

II. GENERAL FINDINGS AND RECOMMENDATIONS RELATING TO BUSINESS TAX MATTERS

A. General Findings Relating to Business Tax Matters

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

1. Cost-benefit analysis with respect to tax motivated transactions

The Joint Committee staff believes that stronger measures are necessary 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.

2. Business purpose

The Joint Committee staff believes that attainment of financial statement benefits based solely on Federal income tax savings is not a valid business purpose for purposes of evaluating a transaction or arrangement under Federal income tax laws.

3. Accommodation parties

The tax laws should not permit the use of accommodation parties such as employees, consultants, or advisors, to serve as a party in a transaction or arrangement to permit a taxpayer to achieve Federal income tax benefits. The Joint Committee staff recommends that severe penalties be imposed on the accommodation party and on the taxpayer who engages the accommodation party.

4. Tax advisors

The Joint Committee staff is concerned about the willingness of tax advisors to render opinions that rely on factual representations that the advisor knows, or has reason to believe, are incorrect, incomplete, or inconsistent with the facts. Many tax-motivated transactions cannot occur without the complicity of a tax advisor who is aware of all the relevant facts, yet chooses to ignore them and instead relies on the taxpayer's purported factual representations. The Treasury Department and IRS should have a broad array of sanctions to impose on advisors who render such opinions, and they should impose stiff sanctions on these advisors (and when appropriate, on the advisor's employer or partners). In addition, the relevant State licensing

authority should be notified when these sanctions are imposed, and the licensing authority also should discipline the advisor as appropriate.

5. Generally accepted accounting principles relating to accounting for Federal income taxes

The Joint Committee staff is concerned that businesses are engaging in tax-motivated transactions primarily to obtain financial accounting benefits. The accounting benefits result solely from the manipulation of the Federal income tax laws to create permanent book-tax differences. The Joint Committee staff further believes that this activity may be occurring because of certain aspects of the financial accounting rules governing accounting for income tax expense. Thus, the Joint Committee staff recommends that those responsible for promulgating the accounting standards evaluate whether changes are warranted to the rules governing accounting for income taxes.

6. Disclosure of tax-motivated transactions

The Joint Committee staff is concerned that the use of multiple entities in connection with tax-motivated transactions, coupled with the inherent complexity of these transactions and the delayed timing of the tax benefits, makes it exceedingly difficult for the Treasury Department and the IRS to timely identify and properly evaluate these transactions. The Joint Committee staff believes that taxpayers should be required to make a detailed disclosure of any tax-motivated transaction on a timely basis, irrespective of whether the transaction has immediate tax return effect.

7. Continued use of certain structured transactions

The Joint Committee staff is concerned that the publication of this Report may encourage taxpayers and promoters to engage in transactions similar to those described in the Report. The Joint Committee staff recommends that the Congress and Treasury Department take appropriate action as soon as practicable.

B. Recommendations Relating to Corporate Tax Issues

1. Curtail duplication of losses

General rule preventing duplication of losses¹⁰

A single economic loss should not be deducted more than once. 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. Alternatively, the Joint Committee staff recommends expanding the sec. 358(h) basis reduction rule.

Specific rule preventing duplication of losses relating to real estate mortgage investment conduit residual interests¹¹

Under the statutory rules regarding the taxation of a real estate mortgage investment conduit ("REMIC"), generally 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.

2. Strengthen rules preventing acquisitions made to evade or avoid Federal income tax¹²

Section 269 disallows certain tax benefits if a taxpayer acquires direct or indirect control of a corporation for the principal purpose of Federal income tax evasion or avoidance. The Joint Committee staff recommends expanding 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.

The Joint Committee staff also recommends expanding 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.

¹⁰ Further discussion of this recommendation is provided in the descriptions of the transactions known as Project Tanya and Project Valor in Part Three of this Report.

¹¹ Further discussion of this recommendation is provided in the descriptions of the transactions known as Project Steele and Project Cochise in Part Three of this Report.

¹² Further discussion of this recommendation is provided in the description of the transaction known as Project Cochise in Part Three of this Report.

3. Strengthen the extraordinary dividend rules¹³

The extraordinary dividend rules were amended in 1997 to prevent a corporate shareholder from structuring a redemption transaction with a related party to take advantage of the dividends received deduction. The Joint Committee staff recommends that the extraordinary dividend rules should be further strengthened.

4. Provide guidance on the replication of earnings and profits in a consolidated group¹⁴

A distribution is treated as a dividend to the extent of a corporation's earnings and profits. The Joint Committee staff believes that guidance is needed to address situations in which a consolidated group attempts to create or replicate earnings and profits in a manner inconsistent with the purpose of the consolidated return rules.

¹³ Further discussion of this recommendation is provided in the description of the transaction known as Project Teresa in Part Three of this Report.

¹⁴ Further discussion of this recommendation is provided in the description of the transaction known as Project Teresa in Part Three of this Report.

C. Recommendations Relating to Partnership Tax Issues

1. Strengthen disclosure of disguised sales¹⁵

The Joint Committee staff recommends that the period for which disclosure is required under the disguised sale regulations should be extended beyond two years, and a more detailed disclosure of the source of permanent book-tax differences should be required. For example, extending the disclosure requirement to seven years, the period applicable to contributions and distributions under the pre-contribution gain rules, could make a facts and circumstances determination by the IRS both more likely to occur and easier for the IRS to administer.

2. Strengthen partnership allocation rules¹⁶

Partnership allocations between members of the same affiliated group (and, in general, related parties) may not have the same economic consequences as allocations between unrelated partners. As a result, related partners can use the partnership allocation rules inappropriately to shift basis among assets. The Joint Committee staff recommends strengthening of the anti-abuse rules relating to partnership allocations for property contributed to a partnership, especially in the case of partners that are members of the same consolidated group, to ensure that the allocation rules are not used to generate unwarranted tax benefits.

3. Provide guidance regarding transfers of partial partnership interests¹⁷

The transfer of partial partnership interests among related partners can result in inappropriate basis shifts among the partners. The Joint Committee staff believes that guidance is needed regarding the apportionment of tax basis upon the transfer of a partial partnership interest (particularly when the transfer involves related parties).

4. Provide rules for the appropriate interaction between partnership rules and corporate stock nonrecognition rules¹⁸

The interaction of the partnership basis adjustment rules and the rules protecting a corporation from recognizing gain on its stock can give rise to unintended tax results. Transactions based on this interaction generally purport to increase the tax basis of depreciable assets and to decrease, by a corresponding amount, the tax basis of the stock of a partner.

¹⁵ Further discussion of this recommendation is provided in the description of the transaction known as Project Tomas in Part Three of this Report.

¹⁶ Further discussion of this recommendation is provided in the description of the transaction known as Project Condor in Part Three of this Report.

¹⁷ Further discussion of this recommendation is provided in the description of the transaction known as Projects Tammy I and Tammy II in Part Three of this Report.

¹⁸ Further discussion of this recommendation is provided in the description of the transaction known as Project Condor in Part Three of this Report.

Because the tax rules protect a corporation from gain on the sale of its stock (including through a partnership), the transactions enable taxpayers to duplicate tax deductions at no economic cost. The Joint Committee staff recommends that either (1) the rules protecting a corporation from recognizing gain on its stock should be modified to limit the nonrecognition of any gain if the gain is attributable to a decrease in the tax basis of the stock resulting from the partnership basis adjustment rules, or (2) that the partnership basis adjustment rules should be altered to preclude an increase in the basis of an asset to the extent the offsetting basis reduction would be to stock of a partner (or related party).

In addition, the Joint Committee staff believes that the proposed regulations under section 337, relating to partnership acquisitions of stock of a corporate partner, would preclude taxpayers from engaging in these types of transactions. The Joint Committee staff recommends that final regulations on this subject should be issued expeditiously.

D. Recommendations Relating to International Tax Issues

1. Modify the rules for allocating subpart F income¹⁹

Treasury regulations contain highly mechanical rules for allocating the earnings and profits of a controlled foreign corporation for subpart F purposes. Special allocation abuses similar to those that have been encountered in the partnership taxation area also are possible in the context of controlled foreign corporations under these rules. In particular, a company may attempt to specially allocate subpart F income to tax-indifferent parties. The Joint Committee staff believes that this tactic is inconsistent with the purposes of subpart F and that the results that it purports to produce are inappropriate. The Joint Committee staff recommends adding an exception to the mechanical allocation method set forth in the regulations for cases involving allocations of earnings and profits to tax-indifferent shareholders made for tax-avoidance purposes.

2. Modify the interaction between the subpart F rules and the passive foreign investment company rules²⁰

In 1997, Congress enacted rules to mitigate the complexity and uncertainty that arose when a foreign corporation met the definitions of both the controlled foreign corporation rules of subpart F and the passive foreign investment company rules, thus requiring shareholders to negotiate two sets of anti-deferral rules in connection with the same investment. The 1997 legislation largely eliminated this overlap by providing that a controlled foreign corporation generally is not treated as a passive foreign investment company with respect to a “U.S. shareholder” of such controlled foreign corporation within the meaning of subpart F. Because this exception from the passive foreign investment company rules is based on a person’s status as a U.S. shareholder, as opposed to the person’s likely taxability under subpart F, situations may arise in which a U.S. shareholder of a controlled foreign corporation with mainly passive assets and passive income can take the position that no tax liability arises under either subpart F or the passive foreign investment company rules.

The Joint Committee staff believes that the exception to the passive foreign investment company rules for U.S. shareholders of controlled foreign corporations should be geared more closely to the U.S. shareholder’s potential taxability under subpart F, as opposed to mere status as a U.S. shareholder within the meaning of subpart F. Accordingly, the Joint Committee staff recommends adding an exception to the 1997 overlap-elimination rule for cases in which the likelihood that a U.S. shareholder would have to include income under subpart F is remote.

¹⁹ Further discussion of this recommendation is provided in the description of the transaction known as Project Apache in Part Three of this Report.

²⁰ Further discussion of this recommendation is provided in the description of the transaction known as Project Apache in Part Three of this Report.

3. Strengthen the earnings stripping rules²¹

The lack of final regulations under the earnings stripping tax rules has created a void in an area in which more definitive guidance is needed. Proposed regulations provide that entities or arrangements established with a principal purpose of avoiding the earnings stripping rules should be recharacterized or disregarded. The Joint Committee staff believes that this proposed anti-abuse rule would change a company's cost-benefit assessment of certain tax-motivated transactions, and thus recommends that the rule be finalized expeditiously.

4. Require annual information reporting with respect to disregarded entities²²

Present law requires no ongoing information reporting with respect to entities that are disregarded pursuant to a "check the box" entity classification election. Although the IRS is alerted of the existence and classification of each entity at the time the election is made, there is no regime of ongoing information reporting with respect to these entities. On the one hand, this lack of separate information reporting may be appropriate, given that the entities are supposed to be "disregarded" for Federal tax purposes pursuant to the election. Nevertheless, it is widely recognized that the application of the "check the box" regulations in the international setting raises a number of issues that the IRS is addressing through guidance and on audit.

The Joint Committee staff believes that a regime of annual information reporting with respect to entities disregarded pursuant to a "check the box" election would significantly enhance the IRS's ability to administer the international tax rules and to identify and address specific issues that arise in applying the "check the box" regulations in the international area.

²¹ Further discussion of this recommendation is provided in the description of the transaction known as Project Apache in Part Three of this Report.

²² Further discussion of this recommendation is provided in the description of Enron's use of foreign entities in Part Three of this Report.

E. Recommendation Relating to Financial Asset Securitization Investment Trusts²³

1. Repeal financial asset securitization investment trust rules

Recent commentary suggests that the financial asset securitization investment trust (“FASIT”) rules, which were first enacted in 1996, are not widely used in the manner envisioned by the Congress and thus have failed to further their intended purposes. The Joint Committee staff believes that the abuse potential inherent in the FASIT vehicle far outweighs any beneficial purpose that the FASIT rules may serve, and thus recommends that these rules be repealed.

²³ Further discussion of this recommendation is provided in the description of the transaction known as Project Apache in Part Three of this Report.

F. Recommendation Relating to Corporate-Owned and Trust-Owned Life Insurance²⁴

1. Repeal grandfather rules for pre-June 20, 1986 contracts

In light of the growth in interest incurred on debt under life insurance contracts that remains deductible due to a grandfather rule applicable to pre-June 20, 1986 corporate-owned and trust-owned life insurance contracts, the Joint Committee staff recommends termination of the grandfather rule for such contracts.

²⁴ Further discussion of this recommendation is provided in the description of Enron's corporate-owned and trust-owned life insurance contracts in Part Three of this Report.

G. Recommendations Relating to Structured Financing Transactions²⁵

1. Modify the rules relating to the characterization and treatment of debt and equity

The proper characterization of financial instruments for Federal income tax purposes as either debt or equity has been a longstanding problem. This problem has been exacerbated in recent years by the escalation in the amount and variety of hybrid financial instruments that have characteristics of both debt and equity. Therefore, the Joint Committee staff recommends that the rules concerning the Federal income tax characterization of financial instruments as either debt or equity should be reviewed in a comprehensive way. There are several possible alternative approaches that are available in considering such changes to present law, including:

- (1) Conform the tax characterization of hybrid financial instruments to the characterization that is used for other reporting purposes, such as financial accounting, so that the non-tax characterization determines the tax characterization.
- (2) Strengthen the requirements for debt characterization, similar to the approaches proposed by the Treasury Department in 1996 and 1997, which may include altering or more precisely articulating the debt-equity factors listed in section 385. This approach also could involve changing the manner in which such factors are applied so that certain financial instruments that exhibit (or lack) certain features are presumptively characterized as equity rather than indebtedness. In any event, section 385 should be amended to apply more broadly to interests in non-corporate entities, as well as corporations.
- (3) Provide restrictions on the proportionate amount of yield payments on hybrid financial instruments that may be deducted as interest. The proportionate amount of deductible yield payments could be determined under such an approach by reference to one or more factors (or some combination thereof), such as the length of the term to maturity of the instrument or the number of months that the issuer could defer yield payments under the terms of the financial instrument.
- (4) Reduce or eliminate the disparate taxation of interest and dividends (for both issuers and holders of financial instruments) that creates the market for hybrid financial instruments.

2. Modify the rules relating to disqualified indebtedness

The interest expense disallowance rules for disqualified indebtedness apply to transactions involving stock in another corporation only if the taxpayer controls the other corporation by virtue of owning more than 50 percent (by vote or value) of the outstanding stock of such corporation. The Joint Committee staff recommends that the 50-percent related party threshold under these rules should be eliminated.

²⁵ Further discussion of these recommendations is provided in the description of Enron's structured financing transactions in Part Three of this Report.