if any person or persons acquire, directly or indirectly, control (defined as at least 50 percent of vote or value) of a corporation; (2) if a corporation acquires, directly or indirectly, property of another corporation (not controlled, directly or indirectly, by the acquiring corporation or its stockholders) where the basis of the property is determined by reference to the basis in the hands of the transferor corporation; or (3) if a corporation acquires at least 80 percent control (measured by both vote and value, but excluding certain nonvoting preferred stock) of another corporation, an election pursuant to section 338 is not made, and the acquired corporation is liquidated pursuant to a plan of liquidation adopted within two years after the acquisition date.

Redemptions between related corporations

If one or more persons are in control[216] of each of two corporations, and one corporation ("acquiring corporation") acquires stock of another corporation ("issuing corporation") in exchange for property, then the transaction is treated as a distribution in redemption of the stock of the acquiring corporation.[217] In determining whether the acquisition is to be treated as a distribution in part or full payment in exchange for the stock, reference is made to the stock of the issuing corporation.[218]

If the distribution is treated as a dividend distribution, the transferor and the acquiring corporation are treated in the same manner as if the transferor had transferred the stock so

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The IRS concluded that the contingent environmental liabilities assumed by S were not included in determining P's basis in S stock. In addition, the contingent environmental liabilities were not treated as money received by P. The IRS also concluded that the contingent environmental liabilities were deductible by S or capitalized as appropriate under its method of accounting. The IRS analogized the fact pattern to that in Rev. Rul. 80-198, 1980-2 C.B. 113 (transfer of trade accounts receivable in connection with the incorporation of a sole proprietorship). The IRS stated that, for business reasons, P transferred substantially all of the assets and liabilities of the manufacturing business to S, and P intended to remain in control of S. P would have been able to deduct/capitalize the remediation costs had P incurred the costs.

[215] Sec. 269.

[216] For this purpose, "control" means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock. Sec. 304(c).

[217] Sec. 304(a)(1).

[218] Sec. 304(b)(1).

acquired to the acquiring corporation in exchange for stock of the acquiring corporation in a section 351 exchange, and then the acquiring corporation redeemed the stock it was treated as issuing in the transaction.[219] The determination of the amount that is a dividend is made as if the property were distributed by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits.[220]

Dividends received deduction

In general, a corporation is entitled to a deduction for a percentage of the amount received as dividends from a domestic corporation that is subject to taxation under Chapter 1 of the Code.[221] The amount of the dividends received deduction generally depends on the corporate shareholder's ownership of the distributing corporation. If the shareholder is a member of the same affiliated group as the distributing corporation (generally 80 percent vote and value), then the dividends may be "qualifying dividends" and a 100 percent dividends received deduction applies.[222] An 80 percent dividends received deduction applies if the corporate shareholder owns 20 percent or more of the vote and value of the stock of the distributing corporation;[223] in other cases, a 70 percent dividends received deduction generally applies.[224] If a corporation is a partner in a partnership that receives a dividend, the corporate partner may be entitled to a dividends received deduction. Little guidance exists in applying the various ownership thresholds under the dividends received deduction to a corporate partner receiving dividends through a partnership.[225]

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[219] Sec. 304(a)(1) last sentence. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, section 1013(a) (August 5, 1997) (change to section 304(a)(1) last sentence). Prior to this change (which took effect on June 9, 1997), the stock that was acquired was treated as having been received by the acquiring corporation as a capital contribution.

[220] Sec. 304(b)(2).

[221] Sec. 243(a).

[222] Sec. 243(a)(3) and (b).

[223] Sec. 243(c).

[224] Sec. 243(a).

[225] In a somewhat analogous situation, the IRS held that two unrelated domestic corporations that form a partnership, each corporation being a 50 percent partner in the partnership, are each treated as owning 50 percent of all of the assets of the partnership. As a result, the partnership's ownership of 40 percent of the stock of a foreign corporation will be treated as owned 20 percent by each corporate partner for purposes of the deemed paid foreign tax credit. Rev. Rul. 71-141, 1971-1 C.B. 211.

Extraordinary dividends

Generally, if a corporation receives an extraordinary dividend with respect to stock and the corporation has not held the stock for more than two years after the dividend announcement date, then the basis of such corporation in the stock is reduced (but not below zero) by the non-taxed portion of the dividends.[226] The non-taxed portion of the dividend is generally the amount of the dividends received deduction with respect to the dividend.[227] An extraordinary dividend means any dividend if the amount of such dividend equals or exceeds ten percent (five percent in the case of preferred stock) of the taxpayer's adjusted basis in such share of stock.[228]

In 1997, Congress amended the extraordinary dividend rules in connection with redemptions between related corporations.[229] In the case of any stock redemption that would not have been treated (in whole or in part) as a dividend if the related corporate redemption rules had not applied, then any amount treated as a dividend with respect to such redemption is treated as an extraordinary dividend without regard to the holding period.[230] In other words, such dividends are per se extraordinary dividends. In addition, only the basis in the stock redeemed in the related corporate redemption transaction (i.e., the hypothetically issued acquiring corporation stock) is subject to the general basis reduction rule.[231]

The Treasury Department has applied the extraordinary dividend rules in the partnership setting pursuant to a Congressional grant of authority.[232]

Earnings and profits in a consolidated group

A corporation that is a member of a consolidated group must compute its earnings and profits so as to reflect the earnings and profits of any subsidiary of that particular member.[233]

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[226] Sec. 1059(a)(1). If the non-taxed portion of the dividends exceeds the corporation's basis in the stock, then the excess is treated as gain for the taxable year in which the extraordinary dividend is received. Sec. 1059(a)(2).

[227] Sec. 1059(b).

[228] Sec. 1059(c).

[229] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, section 1013(b) (August 5, 1997) (effective for distributions and acquisitions after June 8, 1997).

[230] Sec. 1059(e)(1)(A)(iii)(II).

[231] Sec. 1059(e)(1)(A) (last sentence).

[232] Sec. 1059(g); Treas. Reg. sec. 1.701-2(f) example 2. In the example, a partnership composed of two corporate partners received an extraordinary dividend. The partnership was treated as an aggregate of its partners for purposes of section 1059. As a result, the partnership had to make appropriate adjustments to the basis of the stock it owned, and the corporate partners had to make appropriate adjustments to the basis in their partnership interests.

This rule is designed to treat the two entities as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the consolidated group's earnings and profits in the common parent.[234] If the location of a member within a consolidated group changes, then appropriate adjustments must be made to the members to prevent earnings and profits from being eliminated.[235]

Real estate mortgage investment conduits[236]

In general, a real estate mortgage investment conduit ("REMIC") is a self-liquidating vehicle that holds a fixed pool of mortgages and issues multiple classes of investor interests. A REMIC is not treated as a separate taxable entity. Rather, the income of the REMIC is allocated to, and taken into account by, the holders of the interests in the REMIC under detailed rules.[237] In order to qualify as a REMIC, all of the interests in the REMIC must consist of one or more classes of regular interests and a single class of residual interests. A regular interest is an interest in a REMIC that is issued with a fixed term, designated as a regular interest, and unconditionally entitles the holder to receive a specified principal amount (or other similar amount) with interest payments that are either based on a fixed rate (or to the extent provided in regulations, at a variable rate) or consist of a specified portion of the interest payments on qualified mortgages that does not vary during the period such interest is outstanding. The holder of a regular interest generally recognizes income in an amount equal to the taxable income that would be recognized by an accrual method holder of a debt instrument that has the same terms as the regular interest.

In general, a residual interest is any interest in the REMIC other than a regular interest, and which is so designated by the REMIC, provided that there is only one class of such interest and that all distributions (if any) with respect to such interests are pro rata. Holders of residual REMIC interests are subject to tax on the portion of the income of the REMIC that is not allocated to the regular interest holders. Specifically, the holder of a residual interest takes into account the holder's daily portion of the taxable income or net loss of the REMIC for each day during the holder's taxable year in which such holder held such interest. The amount so taken

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[233] Treas. Reg. sec. 1.1502-33.

[234] Treas. Reg. sec. 1.1502-33(a)(1).

[235] Treas. Reg. sec. 1.1502-33(f)(2). For example, if P transfers all of S's stock to another member in a section 351 transaction (and Treas. Reg. sec. 1.1502-13 applies), the transferee's earnings and profits are adjusted immediately after the transfer to reflect S's earnings and profits immediately before the transfer from consolidated return years. Also, if the transferee purchases S's stock from P, then the transferee's earnings and profits are not adjusted. The regulation also provides for an anti-avoidance rule warning that adjustments must be made as necessary to carry out the purpose of the section.

[236] Although unrelated to the general corporate tax laws, a general discussion of the rules relating to REMICs has been included in this section because REMICs were used in connection with Projects Steele and Cochise.

[237] See sections 860A through 860G.

into account is treated as ordinary income or loss. The daily portion is determined by allocating to each day in any calendar quarter, a ratable portion of the taxable income or net loss of the REMIC for such quarter, and by allocating the amount so allocated to any day among the holders (on such day) of residual interests in proportion to their respective holdings on such day.

A holder's basis in a residual interest is increased by the amount of taxable income of the REMIC that is taken into account by the holder. The basis of such an interest is decreased (but not below zero) by the amount of any distributions received from the REMIC and by the amount of any net loss of the REMIC that is taken into account by the holder.

Because of the interest income and deduction accrual rules pertaining to REMIC residual interests, such interests typically produce non-cash "phantom" interest income accruals that cannot be offset by net operating losses or negated by the tax-exempt status of a REMIC residual interest holder.[238] Unlike non-statutory securitization structures, the holder of the residual interest in a REMIC is not required to demonstrate any degree of equity substantiality through a minimum threshold of cash return entitlement, which makes the REMIC a highly efficient securitization structure. Therefore, REMIC residual interests typically have little or no fair market value because they have nominal (if any) entitlement to cash distributions from the REMIC. In fact, REMIC residual interests often have a negative fair market value because, although the non-cash "phantom" interest income accruals are reversed by non-cash "phantom" interest deductions, such deductions may accrue only years after the income inclusions, and REMIC residual interest values reflect the time value of money relating to this timing mismatch. The magnitude of these timing differences depends (among other things) upon the structure of the REMIC regular interest tranches and, in particular, their interest rates and terms to maturity in relation to each other and to the REMIC assets.[239]

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[238] Primarily because of the REMIC excess inclusion rules that require this result, REMIC residual interests have been described as "intensely regulated by arcane and complicated tax rules that are designed principally to maximize a holder's tax liability." Kirk Van Brunt, *Tax Aspects of REMIC Residual Interests,* 2 Fla. Tax Rev. 149, 152 (1994). However, others point out that the excess inclusion rules "tend to reduce the excessive differences in after-tax yields for high and low marginal rate taxpayers," in part because excess inclusion income may not be offset by net operating losses or negated by the tax-exempt status of the holder of a REMIC residual interest. Bruce Kayle, *Where Has All the Income Gone? The Mysterious Relocation of Interest and Principal in Coupon Stripping and Related Transactions,* 7 Va. Tax Rev. 303, 351 (1987).

[239] "Income and deductions created by timing differences will ultimately offset each other and net to zero. However, timing is everything and the pain of a substantial tax liability on phantom income in one year is only partially eased by the prospect of offsetting phantom losses in a later year." Kirk Van Brunt, *Tax Aspects of REMIC Residual Interests,* 2 Fla. Tax Rev. 149, 156 (1994).

Lease versus financing[240]

The IRS has issued a number of revenue rulings and revenue procedures addressing the issue of whether an agreement is a lease or a conditional sales contract (i.e., a financing arrangement).[241] A synthetic lease transaction is a transaction that is structured as an operating

[240] Although unrelated to corporate tax laws, a general discussion of synthetic lease arrangements is included in this section because Project Teresa involved such an arrangement (though this Report does not focus on issues raised by the synthetic lease arrangement).

[241] In Rev. Rul. 55-540, 1955-2 C.B. 39, the IRS stated that whether an agreement, which is in form a lease, is in substance a conditional sales contract depends upon the intent of the parties as evidenced by the terms of the agreement and the facts and circumstances existing at the time of the execution of the agreement. The IRS subsequently issued a number of rulings in distinguishing a lease from a conditional sales contract. *See, e.g.,* Rev. Rul. 55-541, 1955-2 C.B. 19 (sale rather than a lease), Rev. Rul. 55-542, 1955-2 C.B. 59 (sale rather than a lease), Rev. Rul. 60-122, 1960-1 C.B. 56 (two transactions, one considered a lease and the other considered a sale), and Rev. Rul. 72-408, 1972-2 C.B. 86 (sale rather than a lease).

In Rev. Proc. 75-21, 1975-1 C.B. 715, the IRS set forth guidelines that it would use for ruling purposes in determining whether certain transactions purporting to be leases are, in fact, leases for Federal income tax purposes. On May 7, 2001, the IRS published Rev. Proc. 2001-28, 2001-19 I.R.B. 1156, which modifies and supersedes Rev. Proc. 75-21. The new revenue procedure, like its predecessor, applies to leveraged lease transactions.

The leading case in determining the tax ownership of leased property in a sale-leaseback transaction is *Frank Lyon Co. v. United States,* 435 U.S. 561 (1978). In *Lyon,* Worthen Bank & Trust Company ("Worthen") constructed a bank building and sold it to Frank Lyon Company ("Lyon") for approximately $7.64 million. Lyon invested $500,000 of its own funds and financed the remaining purchase price with a mortgage from New York Life Insurance Company payable over 25 years. Lyon then leased the bank building to Worthen for 25 years (equal to the term of the mortgage). The rental payments under the lease also matched in time and amounts the payments due under the mortgage. Under the lease, Worthen had the option after 11 years, 15 years, 20 years, and 25 years, to repurchase the building at a price equal to: (1) the outstanding balance on the mortgage and (2) $500,000 plus six percent compound interest over the lease term. If Worthen did not exercise its option to repurchase the building, it could renew the lease for eight additional five-year terms. The rents under the renewal were calculated to return Lyon's investment plus six percent compound interest. Worthen was responsible for all expenses associated with the maintenance of the building (a "net lease" arrangement).

The Supreme Court respected the form of the transaction and held for the taxpayer. The Court wrote:

> In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-

lease for financial accounting purposes but a financing arrangement for tax purposes. The primary benefit is that the lessee does not record the debt incurred to finance the property acquisition or the rent obligation to the lessor as a liability on its balance sheet. For income tax purposes, the transaction is structured so that the lessee (and not the lessor) is treated as the owner of the property. As a result, for tax purposes, the lessee is entitled to the depreciation and interest deductions.[242]

2. Projects Tanya and Valor

Brief overview

Projects Tanya and Valor were structured to accelerate and duplicate certain deductions within the Enron consolidated group. Each transaction involved a tax-free transfer of assets and unrelated contingent liabilities by Enron to an Enron subsidiary in exchange for stock in the subsidiary. The transferred assets had a value that only slightly exceeded the projected amount of the contingent liabilities.[243] The transferred assets had a tax basis that significantly exceeded the net value of the stock received in the exchange. Therefore, a sale by Enron of the subsidiary stock would result in a significant capital loss (i.e., an acceleration of a future loss). In addition, the contingent liabilities would give rise to a future tax deduction when paid by the subsidiary (resulting in a duplication of the loss).

Project Tanya – background[244]

Reported tax and financial statement effects

In connection with Project Tanya, Enron reported a short-term capital loss of $188.515 million on its 1995 return. Enron also deducted a total of $76.68 million in connection with the assumed liabilities in its 1996 through 2000 tax returns.

The $188.515 million loss that Enron reported on its tax return did not result in a corresponding loss for financial statement purposes. Thus, the tax savings associated with the

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avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. *Id.* at 583-84.

[242] The IRS has issued agency decisions addressing synthetic lease arrangements. For example, in 1998 FSA LEXIS 413 (February 26, 1998), the IRS concluded that a transaction structured as a synthetic lease was a lease for Federal income tax purposes and not a financing arrangement. The IRS reached a contrary result in FSA 19992003 (January 12, 1999).

[243] Project Tanya involved the assumption of liabilities relating to deferred compensation and post-retirement medical, life insurance, and executive death benefit obligations. Project Valor involved the assumption of certain risks associated with third-party commodity contracts.

[244] The information regarding Project Tanya was obtained from Joint Committee staff interviews of Robert J. Hermann, Robert D. Maxey, Greek L. Rice, and Mary K. Joyce, as well as from documents and information provided by Enron and the IRS.

loss resulted in an increase in financial statement earnings (i.e., earnings through a reduction in the provision for income tax expense) of $65.8 million.[245] Enron reported $46.5 million of the earnings in 1995 and the remaining $19.3 million in 1999 (upon the IRS's completion of its review of the stock sale that generated the capital loss).[246]

Development of Project Tanya

Arthur Andersen, Enron's outside auditor, brought the idea for Project Tanya to Enron in August 1995.[247] Robert J. Hermann, Managing Director and General Tax Counsel of Enron Corp., named the transaction after a hurricane.[248] Arthur Andersen, aware that Enron had significant capital gain in 1995 from the sale of stock in Enron Oil & Gas, proposed the transaction as a means to offset a portion of the capital gain. Originally, the transaction contemplated the assumption of potential environmental liabilities; however, Enron did not have such liabilities. So the transaction was customized to involve the assumption of deferred compensation and post-retirement benefit obligations. The transaction had to be completed in December 1995 (presumably to offset the capital gain that was recognized in the same year).

The Finance Committee of Enron Corp.'s Board of Directors approved the transaction on December 11, 1995.[249] The next day, Richard D. Kinder, a member of the Enron Corp. Board of Directors, presented the details of the transaction at a meeting of the Board of Directors. At that meeting, the Board of Directors approved and ratified the transaction.[250]

Implementing the transaction was a time-consuming process, but the Enron tax group received help from different parts of the company for document production. The Enron tax group also depended heavily on Arthur Andersen in implementing the transaction. Enron's Human Resources Department did the modeling for the transaction.

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[245] The calculation is 35 percent (i.e., the statutory Federal corporate income tax rate) of $188.515 million.

[246] The General Background Materials in Appendix B contain the Structured Transactions Group, Summary of Project Earnings & Cash Flows, November 2001. The IRS review of Project Tanya is discussed in greater detail below.

[247] ERMI Structure Presentation by Arthur Andersen, dated August 14, 1995, EC2 000037817-37827.

[248] This tax Project was named for the Atlantic tropical storm, as listed by the World Meteorological Organization, that began with the letter "T" in the year the project was commenced. Projects Teresa, Tomas, and Tammy I and II were also named using this convention.

[249] Agenda item #3 of the Meeting of the Finance Committee of the Enron Corp. Board of Directors, December 11, 1995, EC2 000037848.

[250] Minutes of the Meeting of the Board of Directors of Enron Corp., December 12, 1995, EC2 000037855-56.

The purported business purpose of the transaction was to provide an incentive for human resource personnel to manage the deferred compensation and post-retirement benefit obligations by allowing the employees to share in the successes that may result from their management efforts. According to an Arthur Andersen memo, "the biggest issue to be resolved [is the] business purpose for [the subsidiary's] managing these items."[251]

Implementation of Project Tanya

In December 1995, Enron Corp. transferred two intercompany promissory notes to Enron Management, Inc:[252] (1) a 20-year promissory note with a tax basis of $120.84 million, and (2) a 10-year promissory note with a tax basis of $67.7 million. As part of the transfer, Enron Management, Inc. also assumed certain contingent liabilities of Enron Corp. -- a contractual assumption of Enron Corp.'s deferred compensation obligations of approximately $67.7 million, and a contractual assumption of post-retirement medical, life insurance, and executive death benefit obligations of approximately $120.8 million. Enron Management, Inc. also assumed responsibility for administering Enron Corp.'s other compensation and benefit plans. These employee benefit liabilities were segregated from the employee benefit liabilities that were not involved in the transfer.

In exchange for the two promissory notes (and the assumption of the contingent liabilities), Enron Corp. received 20 shares (i.e., all of the issued shares) of a newly created class of voting preferred stock in Enron Management, Inc. The preferred stock had a reported tax basis of $188.555 million.[253] The preferred stock provided for a nine percent annual dividend and represented $40,000 of Enron Management, Inc.'s existing net equity. In addition, the class of preferred stock was entitled to three percent of any increase in Enron Management, Inc.'s net equity up to a maximum redemption value of $340,000.

On December 28, 1995, Enron Corp. sold the 20 shares of Enron Management preferred stock to Patricia L. Edwards and Mary K. Joyce (10 shares to each), both of whom were officers in Enron Corp.'s Human Resources Department and were involved in the management of deferred compensation and post-retirement benefit obligations.[254] The sales price of the stock

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[251] The Project Tanya materials in Appendix B contain a Memo from Robert P. Palmquist of Arthur Andersen to Robert J. Hermann dated October 27, 1995, item # 4, EC2 000037798.

[252] Enron Management, Inc. was a wholly-owned subsidiary of Enron Corp. and a member of the Enron consolidated group.

[253] The tax basis equaled the tax basis of the promissory notes Enron Corp. contributed to Enron Management, Inc.

[254] According to current Enron management, the shares were offered to Ms. Joyce and Ms. Edwards because of their cost-management knowledge and expertise regarding the various pension and deferred compensation liabilities contributed to Enron Management, Inc. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Chief of Staff of the Joint Committee on Taxation, dated January 13, 2003, answer 5.

was $40,000,[255] and Enron Corp. reported a capital loss from the stock sale of $188.515 million ($40,000 amount realized less a tax basis of $188.555 million).

The terms of the Enron Management preferred stock, as contained in a Stock Sale and Purchase Agreement, included a put option after five years for the shareholders and a call option after six years. The holders of the preferred stock had the right to elect one of the six directors of Enron Management, Inc.[256]

It was anticipated that in 2002, Enron Management, Inc. would be liquidated into Enron Corp., and Enron Corp. would assume the deferred compensation and post-retirement benefit obligations that Enron Management, Inc. had assumed from Enron Corp. in 1995.[257]

The diagram on the next page depicts the general structure of Project Tanya.

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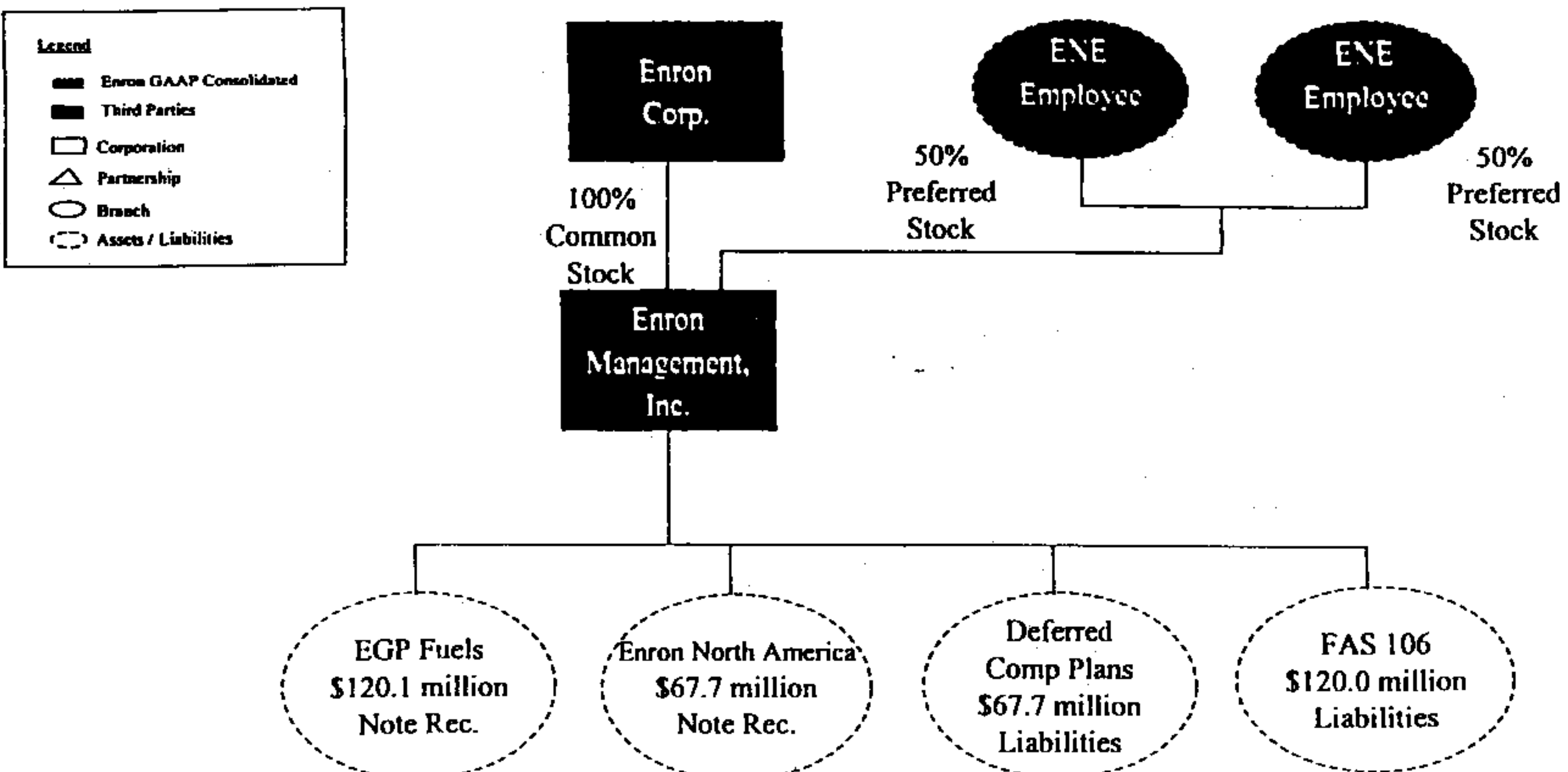
[255] Current Enron management is not aware of any investment information or advice provided to either Ms. Joyce or Ms. Edwards in connection with the investment. In addition, current Enron management is not aware of any payments that were made to Ms. Joyce or Ms. Edwards regarding the economic outlay for the Enron Management, Inc. preferred stock. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Chief of Staff of the Joint Committee on Taxation, dated January 13, 2003, answers 6 and 8.

[256] Current Enron management is not aware of any promises or commitments made by Enron to Ms. Joyce or Ms. Edwards regarding a return of their investments. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Chief of Staff of the Joint Committee on Taxation, dated January 13, 2003, answer 9.

[257] Project Tanya Structure Overview, EC2 000038324.

Transaction Structure



Time to execute	2 months
Closing date	December 1995
Total earnings	$66 million

Role of outside advisors

Arthur Andersen promoted the transaction to Enron. In connection with Project Tanya, Arthur Andersen provided a tax opinion which concluded that the overall tax result of the transaction, "more likely than not," is the recognition of a capital loss by Enron on the sale of the Enron Management, Inc. preferred stock. The specific tax issues discussed in the opinion were: (1) the qualification of the transfer of the intercompany promissory notes to Enron Management, Inc., subject to the contractual assumption of the contingent liabilities, as a tax-free contribution; (2) Enron Corp.'s tax basis in the Enron Management, Inc. preferred stock not being reduced by the deferred compensation and post-retirement benefit liabilities; (3) Enron Corp.'s loss on the sale of the Enron Management, Inc. preferred stock not being a duplicated loss (and thus a disallowed loss) under the Treasury consolidated return regulations; and (4) the contribution of the assets in exchange for the Enron Management, Inc. preferred stock not being considered an acquisition made to evade or avoid income taxes.

Arthur Andersen's fee in connection with Project Tanya was approximately $500,000.[258]

Appendix C, Part I to this Report contains the tax opinion Enron received in connection with Project Tanya.

Subsequent developments

In the years following the transaction, Enron Management, Inc. claimed the following deductions in connection with the assumed employee benefit obligations: $16.977 million on its 1996 return; $16.217 million on its 1997 return; $13.682 million on its 1998 return; $14.7 million on its 1999 return; and $15.103 million on its 2000 return.

In July 1998, Ms. Edwards left Enron and sold her 10 shares to Ms. Joyce for $85,000. In 2001, Enron notified Ms. Joyce that it intended to exercise the call option pursuant to the Stock Sale and Purchase Agreement and purchase the 20 shares of Enron Management, Inc. preferred stock. The purchase price was $440,000 (i.e., $22,000 per share).[259] The stock purchase occurred in year 2000.

The IRS reviewed the transaction and ultimately allowed the $188.515 million short-term capital loss to Enron in its audit of Enron's 1995 consolidated tax return.[260] The IRS is in the process of auditing Enron's tax returns for years 1996 through 2001.

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[258] Letter from Enron's counsel (Skadden Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 7; confirmed by information obtained from interviews.

[259] According to current Enron management, the price was the result of negotiations between Ms. Joyce, Mr. Richard A. Causey and other personnel who are no longer at Enron. Letter from Enron's counsel (Skadden Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 31, 2003, answer 1.

[260] There were disagreements within the IRS regarding the proper tax treatment of the transaction. The IRS Houston field office (including the audit team responsible for the Enron

Project Valor – background[261]

Reported tax and financial statement effects

In connection with Project Valor, Enron reported a short-term capital loss of $235.327 million on its 1996 tax return. Enron also deducted $181.73 million in connection with the assumed liabilities in its 1997 tax return, and a total of $88.56 million in connection with the assumed liabilities in its 1998 through 2001 tax returns.

The $235.327 million loss Enron reported on its tax return resulted in an increase in financial statement earnings (i.e., earnings through a reduction in the provision for income tax expense) of $82.38 million.[262] However, it appears that Enron never recorded any benefits from Project Valor in its financial statements.[263]

Development of Project Valor

Project Valor was patterned after Project Tanya, though Project Valor involved different types of contingent liabilities. Project Valor was designed to generate a capital loss that could be used to offset capital gain realized by Enron from the sale of additional stock in Enron Oil & Gas.

It appears that Ben F. Glisan, Jr., recruited from Arthur Andersen in 1996 to be a Director at Enron Capital Trade & Resources Corp. ("Enron Capital Trade"),[264] led the effort to

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audit) believed that the capital loss should be disallowed. The IRS Houston field office forwarded to IRS District Counsel Office a proposed notice of deficiency that would have disallowed the loss on the grounds that the transaction lacked economic substance, or alternatively, that it lacked business purpose. The IRS District Counsel Office, in consultation with the Corporate Division of the Office of Chief Counsel, declined to support the audit team's position. As a result, the issue was not included in the Revenue Agent Report for Enron's 1995 tax year. The Project Tanya materials in Appendix B contain a Memo dated August 16, 1999, from IRS District Counsel, Houston District to Chief, Quality Measurement Staff, Houston District, regarding this matter.

[261] The information regarding Project Valor was obtained from Joint Committee staff interviews of Robert J. Hermann, Jordan H. Mintz, Robert D. Maxey, and Greek L. Rice, as well as from documents and information provided by Enron and the IRS.

[262] The calculation is 35 percent (i.e., the statutory Federal income tax rate) of $235.327 million.

[263] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 12; confirmed by information obtained from interviews.

[264] Enron Capital Trade is a wholly-owned subsidiary of Enron Corp. and a member of the Enron consolidated group.

implement Project Valor. Sometime in September 1996, Mr. Glisan began assembling a team to restructure certain commodity contracts used by Enron in its commodity business. Mr. Glisan was considered the team leader of Project Valor, and he reported to Andrew Fastow (who was Managing Director of Enron Capital Trade). In early December 1996, Mr. Hermann asked Jordan H. Mintz (who had recently been hired by Enron Capital Trade as its Vice President of Taxes) to assist in the project, which Mr. Hermann wanted completed before December 31, 1996. Mr. Mintz became the tax representative of the team.[265] Other significant participants in Project Valor included Richard Kieval (who was selected to manage the risk management liabilities), Bill Bradford (who was selected to manage the credit risk liabilities), Debra Culver (internal counsel representative on the team), and Paige Grumulaitis (Assistant Business Unit Coordinator).[266]

Unlike Project Tanya, Project Valor apparently was not presented to Enron Corp. management for formal approval.[267] Rather, Mr. Glisan informally presented an overview of the concept to Mr. Fastow, and Mr. Fastow gave Mr. Glisan an informal approval to proceed. To account for control policies, Ms. Culver (from internal counsel) was included on the team.[268]

The purported business purpose of the transaction was to provide an incentive for employees responsible for managing Enron's potential credit risk obligations and fixed price and risk management contract liabilities to manage effectively such liabilities by allowing the employees to share in the successes that may result from their management efforts.

Implementation of Project Valor

Enron Capital Trade was a purchaser and marketer of natural gas and wholesale electricity. In addition, it managed a portfolio of contracts offering physical and financial energy products and services. In support of its business activities, Enron Capital Trade would enter into various swaps, options, and forward contracts with unrelated parties, including numerous fixed price and risk management contracts ("FPRM contracts"). Due to changes in commodity prices and interest rates, some FPRM contracts were liabilities to Enron Capital Trade (because it would owe a payment to the counterparty pursuant to the contract). Enron Capital Trade also had certain credit risks that were characterized as liabilities in its financial records.

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[265] The project was approximately 25 to 50 percent complete when Mr. Mintz became involved.

[266] IRS compilation of interviews with Ben Glisan, Paige Grumulaitis, Bill Bradford, Jordan Mintz, Richard Kieval, and Debra Culver.

[267] However, current Enron management understands that Project Valor was presented to and approved by the Board of Directors of Enron Capital Trade. Letter from Enron's counsel (Skadden, Arps), to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 17.

[268] IRS compilation of interview with Mr. Glisan.

On December 20, 1996, Enron Capital Trade transferred to Enron Capital Trade Strategic Value Corp. ("ECT Strategic")[269] two intercompany promissory notes: (1) a 10-year promissory note with a tax basis of $217 million, and (2) a 10-year promissory note with a tax basis of $50.32 million. As part of the transfer, ECT Strategic assumed certain contingent liabilities of Enron Capital Trade -- a contractual assumption of $5.01 million of Enron Capital Trade's credit reserve obligations and a deemed assumption of $262.27 million of Enron Capital Trade's FPRM contract liabilities.[270] Pursuant to a Liability Management Agreement between Enron Capital Trade and ECT Strategic dated December 20, 1996, ECT Strategic assumed responsibility for managing the FPRM contract liabilities and the credit reserves, but any restructuring of the FPRM contracts or the credit reserves required prior approval by Enron Capital Trade. Employees who were responsible for the management of these liabilities, including Richard Kieval and Bill Bradford, were transferred to ECT Strategic.

In exchange for the promissory notes (and the assumption of the contingent liabilities), Enron Capital Trade received 40 shares (i.e., all of the issued shares) of a new class of ECT Strategic voting participating preferred stock. The preferred stock had a reported tax basis of $235.367 million.[271] The preferred stock paid a nine percent annual dividend and represented in the aggregate, $40,000 of ECT Strategic's net equity. In addition, the class of preferred stock was entitled to four percent of any increase in ECT Strategic's net equity up to a maximum redemption value of $2 million.

On December 27, 1996, Enron Capital Trade sold the 40 shares of ECT Strategic preferred stock to three employees involved in the monitoring of the commodity trading activities – Mr. Kieval (who purchased 30 shares for $30,000), Mr. Bradford (who purchased five shares for $5,000) and Mr. Glisan (who purchased five shares for $5,000).[272] Thus, the aggregate sales price of the stock was $40,000, and Enron reported a capital loss from the stock sale of $235.327 million ($40,000 amount realized less a tax basis of $235.367 million).

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[269] ECT Strategic, formerly known as Enron Gas Gathering Inc., was formed in March 1985, to manage various gathering assets of Enron. In connection with Project Valor, its name was changed to ECT Strategic, and its purpose was altered to undertake responsibilities associated with credit reserve obligations and FPRM contract liabilities.

[270] In order to avoid a breach of the terms of the FPRM contracts (which required consent for any assignment), Enron Capital Trade and ECT Strategic entered into a Master Swap Agreement and a Liability Management Agreement. These agreements replicated the economics that would have resulted from an actual transfer of the FPRM contracts to ECT Strategic.

[271] This amount equals the aggregate basis in the promissory notes of $267.37 million less approximately $32 million of premiums on unrealized liabilities that were assumed by ECT Strategic in connection with the transfer.

[272] Current Enron management is not aware of any payments that were made to Messrs. Kieval, Bradford, or Glisan specifically to cover the economic outlay for the ECT Strategic preferred stock. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 15.

The terms of the ECT Strategic preferred stock included a put option exercisable by the shareholders (requiring ECT Strategic to redeem its shares) after five years[273] and a call option exercisable by ECT Strategic (requiring the preferred shareholder to sell the stock to ECT Strategic) after six years.[274] The holders of the ECT Strategic preferred stock had the right to elect one of the six directors of ECT Strategic.

Role of outside advisors

In connection with Project Valor, Arthur Andersen provided a tax opinion, dated December 27, 1996, which concluded that the overall tax result of the transaction, "more likely than not," is the recognition of a capital loss by Enron Capital Trade on the sale of the voting participating preferred stock of ECT Strategic. The specific tax issues discussed in the opinion were: (1) the qualification of the transfer of the intercompany promissory notes to ECT Strategic, subject to the contractual assumption of the contingent liabilities, as a tax-free contribution; (2) Enron Capital Trade's tax basis in the ECT Strategic preferred stock not being reduced by the amount of the credit reserve obligations and FPRM contract liabilities assumed by ECT Strategic; (3) Enron Capital Trade's loss on the sale of the ECT Strategic preferred stock not being a duplicated loss (and thus a disallowed loss) under the Treasury consolidated return regulations; and (4) the contribution of the assets for ECT Strategic stock not being considered an acquisition made to evade or avoid income taxes.

Arthur Andersen's fee in connection with Project Valor was approximately $100,000.[275]

Appendix C, Part II to this Report contains the tax opinion Enron received in connection with Project Valor.

Subsequent developments

In the years following the transaction, ECT Strategic claimed the following deductions in connection with the assumed credit risk and risk management liabilities; $181.729 million on its 1997 return; $49.099 million on its 1998 return; $26.064 million on its 1999 return; $10.317 million on its 2000 return; and $3.085 million on its 2001 return.[276]

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[273] The price at which the preferred stock could be put to the company would be equal to four percent of any increase in ECT Strategic's net equity up to a maximum redemption value of $2 million.

[274] The right to call the preferred stock had a maximum redemption value of $2 million.

[275] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 22.

[276] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 18. The total of these losses exceeds the amount of the loss reported in 1996 in connection with the sale of the ECT Strategic preferred stock.

Around March 30, 1999, Mr. Kieval left Enron. Immediately prior to his departure, ECT Strategic redeemed the 30 shares of preferred stock owned by Mr. Kieval for $30,000 (i.e., the initial investment). The 30 shares were resold to Messrs. Bradford and Glisan, effective March 30, 1999, in the amount of $15,000 per each investor. According to current Enron management, Enron included amounts equal to the purchase price of the additional 15 shares each of the ECT Strategic preferred stock in Messrs. Bradford's and Glisan's 1999 bonuses (paid in February 2000).[277] Messrs. Bradford and Glisan apparently continue to hold their ECT Strategic preferred stock.

The IRS is in the process of auditing Enron's tax returns for years 1996 through 2001.

Discussion

In Projects Tanya and Valor, Enron sought to both duplicate and accelerate certain deductions with respect to contingent liabilities assumed by the respective Enron subsidiaries. Enron claimed a loss with respect to the contingent liabilities when Enron sold the preferred stock, and a second deduction in subsequent years as the liabilities were paid.[278]

A determination of whether Enron should be entitled to a capital loss on the sale of the preferred stock and on the subsequent accrual of the contingent liabilities necessarily involves an analysis regarding Enron's satisfaction of the literal requirements of the corporate tax rules as well as the rules and judicial doctrines (such as business purpose and economic substance) that are often applied to evaluate claimed tax benefits in tax-motivated transactions.[279]

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[277] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 15.

[278] The transfer of swap liabilities raises an issue that is unique to Project Valor. By independent operation of the Treasury regulations concerning the tax treatment of notional principal contracts with significant nonperiodic payments, Treas. Reg. sec. 1.446-3(g)(4), the manner in which the promissory notes and swap liabilities were transferred to ECT Strategic could have caused the transfer (at least to the extent of the swap liabilities and a corresponding amount of the promissory notes) to be recharacterized instead as a deemed contribution of on-market swaps and a loan by Enron Capital Trade to ECT Strategic (with the amount of the deemed loan being equal to the actual liabilities associated with the individual swaps). In such a case, the basis in the ECT Strategic preferred stock received by Enron Capital Trade in the exchange would be reduced by the amount of the deemed loan to ECT Strategic.

[279] For detailed information of the present law rules and judicial doctrines applicable to tax motivated transactions and related recommendations and developments, *see, e.g.*, Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters* (JCX-19-02), March 19, 2002; Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including provisions relating to Corporate Tax Shelters)* (JCS-3-99), July 22, 1999; Temporary Treasury regulations (T.D. 9017) to section 6011 (October 22, 2002); Temporary Treasury regulations (T.D. 9018) to section 6012 (October 22, 2002); Joint

From a policy perspective, there is little question that, assuming Enron remains responsible for the liabilities, Enron should be entitled to a deduction when the liabilities are paid or accrued. Had Enron not engaged in Projects Tanya and Valor, it would have been entitled to a deduction with respect to the liabilities when the liabilities are taken into account under Enron's method of accounting. By the same token, however, there is no policy justification for allowing a single taxpayer multiple deductions with respect to the same liabilities.[280]

In Projects Tanya and Valor, Enron remained accountable for the liabilities both before and after the transactions. Also in each project, the same employees remained responsible for monitoring and managing the liabilities both before and after the transactions. Thus, apart from the tax benefits, there appeared to be little justification for participating in Projects Tanya and Valor. The purported rationale -- to provide an incentive for employees responsible for managing these liabilities to share in the success of their efforts -- is dubious. The maximum value of the preferred stock (whose value was dependent upon the successful management of the liabilities) was capped and subject to a call option, which had the effect of limiting the employee incentives. Enron could have provided similar incentives (without engaging in a complex and costly restructuring of its liabilities) through employment contracts. Indeed, Arthur Andersen noted that "the biggest issue to be resolved [is the] business purpose for [the subsidiary's] managing these items."[281]

If the non-tax business purpose of a transaction is not self-evident -- or stated another way, if a taxpayer and its tax advisor have to develop or devise a justification for the taxpayer's involvement in a particular transaction -- then the transaction in all likelihood lacks a non-tax

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Committee on Taxation, *Description of the "CARE Act of 2003,"* (JCX-04-03), February 3, 2003; Symposium: *Business Purpose, Economic Substance and Corporate Tax Shelters,* 54 SMU L. Rev. 1 (2001).

[280] *Cf. Rite Aid Corp. v. United States,* 255 F.3d 1357 (Fed. Cir. 2001), *reh'g denied,* 2001 U.S. App. LEXIS 23207 (Oct. 3, 2001), where the Circuit Court of Appeals for the Federal Circuit invalidated a provision in the consolidated return regulations that prevented the taxpayer from claiming a loss on the sale of stock of a subsidiary to the extent the subsidiary had assets that had a built-in loss, or had a net operating loss, that could be recognized or used by another taxpayer. Subsequent to the *Rite Aid* decision, the IRS issued Notice 2002-18, 2002 I.R.B. 644, in which the Treasury Department reiterated its belief that "a consolidated group should not be able to benefit more than once from one economic loss," and indicated its intent to issue regulations that will prevent a consolidated group from claiming multiple losses with respect to one economic loss. In October 2002, the Treasury Department proposed regulations under section 1502 that redetermine the basis of the stock of a subsidiary member of a consolidated group immediately prior to dispositions and deconsolidations of the stock. The proposed regulations also suspend certain losses recognized on the disposition of such stock. *See* REG-131478-02, 67 FR 65060 (Oct. 23, 2002).

[281] The Project Tanya materials in Appendix B contain a Memo from Robert P. Palmquist of Arthur Andersen to Robert J. Hermann dated October 27, 1995, item # 4, EC2 000037798.

business purpose and should be challenged accordingly. In Project Tanya, Enron and Arthur Andersen shared the responsibility of developing a business purpose for the transaction.[282] The fact that Enron's tax advisor, who promoted the transaction and assisted in its implementation, actually shared in the responsibility for developing the business purpose for Project Tanya should be *prima facie* evidence that Enron lacked a non-tax business purpose for the transaction.

Related to the concept of a non-tax business purpose is section 269. This provision grants the IRS the authority to disallow benefits if a taxpayer acquires control (defined as at least 50 percent of vote or value) of a corporation, and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax.[283] In Projects Tanya and Valor, the Arthur Andersen tax opinions concluded that section 269 was not implicated because Enron Management, Inc. and ECT Strategic were preexisting entities (and the acquisition occurred when Enron acquired the common stock, not the preferred stock, of these subsidiaries). Furthermore, even if control were measured at the time the preferred stock was acquired, the opinion letters rely on Enron's representations regarding its business purpose to conclude that the principal purpose was not the evasion or avoidance of income tax.[284] Given that Arthur Andersen shared in the responsibility for devising a business purpose for the transactions, its reliance on Enron's representations is difficult to justify. Similarly, if called upon, Enron should have a difficult time asserting that its reliance on the tax opinion constitutes reasonable cause and good faith.[285]

As to the economic substance of the transactions, even the most optimistic projections regarding the expected additional savings resulting from the transaction would be miniscule

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[282] The Project Tanya materials in Appendix B contain a facsimile that Enron Corp. received from Arthur Andersen of a "To Do List" dated November 9, 1995, EC2 000037845-37847, which states (action step #7) that Arthur Andersen and Enron shared the responsibility of developing a business purpose for Project Tanya.

[283] Sec. 269(a)(1).

[284] Appendix C, Part I to this Report contains the tax opinion Enron received in connection with Project Tanya (with the section 269 analysis in appendix E of the tax opinion). Appendix C, Part II to this Report contains the tax opinion Enron received in connection with Project Valor (with the section 269 analysis in appendix E of the tax opinion).

[285] An accuracy-related penalty is not imposed with respect to any portion of any underpayment if the taxpayer can show that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion. Section 6664(c)(1). Reliance on a tax opinion constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. This standard is not satisfied if the advice or opinion is based on unreasonable factual or legal assumptions. "For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner." Treas. Reg. sec. 1.6664-4(c)(1)(ii).

when compared to the $423.8 million in additional tax deductions claimed by Enron (i.e., the aggregate loss from the sale of the Enron Management preferred stock and ECT Strategic preferred stock).

Another troubling aspect of Projects Tanya and Valor was Enron's use of an accommodation party -- its employees. While these shareholders were not "related" to Enron as the term is generally used under the tax laws, their interests were aligned with Enron and they shared the same objectives as Enron for purposes of the transactions. In these situations, the tax rules oftentimes do not function as intended and may produce undesirable results.

Subsequent legislation

Congress enacted legislation in 2000 out of concern that taxpayers were accelerating and potentially duplicating deductions involving contingent liabilities -- precisely what Projects Tanya and Valor were designed to accomplish.[286] The provision applies if, after application of the other transferor basis rules, the basis of property permitted to be received without the recognition of gain or loss exceeds its fair market value. In such a case, the basis of the property is reduced (but not below its fair market value) by the amount of any liability that is assumed in exchange for such property if the liability was not treated as money received by the taxpayer in the exchange.[287] Had section 358(h) been in effect at the time that Projects Tanya and Valor were undertaken, the provision would have reduced Enron's aggregate tax basis in its Enron Management and ECT Strategic preferred stock from $423.8 million to $80,000.

Administrative guidance

The IRS also has made several administrative pronouncements with respect to contingent liability transactions. On February 26, 2001, the IRS released a notice on the contingent liability tax shelter.[288] The notice describes the transaction and states that the IRS was "not aware of any case in which a taxpayer has shown a legitimate non-tax business reason to carry out the combination of steps... ." In addition, "any business purposes taxpayers may assert for certain aspects of these transactions are outweighed by the purposes to generate deductible losses... ." The notice states that the IRS will disallow any loss from the sale of the stock.[289] The IRS also

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[286] The Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, sec. 1(a)(7) (Dec. 21, 2000). *See* Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 106th Congress* (JCS-2-01), April 19, 2001, at 154.

[287] Sec. 358(h)(1).

[288] Notice 2001-17, 2001-09 I.R.B. 730. The notice identifies the contingent liability tax shelter (and transactions similar to it) as a "listed transaction."

[289] For transfers after October 18, 1999, the losses are disallowed by reason of section 358(h). For transfers on or before October 18, 1999 (and for transfers not subject to section 358(h)), the IRS stated that it would disallow such losses under several different legal theories, including: (1) the purported section 351 exchange lacks a sufficient business purpose; (2) the transfer of the asset to the transferee corporation is in substance an agency arrangement or a payment to the transferee corporation for its assumption of a liability; (3) the purported section

noted that any deduction claimed by the transferee corporation for payments on the assumed liability may be subject to disallowance on one or more of several possible grounds, including that the payments are not for ordinary and necessary business expenses of the transferee corporation.[290] The IRS also has issued notices to assist Chief Counsel attorneys in advising field personnel in the development of cases involving these (or similar) transactions.[291]

Tax shelter resolution initiative program

On October 4, 2002, the government announced a tax shelter resolution initiative[292] under which it will agree to enter into settlement agreements with taxpayers involved in three abusive tax-avoidance transactions (including the contingent liability transactions). With respect to the contingent liability transaction, the settlement initiative provides for two resolution methodologies that an eligible taxpayer can elect.[293] A taxpayer that wishes to participate in the program must notify the IRS by a written application before March 5, 2003.[294]

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351 exchange is disallowed under section 269(a); (4) the principal purpose of the transferee's assumption of the liability was to avoid federal income tax or was not a bona fide business purpose under section 357(b)(1) and therefore the assumption of the liability should be treated as money received by the transferor; (5) the purported loss on the sale of stock of the transferee corporation is disallowed or limited by the loss disallowance rules of Treas. Reg. sec. 1.1502-20; (6) the purported loss on the sale of stock of the transferee corporation is not a bona fide loss under section 165; and (7) the transaction lacks sufficient economic substance.

[290] The IRS distinguished Rev. Rul. 95-74 by noting that in the ruling, the transferee corporation assumed the liabilities in connection with the transfer of substantially all the assets associated with the operation of a manufacturing business.

[291] *See*, CC-2001-033 (June 22, 2001) and CC-2001-033a (revised) (June 28, 2001). The IRS has released a number of agency decisions in which it has cited Notice 2001-17. *See, e.g.*, FSA 200121013 (February 12, 2001) (transaction involving nonqualified deferred compensation liabilities in a consolidated return context); FSA 200122022 (February 23, 2001) (transaction involving swap liabilities and credit reserves in a consolidated return context); CCA (chief counsel advice) 200117039 (March 13, 2001) (transaction involving an obligation to pay rent under a leasehold position following a lease stripping transaction); FSA 200134008 (May 15, 2001) (transaction involving employee benefits); and FSA 200146025 (August 2, 2001) (in determining whether a loss is a bona fide loss in an equity stripping transaction).

[292] IR-2002-105 (Oct. 4, 2002).

[293] Under one methodology -- the "fixed concession procedure" -- an eligible taxpayer is permitted a capital loss deduction equal to 25 percent of the amount of the capital loss reported for the sale of the transferee stock received in the contingent liability transaction. To prevent a duplication of the tax benefits, the taxpayer must include an amount equal to the permitted capital loss as income in equal annual amounts over a 15-year period. Under the second methodology -- the "fast track dispute resolution procedure" -- the taxpayer must concede between 50 and 90 percent of the amount of the capital loss reported for the sale of stock (with a

Recommendations

The legislation enacted in 2000 makes it more difficult for taxpayers to achieve the duplication of losses sought by Enron in Projects Tanya and Valor. The IRS and Treasury Department also have taken measures to address the specific transaction. Therefore, with respect to the specific transaction, a recommendation is not necessary at this time.

The linchpin to the contingent liability transaction is the interactive effect of the corporate tax-free transfer rules and the tax basis rules,[295] which results in a duplication of losses for the transferor and transferee. Equally as important to the transaction is the use of a liability that is not taken into account for Federal income tax purposes.[296] While section 358(h) was an appropriate response to the transaction at issue, there are instances in which it falls short of addressing other transactions that raise similar concerns. For example, the provision does not apply to situations in which the duplication of loss is achieved via a transfer of built-in loss assets without an assumption of liabilities.[297]

The duplication of gains and losses is one of the fundamental underpinnings of subchapter C. Some commentators have said that duplication of gain and loss is the price a transferor pays in order to achieve deferral of gain and loss.[298] Such a rationale, however, does

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binding arbitration procedure if the taxpayer and IRS cannot agree on the amount of the disallowed loss). The details of the settlement offer in connection with the contingent liability transaction are described in Rev. Proc. 2002-67, 2002-43 I.R.B. 733 (Oct. 28, 2002).

[294] In Announcement 2002-110, 2002-50 I.R.B. 1, the IRS announced it was extending the deadline for participating in the resolution program from January 2 to March 5.

[295] Secs. 351, 358 and 362.

[296] For a general discussion of the treatment of liabilities, *see generally,* Lee Sheppard, *What is a Liability,* 89 Tax Notes 1513 (2000).

[297] Bank of America used a similar section 351 loss duplication strategy in connection with certain problem loans to increase its 2001 fourth-quarter earnings by $418 million (i.e., earnings through a permanent reduction in its income tax liability). *See* Bank of America News Release dated January 22, 2002 ("During the year, the company realigned operations that manage distressed assets to make them more effective. The establishment of this new unit and the disposal of distressed assets generated a $418 million tax benefit which resulted in a 17 percent [effective] tax rate for the company."). *See also,* Carry Mollenkamp, *Rare Use of Tax Law Helps Lift Bank of America to Hefty Profit,* Wall St. Journal, p. A-2 (Jan. 24, 2002); Lee Sheppard, *Bank of America's Tax Plan for Bad Loans,* Tax Notes Today, 2002 TNT 38-5 (Feb. 26, 2002). *See also,* the following discussions of Projects Steele and Cochise in this Report.

[298] *See, e.g.,* Boris Bittker & James Eustice, *Federal Income Taxation of Corporations and Shareholders,* par. 3.01 at 3-8 (7th ed. 2002) ("In short, the cost of deferral under sec. 351 is that gain or loss accruing during the individual transferor's ownership is escalated from the one-tier tax treatment of individual to the two-tier corporate regime. This is one of the features

not justify permitting a transaction whose primary purpose is to duplicate losses, particularly in light of the degree of tax planning flexibility that taxpayers enjoy with respect to tax-free transfers.

A single economic loss should not be deducted more than once. If the loss duplication issue is to be addressed, a question arises as to which party should be entitled to the deduction. One theory is that the transferor bore the economic consequences of the loss and therefore should be entitled to the deduction. If this theory is followed, the Joint Committee staff recommends limiting a corporation's basis in property acquired in a tax-free transfer (or reorganization) to its fair market value.[299] An alternative view is that the loss is a tax attribute that is inherent in the property, and therefore it should remain with the property. The depreciation recapture rules reflect this concept -- if depreciable property is transferred to a corporation in a tax-free transaction, the recharacterized gain element remains with the asset (as opposed to tainting the stock received in the exchange).[300] If this theory is followed, the Joint Committee staff recommends expanding the sec. 358(h) basis reduction rule.

In addition to the above specific recommendations, Projects Tanya and Valor highlight the need for stronger measures to discourage transactions that lack a non-tax business purpose or economic substance. Such measures, however designed, must significantly increase the economic risk to taxpayers of entering into tax-motivated transactions. Under the present system, the expected tax benefits from these transactions typically far outweigh the associated costs. Taxpayers will continue to engage in tax-motivated transactions unless and until there is a meaningful change in this cost-benefit analysis. At a minimum, taxpayers that engage in tax-motivated transactions should be subject to substantial penalties. A number of recommendations and proposals have been made in recent years to curtail the use of tax-motivated transactions (including by the Joint Committee staff).[301]

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making life in the subchapter C lobster pot confining, complicated, and costly, even though entry, thanks to sec. 351, is usually simple and painless.") (citations omitted).

[299] For example, section 301 of H.R. 2520, the "Abusive Tax Shelter Shutdown Act of 2001," would reduce a transferee corporation's basis under section 362 with respect to loss property the corporation receives from a foreign transferor in a tax-free transaction. Such a proposal would raise several related issues, most notably whether the basis limitation rule should apply to aggregate asset transfers or to individual assets.

[300] Sec. 1245(b)(3).

[301] For detailed information of the present law rules and judicial doctrines applicable to tax motivated transactions and related recommendations and developments, *see, e.g.,* Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters* (JCX-19-02), March 19, 2002; Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including provisions relating to Corporate Tax Shelters)* (JCS-3-99), July 22, 1999; Temporary Treasury regulations (T.D. 9017) to section 6011 (October 22, 2002); Temporary Treasury regulations (T.D. 9018) to section 6012 (October 22, 2002); Joint

The Joint Committee staff recommendations regarding Project Cochise[302] include recommendations to expand section 269. These recommendations also are appropriate for consideration with respect to Projects Tanya and Valor.

3. Project Steele

Brief overview

Project Steele was structured to generate approximately $130 million of pre-tax financial statement operating income[303] while, conversely, generating significant Federal income tax deductions for Enron. Project Steele involved a tax-free transfer of (1) cash and leased assets by Enron, and (2) cash and assets[304] with tax basis significantly in excess of their fair market value by Bankers Trust Company, a New York banking corporation ("Bankers Trust"),[305] to a newly formed corporation in return for common and preferred stock. Because Enron received more than 80 percent of the vote and value of the corporation, the corporation's income and loss was included in Enron's consolidated tax return. Therefore, the ensuing tax losses from the built-in loss assets contributed by Bankers Trust are generally available to offset taxable income of Enron.

Additionally, because Bankers Trust's tax basis in the stock received is determined by reference to the built-in loss assets contributed, Bankers Trust's tax basis in the stock significantly exceeds its fair market value. Thus, the transaction effectively duplicates the built-in loss in the contributed assets (i.e., Bankers Trust and Enron both seek to shelter taxable income as a result of the built-in-loss on the contributed assets). In order to provide substance to the transaction, Bankers Trust anticipated holding the stock received until at least 2002. In order to compensate Bankers Trust for delaying the realization of its tax loss for a number of years, Bankers Trust requested Enron pay Bankers Trust the present value cost of delaying such losses.

Committee on Taxation, *Description of the "CARE Act of 2003,"* (JCX-04-03), February 3, 2003; Symposium: *Business Purpose, Economic Substance and Corporate Tax Shelters,* 54 SMU L. Rev. 1 (2001).

[302] Project Cochise is discussed in this corporate section of the Report (following Project Steele).

[303] This amount was obtained from an Enron presentation material titled "Show Me the Money! Project Steele Earnings Benefits." The after-tax amount was anticipated to be approximately $83.5 million. The Project Steele materials in Appendix B contain the document. EC2 000038546.

[304] The assets contributed by Bankers Trust entities were Real Estate Mortgage Investment Conduit residual interests (hereinafter "REMIC residual interests").

[305] The assets were contributed by Bankers Trust (Delaware) and Bankers Trust. On or about June 4, 1999, all of the outstanding stock of Bankers Trust Corp., a New York corporation and the holding company parent of Bankers Trust, was acquired by Deutsche Bank.

This was described in correspondence between Bankers Trust and Enron that quantified the present value cost to Bankers Trust of entering into Project Steele.[306]

Background[307]

Reported tax and financial statement effects

Project Steele generated approximately $112 million of net Federal income tax deductions from 1997 through 2001.[308] In addition, Project Steele generated approximately $65 million in net earnings for financial reporting purposes from 1997 through 2001.[309]

Development of Project Steele

Bankers Trust promoted the concept of Project Steele to Enron in April of 1997.[310] The transaction was presented to Enron as a mechanism to generate financial statement income while providing significant Federal income tax deductions. A memorandum prepared by Bankers Trust provided an analysis of the financial accounting and Federal income tax treatment of three alternative structures that could be used to undertake the proposed transaction.[311] The memorandum states that in Bankers Trust's professional opinion that it would not receive much, if any, fee solely for the tax benefits (alternative structure one), but if the transaction were

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[306] Letter from Thomas Finley of Bankers Trust to Mr. Maxey dated August 11, 1997. The Project Steele materials in Appendix B contain the letter. EC00003795-96.

[307] The information regarding Project Steele was obtained from Joint Committee staff interviews of Robert J. Hermann and R. Davis Maxey, as well as from documents and information provided by Enron Corp. and the Internal Revenue Service.

[308] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 31, 2003, answer 4.

[309] Enron stated that no opinion or memoranda was obtained from Arthur Andersen regarding the financial accounting treatment of Project Steele. However, Enron provided documentation from Bankers Trust regarding the accounting treatment of Project Steele. The Project Steele materials in Appendix B contain the letter. EC2 000037573 - EC2 000037592. The financial statement net earnings source documentation is a letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13 and January 31, 2003, answers 32 and 4, respectively.

[310] Project Steele Overview contained in a document titled Enron Structured Transactions Group Summaries of Project Earnings and Cash Flows dated November 2001. See also letter from Mr. Finley of Bankers Trust to Mr. Maxey dated June 17, 1997. The Project Steele materials in Appendix B contain the letter. EC2 00037571 - EC2 000037572.

[311] Letter and attachment from William B. Boyle of Bankers Trust to William McKee of King & Spalding, dated June 2, 1997. The Project Steele materials in Appendix B contain the letter and attachment. EC2 000037574- EC2 000037592.

redesigned to provide for financial accounting benefits, as well, then corporate clients would be extremely interested and would pay a substantial fee (alternative structures two and three).[312]

On June 17, 1997, Bankers Trust provided an engagement letter to Enron indicating that Bankers Trust agreed to provide Enron with all information regarding the proposed transaction, including all analyses and documents prepared by Bankers Trust or any of its advisors, and, in consideration thereof, Enron agreed to employ Bankers Trust as its exclusive financial advisor in connection with the consummation of one of the alternative structures.[313]

During the summer and early fall of 1997, the alternatives were evaluated and various details of the transaction were agreed to by Enron and Bankers Trust. On October 28, 1997, Enron and Bankers Trust entered into an agreement: (1) providing that Enron would enter into the proposed transaction with Bankers Trust; (2) providing that Enron would engage Bankers Trust to act as its financial advisor in connection with such transaction; and (3) detailing the compensation to be paid by Enron to Bankers Trust and to Akin, Gump, Stauss, Hauer & Feld, LLP (hereinafter "Akin, Gump") by Enron.[314] The transaction was subsequently completed on October 31, 1997.

It is unclear from the documents which corporate officers, other than Mr. Causey, approved the transaction prior to its completion. However, on March 4, 1998, Kenneth L. Lay, Chairman and Chief Executive Officer of Enron Corp. thanked Mr. Hermann and Mr. Maxey for their good job on the transaction.[315] In addition, Enron's Board of Directors was made aware of the completion of Project Steele at the December 9, 1997 meeting.[316]

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[312] *Id.* at EC2 0000375092. The letter also states that "other less expensive alternatives exist to generate equivalent tax benefits." EC2 000037592 and EC2 000037573.

[313] Letter from Mr. Finley of Bankers Trust to Mr. Maxey, dated June 17, 1997. Although the letter limits disclosure of the information, it does not explicitly require confidentiality; however, it states "[i]f any law enacted after the date of this letter shall require that the Transaction be registered as a 'tax shelter'... then this letter shall be null and void...including without limitation any payment obligations or any requirements of confidentiality or exclusivity." The Project Steele materials in Appendix B contain the letter. EC2 00037571 - EC2 000037572.

[314] Letter from Mr. Finley of Bankers Trust to Richard A. Causey, dated October 28, 1997. Although Akin, Gump was not a party to the agreement, the agreement specifically references fees to be paid to Akin, Gump, an unrelated and otherwise unnamed third party. Enron stated it was not aware why Akin, Gump was included in the agreement.

[315] Mr. Lay relayed his comments to Mr. Hermann and Mr. Maxey by forwarding a letter from Frank N. Newman, Chairman of the Board and Chief Executive Officer of Bankers Trust, in which Mr. Newman congratulates Mr. Lay on the successful completion of Project Steele. Mr. Newman wrote that Bankers Trust " is extremely pleased to have worked with your company as both financial advisor and principal on this transaction to collaboratively meet Enron's financial objectives. Moreover, we view this transaction as a solid platform for

Enron's purported principal business purpose for the transaction was to generate financial accounting income. Other business purposes stated were (1) that the transaction is expected to reduce Federal income taxes owed by Enron, (2) that the transaction is expected to generate investment profits, and (3) that the transaction provides access to Bankers Trust investment expertise.[317]

Implementation of Project Steele

On October 27, 1997, Enron Corp., indirectly through three wholly owned subsidiaries ("the Enron Subsidiaries"), formed ECT Investing Partners, LP ("ECT Partners").[318] Although legally a limited partnership, ECT Partners elected under the "check the box" regulations to be treated as a corporation for Federal income tax purposes.[319]

On October 29, 1997, ECT Partners borrowed on a short-term basis $51.2 million from Enron North America, Inc.[320] The next day, ECT Partners used the entire proceeds to purchase corporate bonds from Bankers Trust.[321] The purchased bonds were high-grade corporate bonds

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continuing to explore innovative solutions that are tailored to your needs." It is unclear if Mr. Newman's reference to "financial objectives" was to the stated business purpose of generating financial accounting income. The Project Steele materials in Appendix B contain the letter. EC2 000037643. In addition, subsequent to the completion of Project Steele, Bankers Trust invited Mr. Maxey to the Potomac Capital Investment Corporation Conference on Februrary 8, 1998 through February 11, 1998. The Project Steele materials in Appendix B contain the letter. EC2 000037639-EC2 000037642.

[316] Enron 1998 - 2000 Operating & Strategic Plan for Enron mentioned that Project Steele, a tax strategy, will contribute pre-tax earnings of about $20 million per year in 1998-2000. EC 000046108 and EC 000046154.

[317] Federal tax opinion letter from Akin, Gump to Mr. Maxey dated December 16, 1997 at EC2 000033872. Appendix C, Part III to this Report contains the tax opinion letter.

[318] The Enron Subsidiaries received general and limited partnership interests in return for their contributions. The contributing subsidiaries were ECT Investing Corp., ECT Investments Holding Corp., and Enron Pipeline Company.

[319] Treas. Reg. sec. 301.7701-3.

[320] At the time of the loan, Enron North America, Inc. was known as Enron Capital & Trade Resources Corp. Enron North America, Inc. (a wholly owned subsidiary of Enron) is an parent corporation of two of the ECT Partners.

[321] The bonds were subsequently transferred to ECT Diversified Investments, LLC, a wholly owned subsidiary of ECT Partners. ECT Diversified Investments, LLC elected to be treated as a disregarded entity for Federal income tax purposes.

of various energy companies.[322] On October 30, 1997, and October 31, 1997, the three Enron owners contributed approximately $48 million of cash, $93.5 million of preferred stock of Enron Liquids Holding Corporation,[323] and a beneficial interest in certain leased aircraft with a fair market value of $42.6 million and a tax basis of zero to ECT Partners. The leased aircraft interest was contributed subject to $42.6 million of debt. In exchange for such property, Enron received approximately 95 percent ownership in ECT Partners. Also on October 31, 1997, ECT Partners repaid $50.5 million to Enron North America, Inc. in satisfaction of all but $700,000 of ECT Partner's borrowing from Enron North America, Inc.

On October 31, 1997, Bankers Trust, through two entities, contributed to ECT Partners $4.4 million of cash and REMIC residual interests with an approximate fair market value of $7.6 million and a tax basis of $233.8 million. In return, the Bankers Trust entities received approximately a five percent preferred ownership interest in ECT Partners and $4.5 million of ECT Partners debt securities. Bankers Trust also purchased from Enron Corp. two puts for $1,000 ($500 per option). The puts permits Bankers Trust to put its interest in ECT Partners to Enron at specified times (2 years and 6 ½ years after a recapitalization of ECT Partners).[324]

As a result of these steps, the Enron Subsidiaries received common and preferred shares in ECT Partners representing approximately 95 percent of the total vote and value of ECT Partners's shares. Bankers Trust's received preferred shares representing approximately 5 percent of the total vote and value of ECT Partners and $4.5 million of ECT Partners debt securities. After the contribution of property, ECT Partners owned REMIC residual interests with a fair market value of approximately $7.5 million and a tax basis of $234 million. The partnership also owned $51.2 million of corporate bonds, $2 million cash, and $42.6 million in leased assets (with a zero tax basis) subject to debt in an equal amount, and 100 percent of the

[322] The companies included Mobil Oil, Texaco Capital, Pacificorp, Alabama Power, Florida Power and Light, Imperial Oil, and Northern States Power. Ecx000003222.

[323] ECT Partners subsequently contributed the Enron Liquids Holding Corporation preferred stock to Enron Equity Corporation in return for a preferred interest in such entity. Enron North America contributed a $110 million intercompany note receivable from Enron Reserve Acquisition Corporation for the common interest in Enron Equity Corporation. Enron Equity Corporation immediately sold the Enron Liquids Holding Corporation preferred stock to Enron Corp. in exchange for a $93.5 million intercompany note receivable from Houston Pipeline Company, another wholly owned subsidiary of Enron Corp. Enron stated that it is not aware of any non-tax business reasons for the issuance of the $110 million intercompany note receivable from Enron Reserve Acquisition Corporation or the $93.5 million of Enron Liquids Holding Corporation preferred stock.

[324] At any time after five years, any equity owner of ECT Partners could cause a recapitalization of ECT Partners pursuant to which preferred shares and debt securities held by Bankers Trust would be exchanged for new debt securities of ECT Partners with a current cash pay London Interbank Offering Rate based rate of return.

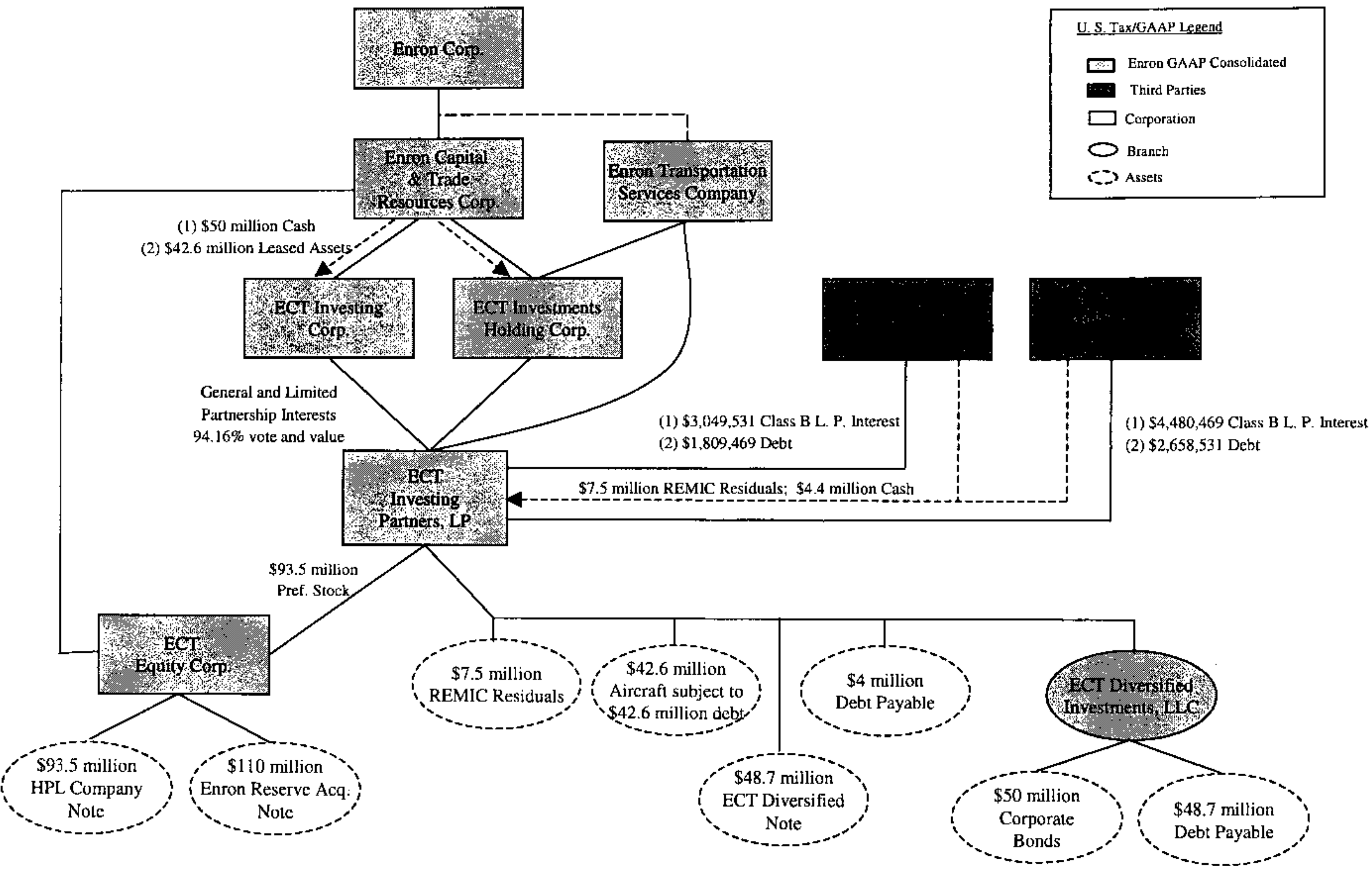
preferred stock of ECT Equity Corp. which owned $203.5 million of intercompany notes of Enron affiliates.[325]

The diagram on the next page depicts the Project Steele structure.

[325] ECT Equity Corp. held a $93.5 million note receivable from Houston Pipeline Company and a $110 million note receivable from Enron Acquisition Corporation. Enron North America, Inc. owned 100 percent of the common shares of ECT Equity Corp.

Confidential

Project Steele
Structure as of October 31, 1997



Role of outside advisors

As noted above, Bankers Trust promoted and was the exclusive financial advisor on the transaction to Enron; in addition, Bankers Trust was the only legally unrelated counterparty to the transaction. Enron's outside counsel for Project Steele was Akin, Gump. In connection with Project Steele, Akin, Gump provided two tax opinion letters. The first opinion analyzed the tax implications of the transaction and concluded that (1) the contribution of property and assets by the Enron Subsidiaries and Bankers Trust should constitute nontaxable transfers of property under section 351; (2) the tax basis of the contributed property to the corporation should equal the tax basis of such assets in the hands of the contributor; (3) the losses attributable to the REMIC residual interests should not be disallowed, whether by the business purpose doctrine, section 269, the step transaction doctrine, or Treas. Reg. sec. 1.1502-13(h); (4) losses attributable to the REMIC residual interests recognized during the five-year period after the closing of the transaction more likely than not will be subject to limitation under the SRLY rules of the consolidated return regulations; and (5) ECT Partners should be eligible to join the consolidated group of Enron.[326] The second tax opinion analyzed the potential accuracy-related penalties (under section 6662) and tax shelter disclosure requirements (under section 6111). The opinion concluded that (1) the accuracy-related penalty should not apply in the event the deductions attributable to the REMIC residual interests are disallowed, and (2) no person principally responsible for, or participating in, the organization and management of ECT Partners should be required to register ECT Partners as a tax-shelter.[327] In addition, Arthur Andersen was engaged to do a tax basis study on the REMIC residual interests contributed by Bankers Trust.

Bankers Trust was paid $8.65 million for its services.[328] Akin, Gump was paid $1 million for the tax opinion letters and Arthur Andersen was paid $49,600 for its services.[329]

Discussion

Project Steele was designed to provide Enron with the tax benefits associated with built-in losses in the REMIC residual assets at a cost significantly less than the amount of the tax benefit. A determination of whether Enron should be entitled to deduct the built-in losses in the REMIC residual assets necessarily involves an analysis regarding Enron's satisfaction of the

[326] Federal tax opinion letter from Akin, Gump to Mr. Maxey dated December 16, 1997. Appendix C, Part III to this Report contains the tax opinion letter Enron received in connection with Project Steele. EC 000033867-EC 000033903.

[327] Akin, Gump tax opinion letter to Mr. Maxey dated December 16, 1997. EC 000033905-EC 000033916. Appendix C, Part III to this Report contains the tax opinion letter Enron received in connection with Project Steele.

[328] The contractual fee was $10 million. Enron is still obligated on the final three installments of $450,000.

[329] The General Background Materials in Appendix B contain the Estimated Project Fees schedule (6/4/01). The fees were determined from a table summarizing fees paid on structured transactions. EC2 000036379.

literal requirements of the applicable statutory requirements as well as the rules and judicial doctrines (such as business purpose and economic substance) that are often applied to evaluate the purported tax benefits in tax-avoidance transactions.[330]

The Code and Treasury regulations recognize the potential for abusive activity and contain provisions intended to limit the benefits of arrangements that, although satisfying the literal requirements of a provision, are used to distort, pervert, and defeat the basic purpose of the underlying statute.[331] These provisions address such policy concerns by limiting the benefit of the underlying statute through the use of general disallowance if (1) specific factual tests are met or (2) if the principal purpose of the transaction is to evade or avoid income tax.

Acquisitions made to evade or avoid income tax

If a taxpayer acquires control (defined as at least 50 percent of vote or value) of a corporation, and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax, the deductions or other tax benefits may be disallowed.[332] In Project Steele, the formation of ECT Partners by the Enron Subsidiaries and Bankers Trust was the acquisition of control. Thus, in order to avoid the disallowance of the tax benefits from Project Steele, Enron had to have a principal purpose other than the avoidance or evasion of Federal income tax.

In determining Enron's motives for engaging in Project Steele, Akin, Gump relied heavily upon Enron's representation that its principal purpose for entering into the transaction

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

[331] *See, e.g.*, sec. 269 (acquisitions made to evade or avoid income tax), sec. 362(d) (limitation on basis increase attributable to assumption of liability), sec. 358(h) (reduction to basis of assets in connection with transfers of liabilities that give rise to a deduction), Treas. Reg. sec. 1.701-2 (partnerships formed or availed of in connection with a transaction with a principal purpose of reducing tax), and sec. 732(f) (adjustment to basis of assets of a distributed corporation controlled by a corporate partner). *See also* proposed regulations to prevent a consolidated group from obtaining more than one tax benefit from a single economic loss (IRS Proposed Rules and Public Hearing Notice (Reg-131478-02) On Suspension of Losses on Certain Stock Dispositions Federal Register October 23, 2002).

[332] Sec. 269(a)(1).

was to generate financial accounting benefits and that it would not have entered into the transaction in the absence of the accounting benefits. In addition, Akin, Gump relied on Enron's representation that it would have entered into the transaction even if no net cash benefit was anticipated to arise as a result of an excess of net present value tax savings over the transaction costs. Based on these representations, Akin, Gump concluded that section 269 would not disallow the benefits obtained from Project Steele.[333]

Akin, Gump's conclusion is disturbing in two respects. First, concluding that a non-tax business purpose exists based on the accounting benefits of Project Steele fails to consider the origin of the accounting benefit (i.e., solely reduction of taxes). Such an analysis significantly diminishes the purpose for having a substantial non-tax business purpose.[334] Second, Akin, Gump's reliance on Enron's representation that Enron would have engaged in the transaction even if there were no present value tax benefits after transaction costs fails to recognize that Project Steele under all circumstances, absent an extraordinary fee to the promoter, would have significant present value tax benefits. Reliance on answers given to unimaginable hypothetical transactions, especially when evaluating a taxpayer's non-tax business purposes, may call into question the reasonableness and objectivity of the advice given, especially for purposes of the accuracy related penalty.[335]

Section 351

The Code and Treasury regulations also contain specific provisions intended to limit a taxpayer's ability to transfer tax attributes, such as net operating losses, built-in-losses, and

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[333] Appendix C, Part III to this Report contains the Akin, Gump tax opinion.

[334] *See, e.g., American Electric Power, Inc. v. U.S.,* 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'" *citing Winn-Dixie v. Commissioner,* 113 T.C. 254, 287 (1999)).

[335] An accuracy-related penalty is not imposed with respect to any portion of any underpayment if the taxpayer can show that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion. Sec. 6664(c)(1). Reliance on a tax opinion constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. This standard is not satisfied if the advice or opinion is based on unreasonable factual or legal assumptions. "For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner." Treas. Reg. sec. 1.6664-4(c)(1)(ii).

various credit items.[336] The general purpose of these provisions is to limit the ability of such tax benefits by a taxpayer who did not suffer the economic loss that gave rise to the tax benefit.

Project Steele purported to use the tax-free incorporation rules and resulting carryover basis rules to transfer losses and duplicate a single economic loss. The ability to transfer losses and duplicate a single economic loss through section 351 has been, and continues to be, a concern in the administration of tax policy.[337] In order for Project Steele to achieve the desired tax results (and the corresponding financial accounting benefits), the transfer of the REMIC residual interests by Bankers Trust had to occur in a tax-free incorporation such that the REMIC residual interests tax basis would carry over to ECT Partners.

It may be argued that the application of section 351(a) is predicated upon a valid non-tax business purpose and that the transfer by Bankers Trust did not have the requisite business purpose.[338] Documents exchanged between Bankers Trust and Enron clearly reflect that one of the considerations in the transaction was the fee paid to Bankers Trust for the delay the structure imposed on Bankers Trust's ability to deduct the losses. Bankers Trust provided schedules to Enron detailing the net present value cost of delaying their tax benefits until the recapitalization was permitted.[339] The documentation reviewed by the Joint Committee staff demonstrated no

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[336] *See, e.g.*, sec. 382 (limitation on net operating loss carryforwards and certain built-in-losses following ownership changes, sec. 383 (special limitations on certain excess credits, etc.), and Treas. Reg. sec. 1.1502-15 (SRLY limitation on built-in-losses).

[337] For example, in the year 2000, Congress enacted rules requiring a reduction in basis of assets in connection with transfers of certain liabilities in order to stop transactions that duplicated a single economic loss. *See*, the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, sec. 1(a)(7) (Dec. 21, 2000). *See* Staff of the Joint Committee on Taxation, *General Explanation of Tax Enacted in the 106th Congress* (JCS-2-01), April 19, 2001, at 154. In addition, President Clinton's Fiscal Year 2001 Budget Proposals contained a proposal that was aimed at limiting the ability of taxpayers to transfer built-in losses into the U.S. tax system by requiring marking to fair market value such assets when such assets become "relevant" for U.S. tax purposes (See Office of Management and Budget, *Budget of the United States Government, Fiscal 2001: Analytical Perspectives* (H.Doc. 106-162, Vol. III). See also Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal* (JCS-2-00), March 6, 2000.) Most recently, the Treasury Department issued proposed regulations to prevent a consolidated group from obtaining more than one tax benefit from a single economic loss (IRS Proposed Rules and Public Hearing Notice (Reg-131478-02) On Suspension of Losses on Certain Stock Dispositions Federal Register October 23, 2002).

[338] An analysis of the non-tax business purpose is also relevant for the application of the judicial doctrines referred to above.

[339] Letter from Mr. Finley of Bankers Trust to Mr. Maxey dated August 11, 1997. The Project Steele materials in Appendix B contain the letter. EC2 000037595 - EC2 000037596. King & Spalding was counsel to Bankers Trust on Project Steele.

purpose for the transaction other than to facilitate the transfer of Federal income tax benefits, and the resulting financial accounting benefits to Enron.

Bankers Trust's reason for engaging in the transaction can be gleaned from a letter to King & Spalding.[340] Bankers Trust provided a detailed analysis of how the "base case" duplication of losses from the REMIC residual interests could be enhanced by inserting a recapitalization feature and having a corporation (in this case Enron) transfer additional unrelated assets into the structure.[341] By inserting these features, Bankers Trust concluded that significant financial accounting benefits inure to a participant, including reflecting the tax benefits in operating income rather than as reduction to tax expense.[342] Most importantly to Bankers Trust, though, was its conclusion that by inserting the recapitalization feature into the structure, it could earn a modest fee, but with both features inserted, it could obtain a substantial fee from its corporate clients.

Recommendations

The Joint Committee staff recommendations regarding Projects Tanya and Valor[343] include recommendations to limit the duplication of a single economic loss. These recommendations also are appropriate for consideration with respect to Project Steele.

Irrespective of whether an overall change is made to limit the duplication of a single economic loss under subchapter C generally, the Joint Committee staff believes it is appropriate to limit the ability to transfer REMIC residual interests in a carryover basis transaction. Under the statutory rules regarding the taxation of REMICS, phantom income is allocated to REMIC residual interest holders. The phantom income allocation inevitably creates built-in losses to the holders of the REMIC residual interests, thus making such interests a natural component for transactions designed to duplicate a single economic loss. As such, the Joint Committee staff recommends that either a corporation's basis in REMIC residual interests acquired in a tax-free transfer (or reorganization) be limited to its fair market value or that a transferor's basis in the stock received in exchange for REMIC residual interests be limited to the fair market value of the REMIC residual interests.[344]

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[340] *See* letter and attachment from William B. Boyle of Bankers Trust to William McKee of King & Spalding dated June 2, 1997. The Project Steele materials in Appendix B contain the letter. EC2 000037574 - EC2 000037592.

[341] Both of these features were included in Project Steele.

[342] A short explanation of why operating earnings are considered more beneficial than a reduction in income tax expense is contained in Background and Rationale of this Part of the Report.

[343] Projects Tanya and Valor are discussed in this section of the Report immediately preceding Project Steele.

[344] *See* recommendations for Projects Tanya and Valor for a discussion of general issues with respect to this type of proposal.

4. Project Cochise

Brief overview

Project Cochise was a variation on Project Steele and, like Project Steele, was designed to produce operating income on Enron's financial statements, while also providing Enron with significant Federal income tax deductions. Thus, the prearranged transaction was intended to yield Enron a combination of both income for financial statement purposes and deductions for Federal income tax purposes.

In general, Project Cochise involved tax-free transfers by Enron of assets with a steady income stream (i.e., REMIC regular interests)--along with tax-free transfers by the London branch of Bankers Trust of assets with a tax basis significantly in excess of fair market value (i.e., residual interests in the same portfolio of REMICs)--to an existing wholly-owned subsidiary of Enron. The subsidiary subsequently elected to be treated as a real estate investment trust ("REIT") for Federal income tax purposes. Based upon the differences between the financial accounting and Federal income tax treatment of the REMIC residual interests that were transferred to the subsidiary by Bankers Trust, Project Cochise produced for Enron a substantial amount of financial accounting income through the immediate creation of a deferred but undiscounted tax asset.[345]

Because the subsidiary would no longer be part of Enron's consolidated group (as a result of its REIT status election) and Bankers Trust would own all of the common stock of the subsidiary following the transfers, all of the remaining so-called "phantom" (i.e., non-cash) income from the REMIC residual interests would be distributed to Bankers Trust through the declaration of consent dividends on the common stock in the subsidiary held by Bankers Trust. Furthermore, it was anticipated that Enron would recognize in later years the tax deductions resulting from the reversal of the earlier REMIC non-cash "phantom" income, after the subsidiary was recapitalized and rejoined the Enron consolidated group in 2004. Based upon the special deconsolidated treatment of the subsidiary as a REIT and the anticipated future reconsolidation of the subsidiary with the Enron consolidated group, Project Cochise was intended to redirect the REMIC non-cash "phantom" income and the subsequent offsetting deductions so that Enron could claim the deductions on its Federal income tax return after 2003 without having recognized the associated income in earlier tax years.

As with Project Steele, Project Cochise also produced a duplication of the loss that was built into the REMIC residual interests transferred by Bankers Trust to the subsidiary. Specifically, the tax basis of the subsidiary stock received by Bankers Trust in exchange for the REMIC residual interests significantly exceeded its fair market value because the tax basis in the stock was determined by reference to the built-in loss assets (i.e., the REMIC residual interests) contributed by Bankers Trust to the subsidiary. Consequently, Project Cochise enabled both Enron and Bankers Trust to shelter other taxable income with the losses that were built into the

[345] The financial accounting benefits of Project Cochise also were facilitated by the acquisition by Enron from Bankers Trust of two leased aircraft and the associated leases.

REMIC residual interests, either directly with future deductions generated by the REMIC residual interests (in the case of Enron) or indirectly through the disposition of stock in the subsidiary that mirrored the built-in loss in the interests (in the case of Bankers Trust).

Background[346]

Reported tax and financial statement effects

Although Project Cochise did not (and was not intended to) generate any material net tax deductions during the period 1999 through 2001 (out of a projected total of approximately $388 million beginning after 2004), it did generate approximately $100 million (out of a projected total of approximately $140 million) in reported net earnings for financial reporting purposes through the third quarter of 2001.[347]

Development of Project Cochise

The development of Project Cochise began as early as July of 1998 and, on December 18, 1998, the executive committee of Enron's Board of Directors approved for recommendation to the full Board a resolution authorizing Enron to undertake the transactions involved in Project Cochise.

On January 28, 1999, Bankers Trust provided an engagement letter to Enron indicating that Bankers Trust agreed to act as the exclusive financial advisor to Enron in connection with assisting in the implementation of Project Cochise. The engagement letter provided that Enron would pay Bankers Trust $15 million in consideration of the services provided by Bankers Trust pursuant to the engagement letter, with an initial payment of $5,250,000 on September 1, 1999 and quarterly installments of $750,000 beginning on December 1, 1999 and ending on December 1, 2002.[348]

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[346] The information regarding Project Cochise was obtained from Joint Committee staff interviews of Robert J. Hermann, Robert Davis Maxey, David Williams, and Alicia Goodrow, as well as from documents and information provided by Enron Corp. and the IRS.

[347] The General Background materials in Appendix B contain the Structured Transactions Group Summary of Project Earnings & Cash Flows (Nov. 2001). In response to questions from the Joint Committee staff, Enron has indicated that it recorded financial statement benefits from Project Cochise as follows: (1) $27.7 million in 1999; (2) $50.3 million in 2000; and (3) $23.2 million in 2001. However, Enron also has indicated that it recorded a financial statement valuation reserve in December 2001 with regard to Project Cochise in the amount of $73.5 million. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003.

[348] Bankers Trust letter from Brian J. McGuire to Richard A. Causey, dated January 28, 1999. EC2 000037417 through EC2 000037421. The Project Cochise materials in Appendix B contain this letter. Although the contractual fee was $15 million, it appears that Enron has not paid the final five installments of $750,000. Thus, the fees paid to date by Enron to Bankers

On January 28, 1999, the primary initial transactions involved in Project Cochise (e.g., transfers of assets to Enron subsidiary) were executed, as described below.

On January 28, 1999, Potter Anderson & Corroon LLP provided an opinion to Enron relating to the application of Delaware law to the transactions involved in Project Cochise.

On February 8, 1999, the Enron Board of Directors approved the board resolution relating to Project Cochise.[349]

On May 26, 1999, Arthur Andersen provided a SAS 50 opinion to Bankers Trust relating to the appropriate financial accounting treatment of the transactions involved in Project Cochise.[350]

On March 21, 2001, McKee Nelson, Ernst & Young LLP provided an opinion to Enron relating to the Federal income tax consequences of the transactions involved in Project Cochise.[351]

On May 14, 2001, King & Spalding provided an opinion to Enron relating to the REIT qualification of the Enron subsidiary involved in Project Cochise for Federal income tax purposes.[352]

The principal tax personnel involved in executing the transaction for Enron were Mr. Hermann and Mr. Maxey.

Enron's purported principal business purposes for the transaction were to: (1) invest in REMIC regular and residual interests; (2) invest in leased aircraft; and (3) increase the pre-tax financial accounting income and net earnings of Enron.[353]

Trust with regard to Project Cochise equal $11,250,000. The General Background materials in Appendix B contain the Estimated Project Fees schedule (June 4, 2001).

[349] The Project Cochise materials in Appendix B contain the minutes of the February 8, 1999 meeting of the Enron Board of Directors at which the Board discussed and approved Project Cochise and the associated resolution.

[350] Arthur Andersen letter to Bankers Trust Company, dated May 26, 1999. EC2 000037349 through EC2 000037367. The Project Cochise materials in Appendix B contain this letter.

[351] McKee Nelson, Ernst & Young LLP letter from William S. McKee and James D. Bridgeman to R. Davis Maxey, dated March 21, 2001. EC2 000033988 through EC2 000034072. Appendix C, Part IV of this Report contains the tax opinion letter Enron received from McKee Nelson, Ernst & Young LLP in connection with Project Cochise.

[352] King & Spalding letter to Enron, dated May 14, 2001. EC2 000033980 through EC2 000033983. Appendix C, Part IV of this Report contains the tax opinion letter Enron received from King & Spalding in connection with Project Cochise.

Implementation of Project Cochise

Prior to the execution of Project Cochise, Enron owned all of the outstanding stock (1,000 shares of common stock) of Maliseet Properties, Inc. ("Maliseet"), a Delaware corporation that was formed on April 16, 1985.[354]

On January 28, 1999, the following events occurred contemporaneously and as part of a prearranged plan in the implementation of Project Cochise:[355]

(1) BT Green, Inc., a New York corporation and member of the Bankers Trust consolidated group ("BT Green"), sold undivided interests in REMIC regular interests to Bankers Trust for approximately $2.7 million;

(2) BT Green sold to Enron its remaining undivided interests in the REMIC regular interests for $24.8 million;

(3) Enron contributed the REMIC regular interests that it purchased from BT Green to Maliseet in exchange for 39,000 shares of Maliseet Series A preferred stock and 572 shares of Maliseet Series B preferred stock;[356]

(4) Enron sold all of its Maliseet common stock to Bankers Trust for $100;

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[353] "Representations and Assumptions" described in the McKee Nelson, Ernst & Young LLP Federal income tax opinion letter from William S. McKee and James D. Bridgeman to R. Davis Maxey, dated March 21, 2001, at 12-13. EC2 000033999.

[354] Maliseet was the result of the recapitalization and renaming of Enron Interstate Pipeline Company by Enron in January 1999. "Structured Transactions Group: Business Review", dated October 2001. EC2 000038350. The Project Cochise materials in Appendix B contain this document.

[355] "Statement of Facts" described in the McKee Nelson, Ernst & Young LLP Federal income tax opinion letter from William S. McKee and James D. Bridgeman to R. Davis Maxey, dated March 21, 2001, at 4-12. EC2 000033991 through EC2 000033999.

[356] In general, the Series A preferred stock were junior to the Series B preferred stock and provided for cumulative quarterly dividends to be accrued at an initial annual rate of 5.06788 percent of the stated liquidation preference with respect to the stock. The Series B preferred stock were senior to the Series A preferred stock and provided for cumulative quarterly dividends to be accrued at an annual rate of 15 percent of the stated liquidation preference with respect to the stock. The Series A preferred stock provided voting rights, but the Series B stock did not. The Series A and Series B preferred stock each were immediately redeemable upon an affirmative vote of at least 80 percent of both the holders of the preferred stock to be redeemed and the common stockholders. In addition, the Maliseet Board of Directors could compel a redemption of the Series B preferred stock at any time on or after January 28, 2004 upon an affirmative vote of at least 80 percent of both the holders of the Series A preferred stock and the common stockholders.

(5) Bankers Trust contributed the REMIC regular interests that it purchased from BT Green and REMIC residual interests to Maliseet in exchange for 1,000 shares of the common stock of Maliseet worth approximately $1.25 million and a 20-year zero coupon debt instrument issued by Maliseet with a stated principal amount of approximately $5.4 million and a stipulated fair market value of approximately $1.6 million;[357]

(6) Enron and Bankers Trust executed a shareholders agreement whereby (a) either Enron or Bankers Trust could compel the recapitalization of Maliseet, which would redeem all of the Series B preferred stock on or after January 28, 2004, exchange the common stock and the debt instrument issued by Maliseet to Bankers Trust for 10-year notes of equal value that pay current interest, and exchange the Series A preferred stock issued by Maliseet to Enron for common stock of Maliseet, (b) Enron would ensure that Maliseet elected REIT status and qualified as a REIT at all times from January 1, 1999 to January 1, 2004, and (c) Bankers Trust agreed to treat Maliseet as having paid to Bankers Trust "consent dividends" (as defined in section 565) and to be treated for Federal income tax purposes as having received an actual cash dividend from Maliseet at the end of each taxable year in an amount equal to the consent dividend for such year;

(7) Bankers Trust purchased from Enron for $1,000 two put options that permitted Bankers Trust to require Enron to purchase from Bankers Trust any of the 10-year notes received by Bankers Trust in a recapitalization of Maliseet at any time on or after two years (in the case of one put option) or 78 months (in the case of the other put option) following such recapitalization;

(8) Enron and Bankers Trust entered into put and call options that permitted Bankers Trust to purchase (in the case of the call option) or Enron to require Bankers Trust to purchase (in the case of the put option) at a stipulated fair market value the Maliseet preferred stock held by Enron upon a change in law that prevented Maliseet from qualifying as a REIT, holding REMIC residual interests, or declaring consent dividends; and

(9) BT Ever, Inc., a New York corporation and member of the Bankers Trust consolidated group ("BT Ever"),[358] sold two aircraft, and leases to which they

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[357] The Bankers Trust London branch previously had purchased the REMIC residual interests in two packages--one package in September 1997 and the other package in December 1997. The REMIC residual interests currently generate phantom income and are not expected to generate phantom deductions until after January 1, 2004.

[358] Bankers Trust, as well as three of its affiliates and an affiliate of Potomac Capital Investment Corp. (a taxable subsidiary of Potomac Electric Power Co. and also a minority investor in Project Teresa), own non-voting participating preferred stock in BT Ever. EC2 000037412.

were subject, to an Enron subsidiary (ECT Investments Holding Corp., a Delaware Corporation) for $44,046,885.85.

On or before February 15, 1999, six directors of Maliseet each contributed $1,000 to Maliseet in exchange for one share of Series B preferred stock,[359] and 98 other investors each contributed $1,000 to Maliseet in exchange for one share of Series B preferred stock.[360]

After the contributions to Maliseet, Enron owned approximately 95 percent of the total combined voting power of all classes of stock of Maliseet that were entitled to vote and approximately 95 percent of the total value of shares of all classes of stock of Maliseet. Bankers Trust owned approximately five percent of the total combined voting power of all classes of stock of Maliseet that were entitled to vote and approximately five percent of the total value of shares of all classes of stock of Maliseet.

Because of the creation of non-cash phantom income on REMIC residual interests for Federal income tax purposes, the REMIC residual interests that Bankers Trust contributed to Maliseet had an aggregate adjusted tax basis ($120 million) significantly in excess of their aggregate fair market value ($165,000). Furthermore, the adjusted basis in the REMIC residual interests was expected to increase by approximately $268 million over the life of these interests because of such treatment.

In June 2000, ECT Investments Holding Corp. sold the aircraft and associated leases that it had acquired from BT Ever for approximately $36 million.

The diagram on the next page depicts the structure of Project Cochise at formation.

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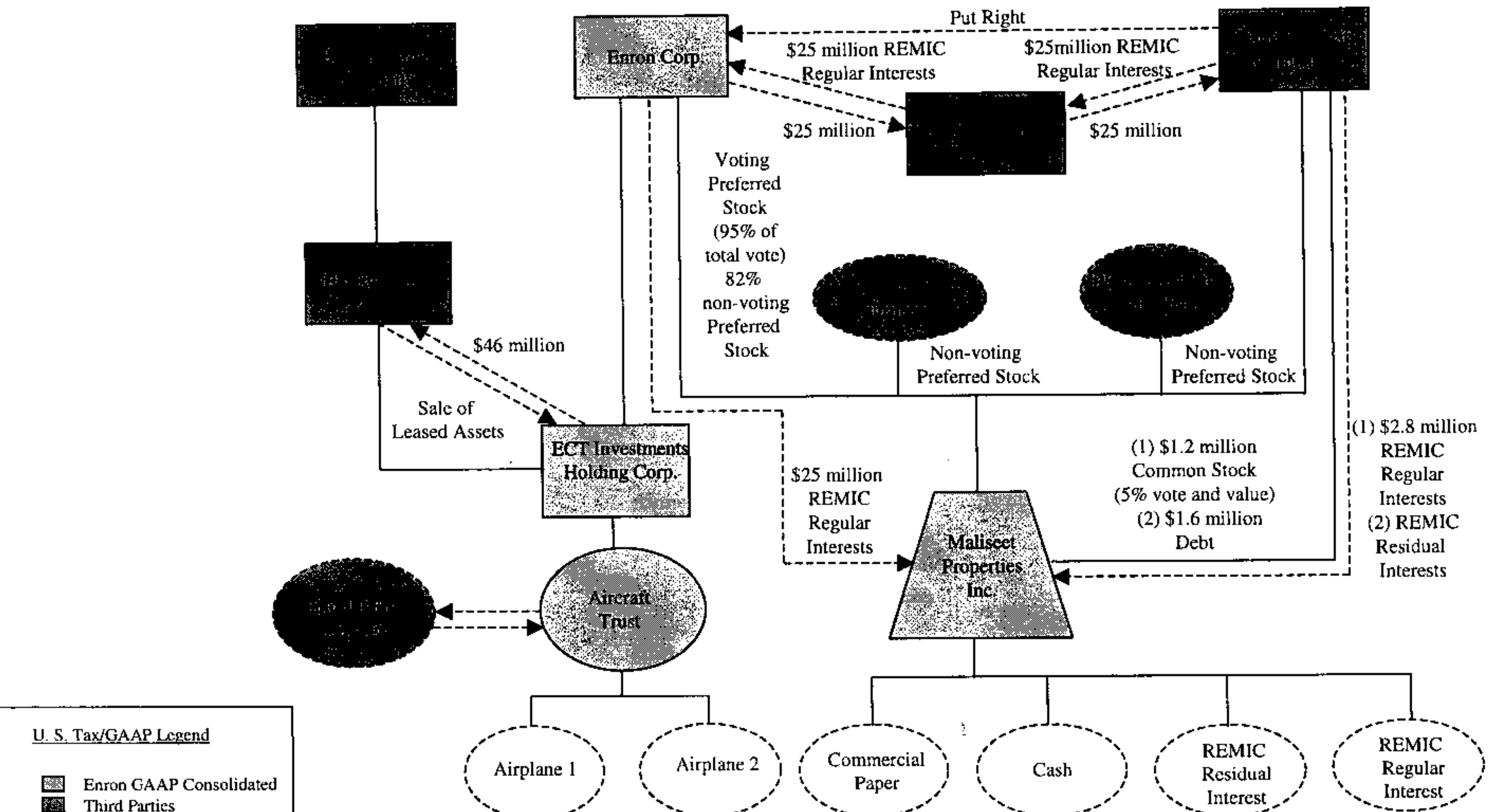
359 The Maliseet directors who received shares were Jeffrey McMahon, James V. Derrick, Jr., Richard A. Causey, Robert H. Butts, Mr. Hermann, and Andrew S. Fastow. The stock subscription agreements with these directors were executed on behalf of Maliseet by Mr. Maxey as vice president of Maliseet. Maliseet stock subscription agreements dated February 12, 1999. EC2 000036853 through EC2 000036908.

360 According to interviews with Enron tax department personnel, Enron utilized the services of a firm called REIT Funding, Inc. to assist in placing the Maliseet shares with the other 98 investors. Joint Committee staff interview with Alicia Lynn Lockheed Goodrow, September 23, 2002. Most of these investors were residents of the Atlanta, Georgia, metropolitan area, and all of the investors were residents of Georgia, Tennessee, North Carolina, or Florida. Maliseet stock subscription agreements, EC2 000054439 through EC2 000054738. At some point during the development of Project Cochise, consideration apparently was given to using partners of the law firm Akin, Gump, Strauss, Hauer & Feld as the outside investors in Maliseet. The Project Cochise materials in Appendix B contain a preliminary diagram of Project Cochise indicating that Series B preferred stock would be transferred to at least 99 partners of Akin, Gump, Strauss, Hauer & Feld "in satisfaction of legal services provided on matters unrelated to [Maliseet]."

Confidential

Project Cochise
Structure as of January 1999



Following the implementation of Project Cochise, it was intended that Maliseet would distribute current cash dividend payments on the Series A and Series B preferred stock, and would distribute any remaining taxable income through cash and consent dividends to Bankers Trust as holder of the Maliseet common stock.

Pursuant to the terms of the shareholders agreement between Enron and Bankers Trust, it was anticipated that either Enron or Bankers Trust would prompt the recapitalization of Maliseet after five years (i.e., on or after January 28, 2004), which would redeem all of the Series B preferred stock, exchange the common stock and the debt instrument issued by Maliseet to Bankers Trust for 10-year notes of equal value that pay current interest, and exchange the Series A preferred stock issued by Maliseet to Enron for common stock of Maliseet.[361] By then (or shortly thereafter), the REMIC residual interests would begin to generate tax deductions to reverse the previous REMIC non-cash phantom income that was distributed exclusively to Bankers Trust (primarily through consent dividends) as holder of the Maliseet common stock. Accordingly, it was expected that Maliseet would intentionally lose its REIT status (either through a revocation of its REIT election or by failing to qualify as a REIT) and would rejoin the Enron consolidated group, which would then take into account the tax deductions generated by the REMIC residual interests held by Maliseet.

Role of outside advisors

According to interviews with Enron tax department personnel, Bankers Trust promoted Project Cochise to Enron.[362] As noted above, Bankers Trust also was the exclusive financial advisor to Enron with respect to Project Cochise. Bankers Trust was the sole financial advisor for Enron irrespective that Bankers Trust was the only unrelated counterparty to the transaction (other than the handful of individual investors in Maliseet).

The documentation for Project Cochise indicates that William S. McKee and James D. Bridgeman of McKee Nelson, Ernst & Young LLP were the primary counsel responsible for the development and implementation of Project Cochise, with King & Spalding providing counsel on the more limited issue of REIT status qualification for Maliseet.[363] In connection with Project Cochise, McKee Nelson, Ernst & Young LLP provided a tax opinion letter that analyzed the tax implications of the transaction and concluded that:

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[361] The tax deductions included in Enron's projections with respect to Project Cochise would become available to Enron only upon the recapitalization of Maliseet. The Project Cochise materials in Appendix B contain projections and diagrams in connection with Project Cochise indicating that the recapitalization of Maliseet was a prearranged step in the implementation of Project Cochise.

[362] Interview with Mr. Maxey, August 6, 2002.

[363] Appendix C, Part IV of this Report contains the tax opinion letters Enron received from McKee Nelson, Ernst & Young LLP and King & Spalding in connection with Project Cochise.

(1) the contributions to Maliseet of REMIC regular interests by Enron and REMIC regular and residual interests by Bankers Trust "should" constitute non-taxable transfers of property under section 351;[364]

(2) the tax basis of the REMIC residual interests contributed to Maliseet by Bankers Trust "should" equal the tax basis of such interests in the hands of Bankers Trust immediately before the contributions;

(3) Enron "will" be treated as the owner of the Series A and Series B preferred stock received from Maliseet,[365] and "will" be treated as the owner of the two aircraft and leases to which they were subject;[366]

(4) section 269 "should not" apply to disallow any tax deductions generated by the reversal of earlier non-cash phantom income on the REMIC residual interests in the hands of Maliseet;[367]

(5) Maliseet's use of any tax deductions generated by the reversal of earlier non-cash phantom income on the REMIC residual interests "should not" be subject to limitation under section 382 solely as a result of either the contributions of the REMIC residual interests by Bankers Trust to Maliseet or the acquisition of Bankers Trust Corp. by Deutsche Bank;

(6) "it is more likely than not" that neither Maliseet, the REMIC residual interests, nor the transactions involved in Project Cochise are required to be registered as a tax shelter under section 6111;

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[364] Included in this opinion was the conclusion that Enron and the Bankers Trust London Branch were in "control" of Maliseet (within the meaning of section 368(c)) immediately after the exchange notwithstanding the 2004 recapitalization provisions in the shareholders agreement between Enron and Bankers Trust.

[365] Employing an economic substance analysis, this opinion was based upon representations from Enron that it would earn annual pre-tax profits of at least five percent with regard to its investment in the Series A preferred stock and 15 percent with regard to its investment in the Series B preferred stock, exclusive of finance costs and the time value of money.

[366] Employing an economic substance analysis, this opinion was based upon representations from Enron that it would earn an annual pre-tax profit of at least 4.12 percent with regard to its investment in the aircraft and leases, exclusive of finance costs and the time value of money.

[367] Included in this opinion was the conclusion that neither Enron nor the Bankers Trust London Branch "acquired" control of Maliseet in the transaction because Enron owned 100 percent of the vote and value of Maliseet before the transaction and owned 95 percent of the vote and value of Maliseet after the transaction.

(7) Enron "should not" be subject to penalties under section 6707 for failing to register Maliseet, the REMIC residual interests, or the transactions involved in Project Cochise as a tax shelter under 6111 prior to January 28, 1999;

(8) Maliseet "should" be entitled to a deduction for dividends paid under section 857(b)(2)(B), provided (a) Bankers Trust (the sole owner of the Maliseet common stock) properly consents to be treated as having received the consent dividends, (b) Maliseet timely files such consent with it Federal income tax returns, and (c) there are no arrearages of any accrued dividends on the Series A and Series B preferred stock as of December 31 of each taxable year; and

(9) for purposes of sections 6662 and 6664, there is "substantial authority" for the tax treatment of the transactions involved in Project Cochise and there is a "greater than 50 percent likelihood" that the tax treatment of such transactions will be upheld in litigation if challenged by the IRS.

To date, Enron has paid $1,022,774 in fees to McKee Nelson, Ernst & Young LLP in connection with Project Cochise.[368]

In addition, King & Spalding provided a tax opinion letter that analyzed the tax implications of the transaction and concluded that Maliseet "should" qualify as a REIT for Federal income tax purposes for its taxable year ended December 31, 1999, and that the organization and proposed method of operation of Maliseet "should" enable it to continue to satisfy the requirements for qualification and Federal income taxation as a REIT for its taxable year ended December 31, 2000 and subsequent taxable years.

As indicated above, Arthur Andersen provided a hypothetical accounting opinion letter to Bankers Trust that analyzed the financial accounting treatment of a hypothetical transaction that was substantially identical to Project Cochise. Based upon the Arthur Andersen opinion, Enron took various favorable financial accounting positions. For purposes of producing accounting income on its financial statements, Enron took the position that Project Cochise generated a deferred tax asset that was not discounted to take into account the time value of money.[369] In

[368] The General Background materials in Appendix B contain the Estimated Project Fees schedule (June 4, 2001). Enron was unable to provide to the Joint Committee staff a copy of any engagement letter between Enron and McKee Nelson, Ernst & Young LLP with respect to Project Cochise, and was unable to provide information concerning the entire fee arrangement between Enron and McKee Nelson, Ernst & Young LLP with regard to Project Cochise. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003. It is unclear from a review of documents provided by Enron whether these fees actually were paid to McKee Nelson, Ernst & Young LLP (Mr. McKee's current firm) or King & Spalding (Mr. McKee's previous firm).

[369] According to internal Enron documents, the transaction would enable Enron "to record deferred tax assets at gross amounts well in excess of their present value." The Project Cochise materials in Appendix B contain an executive summary describing the accounting benefits of Project Cochise. EC2 000037381.

essence, this deferred tax asset purportedly arose because of the prearranged confluence of several factors, including:

(1) the treatment of the contribution of the REMIC residual interests to Maliseet as a purchase of the interests by Maliseet for financial accounting purposes (in contrast to the treatment of the contribution as a tax-free, carryover basis transaction for Federal income tax purposes);

(2) the disparity between the $120 million aggregate adjusted tax basis in the REMIC residual interests (which carried over to Maliseet for Federal income tax purposes) and the $165,000 aggregate fair market value of the assets;

(3) the fact that the taxable non-cash phantom income generated by the REMIC residual interests would be distributed to Bankers Trust through consent dividends on the Maliseet common stock held by Bankers Trust;

(4) the fact that such phantom income would reverse in later years and generate deductions for Enron after Maliseet relinquishes its REIT status and becomes reconsolidated with Enron for Federal income tax purposes; and

(5) the fact that FAS 109 provides for the recording of an undiscounted deferred tax asset that does not take into account the time value of money.

Apparently, no tax basis study was performed for Enron with regard to the REMIC residual interests that were transferred to Maliseet. However, Deutsche Bank and Morgan Stanley & Co., Inc. provided historical basis information concerning the REMIC regular and residual interests transferred to Maliseet.[370]

Subsequent developments

Project Cochise remains in place pursuant to the original plan and, with the assistance of PricewaterhouseCoopers, Enron continues to monitor Maliseet to ensure that it maintains its status as a REIT for Federal income tax purposes. Maliseet is not a debtor in the Enron bankruptcy.

IRS examination of Project Cochise

As with Project Steele, the IRS examination team undertook an expedited review of Project Cochise that was limited to examining whether Maliseet satisfied the REIT qualification requirements. Having determined that Maliseet was properly formed as a REIT, and did properly operate as a REIT, for the tax years under review, the IRS examination team stated that they would not review Project Cochise any further and would propose no tax liability adjustments relating to Project Cochise.[371]

[370] EC2 000054739 through EC2 000054743.

[371] Interview with IRS examination team, August 8, 2002.

Discussion

In general

Like Project Steele, Project Cochise was designed to provide Enron financial accounting benefits from the acquisition of future tax deductions through REMIC residual interests, and at a cost that was significantly less than the acquired tax benefits. Determining whether Enron should be entitled to deduct the future tax deductions inherent in the REMIC residual interests necessarily involves an analysis regarding Enron's satisfaction of the literal requirements of the applicable statutory requirements as well as the rules and judicial doctrines (such as business purpose and economic substance) that are often applied to evaluate the purported tax benefits in tax-motivated transactions.[372]

A number of Code provisions are specifically designed to remove tax impediments from bona fide business transactions. In developing these provisions, the basic policies contemplate the bona fide conduct of business in the ordinary course. However, these provisions potentially can be utilized to effectuate unintended tax benefits. The Code and Treasury regulations recognize the potential for abusive activity and contain provisions intended to limit the benefits of arrangements that, although satisfying the literal requirements of a provision, are used to distort or defeat the basic purpose of the underlying statute.[373] These provisions address such policy concerns by limiting the benefit of the underlying statute through the use of general disallowance if specific factual tests are met, or if the principal purpose of the transaction is to evade or avoid income tax.

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

[373] *See, e.g.*, sec. 269 (acquisitions made to evade or avoid income tax), sec. 362(d) (limitation on basis increase attributable to assumption of liability), sec. 358(h) (reduction to basis of assets in connection with transfers of liabilities that give rise to a deduction), Treas. Reg. sec. 1.701-2 (partnerships formed or availed of in connection with a transaction with a principal purpose of reducing tax), and sec. 732(f) (adjustment to basis of assets of a distributed corporation controlled by a corporate partner). *See also* proposed regulations to prevent a consolidated group from obtaining more than one tax benefit from a single economic loss (IRS Proposed Rules and Public Hearing Notice (Reg-131478-02) On Suspension of Losses on Certain Stock Dispositions Federal Register October 23, 2002).

Carryover basis of REMIC residual interests transferred to Maliseet

The Code and Treasury regulations also contain specific provisions intended to limit a taxpayer's ability to transfer tax attributes, such as net operating losses, built-in-losses, and various credit items.[374] The general purpose of these provisions is to limit the ability of such tax benefits by a taxpayer who did not suffer the economic loss that gave rise to the tax benefit.

Project Cochise purported to use the tax-free incorporation rules and resulting carryover basis rules to transfer losses and duplicate a single economic loss. The ability to transfer losses and duplicate a single economic loss through section 351 has been, and continues to be, a concern in the administration of tax policy.[375] In order for Project Cochise to achieve the desired tax result (and the corresponding financial accounting benefits), the transfer of the REMIC residual interests by Bankers Trust had to occur in a tax-free manner such that the REMIC residual interests tax basis would carry over to Maliseet.

It may be argued that the application of section 351(a) is predicated upon a valid non-tax business purpose and that the transfer by Bankers Trust to Maliseet did not have the requisite business purpose. Although it is unclear under present law whether section 351(a) does require a valid business purpose and, if so, how it is to be applied in the specific context of purported transfers under section 351(a), the tax opinion letter provided to Enron by McKee Nelson, Ernst & Young LLP includes no discussion of this issue in its analysis of the application of section 351 to Project Cochise. Moreover, the documentation of Project Cochise reviewed by the Joint Committee staff demonstrated no purpose for the transaction other than facilitating the generation of financial statement and tax benefits to Enron, as well as the duplication of losses built into the REMIC residual interests that Bankers Trust transferred to Maliseet.

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[374] *See, e.g.*, sec. 382 (limitation on net operating loss carryforwards and certain built-in-losses following ownership changes, sec. 383 (special limitations on certain excess credits, etc.), and Treas. Reg. sec. 1.1502-15 (SRLY limitation on built-in-losses).

[375] For example, in the year 2000, Congress enacted rules requiring a reduction in basis of assets in connection with transfers of certain liabilities in order to stop transactions that duplicated a single economic loss. *See*, the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, sec. 1(a)(7) (Dec. 21, 2000). *See* Staff of the Joint Committee on Taxation, *General Explanation of Tax Enacted in the 106th Congress* (JCS-2-01), April 19, 2001, at 154. In addition, President Clinton's Fiscal Year 2001 Budget Proposals contained a proposal that was aimed at limiting the ability of taxpayers to transfer built-in losses into the U.S. tax system by requiring marking to fair market value such assets when such assets become "relevant" for U.S. tax purposes (See Office of Management and Budget, *Budget of the United States Government, Fiscal 2001: Analytical Perspectives* (H. Doc. 106-162, Vol. III). See also Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal* (JCS-2-00), March 6, 2000.) Most recently, the Treasury Department issued proposed regulations to prevent a consolidated group from obtaining more than one tax benefit from a single economic loss (IRS Proposed Rules and Public Hearing Notice (Reg-131478-02) On Suspension of Losses on Certain Stock Dispositions Federal Register October 23, 2002).

In analyzing whether Project Cochise had a non-tax business purpose, McKee Nelson, Ernst & Young LLP placed significant weight in its tax opinion letter on the fact that the financial accounting benefits overshadowed the Federal income tax benefits of Project Cochise. As in Project Steele, a conclusion that a non-tax business purpose exists based on the accounting benefits of Project Cochise fails to consider the origin of the accounting benefit (i.e., solely reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement.[376]

Application of section 269 to transfer

The tax opinion letter provided to Enron by McKee Nelson, Ernst & Young LLP concerning Project Cochise contains a lengthy discussion and analysis of section 269, and concludes that the provision "should not" apply to disallow any tax deductions generated by the reversal of earlier non-cash phantom income on the REMIC residual interests in the hands of Maliseet. The tax opinion letter points out that Enron did not relinquish, and Bankers Trust did not acquire, control of Maliseet as a result of the transfers to Maliseet. Even if Enron had obtained control of Maliseet in the transaction, the tax opinion letter argues further that the application of section 269 to acquisitions of control[377] is limited to transactions securing the types of tax benefits that can be obtained only through the acquisition of control. In addition, the tax opinion letter argues that, although Maliseet acquired the REMIC regular and residual interests in a purported carryover basis transaction to which section 269 also could apply,[378] Project Cochise was not motivated by the tax avoidance or evasion purposes contemplated by section 269.

Acquisition of control.–With regard to acquisitions of control, the tax opinion letter concludes that section 269 applies only to the types of tax benefits that can be secured only through the acquisition of control by relying upon case law for the proposition that "section 269 does not apply to a case where the taxpayer would have obtained the tax benefit regardless of whether the taxpayer acquired control in the acquisition in question." Specifically, the tax opinion letter cites *Commodores Point Terminal Corp. v. Commissioner*,[379] in which the Tax Court interpreted the phrase in section 269 "which such person [or corporation] would not

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[376] *See, e.g., American Electric Power, Inc. v. U.S.*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'" *citing Winn-Dixie v. Commissioner*, 113 T.C. 254, 287 (1999)).

[377] Sec. 269(a)(1).

[378] Sec. 269(a)(2).

[379] 11 T.C. 411 (1948), *acq*. 1949-1 C.B. 1.

otherwise enjoy" as conditional language that limits the denial of tax benefits under section 269 to those benefits that can be obtained only through the acquisition of control.[380]

The tax opinion letter also cites subsequent decisions in *Coastal Oil Storage Co. v. Commissioner*[381] and *Cromwell Corp. v. Commissioner*,[382] in which the Tax Court appeared to follow its earlier interpretation of section 269 in the *Commodores Point* case. In *Coastal Oil Storage*, the Fourth Circuit Court of Appeals reversed the Tax Court, in part based upon its apparent conclusion that section 269 can disallow tax benefits without regard to whether such benefits can be obtained only through the acquisition of control. However, the tax opinion letter discounts the Fourth Circuit decision in *Coastal Oil Storage* as deficient because, in contrast to the Tax Court decisions upon which the tax opinion letter does rely, the Fourth Circuit did not sufficiently take into account legislative history supporting the analysis adopted by the Tax Court.[383] Finally, the tax opinion letter cites several administrative rulings issued during the 1990s by the IRS National Office in which the National Office interpreted the scope of section 269 consistent with the interpretation adopted by the Tax Court.

Proscribed tax evasion or avoidance purpose.–The tax opinion letter concludes that Project Cochise was not imbued with the Federal income tax evasion or avoidance purpose proscribed by section 269 primarily on the basis that Maliseet would have obtained most of the future phantom deductions from the REMIC residual interests without regard to whether Maliseet received the interests with a high carryover basis (as opposed to a nominal fair market value basis). In particular, the tax opinion letter argues that the remaining future phantom income inclusions from the interests would increase Maliseet's basis in the interests by a greater amount than the initial carryover basis in the interests. Therefore, according to the tax opinion letter, the tax motivation for transferring the REMIC residual interests to Maliseet in a carryover basis transaction was quantitatively outweighed by the basis increases from the phantom income inclusions that would occur without regard to whether the transfer of the interests occurred in a manner that carried over the basis of the interests.

In addition, the tax opinion letter contends that the transfer of future phantom deductions imbedded in the REMIC residual interests by the taxpayer that has already recognized the associated initial phantom income inclusions does not distort the tax liabilities associated with a REMIC residual interest over the life of the interest. The tax opinion letter recognizes several

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[380] *See* 11 T.C. at 415-417 (stating that "[t]he word 'otherwise' can only be interpreted to mean that the deduction, credit, or allowance, if it is to be disallowed, must stem from the acquisition of control").

[381] 25 T.C. 1304 (1956), *aff'd in part and rev'd in part*, 242 F.2d 396 (4th Cir. 1957).

[382] 43 T.C. 313 (1964).

[383] The tax opinion letter also notes that the Fourth Circuit decision in *Coastal Oil Storage* would not be binding upon the Tax Court if it were to consider the application of section 269 to Project Cochise because an appeal of a Tax Court decision with regard to Project Cochise would lie in the Fifth Circuit.

unique tax rules associated with REMIC residual interests that are intended to ensure that the initial phantom income inclusions are taxed in light of the subsequent offsetting phantom deductions, but argues that none of these or the other tax rules relating to REMIC residual interests evidence a legislative plan or intent that the same taxpayer should recognize both the phantom income inclusions and the subsequent phantom deductions.

In its only acknowledgement that Project Cochise results in a duplication of the future phantom deductions to be produced by the REMIC residual interests transferred to Maliseet, the tax opinion letter states in a brief footnote that the transfer of the interests in a carryover basis transaction duplicates the future deductions through a difference between the low value and high basis of the common stock received by Bankers Trust from Maliseet in exchange for the REMIC residual interests. However, the tax opinion letter concludes that this duplication should not be taken into account for purposes of determining whether the requisite tax evasion or avoidance purpose under section 269 is present with regard to Project Cochise because section 269 only takes into account the tax motivation of Maliseet as the actual acquirer of the interests. According to the tax opinion letter, the potential benefits to Bankers Trust of duplicating the future phantom deductions is not pertinent in evaluating the tax motivation of Project Cochise under section 269.

Even if such duplication should be considered in examining the application of section 269 to Project Cochise, the tax opinion letter suggests that Bankers Trust would not have had a principal tax motivation for its participation in the transaction, as measured by the likelihood that Bankers Trust would trigger its recognition of the duplicated losses through a compelled recapitalization of Maliseet, followed by an exercise of the put option that it purchased from Enron as part of the transaction. In discussing the application of the section 351(a) control requirement to the transfers of REMIC regular and residual interests by Bankers Trust to Maliseet, the tax opinion letter states the following:

> [At the time of the transfers by Enron and Bankers Trust to Maliseet], the London Branch had no plan or intention of transferring, disposing of, or exchanging any of the Common Stock, other than possibly pursuant to a Recapitalization. In any event, however, a Recapitalization will not occur before January 1, 2004. Accordingly, because Enron and the London Branch together owned 100 percent of the outstanding stock of Maliseet immediately after the transfers of the [REMIC regular and residual interests] to Maliseet and had no plan or intention of disposing of such stock until possibly on or after January 1, 2004, Enron and the London Branch should be treated as satisfying the Control Requirement in connection with such transfers.

This statement may not be patently false but, at minimum, it understates the clear intention of Bankers Trust to activate the recapitalization provisions of the shareholders agreement and exercise its option to sell to Enron the notes that Bankers Trust would receive in the recapitalization. Internal company documents describing Project Cochise and quantifying the overall tax consequences of the transactions unambiguously demonstrate that the parties structured the transaction with every intention that Maliseet would be recapitalized at the earliest possible opportunity and Bankers Trust would exercise its put option, thus recognizing the duplicated loss. Taking into account the duplicated loss and the inevitability of its recognition in

2004 would cast substantial doubt as to whether Project Cochise was undertaken for the principal purpose of evading or avoiding Federal income tax under section 269 through the duplication of the loss that was built into the REMIC residual interests transferred to Maliseet.

Recommendations

Carryover basis of REMIC residual interests transferred to Maliseet

The Joint Committee staff recommendations regarding Projects Tanya and Valor include recommendations to limit the duplication of a single economic loss. These recommendations also are appropriate for consideration with respect to Project Cochise.[384]

Irrespective of whether an overall change is made to limit the duplication of a single economic loss under subchapter C generally, the Joint Committee staff believes it is appropriate to limit the ability to transfer REMIC residual interests in a carryover basis transaction. Under the statutory rules regarding the taxation of REMICS, phantom income is allocated to REMIC residual interest holders. The phantom income allocation inevitably creates built-in losses to the holders of the REMIC residual interests, thus making such interests a natural component for transactions designed to duplicate a single economic loss. As such, the Joint Committee staff recommends that either a corporation's basis in REMIC residual interests acquired in a tax-free transfer (or reorganization) be limited to its fair market value or that a transferor's basis in the stock received in exchange for REMIC residual interests be limited to the fair market value of the REMIC residual interests.[385]

Acquisitions made to evade or avoid Federal income tax

Project Cochise highlights the limited reach of section 269 as it applies to acquisitions of corporate equity interests for the principal purpose of obtaining tax benefits. Tax avoidance transactions involving the acquisition of a non-controlling interest in a corporation are no less pernicious (and actually may be more prevalent) than similarly motivated transactions involving the acquisition of a controlling interest in a corporation. Therefore, the Joint Committee staff recommends that Congress expand section 269 to apply to acquisitions of equity interests in a corporation, without regard to whether such interests provide to the acquirer control of the corporation, if the principal purpose of the acquisition is the evasion or avoidance of Federal income tax.[386]

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[384] Projects Tanya and Valor are discussed elsewhere in this section of the Report.

[385] *See* recommendations for Projects Tanya and Valor for a discussion of general issues with respect to this type of proposal.

[386] This recommendation is not limited to acquisitions in which the ownership percentage of a pre-existing interest in a corporation is increased. Accordingly, this recommendation also includes acquisitions involving a change to the capital structure of a pre-existing corporation (e.g., an existing shareholder relinquishes common stock and obtains preferred stock in the transaction), without regard to whether the change results in an increase in the percentage (by vote or value) of a pre-existing ownership interest.

With regard to acquisitions of corporate interests, present-law section 269 also is circumscribed by the judicial interpretation that the provision applies only to the types of tax benefits that can be obtained only through the acquisition of control of a corporation. Project Cochise demonstrates that tax motivated transactions can generate significant tax benefits that can be obtained through a non-controlling interest in a corporation. Regardless of whether the application of section 269 is limited to acquisitions of controlling interests in a corporation, the tax policy rationale is unclear for insulating from the application of section 269 tax benefits that can be obtained through either controlling or non-controlling corporate interests. Therefore, the Joint Committee staff also recommends that Congress expand section 269 to disallow tax benefits that can be obtained through either controlling or non-controlling interests in a corporation, if the principal purpose of the transaction in which the benefits are acquired is the evasion or avoidance of Federal income tax.

Because the application of section 269 to a particular transaction is conditioned upon the tax evasion or avoidance purpose for the transaction, the Joint Committee staff acknowledges that implementation of these recommendations would not necessarily eradicate transactions such as Project Cochise. Nevertheless, the Joint Committee staff believes that these recommendations would make section 269 generally more effective in deterring tax motivated transactions that involve the acquisition of an equity interest in a corporation.

5. Project Teresa

Brief overview

Project Teresa[387] was a synthetic lease arrangement designed to result in an increase in tax basis in depreciable assets (the most significant asset being the Enron North office building) with minimal economic outlay. This was accomplished in the following manner: Enron, through a deconsolidated entity, contributed depreciable assets and preferred stock of an affiliate to a partnership. Bankers Trust (the promoter of the transaction) contributed cash to the partnership. Enron affiliates would periodically acquire (or redeem) the preferred stock from the partnership, with the acquisition/redemption being treated as a taxable dividend eligible for an 80 percent dividends received deduction. Enron's basis in its partnership interest was increased by the total amount of the dividend (without regard to the dividends received deduction). Ultimately, the partnership was to be liquidated in a manner that would result in Enron receiving the depreciable assets with the increased basis. Enron would recover this increased tax basis through higher future depreciation deductions on the Enron North office building and the other depreciable assets.

Background[388]

Reported tax and financial statement effects

Project Teresa involved the reporting of dividend income in the early years, followed by increased depreciation deductions in later years. The transaction was projected to result in Enron reporting additional tax liability of $75.525 million for years 1997 through 2001.[389] During the entire life of the project, however, it was projected that Enron would report aggregate tax savings (though greater depreciation deductions on the Enron North office building) of $261.6 million.

The amount of the dividend income that was deducted by virtue of the dividends received deduction (but resulted in an increased partnership basis) gave rise to a permanent book-tax difference. In connection with Project Teresa, Enron recorded financial statement earnings (i.e., earnings through a reduction in the provision for income tax expense) of $226.0 million during the period 1997-2001.[390]

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[387] As in Project Tanya, Mr. Hermann named this transaction after a hurricane.

[388] The information regarding Project Teresa was obtained from Joint Committee staff interviews of Robert J. Hermann, Robert D. Maxey, Greek L. Rice, and Jordan H. Mintz, as well as from documents and information provided by Enron and the IRS.

[389] According to Enron, the deconsolidated entity paid approximately $107 million of Federal income tax from years 1997 through 2000.

[390] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 24. Current Enron management stated that Enron recorded a valuation reserve in December 2001 of approximately $269.8 million in connection with Project Teresa. The $43.8 million excess of the valuation reserve over the Project Teresa

Development of Project Teresa

Bankers Trust brought the idea for Project Teresa to Enron. The original contact appears to have been a "cold call" made by someone in the Bankers Trust marketing group to Mr. Rice, though the contact might have been established through Enron's finance group. In a letter dated May 16, 1996, Bankers Trust provided Mr. Hermann with certain discussion materials regarding a proposed joint venture arrangement developed by Bankers Trust. The discussion materials (modified in subsequent presentations) described the benefits of the transaction as follows:

(1) Accounting earnings -- recognize deferred tax assets over the five [year] life of the project.

(2) High basis tax asset -- create an asset(s) with a tax basis much higher than its FMV; the differential can be either recognized over time through depreciation or triggered sooner by a sale of the asset.

(3) Low tax risk – under current law, if modeled properly, the transaction will be revenue neutral to the IRS; thus, there is little motivation for the Service to challenge this structure upon audit.[391]

The transaction was designed to provide an after-tax accounting benefit of $230 million, and a net cash flow to Enron of $30.142 million.[392]

After the initial contact, Messrs. Hermann, Maxey and Rice met with representatives of Bankers Trust and the law firm of King & Spalding (that was representing Bankers Trust in connection with the transaction).[393] Following these discussions, Enron tax personnel began searching for assets that could be utilized in the transaction.

In February 1997, Messrs. Hermann, Maxey and Rice met in Washington, D.C., with representatives of Bankers Trust and King & Spalding to work through the details of the transaction. At the meeting, the Enron representatives indicated that they required a "should" level tax opinion for the transaction. There was some discussion as to who would provide the tax opinion. According to one participant, an attorney from King & Spalding indicated that it would

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financial benefits relates to the GAAP tax accounting for the taxable portion of the dividends. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 31, 2003, answer 2. It is unclear why Enron used a valuation reserve (as opposed to a reversal of the financial income benefit).

[391] The Project Teresa materials in Appendix B contain the "Description of Partnership Leasing Proposal" in discussion materials from Bankers Trust dated March 27, 1997, EC2 000037929.

[392] *Id.* at EC2 000037931-37932.

[393] The law firm of Akin, Gump, Strauss, Hauer & Feld acted as special counsel to the Bankers Trust entity that was involved in Project Teresa.

receive a $1 million fee for the transaction regardless of whether King & Spalding provided the tax opinion. Ultimately, it was decided that King & Spalding would provide the tax opinion to Enron. There was also some discussion regarding the timing of the transaction. Of particular concern was the fact that Congress was considering legislation that would affect the transaction structure. Timing also was critical because the lease on the Enron North office building (the primary asset being considered for Project Teresa) was up for renewal. After a few days of meetings, Mr. Rice returned to Houston to apprise Richard A. Causey, Chief Accounting Officer of Enron Corp., of the developments in anticipation of a meeting of the Enron Corp. Board of Directors.

On March 25, 1997, the Executive Committee of the Enron Corp. Board of Directors met to discuss (among other items) Project Teresa. Edmund P. Segner presented an overview of the transaction, and Mr. Causey described the details of the transaction. Mr. Causey stated that the net effect of the transaction would be to create book earnings of $242.6 million during years 1997 through 2002 by virtue of the deemed dividends paid to the leasing partnership.[394] The Executive Committee adopted a resolution authorizing the transaction, including the contribution of the lessee rights in the Enron North office building to the leasing partnership and a schedule of fees.[395] The Enron Board of Directors heard a report regarding the Executive Committee action at its meeting on May 6, 1997.[396]

The business purpose given for the transaction was to raise third party capital and manage a portfolio of leased assets with enhanced earnings potential.[397] The tax opinion prepared by King & Spalding states "the predominant purpose of Enron and its Affiliates for participating in [the redemption transaction in Project Teresa] was to generate income for financial accounting purposes."[398]

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[394] Project Teresa estimated earnings benefit, EC2 000037959. According to minutes from the meeting, "[a] thorough discussion ensued during which Messrs. Causey, Rice, and Skilling responded to questions by the Committee."

[395] Minutes of the Meeting of the Executive Committee of the Board of Directors of Enron Corp., March 25, 1997, EC2 000037952-55.

[396] Minutes of the Meeting of the Board of Directors of Enron Corp., May 6, 1997, ENE 0000000199-200. The Board of Directors had been made aware of the transaction at its previous meeting on February 11, 1997. At that meeting, the Board of Directors reviewed a presentation regarding Enron's 1997 strategic goals, which contained a projection of future earnings that included a $280 million benefit during the years 1997 through 2001 attributable to the "building lease tax structure." Enron Board of Directors Meeting, February 11, 1997, EC 000044834.

[397] Project Teresa Tax Overview, EC2 000037866.

[398] King & Spalding opinion letter, by Abraham N.M. Shashy, Jr. for himself and William S. McKee, to R. Davis Maxey, dated July 29, 1997, Appendix C, Part V, at 4.

Implementation of Project Teresa

The initial step in the implementation of Project Teresa was the organization and financing of the various participating entities. On March 21, 1997, Enron Corp., together with Potomac Capital Investment Corp. ("Potomac Capital," a subsidiary of Potomac Electric Power Co.) and EN-BT Delaware, Inc. ("EN-BT Delaware") (a subsidiary of Bankers Trust) contributed property to Organizational Partner, Inc. ("Organizational Partner" or "OPI") in exchange for OPI common stock and OPI preferred stock. The property that Enron contributed included: (1) its lessee interest in the Enron North office building,[399] (2) certain interests in aircraft operated by Enron Corp., (3) a note receivable from Houston Pipe Line Co. in the amount of $1.097 billion and (4) $10,250 in cash, in exchange for OPI common stock that represented 98 percent of the equity but only 75 percent of its voting rights.[400] Potomac Capital and EN-BT Delaware collectively contributed $22.4 million in cash in exchange for 20,000 shares of OPI preferred stock that represented two percent of the equity and 25 percent of the voting rights in Organizational Partner.

The second step involved the issuance of the preferred stock that would be used in the redemption transactions. On March 21, 1997, Enron Corp. contributed all of the common stock of Enron Operations Corp. and its subsidiaries to Enron Liquids Holding Corp. ("Enron Liquids") in exchange for 80 percent of the Enron Liquids common stock. Organizational Partner contributed the note receivable from Houston Pipe Line Co. and $10,250 in exchange for 20 percent of the Enron Liquids common stock (with a value of $97.5 million) and 10,000 shares (i.e., 100 percent of the issued and outstanding class) of Enron Liquids preferred stock (with a value of $1 billion).

The next step was the organization and funding of the partnership that was to hold the Enron Liquids preferred stock through the tax-deconsolidated entity. To accomplish this, on March 27, 1997, Enron Leasing Partners, LP ("Enron Leasing") was formed. Organizational Partner contributed to Enron Leasing: (1) the lessee interest in the Enron North office building, (2) $22.4 million in cash, and (3) the Enron Liquids preferred stock (worth $1 billion), in exchange for a 98 percent limited partner interest. Enron Property Management Co. contributed cash and U.S. Treasury obligations with a value of $10.433 million in exchange for a one percent general partner interest, and EN-BT Delaware contributed $10.433 million in cash in exchange for a one percent limited partner interest.

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[399] A contribution agreement between Enron Corp. and Organizational Partner dated March 21, 1997, states that, with respect to the lessee interest, Enron Corp. agrees to designate Organizational Partner as the lessee under the lease (and have the necessary documentation to effectuate the assignment) no later than April 30, 1997. Ecx000006707. The actual transfer occurred on April 14, 1997.

[400] Enron Corp. owned less than 80 percent of the vote of Organizational Partner, and, as a result, Organizational Partner was not a member of the Enron affiliated group (i.e., it was a tax deconsolidated entity). However, Organizational Partner was consolidated with Enron Corp. for financial statement purposes.

Once the entities were organized and funded, the next step was to generate dividend income. As originally contemplated, an Enron affiliate was to make periodic purchases of Enron Liquids preferred stock from Enron Leasing over a five-year period (with the purchase being treated as a dividend from a related corporation under the tax laws). Thus, on May 14, 1997, Enron Pipeline Company ("Enron Pipeline"), a wholly owned subsidiary of Enron Corp., purchased 1,980 shares of Enron Liquids preferred stock from Enron Leasing in exchange for an intercompany promissory note in the principal amount of $198 million creating dividend income to the partnership. However, a change to the tax laws that became effective in June 1997 eliminated the advantage associated with this structure.[401] Consequently, beginning in March 1998,[402] Enron Liquids implemented a plan of quarterly pro-rata redemptions of its preferred and common stock designed to achieve a similar tax result (i.e., redemptions treated as dividends under the tax laws). Thus, on March 31, 1998, Enron Liquids redeemed (on a pro-rata basis) 40 shares of its common stock in exchange for promissory notes with a principal amount of $16.979 million and 325 shares of its preferred stock in exchange for promissory notes with a principal amount of $32.5 million.[403] This amount represented 3.25 percent of each class of stock held by each shareholder. The predominant purpose of Enron Corp. and its affiliates for participating in the redemption was to generate income for financial accounting purposes.[404]

In 1999, Enron Liquids paid dividends on its preferred stock, and engaged in redemptions of its common and preferred stock, in the amount of approximately $170.7 million.[405] In November 1999, Enron Pipeline sold its remaining 1,045 shares of Enron Liquids preferred stock to Enron Corp. Subsequent to the sale, Enron contributed all of the stock in Enron Pipeline to Enron Operations Corp. (a subsidiary of Enron Liquids) in exchange for preferred stock. In 2000 and 2001, Enron Liquids paid dividends on its preferred stock and engaged in stock redemption transactions in the aggregate amount of approximately $686.2 million and $49.5 million, respectively.[406] In total, during the period 1997 through 2001, the amount of dividends on the Enron Liquids preferred stock and the stock sales and redemptions that Enron treated as dividends with respect to the Enron Liquids preferred stock, exceeded $1 billion.

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[401] Congress amended the extraordinary dividend rules of section 1059, which is discussed in greater detail below.

[402] At some time between May 14, 1997 and March 31, 1998, Enron Pipeline transferred 935 shares of Enron Liquids preferred stock to Enron Corp.

[403] In a letter to King & Spalding dated September 27, 2000, Mr. Maxey represented that Enron Liquid's current and accumulated earnings and profits for taxable year ended December 31, 1998, exceeded the aggregate amount of the promissory notes and cash transferred by Enron Liquids in connection with the March 31, 1998 redemption.

[404] *Id.*, at EC2 000033830.

[405] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 25.

[406] *Id.*, at answer 26.

Although the precise exit strategy with respect to Project Teresa is uncertain, it would have involved a reconsolidation of Organizational Partner in the Enron consolidated group.[407] Thereafter, Enron Leasing would be liquidated, with Organizational Partner receiving the Enron North office building in a liquidating distribution (and a tax basis that reflects the gross amount of Enron Leasing's dividend income). This was projected to occur in 2003. At such time, Organizational Partner would begin to recover the increased tax basis via higher depreciation deductions.

The diagram on the next page depicts the general structure of Project Teresa as of December 2001.

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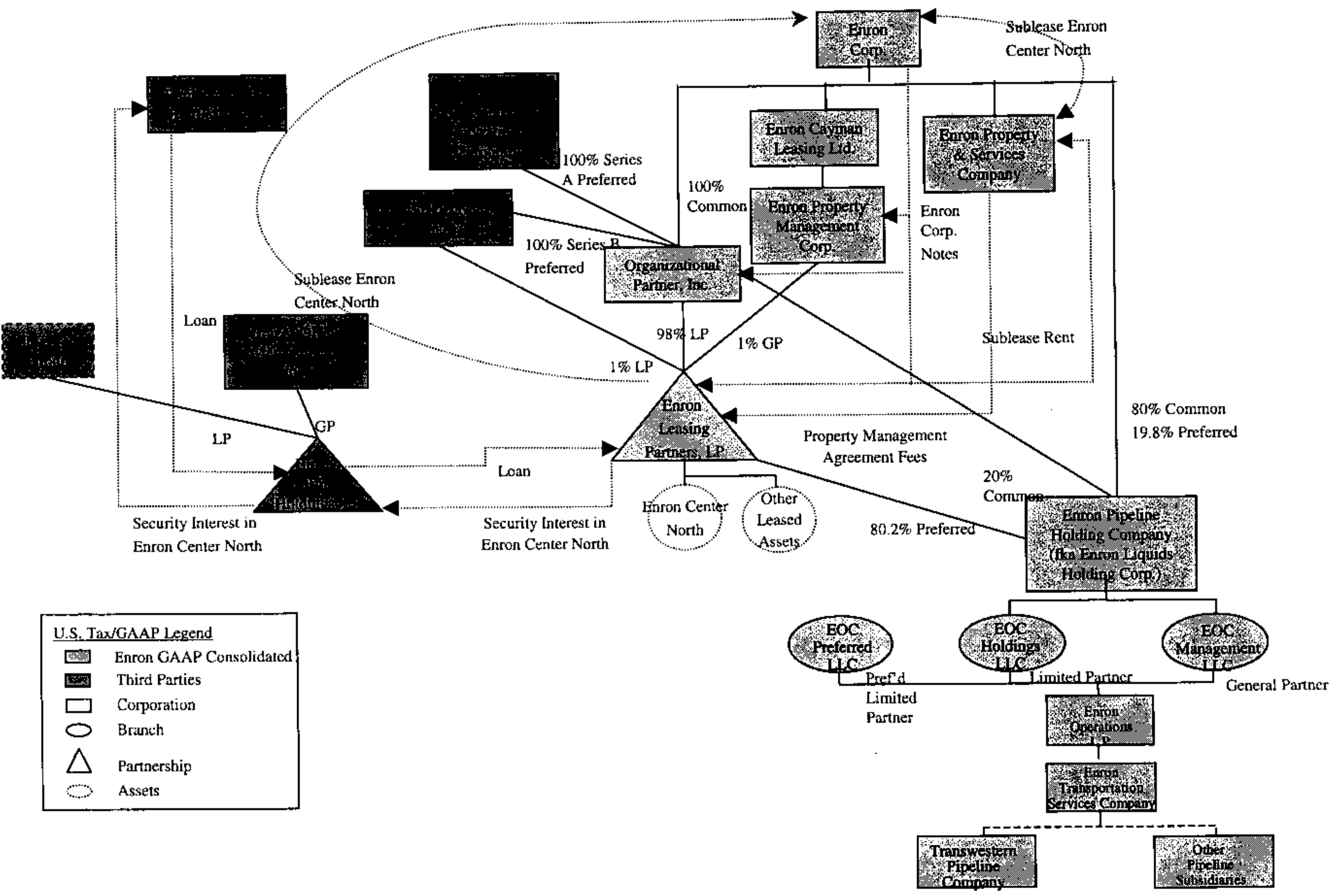
[407] At any time after April 30, 2002, Organizational Partner had the option to redeem all the OPI preferred stock from Bankers Trust and Potomac Capital. Similarly, at any time after December 31, 2003, Bankers Trust and Potomac Capital had the right to force Organizational Partner to redeem the OPI preferred stock.

Project Teresa
Structure as of December 2001

Confidential



Role of outside advisors

Bankers Trust promoted the transaction to Enron. A schedule of fees presented at the March 25, 1997, Board of Directors Executive Committee meeting shows that Bankers Trust was to receive a fee of $11 million in connection with Project Teresa -- an amount representing approximately one percent of the increased basis in the partnership as a result of the deemed dividends. In 1998, the fee was reduced by $1.375 million to compensate Enron for its role as an accommodation party to Bankers Trust in connection with Project Renegade.[408] The fee to Bankers Trust was to be paid over time as follows: $6.2 million in 1997; $1.1 million in 1998; $1.2 million in 1999; $1.2 million in 2000 and $1.2 million in 2001.[409] According to Enron records, as of June 2001, Bankers Trust had received fees of $8.839 million in connection with Project Teresa.[410]

Enron relied on King & Spalding for its legal representation in connection with Project Teresa. The schedule of fees presented at the March 25, 1997, Executive Committee meeting shows that King & Spalding was to receive a fee of $1 million in connection with Project Teresa, which was to be paid after the close of the deal when the tax opinion was rendered.[411]

In the tax opinion, King & Spalding concluded that (1) the payment by Enron Pipeline to Enron Leasing for the purchase of the Enron Liquids preferred stock "should" be treated as a distribution in redemption of the stock of Enron Pipeline; (2) the distribution "should" be treated as a dividend distribution; (3) the adjusted basis of the Enron Liquids preferred stock retained by Enron Leasing "should" be increased by an amount equal to Enron Leasing's adjusted basis in the Enron Liquids preferred stock sold to Enron Pipeline; (4) the adjusted basis of Organizational Partner's interest in Enron Leasing "should" be increased by its distributive share of the dividend; (5) for purposes of the dividends received deduction, Organizational Partner "should" be treated as having received its distributive share of the dividend from Enron Pipeline; (6) it is "more likely than not" that Organizational Partner will be treated as owning 20 percent or more of the stock of Enron Pipeline for purposes of the dividends received deduction; and (7) the extraordinary dividend rules "should" not apply to the redemption transaction.[412] According to

[408] Project Renegade is discussed in detail in the section of the Report that describes transactions in which Enron acted as an accommodation party.

[409] Executive Board Meeting -- Project Teresa, March 25, 1997, schedule of fees, EC2 000037962.

[410] The General Background Materials in Appendix B contain the Estimated Project Fees schedule (6/4/2001), EC2 000036379. According to current Enron management, no subsequent payments have been made. Letter from Enron's counsel (Skadden Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 30.

[411] Executive Board Meeting -- Project Teresa, March 25, 1997, schedule of fees, EC2 000037962.

[412] Appendix C, Part V, contains the King & Spalding opinion letter to R. Davis Maxey, by Abraham N.M. Shashy, Jr. for himself and William S. McKee, dated July 29, 1997.

Enron records, as of June 2001, King & Spalding had received fees of $1.046 million in connection with Project Teresa.[413]

The accounting firm of Ernst & Young provided an opinion letter regarding the effects on Enron Liquids earnings and profits resulting from Enron's contribution of the Enron Pipeline stock to Enron Operations Corp.

In addition to the fees paid to Bankers Trust and King & Spalding, Enron records reflect that it paid $250,000 of fees to others, bringing the total amount of fees paid with respect to Project Teresa to $10.135 million.

Appendix C, Part V, to this Report contains the tax opinion letters Enron received in connection with Project Teresa.

Subsequent developments

Organizational Partner defaulted on its dividend payments to Potomac Capital and EN-BT Delaware in connection with the OPI preferred stock. Enron Corp. is in default under its sublease agreement with Organizational Partner with respect to the Enron North office building, though a standstill agreement has prevented the lenders from foreclosing on the building. The intercompany receivables were partially written off in December 2001. Potomac Capital and EN-BT Delaware continue to hold their OPI preferred stock. No steps have been taken to unwind the structure.[414]

The IRS is in the process of auditing Enron's tax returns for years 1996 through 2001. Enron received a tax shelter registration number in connection with Project Teresa.

Discussion[415]

Project Teresa was an elaborate structure designed to achieve a financial statement benefit that results from a shift of $1 billion in tax basis from a nondepreciable asset (i.e., the Enron Liquids preferred stock) to depreciable assets (the most significant asset being the Enron North office building) via the use of a partnership that Enron controlled. Project Teresa used the related party redemption rules and the dividends received deduction to generate additional tax basis (in excess of book basis). The partnership structure was necessary to accomplish the basis shift. In essence, Enron was willing to incur income tax on 20 cents of each dollar of dividend

[413] The General Background Materials in Appendix B contain the Estimated Project Fees schedule (6/4/2001), EC2 000036379.

[414] The Project Teresa materials in Appendix B contain the Project Teresa deal basics, EC2 000037870; Letter from Enron's counsel (Skadden Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answers 27, 31.

[415] Enron's bankruptcy effectively prevents Enron from realizing the tax benefits that were contemplated in Project Teresa. Nevertheless, this section discusses the tax benefits that Enron sought to achieve from the transaction (without regard to the bankruptcy).

income (borne by Organizational Partner, a deconsolidated subsidiary of Enron) in exchange for one dollar of future depreciation deductions.

Under the strategy devised in Projects Teresa, the benefits of the increased tax basis (in the form of greater depreciation deductions on the Enron North office building) would inure over a 39-year period and was not expected to be reflected in Enron's consolidated tax return until 2003. However, and potentially more important to Enron, the strategy permitted Enron to begin recording the benefits immediately for financial accounting purposes.[416]

Key to the success of Project Teresa was Organizational Partner's ability to receive a basis increase for the gross amount of the dividends received notwithstanding that 80 percent of such dividends were exempt from tax by virtue of the dividends received deduction. To accomplish this result, the redemption transactions had to be structured in a manner that would (1) generate dividend income (thus making them eligible for a dividends received deduction) and (2) avoid the application of the extraordinary dividend rules (which would require a basis reduction equal to the amount of the dividends received deduction). In addition, the redeeming corporation needed to have sufficient earnings and profits (so that the distributions are treated as dividends).

Also critical to Project Teresa was the use of a partnership. The partnership structure provided the mechanism to achieve the basis shift from the Enron Liquids preferred stock to the Enron North office building. The basis shift would have occurred on a liquidating distribution of the Enron North office building to Organizational Partner.[417]

Redemption transactions

As an initial matter, the redemption transactions had to involve a corporation that was not included in Enron's consolidated return because the consolidated return regulations generally reduce basis for untaxed dividends within a consolidated group. This explains why Organizational Partner was capitalized with stock with voting rights that differed from its value. By owning stock that represented 98 percent of Organizational Partner's value but only 75 percent of its voting power, Enron was able to exercise de facto control over the entity without causing it to be a member of Enron's consolidated group. Some might question Enron's non-tax business reason for allowing purported third parties to purchase a 25-percent voting interest in a

[416] *See* the Background and Rationale section to this part of the Report which contains a general explanation of relevant aspects of Financial Accounting Standard No. 109, Accounting for Income Taxes.

[417] Section 732(b), which is discussed in greater detail in the next section of this Report (in connection with the partnership transactions), provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest is equal to the partner's adjusted basis in the partnership interest reduced by any money distributed in the same transaction.

company that was valued at over $1 billion for only $22.4 million, and whether Bankers Trust and Potomac Capital were truly independent third parties.[418]

The stock redemptions had to be structured in a way that would generate dividend income to Enron Leasing (the partnership that was 98 percent owned by Organizational Partner). The 1997 related party redemption (Enron Pipeline's purchase of 1,980 shares of Enron Liquids preferred stock from Enron Leasing) was structured as a redemption between related corporations.[419] By virtue of the applicable constructive ownership rules, Enron Leasing arguably was in control of both Enron Pipeline and Enron Liquids, and the redemption did not result in a diminution of Enron Leasing's stock interest in Enron Liquids.[420] Therefore, the parties characterized the transaction as a distribution in redemption of Enron Pipeline stock, with the result that the redemption was treated as a dividend. In the years subsequent to 1997, the redemptions took the form of pro-rata redemptions by Enron Liquids. A change to the extraordinary dividend rules in 1997 (discussed below) necessitated the change to a pro-rata redemption.

Also critical to the transaction is that any resulting dividend must qualify for the dividends received deduction. In a partnership structure, each partner takes into account separately its distributive share of certain partnership items, including dividends with respect to which a dividends received deduction is applicable.[421] In Project Teresa, Organizational Partner claimed an 80 percent dividends received deduction.[422]

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[418] As previously noted, after April 30, 2002, Organizational Partner had the option to redeem all the OPI preferred stock from Bankers Trust and Potomac Capital. Similarly, at any time after December 31, 2003, Bankers Trust and Potomac Capital had the right to force Organizational Partner to redeem the OPI preferred stock.

[419] *See* sec. 304(a)(1).

[420] In determining whether the acquisition is treated by reason of section 302(b) as a distribution in part or full payment in exchange for the stock, reference is made to Enron Leasing's ownership of the Enron Liquids stock. Sec. 304(b)(1).

[421] Sec. 702(a)(5). A partner will increase its basis in its partnership interest by that partner's distributive share of partnership income, including dividend income. Sec. 705(a).

[422] The issue is whether Organizational Partner qualifies for the 80 percent dividends received deduction (as opposed to a 70 percent deduction) by virtue of stock ownership through a partnership. As noted in the discussion of the relevant corporate tax laws, the Treasury Department has permitted stock ownership thresholds to be met by virtue of stock ownership through a partnership. *See,* Rev. Rul. 71-141, 1971-1 C.B. 211; *see also,* T.D. 8708, 62 Fed. Reg. 923, 924 (January 7, 1997) (for purposes of section 902, domestic shareholder includes a domestic corporation that "owns" the requisite voting stock in a foreign corporation rather than one that "owns directly" the voting stock; IRS is still considering under what other circumstances Rev. Rul. 71-141 should apply).

Extraordinary dividend rules

In addition to generating dividend income that qualifies for a dividends received deduction, Project Teresa had to be structured in a manner so as not to implicate the extraordinary dividend rules. If the dividend that Organizational Partner received as part of its distributive share of Enron Leasing income were treated as an extraordinary dividend, then Organizational Partner would be forced to reduce its basis in its partnership interest by the untaxed portion of the dividend, thereby eliminating an important aspect of the transaction.[423]

Congress enacted the extraordinary dividend rules in 1984 in response to a tax-motivated transaction (known as a "dividend strip" transaction) in which a corporation would acquire dividend-paying stock shortly before the stock's ex-dividend date, receive a dividend that is eligible for a dividends received deduction, and then sell the stock for a short-term capital loss.[424] The extraordinary dividend rules provide that if a corporation receives an extraordinary dividend with respect to stock and the corporation has not held the stock for more than two years after the dividend announcement date, then the corporation's basis in the stock is reduced (but not below zero) by the non-taxed portion of the dividends.[425] The non-taxed portion of the dividend generally is the amount of the dividends received deduction with respect to the dividend.[426]

While the original purpose of the extraordinary dividend rules was to prevent dividend strip transactions, Congress in recent years has expanded the scope of the extraordinary dividend rules to address other tax-motivated transactions that exploit the dividends received deduction. Of particular relevance to Project Teresa was the change made in 1997, in which the extraordinary dividend rules were expanded to treat certain dividends resulting from a related party redemption as an extraordinary dividend (thus resulting in a basis reduction equal to the amount of the dividends received deduction).[427] The law change was necessary because

> "Section 304 is directed primarily at preventing a controlling shareholder from claiming basis recovery and capital gain treatment on transactions that result in a

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[423] In addition, Enron Leasing would have to adjust its basis in the Enron Liquids preferred stock.

[424] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of The Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, at 138-39.

[425] Sec. 1059(a)(1). If the non-taxed portion of the dividends exceeds the corporation's basis in the stock, then the excess is treated as gain for the taxable year in which the extraordinary dividend is received. Sec. 1059(a)(2).

[426] Sec. 1059(b).

[427] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, section 1013(b) (August 5, 1997) (effective for distributions and acquisitions after June 8, 1997). Specifically, section 1059(e)(1)(A)(iii)(II) provides that if a redemption of stock would not have been treated (in whole or in part) as a dividend absent section 304, then any amount treated as a dividend with respect to such redemption is treated as an extraordinary dividend.

withdrawal of earnings from corporate solution. . . . Different concerns may be present if the shareholder is a corporation, due in part to the availability of the dividends received deduction."[428]

Enron Pipeline's 1997 purchase of 1,980 shares of Enron Liquids preferred stock from Enron Leasing raised a number of issues regarding the potential application of the extraordinary dividend rules to the related party redemption.[429] These issues were rendered moot by the 1997 expansion of the extraordinary dividend rules. However, by modifying the transaction to make it a pro-rata redemption (and thus avoiding the related party redemption rules), Enron avoided the effects of the 1997 law change and continued to claim the desired benefits from Project Teresa.

Earnings and profits in a consolidated group

A distribution with respect to stock (including certain redemptions) is treated as a dividend only to the extent that the distribution is from the corporation's current or accumulated earnings and profits.[430] Enron contributed stock in Enron Pipeline to Enron Operations Corp. (a subsidiary of Enron Liquids) apparently in an effort to bolster the earnings and profits of Enron Liquids.[431]

There is little guidance regarding the tiering up of earnings and profits when the location of a member within a consolidated group changes. Two examples in the consolidated return regulations provide that "appropriate adjustments must be made to the members to prevent earnings and profits from being eliminated."[432] The regulations also provide an anti-avoidance

[428] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), December 17, 1997, at 207.

[429] For a detailed discussion of these issues, *see* the King & Spalding opinion letter to R. Davis Maxey, by Abraham N.M. Shashy, Jr. for himself and William S. McKee, dated July 29, 1997, Appendix C, Part V, at 28-36.

[430] Sec. 316(a).

[431] *See,* tax opinion by Kevin A. Duvall of Ernst & Young to R. Davis Maxey, dated November 16, 1999, Appendix C, Part V. The sole issue raised in this tax opinion was the extent to which Enron Corp.'s contribution of Enron Pipeline stock will result in Enron Pipeline's earnings and profits being replicated in the earnings and profits of Enron Operations Corp. and Enron Liquids. The opinion letter concludes that, "more likely than not," Enron Pipeline's earnings and profits will be replicated, and therefore, Enron Liquids should have sufficient earnings and profits to treat $237 million of distributions and stock redemptions in 1999 as dividends for purposes of section 301.

[432] Treas. Reg. sec. 1.1502-33(f)(2). The regulations appear to focus on the elimination of earnings and profits through changing the location of a member within a group rather than the replication of earnings and profits.

rule warning that adjustments must be made as necessary to carry out the purpose of the section.[433]

Partnership issues

As previously noted, the partnership structure was essential in order to achieve the basis shift. Although the precise exit strategy with respect to Project Teresa is uncertain, it presumably involved Organizational Partner exercising its option to redeem all the OPI preferred stock from Bankers Trust and Potomac Capital (resulting in a reconsolidation of Organizational Partner in the Enron consolidated group). Thereafter, Enron Leasing would be liquidated, with Organizational Partner receiving the Enron North office building in a liquidating distribution with a tax basis that reflects the gross amount (not the taxed amount) of Enron Leasing's dividend income. Organizational Partner would recover the increased tax basis via higher depreciation deductions. If a section 754 election were not in effect, then any remaining asset owned by Enron Leasing would retain its basis (when the Enron North office building is distributed to Organizational Partner).[434]

The Treasury Department has issued regulations that apply the extraordinary dividend rules to partnerships.[435] Known as the partnership anti-abuse regulations,[436] the regulations state that if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate Federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for Federal tax purposes to achieve tax results that are consistent with the intent of subchapter K.[437] Under this theory, Enron Leasing should be viewed as inconsistent with the intent of subchapter K, considering that (1) the predominant purpose for the formation of Enron Leasing was to generate income for financial accounting purposes,[438] (2) the financial accounting income was attributable solely to the shifting of tax basis to depreciable assets (in

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[433] Treas. Reg. sec. 1.1502-33(g).

[434] As discussed in greater detail in the next section of this Report (in connection with the partnership tax laws), a section 754 election may have required a downward basis adjustment with respect to the assets owned by Enron Leasing following the liquidating distribution.

[435] Sec. 1059(g); Treas. Reg. sec. 1.701-2(f) example 2 (a partnership comprised of two corporate partners that receives an extraordinary dividend has to make appropriate basis adjustments).

[436] The partnership anti-abuse regulations are discussed in greater detail in connection with transactions that raise partnership tax issues.

[437] Treas. Reg. sec. 1.701-2(b). For a discussion of why the partnership anti-abuse rules should not apply to Enron Leasing, *see* the King & Spalding opinion letter to R. Davis Maxey, by Abraham N.M. Shashy, Jr. for himself and William S. McKee, dated July 29, 1997, Appendix C, Part V, at 38-44.

[438] *Id.*, at 37-38.

excess of book basis),[439] and (3) the accounting benefits of the transaction could not be accomplished without the partnership.[440] Such a conclusion is further supported by recent court decisions that have rejected the existence of an otherwise valid partnership because of the lack of a non-tax business purpose.[441]

Recommendations

In order to achieve the desired tax results from Project Teresa, Enron needed the assistance of an unrelated accommodation party. Bankers Trust, which was the promoter and (along with Potomac Capital) an investor in Project Teresa, facilitated the planned temporary deconsolidation of Organizational Partner (which gave rise to the dividends received deduction). Bankers Trust also participated in the partnership structure (through which the basis shift was accomplished). The following specific recommendations are perhaps appropriate to address specific issues raised by Project Teresa. However, specific tax rules cannot adequately address the broader concerns that arise when an accommodation party acts in concert with a taxpayer to achieve a desired tax result. Implicit in the income tax system is an assumption that unrelated parties have adverse economic interests. When this paradigm breaks down, it is not surprising that the tax laws generate unwarranted results. Transactions with accommodation parties must be addressed by a rigorous application of the various common-law doctrines applicable to tax motivated transactions.[442]

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[439] The argument that a financial accounting benefit constitutes a substantial non-tax business purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a non-tax business purpose requirement. *See, e.g., American Electric Power, Inc. v. U.S.,* 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'" *citing Winn-Dixie v. Commissioner,* 113 T.C. 254, 287 (1999)).

[440] *See,* the King & Spalding opinion letter to R. Davis Maxey, by Abraham N.M. Shashy, Jr. for himself and William S. McKee, dated July 29, 1997, Appendix C, Part V, at 40.

[441] See, e.g., Boca Investerings Partnership v. U.S., 2003 U.S. App. LEXIS 429 at *12 (D.C. Cir. Jan. 10, 2003) ("As we noted in Saba Partnership, 'ASA makes clear that the absence of a nontax business purpose is fatal to the argument that the Commissioner should respect an entity for federal tax purposes,'' citing Saba Partnership, 273 F.3d at 1141 (quoting ASA Investerings, 201 F.3d at 512).

[442] For detailed information of the present law rules and judicial doctrines applicable to tax motivated transactions and related recommendations and developments, *see, e.g.,* Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters* (JCX-19-02), March 19, 2002; Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including provisions relating to Corporate Tax Shelters)* (JCS-3-99), July

Similarly, the partnership anti-abuse rules were promulgated to deter partnership arrangements in which the principal purpose is to reduce taxes in a manner that is inconsistent with the intent of the partnership tax rules. In Project Teresa, the principal purpose for Enron Leasing appears to have been to facilitate the shifting of tax basis from a nondepreciable asset to depreciable assets (in excess of book basis). If this conclusion is correct, then the partnership anti-abuse regulations should be available to recast the transaction as appropriate. If the partnership anti-abuse regulations do not apply to a transaction such as Project Teresa, then the regulations need to be reevaluated.

In terms of specific recommendations, the extraordinary dividend rules were amended in 1997 to prevent a controlling corporate shareholder from structuring a redemption transaction with a related party to take advantage of the dividends received deduction. Enron concluded that it could circumvent the 1997 law change and continue to claim the desired benefits from Project Teresa. The Joint Committee staff recommends that the extraordinary dividend rules should be further strengthened.

In addition, while guidance exists to prevent the inappropriate elimination of earnings and profits, the Joint Committee staff believes that additional guidance is needed to address situations in which a consolidated group is attempting to create or replicate earnings and profits in a manner inconsistent with the purpose of the consolidated return rules.

22, 1999; Temporary Treasury regulations (T.D. 9017) to section 6011 (October 22, 2002); Temporary Treasury regulations (T.D. 9018) to section 6012 (October 22, 2002); Joint Committee on Taxation, *Description of the "CARE Act of 2003,"* (JCX-04-03), February 3, 2003; Symposium: *Business Purpose, Economic Substance and Corporate Tax Shelters,* 54 SMU L. Rev. 1 (2001).