PART THREE: DISCUSSION OF SELECTED TAX MOTIVATED TRANSACTIONS AND BUSINESS ARRANGEMENTS USED BY ENRON

This Part Three of the Report addresses Enron's participation in arrangements that were designed to achieve significant tax and financial accounting benefits. As early as the late 1980s, Enron recognized the importance of managing its Federal income tax liability by generating taxable income to absorb certain temporary energy credits. In the 1990s, Enron began to engage in structured transactions that were motivated largely, if not entirely, to achieve certain desired tax benefits. These tax-motivated transactions, referred to in this Report as "Projects," initially were done to shelter capital gain that Enron realized from its sales of subsidiary stock. As Enron began reporting net operating losses for Federal income tax purposes, its need for tax savings diminished. Around the same time, however, the importance to Enron of reporting of financial statement earnings increased dramatically.[182] In essence, Enron's tax department was given a new responsibility -- to contribute to Enron's bottom line earnings, much like Enron's operating business units. To achieve this objective, the tax department, in consultation with outside experts, designed transactions to meet or approximate the technical requirements of tax provisions with the primary purpose of manufacturing financial statement income. The slogan "Show Me the Money!" exemplified this effort.[183]

Along with the change in responsibility came an organizational change to Enron Corp.'s tax department. In 1998, Enron segregated the personnel responsible for the Projects into a separate group within Enron's corporate tax department. Known as the structured transactions group, the employees in this group handled all aspects of the Projects.

This Part of the Report analyzes in detail the Projects that were done by Enron's structured transactions group. Each analysis has been written to "tell the story" of the Project, beginning with a brief overview of the Project, followed by the relevant background information, how the Project was implemented, a diagram that depicts the Project structure, the role of outside advisors, and any significant event that occurred subsequent to the Project. Each analysis then discusses the significant tax issues raised by the Project and concludes with specific recommendations (if appropriate). In order to provide a brief discussion of the relevant present-law tax laws that are implicated by the Projects, each Project has been classified into one of the following categories: (1) structured transactions that raise corporate tax issues; (2) structured

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[182] For example, as part of its "Enron 2000" plan, Enron announced its commitment to achieving $1 billion of net income by the year 2000. *See* Presentation to Enron Corp. Board of Directors, December 9, 1997 (describing the history regarding introduction of Enron 2000 and its importance as the standard against which the company's actual financial performance was to be measured. EC000046072.

[183] This is documented by Enron presentation materials titled "Show Me the Money! Project Steele Earning Benefits." The expected pre-tax operating earnings from this transaction was approximately $133 million. The Project Steele materials in Appendix B contain the document. EC2 000038546.

transactions that raise partnership tax issues; (3) other structured transactions; and (4) transactions in which Enron served as an accommodation party.

This Part of the Report also analyzes Enron's use of corporate-owned and trust-owned life insurance arrangements, structured financings arrangements, and offshore entities. This Part of the Report concludes with a general discussion of certain of Enron's off-balance sheet partnership arrangements that were motivated by financial reporting objectives.

I. STRUCTURED TAX MOTIVATED TRANSACTIONS

A. Background and Rationale

In the early 1990s, Enron engaged in several structured financing transactions in which Enron received upfront payments in exchange for the future delivery of a specified commodity such as crude oil or natural gas ("commodity prepay transactions").[184] The commodity prepay transactions originally were entered into in order to generate current taxable income to use tax credits generated by Enron Oil and Gas that would have otherwise expired. In the mid-1990s, Enron continued its use of structured financing transactions and used other structured transactions to shelter capital gain income on the sale of Enron Oil and Gas stock.[185]

Although providing financial accounting benefits, the early structured transactions, including the commodity prepay transactions, were primarily engaged in for Federal income tax benefits. However, as Enron began to report losses for Federal income tax purposes, the importance of immediate tax deductions declined. At the same time, the importance of financial accounting income to Enron increased. As a result, Enron's focus shifted from structured transactions that could shelter specific tax items to transactions that could generate financial accounting benefits.

Arguably, the primary reason for engaging in most of the subsequent structured transactions after 1996 was for the financial accounting benefits they generated rather than the Federal income tax benefits.[186] Indeed, many of the structured transactions were designed to permit Enron to begin reporting the financial accounting benefits of a transaction immediately even though the Federal income tax benefits (which generated the financial accounting benefit) would not occur until significantly into the future.[187] In some of the structured transactions,

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[184] The commodity prepay transactions are discussed in more detail later in this Part of the Report.

[185] For example, Enron issued investment unit securities (discussed later in this Part of the Report) to monetize part of its investment in Enron Oil and Gas common stock. In addition, Project Tanya and Project Valor were structured transactions that Enron engaged in to shelter taxable income on capital gain on the sale of Enron Oil and Gas stock.

[186] In all of the structured transactions discussed in this Report, except two structured transactions in which Enron was an accommodation party, the origin of the financial accounting benefits was the reduction in Federal income tax that the transaction was anticipated to provide either currently or in the future.

[187] Statement of Financial Accounting Standards 109 ("SFAS 109"), Accounting for Income Taxes, generally provides that assets and liabilities that are recorded at different amounts for financial reporting purposes and income tax purposes create differences for which a deferred tax asset or liability generally must be reported in the financial statements. However, certain basis differences may not result in taxable or deductible amounts in future years when the related asset is recovered or settled because the tax law provides a means for the taxpayer to recover the asset in a tax-free transaction. In such situations, if management reasonably represents that,

specific attributes intentionally were incorporated to accelerate the recognition of the associated financial accounting income and enable the income to be reported as operating income in lieu of a reduction in income tax expense. In general, operating earnings are more valuable to a business than a reduction in income tax expense because many stock analysts and valuation specialists utilize operating earnings when analyzing the appropriate value and stock price for a business.[188] In addition, because the relevant accounting standard does not use present value concepts, in many cases the reported financial accounting income significantly exceeded the present value of the anticipated Federal income tax benefits.[189]

Organization of the structured transactions group

The general tax-planning group within Enron's corporate tax department initially was responsible for implementing the structured transactions. However, in June of 1998, Mr. Hermann segregated the personnel responsible for the structured transactions into a separate

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without incurring significant cost, the company will use a tax planning action that permits the asset to be recovered in a tax-free transaction, then no deferred taxes are reported in the financial statements. Because no deferred tax asset or liability is reported, such difference will increase or decrease income reported in the financial statements in the year the basis difference arises, irrespective that such tax planning action may not be undertaken for until a later year. In many of the structured transactions, Enron represented that it would use tax-planning actions in the future to recover a basis difference in a tax-free manner and, consequently, did not report deferred taxes on such basis differences (i.e., increased financial accounting income). The Joint Committee staff has not addressed whether the financial accounting treatment reported by Enron is appropriate as it is beyond the scope of the Report.

[188] Commonly, stock analysts and valuation specialists use earnings before income, taxes, and depreciation and amortization ("EBITDA") to value a company. Using EBITDA, stock analysts and valuation specialist ignore the tax expense line in an income statement (among others). Accordingly, because the compensation of a business entity's executive officers often is tied to the market or trading value of the entity, some executives place much greater priority on increasing operating income and are generally less concerned about the entity's net income. For example, an increase in operating earnings of $10 for a company trading at a multiple of fifteen times EBITDA would be expected in increase the market value of a company by $150. From 1997-2001, two Enron structured transactions enabled Enron to increase operating income by a total of approximately $260 million (and to increase net income by approximately $170 million).

[189] The difference between the reported financial accounting income and the present value of the Federal income tax benefits can be significant because, unlike some financial accounting rules, SFAS 109 does not determine deferred tax assets and liabilities on a present value or discounted basis. Enron and its advisors used this rule to devise transactions that could report financial statement benefits that were significantly in excess of the anticipated present value of the Federal income tax benefits. Although not discounting income taxes for financial reporting can result in anomalies, as highlighted by some of the structured transactions, the conceptual and implementation issues with discounting income taxes for financial reporting are numerous and complex.

"structured transactions" group within Enron's corporate tax department.[190] The group apparently was separated due to the increase in the number of structured transactions, the ongoing responsibilities associated with implementing and administering existing structured transactions, and the time expended to review proposed structured transactions. The structured transactions group was modeled after similar groups established by a select group of corporations and financial institutions. Mr. Maxey headed the structured transactions group, which had (at its peak) over twenty-five attorneys and accountants.

The structured transactions group's focus was to synthesize tax, finance, legal, and accounting principles to enhance economic returns to Enron. The structured transactions group effectively was responsible for managing a structured transaction from its inception to final execution. The group handled all aspects of the entities involved in a structured transaction, including the bookkeeping, financial reporting, tax reporting, investor reporting, dividend payments, and corporate governance responsibilities. Although many of these formalities were not tax-related, they were centralized in the structured transactions group as well, because other corporate departments were not always responsive to requests to perform the additional functions required to demonstrate the substance of entities that otherwise generally were ignored for financial accounting purposes and overall corporate management. Effectively, the group operated substantially independent of the remaining tax professionals and, to some extent, operated as a standalone business unit.[191]

Operation of the structured transactions group

The structured transactions group completed 11 large structured transactions over seven years. One additional structured transaction was approved but never implemented because of Enron's bankruptcy. The ideas for the structured transactions primarily were brought to the attention of Enron's corporate tax department via referrals from Enron's finance department or direct calls to Mr. Hermann or Mr. Maxey. The promoters of the transactions comprised a select group of investment banks, law firms, and accounting firms.

In general, Enron would listen to a "pitch" and then evaluate the idea.[192] The structured transactions group used a multistage process to evaluate the ideas. The first part of this process was to determine whether the transaction was technically sound. Enron generally reviewed a

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[190] Although those responsible for the structured transactions were part of the planning group until 1998, for purposes of this Report they are referred to as part of the structured transactions group.

[191] In many cases, Enron tax personnel outside of the structured transactions group had limited knowledge of the transactions being undertaken by the group even when they were responsible for tax matters affecting a business unit that was a party to a transaction.

[192] In addition, Enron tax personnel periodically traveled to New York, Washington D.C., and other locations to seek out tax advantageous transactions.

general tax opinion provided by the promoter[193] and would raise concerns and issues specific to Enron's organization and tax situation. In addition to structured transactions personnel, other senior level tax personnel reviewed aspects of a proposed structured transaction based on their specific technical expertise. For a structured transaction to proceed, Mr. Hermann required counsel to indicate that it could provide a "should" level opinion.[194]

The second part of the process was to fit the structured transaction into Enron's business strategy. Effectively, the structured transaction would need to be attached to an existing transaction that the company was contemplating to provide a purported business purpose for the transaction. Finding a business purpose for a structured transaction was the most important and the most difficult aspect of the development of a structured transaction. For example, an Arthur Andersen memorandum discussing a structured transaction stated "the biggest issue to be resolved [is the] business purpose."[195] The difficulty of obtaining reasonable operational purposes for entering into some of the structured transactions resulted in Enron representing that its business purpose for some structured transactions was the financial accounting benefits obtained.[196] Other structured transactions were able to fit into to an existing business transaction; however, based on the documents reviewed by the Joint Committee staff, their stated business purposes for the structured transactions were lacking or tenuous and, in general, unrelated to underlying business transaction.

If an idea satisfied the technical and business strategy requirements, accounting, finance, legal, and other relevant personnel would become involved in further vetting the idea. If a transaction appeared to satisfy all parties, the transaction generally would be sent to Mr. Causey, Chief Accounting and Information Officer, for approval. Whether additional approvals were

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[193] Generally, the promoters provided a general explanation of the expected accounting treatment for an idea. In some cases, they provided internal opinions or opinions written by accounting firms based upon a hypothetical transaction that effectively mirrored the idea being promoted.

[194] The "should" level requirement was added after the first two structured transactions. Those transactions received "more likely than not" tax opinions.

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

[196] Projects Steele, Cochise, and Teresa all relied heavily on this "business purpose." However, claiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) in these transactions and significantly diminishes the purpose for having a substantial non-tax 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)).

needed depended upon the general Enron corporate approval guidelines for engaging in a transaction. In many cases, the Board of Directors or one of its committees approved the structured transactions.

Once a structured transaction was approved, Enron would enter into an agreement with the promoter detailing the responsibilities of each party and setting forth the compensation to be paid. In general, the engagement letters reviewed by the Joint Committee staff indicate that Enron would pay a fee of approximately $8 to $15 million to the "idea provider" selling the specific transaction and would incur approximately $800,000 to $1.2 million for the legal work including the tax opinion for a transaction.[197]

Besides engaging in structured transactions for its own tax and financial accounting benefits, Enron also acted as an accommodation party, for a fee, in two structured transactions with Bankers Trust. In addition, it appeared that the structured transactions group viewed this role as a new source of value to Enron. Highlighting the transformation of the tax department, Mr. Maxey stated that because of the group's successful completion of structured transactions, "the relationships developed by group members with outside parties have grown, enabling the group to act as facilitator for other entities or to joint venture with other entities to provide similar services to other companies in addition to Enron. In effect, we have created a business segment for Enron that generates earnings and interacts with other entities for profit."[198]

Table 1, below summarizes certain tax and accounting information regarding 12 of Enron's structured transactions. The table shows that Enron's financial accounting benefits that it expected to derive from the structured transactions were front loaded to provide immediate reporting of earnings for its financial statements, even though the bulk of the tax benefits would not be derived, if at all, until well into the future. The table also lists the promoter of the transaction, the primary tax opinion provider, and project fees paid by Enron with respect to each transaction.

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[197] Two exceptions to the general range of fees paid for the idea were the fees paid to Arthur Andersen for Projects Tanya and Valor. Arthur Andersen was paid $500,000 and $100,000, respectively, for the idea and the tax opinion on these transactions. The General Background Materials in Appendix B contain the Estimated Project Fees schedule (6/4/01) for certain structured transactions. EC2 000036379.

[198] Interoffice memorandum dated October 2, 2000 to Richard J. Causey from R. Davis Maxey. EC2 000038284 - EC2 000038285.

Table 1.–Benefits and Fees of Enron's Structured Transactions (1995-2001)
[millions of dollars]

Project Name	Financial Accounting Income through 2001	Total Projected Financial Accounting Income	Federal Tax Savings through 2001	Total Projected Federal Tax Savings	Promoter	Primary Tax Opinion Provider	Total Project Fees
Tanya (1995)	66	66	66	66	Arthur Andersen	Arthur Anderson	0.5
Valor (1996)	---	82	82	82	Arthur Andersen	Arthur Andersen	0.1
Steele (1997)	65	83	39	78	Bankers Trust	Akin, Gump, Strauss, Hauer & Feld	11
Teresa (1997)	226	257	-76	263	Bankers Trust	King & Spalding	12
Cochise (1998)	101	143	---	141	Bankers Trust	McKee Nelson, Ernst & Young	16
Apache (1998)	51	167	51	167	Chase Manhattan	Shearman & Sterling	15
Tomas (1998)	37	113	95	109	Bankers Trust	Akin, Gump, Strauss, Hauer & Feld	14
Renegade (1998)	1	1	0	0	Bankers Trust	---	---
Condor (1999)	88	328	0	332	Deloitte & Touche	Vinson & Elkins	10
Valhalla (2000)	16	64	0	0	Deutsche Bank	Vinson & Elkins	---
Tammy I (2000)	---	406	0	414	Deloitte & Touche	Vinson & Elkins	9
Tammy II (2001)	---	369	0	370	---	---	---
Totals	**651**	**2,079**	**257**	**2,022**	**N/A**	**N/A**	**87.6**

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

Reporting of activities to management

As the number of transactions entered into by Enron increased, the structured transactions group began preparing reports for Mr. Causey and senior tax personnel summarizing the executed transactions, the cash flow savings by year, the financial statement earnings impact, and new transactions under consideration by the group. This report was updated fairly frequently and was conveyed to appropriate personnel. Appendix B contains the Structured Transactions Group Summaries of Project Earnings & Cash Flows November 2001 report, as well as other reports prepared by the group regarding its activities.

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The following discussion provides an overview of selected tax motivated structured transactions into which Enron entered. The discussion includes information on the development and implementation of each transaction, the reported financial accounting and tax implications, the role of outside advisors in the transaction, a discussion of the relevant tax authorities, and recommendations by the Joint Committee staff.

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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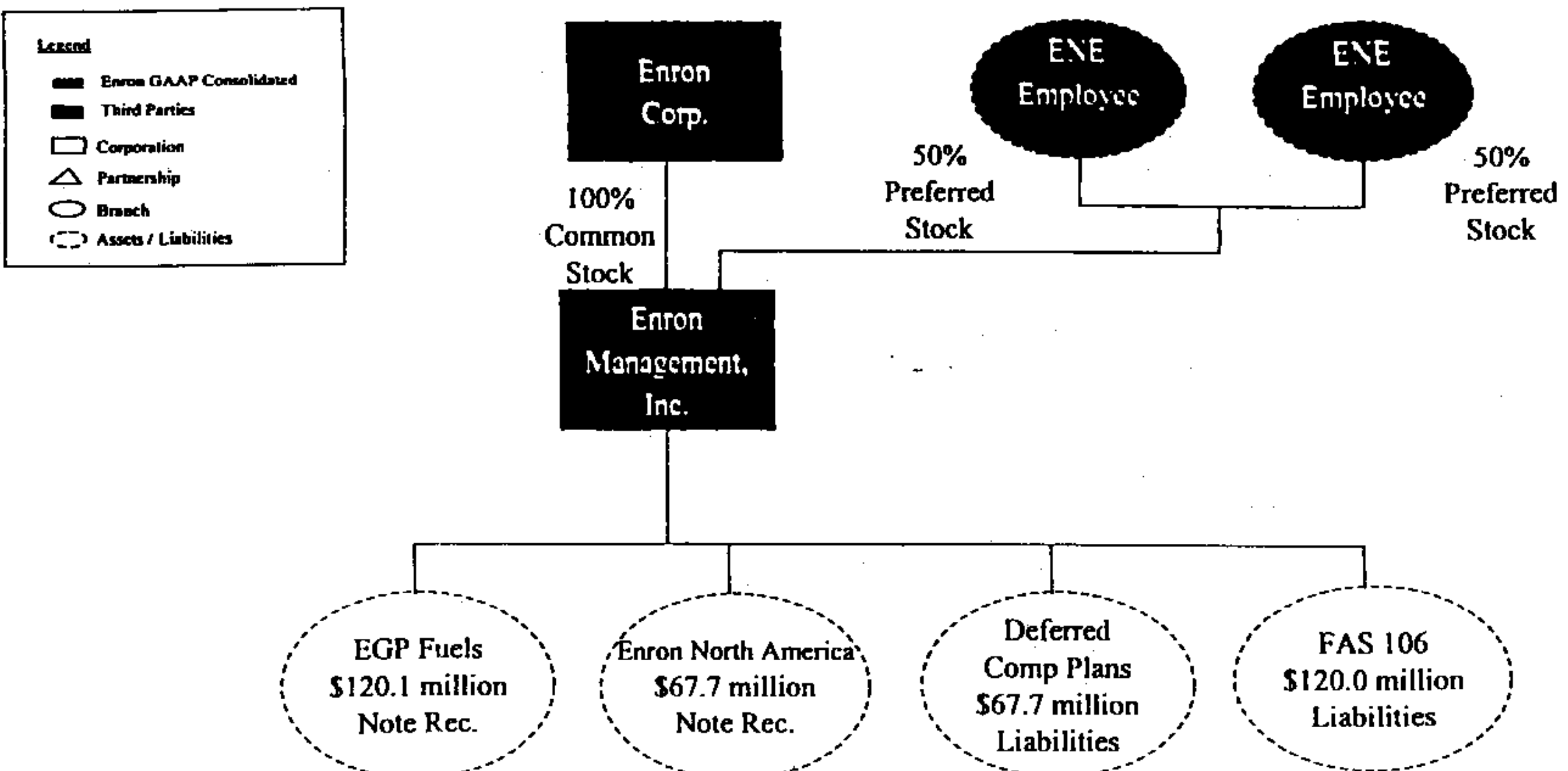
[255] Current Enron management is not aware of any investment information or advice provided to either Ms. Joyce or Ms. Edwards in connection with the investment. In addition, current Enron management is not aware of any payments that were made to Ms. Joyce or Ms. Edwards regarding the economic outlay 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.

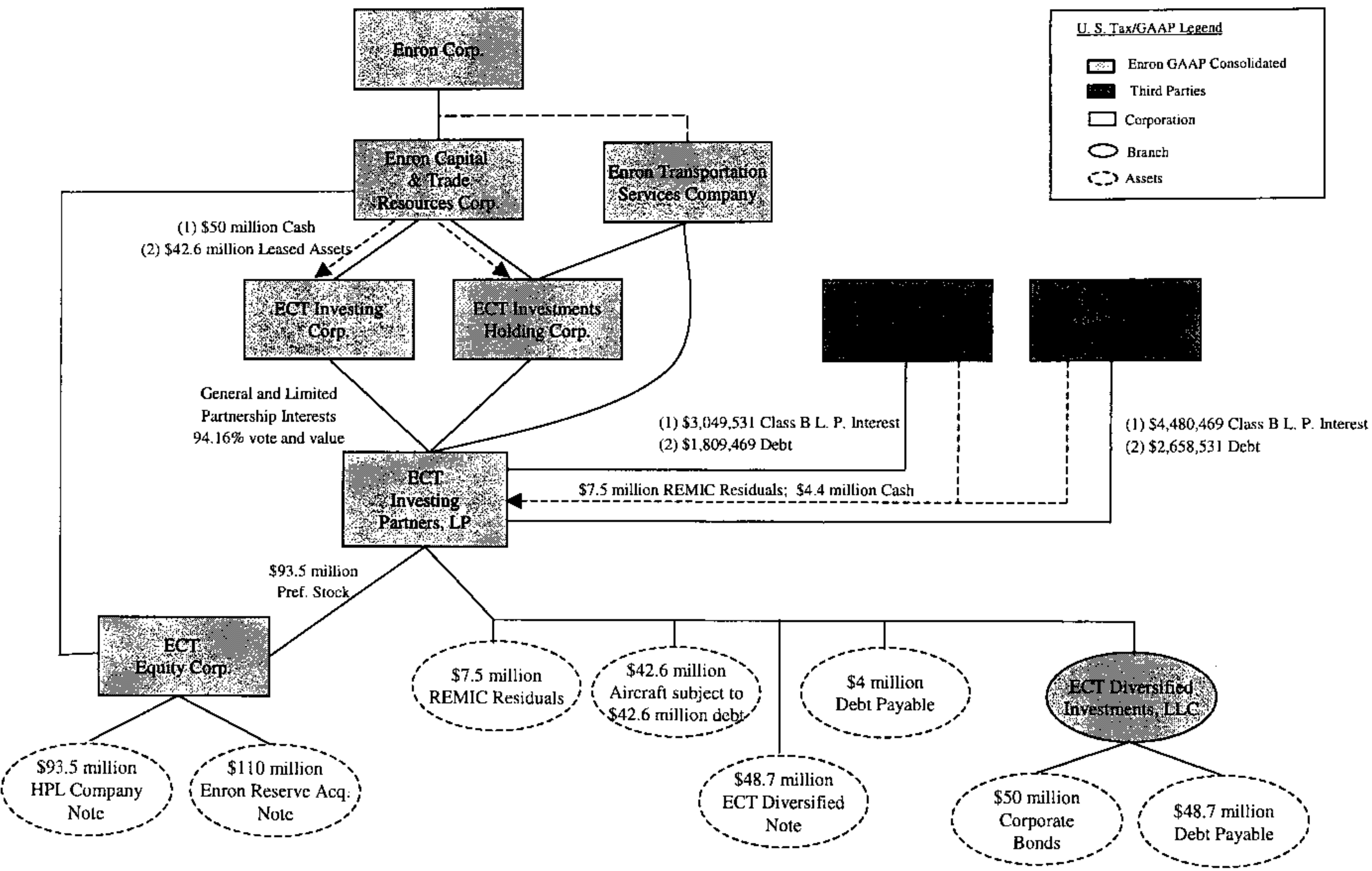
preferred stock of ECT Equity Corp. which owned $203.5 million of intercompany notes of Enron affiliates.[325]

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

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[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

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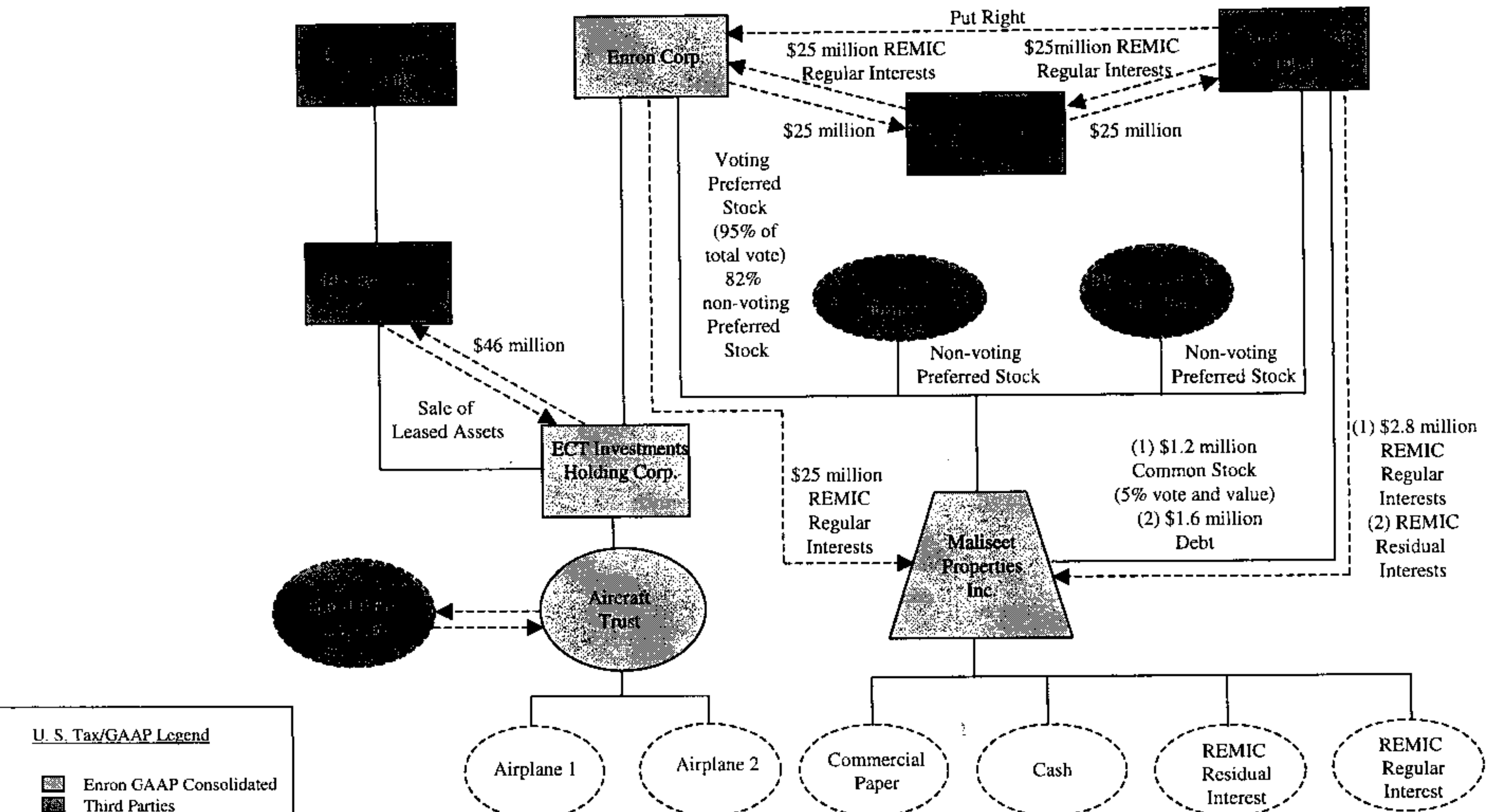
[359] The Maliseet directors who received shares were Jeffrey McMahon, James V. Derrick, Jr., Richard A. Causey, Robert H. Butts, Mr. Hermann, and Andrew S. Fastow. The stock subscription agreements with these directors were executed on behalf of Maliseet by Mr. Maxey as vice president of Maliseet. Maliseet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

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[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

[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.

[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

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[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).

C. Transactions That Raise Partnership Tax Issues

Several of Enron's structured transactions relied on partnership tax rules to shift basis to assets that would be depreciated or sold, in order to maximize depreciation deductions or minimize taxable gain on sale. The reported tax benefits (and corresponding financial statement benefits) depended on the application of partnership tax rules, including rules that require allocation of tax attributes associated with contributed assets, and rules that permit basis to be shifted to partnership assets when the partnership makes distributions. For example, Project Tomas (done in 1998) relied on some of these rules in order to dispose of a portfolio of low-basis leased assets without gain recognition. Projects Condor (done in 1999) and Tammy I and II (done in 2000 and 2001) also relied on these rules to shift basis to depreciable assets. The "unwind" strategies of Projects Condor, Tammy I and Tammy II also relied on rules protecting a corporation from recognition of gain on the sale or exchange of its stock.[443]

This section of the Report begins with a brief discussion of relevant partnership tax rules and then describes in detail Projects Tomas, Condor, Tammy I and Tammy II.

1. Discussion of relevant partnership tax law rules

In general

In general, partnerships are not treated as separate taxpayers for Federal income tax purposes. The income of the partnership is taxed to the partners. Items of income, gain, loss, deduction and credit generally are allocated to the partners in accordance with the partnership agreement. Partnership income, unlike corporate income, is thus subject to one level of Federal income tax, which is imposed at the partner level. As a result of the different tax rules applying to partnerships and corporations, taxpayers have structured transactions attempting to combine the benefits contained in each set of rules.[444]

The four structured transactions undertaken by Enron that are described in this section of the Report (Projects Tomas, Condor, and Tammy I and II) utilize the partnership tax rules, and their interaction with corporate tax rules, to attempt to achieve favorable tax treatment.

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[443] Sec. 1032. This rule of present law is described above in Part III.A.1., Discussion of relevant corporate tax laws.

[444] For an example of taxpayers attempting to take advantage of the benefits of both the corporate and partnership rules, *see* Prop. Treas. Reg. sec. 1.337(d)-3 (gain recognition upon certain partnership transactions involving a corporate partner's stock), Notice 89-37, 1989-1 C.B. 679, and Notice 93-2, 1993-2 C.B. 292.

Contributions to partnerships generally tax-free

Generally, a partner does not recognize any gain or loss on a contribution of property to a partnership.[445] The partnership also does not recognize gain or loss when property is contributed.

Liquidation of a partner's interest

Tax-free distributions of partnership property

Generally, a partner and the partnership do not recognize gain or loss on the distribution of partnership property.[446] This includes distributions in liquidation of a partner's interest. There are, however, a number of exceptions to this general rule of non-recognition on a distribution of partnership property.

Taxable partnership distributions

One such exception is that a partner must recognize gain to the extent that any money distributed exceeds the partner's basis in its partnership interest immediately before the distribution.[447]

Two additional exceptions, enacted in 1989 and 1992, provide that gain or loss is recognized on a distribution of partnership property, if a partner contributed property with built-in gain or built-in loss, and either (1) the property is distributed to another partner within seven years of its contribution, or (2) the contributing partner receives a distribution of other property within seven years of the contribution.[448]

In general, this gain recognition rule does not apply to a distribution of property that the distributee partner contributed to the partnership.[449] However, if the property distributed is an interest in an entity (e.g., corporate stock), the exception from gain recognition does not apply to the extent the value of the interest is attributable to property contributed to the entity after the entity was contributed to the partnership.

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[445] Sec. 721(a).

[446] Sec. 731(a) and (b).

[447] Sec. 731(a)(1). The term "money" includes marketable securities; however, marketable securities are excluded from the definition of money for purposes of gain recognition on the distribution if the distributee partner contributed the security to the partnership. Sec. 731(c).

[448] Secs. 704(c)(1)(B) and 737.

[449] Secs. 704(c)(1)(B) and 737(d).

Tax basis of distributed property received in liquidation of partnership interest

The basis of property distributed in liquidation of a partner's interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction).[450]

Election to adjust basis of partnership property

When a partnership distributes partnership property, generally, the basis of partnership property is not adjusted to reflect the effects of the distribution or transfer. The partnership is permitted, however, to make an election (referred to as a 754 election) to adjust the basis of partnership property in the case of a distribution of partnership property.[451] The effect of the 754 election is that the partnership adjusts the basis of its remaining property to reflect any change in basis of the distributed property in the hands of the distributee partner resulting from the distribution transaction. Such a change could be a basis increase due to gain recognition, or a basis decrease due to the application of a limitation, for example. If the 754 election is made, it applies to the taxable year with respect to which such election was filed and all subsequent taxable years.

In the case of a distribution of partnership property to a partner with respect to which the 754 election is in effect, the partnership increases the basis of partnership property by (1) any gain recognized by the distributee partner (2) the excess of the adjusted basis of the distributed property to the partnership immediately before its distribution over the basis of the property to the distributee partner, and decreases the basis of partnership property by (1) any loss recognized by the distributee partner and (2) the excess of the basis of the property to the distributee partner over the adjusted basis of the distributed property to the partnership immediately before the distribution. The allocation of the increase or decrease in basis of partnership property is made in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties.[452]

Disguised sales of property through partnerships

In 1984, Congress enacted a rule providing that if there is a transfer of money or other property by a partner to a partnership and there is a related transfer of money or other property by the partnership to such partner, the two transfers (when viewed together) may be properly characterized as a taxable sale or exchange of property.[453]

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[450] Sec. 732(b).

[451] Sec. 754.

[452] Sec. 755.

[453] Sec. 707(a)(2)(B). Treasury, in regulations issued in 1956, had recognized the possibility that a contribution of property coupled with a distribution of money or other consideration may, in substance, be a sale or exchange of property. See Treas. Reg. secs. 1.721-1(a) and 1.731-1(c)(3).

The regulations provide that a transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances (1) the transfer of money or other consideration would not have been made but for the transfer of property and (2) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.[454] The regulations then provide ten factors that may tend to prove the existence of a sale.[455]

If the two transfers are made within a two-year period (without regard to the order of the transfers), then the transfers are presumed to be a sale of the property unless the facts and circumstances clearly establish otherwise.[456] If, however, the two transfers are more than two years apart, then the transfers are presumed not to be a sale of the property unless the facts and circumstances clearly establish otherwise.[457]

Adjustment to basis of assets of a distributed corporation controlled by a corporate partner

In December 1999, Congress enacted a rule requiring a reduction in the basis of stock distributed by a partnership to a corporate partner, in certain circumstances. The provision was enacted in response to the perceived abuse of the interaction of the tax-favored treatment of partnership distributions and the tax-free treatment of certain corporate liquidations.[458] The Congress was concerned that the downward adjustment to the basis of property distributed by a partnership to a low-basis partner may be nullified if the distributed property is corporate stock. The corporate partner could then liquidate the distributed corporation, eliminating the stock and owning assets directly, so that the stock basis reduction would have no effect.[459]

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[454] Treas. Reg. sec. 1.707-3(b)(1).

[455] Treas. Reg. sec. 1.707-3(b)(2).

[456] Treas. Reg. sec. 1.707-3(c)(1).

[457] Treas. Reg. sec. 1.707-3(d).

[458] Sec. 732(f) was enacted in the Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, section 538(a) (December 17, 1999). Section 732(f) is effective for distributions made after July 14, 1999. However, in the case of a corporation that is a partner in a partnership as of July 14, 1999, section 732(f) is effective for distributions made to that partner from that partnership after June 30, 2001 (approximately a two-year deferred effective date).

[459] Generally, section 332 provides that no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation in which it holds 80 percent of the stock (by vote and value).

The provision provides for a basis reduction to assets of a corporation, if stock in that corporation is distributed by a partnership to a corporate partner, and after the distribution the corporate partner controls the distributed corporation.[460] The amount of the reduction in basis of property of the distributed corporation generally equals the amount of the excess of (1) the partnership's adjusted basis in the stock of the distributed corporation immediately before the distribution over (2) the corporate partner's basis in that stock immediately after the distribution.[461]

Partnership allocations with respect to contributed property

Allocations to contributing and non-contributing partners to reflect pre-contribution gain or loss

The partnership rules generally provide that a partner's distributive share of partnership income, gain, loss, or deduction is allocated to the partner in accordance with the partner's interest in the partnership.[462] However, a special rule requires that income, gain, loss, and deduction with respect to contributed property must be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution to the partnership.[463] The purpose of this rule is to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. Under regulations promulgated by the Treasury Department, three different allocation methods are generally reasonable in carrying out the purpose of this rule.[464] However, an allocation method (or combination of methods) is not reasonable if the contribution of property and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.[465]

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[460] For this purpose, the term "control" means ownership of stock meeting the requirements of section 1504(a)(2) (generally, an 80-percent vote and value requirement).

[461] Sec. 732(f)(1). The provision limits the amount of the basis reduction in two respects. First, the amount of the basis reduction may not exceed the amount by which (1) the sum of the aggregate adjusted bases of the property and the amount of money of the distributed corporation exceeds (2) the corporate partner's adjusted basis in the stock of the distributed corporation. Second, the amount of the basis reduction may not exceed the adjusted basis of the property of the distributed corporation. Sec. 732(f)(3).

[462] Sec. 704(b).

[463] Sec. 704(c).

[464] The methods are the traditional method, the traditional method with curative allocations, and the remedial method. Treas. Reg. sec. 1.704-3.

[465] Treas. Reg. sec. 1.704-3(a)(10).

Sale of partnership interest with pre-contribution gain or loss

If a contributing partner transfers a partnership interest, pre-contribution built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner.[466] If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner.[467]

Basis of a partner's interest in a partnership

In general, a partner's basis in its partnership interest is increased by that partner's distributive share of partnership income and is decreased by that partner's distributive share of partnership losses.[468] Increasing the partner's basis in this manner ensures that a partner is taxed only once on its distributive share of partnership income, and deducts its share of partnership loss only once. In addition, a partner's basis is increased by the partner's distributive share of non-taxable income so that the partner does not lose the benefit of that type of income.

Sale of stock contributed to a partnership

In Rev. Rul. 99-57,[469] the IRS addressed the tax treatment of gain on the sale of a corporate partner's stock that it had previously contributed to the partnership. In the ruling, the IRS concluded that the corporate partner's share of the gain resulting from the partnership's sale of the stock was not subject to tax. Effectively, the IRS treated the corporate partner as owning an undivided interest in its own corporate stock, and that as such it does not recognize gain or loss on the receipt of money or other property in exchange for the its own stock.[470] In addition, the corporate partner increased its basis in its partnership interest thereby preserving the non-recognition result of the transaction in accordance with the policy underlying section 1032 (preventing a corporation from recognizing gain or loss when dealing in its own stock). A similar analysis would apply to a transaction in which a corporate partner is allocated a loss from a transaction involving the disposition of stock of the corporate partner held by the partnership.

In Notice 99-57,[471] the IRS stated its intent to promulgate regulations under section 705 to address certain situations in which gain or loss may be improperly created by adjusting the

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[466] Treas. Reg. sec. 1.704-3(a)(7).

[467] *Id.*

[468] Sec. 705(a).

[469] 1999-2 C.B. 678 (Dec. 20, 1999). For an example of an earlier agency decision applying partnership aggregate principles to section 1032, see Priv. Ltr. Rul. 9822002 (Oct. 23, 1997).

[470] Section 1032.

[471] 1999-2 C.B. 693 (Dec. 20, 1999).

basis of a partnership interest for partnership income that is not subject to tax, or for partnership losses or deductions that are permanently denied, with respect to a partner. The regulations will apply to situations in which a corporation acquires an interest in a partnership that holds stock in that corporation, and a section 754 election is not in effect. In those situations, a corporate partner may increase the basis in its partnership interest under section 705 only by the amount of its portion of the section 1032 gain that the partner would have realized had a section 754 election been made. The IRS also stated that the regulations will apply to situations in which the price paid for a partnership interest reflects built-in gain or accrued income items that will not be subject to income tax, or built-in loss or accrued deductions that will be permanently denied, when allocated to the transferee partner, and the partnership has not made a section 754 election. The IRS also warned that it may challenge any transaction within the scope of the Notice under the anti-abuse provisions of Treas. Reg. sec. 1.701-2.[472]

Proposed regulations on partnership distributions of corporate stock

Similarly, under Notice 89-37,[473] which was issued in response to a well-known transaction engaged in by the May Company,[474] the IRS addressed certain situations in which gain may be avoided through the use of a partnership and stock of a corporate partner. The notice states that if a partnership distributes to a corporate partner the stock of such corporation or the stock of an affiliate of such corporation after March 9, 1989, the distribution is characterized as a redemption of the corporate partner's stock with "property consisting of its partnership interest." In other words, gain recognition will apply instead of the general partnership non-recognition provisions on distributions of property. In addition, the Notice also states that if a partnership acquires stock of a corporate partner after March 9, 1989, the IRS intends to treat the acquisition as resulting in a "deemed redemption" of the corporate partner's stock.[475] In such case, the deemed redemption rule will apply so that "gain will be recognized at the time of, and to the extent that, the acquisition has the economic effect of an exchange by a corporate partner of its interest in appreciated property for an interest in its stock [or stock of an affiliate] owned or acquired by the partnership."

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[472] On January 3, 2001, the Treasury and the IRS published a notice of proposed rulemaking under section 705 (REG-106702-00, 2001-4 I.R.B. 424). On March 28, 2002, the Treasury and the IRS issued final regulations under section 705 (T.D. 8986, 67 Fed. Reg. 15112 (March 29, 2002)). On March 28, 2002, the Treasury Department and the IRS issued a notice of proposed rulemaking under section 705, addressing remaining issues that Treasury and the IRS considered during the development of the final regulations (REG-16748-01, 67 Fed. Reg. 15132 (March 29, 2002)).

[473] 1989-1 C.B. 679.

[474] In this transaction, a corporate partner contributed property with a built-in gain to a partnership. The partnership made a distribution of corporate stock.

[475] In the Notice, the IRS stated that the deemed redemption rule would apply to other transactions, including partnership purchases of a corporate partner's stock, disproportionate distributions, and amendments to the partnership agreement.

In December 1992, Treasury issued proposed regulations interpreting the Notice.[476] The proposed regulations, which have not been finalized, describe the tax consequences of a distribution of a partner's stock after the application of the deemed redemption rule.

The IRS has stated "further study is appropriate for cases in which affiliation did not exist prior to a distribution of stock by a partnership to a corporate partner, but rather results from such distribution."[477] As a result, the proposed regulations will be amended to limit their application to cases in which affiliation exists immediately before the deemed redemption or distribution.

Partnership anti-abuse regulations

In late 1994, the Treasury Department issued regulations containing two anti-abuse rules relating to subchapter K. The first rule focuses on the intent of subchapter K, which is to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements: (1) the partnership must be bona fide and each partnership transaction or series of related transactions must be entered into for a substantial business purpose; (2) the form of each partnership transaction must be respected under substance over form principles; and (3) the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partner's economic agreement and clearly reflect the partner's income.[478] 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, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances.[479]

The second rule permits the Commissioner to treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Code or regulations.[480] However, this second rule does not apply to the extent that a provision of the Code (or regulations) prescribes the treatment of a partnership as an entity, in whole or in part, and that treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.[481]

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[476] PS-91-90, 1993-2 I.R.B. 29; 57 Fed. Reg. 59324 (December 15, 1992).

[477] Notice 93-2, 1993-2 C.B. 292.

[478] Treas. Reg. sec. 1.701-2(a).

[479] Treas. Reg. sec. 1.701-2(b).

[480] Treas. Reg. sec. 1.701-2(e).

[481] *Id.*

Summary

The present-law rules discussed above were integral to effectuating the beneficial tax results sought by Enron in Projects Tomas, Condor, Tammy I, and Tammy II. Project Tomas uses the partnership distribution rules in connection with the corporate tax-free liquidation provisions to generate tax deductions without an economic outlay. Projects Condor, Tammy I, and Tammy II use the partnership allocation rules and the non-recognition treatment accorded to dealings in one's own stock to purportedly enable Enron to generate tax deductions without an economic outlay.

2. Project Tomas

Brief overview

Project Tomas was structured to increase the tax basis of a portfolio of leased assets that Enron liquidated. The increased basis of the assets eliminated approximately $270 million of taxable gain for Enron on the disposition of the property. The transaction involved the assumption, and repayment, of debt to increase the basis of the assets without an economic outlay. At the same time, Enron took the position that tax savings from the transaction generated financial accounting earnings of $18.1 million for 1998, and $18.4 million for 2000.

The transaction involved the formation of a partnership between an existing Enron subsidiary holding low-basis leased assets, and two subsidiaries of Bankers Trust. By contributions to the partnership, and later liquidation of the Enron subsidiary's interest in the partnership, the Bankers Trust subsidiaries acquired the leased assets. Later, through the partnership, they would start to sell them off.

When the partnership was formed, the Enron subsidiary, PGH, contributed both the portfolio of depreciable assets that had high value but a low tax basis, and all the stock of another corporation, Oneida. The Bankers Trust partners contributed cash for small partnership interests. The partnership assumed a large amount of debt. Oneida, the corporation whose stock the partnership held, received valuable assets in the form of notes receivable from a Bankers Trust affiliate. After a period of time, the partnership distributed the stock of Oneida back to the Enron affiliate, PGH, in redemption of its partnership interest. The basis of the Oneida stock was reduced, under the tax law, to equal the amount of PGH's low basis in its partnership interest.

At the same time, the partnership made a 754 election to increase the basis of the depreciable assets it retained. The basis increase was equal to the amount of the reduction in basis of the distributed Oneida stock. No corresponding reduction in the basis of Oneida's assets, however, was required under the law in effect at the time of the transaction. Thus, the basis of those assets was unaffected by the distribution of corporate stock, while the amount of the reduction in stock basis resulting from the distribution was added to the basis of the partnership's remaining assets. In effect, this amount of basis was duplicated in the transaction, and this duplicated amount of basis was shifted from the corporate stock to the partnership's other assets, that is, the portfolio of leased assets. Gain on their later sale would be reduced by this increase in basis.

Background[482]

Reported tax and financial statement effects

Enron reported that it was not subject to tax on approximately $270 million of built-in gain.[483] This tax benefit is attributable to the step-up in the basis and subsequent disposition of the leased assets without Federal income tax on the built-in gain.[484] Since the transaction was put in place in 1998, subsequent tax legislation has changed some of the tax results of this type of transaction.[485]

Enron reported annual financial statement benefits from the Tomas transaction of $18.1 million for 1998, and $18.4 million for 2000.[486] It is represented that current management is not aware of any reversals of these financial statement benefits.[487]

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[482] The information regarding Project Tomas was obtained from Joint Committee staff interviews of Mr. Hermann and Mr. Maxey, as well as from documents and information provided by Enron and the IRS.

[483] Enron Corp. Presentation to Joint Committee on Taxation staff, Washington, D.C., June 7, 2002, at 26. Appendix B, Part I contains this document.

[484] The Structured Transactions Group, Summaries of Project Earnings and Cash Flows, November 2001 (which is contained in Appendix B, Part I) showed that the estimated current tax benefit attributable to Project Tomas was $109 million as of the end of 2001.

[485] Sec. 538 of Pub. L. No. 106-170, the "Ticket to Work and Work Incentives Improvement Act of 1999," provided for a corresponding reduction in the basis of assets of a distributed corporation controlled by a corporate partner.

[486] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, January 13, 2003, answer 101.

[487] *Id.* Another Enron calculation of the financial statement benefits of Project Tomas differed. The Structured Transactions Group, Summaries of Project Earnings and Cash Flows, November 2001 (which is contained in Appendix B, Part I) showed that the net income for financial reporting purposes from Project Tomas totalled approximately $113 million through 2001. The yearly financial statement income or loss shown was $55.99 million in 1998, $9.85 million in 1999, and $51.29 million in 2000, with losses of under $10 million estimated or projected for 2001 through 2004, and smaller amounts of income projected annually through 2010.

Development of Project Tomas[488]

Portland General Holdings ("PGH"), a wholly-owned Enron subsidiary acquired in 1997, held "burned-out" leases of depreciable property. These leased assets were held through subsidiaries of PGH. The leased assets consisted of property such as commercial aircraft, containers for containerized shipping, and rail cars, as well as other types of assets such as an acid-recovery plant used in making pickles. The leases were "burned out" in the sense that the tax basis of the leased property had been reduced to approximately $8 million, a small fraction of the property's value, by depreciation deductions. Nevertheless, the property had substantial economic value of approximately $280 million (not taking into account nonrecourse debt of approximately $170 million).

In December of 1997, Enron received a letter from Arthur Andersen regarding a technique for "permanent gain deferral."[489] The letter described "a technique through which a corporate partner may redeem its partnership interest while minimizing any potential tax consequences on the redemption."[490] The letter urged, "[b]ecause of the substantial benefits that the product provides, and the possibility of legislative action, you should be advised to utilize the technique now, as its shelf life may be limited."[491]

At Enron, Project Tomas was approved by the Enron Board of Directors Executive Committee at a meeting on March 2, 1998.[492] At a meeting of the Board of Directors of Enron Corp. on May 4-5, 1998, Mr. John Duncan reported to the Board that the Executive Committee had approved Project Tomas.[493]

Although $250 million of debt used in the transaction was incurred in July of 1998, the Enron tax department was still considering modifications to the series of transactions involved in Project Tomas during August of 1998.[494]

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[488] Like several other transactions in which Enron affiliates engaged, Project Tomas was named after a recent hurricane beginning with the letter "T."

[489] Letter from Robert P. Palmquist of Arthur Andersen to Mr. David Maxey of Enron dated Dec. 11, 1997, EC2 000038050 - EC2 000038052.

[490] *Id.*

[491] *Id.*

[492] Minutes, Meeting of the Executive Committee of the Board of Directors, Enron Corp., March 2, 1998, EC2 000037991 - EC2 000037994.

[493] Minutes, Meeting of the board of Directors, Enron Corp., May 4-5, 1998, EC2 000037995 - EC2 000037996.

[494] Project Tomas, August 4, 1998, EC2 000038005 - EC2 000038018; Project Tomas, August 14, 1998, EC2 000038019 - EC2 000038032.

Project Tomas' tax goal was to increase the tax basis of the "burned-out" leased property without incurring tax, permitting elimination or reduction of gain (or increase of loss) on the later sale of the depreciable property (or greater depreciation deductions in the future). The transaction was designed to result in the liquidation of these assets for Enron. At the same time, the financial accounting goal was to increase earnings. The financial accounting treatment (to increase earnings) was the opposite of the tax treatment (to eliminate or reduce gains).

Implementation of Project Tomas

PGH, a wholly-owned Enron affiliate acquired in 1997, owned a portfolio of leased assets through subsidiaries.[495] In total, the leased assets had a fair market value of approximately $280 million and were encumbered by non-recourse debt totaling approximately $170 million. The tax basis of the leased assets was approximately $8 million.

PGH also owned all the stock of Oneida Leasing, Inc. ("Oneida"). Oneida had no significant assets at the beginning of the transaction.

On July 17, 1998, PGH borrowed approximately $250 million on a recourse basis from Toronto Dominion, an unrelated Texas bank.[496] This recourse debt was not secured by any property, although Enron guaranteed the debt. On the same date, PGH contributed the $250 million cash proceeds to its subsidiary, Oneida. Oneida in turn loaned $250 million to Enron in exchange for Enron's demand promissory note, also dated July 17, 1998.[497] Thus, the $250 million cash proceeds were cycled from PGH through its subsidiary, Oneida, and then back to Enron, the guarantor of the Toronto Dominion debt. PGH was still liable on its $250 million recourse debt to the Toronto Dominion bank.

On September 9, 1998, PGH formed a partnership with two affiliates of Bankers Trust. PGH's two partners were BT Leasing and EN-BT Delaware. The partnership was named Seneca Leasing Partners, L.P. ("Seneca"). The three partners of Seneca contributed assets to the partnership in exchange for their interests in the partnership.

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[495] One of the subsidiaries was Columbia Willamette Leasing, Inc. ("CWL"). CWL in turn owned all the stock of Rail Leasing, Inc. ("Rail Leasing"). CWL held 16 groups of leased assets (the aircraft, containers for shipping, and similar large assets), and Rail Leasing held one lot of leased rail cars. On September 4 and September 10, 1998, CWL and Rail Leasing merged into their parent corporation, PGH. As a result of these two mergers, PGH owned all of the assets formerly held by CWL and Rail Leasing, which consisted of the 17 groups of leased assets.

[496] The loan was due on or before October 30, 1998.

[497] The terms of the demand note were that Enron agreed to pay the principal amount upon the carlier of demand or July 31, 2003.

On September 15 and 30, 1998, PGH transferred the leased assets to the Seneca partnership.[498] PGH also transferred all of the Oneida stock to Seneca on September 15, 1998. In exchange for the assets and stock it contributed, PGH received a 95-percent limited partnership interest.

PGH's limited partnership interest in Seneca provided for a floating preferred return on approximately $68 million of its capital in the partnership. This limited partnership interest also included a retirement right, permitting PGH to withdraw from the partnership after two years.[499] On September 16, 1998, PGH transferred its limited partnership interest to PGH LLC, a Delaware limited liability company formed two days before that was disregarded (treated as part of PGH) for Federal income tax purposes.

BT Leasing, one of the two Bankers Trust affiliates that were partners in Seneca, contributed approximately $9 million cash to Seneca in exchange for a four-percent general partnership interest. The other partner, EN-BT Delaware, contributed approximately $2 million cash to Seneca in exchange for a one-percent general partnership interest.[500]

On September 15, 1998, the partnership, Seneca, assumed the $250 million recourse debt from PGH to Toronto Dominion. As a result, BT Leasing and EN-BT Delaware, as general partners of Seneca, became primarily liable on the debt. Enron remained as guarantor of this $250 million debt for two more days until the debt was repaid.

On September 15, 1998, the $250 million PGH had borrowed in July from Toronto Dominion changed hands several times. On that date, but prior to the contribution of Oneida stock to the partnership, Enron transferred approximately $250 million cash to Oneida in satisfaction of Enron's July 17 demand promissory note to Oneida. Oneida loaned approximately $250 million on a recourse basis to Bankers Trust in exchange for Bankers Trust's

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[498] The fair market value of the 17 leased assets remained at approximately $280 million on PGH's transfer to the partnership and the non-recourse debt encumbering the assets remained at approximately $170 million. As of September 15, PGH transferred 16 of the 17 groups of assets, and was obligated to transfer the 17th leased asset (a Mack Truck facility) or its cash equivalent value to Seneca, and did transfer the 17th leased asset to Seneca on September 30, 1998.

[499] Under the retirement right associated with this partnership interest, at any time after two years from September 30, 1998, PGH LLC, as the transferee of PGH's 95 percent limited partnership interest in Seneca, could exercise its right to compel the partnership to liquidate its interest in exchange for assets of the partnership. PGH LLC was to receive distributions in an amount equal to the positive balance in its capital account (adjusted to account for revaluation of partnership assets), plus the amount of nonrecourse debt assumed by it.

[500] BT Leasing and EN-BT Delaware were to pay all ordinary and necessary expenses of Seneca in exchange for a management fee of $300,000 per year. Pursuant to a service agreement dated September 15, 1998, Oneida was required to pay BT Leasing $300,000 per year to act as its agent to engage in the business of owning and operating a portfolio of leased equipment.

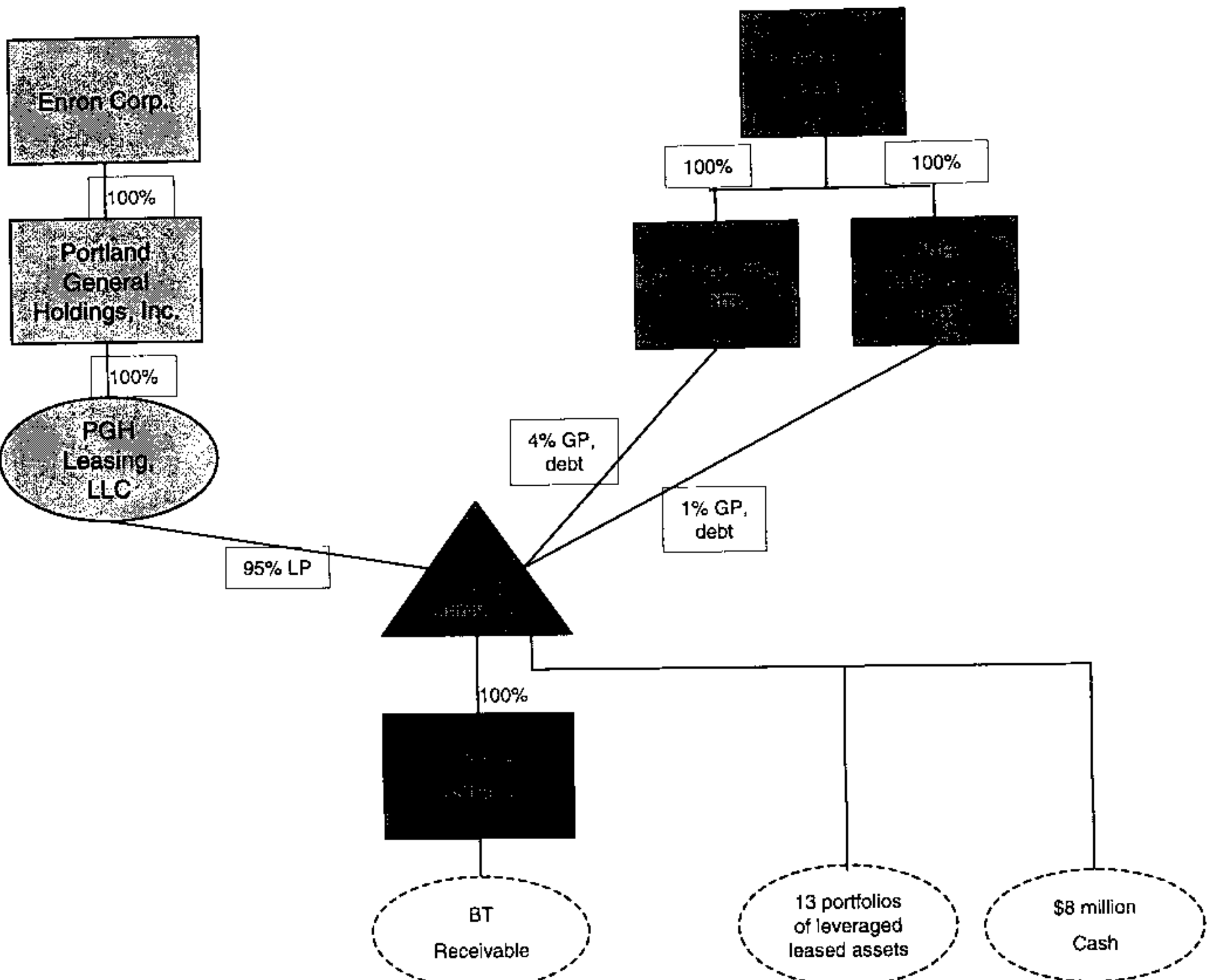
demand promissory note. In turn, Bankers Trust loaned approximately $250 million on a recourse basis to Seneca in exchange for Seneca's note. Seneca repaid $250 million to Toronto Dominion on September 17, 1998.

The end result of the borrowings and repayments on September 15 and 17 among Enron, PGH, Oneida, Seneca, and Bankers Trust was that Oneida held a note receivable from Bankers Trust for approximately $250 million.

The following diagram depicts the structure of Project Tomas after the formation of and contributions to the partnership in September, 1998.

Confidential

Project Tomas
Structure as of September 30, 1998



Less than two years later, in June 2000, PGH LLC (the wholly-owned company to which PGH had transferred its partnership interest in Seneca) gave notice of its intent to withdraw from the Seneca partnership. Pursuant to the retirement right under PGH LLC's 95-percent limited partnership interest, this notice triggered a public bid valuation process to determine the retirement price. The actual distribution of Oneida stock did not take place until just over two years after the last contribution of property by PGH to the Seneca partnership on September 30, 1998.

On October 2, 2000 (two years and two days after the last contribution to the partnership on Sepptember 30, 1998), PGH LLC's interest in the partnership was liquidated. Seneca distributed the Oneida stock to PGH LLC, the Enron subsidiary, in liquidation of its partnership interest. Because the value of Oneida stock was greater than PGH LLC's capital account in the partnership, PGH LLC also assumed debt of Seneca.[501] The amount of debt assumed was approximately equal to the excess of the value of Oneida stock over PGH LLC's capital account.

Under the tax rules, PGH LLC's basis in the distributed Oneida stock was equal to PGH LLC's basis in its partnership interest (adjusted for the debt assumed in liquidation). As a result, the basis of the Oneida stock was required to be reduced in the hands of PGH LLC.

Seneca made a section 754 election and increased the basis of its remaining property, the leased assets.[502] PGH's low basis in its stock of Oneida would become irrelevant on a liquidation of Oneida into PGH, under the partnership tax rules then in effect, because at that time, the basis of the property inside Oneida was not required to be reduced corresponding to the reduction in the basis of Oneida stock.

Role of outside advisors

Bankers Trust signed an engagement letter dated September 15, 1998, agreeing to serve as Enron's exclusive financial advisor for the transaction.[503] The letter provides that a partnership would be structured between Enron representatives and Bankers Trust

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[501] Oneida issued a demand promissory note to Bankers Trust for $156 million on October 2, 2000 (the date PGH LLC's interest in the Seneca partnership was liquidated). On that same date, Bankers Trust demanded payment of the $156 million, and the note was cancelled. Meanwhile, Bankers Trust agreed to pay Oneida $21 million, in a demand promissory note also dated October 2, 2000. Demand Promissory Note, $156,005,946, October 2, 2000 (ECx000007853 - ECx000007855); Letter of Bankers Trust to PGH Leasing, LLC, Attention: Mr. R. Davis Maxey (October 2, 2000), ECx000007871; Cancelled - Demand Promissory Note, $156,005,946, October 2, 2000, ECx000007872 - ECx000007874; Demand Promissory Note, $21,661,889.67, October 2, 2000, ECx000007876 - ECx000007878.

[502] In April 1999, two of the leased assets were sold to the lessees and a third lease was renegotiated and renewed.

[503] Letter of Brian J. McGuire of Bankers Trust to Mr. Richard A. Causey of Enron, dated September 15, 1998, EC2 000038045 - EC2 000038049. Appendix B, Part VI contains this document.

representatives for purposes of the transaction. Bankers Trust agreed to advise and assist in designing an appropriate structure for the transaction and to perform other services. Bankers Trust would be paid fees of $10 million. This amount did not include fees for additional services such as leased asset management and disposition fees, swaps, bridge financing, valuation services and other services. As of June 4, 2001, Bankers Trust was paid an estimated $11.875 million in project fees in connection with Project Tomas.[504]

The opinion letter regarding the Federal tax issues in the transaction[505] was provided by Akin, Gump, Strauss, Hauer & Feld, L.P. ("Akin, Gump"), and was dated November 23, 1998 (after the formation of and contributions to the partnership in September, 1998). In its opinion letter, Akin, Gump concluded that (1) mergers of PGH subsidiaries holding the leased assets should be treated as corporate liquidations, (2) Seneca should be treated as a partnership for Federal tax purposes, (3) PGH's transfers of the leased assets and the stock of Oneida to Seneca should be tax-free contributions to a partnership, (4) neither the Seneca's receipt of the leased assets subject to $170 million nonrecourse debt, nor Seneca's assumption of the $250 million recourse debt, should be treated as a disguised sale taxable to PGH, (5) the nonrecourse debt should be allocated to PGH first to the extent of the partnership's minimum gain, second to the extent of PGH's precontribution gain, and third, in accordance with its 95-percent profit share, (6) PGH LLC will disregarded for Federal tax purposes, (7) no gain should be recognized in the event PGH LLC exercises its retirement right and receives distributions of cash, the leased assets and stock of Oneida, no gain should be recognized to PGH LLC (except to the extent cash distributed exceeds its basis), because the exceptions for distributions of property the partner contributed should apply, and (8) the foregoing opinions should not be subject to change under the business purpose doctrine, section 269 (relating to acquisitions made to evade or avoid income tax), the substance-over-form doctrine, or the section 701 partnership anti-abuse regulations. Akin, Gump was paid fees of $813,694 in connection with Project Tomas.[506]

In addition, the firm of Andrews & Kurth provided legal counsel with respect to aircraft sales that were planned to take place following operation of the partnership created in the Project Tomas transactions.[507] Accounting support was provided by Arthur Andersen.[508]

As of June 4, 2001, project fees had been paid to several parties in connection with Project Tomas, in addition to Bankers Trust and Akin, Gump. Arthur Andersen, Enron's auditor,

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504 Estimated Project Fees Paid to Date, 6/4/2001, EC2 000036379. Appendix B, Part I, contains this document.

505 Appendix C, Part VI to this Report contains the Akin, Gump tax opinion letter Enron received in connection with Project Tomas (EC2 000033917 - EC2 000033979).

506 Estimated Project Fees Paid to Date, 6/4/2001, EC2 000036379. Appendix B, Part I, contains this document.

507 Project Tomas, Advisory History, EC2000037987.

508 *Id.*

was paid fees of $252,593 in connection with Project Tomas. In addition, another $600,000 in fees was paid to "others" in connection with the transaction.[509]

Subsequent developments

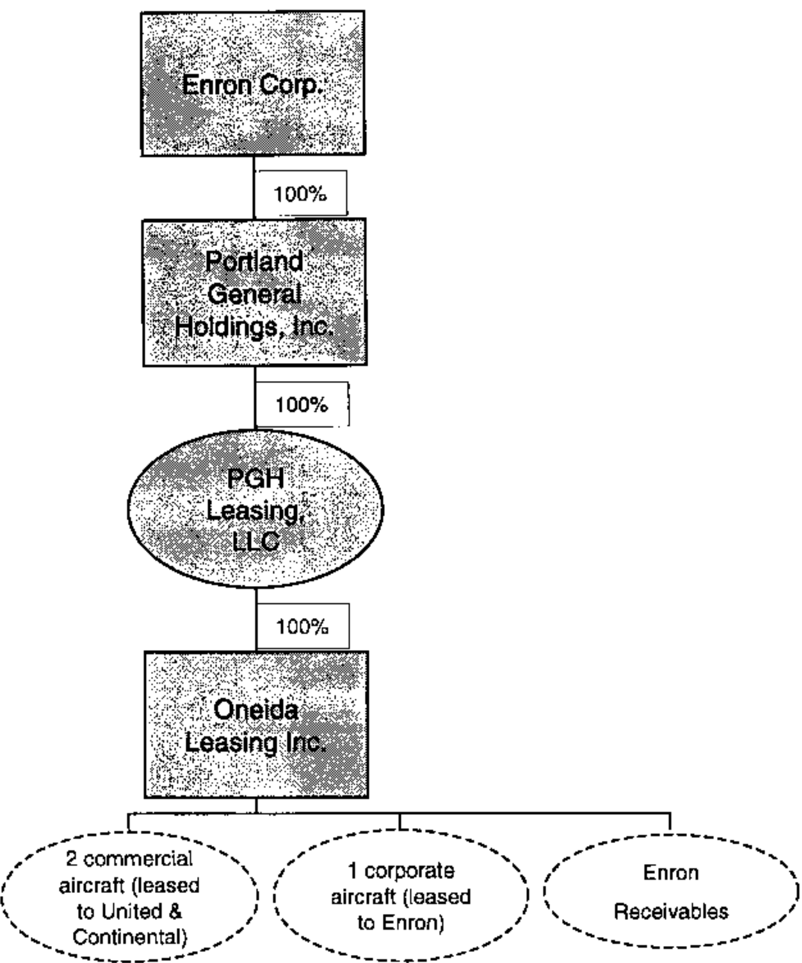
PGH LLC's interest in the Seneca partnership was liquidated on October 2, 2000, just over two years after the assets had been contributed to the partnership in September, 1998. After the liquidation of PGH's LLC interest, the leased assets remained in the partnership. The partnership was owned by the remaining two partners, the two Bankers Trust affiliates (BT Leasing and EN-BT Delaware). Thus, Enron no longer had an interest in the leased assets held by the partnership.

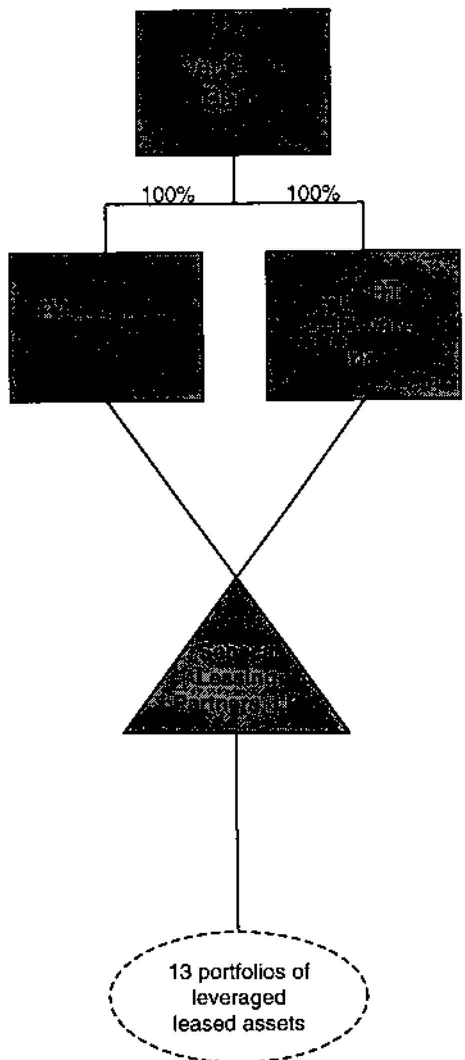
The following diagram depicts the structure of Project Tomas after the liquidation of the partnership interest of the Enron affiliate, PGH LLC, on October 2, 2000.

[509] Estimated Project Fees Paid to Date, 6/4/2001, EC2 000036379. Appendix B, Part I, contains this document.

Confidential

Project Tomas
Structure as of December 31, 2001





U. S. Tax/GAAP Legend

- Enron GAAP Consolidated
- Third Parties
- Equity Method Investment
- Corporation
- Partnership
- Branch
- Assets

After PGH LLC's interest in Seneca was liquidated in October, 2000, the Seneca partnership sold 18 of its assets on three dates in December, 2000.[510] The sale price for 11 of these assets was reported to be equal to the tax basis, due to the basis increase claimed pursuant to the Tomas transaction. Thus, the Seneca partners (the Bankers Trust affiliates) would have had no taxable gain to report with respect to these 11 sales. In addition to the sales in 2000, the Seneca partnership had sold four assets during 1999, at least one at a loss.[511]

Later, in December 2001, Oneida collected on a "large Deutsche Bank receivable."[512] Bankers Trust had been acquired by Deutsche Bank, so this receivable may have been the note receivable from Bankers Trust for $250 million that Oneida entered into in 1998, in the course of Project Tomas.[513]

One of the representations made by PGH described in the Akin, Gump opinion letter was that PGH intended "that Oneida acquire a substantial portfolio of lease equipment that will further diversify the Partnership's portfolio of equipment."[514] In July 2000, Oneida had acquired two leased assets.[515] These two assets were aircraft, one a Boeing 747 leased to United Airlines, and the other a McDonnell-Douglas DC-9 leased to Continental Airlines. This acquisition preceded by a few months the October, 2000, distribution of Oneida's stock by the Seneca partnership in liquidation of the partnership interest of Enron's subsidiary, PGH LLC. Towards the end of 2001, after Oneida had been distributed to PGH, Enron contacted 13 potential counterparties in connection with disposing of the aircraft. In June, 2002, the sale of the two commercial aircraft by Oneida for $10.3 million (reduced by approximately $4 million of back

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[510] December 11, 20 and 21, 2000, as provided in Exhibit XX -- Sales of Leased Assets by Seneca Leasing Partners, L.P., EC2 000054818. Appendix B, Part VI, contains this document.

[511] The assets sold in by Seneca in 1999 were: Acid Recovery Plant, sold 4/1/99 for $4,649,500 (though the tax basis was $1,278,230, giving rise to a tax loss); Rail Cars (CSX 1998-1), sold 1/4/99 for $8,908,000; Rail Cars (SOO Line 1989), sold 8/2/99 for $32,198; and Tank Cars (GATC 86-1), sold 2/12/99 for $13,871. The tax basis for the latter three items was not stated on Exhibit XX -- Sales of Leased Assets by Seneca Leasing Partners, L.P., EC2 000054818. Appendix B, Part VI, contains this document.

[512] Structured Transactions Group, Summaries of Project Earnings and Cash Flows, November 2001. Appendix B, Part I contains this document.

[513] Oneida also held a demand promissory note of Bankers Trust for $21 million, dated October 2, 2000 (the date PGH LLC's interest in the Seneca partnership was redeemed). Demand Promissory Note, $21,661,889.67, October 2, 2000, ECx000007876 - ECx000007878.

[514] Akin, Gump opinion letter at 10. Appendix C, Part VI, contains this document.

[515] Structured Transactions Group, Summaries of Project Earnings and Cash Flows, November 2001. Appendix B, Part I contains this document.

rent and interest due) was approved by Enron.[516] Oneida also acquired a corporate aircraft that was leased to Enron.[517]

Discussion

The result of the series of transactions comprising Project Tomas was that Enron had disposed tax-free of a portfolio of leased assets that had a built-in gain of $270 million, while the tax basis of assets that Enron received in exchange (i.e., assets held by Oneida) was not reduced. Further, the $270 million built-in gain ultimately was not taxed to the Bankers Trust affiliates that (through the partnership) commenced selling off the portfolio of leased assets.

This permanent tax saving associated with Project Tomas resulted in a significant financial accounting benefit to Enron. Enron could not immediately utilize some types of tax benefits, such as increased deductions or losses, as it was already in a loss position with NOL carryovers. Rather, the permanent tax saving that led to the financial statement benefits from Project Tomas arose from the fact that the Enron received Oneida's underlying assets with a high tax basis without incurring an economic cost (i.e., the recognition of gain on disposed leased assets).

Sale of the leased assets

Central to the structure of Project Tomas was the use of a partnership as a means of exchange between Enron and Bankers Trust of the leased assets that Enron disposed of. Several provisions of present law, designed to prevent the characterization of an otherwise taxable sale as a tax-free partnership contribution and distribution, are implicated in the transaction.

Receipt of property that the Enron affiliate had contributed to the partnership.–Seneca's distribution of the Oneida stock raises the issue of the potential for gain recognition under the "seven-year" rule of present law. Under this rule, gain or loss is recognized on a distribution of partnership property, if a partner contributed property with built-in gain or built-in loss (i.e., the leased assets), and that partner receives a distribution of other property (i.e., stock of a corporation, Oneida, holding a large note) within seven years of the contribution.[518] If this gain recognition rule applied in Project Tomas, PGH LLC would be required to include in income the pre-contribution gain of approximately $270 million on the leased assets when Seneca distributed the Oneida stock.

The transaction is structured so as to rely on the exception providing that this gain recognition rule does not apply to a distribution of property that the distributee partner

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[516] Enron Risk Assessment and Control - Deal Approval Sheet, dated June 26, 2002. EC2 000038061 - EC2 000038065. Appendix B, Part VI contains this document.

[517] Enron Corp. Presentation to Joint Committee on Taxation staff, Washington, D.C., June 7, 2002, Appendix at A-8. Appendix B, Part I contains this document.

[518] Sec. 737.

contributed to the partnership.[519] However, the present-law exception goes on to provide if the property distributed is an interest in an entity (e.g., corporate stock), the exception from gain recognition does not apply to the extent the value of the interest is attributable to property contributed to the entity after the entity was contributed to the partnership. Although the Akin, Gump opinion letter refers to several examples in the regulations in which partnership distributions of stock were taxed to the extent of the value added to a corporation after its stock is contributed to the partnership, the opinion letter does not apply this notion to Seneca's distribution of the Oneida stock. The Akin, Gump opinion letter does not address the point that the $250 million in value was contributed by PGH to Oneida less than two months before the Oneida stock was contributed to the partnership, nor that Enron paid $250 million to Oneida in satisfaction of its note on the same day, September 15, that the Oneida stock was contributed to the partnership. Whether there should be a link between these events as part of an overall planned transaction is not addressed.

Disguised sale treatment.–The tax opinion letter does not discuss whether the contribution of leased assets and the distribution of Oneida stock, taken together, should be characterized as a disguised sale.[520] The Akin, Gump opinion letter refers to the distribution of the Oneida stock hypothetically, "in the event that PGH exercises the retirement right."[521] Nevertheless, it could be inferred that the transaction was deliberately structured to attempt to avoid the disguised sale rules, by ensuring that the partnership distribution does not take place until two years and two days after the last contribution.

Treasury regulations provide a presumption that a transaction does not amount to a disguised sale if the transfer of property and the related contribution of property to the partnership take place more than two years apart.[522] Under these regulations, such transfers are presumed not to be a sale "unless the facts and circumstances clearly establish that the transfers constitute a sale."[523] The two-year presumption in the regulations has two aspects. First, if the contributing and distributing transfers are made within two years, there is presumed to be a sale, unless the facts and circumstances clearly establish there is not a sale. Disclosure to the IRS is required.[524] Second, if the contributing and distributing transfers are made more than two years

[519] Sec. 737(d). Akin, Gump opinion letter at 33-34. Appendix C, Part VI contains this document.

[520] The tax opinion does discuss whether the partnership's taking the leased assets subject to $170 million of nonrecourse debt, and the partnership's assumption of $250 million of recourse debt, constitute disguised sales of all or part of the leased assets or the Oneida stock PGH contributed to the partnership. Based on a technical analysis applying debt proceeds tracing rules, the opinion concludes that neither constitutes a disguised sale. Akin, Gump opinion letter at 26. Appendix C, Part VI contains this document.

[521] Akin, Gump opinion letter at 31. Appendix C, Part VI contains this document.

[522] Treas. Reg. sec. 1.707-3(d).

[523] *Id.*

apart, the transfers are presumed not to be a sale, unless the facts and circumstances clearly establish that the transfers constitute a sale.[525] No disclosure is required.

Structuring a transaction so that the partnership contribution and distribution are two years and two days apart, as in the case of Project Tomas, may be a fact indicating that a sale should be presumed. Further, the fact that PHG LLC had a "retirement right" under the partnership agreement, permitting it to compel the partnership to liquidate its interest in the partnership after two years, may be a fact indicating that PGH LLC bore very little risk during the two-year period and that it effectively was disposing of the leased assets despite its retention of a 95-percent interest in the partnership during the two-year period. For the IRS to administer this determination based facts and circumstances may be difficult, however, without any requirement of disclosure in the case of transfers more than two years apart.

Partnership anti-abuse rules.–The partnership anti-abuse 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 tax rules governing partnerships), the Commissioner can recast the transaction for Federal tax purposes to achieve tax results that are consistent with the intent of subchapter K.[526] The opinion letter concludes that this rule should not result in recasting the transaction to provide that the Oneida stock was never contributed to the partnership, because PGH LLC has a low basis in the Oneida stock upon its distribution. However, the fact that PGH LLC had easy access to the high-basis, high-value assets Oneida held through the simple expedient of liquidating Oneida[527] cannot be dismissed as irrelevant to the rules of partnership taxation,[528] as it was available to achieve the tax savings that were central to Project Tomas. The use of a partnership to achieve the tax-free disposition of built-in gain assets should be considered inconsistent with the intent of subchapter K, within the meaning of these regulations.

Tax legislation over the past two decades has included several provisions intended to prevent the use of partnerships as a vehicle to disguise sales of assets as tax-free transactions. In 1984, Congress enacted the rule providing that if there is a transfer of money or other property

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[524] Treas. Reg. sec. 1.707-3(c).

[525] Treas. Reg. sec. 1.707-3(d).

[526] Treas. Reg. sec. 1.701-2(b).

[527] Sec. 332, discussed in the Akin, Gump opinion letter at 48. Appendix C, Part VI contains this document.

[528] This argument is made in the Akin, Gump opinion letter at 48. Appendix C, Part VI contains this document. Partnership tax legislation enacted in 1999, before the distribution of Oneida stock was consummated, would have applied to this transaction and required that the basis of Oneida's assets be reduced, except for a transition rule providing a two-year window for distributions from existing partnerships. See Pub. L. No. 106-170, section 538(a) (December 17, 1999), enacting section 732(f).

by a partner to a partnership and there is a related transfer of money or other property by the partnership to such partner, the two transfers (when viewed together) may be properly characterized as a sale or exchange of property and will therefore be treated as such. In 1989 and 1992, Congress added rules requiring gain recognition with respect to appreciated property contributed to a partnership in the event that distributions (either of the contributed property to a noncontributing partner, or of other property to the contributing partner) are made within seven years of the contribution.[529] Though it postdates the initiation of Project Tomas, in 1999, Congress enacted rules providing that the basis of a corporation's assets is reduced to parallel the reduction in the basis of the corporation's stock when it is distributed to a partner with a low basis in its partnership interest.[530] The enactment of these rules indicates a concern over the use of partnerships to transfer property among persons in a manner that avoids tax that would be due on sale of the property. Project Tomas' use of partnership rules for a tax-free disposition of the leased assets owned by Enron affiliates to the Bankers Trust affiliates, who remained as partners after the Enron affiliate retired from the partnership, contravenes the intent of this legislation in subchapter K.

Use of debt

In the Project Tomas transaction, the basis increase to the leased assets arose from recent debt incurred by an Enron affiliate and guaranteed by Enron. Whether this debt had real economic substance apart from its use to facilitate tax benefits in the transaction could be questioned. This debt was cycled through Oneida, assumed by the partnership and was paid off by the partnership within two months of when the debt was incurred. As the proceeds of the debt were passed from one party to the transaction to another, a debt obligation of Bankers Trust to Oneida was created that later may have served as Bankers Trust's "payment" to Enron in the "sale" of the leased assets. The purpose, function, and economic substance of debt whose proceeds are rapidly cycled through parties to a complex transaction warrant close examination.

Business purpose

Scrutiny of Project Tomas as a whole, rather than as numerous separate pieces of a complex series of transactions, gives a different picture of the goal of the transaction. While the tax opinion concluded that utilizing the lease management expertise of Bankers Trust was an appropriate business purpose for the transaction, it also concluded that the expectation of financial accounting benefits constituted a business purpose.[531] The tax benefits with respect to a transaction that satisfies the literal requirements of a particular tax provision may not be respected if the transaction fails the statutory rules and judicial doctrines (such as business purpose and economic substance) that are often applied to evaluate the purported tax benefits in

[529] Secs. 704(c)(1)(B) and 737.

[530] Sec. 732(f).

[531] Akin, Gump opinion letter at 7. Appendix C, Part VI contains this document.

tax-motivated transactions. Therefore, any analysis of whether the tax benefits in Project Tomas would be respected must take into account the applicability of these doctrines.[532]

Duplication of tax basis of assets

The opinion letter for Project Tomas did not address the issue of whether the basis of Oneida's assets should be reduced to parallel the reduction in the basis of the Oneida stock when it was distributed to a partner with a low basis in its partnership interest.[533] The provision that would require such a reduction in the basis of Oneida's assets was not enacted until 1999.[534] This provision was designed to prevent taxpayers from nullifying the downward basis adjustment to property distributed by a partnership to a corporate partner with a low basis in its partnership interest. If the property distributed to a corporate partner is corporate stock, then a subsequent liquidation of the corporation so distributed could nullify the required adjustment to the stock basis, if the basis of the distributed corporation's assets is not also reduced.

Enron was made aware of the likelihood of legislative change in this area as Project Tomas was being planned. The December 11, 1997, letter from Arthur Andersen to Enron setting forth an early version of the Project Tomas transaction describes this technique, and notes that among the possible risks of doing such a transaction would be the risk that Congress would change the rule, identifying it as "a possible target for legislative change."[535] The letter concluded, "[b]ecause of the substantial benefits this product provides, and the possibility of legislative action, you should be advised to utilize the technique now, as its shelf life may be

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[532] For detailed information on 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).

[533] The opinion letter did refer to possible legislation, but concludes that Congress "has chosen not to revise the Code in such a fashion." Akin, Gump opinion letter at 48. The provision was enacted on December 17, 1999 (Pub. L. No. 106-170).

[534] Sec. 732(f). In the case of a partnership already in existence on July 14, 1999, the rule applied to distributions after June 30, 2001. The distribution of the Oneida stock by the Seneca partnership took place on October 2, 2000.

[535] Letter from Robert P. Palmquist of Arthur Andersen to David Maxey of Enron Corp., dated December, 11, 1997, EC2 000038050 – EC2 000038052. Appendix B, Part VI contains this document.

limited."[536] The assets of the distributed corporation, Oneida, consisted principally of a note from Bankers Trust.[537] If the basis of the note had been reduced, Enron affiliates would have been subject to tax on the gain when the notes were collected or when Oneida was liquidated.

In enacting the downward basis adjustment rule[538] in 1999, Congress directly addressed the type of basis duplication that occurred in the Tomas transaction. Had the downward basis adjustment rule applied to the Tomas transaction, Enron would not have been able to take the position that the transfer of the portfolio of leased assets to the Bankers Trust affiliates that remained as Seneca partners would result ultimately in no tax to Enron or its affiliates. Gain would have resulted from liquidation of Oneida or sale or other disposition of the assets held by Oneida. Project Tomas was the only transaction of this type in which Enron engaged.

Recommendations

To dispose of the leased assets with a stepped-up basis without incurring tax, Enron formed a partnership with Bankers Trust, which in essence served as an accommodation party in the transaction. Without a willing though unrelated third party to hold the leased assets through a partnership for at least two years before selling them off, the tax savings and financial statement benefits claimed through the use of this structure would not have been possible. Use of accommodation parties to achieve results under tax rules that contemplate parties with adverse interests can give rise to unintended results. The Joint Committee staff recommends that use of accommodation parties under the tax rules be addressed.

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. Congress has repeatedly enacted legislation to limit the utility of partnerships as vehicles for the tax-free disposition of assets. However, enforcement some of these rules, especially those involving a facts and circumstances determination, may be difficult without adequate disclosure of the transactions to the IRS. For example, extending the disclosure requirement under the disguised sale rules to seven years, the period applicable to contributions and distributions under the pre-contribution gain rules,[539] could make a facts and circumstances determination by the IRS both more likely to occur and easier for the IRS to administer. Despite the possible recordkeeping burden it might impose on taxpayers, a longer disclosure period would facilitate examination of tax motivated transactions without impeding legitimate joint ventures.

For the IRS to identify this transaction on Enron's voluminous tax return may be difficult without specific signposts pointing to it, because the high basis in Oneida's assets would be

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[536] *Id.*

[537] Oneida also acquired two commercial aircraft, which it sold in 2002, and a corporate jet leased to Enron.

[538] Sec. 732(f).

[539] Secs. 704(c)(1)(B) and 737.

recovered primarily as depreciation deductions over time, or as the absence of gain recognition on receipt of payment on a note Oneida held. As a corollary to increased disclosure of contributions to and distributions from partnerships, a more detailed or earlier disclosure to the IRS of the source of permanent book-tax differences could facilitate the discovery of questionable transactions on audit.

3. Project Condor

Background

Brief overview

Project Condor[540] was structured to generate approximately $930 million of Federal income tax deductions without incurring any economic outlay. In addition, because there was no corresponding financial statement expense, the tax savings associated with these deductions were anticipated to generate approximately $330 million after-tax financial statement income. Enron intended to report the $330 million of financial statement income over the anticipated 16-year life of the structure, whereas the $930 million of Federal income tax deductions were not anticipated to be available to offset Enron's taxable income until beginning in 2015.

The structure involved the use of an existing partnership, Whitewing Associates, LP ("Whitewing LP"), between Enron Corp. and an outside investor (the "Osprey Invesors") that held Enron Corp. preferred stock.[541] In 1999, purportedly in connection with a restructuring of the partnership, Houston Pipe Line Company ("HPL"), a wholly owned subsidiary of Enron Corp., contributed natural gas pipelines and related storage facilities (the "Bammel Assets") with a fair market value of approximately $930 million and minimal tax basis[542] to Whitewing in return for a preferred partnership interest. The contributed assets were immediately leased back to HPL for a period of 18 years.

Because the fair market value of the Bammel Assets was different than their adjusted tax basis, the partnership tax rules operate to specially allocate the taxable income of the partnership to take into account the tax consequences of this disparity (the "pre-contribution gain").[543] Enron planned to use these rules to allocate $930 million of deductions to Enron Corp. and to allocate $930 million of income to HPL over a 16-year period. Because Enron Corp. and HPL were both members of the Enron consolidated group, the allocation and the offsetting allocation, in essence, equalized so as not to create any additional tax liability for the consolidated group. However, under the partnership tax rules, the special allocation of income and deductions results

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540 The information regarding Project Condor was obtained from Joint Committee staff interviews of Robert J. Hermann, R. Davis Maxey, James A. Ginty, and Anne Marie Tiller, as well as from documents and information provided by Enron Corp. and the Internal Revenue Service.

541 The primary purpose of the original transaction between Enron and the Osprey investors had been to convert debt to equity. EC2 000037507.

542 Enron reported that the assets had $31 million of tax basis and a fair market value of $930 million.

543 Sec. 704(c).

in a reduction of Enron Corp.'s tax basis in its partnership interest to zero[544] and an increase in HPL's tax basis in its partnership interest from zero to $930 million.[545]

The strategy anticipated distributing the Bammel Assets back to HPL in redemption of its Whitewing preferred partnership interest after 16 years. Under the partnership tax rules, HPL would ascribe its partnership tax basis to the Bammel Assets. Thus, the tax basis would be "stepped-up" from zero to $930 million and HPL could begin to depreciate the Bammel Assets for Federal income tax purposes. The Enron preferred stock held by the partnership would be "stepped-down" by a corresponding amount; however, Enron Corp. could use one of several strategies to avoid recognizing any taxable gain with respect to such stock.

Reported tax and financial statement effects

Project Condor generated approximately $88 million in net earnings for financial reporting purposes through the third quarter of 2001.[546] Project Condor had no impact on Enron's tax return through 2001[547] other than the deduction of approximately $2 million of transaction costs.[548]

Development of Project Condor

The development of the tax aspects of Project Condor began as early as December of 1998.[549] Correspondence between Deloitte & Touche LLP ("Deloitte & Touche"), and Mr. Maxey and other Enron tax personnel indicate that during the early months of 1999 various

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[544] The $930 million of deductions would have exceeded Enron Corp.'s tax basis, thus resulting in some deductions being suspended under sec. 704(d). However, the structure envisioned Enron Corp. purchasing the interest of the Osprey Investors or contributing cash to alleviate this problem.

[545] Sec. 705.

[546] In December 2001, Enron recorded an $84.1 million financial accounting charge in order to place a valuation reserve against the previously reported earnings. The Project Condor materials in Appendix B contain an opinion letter to Chase Securities, Inc. from Arthur Andersen regarding the the financial accounting implications of a transaction that mirrors Project Condor. Enron indicated that it was unclear why Chase Securities, Inc. received this opinion or why they sent it to Enron. Presumably, that Chase was marketing or engaging a transaction similar to Project Condor and was interested in ascertaining the accounting benefits of such transaction. EC2 000037515 - EC2 000037520.

[547] The approximately $930 million of tax deductions to be generated by Project Condor were projected to be available beginning in 2015.

[548] Information obtained from a summary discussion of Project Condor. EC2 000037455. Enron stated it was amortizing the transaction costs over a three-year period.

[549] Structured Transactions Group Summary Nov. 2001 - Project Condor.

models were developed to evaluate the benefits to Enron of engaging in the tax strategy.[550] The models used differing assumptions as to assets contributed, the tax basis of the assets contributed, and residual value of the contributed property.

In April 1999, a draft presentation was prepared for Project Condor providing a broad overview of the transaction structure, financial accounting impacts, the tax benefits of the transaction, and the risks of the transaction and mitigating factors.[551] The presentation materials identified the following transaction risks (1) the need for a business purpose, (2) a fiscal year 2000 budget proposal that would tighten the standards applicable to corporate tax shelters and basis shifting transactions, and (3) a general risk of law change. The primary mitigating factors listed were that (1) the transaction would occur as part of an overall restructuring of an existing partnership, (2) the budget proposals were not expected to receive Congressional support and could be structured around, and (3) the transaction could be unwound at any time and the complications on an "unwind" are minimized since the transaction occurs mainly between two Enron entities. A subsequent presentation document indicated that another mitigating factor was that the audit risk is very low because no position is taken on Enron's consolidated tax return until assets are distributed from the Whitewing structure (anticipated to be 2015).[552]

The evaluation of the proposed transaction continued into the summer months and on August 20, 1999, an engagement letter between Enron and Deloitte & Touche was signed.[553] The agreement provided that Deloitte & Touche would advise Enron on structuring a preferred return partnership interest to be issued out of an existing entity.

At a special meeting of the Board of Directors of Enron on September 17, 1999, the Board of Directors was presented with a broad overview of the proposed restructuring of the Whitewing partnership, including the redemption of Whitewing's existing Enron preferred stock in exchange for a new class of Enron preferred stock and the contribution of merchant assets to the Whitewing structure. Following the presentation, the Board of Directors approved a resolution authorizing Enron to undertake the transactions involved in the refinancing of approximately $1 billion of mandatory convertible preferred stock of Enron.

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[550] A memo from Steven E. Klig of Deloitte & Touche to Mr. Maxey dated February 27, 1999 provided a summary of various alternatives and detailed schedules of the implications of these alternatives for the anticipated sixteen year period of the structure. EC2 000037456 - EC2 000037481.

[551] There is no indication of who prepared or received copies of the presentation materials. The Project Condor materials in Appendix B contain the presentation materials. EC2 000037482 - EC2 000037493.

[552] Discussion materials for Project Condor dated November 9, 1999. EC2 000037500.

[553] Richard J. Causey on behalf of Enron and Stephen E. Klig on behalf of Deloitte & Touche signed the agreement.

Enron's stated business purpose for contributing the Bammel Assets to the Whitewing LP structure was to provide enhanced collateral to support the Osprey Investors investment, thereby reducing the overall financing cost to Enron.

Implementation of Project Condor

HPL Asset Holdings LP ("HPL Asset Holdings"), a Delaware limited partnership, was formed on November 9, 1999. On November 10, 1999, HPL and Enron Corp.[554] contributed property to HPL Asset Holdings in return for partnership interests. HPL transferred the Bammel Assets[555] to HPL Asset Holdings in return for a 99.89 percent limited partner interest and a 0.01 percent general partner interest.[556] Enron contributed $1 million to HPL Asset Holding in return for a 0.10 percent limited partnership. The Bammel Assets contributed by HPL had adjusted tax basis of approximately $30 million and an ascribed fair market value of $930 million. The Bammel Assets were immediately leased back to HPL for a period of 18 years.[557]

Immediately following the contribution, HPL assigned its general partnership interest to Blue Heron I LLC, ("Blue Heron") a single member limited liability company owned by Whitewing LP, in exchange for an interest in Blue Heron. Immediately thereafter HPL assigned its interest in Blue Heron and its 99.89 percent limited partnership interest in HPL Asset Holding to Whitewing LP in exchange for a preferred partnership interest in Whitewing LP. HPL, immediately thereafter, contributed its limited partnership interest in Whitewing LP to Kingfisher I LLC ("Kingfisher"), a single member Delaware limited liability company owned by HPL.[558]

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[554] Enron's interest was legally held by Peregrine I LLC. Because Enron Corp. elected to disregard Peregrine I LLC for Federal income tax purposes, Enron Corp. is considered the owner for Federal income tax purposes. As such, this Report reflects Enron Corp. as the owner rather than Peregrine.

[555] The Bammel Assets consisted of an underground natural gas storage reservoir and related facilities, the storage facility equipment, and the Houston Loop and Texas City Loop natural gas pipelines and related assets.

[556] Information contained in Agreement of Limited Partnership of HPL Asset Holdings. Ecx000002059.

[557] The lease agreement between HPL Asset Holding and HPL required the parties to obtain an appraisal to determine the fair value and residual value of the Bammel Assets for purposes of computing the appropriate base rent between the related parties. This was to be performed by December 31, 1999. The appraisal was never done.

[558] Because HPL elected to disregard Kingfisher I LLC for Federal income tax purposes, HPL is considered the owner of the Whitewing partnership interest for Federal income tax purposes. As such, this Report reflects HPL as the owner rather than Kingfisher I LLC.

As a result of the aforementioned steps, Whitewing LP owned a 99.89 percent limited partnership interest and 0.01 percent general partnership interest in HPL Asset Holdings[559] and Enron Corp. owned a 0.10 percent limited partnership interest in HPL Asset Holdings. In addition, the Osprey Investors and HPL owned preferred partnership interests of Whitewing LP with Enron Corp. and a partnership between Enron Corp. and the Osprey Investors owning the remaining interests in Whitewing LP.

Because the Bammel Assets contributed by HPL had a minimal tax basis and an ascribed value of $930 million at the time of contribution, the assets were subject to the tax allocation rules of section 704(c). HPL Asset Holdings elected to use the remedial allocation method under section 704(c) with respect to the Bammel Assets.[560] For purposes of section 704(c), HPL Asset Holdings elected to recover the Bammel Assets using the 150-percent declining balance method over 15 years.[561]

The amended Whitewing LP partnership agreement contains special provisions that allocate 100 percent of the depreciation deductions associated with the Bammel Assets to Enron and 100 percent of the income, gains, deductions and losses associated with the Bammel Assets to Enron and HPL.[562] Thus, the allocations required under section 704(c) and any income or loss in the Bammel Assets would impact only Enron and its affiliate, HPL. The special partnership provision, in connection with the section 704(c) allocation rules, would cause Enron Corp.'s tax basis in Whitewing to decrease by $930 million and HPL's to increase by $930 million over the recovery period of the Bammel Assets.

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[559] Whitewing's interest in HPL Asset Holdings was legally owned by Blue Heron. However, Whitewing disregarded Blue Heron for Federal income tax purposes. Thus, Whitewing is considered the owner of the HPL Asset Holding partnership interest for Federal income tax purposes. As such, this Report reflects Whitewing as the owner rather than Blue Heron.

[560] As a result of HPL contributing its partnership interests in HPL Asset Holdings to Whitewing LP (and Blue Heron), the regulations under section 704(c) require that Whitewing LP allocate its distributive share of HPL Asset Holdings income and loss with respect to the section 704(c) property in a manner that takes into account the contributing partner's remaining built-in gain or loss. Treas. Reg. sec. 1.704-3(a)(9).

[561] Asset Class 46.0 ascribed a recovery period of 15 years to assets used in the commercial and contract carrying of natural gas by means of pipes. See Rev. Proc. 87-56,1987-2 CB 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 CB 785).

[562] The Osprey Investors had no economic interest in the income, gain, loss, or deduction associated with the Bammel Assets. E 28035 - E28036.

The strategy envisioned distributing the Bammel Assets back to HPL after 16 years, in redemption of HPL's partnership interest.[563] Under the partnership tax rules, HPL would ascribe its partnership tax basis (as increased through the partnership allocations) to the distributed pipeline. Thus, it was anticipated that the tax basis in the Bammel Assets would be "stepped-up" from approximately zero to $930 million. Whitewing, if a section 754 election were made, would be required to decrease the basis of the remaining partnership property by an offsetting amount. The strategy anticipated that Whitewing's only asset at such time would be Enron stock. As such, the Enron stock would be reduced by $930 million. However, Enron Corp. could avoid recognizing the inherent gain in the Enron stock either through section 1032 or by other tax strategies. Thus, Project Condor would result in an additional $930 million of tax deductions without any economic outlay.

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

[563] Although the Whitewing partners generally had no right to a return of capital contributions, a special provision of the partnership agreement permitted HPL to request a distribuion of the Bammel Assets to the extent of its capital account. E28035

Confidential

Project Condor
Structure as of December 31, 2001

Enron Corp.

100%

BAM Lease Company

Kingfisher LLC

100%

$500 cash

Egret LLC

Peregrine LLC

$500 cash

50% vote

$500 cash

50% vote

$2.4 billion

$2.62 billion cash

0.1% LP interest

LP interest

LP interest

GP interest 100% vote
0.1% of capital gains/
losses >$750 million

Preferred LP interest
Preferred distribution +1 1/2%
of cap. gains/losses > $750 million

Share Settlement Agreement

99.89% LP

100% vote

99.99% LP

99.99% LP

GP .01%

GP .01%

ENA Asset Holdings LP

Bammel Assetss

$1.0 billion (Face Amount) Enron
Convertible Preferred Stock
$58 million Enron Note
$115 million Enron Debt Securities
(Overfunding Amount)

U. S. Tax/GAAP Legend

- Enron GAAP Consolidated
- Equity Method Investment
- Third Parties
- Branch/Disregarded Trust
- Corporation
- Partnership
- Assets

Role of outside advisors

Deloitte & Touche promoted the strategy and was the tax advisor on the structuring of the preferred partnership structure. In addition, Vinson & Elkins was engaged to provide tax advice on the transaction including a tax opinion regarding the Federal income tax treatment of certain partnership events and activities.

Deloitte & Touche was paid $8.325 million for its services.[564] Vinson & Elkins was paid $1.2 million for its services.[565]

Subsequent developments

In June 2001, Enron Corp. sold HPL stock to American Electric Power ("AEP"), an unrelated party. In connection with the sale, HPL transferred its leasehold interest in the Bammel Assets and its interest in Whitewing LP to BAM Lease Company, a wholly owned subsidiary of Enron. In addition, BAM Leasing Company subleased the Bammel Assets to AEP for 30 years with a option to extend for an additional 20 years.[566]

Discussion

Project Condor was specifically structured to take advantage of the interaction between the partnership allocation and basis rules and section 1032, which provides for the nonrecognition of gain or loss to a corporation on the receipt of money or other property in exchange for stock of such corporation. Described in its simplest form, Project Condor purports to permit Enron to shift approximately $930 million of tax basis from Enron's own stock to the Bammel Assets owned by HPL, a wholly owned subsidiary of Enron. Under the strategy devised in Project Condor, the benefits of the increased tax basis would inure over a 16-year period and would not be available for use on Enron's consolidated tax return until the end of that

[564] Engagement letter between Deloitte & Touche and Ernon Corp. dated August 20, 1999. EC2 000037496 - EC2000037498.

[565] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated Jan 13, 2003, answer 57.

[566] As mentioned above, Enron did not obtain an appraisal of the Bammel Assets in 1999 as required under the original lease agreement. Enron ascribed a value of approximately $930 million to the Bammel Assets for purposes of section 704(c). In 2001, in connection with the sale of HPL to AEP, an internal Ernon memorandum valued the Bammel Assets at $460 million. EC2 000054384. Because no independent appraisal was done in 1999, it is not clear whether the value of the Bammel Assets declined by 50 percent between 1999 and 2001 or whether the original valuation ascribed by Enron was grossly overstated to maximize the tax benefits of Project Condor.

period (2015). However, and potentially more important to Enron, the strategy permitted Enron to begin to record the benefits immediately for financial accounting purposes.[567]

Business purpose

A determination of whether Enron should be entitled to the tax benefits Project Condor purported to provide necessarily involves an analysis regarding Enron's satisfaction of the literal requirements of the 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-avoidance transactions.[568]

Partnership allocations

Project Condor's strategy involved the use of the remedial allocation method under section 704(c) to allocate deductions to Enron while allocating an offsetting amount of income to HPL. As described in more detail in present law, these rules were enacted in order to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. Under these rules, the required allocations generally have significant tax implications to the partners.[569] However, when related parties are involved, the shifting of income and deductions among the partners, which would normally have significant economic implications to each partner, is no longer a concern. Thus, a taxpayer is potentially able to use the required allocation rules to shift tax attributes among related entities to its advantage without any economic implications to the taxpayer.

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[567] This occurs in certain situations because Statement of Financial Accounting Standard 109 in some cases permits the recognition of financial accounting benefits prior to the period in which the tax benefits are recognized for income tax purposes. 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.

[568] 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).

[569] In many situations, the allocation method chosen by the partnership to account for the pre-contribution gain can be one of most contentious tax negotiations between the partners because of the tax implications to the respective partners.

Highlighting that the allocation had no economic impact on the Enron partners, the Whitewing partnership agreement contained a special provision that allocated 100 percent of the depreciation deductions associated with the Bammel Assets to Enron (instead of its ratable ownership share). Normally, such a special allocation would be detrimental to the contributing partner as it would result in additional taxable income to such partner, but because both Enron and HPL were part of the Enron consolidated tax return, the allocations had no impact on the consolidated group's taxable income.

The use of the remedial allocation method and the special provision allocating 100 percent of the Bammel Assets depreciation to Enron Corp. facilitated the maximization of the purported tax benefits of the structure. Without these items Enron Corp. and HPL would have been able to effectuate a basis shift between themselves of only a portion of the $930 million value.[570] However, through these items, a basis shift of the full $930 million value of the Bammel Assets could be accomplished at no economic cost and the exit strategy could be undertaken.

Partnership basis rules on liquidating distributions and section 754 adjustments

The strategy anticipated distributing the Bammel Assets back to HPL in redemption of its Whitewing preferred partnership interest after 16 years. Under the partnership rules, HPL ascribes its partnership tax basis to the Bammel Assets. Thus, the tax basis would be "stepped-up" from zero to $930 million and HPL could begin to depreciate the Bammel Assets for Federal income tax purposes. It was anticipated that the only remaining asset of Whitewing would be Enron stock, and that the stock would be "stepped-down" by a corresponding amount. However, Enron Corp. could use one of several strategies to avoid recognizing any taxable gain with respect to such stock under section 1032. The permanent exclusion of this gain allowed Enron to report a financial accounting benefit with respect to the transactions.[571]

Application of May Company regulations

If finalized, it is possible that the transaction would be subject to proposed regulations regarding gain recognition upon certain partnership transactions involving a partner's own stock.[572] Specifically, under the proposed regulations, the contribution of the Bammel Assets to the Whitewing partnership (which held Enron preferred stock) may have resulted in a deemed

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[570] The exact amount would depend on the partnership ownership percentages and operations.

[571] If the partnerships held assets other than Enron stock, then instead of a permanent exclusion of gain, the transactions would have generated only a deferral of gain (because Enron eventually would pay tax with respect to the assets) with no resulting financial statement income.

[572] Prop. Treas. Reg. sec. 1.337(d)-3(d). These regulations apply to transactions or distributions occurring after March 9, 1989. *See also*, Notice 89-37, 1989-1 C.B. 679, and Notice 93-2, 1993-2 C.B. 292 (effective date of proposed regulations under sec. 1.337(d)-3).

redemption requiring gain recognition by HPL.[573] In addition, if Whitewing distributed to Enron its own stock (or the stock of an affiliate), the distribution would be characterized as a redemption (or an exchange of the stock of the partner) for a portion of the partner's partnership interest with a value equal to the stock distributed.[574] Thus, gain could be recognized on that portion of the distribution.[575]

In evaluating the risks of the proposed regulations to Project Condor, Enron stated that, in off-the-record discussions, Treasury Department personnel had indicated that the regulation will never be finalized, and even if finalized, the regulation would take a different form.[576] Because the regulations have not been finalized, they are not authoritative at this time.[577]

Application of partnership allocation anti-abuse rule

The section 704(c) regulations upon which Enron relied to trigger the basis shift state that generally, the remedial allocation method is a reasonable method for allocating pre-contribution gain.[578] However, an anti-abuse rule states that an allocation method is not reasonable if the contribution of the property and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in-gain or loss among partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.[579] Although the allocations between the Enron entities offset for tax purposes, considering that Enron had prearranged all of the steps to cause a substantial reduction of its tax

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[573] Because of the special allocations, distribution rights, and Enron Corp. being a partner, it is not certain that HPL would be considered to have exchanged appreciated property for an interest in Enron stock.

[574] Prop. Treas. Reg. sec. 1.337(d)-3(e).

[575] *Id.*

[576] The Project Condor materials in Appendix B contain part of an interoffice memorandum regarding the proposed restructuring of Whitewing LP from Anne Marie Tiller dated February 26, 1999. EC 000850731- EC00850735. See also, Project Condor materials in Appendix B, document titled "Nighthawk Restructuring Summary." EC 000850800 - EC 000850801. Enron called the overall restructuring of which Project Condor was a part Project Nighthawk and Project Daybreak.

[577] For the legal authority attributed a proposed regulation, see *Freesen v. Commissioner*, 84 TC 920 (1985) (proposed regulations carry no more weight than position or argument advanced by party on brief), *Estate of H.A. True, Jr. v. Commissioner*, 82 T.C. Memo 2001-167 ("we [courts] accord them [proposed regulations] no more weight than a litigating position").

[578] Treas. Reg. sec.1.704-3(a)(1).

[579] Treas. Reg. sec. 1.704-3(a)(10).

liability, and made affirmations that it would complete the steps,[580] the anti-abuse rule should apply to preclude the use of the remedial allocation method in this situation.[581] If the anti-abuse rule does not preclude this type of activity, then the meaningfulness of this rule must be questioned.[582]

Application of partnership anti-abuse regulations

Subchapter K contains two anti-abuse rules relating to partnerships.[583] These rules 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, as appropriate, to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances.[584]

One factor that is potentially indicative of abuse is whether substantially all of the partners are related. Using the Whitewing partnership superficially provided Enron with an unrelated partner (the Osprey investors). However, a review of the documents indicates that the

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[580] In order for Enron to record the financial accounting benefits of such transaction it was required to reasonably represent to its independent auditor that it has a planning strategy that, without incurring significant cost, would enable it to retire or dispose of the Enron shares without incurring a tax cost.

[581] Treasury Regulation 1.704-3(a)(1) states that an allocation method is not necessarily unreasonable merely because another allocation method would result in a higher aggregate tax liability. However, related parties acting in concert should be a situation that warrants the imposition of the anti-abuse rule. In this situation, had Enron used the traditional allocation method the tax results it was intending to obtain would not have been available. It is also possible that the traditional method with curative allocations would not have precluded it from obtaining the desired results.

[582] Interestingly, neither the Vinson & Elkins tax opinion nor any of the tax advice the Joint Committee staff reviewed from Deloitte & Touche discussed the application or potential application of the section 704(c) anti-abuse rule. However, Enron internal documentation indicates that the application of the remedial allocation method should not run afoul of the rule and, in fact, follows it to the letter. The document indicates that the anti-abuse regulation is not applicable because in this case, the tax consequences are not being "shifted" but are instead being allocated to the partner whose contribution of property had the built-in gain. EC 000850646. This reading of the regulation results in the remedial allocation never being subject to the anti-abuse rule, a result specifically rejected by the Treasury Department in the issuance of the final regulations (TD 8585, 1995-1 CB 120). The Project Condor materials in Appendix B contain the internal document in its entirety. EC 000850644- EC 000850647.

[583] Treas. Reg. sec. 1.701-2.

[584] Treas. Reg. sec. 1.701-2(b).

unrelated partner did not share in any of the economic income or loss in the Bammel Assets. Specifically, any income, gain, loss, or deduction associated with the Bammel Assets was allocated solely to Enron or HPL. In addition, the partnership agreement contains a special provision that requires the distribution of Bammel Assets to HPL upon HPL's request.[585] These facts reflect that, substantively, these transactions were solely between Enron and its wholly owned subsidiary HPL.

Another factor that is potentially indicative of abuse is the lack of a business purpose. Enron's stated business purpose for engaging in the structure was to enhance the collateral of the Whitewing LP structure to lower it's financing cost with the Osprey investors. However, the amended and restated Whitewing LP agreement was completed on September 24, 1999. The partnership agreement permits, but does not require, Enron to make further capital contributions to Whitewing.[586] As described above, the Osprey investor had no economic interest in the income, gain, loss, or deduction with respect to the Bammel Assets. In reality, the reviewed documents indicate that the Whitewing LP partnership and its financial restructuring were used to facilitate a transaction that arguably had no business relationship to the overall financial restructuring.

Recommendations

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. Although the Joint Committee staff believes that the partnership allocation anti-abuse rules should apply to preclude the tax benefits Project Condor purported to generate, 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.

In addition, transactions that use partnership tax rules and section 1032 to obtain unintended tax results appear to continue unabated. The Treasury Department has issued guidance addressing certain situations in which gain or loss may be improperly created by adjusting the basis of a partnership interest for partnership income that is not subject to tax under section 1032, but as with many tax-motivated transactions, it is difficult to keep pace with the promoters of these ideas. In light of this activity, the Joint Committee staff believes that further guidance is needed to address the interaction of the partnership basis rules with the corporate nonrecognition of gain rules under section 1032. Of particular concern is gain being excluded by

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[585] Absent this special provision, the Whitewing LP partners had no ability to request a distribution of their capital contributions.

[586] The Whitewing partnership agreement permitted Enron or an affiliate to make additional capital contributions in exchange for additional partnership interests so long as such interests are subordinate to the Osprey Investors preferred interest in Whitewing.

virtue of section 1032 that is attributable to a downward basis adjustment mandated by a section 754 election.

The Joint Committee staff recommends that either (1) section 1032 limit the nonrecognition of any realized gain allocated to the corporate partner to the extent that the gain is attributable to an economic benefit accruing to the corporate partner, or (2) that the partnership basis rules should be altered to preclude an increase in basis to an asset if the offsetting basis reduction would be allocated to stock of a partner (or related party). For example, if a partnership sells the stock at a gain and the gain is due not to appreciation in the value of the stock but rather to a decrease in the basis of the stock (as required by a section 754 election), then the realized gain is not due to an economic benefit accruing to the partner (i.e., increase in stock value). Rather, it is simply due to a reduction to the basis of the stock that was offset by an increase in basis to another asset. Consequently, the corporate partner should not be permitted to utilize section 1032 to avoid recognition of the realized gain allocated to it (or to have increased the basis of an asset)

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.

4. Projects Tammy I and Tammy II

Brief overview

Projects Tammy I and Tammy II were structured to generate financial statement benefits attributable to an increase in tax basis (in excess of book basis) in the Enron South office building and other depreciable assets. In a simplified version of the transaction, Enron Corp. and several of its subsidiaries contributed assets with significant unrealized built-in gains to a newly-formed partnership. Financial institutions provided $500 million of financing to the partnership in exchange for a preferred interest. Following the formation of the partnership, Enron and all but one of the Enron partners transferred approximately 95 percent of their partnership interests to a single Enron affiliate. The partnership then sold built-in gain assets, with the gain (and the resulting basis increases) allocated almost entirely to the single Enron affiliate -- giving the single Enron affiliate a high basis in its partnership interest. The partnership was to use the sales proceeds to: (1) purchase a low value depreciable asset, (2) purchase Enron preferred stock, and (3) repay the financial institutions.

In a later year, the partnership would distribute the low value depreciable asset to the single Enron affiliate in redemption of its partnership interest. The depreciable asset would inherit the single Enron affiliate's high basis in its partnership interest. The only remaining asset in the partnership would be Enron preferred stock. The Enron partners then could implement exit strategies to avoid the recognition of gain with respect to the Enron preferred stock.

Project Tammy I – background[587]

Reported tax and financial statement effects

Project Tammy I was projected to generate $1.09 billion in Federal income tax deductions (without any economic outlay) resulting primarily from enhanced depreciation deductions attributable to the Enron South office building. These deductions were anticipated to be available to offset Enron's taxable income beginning in 2007. The tax savings associated with these deductions would have generated approximately $406.5 million of financial statement income. The financial statement income would accrue during the years 2001 through 2005.[588]

In actuality, Enron did not report a financial statement benefit with respect to Project Tammy I for year 2001. As to the Federal income tax benefits, Project Tammy I was terminated prior to their realization. However, the three dispositions by the partnership in year 2001 did result in the recognition of gain (which was offset by losses from the Enron consolidated group).

Development of Project Tammy I

Deloitte & Touche proposed the idea for Project Tammy I to Enron. Enron held appreciated non-core business assets that it planned to sell. Enron had sufficient net operating losses to offset the projected gains from such sales. Project Tammy I was a mechanism that allowed Enron to shift basis to another asset held by the Enron consolidated group (resulting in greater future depreciation deductions).

The transaction was the product of collaboration between the Enron tax department and Deloitte & Touche, Akin Gump, and Vinson & Elkins. Much time was spent on identifying the proper Enron assets to place in the project structure. In addition, the structure originally contemplated an intercompany sale of the partnership interests. The structure later was revised to involve a tax-free transfer of the partnership interests.

On August 7, 2000, the Finance Committee of Enron Corp.'s Board of Directors approved Project Tammy I for recommendation to the Enron Corp. Board of Directors. At the Enron Corp. Board of Directors meeting (held later that day), Rebecca C. Carter presented a report of the Finance Committee's action, and the Board of Directors approved and ratified Project Tammy I.[589] On May 1, 2001, the Enron Corp. Board of Directors adopted and ratified all of the actions taken with respect to Project Tammy I and authorized the creation of a new

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587 The information regarding Project Tammy I was obtained from Joint Committee staff interviews of James A. Ginty, Robert J. Hermann, Robert D. Maxey, and Alicia L. Goodrow, as well as from documents and information provided by Enron and the IRS.

588 The General Background Materials in Appendix B contain the Structured Transactions Group, Summary of Project Earnings & Cash Flows, November 2001.

589 Agenda item #5(c) of the Meeting of the Finance Committee of the Enron Corp. Board of Directors, August 7-8, 2000, EC 000043879, 000043966-43972.

series of Enron preferred stock in the amount of $1 billion to be sold to a subsidiary of the partnership.[590]

Implementation of Project Tammy I

The implementation of Project Tammy I involved several steps that were to be executed over a period of years. The steps involved: (1) the formation of a partnership, (2) a transfer of the partnership interests, (3) a sale of the built-in gain assets, and (4) certain post-sale events.

Formation of the partnership.–The initial step in the implementation of Project Tammy I was the formation of the partnership through which the reallocation of built-in gain would occur. The partnership, called Enron Finance Partners, LLC ("Enron Finance"), was formed on July 14, 2000, with three members of the Enron consolidated group being the initial members.[591] New members were admitted to the partnership during October and November 2000.

On November 28, 2000, Enron Finance's membership interests were reclassified into Class A Members, Class B Members, and Class C Members. The managing member of the partnership[592] owned the Class A Membership interest, the Enron consolidated group members owned the Class B Membership interests, and Zephyrus LLC ("Zephyrus"), through which the minority interest was held,[593] owned the Class C Membership interest.

In exchange for their membership interests, the members contributed various assets and had various liabilities assumed by Enron Finance. Zephyrus contributed $500 million in exchange for its Class C Membership interest.[594] The Class B Members contributed several assets with significant unrealized built-in gain. For example, Enron Corp. contributed 11.5 million shares of EOG Resources, Inc. stock with an agreed fair market value of $485.875

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[590] Minutes of the Meeting of the Enron Corp. Board of Directors, May 1, 2001, EC 000049817-49828.

[591] The three members were Smith Street Land Company ("Smith Street"), Enron Capital Investments Corp., and Enron Global Exploration & Production, Inc. Smith Street was developing the Enron South office building.

[592] Enron Finance Management, LLC, a disregarded entity from its sole owner, Enron, was the sole manager of Enron Finance.

[593] Zephyrus was a Delaware limited liability company formed on November 17, 2000. Its initial members were Chase Equipment Leasing, Inc., Bank of America, N.A., BNP Paribas, and Fleet National Bank. Royal Bank of Scotland subsequently was admitted as a member. The members contributed to Zephyrus an aggregate of $481.725 million in their capacities as "lenders" and $18.275 million in their capacities as "certificate purchasers," for a total of $500 million in minority interest financing.

[594] Zephyrus received ten membership units evidencing the Class C Membership interest. Each Class C unit represented a capital contribution of $50 million. The Class C Membership interest was to have been redeemed sometime in year 2005.

million (subject to a debt of approximately $461.5 million) and a tax basis of approximately $40.71 million. Another Class B Member executed an option that allowed Enron Finance to purchase (for $1) the stock of Enron Renewable Energy Corp. with an agreed fair market value of $550 million (subject to a debt of approximately $524 million) and a tax basis of approximately $200 million.[595] Another Class B Member contributed all of the outstanding stock of Enron Oil & Gas India Ltd. with an agreed fair market value of $550 million (subject to a debt of $523.2 million).[596] Other built-in gain assets contributed to Enron Finance included the outstanding stock of Enron LNG Power (Atlantic) Ltd., with an agreed fair market value of $260 million (subject to a debt of $118.750 million) and a tax basis of $14.283 million, and a partnership interest in Enron Capital Management III Limited Partnership with an agreed fair market value of $99.083 million (subject to a debt of $93.634 million) and a tax basis of $21.288 million.[597]

Collectively, the Class B members (i.e., Enron Corp. and its subsidiaries) contributed property with a gross value of approximately $1.95 billion (subject to a debt of $1.85 billion) and an estimated tax basis of $500 million. In each instance, the contributing member remained liable for the debt that Enron Finance had assumed in connection with the contributions.

Transfers of partnership interests.–The second step of the transaction involved a transfer of the partnership interests within the Enron consolidated group. In this regard, Enron and all but one of the Class B members contributed 95 percent of their respective Class B Membership interests to Enron Capital Investments Corp. (the other Class B Member) in exchange for Enron Capital Investments common stock.[598] Each contributor remained liable for the debt that Enron Finance had previously assumed. After the transfers, Enron Capital Investments Corp. owned more than 98 percent of the Class B Membership interests in Enron Finance, and the other Class B members (Enron Corp., Smith Street, Enron Global, Enron Caribbean Basin, and Boreas

[595] The option was intended to transfer tax ownership of the Enron Renewable Energy Corp. stock to Enron Finance without requiring the approval of the Federal Energy Regulatory Commission to transfer the stock. Discussion material for Project Tammy, June 30, 2000, EC2 000037666.

[596] Enron's tax basis in the Enron Oil & Gas India Ltd. stock is unclear.

[597] Capital contribution schedule for Project Tammy I as of May 30, 2002, EC 000851323.

[598] On November 21, 2000, Enron, Smith Street, Enron Global, and Enron Caribbean Basin LLC contributed their interests to Enron Capital Investments Corp. On December 11, 2000, Boreas Holdings agreed to contribute 95 percent of its Class B Membership interest in Enron Finance in exchange for Enron Capital Investments Corp. stock with a value of $5.177 million. ECx000005165-5167.

Holdings) collectively owned less than two percent of the Class B Membership interests.[599] The net value of the transferred Class B Membership interests was $95,302,656.[600]

Sale of built-in gain assets.–Following the transfers of the Class B Membership interests to Enron Capital Investments Corp., Enron Finance was to sell the unrealized built-in gain assets.[601] Enron Finance, through a lower-tiered partnership,[602] sold the following assets: (1) the stock of Enron Oil & Gas India Ltd. for $388 million,[603] (2) the stock of EOG Resources, Inc. for approximately $400 million,[604] and (3) an interest in an East Coast power plant.[605]

Post-sale events.–Enron Finance was to use the sales proceeds to: (1) purchase the Enron South office building from Smith Street, (2) purchase newly-issued Enron preferred stock and (3) redeem the Class C Membership interest held by Zephyrus.[606] Thereafter, Enron Finance was to distribute the Enron South office building to Enron Capital Investment Corp. in liquidation of its partnership interest, leaving the Enron preferred stock as Enron Finance's only asset. The precise exit strategy with respect to the Enron preferred stock was unclear -- one option under

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599 ECx000005156.

600 ECx000005155.

601 As discussed below, this would result in the recognition of the built-in gain (of which 95 percent would have been allocated to Enron Capital Investments Corp., thereby increasing its tax basis in its partnership interest).

602 Enron Finance contributed the assets to Enron Intermediate Holdings (a disregarded entity), which, in turn, contributed the assets to Enron Asset Holdings. Enron Asset Holdings continues to hold the unsold assets.

603 A revised agreement was signed on January 22, 2002, with a sales price of $350 million. Enron Deal Approval Sheet for EOGIL Divestiture, EC2 000037748-37752.

604 Enron Risk Assessment and Control Deal Approval Sheet for Cerberus (involving the divestiture of the EOG stock), EC2 000037753-61. The EOG Resources, Inc. stock had already been monetized for approximately $517.5 million through an arrangement with the Cooperatieve Centrale Raiffeisen-Boerenleenbank B.A. ("Rabobank"). As part of the arrangement, Enron North America entered into an equity swap with Rabobank to make up any shortfall between the $517.5 million and the proceeds from the disposition of the EOG Resources, Inc. stock.

605 Enron transaction history of Project Tammy I, EC2 000037647.

606 As originally planned, Enron Asset Holdings was to purchase approximately $630 million of Enron Corp. preferred stock in September 2000, using the proceeds from the monetization of the EOG Resources, Inc. stock. As previously discussed, the Enron Corp. Board of Directors did not approve the issuance of a new class of Enron Corp. preferred stock until May 1, 2001. Enron Asset Holdings never purchased the Enron Corp. preferred stock, nor did it purchase the Enron South office building.

consideration was for Enron Finance to distribute the stock to the remaining partners (all members of the Enron consolidated group) in liquidation of their partnership interests.[607]

The diagram on the next page depicts the Project Tammy I structure as of December 31, 2001.

[607] Discussion material for Project Tammy I dated June 30, 2000, pgs. EC2 000037662-37665.

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Project Tammy I
Structure as of December 2001

Enron Corp.
Direct or Indirect Wholly-Owned Affiliates of Enron Corp.
Sole Member
Enron Finance Management, LLC
Smith Street Land Company
Enron Global Exploration & Production Inc.
Boreas Holdings Corp.
Enron Caribbean Basin LLC
Enron Caribbean
Managing Member
Enron Capital Investment Corp.
$500 million
$1.9 billion debt payable
Managing Common Member
Enron Finance Partners, LLC
Enron Intermediate Holdings, LLC
Sole Member
Sequoia Notes
Preferred Member
Enron Asset Holdings, LLC
Enron N/R from sale of EOGR shares
Option to Acquire EREC Stock
Subsidiaries
Proceeds from sale of Enron Oil & Gas India
Enron LNG Power (Atlantic) Ltd.
Subsidiaries
ECM III
ECP Tracker Interest
Notes
Other Notes Receivable

U. S. Tax/GAAP Legend
- Enron GAAP Consolidated
- Third Parties
- Corporation
- Tax Ownership only
- Partnership
- Branch
- Assets

Role of outside advisors

Deloitte & Touche promoted the idea of Project Tammy I to Enron and was a principal advisor with respect to its structuring. Deloitte & Touche received fees totaling $8 million in connection with the transaction.[608] Vinson & Elkins acted as Enron's corporate and tax counsel in Project Tammy I and received fees totaling $698,775 for its services. Vinson & Elkins provided a tax opinion in connection with the transaction. In the opinion, Vinson & Elkins concluded that (1) no gain or loss "should" be recognized by Enron or the other Class B Members upon the contributions of the assets to Enron Finance; (2) no gain or loss "should" be recognized by Enron Capital Investments Corp. or the Class B Members on the contribution of 95 percent of their interests to Enron Capital Investments Corp.; (3) 95 percent of the built-in gain with respect to the contributed assets "should" be allocable to Enron Capital Investments Corp. by reason of the contribution, and on the subsequent sale of the contributed assets, Enron Capital Investments Corp.'s basis in its partnership interest "should" be increased by the built-in gain allocated to it; and (4) the creation and use of Enron Finance "should" not be disregarded as a sham and should not be subject to the partnership anti-abuse rules.

Akin, Gump also served as tax counsel to Enron and received fees totaling $235,234 for its services.[609]

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

Subsequent developments

Enron's bankruptcy foreclosed the ability to recognize the anticipated financial and tax benefits with respect to Project Tammy I. Enron and Zephyrus are in litigation/settlement discussions over defaults in payments related to the minority interest financing. In addition, some groups are reviewing some of the asset sales, and a number of issues are expected to be

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

[609] Other law firms that were involved in Project Tammy I included LeBouef, Lamb, Greene & Mac (received fees totaling $219,231) and Freshfields Bruckhaus Deringer (received fees totaling $145,000).

Arthur Andersen acted as Enron's principal advisor on accounting and financial statement issues in connection with Project Tammy I and received a fee of $152,250 in connection with the transaction.

JP Morgan Chase led the group of financial institutions that invested $500 million in Project Tammy I (through Zephyrus). JP Morgan Chase received fees totaling $2.289 million in connection with the transaction.

presented to the creditors committee.[610] The IRS is in the process of auditing Enron's tax returns for years 1996 through 2001.

Project Tammy II – background[611]

Project Tammy II employed the same structure as Project Tammy I. The only differences were the assets to be sold and the depreciable asset(s) that would benefit from the increased tax basis. As originally contemplated, the primary asset Enron Corp. intended to sell through the Project Tammy structure was its interest in Portland General Electric Company ("PGE"). However, in order to reduce its exposure in connection with an IRS audit of the transaction, the Enron tax department decided to create two separate Project Tammy structures to dispose of the unwanted assets. Project Tammy II was the vehicle through which Enron was to sell its PGE stock. Enron never identified the depreciable assets that were to benefit from the increased tax basis.

Reported tax and financial statement effects

Project Tammy II was expected to generate approximately $1.06 billion of Federal income tax deductions (without any economic outlay) resulting primarily from enhanced depreciation deductions attributable to unidentified depreciable assets. These deductions were anticipated to be available to offset Enron's taxable income beginning in 2007. In addition, the tax savings associated with these deductions would have generated approximately $370 million of financial statement income. The financial statement income would accrue during the years 2002 through 2005.[612]

In actuality, Enron did not report a financial statement benefit with respect to Project Tammy II. As to the Federal income tax benefits, Project Tammy II was terminated prior to their realization. However, the two dispositions by the partnership in 2001 did result in the recognition of gain (which was offset by losses from the Enron consolidated group).

Development of Project Tammy II

As previously discussed, Projects Tammy I and II relied on the same legal analysis and involved similar structures (except for the assets to be sold and the depreciable asset(s) that

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[610] The Project Tammy I materials in Appendix B contain the Project Tammy I deal basics, EC2 000037649.

[611] The information regarding Project Tammy II was obtained from Joint Committee staff interviews of R. Davis Maxey, Robert J. Hermann, and Alicia L. Goodrow, as well as from documents and information provided by Enron, the IRS, and filings with the United States Bankruptcy Court in the Southern District of New York.

[612] The General Background Materials in Appendix B contain the Structured Transactions Group, Summary of Project Earnings & Cash Flows, November 2001.

would benefit from the increased tax basis).[613] The primary motivation for using multiple projects was to reduce Enron's IRS audit exposure with respect to the transactions.

On April 30, 2001, Finance Committee of Enron Corp.'s Board of Directors approved Project Tammy II for recommendation to the full Board of Directors. At the Enron Corp. Board of Directors meeting held the following day, Herbert S. Winokur, Jr. presented a report of the Finance Committee's action, and the Board of Directors approved and ratified Project Tammy II.[614] At the same time, the Board authorized the creation of a new series of Enron Corp. preferred stock in the amount of $1 billion that was to be sold to a subsidiary of the partnership.[615]

Implementation of Project Tammy II

Like Project Tammy I, the implementation of Project Tammy II involved several steps that were to be executed over a period of years. The steps involved: (1) the formation of the partnership, (2) the transfer of the partnership interests, (3) the sale of the partnership's built-in gain assets, and (4) certain post-sale events.

Formation of the partnership.–The initial step was the formation of the partnership that would be used to reallocate the built-in gains. The partnership, called Enron Northwest Finance, LLC ("Enron Northwest"), was formed on May 2001, with Enron Corp., Enron Property & Services Corp. ("Enron Property"), and JILP-LP[616] (all members of the Enron consolidated group) as the initial members.[617]

In exchange for a Class B Membership interest in Enron Northwest, the members contributed various assets and had various liabilities assumed by Enron Northwest.[618] Enron Corp. contributed the following assets:

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[613] Current Enron management is not aware of any written documentation prepared by Deloitte & Touche in connection with the development and implementation of Project Tammy II. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 98.

[614] Agenda item #8(c) of the Meeting of the Enron Corp. Board of Directors, EC 000049507, ENE 0000001542, 15550-15555.

[615] *Id.*

[616] JILP-LP was a wholly-owned subsidiary of Enron North America.

[617] Enron Finance Management, a disregarded entity from its sole owner (Enron Corp.) was the sole manager of Enron Northwest. Enron Finance Management contributed $1,000 to Enron Northwest for its Class A Membership interest. Enron Finance Management also acted as the sole managing member in the Project Tammy I structure.

[618] In each instance, the contributing member remained liable on the debt that was assumed by Enron Northwest in connection with the particular transfer.

(1) An agreement that granted Enron Northwest an option to purchase (for $1) all the stock of PGE (a wholly-owned subsidiary of Enron) with an agreed fair market value of $2.1 billion and a tax basis of approximately $1.25 billion ("PGE Option"),

(2) 3,276,811 common units of EOTT Energy Partners, LP (the "EOTT Units") with an agreed fair market value of $58,491,076, and a zero tax basis, and

(3) A derivative interest that tracked the economic value of its limited partnership interest in Joint Energy Development Investments, LP ("JEDI") relating to an indirect interest in 67,849 shares of common stock of Hanover Compressor.

Enron Property assigned to Enron Northwest a $200 million demand note issued by Enron to Enron Property with an agreed fair market value of $200 million.

JILP-LP contributed a derivative interest that tracked the economic value of its limited partnership interest in Ponderosa Assets, LP relating to an interest in 1,680,840 shares of common stock of Hanover Compressor.

In the aggregate, the Class B members (i.e., Enron Corp. and its subsidiaries) contributed property with a gross value of approximately $2.1 billion (subject to liabilities of $2 billion) and an estimated tax basis of $1 billion. In each instance, the contributing member remained liable for the debt that Enron Northwest had assumed in connection with the contributions.[619]

Enron Northwest was designed to raise $500 million of minority interest financing, but the financing was never arranged.[620]

Transfers of partnership interests.–Following the formation of the partnership, Enron Corp. contributed 2.715 percent of its Class B Membership interest in Enron Northwest to Enron Property (another holder of a Class B Membership interest). JILP-LP contributed 95 percent of its Class B Membership interest in Enron Northwest to Enron Property in exchange for shares of Enron Property common stock.

Sale of built-in gain assets.–In the second half of 2001, Enron Northwest, through a lower-tiered partnership, sold (1) the EOTT Units for $64.55 million (all of which was gain),[621]

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[619] Enron Northwest contributed the assets (and transferred the liabilities) to Enron Northwest Intermediate LLC, which in turn, contributed the assets to Enron Northwest Assets, LLC. Enron Northwest Assets, LLC continues to hold the unsold assets.

[620] Project Tammy II Tax Overview, EC2 000037764; Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 94.

[621] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 95.

and (2) the derivative interest in the Hanover Compressor stock.[622] In October 2001, Northwest Natural Gas Company entered into an agreement to purchase the PGE stock from Enron (and Enron Northwest Assets, LLC). Because of issues raised by Enron's bankruptcy, however, the purchase was never consummated. The parties terminated the agreement in May 2002.[623]

Post-sale events.–Project Tammy II effectively was terminated before Enron Northwest purchased either the depreciable asset for distribution to Enron Property or the Enron Corp. preferred stock.[624]

The diagram on the next page depicts the Project Tammy II structure.

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[622] Project Tammy II Tax Overview, EC2 000037766.

[623] *See In re Enron Corp., et al.*, Motion of Enron Corp., et al., for an Order, Pursuant to Sections 105, 363(b), and 365 of the Bankruptcy Code and Rules 2002, 6004 and 9013 of the Federal Rules of Bankruptcy Procedure, Authorizing and Approving (a) the Execution and Delivery of Termination Agreements in connection with the PGE Option Agreement, (b) the Execution and Delivery of a Tax Allocation Agreement, and (c) the Consummation of the Transactions Contemplated Therewith, Filed by Debtors and Debtors in Possession, U.S. Bankruptcy Court (S.D.N.Y.), Dec. 6, 2002.

[624] Current Enron management is not aware that any replacement asset was ever identified. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 97.

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Project Tammy II
Structure as of December 2001

Enron Corp.

Sole Member

Enron Finance Management, LLC

Enron North America

JILP – L.P.

Enron Property & Services Corp.

Managing Member

$2.097 billion debt payable

Managing Common Member

Enron Northwest Finance, LLC

Sole Member

Enron Northwest Inter-Mediate, LLC

Note Receivable from Enron

Preferred Member

Enron Northwest Assets, LLC

LP Tracker Interest

Ponderosa Assets LP

LP Tracker Interest

JEDI

Option to Acquire PGE Common Stock

Subsidiaries

Enron N/R

U. S. Tax/GAAP Legend

- Enron GAAP Consolidated
- Third Parties
- Corporation
- Tax Ownership Only
- Partnership
- Branch
- Assets

Role of outside advisors

Vinson & Elkins acted as corporate and tax counsel to Enron on Project Tammy II. Deloitte & Touche advised Enron with respect to the tax structuring and other related matters. Enron did not receive any tax opinions in connection with Project Tammy II.[625]

Subsequent developments

Enron's bankruptcy foreclosed the ability to recognize the anticipated financial and tax benefits with respect to Project Tammy II. Pursuant to a motion filed and approved by the bankruptcy court, effective December 23, 2002, Enron Corp., Enron Northwest Intermediate LLC, and Enron Northwest terminated the PGE Option and the assumption of the Enron Corp. liabilities.

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

Discussion[626]

Similar to Project Condor, the transactions in Projects Tammy I and II were designed to generate a total of over $2 billion in additional depreciable tax basis via the shifting of tax basis (in excess of book basis) to long-lived assets. The expected tax benefits were the result of the interaction of the partnership tax rules that address the allocation of built-in gains with respect to contributed assets,[627] the partnership basis rules on liquidating distributions,[628] and, depending on the exit strategy, the interaction of the partnership basis rules and the corporate nonrecognition rules in exchanges involving a corporation's own stock.[629] These rules are discussed below.

Under the strategy devised in Projects Tammy I and II, the benefits of the increased tax basis (in the form of greater depreciation deductions) would inure over a 39-year period and was not expected to be reflected in Enron's consolidated tax return until 2007. However, and

[625] The Project Tammy II materials in Appendix B contain the Project Tammy II deal basics, EC2 000037767; Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 99.

[626] Enron's bankruptcy effectively prevents Enron from realizing the tax benefits that were contemplated in Projects Tammy I and II. Nevertheless, this section discusses the tax benefits that Enron sought to achieve from the transactions (without regard to the bankruptcy).

[627] Sec. 704(c).

[628] Sec. 732(b).

[629] Secs. 705 and 1032.

potentially more important to Enron, the strategy permitted Enron to begin recording the benefits immediately for financial accounting purposes.[630]

Partnership allocations

One of the first steps in the implementation of Projects Tammy I and II involved the contribution of built-in gain assets by members of the Enron consolidated group to a partnership. As previously discussed, present law requires that any income, gain, loss, and deduction with respect to contributed property must be shared among the partners so as to take account of the variation between the tax basis of the property to the partnership and its fair market value at the time of contribution.[631] The purpose of this rule is to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. However, the regulations under section 704(c) state that when a contributing partner transfers a partnership interest (or a portion of such interest), built-in gain or loss (proportionate to the interest transferred) must be allocated to the transferee partner as it would have been allocated to the transferor partner.[632] Therefore, in Projects Tammy I and II, when the various members of the Enron consolidated group transferred 95 percent of their partnership interests (the "transferring members") to another Enron partner the "single Enron affiliate"),[633] a corresponding amount of the built-in gain on the contributed property had to be allocated to the single Enron affiliate. Typically, such a transaction does not present a problem and results in an appropriate tax and economic result. Under this rule, the sale of the built-in gain assets will result in 95 percent of the built-in gain being allocated to the single Enron affiliate, with a corresponding increase in the affiliate's tax basis in the partnership interest.[634]

In Projects Tammy I and II, the transferring members remained liable on the indebtedness that Enron Finance (in Tammy I) and Enron Northwest (in Tammy II) assumed in connection with the formation of the partnerships.[635] Similarly, when the transferring members contributed their 95 percent partnership interests to the single Enron affiliate, the transferring members

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[630] *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.

[631] Sec. 704(c)(1)(A).

[632] Treas. Reg. sec. 1.704-3(a)(7).

[633] The single Enron affiliate was Enron Capital Investments Corp. in Project Tammy I and Enron Property in Project Tammy II.

[634] Whether the gain is allocated to the single Enron affiliate or to Enron Corp. is irrelevant because both partners are members of the Enron consolidated group (and the gain will be offset by consolidated net operating losses).

[635] By remaining liable on the indebtedness, the contributing partners avoided any gain recognition that would have resulted by virtue of having been deemed to receive a distribution of money in excess of the partners' basis. *See* secs. 752(b) and 731(a)(1).

remained liable on their respective amount of indebtedness (presumably to avoid a deemed distribution or discharge on the transfer).

The contribution of the 95 percent partnership interests has the effect of splitting each partnership interest into two components: (1) a five percent equity interest that guarantees partnership debt (which the transferring partners retained), and (2) a 95 percent equity interest (which the transferring partners transferred to the single Enron affiliate). In general, when a part of a larger property is sold, the tax basis is equitably apportioned among the parts for determining gain or loss.[636] This determination is usually not difficult to make. However, the determination becomes much more difficult when dealing with a transfers of a non-economic property interest. This is what occurred in Projects Tammy I and Tammy II. While the 95 percent equity interest had economic value as measured by the value of the partnership assets, the interest was uneconomical if the associated tax liabilities embedded in the partnership interest are considered. Enron determined that the single Enron affiliate would take a zero basis in the 95 percent equity interest.[637] This result, coupled with the partnership allocation rules, enabled Enron to shift tax basis to a depreciable asset in excess of its value.

The following example illustrates how the basis shift occurred. Assume that a partnership has a single long-lived depreciable asset with a value of $1 billion, a tax basis of $200 million, and a $900 million partnership liability that the partner ("transferor partner") guarantees.[638] The transferor partner has a $200 million basis in its partnership interest. Assume further that the transferor partner transfers 95 percent of its partnership interest (with no guarantee of the liability) to another partner, and that the transferee partner ultimately will receive an interest in the long-lived asset in a liquidating distribution. The transferee partner has received an interest in partnership property worth $95 million (95 percent x $100 million value) with an associated tax liability of $266 million ($800 million of sec. 704(c) gain x 95 percent x 35 percent tax rate).[639] The unresolved question is what portion of the transferor partner's $200

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[636] Treas. Reg. sec. 1.61-6(a).

[637] This conclusion was based on an interpretation of Rev. Rul. 84-53, 1984-1 C.B. 159. This revenue ruling involves the determination of tax basis in connection with a sale of a partial partnership interest to an unrelated purchaser. In Projects Tammy I and II, the transactions involved a tax-free transfer of a partial interest to members of the same consolidated group.

[638] This hypothetical is similar to an example that Steve Klig of Deloitte & Touche provided to Alicia Goodrow of Enron, in a message dated October 23, 2001, regarding the application of Rev. Rul. 84-53 to Project Tammy I. The Project Tammy I materials in Appendix B contain a Message from Steven E. Klig to Alicia L. Goodrow, subject: Tammy Example.

[639] While the built-in gain will give rise to $760 million in greater future depreciation deductions ($800 million x 95 percent), unrelated taxpayers (without capital losses) generally would be unwilling to realize $760 million of current year gain in exchange for $760 million in future depreciation deductions. If the partner could force an immediate liquidation of the partnership, then the transferee partner would be entitled to receive $95 million and would have a $665 million capital loss (that would offset most of the $760 million of gain).

million basis should be ascribed to the transferred interest. Under similar facts, Enron apportioned a zero basis to the transferred partnership interest because the transferee partner (i.e., the single Enron affiliate) did not assume any of the liabilities. While there is support for this position,[640] the result is difficult to justify and easy to manipulate (particularly when the transferor and transferee are related). A more theoretically sound approach may be to apply principles similar to the excess loss account rules of the consolidated return regulations,[641] (that allow downward basis adjustments below zero) to the transferee partner's interest. The basis reduction rules of section 358(h) also might serve as a useful model.[642] These approaches more accurately reflect the underlying economics of the transfer, and would negate the tax and financial accounting benefits that Enron sought to achieve from Projects Tammy I and II.[643]

To summarize, the partnership built-in gain rules generally provide appropriate economic results with respect to partnerships whose partners have adverse interests. When the partners are related, however, the section 704(c) rules may be manipulated to produce uneconomic and unwarranted results. This was the case in Project Condor, and the pattern continued in Projects Tammy I and Tammy II.

Partnership basis rules on liquidating distributions and section 754 adjustments

In Projects Tammy I and II, the partnership was to use the proceeds from the sale of the built-in gain assets to purchase (1) a low value depreciable asset(s) and (2) a new series of Enron preferred stock. Subsequently, the low value depreciable asset(s) was to be distributed to the single Enron affiliate in liquidation of the affiliate's high basis partnership interest. Under the

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[640] *See,* Rev. Rul. 84-53, 1984-1 C.B. 159 (situation four).

[641] The excess loss account rules allow negative adjustments to a consolidated member's stock basis that exceed the shareholder's basis in such stock. The resulting negative amount is the shareholder's excess loss account in the stock and is treated as negative basis. Treas. Reg. sec. 1.1502-19.

[642] Section 358(h), previously discussed in the corporate section of this Report, mandates a basis reduction 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 which was not treated as money received by the taxpayer. If the resulting outside basis is lower than the partnership's basis in the asset, then basis reduction principles similar to section 732(f), previously discussed in this section of the Report, also may be appropriate.

[643] The idea of using low-basis high value assets to maximize the financial accounting benefits in Project Tammy I was not lost on the Deloitte & Touche advisors. As Steven E. Klig from Deloitte & Touche noted in an electronic message to the Enron tax department, "THE MORAL OF THE STORY IS THAT THE HIGHER THE BASIS OF THE BUILT-IN GAIN PROPERTY TRANSFERRED TO THE PARTNERSHIP, THE SMALLER THE SHIFT IN BUILT-IN GAIN AS A PERCENTAGE OF TOTAL BUILT-IN GAIN." EC2 000054817. The Project Tammy I materials in Appendix B contain an Electronic Message from Steven E. Klig to Alicia L. Goodrow, subject: Tammy Example, at 2.

partnership tax laws, the depreciable asset(s) would take a tax basis equal to the affiliate's basis in its partnership interest. This results in larger depreciation deductions over the life of the depreciable asset (or a larger loss on the sale of such asset). This was the tax benefit that Enron sought to achieve.[644]

The excess of the basis of the depreciable asset in the hands of the single Enron affiliate over its basis in the hands of the partnership immediately prior to the distribution would trigger a downward basis adjustment in some or all of the remaining partnership property assuming that a section 754 election was in effect. If the only remaining partnership property was Enron preferred stock and it was of a similar character to the depreciable asset, then the partnership would be required to reduce its basis in the Enron preferred stock, thereby creating built-in gain on the Enron preferred stock.[645] This is a desirable result -- Enron would not recognize gain when the partnership sells the Enron preferred stock,[646] but Enron would increase its basis in the partnership interest by its proportionate share of the gain. The permanent exclusion of this gain allowed Enron to report a financial accounting benefit with respect to the transactions.[647]

Business purpose

As is the case with several of Enron's structured transactions, any analysis of whether the tax benefits in Projects Tammy I and II would be respected must take into account the applicability of the relevant rules and judicial doctrines regarding tax-motivated transactions.[648]

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[644] *See* generally Christopher H. Hanna, *Partnership Distributions: Whatever Happened to Nonrecognition?* 82 Ky. L. J. 465, 488-92 (1994) (various examples, ranging from a bag of peanuts to a typewriter, in which a low value, low basis asset would receive a high basis on liquidation of a partner's interest).

[645] The depreciable asset distributed to the single Enron affiliate should be section 1231(b) property (assuming it was held by the partnership for more than one year). If the partnership distributes the depreciable asset and is required to make a downward adjustment to the basis of its remaining partnership property, the downward adjustment must be made to property of a similar character, i.e., capital assets or section 1231(b) property. *See* sec. 734(c), sec. 755(b), and Treas. Reg. sec. 1.755-1(c). The Enron preferred stock should be a capital asset and therefore the downward adjustment would be made to it.

[646] Sec. 1032.

[647] If the partnerships held assets other than Enron stock, then instead of a permanent exclusion of gain, the transactions would have generated only a deferral of gain (because Enron eventually would pay tax with respect to the assets) with no resulting financial statement income.

[648] 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

The Vinson & Elkins tax opinion states that Enron engaged in the transaction "to secure $500 million of financing from unrelated banks through a structure that would provide favorable 'minority interest' treatment."[649] The tax opinion discusses a Tax Court memorandum decision[650] in which the court respected a partnership arrangement that yielded significant tax benefits because the taxpayer established that the investment had a valid non-tax business purpose. The tax opinion states that "[c]learly, [Project Tammy I] serves an important business purpose as it facilitates the raising of $500 million of funds for use within the Enron Group," and on this basis, concludes that the transaction should not be treated as a sham or without substance.[651]

The business purpose test is a subjective inquiry into the motives of the taxpayer -- that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose.[652] While a proper analysis of the non-tax business purpose requires a more thorough knowledge of the relevant facts and circumstances (which is beyond the scope of this Report), some general observations are appropriate. The tax opinion apparently accepts as fact the notion that the partnership structure "facilitates" the borrowing, but fails to explain how it facilitates the borrowing. The tax opinion also fails to analyze (1) recent court cases that have disregarded the existence of a partnership structure that serves little business purpose other than to achieve tax benefits,[653] or (2) the possibility that a court may separate a transaction in which independent activities with non-tax objectives are combined with an unrelated transaction having only tax-avoidance objectives in order to establish an overall business purpose.[654]

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).

[649] Opinion Letter from Vinson & Elkins to Enron Corp., February 9, 2001, Appendix C, Part VIII, at 19.

[650] *Salina Partnership LP v. Commissioner*, 80 T.C.M. 686 (2000)

[651] Opinion Letter from Vinson & Elkins to Enron Corp., February 9, 2001, Appendix C, Part VIII, at 19-20.

[652] *See, e.g., Rice's Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985); *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999); *Peerless Indus. v. Commissioner*, 1994-1 U.S.T.C. (CCH) para. 50,043 (E.D. Pa. 1994).

[653] *See, e.g., ASA Investerings Partnership v. Commissioner*, 76 T.C.M. (CCH) 325 (1998), *aff'd*, 201 F.3d 505 (D.C. Cir. 2000), *cert. denied*, 531 U.S. 871 (2000).

[654] *ACM Partnership v. Commissioner*, 157 F.3d 231, 256 at n. 48 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied*, 526 U.S. 1017 (1999). Otherwise, any tax-motivated transaction that is combined with, for example, a borrowing, would be respected.

Of greater concern is the fact that the opinion letter regards and analyzes each element of the transaction (i.e., the contributions to the partnership, the transfer of the partnership interests, and the allocation of the built-in gain) as if the steps were independent and isolated. The tax opinion fails to consider the tax consequences of the anticipated exit strategy and does not provide an overall evaluation of the transaction (notwithstanding that the tax opinion describes the strategy).[655] Project Tammy I was a multi-step, orchestrated arrangement, whose tax and financial statement benefits were known to Enron, the promoter, and the accountants[656] long before Vinson & Elkins issued its tax opinion. Ignoring the exit strategy and failing to provide an overall evaluation should call into question (1) the tax advisor's compliance with the relevant tax shelter opinion standards,[657] and (2) Enron's reliance on the tax opinion to establish reasonable cause and good faith.[658]

Recommendations

The Joint Committee staff recommendations regarding Project Condor[659] include recommendations regarding the partnership allocation rules under section 704(c) and corporate

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[655] Opinion Letter from Vinson & Elkins to Enron Corp., February 9, 2001, Appendix C, Part VIII, at 7-8.

[656] Arthur Andersen provided an opinion regarding the appropriate application of GAAP to the transaction in June, 2000. EC2 000037676-000037685.

[657] Proposed regulations under Circular 230, Regulations Governing Practice Before the IRS, provide that, in rendering a tax shelter opinion to a client, the advisor must not rely on unreasonable factual assumptions. An unreasonable factual assumption includes "a factual assumption that the practitioner knows or has reason to believe is incorrect, incomplete, inconsistent with an important fact, or another factual assumption, or implausible in any material respect." Circular 230, Prop. Sec. 10.35(a)(1)(ii)(A). Even the standards applicable to marketed tax shelter opinions provides, "[a] practitioner who provides a tax shelter opinion analyzing the Federal tax effects of a tax shelter investment shall . . .[w]here possible. . .provide an overall evaluation whether the material tax benefits in the aggregate more likely than not will be realized. Where such an overall evaluation cannot be given, the opinion should fully describe the reasons for the practitioner's inability to make an overall evaluation." Circular 230, Sec. 10.33(e).

[658] 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. Among the elements needed to establish such reliance, "[t]he advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances." Treas. Reg. sec. 1.6664-4(c)(1)(i).

[659] Project Condor is discussed in this partnership section of the Report (following Project Tomas).

nonrecognition of gain rules under section 1032. Those recommendations also are appropriate with respect to Projects Tammy I and Tammy II. In addition, the Joint Committee staff believes that further guidance is needed regarding the apportionment of tax basis upon the transfer of a partial partnership interest (particularly when the transfer involves related parties).

D. Other Structured Transactions

1. Project Apache

Brief overview

Project Apache was a financing arrangement in which the Enron group borrowed funds from third-party foreign lenders. By channeling this third party borrowing through an Enron controlled foreign corporation and blending this borrowing with debt that the Enron group owed itself, the Enron group sought to claim U.S. tax deductions not only for interest paid on the third-party debt, but also for the interest paid to itself, without triggering any offsetting income inclusion on the Enron controlled foreign corporation's receipt of such interest. Viewed another way, the transaction was intended to generate deductions on the Enron U.S. consolidated return in an amount roughly equal to the entire cash flow paid by Enron to the third-party lenders -- not only the interest, but also the repayment of principal. The third-party borrowing also was designed to be treated as "mezzanine," or minority interest financing for financial reporting and rating agency purposes, notwithstanding its characterization as debt for U.S. Federal income tax purposes.

In general terms, the transaction involves a U.S. corporation and its unrelated foreign lenders indirectly establishing and funding a Dutch entity that in turn lends its funds indirectly to the U.S. corporation. The U.S. corporation indirectly contributes 60 percent of the cash in exchange for common ownership units representing 60 percent of the value of the entity, and the foreign lenders indirectly contribute 40 percent of the cash in exchange for preferred ownership units representing 40 percent of the value of the entity. The terms of the ownership units ensure that no earnings can be distributed on the U.S. corporation's common units while the foreign lenders' preferred units remain outstanding. The preferred units are redeemable at the option of the Dutch entity and are entitled to cumulative preferred distributions out of retained earnings and to a liquidation preference equal to the foreign lenders' initial investment in the Dutch entity.

The Dutch entity lends nearly all of its funds indirectly to the U.S. corporation, which deducts all of the interest on this debt on its U.S. tax return.[660] In view of the relative cash contributions to the Dutch entity, 60 percent of this debt is effectively owed by the U.S. corporation to itself, and 40 percent represents borrowing by the U.S. corporation from third parties.

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[660] In Enron's case, as explained in further detail below, the bulk of these deductions took the form of factoring deductions arising from purported sales of trade receivables to a financial asset securitization investment trust ("FASIT"). The discounts that generated the factoring deductions may be regarded as equivalent to interest, since the factoring transactions, to the extent that they had any significant non-tax effect, were economically similar to short-term secured borrowings (cf. Treas. Reg. sec. 1.861-9T(b)(3)(i), treating factoring discounts as interest expense for sourcing purposes). As explained below, this form was chosen in an effort to avoid the restrictions of section 163(j).

The Dutch entity is treated as a controlled foreign corporation, which ordinarily would entail current U.S. taxation of the entity's passive type earnings under subpart F. The interest that the Dutch entity receives indirectly from the U.S. corporation is subpart F income, and the Dutch entity's debt investment normally would be subject to the deemed repatriation rules of section 956. However, since the terms of the ownership units and the earnings of the Dutch entity are structured and managed in such a way as to render it impossible for any earnings of the Dutch entity to be distributed to the U.S. corporation, the U.S. corporation takes the position that none of the entity's subpart F income is allocable to the U.S. corporation, and that there is no deemed repatriation of earnings to the U.S. corporation under section 956. In other words, the parties effectively seek to specially allocate all adverse subpart F consequences to the foreign lenders, who are indifferent to it because subpart F does not apply to them.

When the transaction is unwound, the redemption of the foreign lenders' preferred units (i.e., the repayment of their principal) is treated under the terms of the instruments as a distribution of the Dutch entity's remaining undistributed earnings (i.e., the rest of the interest income received indirectly from, and deducted by, the U.S. corporation). The U.S. corporation takes the position that this elimination of the preferred units also eliminates all of the Dutch entity's earnings and profits for U.S. tax purposes, allowing the U.S. corporation to liquidate the entity without any recognition of income.

In sum, by effectively allocating all of the principal repayment on the combined debt to the U.S. corporation's common units and all of the interest payments on the combined debt to the foreign lenders' preferred units, the U.S. corporation ultimately claims U.S. tax deductions approximating the entire cash flow from its group to the foreign lenders -- both interest and principal -- while making no offsetting income inclusions under subpart F or otherwise.

Background[661]

Purported tax and financial statement effects

Project Apache was projected to increase Enron's financial net income by $167 million over the years 1999-2006. Ultimately, according to the company, the transaction increased financial net income by $50.7 million ($11.3 million, $20.6 million, and $18.8 million for 1999, 2000, and 2001, respectively) before the company declared bankruptcy at the end of 2001. This increase in financial net income was attributable to the tax benefit of interest and receivables factoring deductions that were not offset on the company's tax return by subpart F inclusions or other potential tax liabilities.

On its 1999 return, the company claimed $47.6 million of factoring deductions and $33 million of interest deductions on short-term debt, for a total of $80.8 million of deductions for the year in connection with the transaction. On its 2000 return, the company claimed $110.5 million of factoring deductions and $49.9 million of interest deductions on short-term debt, for a

[661] The Joint Committee staff obtained this information through interviews of Robert Hermann, James A. Ginty, and R. Davis Maxey, as well as from documents and materials provided by Enron Corp.

total of $160.5 million of deductions for the year in connection with the transaction. Sixty percent of these amounts were effectively circular -- i.e., paid by the Enron group to itself.

In addition, the Enron group's net borrowing in the amount of $500 million, which was treated as debt for U.S. tax purposes, was treated as minority interest, or "mezzanine" financing, for financial statement and rating agency purposes.

Development of Project Apache

The idea for Project Apache was brought to Enron by Chase Securities, an affiliate of Chase Manhattan Bank, in mid-1998. Mr. Hermann named the transaction after a favorite golf course in Arizona.[662]

As originally proposed, the transaction involved direct lending by the Dutch controlled foreign corporation to Enron.[663] After a concern was raised that interest on a direct loan might be subject to the restrictions of section 163(j), the transaction was redesigned to direct the loan through a FASIT, with the FASIT borrowing from the Dutch controlled foreign corporation and using the borrowed funds to purchase trade receivables from Enron affiliates, effectively loaning the funds to Enron based on the security of the receivables.[664] The transaction was structured to designate a third party as the owner of the FASIT, and Enron was able to take the equivalent of interest deductions largely in the form of receivables factoring deductions.

On September 25, 1998, a presentation was made to management regarding the transaction. The transaction was approved by a corporate officer of Enron, and Enron's Board of Directors' Executive Committee approved the transaction on November 2, 1998. At a meeting on December 8, 1998, Enron's full Board of Directors approved and ratified the transaction. Mr. Maxey and Mike Herman were instructed to execute the transaction.

Implementation of Project Apache

Blending third-party and related-party lending through controlled foreign corporation

In May of 1999, Enron Corp. transferred $748.5 million to Seminole Capital, LLC ("Seminole"), a newly formed Delaware limited liability corporation, in exchange for a 99.8 percent ownership interest in Seminole. The Lucelia Foundation, a New York not-for-profit

[662] Joint Committee staff interviews.

[663] Memorandum from R. Davis Maxey to Robert J. Hermann, with transaction diagram, June 23, 1998, EC2 000037282, EC2 000037285; Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (*see* Appendix B, Part X to this Report).

[664] Joint Committee staff interviews; Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (with the words "163(j) issue" written by hand on a copy of a diagram showing direct lending by the controlled foreign corporation to Enron) (*see* Appendix B, Part X to this Report).

corporation unrelated to Enron, transferred $1.5 million to Seminole in exchange for a 0.2 percent ownership interest. Seminole was treated as a partnership for U.S. Federal income tax purposes.

Seminole in turn transferred its $750 million to Cheyenne Finance SARL ("SARL"), a newly formed Luxembourg company, in exchange for the entire equity interest in SARL. SARL was treated as a corporation for U.S. Federal income tax purposes and was a controlled foreign corporation as defined in section 957.

Rabo Merchant Bank N.V. ("Rabo"), a Dutch bank unrelated to Enron, transferred $15 million to Choctaw Investors B.V. ("Investors B.V."), a newly formed Dutch company, in exchange for all of the Investors B.V. common stock. Investors B.V. then borrowed $485 million from a syndicate of mostly foreign banks.

SARL and Investors B.V. then formed Cherokee Finance VOF ("Dutch VOF"), a Dutch entity treated as a partnership for tax purposes in both the Netherlands and Luxembourg. SARL transferred its $750 million to Dutch VOF in exchange for all of the "common" ownership units of Dutch VOF (the "Common Units"). Investors B.V. transferred its $500 million to Dutch VOF in exchange for all of the "preferred ownership units of Dutch VOF (the "Preferred Units").[665] The holder of the Common Units had the right to elect two out of the three directors of Dutch VOF, and the holder of the Preferred Units had the right to elect one director. Pursuant to an election under the "check the box" regulations, Dutch VOF was treated as a corporation for U.S. Federal income tax purposes. Dutch VOF also was a controlled foreign corporation as defined in section 957, because Enron Corp. (through Seminole and SARL) indirectly owned more than 50 percent of the Dutch VOF stock.

The Common Units held indirectly by Enron Corp. could not receive any distributions of earnings while any of the Preferred Units remained outstanding. The Preferred Units had an initial liquidation preference of $500 million, as well as the right to a floating-rate cumulative preferred distribution out of retained earnings equal to a percentage of the liquidation preference, as declared by the Board of Directors. The Preferred Units were subject to redemption at a stated date ten years from issuance, at which time any outstanding units would be redeemed for their liquidation preference. Dutch VOF also had the right to redeem the Preferred Units in whole or in part at any time, again for the units' liquidation preference. The initial $500 million liquidation preference would be increased by the amount of any accrued but unpaid preferred distributions and would be decreased by the amount of any redemption proceeds received.

Generating receivables factoring and interest deductions through FASIT transactions

Of the $1.25 billion that Dutch VOF possessed immediately upon its formation by SARL and Investors B.V., Dutch VOF invested $1.23 billion in monthly senior debt obligations (the "Interim Notes") of Sequoia Financial Assets, LLC, a FASIT (the "FASIT"). When each Interim Note matured and was repaid, Dutch VOF would reinvest the proceeds in another Interim Note.

[665] This $500 million represented Enron's net third-party borrowing in the transaction and was treated as minority interest financing for financial accounting purposes.

Dutch VOF earned interest on the Interim Notes in the form of short-term original issue discount. The FASIT in turn effectively loaned the Interim Note proceeds to Enron at the beginning of each month by making discounted purchases of third-party trade receivables from Enron North America and Enron Power Marketing, domestic affiliates of Enron Corp.[666] In cases in which the FASIT received payment on the receivables prior to the end of the month, these funds were used to purchase Enron North America commercial paper from Enron Corp. The transactions between Enron Corp. and its affiliates and the FASIT generated factoring deductions on the Enron consolidated return (reflecting the discount on the sales of the receivables), as well as interest deductions with respect to the commercial paper.

The "owner interest" in the FASIT was held by Ojibway, Inc., a domestic corporation unrelated to the Enron group. Ojibway contributed $2 million to the FASIT for this interest. Enron Corp. contributed $50 million to the FASIT in exchange for a subordinated interest in the FASIT.[667] Enron's interest in the FASIT was treated as a "regular interest" under the FASIT rules. The $1.23 billion Interim Notes held by Dutch VOF also were characterized as "regular interests" under the FASIT rules. Enron Corp. acted as the servicer of the FASIT. In this capacity, Enron Corp. not only handled the accounting, billing, collection, and other administrative functions with respect to the receivables sold by its affiliates to the FASIT, but also held the receivables and other assets of the FASIT and administered the monthly reinvestment program described above.

Intended exit strategy and net effects of transaction

At the time of the transaction, it was anticipated that Dutch VOF would exercise its right to redeem the Preferred Units of Investors B.V. in 2006, and that Dutch VOF and SARL would be liquidated immediately thereafter. Since all of Dutch VOF's earnings and profits (i.e., the interest paid by the FASIT) would have been allocated to the Preferred Units, the company would take the position that the redemption of the Preferred Units eliminated Dutch VOF's earnings and profits, and thus that Dutch VOF and SARL could be liquidated tax-free. In order to achieve this characterization, the redemption of the Preferred Units had to be treated as a dividend for U.S. tax purposes. In furtherance of this goal, Seminole had been granted an option to purchase all of the outstanding shares of Investors B.V. from Rabo. This option was intended to make Enron Corp. the "owner" of all of the stock of Investors B.V. and Dutch VOF under the constructive ownership rules of section 318(a)(4), such that the redemption of Investors B.V.'s Preferred Units would be treated as a dividend under section 302 and would eliminate Dutch VOF's earnings and profits.

Over the 7 years that the project was intended to have been in place, the structure would have generated receivables factoring and interest deductions on the Enron group's U.S.

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[666] The receivables arose primarily from Enron North America's natural gas and electric power businesses. The collection rate on these receivables exceeded 98 percent. "Discussion Material for Sequoia Financial Asset Trust," Mar. 2, 1999, at EC2 000037245.

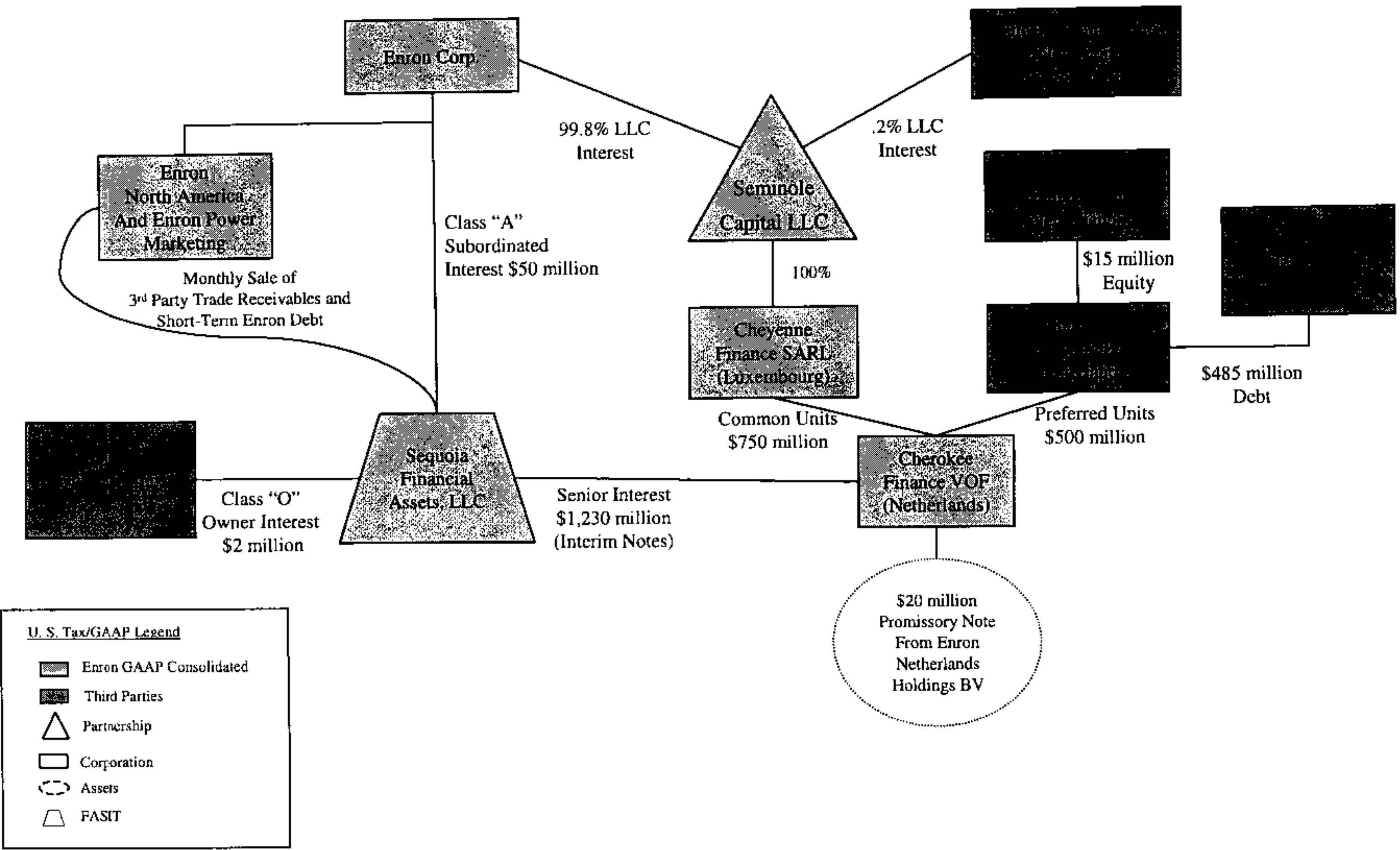
[667] Enron's subordinated interest was intended to insulate Dutch VOF, and hence the third-party foreign lenders, from credit risk on the receivables.

consolidated return approximating the entire cash flow from the Enron group to the unrelated foreign lenders. As it happened, the transaction generated $80.8 million and $160.5 million of such deductions for 1999 and 2000, respectively. These annual deductions were expected to increase gradually through 2006, thus generating deductions at least equal to the principal and interest on the $500 million that the Enron group borrowed from third parties in the transaction. It was intended that this benefit be unmitigated by any offsetting U.S. tax under subpart F or otherwise, despite the fact that 60 percent of the debt in the structure, or $750 million, constituted a circularity in the sense that it was owed by the Enron group to itself.

The diagram on the following page depicts the Project Apache structure.

Confidential

Project Apache
Structure as of May 28, 1999



Role of outside advisors

As noted above, Chase Manhattan Bank promoted the transaction to Enron. Chase Manhattan personnel presented the idea to Messrs. Hermann and Maxey in a meeting and gave them promotional materials.

Shearman & Sterling provided a "should" opinion as to the key intended tax consequences of the transaction, in particular the treatment of the transaction under subpart F, the characterization of various instruments as debt or equity, and the appropriateness of respecting the form of the transaction rather than disregarding it as an economic sham.

Shearman & Sterling also provided a separate tax opinion as to issues relating to the use of the FASIT in the transaction, including qualification as a FASIT ("will" opinion), treatment of Ojibway as the owner of the FASIT ("will" opinion), treatment of the receivables transactions as true sales ("should" opinion), the inapplicability of section 163(j) ("should" opinion), and the inapplicability of U.S. withholding tax on interest paid by the FASIT to Dutch VOF ("should" opinion). This latter opinion letter also included a separate "comments" section that addressed other issues, including the potential treatment of the FASIT as the originator of debt.

As of June 2001, Enron had paid over $14 million in fees in connection with the transaction, including $10,362,038 to Chase Manhattan, $2,070,000 in "syndicate bank fees" relating to various administrative costs of concluding the transaction, $1,108,940 to Shearman & Sterling for its U.S. tax opinions, and $300,000 to Freshfields LLC for a foreign-law opinion, among other fees.[668]

Appendix C, Part IX to this Report contains the tax opinions that Enron received in connection with Project Apache.

Subsequent developments

On January 13, 2003, the company advised the Joint Committee staff that no steps had been taken to unwind the Project Apache transaction structure, but that the parties had stopped cycling cash through the structure since Enron's bankruptcy filing.[669]

Following the bankruptcy filing, JP Morgan Chase Bank (the successor to Chase Manhattan Bank) exercised its right under the Dutch VOF organizing documents to appoint a majority of Dutch VOF's directors. JP Morgan Chase also initiated litigation against Enron on behalf of Dutch VOF and its investors, seeking the turnover of $2.1 billion of accounts receivable, commercial paper, cash, and other property that JP Morgan Chase believes is still

[668] Enron Estimated Structured Transaction Project Fees as of June 4, 2001, EC2 000036379 (*see* Appendix B, Part I to this Report).

[669] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, Jan. 13, 2003, answer 74.

held by Enron in its capacity as servicer of the FASIT.[670] JP Morgan Chase claims that this property is not part of the Enron bankruptcy estate and fears dissipation of the assets if they remain in Enron's hands.

Discussion

In general

In order for Project Apache to provide the tax benefits intended, a number of different issues would have to be resolved in Enron's favor. First, the transaction would have to survive scrutiny under the judicial doctrines applicable to tax-avoidance transactions, despite the obvious tax motivation and large circular flow of cash at the heart of the transaction.[671] Second, the intended allocation of all of Dutch VOF's earnings and profits to the Preferred Units for subpart F purposes[672] would have to be sustained, in order for Enron to avoid current income inclusions under subpart F. Third, the receivables factoring and interest deductions arising from the FASIT transactions would have to be allowed, despite the tax motivation for the use of the FASIT and its close relationship to Enron.

Judicial doctrines and the circular flow of cash

The intended tax benefits of Project Apache arguably should be denied on the grounds that the bulk of the transaction lacked economic substance and non-tax business purpose. The overall transaction undoubtedly had a significant tax motivation, and in particular the circular flow of cash in the form of $750 million of debt (and the interest thereon) owed by the Enron group to itself appears to have lacked both economic substance and non-tax business purpose. Instead, this self-owed debt seems to have been created solely for the purpose of blending it with the third-party debt through Dutch VOF in order to generate interest and interest equivalent

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[670] Since the assets are under Enron's control, JP Morgan Chase could not be sure of the amount and composition of the assets and thus based its complaint on an estimate. The complaint thus also seeks a full and complete accounting of the assets. Complaint, *JP Morgan Chase Bank v. Enron Corp., et al.*, Chapter 11 Case No. 01-16034 (AJG), Adversary Proceeding No. 01-03637 (Bankr. S.D. N.Y.), Dec. 11, 2001, EC2 000054744.

[671] For detailed information on 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).

[672] *See* Treas. Reg. sec. 1.951-1(e)(2).

deductions in excess of those attributable to the third-party debt, while at the same time avoiding any of the offsetting income inclusions that normally apply. To the extent that the receivables factoring and interest deductions claimed by Enron are attributable to this circularity, they arguably should be denied as lacking economic substance and non-tax business purpose. Since this debt accounted for 60 percent of the overall debt in Project Apache, it could reasonably be argued that 60 percent of the deductions claimed by Enron in connection with the structure should be denied.

According to Enron, the non tax business purposes of Project Apache were to raise $500 million of outside financing that would qualify as minority interest financing for financial accounting and rating agency purposes, as well as to manage the trade receivables generated in the course of its affiliates' gas pipeline and electric power wholesale businesses by engaging in factoring transactions.

With respect to the first purpose cited, even if managing financial statement presentation and rating agency evaluations are found to constitute a valid business purpose, this purpose can justify only part of the transaction. This purpose fails to account for the complex and unusual manner in which Enron went about raising $500 million of minority interest financing. Indeed, this purpose fails to account for the majority of the debt involved in the transaction -- the business need to raise $500 million of outside financing does not explain the inclusion of $750 million of intra-group debt in the same structure. The only evident explanation for the use of the intra-group debt relates to the intended tax benefits of the transaction.

The receivables factoring business purpose cited also seems unconvincing. According to Enron tax department personnel interviewed by the Joint Committee staff, Enron did not even consider including trade receivables in the transaction until it concluded that the initial transaction design, which involved a more straightforward loan from Dutch VOF to Enron, was vulnerable to attack under section 163(j), which denies deductions for certain interest on related-party debt.[673] Thus, a tax-motivated transaction structure that did not involve any trade receivables was designed first, and the later inclusion of the receivables and use of the FASIT served the primary purpose of reducing one of the perceived tax risks in the transaction.

Moreover, to the extent that the factoring transactions were ultimately financed 60 percent by intra-group debt, the transactions cannot be said to have achieved the same non-tax effects as factoring transactions with unrelated parties. Factoring transactions generally serve the purpose of accelerating the conversion of trade receivables into cash, thus increasing liquidity and decreasing credit exposure. To the extent that a company effectively advances the bulk of the cash in a factoring transaction to itself and retains an indirect interest in the receivables, these benefits are not realized.

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[673] *See also* Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (with the words "163(j) issue" written by hand on a copy of a diagram showing direct lending by the controlled foreign corporation to Enron) (Appendix B, Part X to this Report).

In sum, while the matter is not free from doubt, the Joint Committee staff believes that a strong argument could be made to deny the intended tax benefits of Project Apache under longstanding judicial doctrines addressing tax-motivated transactions.

Avoidance of subpart F and other potential offsetting tax liabilities

Allocation of subpart F income away from Enron.–The deductions generated by Project Apache would confer no net tax benefit to Enron if they were offset by subpart F inclusions. Under section 951(a), a U.S. shareholder of a controlled foreign corporation generally must include in income its pro rata share of the corporation's subpart F income for the year, as well as its pro rata share of the corporation's deemed repatriations for the year determined under section 956. Enron Corp., as an indirect 60-percent shareholder of Dutch VOF, which was a controlled foreign corporation, ordinarily would have been subject to current U.S. tax with respect to 60 percent of Dutch VOF's subpart F income. Dutch VOF's interest income was treated as subpart F income, and thus, under normal circumstances, it would be expected that Enron Corp. would include 60 percent of this interest income on a current basis for U.S. tax purposes. This of course would have the effect of offsetting 60 percent of the deductions generated in the transaction, thus eliminating the intended tax benefit. This treatment would, however, comport with the overall economics of the transaction, given that 60 percent of the total lending in Project Apache was a self-owed circularity.

Enron sought to avoid these current subpart F inclusions by structuring Dutch VOF's ownership instruments in such a way as to allocate all of the earnings and profits to the Preferred Units held by Investors BV, and none of the earnings and profits to the Common Units held by SARL, and thus indirectly by Enron. In determining a shareholder's pro rata share of subpart F income in cases involving multiple classes of stock, Treas. Reg. section 1.951-1(e)(2) provides that the subpart F income attributable to a class of stock is that proportion of the controlled foreign corporation's total subpart F income that the earnings and profits distributable to such class in a hypothetical year end distribution of all of the corporation's earnings and profits would bear to the corporation's total earnings and profits. Since Dutch VOF's ownership instruments provided that no earnings distributions could be made on the Common Units as long as any Preferred Units remained outstanding, Enron took the position that the Common Units would be entitled to no distribution at all in a hypothetical distribution of all of Dutch VOF's earnings and profits in any particular year, and thus that none of Dutch VOF's subpart F income was allocable to the Common Units (and thus to Enron Corp.) under Treas. Reg. section 1.951-1(e)(2). Even if Dutch VOF's right to redeem the Preferred Units were taken into consideration in this analysis, Enron took the position that the result would not change, on the basis that even a complete redemption of the Preferred Units would be treated as a dividend distribution by reason of the option attribution arrangement described above in connection with Enron's intended exit strategy.

The allocation method applicable to subpart F income also applies in the case of section 956 inclusions, and thus Enron took the same allocation position with respect to both subpart F income and section 956 inclusions.

Enron found support for this allocation position in the case of *Barnette v. Commissioner*,[674] a memorandum opinion of the Tax Court addressing a similar issue that arose under the foreign personal holding company regime.[675] The issue was one of 15 issues decided in the case, which addressed several tax years of an individual who had been convicted of both tax fraud and government contracting fraud in connection with the foreign business arrangements at issue.[676] The present discussion of the case is limited to the issue pertinent to Enron's subpart F position in Project Apache.

Among other tax reduction strategies, the taxpayer in the *Barnette* case arranged for a Panamanian foreign personal holding company that he controlled to issue a new class of preferred stock, with a conceded purpose of deflecting foreign personal holding company income away from himself. As in Project Apache, the terms of the ownership instruments provided that no distributions could be made on the taxpayer's common stock while the preferred stock remained outstanding. Under the applicable Treasury regulation, if a foreign personal holding company has outstanding both preferred and common stock, and the preferred stock is entitled to a specified dividend before any distribution can be made on the common stock, foreign personal holding company income is treated as being distributed first with respect to the preferred shares.[677] Thus, like Enron under the subpart F multiple-classes-of-stock regulation, the taxpayer in *Barnette* took the position that none of the "tainted" foreign income was allocable to the common shares that he held. The IRS, on the other hand, contended that all such income should have been allocated to the taxpayer's common shares, since there was no reason for the creation of the preferred shares other than tax avoidance.

The court ruled in favor of the taxpayer on this issue, sustaining his allocation of foreign personal holding company income away from himself under the regulation, despite the acknowledged tax motivation for the issuance of the preferred stock and related transactions. The court concluded that, even if the sole purpose for creating and transferring the preferred stock were tax avoidance, the stock's existence still could not be ignored. Since the transactions at issue altered the taxpayer's financial position, the court decided that no non-tax business purpose was necessary. In other words, the court seems to have concluded that the foreign personal holding company income allocation regulation was to be applied literally, and its results

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[674] 63 T.C.M. (CCH) 3201 (1992), *reh'g denied*, 64 T.C.M. (CCH) 998 (1992).

[675] The foreign personal holding company regime (secs. 551-558) is an anti-deferral regime that preceded subpart F, and that now has been largely supplanted by it. Under coordination rules applicable for taxable years of U.S. shareholders beginning after July 18, 1984, subpart F generally trumps the foreign personal holding company regime. Sec. 951(d). During the taxable years at issue in the *Barnette* case, however, the foreign personal holding company rules generally trumped the subpart F rules. Sec. 951(d), prior to amendment by P.L. 98-369.

[676] The case also involved several tax years of the individual's company and certain members of his family.

[677] Treas. Reg. sec. 1.551-2(c).

respected, even with respect to a tax-motivated structure entirely lacking any non-tax business purpose.

Given the similarities between the foreign personal holding company issue raised in the *Barnette* case and the subpart F issue raised in Project Apache, the *Barnette* case arguably lends support to Enron's position that none of Dutch VOF's subpart F income should be allocated to Enron, regardless of the tax motivation behind the structuring of the ownership instruments. Nevertheless, if the issue were litigated, a court would approach the issue de novo and accord the *Barnette* case little or no precedential weight. As a memorandum opinion (as opposed to a "regular," or "T.C." opinion) of the Tax Court, the case is not regarded as controlling precedent by any court, including the Tax Court itself.[678] Memorandum opinions are generally limited to their specific facts; if a case raises novel legal issues, the Tax Court generally issues a "regular" opinion, which the court then regards as controlling precedent.

Thus, a court determining how to apply Treas. Reg. section 1.951-1(e)(2) to Enron and Dutch VOF would be free to analyze the issue on its own merits and would not be bound by the earlier memorandum decision of the Tax Court applying Treas. Reg. section 1.551-2(c) to the taxpayer in *Barnette.* On this basis, it is impossible to predict how a court might resolve the issue. A literal application of the regulation to the carefully structured ownership instruments of Dutch VOF appears to yield the results intended by Enron. However, it is possible that a court would sustain an argument along the same lines advocated by the IRS in the *Barnette* case. In other words, a court might conclude that the transaction was structured to generate tax benefits not intended by the Congress, that there was no significant non-tax business purpose for the complex manner in which the transaction was structured, and that the subpart F income allocation sought by Enron would violate the purpose of subpart F and would abuse the rule set forth in Treas. Reg. section 1.951-1(e)(2), thus requiring an allocation of some subpart F income to Enron.

A court might reach this conclusion on a somewhat narrower basis by disregarding Seminole's option to purchase the Investors B.V. stock as lacking any non-tax business purpose. The court then could apply the hypothetical of Treas. Reg. section 1.951-1(e)(2) by treating Dutch VOF's redemption right as exercised, and treating the hypothetical redemption of the Preferred Units as a sale instead of a dividend distribution, which in turn would leave earnings and profits distributable to the Common Units in a hypothetical year-end distribution, thus requiring an allocation of subpart F income to Enron.

Avoidance of other potential offsetting tax liabilities.–Subpart F was the main, but not the only, potential source of U.S. tax that needed to be avoided in order for Project Apache to generate the net tax benefits intended. For example, if the interest paid to Dutch VOF had been subject to U.S. withholding tax, then the transaction would not have been worthwhile, even if the other tax issues raised by the transaction were resolved in Enron's favor. In this regard, Enron took the position that no withholding tax applied, principally because the interest earned by

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[678] *See, e.g., Darby v. Comm'r*, 97 T.C. 51, 67 (1991); *Nico v. Comm'r*, 67 T.C. 647, 654 (1977), aff'd in part and rev'd in part on other grounds, 565 F.2d 1234 (2d Cir. 1977); *McGah v. Comm'r*, 17 T.C. 1458 (1952).

Dutch VOF on the Interim Notes took the form of short-term original issue discount, which is exempt from withholding tax.[679]

Another potential U.S. tax problem for the structure, the passive foreign investment company regime,[680] was avoided by reason of Dutch VOF's status as a controlled foreign corporation, and Enron's status as a U.S. shareholder of Dutch VOF. Under section 1297(e), which Congress enacted in 1997 to address the overlap of the passive foreign investment company rules and subpart F, a controlled foreign corporation generally is not also treated as a passive foreign investment company with respect to a U.S. shareholder of the corporation. Thus, even though Enron took the position that it would not be allocated any of Dutch VOF's subpart F income, Enron's status as a U.S. shareholder of Dutch VOF within the meaning of section 951(b) nevertheless exempted Enron from the application of the passive foreign investment company rules in connection with Dutch VOF.

Use of a FASIT to avoid earnings stripping rules

As explained above, Project Apache as originally conceived did not involve the use of a FASIT. Rather, the original transaction design would have used direct lending by Dutch VOF to Enron to cycle funds through the structure and generate the desired deductions.[681] Only after a concern was raised that the interest on such a direct loan might be subject to disallowance under section 163(j) was the transaction redesigned to direct the loan through a FASIT.[682] Since the limits of section 163(j) generally apply only to interest paid between related parties, Enron took the position that interposing an unrelated FASIT between itself and Dutch VOF rendered those limits inapplicable. The FASIT rules[683] in turn made it possible for Enron to place a relatively small "owner interest" in the FASIT with an unrelated party, and thereby to take the position that the FASIT was unrelated to Enron, despite the fact that Enron: (1) was the largest investor in the

[679] Sec. 871(g)(1)(B). Even if the interest did not qualify as short-term original issue discount, the portfolio debt exception of section 881(c)(2)(B) might have shielded the interest from withholding taxes. In addition, U.S. income tax treaties with the Netherlands and Luxembourg arguably would have provided a further backstop against the imposition of withholding tax.

[680] Secs. 1291-1298.

[681] Memorandum from R. Davis Maxey to Robert J. Hermann, with transaction diagram, June 23, 1998, EC2 000037282, EC2 000037285; Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (*see* Appendix B, Part X to this Report).

[682] Joint Committee staff interviews; Presentation by Chase Securities to Enron, with transaction diagram, June 8, 1998, at EC2 000037313 (with the words "163(j) issue" written by hand on a copy of a diagram showing direct lending by the controlled foreign corporation to Enron) (*see* Appendix B, Part X to this Report).

[683] Secs. 860H - 860L.

FASIT; (2) exercised day-to-day control over the FASIT through the servicing arrangement; and (3) treated the FASIT as an Enron consolidated entity for financial reporting purposes.

Although the Treasury Department has never issued final regulations under section 163(j), a comprehensive set of proposed regulations was issued in 1991.[684] Under these proposed regulations, the IRS would have broad authority to disregard entities created with a principal purpose of avoiding section 163(j). Specifically, the proposed regulations provide that "[a]rrangements, including the use of partnerships and trusts, entered into with a principal purpose of avoiding the rules of section 163(j) and [the proposed regulations] shall be disregarded or recharacterized to the extent necessary to carry out the purposes of section 163(j)."[685]

In the case of Project Apache, it is clear from Joint Committee staff interviews with Enron personnel involved in planning the transaction, as well as from documentary evidence and the structure of the transaction itself, that the FASIT arrangement was established "with a principal purpose of avoiding section 163(j)." In addition, given that the arrangement was used to ensure that no interest or interest-equivalent deductions would be disallowed on what in substance was a related-party borrowing, and that Enron maintained that the payments in question were not subject to any offsetting Federal tax (e.g., withholding tax, or tax arising under subpart F), recharacterizing the transaction would "carry out the purposes of section 163(j)."[686] Thus, if the proposed regulation had applied to the transaction, the conditions for the application of the anti-avoidance rule would have been present.

Proposed regulations do not have the force of law, but taxpayers commonly use them as guidance and as indicators of the government's position on the issues addressed. In this case, Enron disregarded a proposed regulation that was directly on point and contrary to its return position.

The Shearman & Sterling opinion letter that addressed FASIT-related issues briefly discussed the proposed regulations and concluded that "the anti-abuse rule in the proposed regulations should not be applicable to disregard [the FASIT], because no principal purpose of the transaction is to avoid section 163(j)."[687] In light of the evidence that avoiding section 163(j) in fact was the principal purpose for using a FASIT in the first place, the Joint Committee staff finds this statement in the opinion letter troubling.

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[684] Prop. Reg. sec. 1.163(j)-1 *et seq.*

[685] Prop. Reg. sec. 1.163(j)-1(f).

[686] This issue, of course, would not be reached if it were determined that Dutch VOF's subpart F income was taxable to Enron, since the amounts then would be subject to Federal tax, canceling out the benefit of the interest deductions. Sec. 163(j)(3)(A).

[687] Letter from Shearman & Sterling to Enron Corporation and Cherokee Finance VOF c/o Rabobank Management B.V., May 28, 1999, at 10-11 (Appendix C, Part IX to this Report).

Although the analysis of the opinion letter is somewhat elliptical on this point, it implies that avoidance of section 163(j) could not have been a principal purpose of using the FASIT, since payments of interest directly from the obligors on the receivables (i.e., Enron's natural gas and electric power customers) to Dutch VOF would have been payments between unrelated parties, and thus would not have been subject to section 163(j).[688] Of course, the FASIT was not interposed in any larger lending transaction between Enron's customers and Dutch VOF; it was interposed in a larger lending transaction between Enron and Dutch VOF. The purported sales of trade receivables by Enron affiliates to the FASIT may be viewed as secured financings comprising merely one component of the larger financing arrangement -- in other words, Dutch VOF loaned funds to the FASIT, and the FASIT in turn effectively loaned the funds to Enron on the strength of the receivables. Viewed in this manner, the transaction may be understood as avoiding section 163(j), since the interest, if paid directly by Enron to Dutch VOF (and not subjected to Federal tax) potentially would have been subject to section 163(j). The opinion letter raises this possibility, and dismisses it, in a footnote.[689]

The opinion letter's explanation of the transaction is that "the principal purpose of the arrangement is to create a revolving securitization vehicle for accounts receivable generated by [domestic affiliates of Enron]."[690] Again, this declared purpose is implausible, given that the idea to use a FASIT in fact arose as a solution to a perceived section 163(j) problem, and that the structure did not generate the non-tax benefits (increased liquidity, decreased credit exposure) that normally accompany third-party factoring transactions, due to the circularity at the heart of the arrangement. The Joint Committee staff believes that, at a minimum, the opinion letter reflects an unquestioning reliance on company representations as to business purpose, as well as a failure to look beyond isolated parts of an overall transaction to evaluate it in its totality.

Notwithstanding these concerns about the opinion letter's analysis of the proposed regulations, the fact remains that the lack of final regulations on this issue, combined with the availability under the FASIT rules of an entity that Enron could control but treat as unrelated for tax purposes, enabled Enron to take the position that section 163(j) could be avoided through the expedient of interposing an additional entity.[691]

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688 The opinion letter acknowledges that this reasoning would not apply to the Enron-group commercial paper held by the FASIT. The opinion letter instead downplays the importance of this debt, implying that it could not be significant enough to form "a principal purpose" of avoiding section 163(j). *Id.*, at 10-11.

689 *Id.*, at 11, n.7.

690 *Id.*, at 10.

691 Subsequent to the closing of the transaction, the Treasury Department issued proposed regulations under the FASIT rules, which included a broad anti-abuse rule. Prop. Reg. sec. 1.860L-2 (Feb. 7, 2000). In view of the company's treatment of the anti-abuse rule provided in the proposed regulations under section 163(j), it would seem unlikely that a second anti-abuse rule in proposed form would have caused Enron or its advisors to reach a different conclusion as to the appropriateness of the use of the FASIT.

Recommendations

In general

As discussed above, Project Apache raises a set of familiar concerns encountered in connection with tax-motivated transactions, in particular issues relating to the economic substance and business purpose doctrines. In addition to these general concerns, however, the transaction also raises some specific issues regarding the potential abuse of particular statutory and regulatory provisions. The Joint Committee staff believes that amendments to some of these provisions should be considered in order to render them less prone to abuse in tax-motivated transactions.

Allocation of subpart F income

Project Apache exploited a highly mechanical earnings and profits allocation rule in Treas. Reg. sec. 1.951-1(e)(2) in an effort to achieve results that cannot have been envisioned or intended by the Treasury Department when it issued the regulation. The putative ability to allocate all of the subpart F income of Dutch VOF to tax indifferent foreign parties was critical to Enron's position that it could blend its third-party debt with self-owed debt within Dutch VOF in order to generate inflated interest and interest-like deductions without incurring any offsetting tax liability under subpart F. The transaction thus illustrates that special allocation abuses similar to those that have been encountered in the partnership taxation area[692] are also possible in the context of controlled foreign corporations. Enron took the position that it could specially allocate the subpart F "taint" to tax-indifferent parties, and it was able to find some support for this position under both the regulation and analogous non-subpart-F case law.

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 subpart F income allocation method set forth in the regulation for cases involving allocations of earnings and profits to tax-indifferent shareholders, if such allocations are made for tax avoidance purposes. If such an exception had been applicable to Project Apache, the transaction would not have been viable.

Passive foreign investment company regime

Another concern raised by Project Apache involves the statutory elimination of the so-called overlap between the passive foreign investment company regime and the subpart F regime. In 1997, Congress enacted section 1297(e) in order 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. Section 1297(e) largely eliminates this overlap by providing that a corporation generally is not treated as a passive foreign investment company with respect to a particular shareholder if the corporation is also a controlled foreign corporation, and the shareholder is a

[692] *See, e.g.*, sec. 704(b); Treas. Reg. sec. 1.704-1(b)(2) (addressing special partnership allocations that lack "substantial economic effect").

"U.S. shareholder" as defined in section 951(b). Thus, subpart F is allowed to trump the passive foreign investment company rules, and a U.S. shareholder generally no longer needs to contend with these rules in connection with the ownership of controlled foreign corporation stock.

As applied to Project Apache, section 1297(e) enabled Enron to claim exemption from the passive foreign investment company rules with respect to its ownership of Dutch VOF stock on the basis of Enron's subpart F status as a U.S. shareholder, despite the fact that Enron had implemented a structure designed to render it impossible for Enron to recognize any income under subpart F in connection with the stock. Thus, in a case in which Enron was a 60-percent U.S. shareholder of a foreign corporation with nothing but passive assets and passive income, Enron could take the position that neither subpart F nor the passive foreign investment company rules applied.

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 under subpart F. Accordingly, the Joint Committee staff recommends adding an exception to section 1297(e) for cases in which the likelihood that a U.S. shareholder would have to include income under subpart F is remote. In such a case, the subpart F rules and the passive foreign investment company rules cannot be said to "overlap" in the manner that the Congress found objectionable in 1997. Rather, allowing the two regimes to "overlap" in these cases would allow the passive foreign investment company rules to serve the useful purpose of providing a backstop to subpart F. If the passive foreign investment company rules had applied to Enron in Project Apache, the transaction as structured would not have been viable, even if Enron's position under subpart F were sustained.

FASIT rules

As explained above, the availability under the FASIT rules[693] of an entity that Enron could control but treat as unrelated for tax purposes enabled Enron to take the position that section 163(j) could be avoided through the expedient of interposing an additional entity. In view of the wide range of rules under the Code that apply special restrictions to transactions between related parties, the ability to treat a FASIT as unrelated for tax purposes while maintaining effective control of it for other purposes renders FASITs prone to abuse in a wide range of situations. Regulatory anti-abuse rules,[694] if issued in final form, might mitigate this potential to some extent, but history suggests that the administration of such rules would be problematic, leaving considerable potential for abuse remaining. Moreover, recent commentary suggests that the 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.[695]

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[693] Secs. 860H - 860L.

[694] *See, e.g.*, Prop. Reg. sec. 1.163(j)-1(f); Prop. Reg. sec. 1.860L-2.

[695] *See, e.g.*, New York State Bar Association, "Report on Securitization Reforms" (Dec. 20, 2002) ("It is clear that the FASIT rules are not being used to any significant degree and

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.

Earnings stripping regulations

The lack of final regulations under section 163(j) has created a void in an area in which more definitive guidance is needed. Project Apache illustrates that taxpayers may treat proposed regulations as a one-way street, to be relied upon when supportive of the desired return position, and to be disregarded when contrary to such position. If the anti-abuse rule of the proposed regulations under section 163(j)[696] had been in final form, Enron might have reconsidered this transaction. As noted above, the administration of such rules is always problematic, but the existence of a finalized anti-abuse rule directly on point would induce at least some change to a company's cost benefit assessment of a transaction like Project Apache. Accordingly, the Joint Committee staff recommends that the regulations implementing an anti-abuse rule to combat the avoidance of section 163(j) should be finalized expeditiously.

2. Project NOLy[697]

Project NOLy was a series of transactions structured to generate sufficient taxable income so that Enron could offset all of its tax losses from earlier years. Enron engaged in this transaction because it would allow Enron to settle and close tax examinations for those years. Project NOLy involved the constructive sale rules and the partnership rules. The following is a discussion of these rules, followed by a detailed discussion of Project NOLy.

Discussion of relevant tax laws

Tax treatment of section 1259 constructive sales

For transactions entered into after June 8, 1997, taxpayers are required to recognize gain (but not loss) upon entering into a constructive sale of any appreciated position in stock, a partnership interest, or certain debt instruments as if such position were sold, assigned or otherwise terminated at its fair market value on the date of the transaction.[698] If the requirements

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accordingly are not achieving their purpose"); New York State Bar Association, "Simplification of the Internal Revenue Code" (March 18, 2002), reprinted in 95 Tax Notes 575 (April 22, 2002) ("In our experience, the FASIT legislation is not being used by those who would be expected to benefit from it and it is unlikely that situation will change"); Letter from James M. Peaslee and David Z. Nirenberg to Assistant Treasury Secretary (Tax Policy) Mark A. Weinberger (June 6, 2001), reprinted in 91 Tax Notes 2079 (June 18, 2001) ("The FASIT legislation has failed").

[696] Prop. Reg. sec. 1.163(j)-1(f).

[697] The project was named for "Molly," a girlfriend of one of the attorneys on the transaction. Joint Committee staff interview.

[698] Sec. 1259, enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1001(a). A "position" is defined as an interest, including a futures or forward contract, short

for a constructive sale are met, the taxpayer recognizes gain in a constructive sale as if the position were sold at its fair market value on the date of the transaction and immediately repurchased.[699]

In general, a taxpayer is treated as making a constructive sale of an appreciated position if and when the taxpayer (or, in certain circumstances, a person related to the taxpayer) does one of the following: (1) enters into a short sale of the same (or substantially identical) property; (2) enters into an offsetting notional principal contract with respect to the same (or substantially identical) property; or (3) enters into a futures or forward contract to deliver the same (or substantially identical) property.[700] In addition, in the case of an appreciated financial position that itself is a short sale, a notional principal contract, or a futures or forward contract, the holder is treated as making a constructive sale when it acquires the same (or substantially identical) property as the underlying property for the position.[701] Finally, to the extent provided in Treasury regulations, a taxpayer is treated as making a constructive sale when it enters into one or more other transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described.[702]

A forward contract results in a constructive sale of an appreciated financial position only if the forward contract provides for delivery, or for cash settlement, of a substantially fixed

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sale, or option. A "position" includes a notional principal contract or other derivative instrument that provides that a taxpayer make or receive payments (or contractual credits) that approximate the economic effect of ownership of stock, a debt instrument or a partnership interest. For example, a contract that provides a right to receive payments (or contractual credits) based on a calculation having the effect of interest on a notional principal amount is treated as a position with respect to a debt instrument.

[699] Sec. 1259(a)(1).

[700] Sec. 1259(c)(1). A constructive sale does not include a transaction involving an appreciated financial position that is mark to market, including positions governed by section 475 (mark to market for securities and commodities dealers and traders) or section 1256 (mark to market for futures contracts, options and currency contracts). Nor does a constructive sale include any contract for sale of an appreciated financial position which is not a "marketable security" (as defined in section 453(f) if the contract settles within one year after the date it is entered into).

[701] *Id.*

[702] Sec. 1259(c)(1)(E). Future Treasury regulations are anticipated to treat as constructive sales other financial transactions that, like those specified in section 1259, have the effect of eliminating substantially all of the taxpayer's risk of loss and opportunity for income and gain with respect to the appreciated financial position. It is anticipated that the Treasury regulations, when issued, will provide specific quantitative standards for determining whether several common transactions will be treated as constructive sales. H.R. Rep. No. 105-148, at 442-443 (1997).

amount of property and a substantially fixed price.[703] Thus, a forward contract providing for delivery of property, such as shares of stock, the amount of which is subject to significant variation under the contract terms does not result in a constructive sale.[704]

Tax treatment of partnership formation

Generally, a partner does not recognize gain or loss on the exchange of property for a partnership interest[705] and a partner's basis in a partnership interest acquired by contribution of property to a partnership is the amount of money plus the partner's adjusted basis of the property contributed.[706] In Rev. Rul. 80-235[707] the IRS held that if the property contributed to a partnership is an obligation of the contributing partner, that partner's basis is not increased to reflect the partner's obligation because the partner has no basis in its own obligation under certain circumstances. Treasury regulations provide that if parties enter into an off-market swap with significant nonperiodic payments, the contract is treated for Federal income tax purposes as two separate transactions, an on-market swap and a loan.[708] Consequently, it could be argued that the loan part of the swap transaction would be within the holding of Rev. Rul. 80-235 and the contributing partner would receive no basis in its partnership interest as a result of contributing its own obligation.

Liquidation of a partnership

Gain is not recognized to a partner as a result of a distribution from a partnership except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution.[709] No loss generally will be recognized to a partner upon receipt of a distribution from a partnership except upon a distribution in complete liquidation of a partner's interest in the partnership if no property other than money, unrealized receivables and inventory is received.[710] If the criteria for recognizing a loss are met, the loss is recognized to the extent of the excess of the adjusted basis of the partner's interest in the partnership over the sum of the money distributed and the basis to the distributee, as determined

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[703] *See* Sec. 1259(d)(1).

[704] H.R. Rep. No. 105-148, at 442 (1997).

[705] Sec. 721.

[706] Sec. 722.

[707] 1980-2 C.B. 229. *See* also, *Gemini Twin Fund III v. Commissioner*, T.C. Memo 1991-315 (1991) *aff'd without published opinion*, 8 F3d 26 (9th Cir. 1993).

[708] Treas. Reg. sec. 1.446-3(g)(4).

[709] Sec. 731.

[710] Sec. 731(a)(2).

under section 732, of any unrealized receivables and inventory distributed.[711] Gain or loss recognized as a result of a distribution pursuant to section 731 is treated as gain or loss from the sale or exchange of the partnership interest of the distributee partner[712] and is generally treated as gain or loss from the sale of a capital asset.[713] If a distribution is made to a partner of the partner's obligation received by the partnership in exchange for a partnership interest, there is no direct authority as to how this should be treated.[714] Commentators have indicated that this should be treated as a nonevent for tax purposes.[715] As a result the loss on the liquidation would be recognized to the extent basis exceeds the amount of cash distributed plus the basis to the distributee of any unrealized receivables and inventory received.[716]

Capital loss carryback

Capital losses are required to be carried back three years and, if not used in the carryback years, carried forward five years.[717] A capital loss carryback cannot increase or produce a net operating loss for the year to which it is carried back.[718] Treasury regulations provide ordering rules for capital loss carrybacks in situations when there are also net operating losses at issue.[719] Generally, the capital loss carryback would offset capital gains in the carryback year to the extent a net operating loss is not created or increased in the carryback year. To the extent a net operating loss from a year prior to the year that produced the capital loss was carried into the carryback year and offset capital gains, that net operating loss is freed up to be carried to a subsequent year.[720]

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[711] *Id.*

[712] *Id.*

[713] Sec. 741.

[714] Treas. Reg. sec. 1.731-1(c)(2) and Rev. Rul. 93-7, 1993-1 C.B. 125, involve partner obligations that were either a loan or were acquired from a third party.

[715] McKee, Nelson & Whitmire, Federal Income Taxation of Partnerships and Partners, Para. 19.02[5] (1997).

[716] Sec. 731(a)(2).

[717] Sec. 1212(a)(1)(A) and (B).

[718] Sec. 1212(a)(1)(A)(ii).

[719] Treas. Reg. sec. 1.1212-1(a)(3).

[720] *See* Examples 4 and 5 of Treas. Reg. sec. 1.1212-1(a)(3).

Statute of limitations on NOL carryover years and adjustment of NOL carryover

Generally tax must be assessed within three years from the date a return for that year is filed.[721] Courts have held that, although the period of limitations for the year a net operating loss carryover arose is not open, the amount of net operating loss carryover from a barred year can be recalculated when determining a deficiency for an open year.[722]

IRS Appeals' "no immediate tax consequence" policy

If a taxpayer does not agree with adjustments made by an examiner, generally a taxpayer has the opportunity to take that dispute to Appeals, a dispute resolution function within the IRS. Most cases considered by Appeals involve disputed tax liability and as a general rule Appeals will not consider cases when there is "no immediate tax consequence."[723] However, cases can arise in which there is no disputed tax liability for the period under consideration. In such cases, if required by law, IRS policy, regulation, ruling or procedure, Appeals will consider issues that do not have an immediate tax consequence.[724] Appeals has indicated that one example of such a case is a year in which a net operating loss carryover arises and the carryforward year has not yet been examined.[725] The IRS has recently established other dispute resolution procedures and at least one of these might be available in no immediate tax consequence situations.[726]

Brief overview of Project NOLy

Project NOLy was a series of transactions structured to "soak up" losses generated in the 1996 through 2000 taxable years so that Enron could settle and close tax examinations for those years. The transactions involve using limited liability companies ("LLCs") taxed as partnerships and the constructive sale rules of section 1259 to generate capital gains that can be offset by NOL carryovers to and losses incurred in 2000. Because the exact amount of the losses for 2000 was not known, Enron used two techniques to try to match the amount of gain as closely as possible to the ultimately determined losses. First, it set up 14 different LLCs, each with a different amount of potential gain available, so that when the amount of the losses was finally determined, it could be matched as closely as possible by using a combination of LLCs. Also,

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[721] Sec. 6501(a).

[722] *Hill v. Commissioner*, 95 T.C. 437, 440 (1990) and *Stiebling v. Commissioner*, 1994 T.C. Memo 233, *aff'd without published opinion* 113 F3d 1242 (9th Cir. 1997). *See* also Rev. Rul. 56-285, 1956-1 C.B. 134.

[723] IRM 8.1.2.2.3(1) (February 2, 1999). Apparently one reason for this position is that Appeals resources should not be used in cases when there is no tax currently at issue.

[724] IRM 8.1.2.2.3(2) (February 2, 1999).

[725] *Id.*

[726] Internal IRS correspondence indicates that early referral might be available in such a situation. See Rev. Proc. 99-28, 1999-2 C.B. 109, for a description of the early referral program.

Enron used certain technical provisions of the constructive sale rules to delay determining how much gain to report in 2000 until the end of March 2001.[727] Enron intended to recognize the corresponding loss in a subsequent year.

Background[728]

Reported tax and financial statement effects

Enron reported a capital gain of $5.6 billion on its 2000 consolidated tax return as a consequence of Project NOLy and paid taxes of $63 million in that year. The partnerships were liquidated in late 2001, causing recognition of a capital loss of $5.6 billion.[729] That capital loss was carried back to 2000, offsetting capital gain that resulted from the constructive sale in that year.[730] Pursuant to the ordering rules, NOLs would be freed up allowing them to be carried to subsequent years.[731] Enron anticipated that application of the capital loss carryback would also result in a refund of the $63 million in taxes paid in 2000.[732]

For financial purposes, this transaction was considered to be neutral.[733]

Development of Project NOLy

Project NOLy was initially developed internally within Enron. Enron wanted to close out examinations on back years from which there were loss carryovers and believed that to do so they needed to trigger enough gain so that there was tax liability for 2000. The Managing Director and General Tax Counsel asked one of the directors in the Tax Department to devise a plan to accomplish this. A plan was developed that utilized the constructive sale rules of section 1259 to generate gain in 2000 by segregating the gain portion of existing financial contracts into partnerships so that the gain could be recognized. Pursuant to section 1259, a taxpayer is deemed to have sold an appreciated financial asset if derivatives or short sales are used to lock in the gain. The gain part of the project had to be completed by the end of 2000. However, by

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[727] Sec. 1259(c)(3) discussed in more detail below.

[728] The information regarding Project NOLy was obtained from Joint Committee staff interviews of Robert J. Hermann, Greek L. Rice, and Stephen H. Douglas as well as from documents and information provided by Enron and the IRS.

[729] Enron Presentation to the Joint Committee on Taxation Staff, June 7, 2002, at 15. The General Background Materials in Appendix B contain this document.

[730] *Id.*

[731] Treas. Reg. sec. 1.1212-1(a)(3).

[732] EC2 000038222. Part of a document entitled, "Chiricahua Partnerships and Related Transactions ("Project NOLY")" provided to the Joint Committee staff by Enron.

[733] Joint Committee staff interview.

using 14 different LLCs taxed as partnerships and certain technical requirements of section 1259(c)(3), determining the exact amount of the gain to be recognized was postponed until late March 2001.

The business purpose of Project NOLy was stated to be to economically segregate the "in-the-money" portion of the financial trading book of Enron North America, Corp., a wholly owned subsidiary of Enron Corp. ("ENA").[734] The reason 14 LLCs were needed to do this was not given.

Implementation of Project NOLy[735]

ENA routinely entered into positions, including swaps, futures contracts, options and forward contracts with third parties relating to the price of natural gas and other commodities. Usually ENA would enter into offsetting positions with its wholly owned subsidiary Risk Management and Trading Corp. ("RMT") pursuant to an ISDA Master Agreement[736] dated March 31, 1997, and periodic confirmations executed in association with that agreement ("ENA Master Swap). This served to place the risks for these types of transactions in one entity, RMT, which made managing the risk easier.

On December 20, 2000, 14 Delaware LLCs were formed by RMT and FS 360 Corp., a wholly owned subsidiary of RMT ("FS 360").[737] These 14 LLCs, which elected to be taxed as partnerships, were named RMT Chiricahua I[738] through RMT Chiricahua XIV ("Chiricahuas"). FS 360 owned a .01 percent interest in the capital, profits and losses of each partnership, which it acquired in exchange for a cash contribution to that entity. RMT acquired a 99.99 percent

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[734] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 114. The answer references a memorandum to Robert J. Hermann from Stephen H. Douglas dated August 29, 2001. Appendix B, Project NOLy contains this document.

[735] This section is based in large part on an opinion letter from Vinson & Elkins to Enron Corp. dated February 26, 2001, contained in Appendix C, Part X to this Report; a draft opinion letter from Vinson & Elkins to Enron Corp. dated December 17, 2001, also contained in Appendix C, Part X to this Report; summaries of the transaction provided to the Joint Committee staff by Enron at EC2 000038199-206 and a memorandum from Stephen H. Douglas to Robert J. Hermann dated August 29, 2001. Appendix B, Project NOLy contains this memorandum.

[736] An ISDA Master Agreement is a standard form agreement copyrighted by the International Swap Dealers Association that sets forth the terms and conditions governing any specific swaps made pursuant to the agreement among the parties to it.

[737] Current Management is not aware of any internal approval process for Project NOLy. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 110.

[738] The Chiricahua partnerships were named for a golf course at the Desert Mountain Golf Club in Scottsdale, Arizona. Joint Committee staff interviews.

interest in the capital, profits and losses of each entity, in exchange for a cash contribution and its agreement to enter into an ISDA Master Agreement dated December 20, 2000, between RMT and the Chiricahuas and the associated confirmation dated December 27, 2000 ("RMT Swaps"), which represented offsetting positions with respect to certain of the contracts held by RMT. All of the RMT Swaps were substantially in the money at the time of execution and represented a transfer of value from RMT to the Chiricahuas. The amount of the net cash payments required to be made under each of the RMT Swaps to each Chiricahua was based upon the specific terms set forth in the associated confirmation based on the notional volumes and prices set forth therein. It was anticipated that a substantial net payment would be made by RMT to each Chiricahua over the life of the RMT Swaps rather than requiring a payment to be made by the Chiricahuas to RMT. None of the Chiricahuas was required, under the terms of the RMT Swaps, to make any net payments in the aggregate to RMT in excess of the amounts actually received by such entity from RMT.

Tularosa LLC was a Delaware LLC whose members were ENA and Mangas I Corp., a wholly owned subsidiary of ENA ("Mangas"). ENA owned a 99.99 percent interest in Tularosa and Mangas owned the remaining .01 percent interest. Subsequent to the execution of the RMT Swap, RMT entered into an ISDA Master Agreement dated December 20, 2000 with Tularosa and an associated confirmation dated December 27, 2000, for a total return swap ("Tularosa Swap") with respect to RMT's membership interest in each Chiricahua. Under the terms of the Tularosa Swap, RMT was entitled to receive from Tularosa on the settlement date, a fixed sum equal to the fair market value of RMT's membership interests in the Chiricahuas on the initial contract date and RMT was required to pay Tularosa the fair market value of the membership interests in the Chiricahuas on the settlement date, plus the amount of any distributions from the Chiricahuas during the term of the contract. The Tularosa Swap was effective December 27, 2000, and the settlement date was January 2, 2002. Enron Corp. guaranteed Tularosa's obligation under the Tularosa Swap. By entering into the Tularosa Swap, RMT became subject to the constructive sale rules of section 1259, causing it to recognize $5.6 billion in gain (the difference between its basis in the Chiricahuas and the fair market value of its interest in the Chiricahuas) in the 2000 taxable year.

Because it would take a few months to determine precisely the amount of losses at the end of its 2000 taxable year, Enron sought to use technical rules contained in section 1259(c)(3) to delay final determination of the amount of gain until the end of March 2001. There is an exception to constructive sale treatment for any transaction that is closed before the end of the 30th day after the close of the taxable year in which it was entered into.[739] This exception to the constructive sale rules is only available if the taxpayer holds the appreciated financial position to which the transaction relates throughout the 60-day period beginning on the date such transaction is closed and at no time during such 60-day period is the taxpayer's risk of loss reduced (under the principals of section 246(c)(4)) by holding positions with respect to substantially similar or related property.[740]

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[739] Sec. 1259(c)(3).

[740] *Id.*

To this end, less than 30 days after the end of the taxable year, on January 29, 2001, RMT and Tularosa entered into an early settlement of the Tularosa Swap. This early settlement triggered a $701.8 million termination payment by Tularosa to RMT (because gas prices had declined since December 27, 2000) and was considered to be a closed transaction, nullifying the constructive sale, provided the 60-day rule was not applicable.[741] However, Enron intended to use the 60-day rule to further extend the time for determining how much gain was needed to offset the losses. By March 27, 2001, Enron's Tax Department had concluded that the entire $5.6 billion gain should be recognized in 2000. In order to ensure that the entire gain was recognized, RMT and Tularosa entered into a new total return swap within 60 days of termination of the termination of the original Tularosa Swap. This brought the transactions within the 60-day rule[742] with the result that the $5.6 billion gain was deemed to be recognized in 2000. RMT's basis in the Chiricahuas was increased by the same amount.

At the time Project NOLy was developed and implemented, it was assumed that it would be unwound in January 2002.[743] However, due to Enron's financial deterioration in 2001, a decision was made to unwind Project NOLy in 2001 by liquidating the Chiricahuas thereby triggering the offsetting $5.6 billion capital loss. The Chiricahuas were liquidated in December 2001.[744]

The following consequences resulted from the liquidation of the Chiricahuas.[745] FS 360 redeemed its original $500,000 investment and all other assets and liabilities were transferred to RMT. The only assets of the Chiricahuas were accounts receivable from RMT, the RMT Swaps and cash. When the liquidation occurred, RMT was distributed cash and the RMT Swaps. RMT's basis now included the $5.6 billion gain recognized in 2000. Because it received relatively little cash and its own liability, the RMT Swaps, on which it recognized no gain or loss, a large capital loss, essentially equal to the $5.6 billion capital gain in the previous year, was recognized. The recognition of this loss and the resultant carryback to earlier years was projected to result in a refund of the $63 million of tax paid in 2000. Because the capital loss carryback from 2001 cannot increase or produce an NOL, the approximately $2.5 billion of operating losses that arose in 2000 would continue to offset capital gains of that amount in 2000.

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[741] *Id.*

[742] *Id.*

[743] Opinion letter from Vinson & Elkins to Enron Corp. dated February 26, 2001, at 2. Appendix C, Part X to this Report contains this letter.

[744] Enron Corp. Presentation to the Joint Committee on Taxation Staff, June 7, 2002, at 15. The General Background materials in Appendix B contain this document.

[745] Draft opinion letter from Vinson & Elkins dated December 17, 2001, at 4-10. Appendix C, Part X to this Report contains this letter.

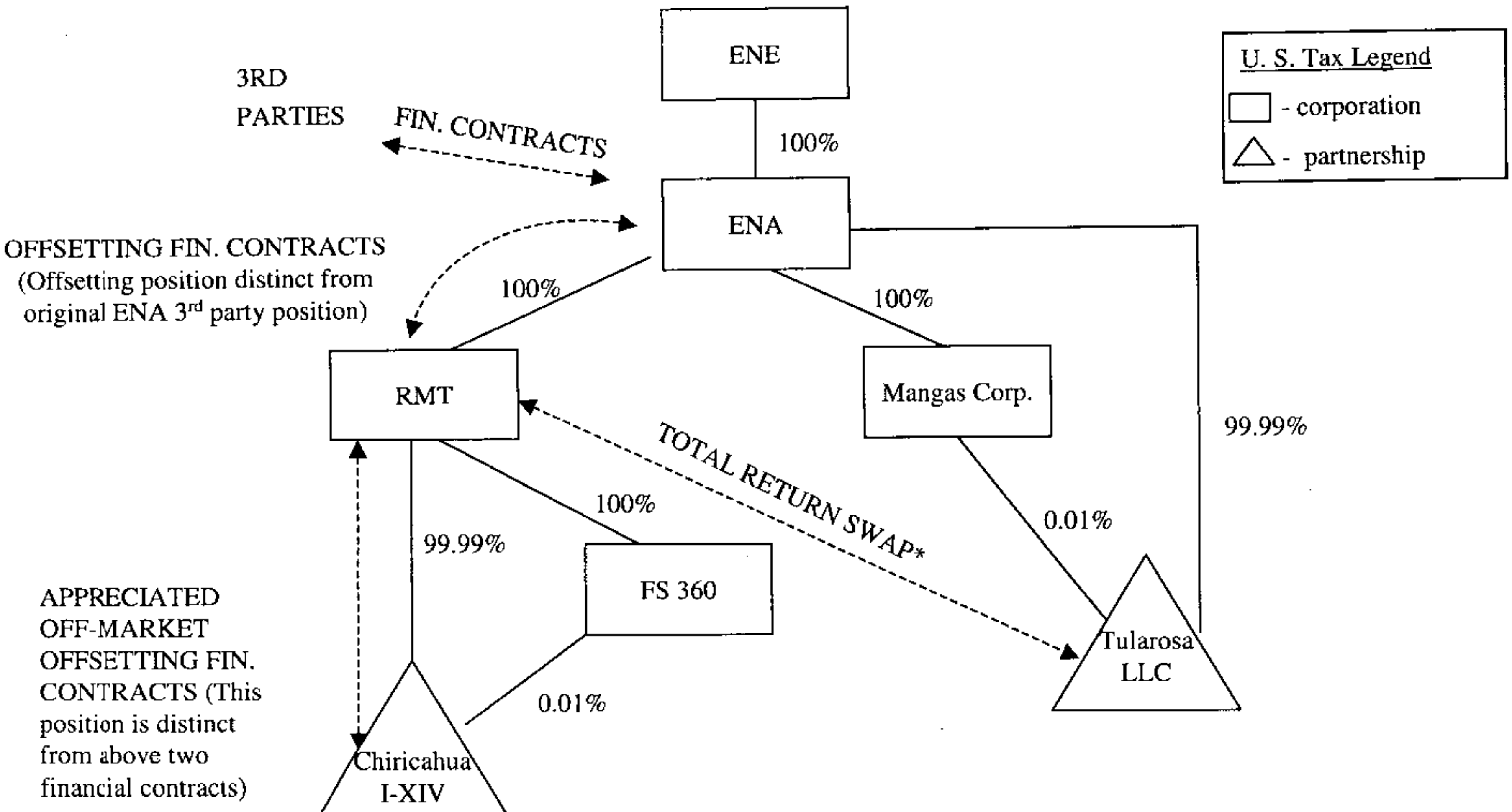
However, the pre-2000 NOL carryovers would be freed up and available to be carried to subsequent years.[746]

The diagram on the next page depicts the Project NOLy structure as of December 2000.

[746] EC2 000038222. Part of a document entitled, "Chiricahua Partnerships and Related Transactions (Project NOLy)" provided by to the Joint Committee staff by Enron.

Confidential

Project NOLy – December 2000



*Total return swap contract whereby Tularosa LLC agrees to pay RMT $5.556 billion in return for RMT's obligation to pay to Tularosa LLC all returns related to RMT's interest in Chiricahua LLC. Net cash settlement of difference between (i) FMV of Chiricahua interest at settlement date + distributions on such interest, and (ii) $5.556 billion fixed payment.

Role of outside advisors

Although the plan that became Project NOLy originated within the Enron Tax Department, Vinson & Elkins became involved during the development stage. Arthur Andersen was involved on the accounting side of the transaction and concluded that it was a "neutral" transaction for financial accounting purposes.[747]

In an opinion letter dated February 26, 2001, Vinson & Elkins opined that the transactions should result in the following: (1) a constructive sale of RMT's membership interest in Chiricahua under section 1259; (2) the recognition of gain in an amount equal to the excess of the fair market value of RMT's member interest in Chiricahua over its basis in such interest; and (3) an increase in RMT's basis in its interest in Chiricahua in an amount equal to the gain recognized as a result of the constructive sale.[748] An important element in conclusion (2) was that RMT did not receive any basis for its interest in any of the Chiricahuas as a result of its agreement to enter into the RMT Swap because it was an obligation of a partner in which the partner had no basis.

In a separate letter, Vinson & Elkins opined with regard to the tax consequences of the liquidation of all of the Chiricahuas concluding the liquidation should generate capital losses that Enron would be able to carry back to 2000. Vinson & Elkins also concluded that RMT's basis in the Chiricahuas would be increased by the amount of gain recognized on the constructive sale in 2000. When the partnerships were liquidated, RMT received only cash and the RMT Swaps. Vinson & Elkins concluded that for the same reasons it was viewed as a nonevent in the formation of the Chiricahuas, it should be viewed as a nonevent in the liquidation. Consequently, RMT should be regarded as receiving only cash in the liquidation enabling it to recognize a loss in the amount its basis exceeded the cash received.

Appendix C, Part X to this Report contains the tax opinions Enron received in connection with Project NOLy.

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[747] Joint Committee staff interviews and letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 107, which indicates that current management of Enron is unaware of "any documents relating to the financial accounting for Project NOLy, other than a passing comment in a document Bates stamped EC2 000038207." The Project NOLy materials in Appendix B contain this document -- a memorandum to Robert J. Hermann from Stephen H. Douglas dated August 29, 2001. The document states "[t]he transaction will not result in negative accounting consequences for ENA because the tax gain resulting at the outset of the transaction will be offset with subsequently recognized tax losses in an equal amount..."

[748] Enron indicated that the February 26, 2001 opinion letter was a final opinion. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 111. However, the copy bears numerous hand-written changes, and therefore does not appear to be the final version.

Fees billed by Vinson & Elkins for project NOLy totaled approximately $90,000.[749] Enron's current management is not aware of any fees paid to Arthur Andersen in connection with services that may have been performed with respect to Project NOLy.[750]

Subsequent developments

By mid-October of 2001, IRS was close to completing the examination cycle involving the losses that were to be carried forward. At that time, it was likely that the examination would be agreed with the exception of one issue. IRS appears to have been concluded that the Appeals Office could take jurisdiction of the remaining disputed issue in the years the NOLs arose.[751] If the disputed issue were resolved, this would allow the examination cycle for those years to be closed.

The IRS is in the process of examining Enron's tax returns for years 1995 through 2001.

Discussion

Enron had loss carryovers from the 1996 through 1999 taxable years into the 2000 taxable year of approximately $3 billion.[752] Based on operations in 2000, it was anticipated that additional operating losses of more than $2 billion would be generated in that year.[753] The Enron Tax Department wanted to close out the earlier loss years to finalize the tax treatment of items in those years, but believed that they needed to use up the loss carryovers and pay some tax in order to do so. Project NOLy was designed to generate sufficient gains to soak up all of the NOLs and losses so that Enron paid some tax in 2000.

The IRS has provided exceptions to its general policy that the Appeals Office will not accept cases unless there is tax at issue.[754] One of the exceptions to this no immediate tax consequence policy is for adjustments made to an NOL carryforward when the carryforward year has not yet been examined. By mid-October of 2001, IRS was close to completing its

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[749] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 113. The answer indicates that Enron has paid $77,228.62 of this amount. The remainder, $13,363.75, was billed in the fall of 2001 and related to the liquidation of the Chiricahua entities, but may not have been paid due to the bankruptcy filing.

[750] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 108.

[751] Internal IRS correspondence.

[752] Opinion letter from Vinson & Elkins to Enron Corp. dated December 17, 2001. Appendix C, Part X to this Report contains this letter.

[753] *Id.*

[754] IRM 8.1.2.2.3(2) (February 2, 1999).

examination of a cycle including years in which the net operating loss carryforwards arose with only one issue remaining unagreed. IRS appears to have concluded that an Appeals forum would be available to Enron in that situation to resolve the unagreed issue.[755]

The stated reason for Project NOLy was to finalize the treatment of items in the years the net operating losses were generated, 1996 through 1999. These were the years in which Enron implemented a number of the structured transactions described in this Report. It appears that the purpose behind Enron's implementation of Project NOLy was to use technical tax rules to manipulate its tax situation in order to put the IRS in the position that it would have to sign off on years in which Enron implemented other structured transactions.

Project NOLy is also another example of the disparity between financial statement treatment of a transaction and tax treatment of the same transaction. For financial statement purposes, Project NOLy was neutral. However, for tax purposes, the taxpayer recognized $5.6 billion of capital gains in one year and an essentially equal amount of capital losses in the next year.

[755] IRS internal correspondence.

E. Transactions in Which Enron is an Accommodation Party

1. Project Renegade

Brief overview

Enron was an accommodation party in Project Renegade. Project Renegade was designed to enable Bankers Trust to achieve favorable tax benefits while Enron received an accommodation fee of $1.375 million for engaging in the transaction.

Project Renegade involved Bankers Trust loaning $320 million to ECT Equity Corporation ("ECT Equity"), a wholly owned subsidiary of Enron, in return for a long-term note payable. Almost immediately, ECT Equity contributed the $320 million to Enron Finance Holding Corporation ("Enron Finance"), a wholly owned subsidiary of ECT Equity, which loaned $8 million of the proceeds to Enron Corp. and contributed the remainder ($312 million) to Wiltshire Financial Assets, LLC ("Wiltshire") in return for approximately 98 percent ownership of Wiltshire.[756] Wiltshire also received a capital contribution of $8 million from a Bankers Trust subsidiary in return for approximately a two percent ownership interest. Subsequently, Wiltshire used the $320 million to purchase from Bankers Trust $320 million note issued by the ECT Equity. Thus, after the circular flow of funds through the various entities, Enron had effectively borrowed $8 million from Bankers Trust. However, as a result of certain tax rules with respect to financial asset securitization investment trusts ("FASITs"), Bankers Trust was able to achieve its desired tax goals.

Background[757]

Reported tax and financial statement effects

Project Renegade generated $1.375 million of taxable income in 1998. The taxable income was the fee paid by Bankers Trust to Enron for acting as an accommodation party in the transaction. In lieu of paying Enron directly, Enron stated that Bankers Trust reduced its fee for advising on Project Teresa by $1.375 million.[758] In addition, Project Renegade increased

[756] Wiltshire elected to be classified as a financial asset securitization investment trust for Federal income tax purposes.

[757] The information regarding Project Renegade 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.

[758] An amended Project Teresa engagement letter between Bankers Trust and Enron was signed on December 29, 1998 to reflect the fee reduction. EC2 000037573 - EC2 000037592.

reported financial statement earnings in 1998 by approximately $800,000 ($1.375 million accommodation fee less associated income taxes on such amount).[759]

Development of Project Renegade

Bankers Trust promoted the concept of Project Renegade to Enron in December 1998.[760] Enron named the proposed project after one of the five golf courses at Desert Mountain Golf Club.[761] The project was presented to Enron as a structure that would enable Enron to use a special purpose entity, owned by Bankers Trust and Enron, to raise capital.

On December 18, 1998 the Executive Committee of the Board of Directors of Enron reviewed the proposed structure. Richard A. Causey presented the proposal to the Executive Committee with Mr. Hermann in attendance.[762] Mr. Causey's presentation indicated that the proposed transaction would create a financial structure that would enable Enron to obtain financing from independent investors at a lower cost of funds.

The presentation to the Executive Committee indicated that a financial institution would loan Enron $320 million in exchange for a long-term note. Subsequently, the note would be contributed by the financial institution to a limited liability company in which Enron would acquire four tranches of debt obligations issued by the limited liability company in an amount approximately equal to the $320 million loaned by the financial institution. As part of the transaction the financial institution agreed to use its best efforts to offer for sale to independent investors the most senior tranche of the debt obligations. The total amount offered was expected to be approximately $80 million. The interest rate payable was expected to be significantly lower than currently available to Enron on borrowed funds. The Executive Committee was informed of two specific risks of entering into the transaction and mitigating factors to such risk. The two specific risks identified were (1) the ability of the outside party to market the debt obligation, and (2) the Federal income tax consequences of the transaction.[763] The Executive

[759] The tax return and financial statements are also impacted by the payment of interest expense on the net $8 million loan from Bankers Trust. The interest expense is accounted for in the same manner as any third party loan.

[760] Discussion Material for Project Renegade dated December 17, 1998 prepared by Bankers Trust. The Project Renegade materials in Appendix B contain the materials. EC2 000037527-EC2 000037544.

[761] Enron also used three of the other four Desert Mountain Country Club golf course names to identify other tax department structured transactions. They are Cochise, Apache, and Chiricahua. The other golf course, Geronimo, was also used, but none of the transactions that used its name were completed.

[762] Minutes of the December 18, 1998 meeting of the Executive Committee, EC 000037550.

[763] Presentation materials titled "Below Market Financing Proposal." EC2 000037546-EC2 000037548.

Committee was informed that the marketing risk was mitigated by (1) the best efforts underwriting agreement, and (2) the fact that the transaction could be unwound at the end of the marketing period. The tax risks were mitigated by (1) an indemnification agreement between Enron and Bankers Trust for any adverse tax consequences to Enron, and (2) the fact that the transaction could be unwound in the event of any adverse tax law change.[764] At the conclusion of the presentation, the Executive Committee adopted resolutions approving the transaction.[765]

Enron's stated business purpose for entering into the transaction was to obtain a net borrowing at a relatively low interest rate and earning fee income for engaging in the transaction with Bankers Trust.[766]

Implementation of Project Renegade

On December 23, 1998, Bankers Trust London branch loaned $320 million to ECT Equity. The note was a 25-year note with interest payable semiannually and principal due at the end of the term.[767] Also, on December 23, 1998, ECT Equity and Bankers Trust entered into a deposit agreement that required ECT Equity to deposit the loaned funds with Bankers Trust for seven days with no right of withdrawal.[768] The deposit agreement would terminate on December 29, 1998, if ECT Equity requested the funds be credited to the account of Enron Finance. Enron Finance also entered into an agreement with Bankers Trust on December 23, 1998, to deposit the funds loaned to ECT Equity on December 29, 1998 unless Enron Finance purchased approximately $312 million of debt securities from Wiltshire.

In addition, on December 23, 1998, Enron Finance and Bankers Trust also entered into a put option that permitted Bankers Trust to sell the $320 million ECT Equity note to Enron Finance unless the note had been validly assigned to Wiltshire before December 30, 1998.[769] Enron Corp. and Bankers Trust also entered into an agreement to permit Enron to purchase the

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[764] *Id.*

[765] Information contained in the minutes of the December 18, 1998 meeting of the Executive Committee. EC 000037551. The Board of Directors of Enron was provided the details of the transaction as part of its meeting on February 8, 1999. At such time, the Board of Directors of Enron approved the recommendation of the Executive Committee, EC2 000037556.

[766] Per Project Renegade tax overview. EC 000037523.

[767] The note had a temporary interest rate of 7.2825 percent for the period December 23 through December 29. In addition, Enron indicated that the permanent rate was also 7.2825 percents. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 31, 2003, answer 5.

[768] The deposit earned interest at a rate of 4.9844 percent per annum.

[769] After assigning the note to Wiltshire, Bankers Trust would have recouped $312 million of the $320 million loaned to ECT Equity and Enron would own all but $8 million of the note.

ECT Equity note on December 30, 1998, if the note had not been validly assigned to Wiltshire, and Bankers Trust had not exercised its put option. Thus, through the various deposit agreements and put agreement, Bankers Trust was able to ensure Enron would complete the steps and make certain the funds would be deposited with Bankers Trust during the implementation of the transactions.

In accordance with the preconceived plan, on December 29, 1998, ECT Equity loaned $320 million to Enron Finance. Enron Finance subsequently loaned $8 million of the proceeds to Enron Corp. and exchanged approximately $312 million for $72 million of Class A interests, $40 million of Class B-1 interests, $40 million of Class B-2 interests, and $160 million of Class B-3 interests of Wiltshire.[770] Subsequently, an affiliate of Bankers Trust exchanged $8 million for an equivalent amount of Class A interests of Wiltshire and Bankers Trust London Branch exchanged $1,000 for all of the Class O interests of Wiltshire. Wiltshire then used the $320 million to purchase the ECT Equity note from Bankers Trust London branch.

Upon its formation, Wiltshire elected to be classified as a FASIT for Federal income tax purposes. The Wiltshire LLC agreement reflects the Class A and Class B interests as regular interests under the FASIT rules (such rules generally treat the interests as a debt instrument) and the Class O interest as the designated ownership interest. Under the Wiltshire LLC agreement the cash flow generated from its assets ($320 million ECT Equity note receivable) was to be used in the following order: (1) to pay the current yield and principal on the Class A interests; (2) the current yield on the Class B-1, Class B-2, and Class B-3 interests, respectively; (3) the principal on the Class B-1, Class B-2, and Class B-3 interests, respectively; and (4) the Class O interests.

In addition, on December 29, 1998, Bankers Trust and Enron Finance entered into a tax indemnity agreement. In general, the tax indemnity agreement provided that Bankers Trust would pay any taxes, penalty, and interest that Enron incurred as a result of its participation in the transactions in excess of the amount of taxes that would be due if the interests Enron Finance purchased were treated as debt instruments with the same economic terms as the Class A and Class B interests purchased.[771]

Enron Finance, Bankers Trust London branch, and BT Alex Brown Incorporated ("BT Alex Brown") entered into a placement agreement on December 29, 1998 in which Enron engaged BT Alex Brown as its exclusive placement agent (on a best efforts basis) for the sale of $72 million of Class A interests in Wiltshire until June 30, 1999. BT Alex Brown's fee was $50,000 plus out-of-pocket expenses. However, the fee was to be paid by Bankers Trust not Enron.

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[770] The Class A interests accrued interest at 5.7 percent per annum, the Class B-1 accrued interest at 7.126283289 percent per annum, the Class B-2 accrued interest at 7.276283289 percent per annum, and the Class B-3 accrued interest at 7.426283289 percent per annum. It was anticipated that the Class A interests would be fully amortized by December 31, 2002.

[771] The Project Renegade materials in Appendix B contain the tax indemnity agreement. ECx000002324-Ecx000002336.

Bankers Trust and Enron Finance also entered into a purchase option agreement on December 29, 1998, permitting Enron Finance the right to purchase Bankers Trust Class O interests in Wiltshire on or after December 15, 2006, provided no Wiltshire Class A interests are then outstanding.

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

Confidential

Project Renegade
Structure as of December 29, 1998

Subsequent developments

The placement of the $72 million of Wiltshire Class A interests held by Enron Finance was not a success. Enron stated that it was unaware of the efforts, if any, that BT Alex Brown made to sell the Class A shares or what market conditions resulted in the sale being unsuccessful.[772] As such, except for interest on approximately $8 million, the interest on the $320 million ECT Equity note held by Wiltshire was returned to Enron Corp. via Enron Finance's interest in Wiltshire.

Discussion

Enron's corporate resolutions state that Enron engaged in Project Renegade to obtain financing at a significantly lower cost of capital than could be obtained through more traditional means. However, Enron tax personnel involved in the project indicated that the primary reason for entering into the arrangement was to earn an accommodation fee. The fact that Project Renegade only provided Enron with $8 million of financing, and such financing was anticipated to fully amortize within five years, lends credence to their statements that Enron engaged in the transaction as an accommodation party. In addition, Enron could not produce any risk analysis, investment analysis, or other documentation regarding the determination of the appropriate market rate of interest on the Class A and B interests in Wiltshire.[773] Enron also could not produce any analysis illuminating the financial reasons an investor would be willing to purchase a general obligation ECT Equity debt instrument at a lower yield than a comparable Enron debt instrument.[774] The lack of contemporaneous financial analysis also indicates that Enron's main objective in the transaction was to earn an accommodation fee.

A review of the documents involved in Project Renegade reflects that many agreements were subject to additional agreements with related parties that effectively altered the actual economic arrangement of the parties and further supports the notion that Enron would not have engaged in the transactions absent the accommodation fee.

For example, ECT Equity borrowed $320 million from Bankers Trust in return for a 25-year note. However, deposit agreements among ECT Equity, Enron Finance, and Bankers Trust required the funds to be deposited with Bankers Trust for one week with no right of withdrawal except for the purpose of enabling ECT Equity and Enron Finance to effectuate the prearranged steps to facilitate Bankers Trust goals. If the prearranged steps were not completed within one week, an option agreement between Bankers Trust and Enron permitted Bankers Trust to put the ECT Equity note to Enron. Thus, through the deposit agreements and the option agreement,

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[772] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 44.

[773] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 47.

[774] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003, answer 46. Enron stated that this type of analysis would normally be undertaken by outside advisors.

Bankers Trust could ensure that the $320 million would never be outside its control unless ECT Equity and Enron Finance completed the prearranged steps. If the steps were completed, Bankers Trust was assured of having only $8 million of capital at risk.[775] Thus, although ECT Equity and Bankers Trust documented a $320 million note, the economic reality was that Bankers Trust was willing to put only $8 million of capital at risk and only if Enron and its controlled subsidiaries engaged in the prearranged steps for the benefit of Bankers Trust.[776]

Although Enron did not engage in Project Renegade to generate a Federal income tax benefit for itself, Project Renegade highlights the potential for abuse of tax code provisions if taxpayers act in concert. In this transaction Enron and Bankers Trust, arguably in an attempt to shroud the facts of its financial relationship, had Bankers Trust pay the accommodation fee via a reduction of fees owed to Bankers Trust with respect to another structured transaction.

As the focus of this Report is to address Enron's tax situation, the Joint Committee staff has not been able to review Bankers Trust's tax situation to determine the reasons Banker Trust desired to engage in the transaction. However, the structure appears to have enabled Bankers Trust to report taxable gain on the sale of the $320 million ECT Equity note to Wiltshire in 1998 that would reverse at a later date.[777]

The taxable gain results from the treatment required for contributions of property to a FASIT under section 860L. In general, gain (but not loss) is recognized immediately by the owner of the FASIT upon the transfer of assets to a FASIT. A taxpayer generally computes any recognized gain based on the fair market value of the contributed assets. However, in the case of debt instruments that are not traded on an established securities market, special valuation rules apply for purposes of computing gain on the transfer of such debt instruments to a FASIT. Under these rules, the value of such debt instruments is the sum of the present values of the reasonably expected cash flows from such obligations discounted over the weighted average life of such assets. The discount rate is 120 percent of the applicable federal rate, compounded semiannually, or such other rate that the Secretary shall prescribe by regulations. Using this formula, Bankers Trust, as the Federal income tax owner of the Wiltshire FASIT, likely reported a taxable gain on the sale of the ECT Equity note irrespective no such gain occurred on the sale.

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[775] This result occurs because one of the prearranged steps required Wiltshire to purchase the ECT Equity note from Bankers Trust for $320 million. Wiltshire paid for such purchase using $312 of the $320 million purportedly loaned to ECT Equity and returning the $8 million contributed by Bankers Trust for a Class A interest.

[776] The Bankers Trust materials presented to Enron specifically highlighted the circular cash flow arrangement with the end result being a $10 million loan to Enron. The Project Renegade materials in Appendix B contain the documents. EC2 000037544. The executed documents resulted in only an $8 million loan to Enron.

[777] Although taxpayers do not normally accelerate taxable income, there are circumstances when such acceleration is beneficial to taxpayers (e.g., *see* Project NOLy in this Report). As stated above, the Joint Committee staff has not reviewed Bankers Trust tax situation.

In summary, the Joint Committee staff believes that the documents reviewed reflect that Project Renegade had no purpose to Enron other than to facilitate its participation as an accommodation party in a tax motivated transaction undertaken by Bankers Trust.

2. Project Valhalla

Brief overview

Project Valhalla was a financing transaction structured to provide tax benefits to Deutsche Bank under foreign law. Enron served as an accommodation party and effectively received a fee for its participation in the transaction. It appears that the transaction allowed Deutsche Bank to receive from Enron a stream of income that was treated as a nontaxable dividend under German law, but to finance this stream of income with deductible interest payments made to Enron. Enron's fee took the form of a rate spread between these two amounts.

In implementing Project Valhalla, Enron formed a German entity that was treated as a corporation under German law, but that elected to be treated as a disregarded entity for U.S. Federal tax purposes. Deutsche Bank transferred $2 billion to this entity in return for participation rights that provided for minimum distribution payments at a 7.7-percent rate of interest. The participation rights were treated as debt for U.S. Federal tax purposes, but as equity for German tax purposes. The German entity used the cash received from Deutsche Bank to purchase preferred stock in an Enron domestic affiliate, and then used the dividend income from the preferred stock to fund the minimum distribution payments on the participation rights.

At the same time, the parties established a largely offsetting loan and payment stream, in which Enron transferred $1.95 billion to a Deutsche Bank branch in exchange for a promissory note bearing interest at a rate of 8.74 percent.

Under German law, since the participation rights were treated as equity, the minimum distribution payments associated with these rights were treated as dividends, which Deutsche Bank was able to receive free of tax under German law. At the same time, the payments of interest to Enron on the note presumably were deductible to the Deutsche Bank branch. Taken together, it appears that this treatment allowed Deutsche Bank to use deductible payments to finance a stream of tax-exempt income.

From Enron's perspective, the rate spread in its favor between the note and the participation rights generated net pre-tax interest income and effectively constituted Enron's accommodation fee. Enron deducted the smaller payments on the participation rights as interest expense, and included the larger payments received on the note as interest income, thus reporting net interest income on its U.S. Federal consolidated return as a result of the transaction.

Background[778]

Reported tax and financial statement effect

The $2 billion in participation rights less the $1.95 billion note resulted in a net $50 million borrowing by Enron from Deutsche Bank.

The interest rate spread in Enron's favor was expected to yield approximately $100 million of pre-tax income, or approximately $65 million in financial net income, over the intended five-year life of the structure.[779] Enron reported approximately $7 million of financial net income from the transaction for 2000, and $9 million through the third quarter of 2001. The primary tax return effect for 2000 was net taxable income of $11 million.[780]

Development of Project Valhalla

Based on Joint Committee staff interviews, it appears that Deutsche Bank originated the idea for Project Valhalla and prepared the early promotional materials for the transaction. R. Davis Maxey and Tina Livingston were the primary Enron personnel working on the transaction.

On December 13, 1999, Richard A. Causey introduced the idea for Project Valhalla to Enron's Board of Directors' Finance Committee. Mr. Causey described the transaction as a proposed subsidiary preferred stock financing. He stated that as part of Enron's overall financing plan, the Company was proposing the sale of up to $2.2 billion of securities to a non-affiliated investor group. The proposed sale of securities was approved for recommendation to Enron's Board of Directors.[781]

The following day, Herbert S. Winokur, Jr. addressed Enron's Board of Directors and recommended the Finance Committee's proposal for a subsidiary preferred stock financing. The Board approved the proposal maintaining that it was in Enron's best interest to provide financing and liquidity to its affiliates and provided for the sale of up to $2.2 billion of securities to an investor or investor group not affiliated with Enron.[782]

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[778] The information regarding Project Valhalla was obtained from Joint Committee staff interviews of Robert Herrman, James A. Ginty, R. Davis Maxey, Jordan Mintz, and Tina Livingston, as well as from documents and information provided by the Enron Corporation.

[779] Enron "Project Valhalla Business Review," EC2 000038364-65.

[780] Enron "Tax Overview of Project Valhalla," EC2 000038072.

[781] Agenda for the Meeting of the Finance Committee of the Enron Board of Directors, December 13, 1999, item #3, at EC2 000038092; Minutes of the Meeting of the Finance Committee of the Enron Board of Directors, December 13, 1999, paragraph 4, at EC2 000038098.

[782] Minutes of the Meeting of the Board of Directors of Enron Corp., December 14, 1999, EC2 000038084-87.

Implementation of Project Valhalla

In May 2000, Enron and Enron Diversified Investments Corporation ("EDIC"), a domestic affiliate of Enron, formed Enron Valkyrie ("Valkyrie"), a Delaware limited liability company that elected to be classified as a partnership for U.S. Federal income tax purposes. Enron contributed $67,535,500 in exchange for a 95 percent membership interest in Valkyrie, and EDIC contributed $3,554,500 in exchange for a five percent membership interest in Valkyrie. Under Valkyrie's company agreement, all items of income, gain, loss, deduction, and credit were allocated in accordance with the members' respective interests.

Shortly thereafter, Valkyrie formed Valhalla GmbH ("Valhalla"), a German limited liability company. Valkyrie contributed $71.09 million to Valhalla in exchange for all of the common shares of Valhalla. Valhalla, in turn, contributed $71.09 million to Rheingold GmbH ("Rheingold"), a German limited liability company, in exchange for all of the common shares of Rheingold. Rheingold obtained additional financing through a loan from Enron of $106.63 million and issuance of a note to Enron evidencing the loan with interest payable at a rate of 7.7 percent.[783] Valhalla and Rheingold both elected to be treated as disregarded entities for U.S. Federal income tax purposes.

Following this series of transactions, Valhalla and Rheingold entered into a subscription and procurement agreement, pursuant to which Valhalla agreed to procure a subscriber for, or to subscribe for, certain participating debt rights in Rheingold. The subscription price for the participation rights was $2 billion. Then Rheingold, Valhalla, and Deutsche Bank entered into an agreement on the participation rights, pursuant to which Valhalla waived its right to subscribe for such rights and Rheingold issued the participation rights to Deutsche Bank in exchange for $2 billion.

Deutsche Bank is a German corporation that is engaged in the banking and financial services business. It is a resident of Germany for German tax purposes and therefore is eligible for benefits under the U.S.-German income tax treaty. Under German corporate law, Deutsche Bank, as holder of the participation rights, had no voting rights and generally had the rights of a creditor. The terms of Deutsche Bank's participation rights were as follows: (1) participation with the common stock in distributions made by Rheingold to the extent of their ratable share of Rheingold's capital; (2) entitlement to minimum distributions paid annually by Rheingold at a rate of 7.7 percent to the extent Rheingold had sufficient distributable profits; (3) participation in liquidation proceeds to the extent of their ratable share of Rheingold's capital; and (4) a fixed maturity of 35 years.[784]

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[783] In order to address certain German tax and accounting issues, the note provided for repayment of the greater of: (1) the Euro equivalent of $106.63 million at the exchange rate on the date of issuance; or (2) the Euro equivalent of $106.63 million on the day the note was repaid. Rheingold had the right under the note to prepay all or any portion of the principal amount of the loan.

[784] Agreement on Participation Rights, May 2, 2000, Ecx000009413.

Subsequent to Deutsche Bank purchasing the participation rights, Valhalla, Valkyrie, and Deutsche Bank entered into put and call option agreements. The agreements generally required Deutsche Bank to sell the rights back to the Enron group within a five-year period. Deutsche Bank and Valhalla entered into a put option agreement pursuant to which Valhalla granted Deutsche Bank the right to sell its participation rights to Valhalla upon the occurrence of a "put circumstance."[785] At the same time, Valkyrie and Deustche Bank entered into a call option agreement[786] pursuant to which Deustche Bank granted Valkyrie the right to acquire the participation rights upon the occurrence of a "call circumstance."[787]

The sale and repurchase agreements served two purposes. They facilitated unwinding the financing transaction in a manner that would minimize both U.S. and German tax consequences, and they provided a mechanism for substantiating Valhalla's beneficial ownership of the participation rights under a U.S. debt-equity analysis. If the participation rights were treated as an equity interest for U.S. tax purposes, it would jeopardize Rheingold's disregarded entity status and result in additional tax to the Enron group. Therefore, the terms related to the put and call option agreements were structured to prevent beneficial ownership of the rights from transferring to Deutsche Bank.

Risk Management and Trading Corporation ("RMT"), a domestic affiliate of Enron, was engaged in the business of hedging and trading financial instruments and commodities. Rheingold used the funds it received from Deutsche Bank's purchase of the participation rights, along with the funds it received from Valhalla's capital contribution and the loan from Enron, to purchase two classes of RMT preferred stock. The first class ("Series 1") was non-voting, non-participating (except to the extent of a fixed 7.54048 percent dividend), and not convertible into any other class of RMT stock. The second class ("Series 2") included voting rights, but was non-participating (except to the extent of a fixed 7.54048 percent dividend).[788] Valkyrie granted Rheingold the right to put the RMT preferred stock to Valkyrie at a price that was the greater of (1) the original issue price of the preferred stock or (2) the U.S. dollar equivalent of the original Deutsche mark price on the date the put was exercised.[789]

As one of the final steps to the transaction, Enron loaned $1.95 billion to Deutsche Bank's New York branch in accordance with the terms of a promissory note. Later in 2000, Deutsche Bank's London branch took the place of the New York branch as obligor on the note.

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[785] Put Option Agreement between Deutsche Bank AG and Valhalla, May 2, 2000, Ecx000009474.

[786] Call Option Agreement, May 2, 2000, Ecx000009432.

[787] The put and call circumstances included, among other things, a downgrade in Enron's long-term credit rating.

[788] Securities and Purchase Agreement between Risk Management and Trading Corp. and Rheingold GmbH, May 2, 2000, Ecx0000099500.

[789] Put Option Agreement between Enron Valkyrie, LLC and Rheingold GmbH, May 2, 2000.

The note was due and payable on May 2, 2005 (or earlier if a "payment event" occurred) and required Deutsche Bank to make annual coupon payments at a fixed rate of 8.74 percent.[790] The spread between the 8.74 percent interest rate on the note and the 7.7-percent rate on the participation rights[791] served as Enron's accommodation fee on the transaction.

The $1.95 billion promissory note largely offset Enron's $2 billion liability to Deutsche Bank with respect to the participation rights. Enron personnel interviewed by the Joint Committee staff could not fully explain why Enron made a net $50 million borrowing from Deutsche Bank on the transaction, but recalled that Deutsche Bank requested that the two instruments not completely offset each other.

The parties intended for the financing arrangement to remain outstanding for a period of up to five years, until May 2005.

The diagram on the following page depicts the Project Valhalla structure.

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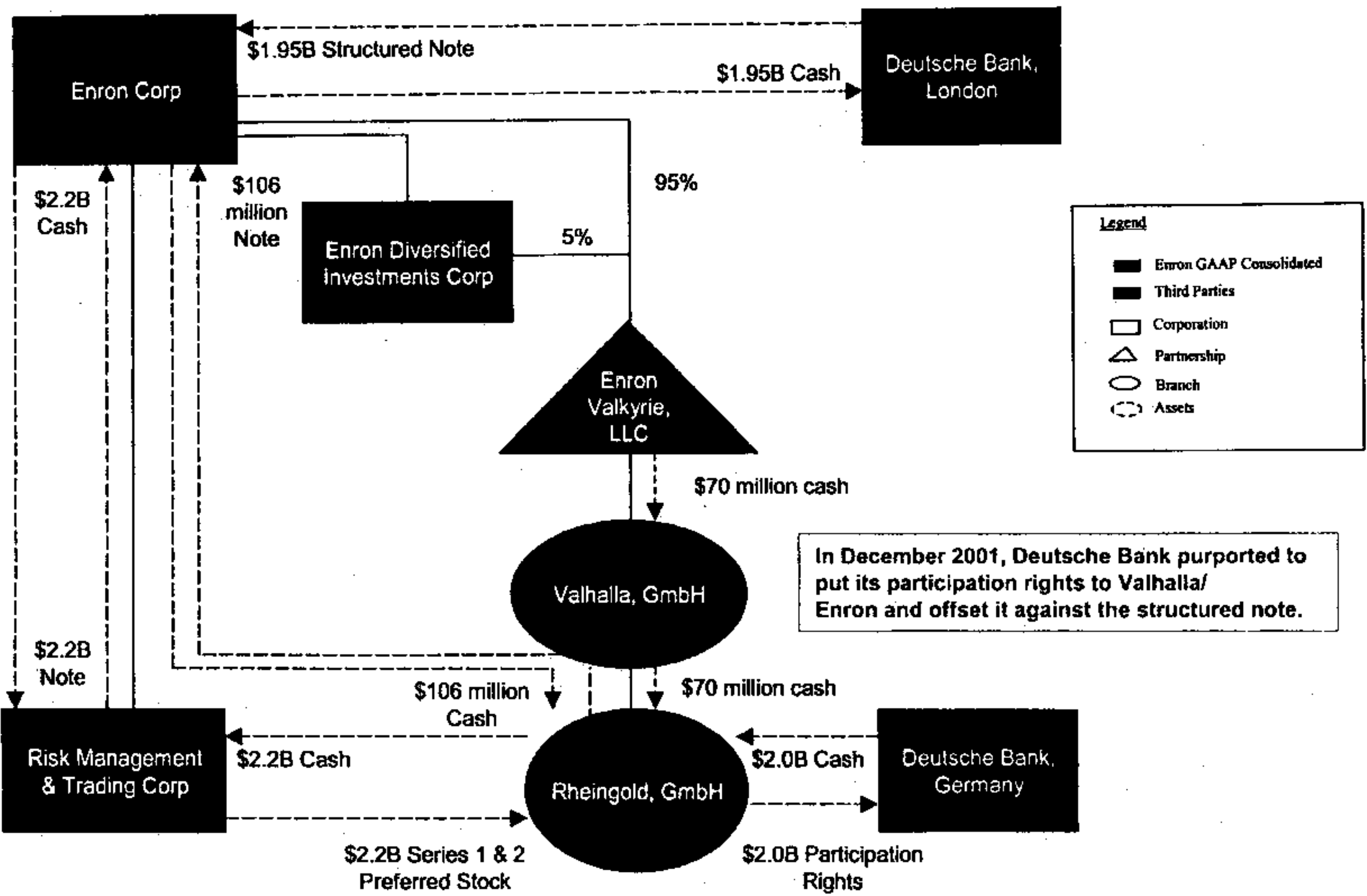
[790] This rate was fixed through the use of an interest rate swap. Enron personnel interviewed by the Joint Committee staff stated that, for reasons unknown to Enron, Deutsche Bank requested the use of a swap to generate the fixed rate, instead of using a simple fixed rate note in the first place.

[791] Promissory Note issued by Deutsche Bank AG New York Branch to Enron Corporation, Ecx000009541.

General Structure



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EC2 000038067

Role of outside advisors

In connection with Project Valhalla, Vinson & Elkins provided a tax opinion discussing the U.S. Federal tax treatment of the transaction. The specific issues addressed in the opinion were: (1) the treatment of Valhalla and Rheingold as disregarded entities; (2) the treatment of the transactions comprising the financing transaction as a loan from Deutsche Bank to Valkyrie (including the purchase of the participation rights, the put and call agreements, and the purchase of RMT preferred stock); (3) the continued status of RMT as a member of the Enron group after the issuance of Series 1 and Series 2 preferred stock; (4) Enron and EDIC's eligibility for a dividends-received deduction with respect to dividends from RMT allocated to them under Valkyrie's company agreement; (5) the deductibility by Enron and EDIC of their distributive shares of Valkyrie's interest expense with respect to the minimum distributions paid on the participation rights; (6) the applicability of U.S. withholding tax on dividends payments from RMT to Rheingold; and (7) the applicability of U.S. withholding tax on interest payments made by Rheingold to Deutsche Bank.

Enron also received a tax opinion from Clifford, Chance and Punder, which addressed a number of German tax issues.

Appendix C, Part XI to this Report contains the tax opinions that Enron received in connection with Project Valhalla.

Subsequent developments

Shortly before the filing of Enron's bankruptcy petition, Deutsche Bank gave notice of intent to exercise its option to put the Rheingold participation rights to Valhalla, and to treat Deutsche Bank's obligations on the promissory note as thereby satisfied. No other steps have been taken to unwind the structure.[792]

Discussion

As explained above, Project Valhalla was structured to provide tax benefits to Deutsche Bank, by allowing Deutsche Bank to use deductible payments to finance a stream of income that was tax-exempt under German law. Because the Joint Committee staff's focus in this report is on Enron and its U.S. tax issues, the staff was not able to gather detailed information or conduct a complete analysis of the Deutsche Bank tax benefits at the center of the transaction.[793]

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[792] Letter from Enron's counsel (Skadden, Arps) to Lindy Paull, Joint Committee on Taxation, dated Jan. 13, 2003, at 10.

[793] Although a complete analysis of Deutsche Bank's tax benefits is beyond the scope of this report, it seems clear that the transaction raises significant issues regarding the ability of taxpayers to exploit differences and inconsistencies between different countries' tax systems (e.g., with respect to debt-equity characterization, or entity classification). *See, e.g.*, Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, vol. I at p. 96 (noting that the interaction between the tax

Enron acted as an accommodation party in Project Valhalla and received a fee for its participation in the transaction in the form of an interest rate spread in its favor. This fee was included as net interest income on Enron's U.S. consolidated tax return. Strictly speaking, from a U.S. Federal tax perspective, Enron's benefit from Project Valhalla was a non-tax benefit, as it originated entirely in pre-tax income and actually increased Enron's tax liability. Nevertheless, some may question the appropriateness of Enron's facilitating, for a fee, the tax-avoidance arrangements of another party.

Leaving aside the question of the appropriateness of Enron's serving as an accommodation party, Enron's tax issues in the transaction mainly involved ensuring that, apart from the net increase in taxable income attributable to the accommodation fee, the structure created a tax-neutral result for Enron. For example, the participation rights had to be characterized as debt for U.S Federal income tax purposes, the payments on those rights had to be deductible as interest expense, and the dividend payments received by Rheingold from RMT had to qualify for the dividends-received deduction, among other issues. These issues are addressed in the tax opinion letter that Enron received from Vinson & Elkins.[794] In this regard, it does not appear that Enron derived any inappropriate U.S. Federal tax benefits in connection with the transaction -- the sum and substance of Enron's tax treatment of the transaction was that the company deducted interest expense that it paid to a third party and included interest income that it received from a third party.

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laws of the United States and those of foreign countries "can lead to tax arbitrage opportunities for taxpayers, particularly when the foreign laws and the U.S. tax rules yield inconsistent tax results for the same transaction").

[794] *See* Appendix C, Part XI, to this Report.

II. COMPANY-OWNED AND TRUST-OWNED LIFE INSURANCE

A. Summary

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

B. Background, Present Law, Discussion and Recommendations

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

Structure of COLI and TOLI arrangements historically

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

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

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

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

Use as funding vehicle

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

Financial statement benefits

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

Borrowing in connection with COLI

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

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

Tax treatment

Pattern of COLI legislation

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Premium and interest deduction limitations with respect to life insurance contracts

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

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

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

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

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[807] Sec. 101(a).

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

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

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

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

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

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

Judicial decisions relating to COLI

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

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

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

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

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

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

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

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

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

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

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

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

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

[817] *Id.* at 290.

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

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

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

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

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

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

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

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

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

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

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

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

2. Enron's COLI and TOLI transactions

Brief overview

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

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

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

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[825] *Id.* at 795.

[826] *Id.* at 769.

Background[827]

Reported tax and financial statement effects

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

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

Development and implementation of COLI and TOLI transactions

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

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

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

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

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

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

[831] Also referred to as Great Western Life.

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

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

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

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

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

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

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

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

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

[838] *Id.*

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

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

Role of outside advisors

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

Subsequent developments

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

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

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

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

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

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

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

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

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

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

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

Discussion

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

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

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

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

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

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

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

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

Recommendations

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

III. STRUCTURED FINANCING TRANSACTIONS

A. Background and Rationale

During the 1990s, Enron's rapid growth necessitated significant infusions of new capital. At tension with its capital requirements, however, was the need for Enron to maintain its credit rating, particularly as Enron's creditworthiness had a direct impact on its stock price. As a consequence of this circumstance, Enron raised nearly $10 billion through various structured financing transactions, including tiered preferred securities, investment unit securities, and commodity prepay transactions. The primary advantage to Enron from some of these transactions was its ability to raise capital without ostensibly incurring additional debt. Thus, such transactions enabled Enron to maintain its credit rating and, in turn, avoid the downward pressure on its market valuation that would likely result from additional leverage. In other transactions, the primary advantage to Enron was its ability to liquidate appreciated equity investments--and eliminate its risk of loss from future declines in the value of these investments--without actually disposing of the investments and incurring immediate recognition of gain for Federal income tax purposes.

In the case of the tiered preferred securities and investment unit securities, the favorable tax treatment accorded these transactions was a principal factor in Enron's decision to raise additional capital by issuing such securities. In the case of the commodity prepay transactions, Enron initially engaged in these transactions solely for tax purposes, but in later years used these transactions to manipulate its reported operating results. Throughout its participation in the commodity prepay transactions, Enron exercised a significant degree of selectivity in its tax treatment of these transactions, including the transactions that were carried out primarily for financial reporting purposes in later years.

B. Discussion of Present Law Relating to Certain Structured Financing Transactions

1. Debt characterization

Whether a financial instrument is treated for tax purposes as debt, equity, or some other characterization is determined on the basis of the pertinent facts and circumstances. If an instrument qualifies as equity, the issuer generally does not receive a deduction for dividends paid and the holder generally includes such dividends in income (although corporate holders generally may obtain a dividends-received deduction of at least 70 percent of the amount of the dividend). If an instrument qualifies as debt, the issuer generally receives a deduction for accrued interest and the holder generally includes such interest in income, subject to certain limitations.

Under present law, the Treasury Department has the statutory authority to issue regulations classifying an interest in a corporation as debt or equity.[847] In 1989, the Treasury Department's authority to issue such regulations was expanded to include classification of an interest as part equity and part indebtedness.[848] In 1992, Congress enacted additional rules to require, in certain circumstances, that an issuer's characterization of an interest be binding on the issuer and the holders.[849] Although the Treasury Department published proposed and final regulations pursuant to its authority, these regulations have been withdrawn and there are no currently applicable regulations.

2. Constructive sales

For transactions entered into after June 8, 1997, taxpayers are required to recognize gain (but not loss) upon entering into a "constructive sale" of any appreciated position in stock, a partnership interest or certain debt instruments as if such position were sold, assigned or otherwise terminated at its fair market value on the date of the transaction.[850] If the requirements for a constructive sale are met, the taxpayer recognizes gain on a constructive sale as if the position were sold at its fair market value on the date of the transaction and immediately repurchased.[851]

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[847] Sec. 385, enacted in the Tax Reform Act of 1969, Pub. L. No. 91-172, sec. 415(a).

[848] Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, sec. 7208(a)(1).

[849] Sec. 385(c), enacted in the Energy Policy Act of 1992, Pub. L. No. 102-486, sec. 1936(a).

[850] Sec. 1259, enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1001(a). A "position" generally is defined as an interest, including a futures or forward contract, short sale, or option.

[851] Sec. 1259(a)(1).

In general, a taxpayer is treated as making a constructive sale of an appreciated position if and when the taxpayer (or, in certain circumstances, a person related to the taxpayer) does one of the following: (1) enters into a short sale of the same (or substantially identical) property; (2) enters into an offsetting notional principal contract with respect to the same (or substantially identical) property; or (3) enters into a futures or forward contract to deliver the same (or substantially identical) property.[852] In addition, in the case of an appreciated position that itself is a short sale, a notional principal contract, or a futures or forward contract, the holder is treated as making a constructive sale when it acquires the same (or substantially identical) property as the underlying property for the position.[853] Finally, to the extent provided in Treasury regulations, a taxpayer is treated as making a constructive sale when it enters into one or more other transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described.[854]

A forward contract results in a constructive sale of an appreciated position only if the forward contract provides for delivery, or for cash settlement, of a substantially fixed amount of property and a substantially fixed price.[855] Thus, a forward contract providing for delivery of property, such as shares of stock, the amount of which is subject to significant variation under the contract terms does not result in a constructive sale.[856]

3. Disqualified indebtedness

For most debt instruments issued after June 8, 1997, no deduction is allowed for interest or original issue discount ("OID") on a debt instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that is payable in stock of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), including a debt instrument a substantial portion of which is mandatorily convertible or convertible at the issuer's option into stock of the issuer or a related party.[857] In addition, a debt instrument is treated as payable in stock if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of stock of the

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[852] Sec. 1259(c)(1).

[853] *Id. See also* Rev. Rul. 2002-44, 2002-28 I.R.B. 84.

[854] Sec. 1259(c)(1)(E). Future Treasury regulations are anticipated to treat as constructive sales other financial transactions that, like those specified in section 1259, have the effect of eliminating substantially all of the taxpayer's risk of loss and opportunity for income and gain with respect to the appreciated position. H.R. Rep. No. 105-148, at 442-43 (1997).

[855] *See* section 1256(d)(1).

[856] H.R. Rep. No. 105-148, at 442 (1997). This treatment of forward contracts is consistent with the anticipated treatment of so-called "collar" transactions under regulations to be issued by the Treasury Department.

[857] Sec. 163(l), enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1005(a).

issuer or related party.[858] A debt instrument also is treated as payable in stock if it is part of an arrangement that is reasonably expected to result in the payment of the debt instrument with or by reference to such stock. For example, a debt instrument may be treated as payable in stock of the issuer or a related party in the case of a forward contract to sell such stock that is entered into in connection with the issuance of the debt.[859]

4. Straddles

A "straddle" generally refers to offsetting positions (sometimes referred to as "legs" of the straddle) with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property. A "position" is an interest (including a futures or forward contract or option) in personal property. When a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for any taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in the straddle.[860] Deferred losses are carried forward to the succeeding taxable year and are subject to the same limitation with respect to unrecognized gain in offsetting positions.

In addition to loss deferral, the straddle rules require taxpayers to capitalize certain otherwise deductible expenditures for personal property if such property is held as part or all of an offsetting position in a straddle.[861] This provision applies to certain specified carrying charges, as well as interest on indebtedness that is incurred or maintained in order to purchase or carry the personal property.[862] On January 18, 2001, the Treasury Department published proposed regulations that elaborate on the operation of the straddle capitalization rules.[863] In addition, the proposed regulations would "clarify" that the straddle rules can apply to a debt instrument that is an obligation of the taxpayer if the debt instrument provides for one or more payments that are linked to the value of personal property or a position with respect to personal property.

The straddle rules generally do not apply to positions in stock. However, the straddle rules apply if one of the positions is stock and at least one of the offsetting positions is: (1) an option with respect to the stock; (2) a securities futures contract (as defined in section 1234B) with respect to the stock; or (3) a position with respect to substantially similar or related property (other than stock) as defined in Treasury regulations. In addition, the straddle rules apply to

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[858] Sec. 163(l)(3)(B).

[859] Sec. 163(l)(3)(C).

[860] Sec. 1092.

[861] Sec. 263(g)(1).

[862] Sec. 263(g)(2).

[863] 66 Fed. Reg. 4746 (Jan. 18, 2001).

stock of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder.

5. Prepayment transactions

Prepaid sales of goods

A taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless the item properly is accounted for in a different period under the taxpayer's method of accounting.[864] In general, a taxpayer may adopt an accounting method that is different than the accounting method of an entity that is affiliated with the taxpayer.[865]

Under an accrual method of accounting, a taxpayer generally is required to include an item in income when all the events have occurred that fix the right to receive such income and the amount of the income can be determined with reasonable accuracy.[866] In general, the IRS has long taken the position that the right to receive income becomes fixed at the earliest of when: (1) the required performance occurs; (2) payment for such performance becomes due; or (3) such payment is made.[867]

Treasury regulations permit taxpayers to defer the recognition of taxable income in certain circumstances if the taxpayer receives an advance payment for the sale of goods that are to be delivered in a later taxable year.[868] In general, such advance payments may be recognized by the taxpayer as taxable income either: (1) in the taxable year of receipt; or (2) the earlier of (a) the taxable year in which the payments would otherwise be included in taxable income under the taxpayer's method of accounting (provided such method results in the inclusion of advance payments in taxable income no later than the time such payments are included in income for financial reporting purposes), or (b) the taxable year in which the payments are included in income for financial reporting purposes (provided the taxpayer's method of accounting for advance payments results in income inclusion earlier for financial reporting purposes than for tax purposes).[869]

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[864] Treas. Reg. sec. 1.451-1(a).

[865] *See* section 446(d); Treas. Reg. sec. 1.446-1(d).

[866] *Id.*

[867] Rev. Rul. 74-607, 1974-2 C.B. 149.

[868] Treas. Reg. sec. 1.451-5. For this purpose, an "advance payment" is defined as any amount which is received in a taxable year by the taxpayer using an accrual method of accounting for purchases and sales pursuant to an agreement for the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. Treas. Reg. sec. 1.451-5(a).

[869] Treas. Reg. sec. 1.451-5(b)(1).

With regard to the deferral of advance payments relating to the sale of inventoriable goods, Treasury regulations generally provide that, if the taxpayer has on hand (or has available through the taxpayer's normal source of supply) inventory in sufficient quantity to satisfy the contract, then all advance payments that the taxpayer has received for such property by the last day of the second taxable year following the year in which such substantial advance payments are received and not previously included in income according to the taxpayer's accrual method of accounting, must be included in taxable income of the taxpayer in that second taxable year.[870]

Prepaid forward contracts

The gain or loss on a forward contract typically cannot be determined until the settlement date of the contract (at which time the value of the cash payment or physical delivery of the underlying property is determined on the basis of the spot price of the underlying property).[871] Therefore, although there is a paucity of authority that addresses the basic tax consequences of forward contracts, it is generally understood that the common law tax treatment of a forward contract is governed by the "open transaction" doctrine, which provides that the recognition of gain or loss on a transaction is, in effect, "held open" until the transaction is closed and such gain or loss can be quantified.[872] Absent the application of the constructive sale rules described above, taxpayers generally take the view that the open transaction doctrine applies to forward contracts even if a prepayment is made.[873]

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[870] Treas. Reg. sec. 1.451-5(c)(1)(i).

[871] A forward contract is an executory contract that is privately negotiated directly between the parties (i.e., there is no market or exchange intermediation as with futures contracts), and generally provides for the delivery of a specified amount of commodities or other property at a specified price (i.e., the "forward price") and on a specified future date (i.e., the "settlement date"). Depending upon the terms agreed to by the parties, a forward contract may be settled by either physical delivery of the underlying property or by the payment of an amount of cash that is equal to the difference between the spot price (i.e., current price on the settlement date) of the underlying property and the forward price specified in the contract. A prepaid forward contract is a forward contract in which the forward price is payable (generally on a present valued basis) on a date earlier than the settlement date, typically the date that the contract is executed by the parties.

[872] *See* Warren, *Financial Contract Innovation and Income Tax Policy*, Harv. L. Rev. 460, 464 (1993).

[873] *Cf. Virginia Iron Coal & Coke Co.*, 37 B.T.A. 195 (1938), *aff'd.*, 99 F.2d 919 (4th Cir. 1938), *cert. denied*, 307 U.S. 630 (1939) (holding that option premiums are not earned and, thus, not taxable until the option lapses or is exercised because it is unknown at the time that the option premium is received whether the option premium will be taxed as ordinary income or capital gain).

6. Notional principal contracts

Pursuant to the statutory authority to prescribe methods of accounting that clearly reflect income,[874] Treasury regulations provide for the recognition of income and deductions with respect to payments that are made or received pursuant to a notional principal contract.[875] The term "notional principal contract" generally describes an agreement between two parties to exchange payments that are calculated by reference to a notional principal amount.[876] Notional principal contracts include interest rate swap agreements, commodity swap agreements, interest rate cap and floor agreements, currency swap agreements, and other similar contracts.[877]

In a typical interest rate swap agreement, one party agrees to make periodic payments based on a fixed rate while the counterparty agrees to make periodic payments based on a floating rate. Payments are calculated on the basis of an underlying hypothetical or "notional principal amount", and payment amounts are typically netted when payments are due on common dates. A commodity swap is similar to an interest rate swap except that a commodity price index is used instead of an interest rate index, and the notional principal amount is measured in units of a specified commodity, rather than in dollars.

The notional principal amount is not actually exchanged by the parties. Therefore, the payments due under a typical notional principal contract do not constitute compensation for the use or forbearance of money and therefore are not characterized as "interest." However, a lump-sum payment under one of these contracts may be economically identical to a loan and, thus, the party making the lump-sum payment receives a return, part of which is properly characterized as interest for tax purposes because it represents compensation for the use or forbearance of money.

The regulations define a notional principal contract as a financial instrument that provides for payments by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to

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[874] Sec. 446(b).

[875] Treas. Reg. sec. 1.446-3.

[876] *See* Treas. Reg. sec. 1.446-3(c)(1).

[877] These contracts are examples of a broader family of financial instruments known as "derivatives", which generally are defined as contracts or securities the value of which is derived from the price of an asset, a pool of assets, or (increasingly) anything that can be valued. Derivatives represent contractual relationships between parties to share the economic benefits and burdens of owning an asset (or pool of assets) without necessarily owning the asset itself (hence the "notional" characteristic of such contracts). Because there is no comprehensive statutory regime for the taxation of derivatives, the tax consequences of derivative contracts are governed in a piecemeal fashion by specific rules that are scattered throughout the Code. *See, e.g.*, secs. 1092 (straddles), 1234 (options), 1234A (payments to terminate certain derivatives), 1234B (securities futures contracts), 1256 (certain exchange-traded contracts), and 1259 (constructive sales). As applied to derivatives, these rules are incomplete and often inconsistent in specific situations.

pay similar amounts.[878] The term "specified index" is broadly defined to include almost any fixed rate or variable rate, price, index, or amount based on current, objectively determinable financial or economic information.[879] Thus, notional principal contracts governed by the regulations include interest rate swaps, basis swaps, interest rate caps and floors, commodity swaps, equity swaps, equity index swaps, and similar agreements. However, the regulations provide that certain contracts do not constitute notional principal contracts, including futures contracts, forward contracts, and options.[880]

The regulations generally provide that net income or deduction from a notional principal contract for a taxable year is included in or deducted from gross income for that taxable year. The net income or deduction from a notional principal contract for a taxable year equals the sum of all of the periodic payments that are recognized from that contract for the taxable year and all of the nonperiodic payments that are recognized from that contract for the taxable year.[881]

A periodic payment is defined as a payment that generally is payable at fixed periodic intervals of one year or less during the entire term of a notional principal contract. The ratable daily portions of periodic payments are included in income or deducted in the taxable year to which such portions relate.[882]

A nonperiodic payment is defined as any payment made or received pursuant to a notional principal contract that is not a periodic payment or a termination payment. Thus, a nonperiodic payment includes prepayments for all or one leg of a swap. The ratable daily portions of nonperiodic payments must be included in income or deducted in the taxable year to which such portions relate such that a nonperiodic payment is recognized over the life of the notional principal contract in a manner that reflects the economic substance of the payment. Thus, a nonperiodic payment for a swap generally must be recognized over the term of the contract by allocating it in accordance with the forward rates (or, in the case of a commodity, the forward prices) of a series of cash-settled forward contracts that reflect the specified index and the notional principal amount.[883]

A termination payment is defined as any payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under a notional principal contract. In general, a party to a notional principal contract must recognize a termination payment in the taxable year in which the contract is extinguished, assigned, or

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[878] Treas. Reg. sec. 1.446-3(c)(1)(i).

[879] Treas. Reg. sec. 1.446-3(c)(2).

[880] Treas. Reg. sec. 1.446-3(c)(1)(ii).

[881] Treas. Reg. sec. 1.446-3(d).

[882] Treas. Reg. sec. 1.446-3(e).

[883] Treas. Reg. sec. 1.446-3(f). The regulations provide alternative methods of recognizing nonperiodic payments that primarily affect the rate of amortization.

exchanged. The party also must recognize any other payments that have been made or received under the contract but have not yet been recognized.[884]

The regulations include a special rule with regard to swaps that provide for "significant" nonperiodic payments. Under this rule, a swap with significant nonperiodic payments is treated as two separate transactions, consisting of: (1) an at-the-market swap (i.e., no nonperiodic payments) with level payments; and (2) a loan. The parties to the contract must account for the deemed loan independently of the swap. The imputed interest component of the loan is accounted for as interest for all purposes of the Code.[885] The regulations do not define what amount of nonperiodic payments constitutes "significant", but examples in the regulations indicate that a nonperiodic payment that is less than 10 percent of total payments under a swap is not significant, while a nonperiodic payment that is 40 percent or more of total payments is significant.[886]

7. Application of present law to Enron structured financing transactions

Enron raised significant amounts of capital by issuing several different types of structured financial instruments that implicate a multitude of tax rules. Enron issued tiered preferred securities, the tax treatment of which primarily involved the application of the rules concerning debt characterization. Enron also issued investment unit securities, which involved debt characterization in general, as well as the constructive sale, disqualified indebtedness, and straddle rules. Enron entered into commodity prepay transactions, which involved debt characterization in general, as well as the tax treatment of prepayment transactions and notional principal contracts.

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[884] Treas. Reg. sec. 1.446-3(h).

[885] Treas. Reg. sec. 1.446-3(g)(4).

[886] Treas. Reg. sec. 1.446-3(g)(6), Examples 2 and 3.

C. Tiered Preferred Securities

1. Brief overview

Between 1993 and 1997, Enron raised over $800 million through the issuance of hybrid financial instruments that combined characteristics of both indebtedness and equity ("tiered preferred securities"). By synthesizing these characteristics into a single financial instrument, Enron was able to report the financing as indebtedness for Federal income tax purposes, while reporting the same financing as a minority ownership interest on its financial statements. Consequently, these transactions enabled Enron to deduct the yield on its financings as interest expense for tax purposes without increasing the amount of liabilities reported in financial statements. Although the individual transactions varied in their details, they shared several common elements, primarily the issuance of securities by a special purpose entity to public or private investors and the transfer of the proceeds from such issuance to Enron in the form of a loan.

2. Background

Reported tax and financial statement effects

With regard to its tiered preferred securities, Enron took the position for Federal income tax purposes that it had issued a debt instrument to the special purpose entity, which Enron treated as a separate entity that was not part of the Enron consolidated group. Accordingly, Enron claimed interest expense deductions of the yield payments on the purported debt instrument.

For financial reporting purposes, Enron disregarded the purported debt instrument because the special purpose entity was consolidated with Enron on its financial statements.[887] Instead, Enron reported the preferred securities as though Enron had issued the preferred securities directly to the outside investors (rather than through the special purpose entity). These securities received equity credit from rating agencies because the borrowing by Enron from the special purpose entity that supported the preferred securities exhibited certain equity characteristics, including a long-term maturity, deep subordination, and an option for Enron to defer the payment of interest for the first several months (or years) that the borrowing was outstanding. Thus, Enron denominated the preferred securities as mezzanine equity, rather than indebtedness, on its balance sheet.[888] Enron reported yield payments to the holders of the preferred securities as "Dividends on Preferred Stock of Subsidiary".

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[887] As amended by Statement of Financial Accounting Standards No. 94, Accounting Research Bulletin No. 51, requires companies to consolidate majority owned subsidiaries unless control of the subsidiary is likely to be temporary, or the majority owner does not actually control the subsidiary. Because of the common ownership interest retained by the ultimate borrower, special purpose entities that issue tiered preferred securities generally satisfy the financial accounting requirements for consolidation with the borrower.

[888] Specifically, Enron's financial statement balance sheets referred to the tiered preferred securities as "Preferred Stock of Subsidiary" in 1993 and 1994, and thereafter have

Development of tiered preferred securities

In 1993, Goldman, Sachs & Co. began marketing a new financial instrument, dubbed monthly income preferred securities ("MIPS"), that was designed to be treated as a debt instrument (with deductible interest payments) for Federal income tax purposes, while simultaneously providing equity treatment for financial reporting and rating agency purposes.[889] Other investment banks subsequently marketed their own version of MIPS, such as trust originated preferred securities ("TOPrS") introduced by Merrill Lynch.[890] Whereas the special purpose entity involved in MIPS is characterized as a partnership for Federal income tax purposes, the special purpose entity involved in TOPrS is characterized as a grantor trust.[891] Regardless of the particular classification of the special purpose entity, the common feature of these transactions in this respect is that the special purpose entity is not classified as a taxable corporation under the entity classification rules.

In general, these financial instruments involve the creation of a special purpose entity by the ultimate borrower.[892] The special purpose entity is treated as a separate entity from the

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referred to the securities as "Company-Obligated Preferred Securities of Subsidiaries". This is consistent with the guidance provided in SEC Regulation S-X, Article 5, Rule 5-02.27.

[889] The issuance of debt instruments containing certain features that are characteristic of equity, such as subordination and deferred interest arrangements, allows borrowers to obtain capital with less impact on their credit rating than straight debt financing because such instruments receive "equity credit" from rating agencies. In addition, the Federal Reserve Board has stated that certain tiered preferred securities can qualify as Tier 1 equity capital for banks. *See* Federal Reserve Press Release, Oct. 21, 1996 ("To be eligible as Tier 1 capital, such instruments must provide for a minimum five-year consecutive deferral period on distributions to preferred shareholders. In addition, the intercompany loan must be subordinated to all subordinated debt and have the longest feasible maturity."); *Capital Briefs--Rule on Cumulative Preferred Stock Eased*, American Banker, Oct. 22, 1996; Padgett, *Surge of New Issues Seen as Fed Approves Use of Hybrid Security*, American Banker, Oct. 24, 1996.

[890] Goldman Sachs also began marketing a variation on MIPS, called quarterly income preferred securities ("QUIPS"), which differ materially from MIPS only in that payments on QUIPS are made quarterly instead of monthly. *See, e.g.*, BFGoodrich Capital 83% Cumulative Quarterly Income Preferred Securities (June 30, 1995).

[891] By using a grantor trust rather than a tax partnership as the special purpose entity, TOPrS significantly reduce the SEC reporting burdens associated with the securities. *See* John C. Reid, *MIPS Besieged--Solutions in Search of a Problem*, 76 Tax Notes 1057, 1058 (Dec. 1, 1997).

[892] Special purpose entities involved in earlier transactions usually were formed offshore. However, with the enactment of limited liability company laws in several States and the issuance by the SEC of "no action" letters exempting the entities from registration under the Investment Company Act of 1940, special purpose entities involved in more recent transactions have been formed as domestic pass-through entities.

borrower for tax purposes, but is not itself subject to tax. For financial reporting purposes, the special purpose entity is disregarded as separate from the borrower because it is consolidated with the borrower. In general, the special purpose entity issues its voting securities (with a nominal value) to the borrower, and issues nonvoting preferred securities to investors. The special purpose entity then lends the proceeds from the preferred securities issuance (along with any cash contributed by the borrower) to the borrower in exchange for a long-term (typically, 30-year) debt instrument. Distributions on the preferred securities closely correspond to the interest payments on the debt instrument issued to the entity by the borrower. When the loan from the special purpose entity to the borrower ultimately matures, the special purpose entity redeems the MIPS for cash.

For tax purposes, the debt instrument issued to the special purpose entity by the ultimate borrower is respected because the entity is treated as separate from the borrower. Thus, the borrower claims interest deductions on the debt instrument. For financial reporting purposes, the debt instrument is disregarded because the special purpose entity is not treated as separate from the borrower. Instead, the borrower is considered to have issued preferred securities directly to the investors. As mentioned earlier, these securities receive equity credit from rating agencies because the debt instrument issued by the borrower that supports the securities is long term, deeply subordinated, and provides the borrower an option to defer the payment of interest for an extended period of time (typically, the first five years) during which the debt instrument is outstanding. Thus, the preferred securities tend to be denominated as mezzanine equity, rather than indebtedness, on the financial statements of the borrower.

Issuance of Enron tiered preferred securities

As indicated, Enron raised over $800 million through several issuances of tiered preferred securities, including MIPS, TOPrS, and adjustable-rate trust securities ("ACTS").[893] In general, the ACTS were substantially similar to TOPrS, except that ACTS provided for a variable (rather than fixed) yield.

Table 2 on the next page summarizes the tiered preferred securities that Enron entered into between 1993 and 1997.

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[893] *See, e.g.*, Minutes, Meeting of the Board of Directors, Enron Corp., December 10, 1996 at 5-6 (approving the 1996 Enron TOPrS issuance), EC 000045039 through EC 000045067; Minutes, Meeting of the Executive Committee of the Board of Directors, Enron Corp., December 18, 1996 (approving proposed resolution authorizing 1997 Enron TOPrS issuance), EC 000045073 through EC 000045079; Minutes, Meeting of the Executive Committee of the Board of Directors, Enron Corp., June 5, 1997 (approving proposed resolution authorizing 1997 ACTS issuance). EC 000045650 through EC 000045655. The structured financing materials in Appendix B contain these minutes.

Table 2.–Enron Tiered Preferred Securities Issuances

Issuance	Year of issuance	Proceeds of issuance (millions of dollars)[1]	Stated yield (percent)	Initial term to maturity[2] (years)	Extended term to maturity[3] (years)	Interest payment deferral period (months)
MIPS	1993	$200	8.00	50	50	18
MIPS[4]	1994	75	9.00	30	19	60
TOPrS	1996	200	8.30	20	n/a	18
TOPrS	1997	150	8.125	20	n/a	18
ACTS	1997	200	Variable[5]	49	n/a	60

<u>Notes</u>:

[1] Amount of proceeds is based upon the amount indicated in the prospectus of each issuance. Actual amount of proceeds from each issuance may differ somewhat from the amount indicated due to over-allotments.

[2] Based upon the loan from the special purpose entity (e.g., Enron Capital LLC) to Enron.

[3] Based upon the loan from the special purpose entity (e.g., Enron Capital LLC) to Enron, not including the initial term to maturity.

[4] This issuance was not formally an issuance of MIPS because the lead underwriter was Merrill Lynch & Co., not Goldman, Sachs & Co. However, this issuance was substantially similar to a MIPS issuance. Thus, this issuance is referred to as MIPS only for purposes of convenience.

[5] The ACTS issuance provided for yield payments at an initial rate of 5.813 percent through September 5, 1997, with subsequent quarterly resets of the yield based upon a Dutch auction process to obtain a yield reflective of current market conditions.

1993 Enron MIPS

On September 27, 1993, Enron convened a special meeting of its Board of Directors primarily for the purpose of hearing a management presentation concerning the issuance of perpetual preferred stock.[894] In its presentation, management stated that Enron would continue to require cash infusions because of its ongoing growth and expansion. However, management also indicated that maintaining Enron's credit quality was a high priority. Management then presented two options that had been proposed to Enron: (1) issuance of standard perpetual preferred stock underwritten by Merrill Lynch & Co.; and (2) issuance of tax deductible perpetual preferred stock underwritten by Goldman, Sachs & Co. According to management, Arthur Andersen & Co. had indicated to Enron that neither option would be treated as indebtedness for financial accounting purposes. In addition, the credit rating agencies had indicated that they would reach the same conclusion. Management also said that the law firm Sullivan & Cromwell had issued a letter confirming the tax deductibility of the option proposed by Goldman, Sachs & Co., but noting that future tax law changes could negate deductibility. Based upon the presentation by management, the Board adopted a resolution that authorized the registration, issuance and sale of up to $250 million of either standard or tax deductible perpetual preferred stock, and authorized the appointment of a special preferred stock committee to determine the terms of the issuance.

On October 12, 1993, the Finance Committee of the Enron Board of Directors met to discuss further the issuance of perpetual preferred stock by Enron.[895] At this meeting, management indicated to the committee that the "determination of the question of whether or not the preferred stock offering would be tax deductible was key to management's decision to proceed."[896] The committee concluded its consideration of perpetual preferred stock by agreeing to recommend that the Board restate its previous resolution and authorize the registration, issuance and sale of: (1) up to $575 million of perpetual preferred stock if the yield on the stock was determined to be tax deductible and the credit rating agencies would treat the stock as equity for debt rating purposes; or (2) up to $350 million of perpetual preferred stock if the yield on the stock was not determined to be tax deductible.[897]

On October 13, 1993, the Enron Board of Directors heard the recommendation of the Finance Committee and approved a resolution authorizing a shelf registration of fixed rate

[894] Minutes, Special Meeting of the Board of Directors, Enron Corp., September 27, 1993 at 1. EC2 000055435 through EC2 000055450. The structured financing materials in Appendix B contain these minutes.

[895] Minutes, Meeting of the Finance Committee of the Board of Directors, Enron Corp., October 12, 1993. EC2 000055452 through EC2 000055456. The structured financing materials in Appendix B contain these minutes.

[896] *Id.* at 2.

[897] *Id.*

perpetual preferred stock in the amount of either $575 million (if tax deductible and rated as equity) or $350 million (if not tax deductible).[898]

Pursuant to the resolution, Enron formed Enron Capital LLC under the law of Turks and Caicos Islands for the sole purpose of issuing shares and lending the net proceeds to Enron.[899] Enron acquired the common shares of Enron Capital LLC for approximately $53.165 million.[900]

In November 1993, Enron Capital LLC authorized the issuance of $9.2 million shares of cumulative guaranteed MIPS with a cumulative preferred dividend rate of 8 percent ("1993 MIPS").[901] The MIPS became redeemable (at the option of Enron Capital LLC) on or after November 30, 1998, at a redemption price of $25.00 per share plus accumulated and unpaid dividends. Following the issuance of the shares and as part of the prearranged transaction, Enron Capital LLC loaned to Enron both the $53.165 million proceeds from the issuance of its common shares to Enron, and the $200 million proceeds from the sale of the MIPS, for an aggregate principal amount of $253.165 million.[902] The loan from Enron Capital LLC to Enron provided a stated interest rate of 8 percent until maturity, payable on the last day of each calendar month of each year beginning on November 30, 1993.[903]

Under the terms of the loan from Enron Capital LLC to Enron, Enron was permitted to defer payment of the monthly interest up to 18 months (provided Enron was not in default on the loan), during which time Enron would not be permitted to declare dividends on any of its capital stock. During any such period of interest payment deferment, Enron Capital LLC would continue to accrue the interest income being deferred, and the deferred interest income would be allocated (but not distributed) to the holders of the MIPS.[904]

The loan provided a maturity date of November 30, 2043 for repayment of the entire principal amount, together with any accrued and unpaid interest, or on any earlier date if Enron

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[898] Minutes, Meeting of the Board of Directors, Enron Corp., October 13, 1993. The structured financing materials in Appendix B contain these minutes.

[899] Prospectus Supplement, Enron Capital LLC 8% Cumulative Guaranteed Monthly Income Preferred Shares (Nov. 4, 1993) at S-6 [hereinafter "1993 Prospectus"].

[900] 1993 Prospectus at S-14.

[901] Terms of the 8% Cumulative Guaranteed Monthly Income Preferred Shares of Enron Capital LLC (Nov. 4, 1993) at 1. Of the total authorized MIPS, Enron Capital LLC issued 8,000,000 shares at $25.00 per share, for a total of $200 million. The remaining unissued 1,200,000 shares of MIPS were reserved for the underwriters' over-allotment option. 1993 Prospectus at S-6.

[902] 1993 Prospectus at S-14.

[903] 1993 Prospectus at S-15.

[904] 1993 Prospectus at S-20.

or Enron Capital LLC was dissolved, wound up or liquidated. The loan could not be prepaid prior to November 30, 1998. Upon repayment by Enron, the loan provided that the repaid principal could be reloaned to Enron under certain conditions, with a final maturity date of the new loan not later than the 100th anniversary of the issuance of the MIPS.[905] The loan was subordinate to all present and future senior indebtedness of Enron.

Enron guaranteed the payment of dividends by Enron Capital LLC to the holders of the MIPS. However, the guarantee agreement constituted an unsecured obligation of Enron and ranked: (1) subordinate and junior in right of payment to all liabilities of Enron; (2) *pari passu* with the most senior preferred or preference stock of Enron; and (3) senior to Enron's common stock. In the event of the bankruptcy of Enron (among other events), Enron Capital LLC automatically would dissolve and be liquidated.[906] In the event of the bankruptcy of Enron (among other events), the holders of a majority in liquidation preference of the outstanding MIPS were entitled to appoint and authorize a trustee to enforce the creditor rights of Enron Capital LLC against Enron, and to declare and pay dividends on the MIPS.[907]

Enron evidently used the loan proceeds to repay other indebtedness, and for general corporate purposes.[908] In its filings with the SEC, Enron stated that "the average cost of long-term debt declined to 8.2 percent at December 31, 1993 from 8.9 percent at December 31, 1992. The decline was accomplished primarily through the retirement of additional higher coupon long-term debt which was subject to call provisions during [1993]."[909]

Role of outside advisers

In the case of the 1993 MIPS, Goldman, Sachs & Co. was the lead underwriter, while Merrill Lynch & Co. was the lead underwriter for the 1994 Enron tiered preferred securities and the 1996 and 1997 TOPrS. The lead underwriter for the 1997 ACTS was Deutsche Morgan Grenfell.

For each transaction except the ACTS transaction, Vinson & Elkins LLP provided a tax opinion letter that analyzed the tax implications of the transaction. For the ACTS transaction, Skadden, Arps, Meagher & Flom LLP provided a tax opinion letter that analyzed the tax implications of the transaction.

With regard to the 1993 MIPS, Vinson & Elkins LLP concluded that:

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[905] 1993 Prospectus at S-7. The repaid principal may not be reloaned to Enron if (among other things) Enron is in bankruptcy.

[906] 1993 Prospectus at S-8.

[907] 1993 Prospectus at S-8 to S-9.

[908] 1993 Prospectus at S-5.

[909] 1993 Enron Form 10-K at 32.

(1) the proceeds received by Enron from Enron Capital LLC "should" be classified as loans for Federal income tax purposes;

(2) Enron Capital LLC "would" be treated as a partnership rather than a corporation or taxable mortgage pool for Federal income tax purposes; and

(3) interest paid by Enron on the proceeds received from Enron Capital LLC "would" qualify as portfolio interest within the meaning of section 1441(c)(9) and, thus, Enron "would" not be required to deduct and withhold tax with respect to such interest.[910]

Vinson & Elkins LLP subsequently issued a second tax opinion letter concerning the 1993 MIPS, in which the law firm concluded that:

(1) Enron "would" be liable for any tax that should have been withheld to the extent such tax is not paid by the holders of the Enron Capital LLC preferred shares;

(2) because of the "reasonable cause" exception, Enron "should not" be liable for penalties or additions to tax by reason of any failure to withhold in respect of a payment (of interest) on the proceeds received by Enron from Enron Capital LLC; and

(3) Enron "would" be liable for interest on any tax that should have been withheld during any calendar year, but that such interest "should not" start to accrue until March 15 of the following year and "should" cease to accrue upon payment of the tax against which such withholding tax may be credited by the holders of the preferred shares issued to investors by Enron Capital LLC (which may be as early as April 15 of such following year).[911]

Arthur Andersen provided an accounting opinion letter that analyzed the financial accounting implications of a hypothetical MIPS transaction and concluded that: (1) the special purpose entity issuing the securities (i.e., the MIPS) should be consolidated with the company that formed the entity; and (2) the securities should be reflected in the company's financial statements as minority interests.[912]

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[910] Vinson & Elkins LLP tax opinion letter to Enron, dated November 4, 1993. EC2 000036276 through EC2 000036289. The structured financing materials in Appendix B contain this opinion letter.

[911] Vinson & Elkins LLP tax opinion letter to Robert J. Hermann, Vice President - Tax, Enron, dated December 17, 1993. EC2 000036290 through EC2 000036302. The structured financing materials in Appendix B contain this opinion letter.

[912] Arthur Andersen opinion letter to Goldman Sachs & Co., dated September 13, 1993. With regard to the accounting treatment of the outside investors as minority interests, the opinion letter states that "[w]hile some may argue that where [sic] a subsidiary's only role is to loan funds to others in the consolidated group and the non affiliated stockholders of the subsidiary can

Table 3 summarizes that amounts of fees and expenses that Enron paid in connection with the tiered preferred share issuances:[913]

Table 3.–Enron Tiered Preferred Securities Issuance Fees and Expenses

Issuance	Year of issuance	Lead underwriter	Lead underwriter fees	Other estimated expenses
MIPS	1993	Goldman, Sachs & Co.	$14,390,000	$300,000
MIPS	1994	Merrill Lynch & Co.	$11,800,000	$400,000
TOPrS	1996	Merrill Lynch & Co.	$37,500,000	$400,000
TOPrS	1997	Merrill Lynch & Co.	$22,000,000	$400,000
ACTS	1997	Deutsche Morgan Grenfell	Not available	$200,000

IRS review of Enron tiered preferred shares

Based upon its audit of Enron's tax returns for the 1993 and 1994 tax years, the IRS issued a statutory notice of deficiency, dated March 4, 1998, in which the IRS determined that Enron improperly deducted interest expense relating to the 1993 MIPS and the 1994 MIPS.[914] In response, Enron filed a petition with the Tax Court on April 1, 1998 contesting the deficiency.[915] Enron also requested consideration of the deficiency determination by the Appeals Division of the IRS, and the IRS assigned the case to the Appeals Division on June 17, 1998.

On May 6, 1998, IRS District Counsel (Midstates Region) sent a memorandum to the IRS National Office requesting technical assistance concerning the proper tax treatment of the 1993 MIPS and 1994 MIPS transactions. On August 12, 1998, the IRS National Office responded with a field service advice memorandum in which the National Office addressed three issues: (1) whether the MIPS securities constituted equity, rather than debt, for tax purposes; (2) whether

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gain control of [the company's] Board in the event of default on the loan [from the special purpose entity to the company], the non affiliate stockholders of the subsidiary should be treated as creditors in the consolidated financial statements of the [company], this is not practice." The structured financing materials in Appendix B contain this opinion letter.

[913] This information is based upon a review of the prospectus for each issuance and information provided to the Joint Committee staff by Enron. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003.

[914] The assessment disallowed interest expenses claimed by Enron in the amounts of: (1) $2,137,497 in 1993 with respect to the 1993 MIPS; (2) $21,645,569 in 1994 with respect to the 1993 MIPS; and (3) $3,512,658 in 1994 with respect to the 1994 MIPS.

[915] *Enron Corp. v. Commissioner*, Docket No. 6149-98. The petition also contested several other deficiencies asserted by the IRS for the 1992-1994 audit cycle, all of which were settled shortly after the filing of the petition.

the MIPS transactions overall lacked economic substance; and (3) whether the special purpose entities issuing the MIPS securities should be treated as taxable corporations, rather than partnerships, for tax purposes.[916]

With regard to whether the MIPS constituted debt or equity, the IRS National Office analyzed the issue by applying the debt-equity characterization factors listed in Notice 94-47[917] to the securities, and concluded that "we do not recommend recharacterizing the debt as equity." The National Office acknowledged that its analysis focused on the proper characterization of the loans from the special purpose entities to Enron, rather than the proper characterization of the MIPS securities themselves as debt or equity. However, the National Office stated that, even if the special purpose entities were not respected as partnerships for tax purposes, "the conclusions would not be different, and the [MIPS] instruments would still be properly characterized as debt."

In determining whether the MIPS transactions overall lacked economic substance, the IRS National Office noted that the transactions decreased the average cost of Enron's long-term debt and decreased Enron's debt-to-equity ratio from 1.2:1 to 1:1. Consequently, the National Office concluded that, "[i]n the balance, it appears from the available information that [Enron] entered into the transactions to obtain loans at lower interest rates and at lower costs generally and, therefore the underlying transactions possess economic substance. Thus, the interest deduction should not be disallowed."

With regard to whether the special purpose entities should be treated as taxable corporations, rather than partnerships, for tax purposes, the IRS National Office determined that the entities appeared to have a "reasonable basis" for their classification as partnerships under the entity classification regulations that were in place at the time of the transactions.[918] Therefore, IRS National Office concluded that the partnership treatment of the entities should be respected.

After receiving and reviewing the field service advice memorandum, the Appeals officer assigned to the case drafted an Appeals Transmittal and Case Memorandum. In the memorandum, the Appeals officer voiced strong disagreement with the analysis and conclusions set forth in the field service advice memorandum. Specifically, the Appeals officer indicated his view that the field service advice memorandum should have analyzed the proper characterization of the MIPS securities as debt or equity. In addition, the Appeals officer argued that the field service advice memorandum "addressed what Enron's business purpose (a partner) was for the MIPS transaction but fail[ed] to provide a business purpose for the partnership itself."

Contrary to the conclusion reached in the field service advice memorandum, the Appeals officer argued strenuously that the special purpose entities should not be respected as

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[916] The structured financing materials in Appendix B contain the field service advice that the IRS National Office provided to the IRS District Counsel in connection with the 1993 MIPS and 1994 MIPS issued by Enron.

[917] 1994-1 C.B. 357.

[918] *See* Treas. Reg. sec. 301.7701(f)(2).

partnerships on economic substance grounds, and that disregarding these entities as partnerships and treating the MIPS as having been issued directly by Enron would require the MIPS to be characterized as equity, rather than debt, for tax purposes. Finally, the Appeals officer raised a non-tax public policy concern that, in a more general context, would become central to Enron's bankruptcy a few years later:

> Here the taxpayer is admitting that they [sic] are skirting well regulated areas by designing a transaction to avoid the standard investor/creditors warning signals: Too much debt and dilution of their ownership rights.
>
> The taxpayer has designed a transaction that avoids both indicators by becoming debt that comes from equity. That is, this is in the bottom of the debt tier, but it takes its payment source from the top of the dividend class of securities. A bottom feeder if you will. Thus, there appears to be a public policy issue as to whether or not IRS should allow a deduction on a payment that is designed to frustrate some clear combination of GAAP, SEC regulations and regulators, and the regulated debt which is relied on by creditors in indicating too much debt.

Notwithstanding the conclusions reached by the National Office in the field service advice memorandum, the Appeals officer recommended litigating the validity of the interest deductions claimed by Enron in 1993 and 1994 with regard to the MIPS transactions.

On October 20, 1998, representatives from Enron and IRS Appeals met in a conference to discuss the MIPS issue. Notes of the conference taken by the Appeals officer indicate that Enron acknowledged "the MIPS were finely crafted to walk that fine line that does exist between debt and equity," but also argued that the mezzanine treatment of MIPS for financial reporting purposes allowed Enron to raise capital for expansion without eroding its credit rating (because the MIPS were not reported as indebtedness) or earnings per share (because the MIPS were not reported as shareholder equity). Thus, according to Enron, issuing the MIPS served a business purpose that was independent of tax considerations. In a revised version of his Appeals case memorandum, the Appeals officer responded to this point as follows:

> Should the IRS condone this treatment of debt to "fool" both GAAP and SEC reporting where both consider the MIPS as having substantial equity features?
>
> Look at it this way: No debt treatment fools creditors, [n]o equity treatment fools the market investors, the extendibility of the LLC and notes in the years at issue allow gradual conversion to actual equity (it seems to me), the continued drain on cash flow without disclosure to the public seems to set up, in [m]acroeconomic terms, a lot of corporations with debt/equity not displayed on they're [sic] books.
>
> If things turn south and payments are suspended:
>
> (1) A lot of investors will be unhappy
>
> (2) A lot of corporations may be required to make mandatory payments after 18 or so months (in the depths of a recession) which will endanger shareholders rights and

(3) If enough corporations are required to do this it could materially affect the nation[']s economy by reducing corporate capital available for operations.

> This entire matter seems to be "leveraging" just like buying stocks on margin or leveraging your way to success... . [I]t works great in good times but in economic recessions it leads to bankruptcy. Potential non-tax shareholder derivative questions present in both years...should be considered in a public policy review by counsel. This is beyond IRS jurisdiction but important public policy implications may be present if the MIPS structure violates the [Enron] Board's duty to its shareholders to maximize shareholder value.

Nevertheless, Enron and the IRS subsequently reached a settlement of the issues concerning the 1993 and 1994 MIPS. In the settlement, the IRS conceded the deductibility of the stated interest payments made by Enron. Specifically, the IRS conceded that: (1) the loan from the special purpose entity to Enron in each transaction constituted indebtedness of Enron for Federal income tax purposes; (2) Enron was entitled to deduct stated interest accrued on such indebtedness; and (3) the special purpose entity was a valid entity that was separate and distinct from Enron for Federal income tax purposes.[919]

Because the settlement of the case (including settlement of the other asserted deficiencies) would result in refunds of overpaid taxes to Enron in excess of $1 million, the IRS referred the settlement to the Joint Committee on Taxation on July 26, 1999 for review as required under the Code.[920] On September 28, 1999, the Joint Committee staff reviewed the settlement and did not raise an objection to it.

The Tax Court approved the settlement on October 1, 1999.[921]

Subsequent developments

Although the offering materials for the tiered preferred securities issued by Enron provided for the dissolution and liquidation of the special purpose entity in the event of the bankruptcy of Enron, the tiered preferred securities remain outstanding except for the securities issued as part of the ACTS transaction.[922] However, the outstanding tiered preferred securities

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[919] First Supplemental Stipulation of Settled Issues, *Enron Corp. v. Commissioner*, Docket No. 6149-98, filed Dec. 24, 1998. *See also* Counsel Settlement Memorandum, MIPS Issues, In re: Enron Corporation & Consolidated Subsidiaries, Docket Number 6149-98, approved July 26, 1999. The structured financing materials in Appendix B contain the counsel settlement memorandum.

[920] Sec. 6405, as in effect at the time of the settlement.

[921] Decision, *Enron Corp. v. Commissioner*, Docket No. 6149-98, entered Oct. 1, 1999.

[922] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003. EC2 000055434.

currently trade over the counter for under $1 per share, down significantly from their $25 initial offering price and liquidation preference per share.

3. Discussion

In general

Under present law, taxpayers have significant flexibility in structuring a financial instrument as debt or equity. Frequently, taxpayers may characterize instruments with very similar economic terms selectively either as equity (for example, if the issuer intends to market them to corporate holders that would benefit from a dividends received deduction) or as debt (if the issuer intends to claim a corporate interest deduction or achieve certain other benefits of debt status).

In general, the characterization of a financial instrument as debt can be based on a number of factors, including the presence (or absence) of an enforceable and unconditional promise to pay a specified amount on a specified date,[923] and the length of the term to maturity of an instrument.[924]

Tiered preferred securities

Tiered preferred share transactions such as MIPS and TOPrS have their genesis in the fundamental principle that leverage generally is favored for tax purposes (because of the deductibility of interest and the non-deductibility of dividends) but disfavored for financial accounting purposes (because reported debt tends to depress marginal share price and credit ratings relative to outstanding equity). Thus, companies generally prefer to obtain equity financing for financial accounting purposes, but prefer to obtain debt financing for tax purposes. Because the financial accounting rules for characterizing financing as either debt or equity do not correspond with the tax rules for determining such characterization, companies have taken advantage of opportunities to arbitrage the financial accounting and tax rules in order to achieve

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[923] *See, e.g., John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972); *United States v. Title Guarantee & Trust Co.*, 133 F.2d 990 (6th Cir. 1943).

[924] *See, e.g., Reef Corp. v. Commissioner*, 24 T.C.M. 379 (1965), *aff'd*, 368 F.2d 125 (5th Cir. 1966); *United States v. Snyder Bros. Co.*, 367 F.2d 980 (5th Cir. 1966). Other factors may include (but are not limited to) a fixed maturity or mandatory redemption date, priority over general creditors of the issuer, rights to participate in the management of the issuer (including voting rights), the level of capitalization of the issuer, and the intent of the parties (although this last "factor" arguably is actually the fundamental question that the other factors attempt to answer as to the characterization of a financial instrument). However, the IRS has indicated that the right to receive a sum certain at maturity "is a *sine qua non* of debt treatment under the Code." Field Service Advice 199940007 (June 15, 1999). *See also Gilbert v. Commissioner*, 248 F.2d 399 (2nd Cir. 1957); *Johnson v. Commissioner*, 108 F.2d 104 (8th Cir. 1939). Section 385(b) provides a non-exclusive list of several traditional factors that Treasury regulations might take into account in determining the classification of an interest in a corporation.

an ideal objective--financing that can be reported on financial statements as equity and on tax returns as indebtedness. Tiered preferred shares are the financial instruments with which many companies have accomplished this result.[925]

Absent more definitive guidance concerning the characterization of the tiered preferred securities themselves, it generally has been believed that certain conditions must be satisfied in order for the tax benefits of tiered preferred share transactions to be realized by the ultimate borrower. Specifically, the special purpose entity that is used in such transactions must be respected for tax purposes as an entity separate from the borrower, and the debt instrument issued by the borrower to the entity in exchange for the proceeds from the issuance of preferred securities by the entity must be respected as indebtedness for tax purposes.

Because the special purpose entity issues two separate classes of securities to two different parties (i.e., the voting securities issued to the borrower and the nonvoting preferred securities to the investors), borrowers take the position that the entity cannot be disregarded as separate from the borrower for tax purposes. With regard to whether the debt instrument issued by the borrower to the special purpose entity should be respected as indebtedness for tax purposes, borrowers take the position that the debt characteristics (in particular, the repayment of a sum certain on a fixed maturity date) of the instrument outweighs its equity characteristics (i.e., long term to maturity, subordination, and the option to defer interest payments) and, thus, it should properly be characterized as indebtedness for tax purposes.

In response to the growth of hybrid financial instruments "that combine long maturities (greater than 50 years) with substantial equity characteristics" (including MIPS and other similar securities), the IRS issued Notice 94-47.[926] In the notice, the IRS listed eight factors to be taken into account in determining whether a security constitutes debt or equity for tax purposes:

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[925] The tax benefits of tiered preferred securities can permit companies to offer securities with a higher yield to investors than they might otherwise offer for comparable conventional preferred securities with non-deductible dividend yield payments. For example, General Motors Corporation ("GM") announced a tender offer in June 1997 to exchange certain classes of its outstanding preferred stock for a new issue of TOPrS. In exchange for an outstanding class of preferred stock that yielded a 7.92 percent dividend, GM issued a class of TOPrS that yielded 8.67 percent to tendering shareholders. In exchange for an outstanding class of preferred stock that yielded a 9.12 percent dividend, GM issued a class of TOPrS that yielded 9.87 percent to tendering shareholders. *See* General Motors Amendment No. 4 to Form S-4, filed June 2, 1997. Although the 75 basis point increase in the yield paid to the tendering shareholders of each class of preferred stock reportedly cost GM an additional $2.7 million per year before taxes, the deductibility of the TOPrS yield payments (as opposed to the nondeductible dividends paid on the tendered preferred stock) reportedly provided GM a tax savings of approximately $9 million per year. Interestingly, the rating agencies gave the GM TOPrS the same equity credit rating as they had given to the preferred stock that TOPrS replaced. *See* Lee A. Sheppard, *GM's Tax-Deductible Preferred Exchange Offer*, 75 Tax Notes 1458 (June 16, 1997).

[926] 1994-1 C.B. 357.

(1) whether there is an unconditional promise to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;

(2) whether holders of the securities possess the right to enforce the payment of principal and interest;

(3) whether the rights of the holders of the securities are subordinate to the rights of general creditors of the issuer;

(4) whether the securities give the holder the right to participate in the management of the issuer of the securities;

(5) whether the issuer of the securities is thinly capitalized;

(6) whether there is identity between holders of the securities and stockholders of the issuer;

(7) the labels placed on the securities by the parties; and

(8) whether the securities are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial purposes.

In the notice, the IRS warned that it "will scrutinize [instruments that combine both debt and equity characteristics] to determine if their purported status as debt for federal income tax purposes is appropriate." However, the notice did not specifically mention MIPS.

Notice 94-47 did not appear to have any discernible impact on the appetite of taxpayers to obtain financing through the issuance of MIPS. In response, the Treasury Department in 1996 proposed an amendment to section 385(c) that would have required an issuer to treat an instrument as equity if the instrument: (1) has a maximum term of more than 20 years; and (2) is not shown as indebtedness on the separate balance sheet of the issuer. In the case of an instrument with a maximum term of more than 20 years issued to a related party (other than a corporation) that is eliminated in a consolidated balance sheet that includes the issuer and the holder, the proposal would have treated the issuer as having characterized the instrument as equity if the holder or some other related party issues a related instrument that is not shown as indebtedness on the consolidated balance sheet. For this purpose, an instrument would not have been treated as shown as indebtedness on a balance sheet merely because it is described as such in financial statement footnotes or other such narrative disclosures. The proposal would have applied only to corporations that file annual financial statements (or are included in financial statements filed) with the SEC.[927] The proposal generally was interpreted as an effort by the Treasury Department to combat tiered preferred securities such as MIPS and TOPrS.

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[927] *See* Department of the Treasury, *General Explanations of the Administration's Revenue Proposals*, March 1996; Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1997: Analytical Perspectives*, H. Doc. 104-162/Vol. 3, at 35-48; Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 1997 Budget Proposal (Released March 19, 1996)* (JCS-2-96), March 27, 1996 at 65.

In 1997, the Treasury Department again proposed amending section 385(c) to foreclose debt characterization of tiered preferred securities.[928] The 1997 proposal was the same as the 1996 proposal, except that the 20 year term that would have triggered the application of the 1996 proposal was reduced to 15 years in the 1997 proposal. Proponents of this proposal took the view that corporations should not be permitted to characterize a financial instrument as indebtedness for tax purposes but not for financial reporting purposes. Furthermore, the extent to which tiered preferred securities such as MIPS and TOPrS have displaced preferred stock may suggest that the securities are viewed in the marketplace as having features closely similar to those of preferred stock.[929] However, others point out that financial statement characterization has not traditionally governed the characterization of items for tax purposes because the goals of generally accepted accounting principles and income tax rules are often different.[930] Indeed, many believe that the purported characterization of tiered preferred securities as indebtedness by the tax rules--not the characterization of such securities for financial statement purposes as equity--is the correct characterization.[931]

Congress did not enact either version of the Treasury proposal and, in fact, the IRS later issued a 1998 technical advice memorandum concluding that a taxpayer that issued tiered preferred securities (apparently, a MIPS transaction) was entitled to the interest deductions claimed in connection with the securities.[932] Specifically, the IRS applied the factors initially set forth in Notice 94-47 and ruled that: (1) loans made to the taxpayer by a foreign limited liability company ("LLC") that it formed constituted debt (rather than equity) for tax purposes; and (2) in any case, the preferred securities issued by the LLC to fund the loans constituted debt, even if the

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[928] *See* Department of the Treasury, *General Explanations of the Administration's Revenue Proposals*, February 1997; Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1998: Analytical Perspectives*, at 45-60.

[929] Joint Committee on Taxation, *Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal* (JCS-10-97), April 16, 1997 at 7.

[930] *Id.*

[931] *See, e.g.*, John C. Reid, *MIPS Besieged--Solutions in Search of a Problem*, 76 Tax Notes 1057, 1068 (Dec. 1, 1997) ("In an all-or-nothing world of the tax law, where an instrument must be debt or equity, MIPS must come down on the debt side of the scale. If an error has been committed in analyzing MIPS, it was committed by the rating agencies, not the tax lawyers."); Victor Fleischer, *Enron's Dirty Tax Secret: Waiting For the Other Shoe to Drop*, 94 Tax Notes 1045, 1046 (Feb. 25, 2002) ("It's never easy to draw a coherent line between debt and equity, but most people agree that the IRS was right to concede, and that MIPS should be treated as debt."). However, Mr. Fleischer also observes that, during the bankruptcy of Enron, the Enron MIPS have been trading significantly lower than Enron traditional debt. Consequently, "now that Enron is in trouble, the deep subordination of MIPS means that the market is treating MIPS more like common stock than debt." *Id.*

[932] Priv. Ltr. Rul. 199910046 (Nov. 16, 1998).

transaction was recast or the separate existence of the LLC was disregarded for tax purposes such that the preferred securities were treated as having been issued directly by the corporation.

The IRS also concluded that the LLC's issuance of the preferred securities and the subsequent loans to the corporation had economic substance because the transaction served non-tax business purposes, including: (1) the provision of funds for working capital and general corporate purposes, including the repayment of outstanding indebtedness; (2) a reduction in the corporation's overall cost of capital; and (3) a reduction in the corporation's debt/equity ratio. In spite of the statutory requirement that partnerships must be formed for the purpose of sharing business profits,[933] the tax transparency of the LLC (which the taxpayer treated as a partnership for tax purposes) apparently did not particularly concern the IRS, which stated:

> The fact that LLC earns no profit on the issuance of the Preferred Securities and the subsequent loans made to Corporation A does not imply the transactions lack economic substance. Although LLC is a "tax-transparent" investment vehicle that acts to pass through the interest earned on the loans to the Preferred Securities holders, the underlying transactions have economic substance.

The remarkable evolution in the reaction of the IRS and the Treasury Department to tiered preferred securities such as MIPS and TOPrS highlights the longstanding and pervasive tax policy dilemma of distinguishing between debt and equity--a problem that one Supreme Court justice presciently identified almost sixty years ago:

> Tax liability should depend upon the subtle refinement of corporate finance no more than it does upon the niceties of conveyancing. Sheer technicalities should have no more weight to control federal tax consequences in one instance than in the other. The taxing statute draws the line broadly between "interest" and "dividend". This requires one who would claim the interest deduction to bring himself clearly within the class for which it was intended. That is not done when the usual signposts between bonds and stock are so obliterated that they become invisible or point equally in both directions at the same time.
>
> Dividend" and "interest," "stock" and "bond," "debenture" or "note," are correlative and clearly identifiable conceptions in their simple and more traditional exemplifications. But their distinguishing features vanish when astute manipulations of the broad permissions of modern incorporation acts results in a "security device" which is in truth neither stock nor bond, but the half-breed offspring of both. At times only the label enables one to ascertain what the manipulator intended to bring forth. But intention clarified by label alone is not always legally effective for the purpose in mind. And there is scarcely any limit to the extent or variety to which this kind of intermingling of the traditional features of stock and bonds or other forms of debt may go, as the books abundantly testify. The taxpayer should show more than a label or a hybrid

933 Sec. 761(a).

security to escape his liability. He should show at the least a substantial preponderance of facts pointing to "interest" rather than "dividends."[934]

The either/or approach taken by the present-law tax rules (i.e., a financial instrument generally must be characterized in its entirety as either equity or indebtedness) is a principal contributor to the difficulties that have long plagued the tax rules concerning the characterization of financial instruments.[935] This rigidity in the tax rules stands in contrast to the analysis of financial instruments undertaken by credit rating agencies, which employs a more flexible scaled approach that can accommodate and give recognition to the presence of both equity and debt characteristics in the same instrument.[936]

With regard to companies that choose to finance their activities with tiered preferred securities rather than traditional indebtedness (or, as in Enron's case, replace existing indebtedness with newly issued tiered preferred securities), it may be argued that such securities do not raise tax policy issues surrounding the distinction between debt and equity,[937] at least to the extent that questions of corporate governance do not fall within the purview of tax policy. On the other hand, it may be the case that companies more commonly have used tiered preferred securities to largely supplant preferred stock (rather than debt) financing, which more directly implicates tax policy concerns to the extent that the tax rules influence the behavior of corporate taxpayers and the financial markets.[938]

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[934] *John Kelley Co. v. Commissioner*, 326 U.S. 521, 534-35 (1945) (Rutledge, J., dissenting) (citations omitted).

[935] Although section 385(a) permits Treasury to issue regulations that characterize certain interests in a corporation as "in part stock and in part indebtedness," no such regulations exist currently.

[936] *See* John C. Reid, *MIPS Besieged--Solutions in Search of a Problem*, 76 Tax Notes 1057, 1065 n.70 (Dec. 1, 1997) ("[T]he tax administrators are making a binary inquiry; an instrument is either debt or it is equity. The rating agencies on the other hand, are placing the instruments somewhere in the range between pure debt and pure equity.").

[937] *Id.* at 1059 ("To the extent that corporations issue MIPS when they would otherwise issue debt, Treasury has no reason to be concerned with the tax treatment of MIPS because interest paid on conventional debt is deductible.").

[938] *See* Joint Committee on Taxation, *Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal* (JCS-10-97), April 16, 1997, at 6 (noting that tiered preferred securities such as MIPS and TOPrS "are reportedly largely replacing regular preferred stock issuances in today's market," and citing Bary, *Preferred Vehicle--How Goldman, Merrill Altered an Entire Market*, Barron's, August 21, 1995, at 13); Norris, *Bush's Plan Taxes Certain Dividends, Fine Print Reveals*, New York Times, January 9, 2003, at A1 (noting that 72 percent of existing preferred stock is actually comprised of hybrid securities that are treated as equity for financial statement purposes but as indebtedness for tax purposes, according to a Merrill Lynch analyst).

The hindsight that the Enron bankruptcy provides may be useful in further evaluating the role that the tax rules play in fostering the development and marketing of tiered preferred securities and other similar hybrid financial instruments that are treated as equity for financial reporting purposes but indebtedness for tax purposes. Consequently, Congress may wish to consider whether such a role raises policy concerns that should outweigh the supposed importance of ensuring that the tax rules in isolation provide the appropriate characterization of such instruments.

4. Recommendations

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 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. This approach would largely eliminate opportunities to arbitrage the various tax and non-tax criteria for determining the character of hybrid financial instruments.

(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. While more definite debt-equity factors ideally would be self-executing (rather than executed through Treasury regulations), developing an appropriate statutory framework for the application of such factors may be exceedingly difficult.[939]

(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 key 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. Similar to the approach used by credit rating agencies in evaluating hybrid financial instruments, this approach would provide

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[939] In any event, section 385 should be amended to apply more broadly to interests in non-corporate entities, as well as corporations.

an alternative to the existing binary debt-equity characterization of financial instruments in appropriate circumstances.

(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.[940] By providing more equivalence in the tax consequences of debt and equity, this approach would eliminate tax considerations from the process by which corporate taxpayers decide to obtain financing. This approach also recognizes the diminishing usefulness of the continuing debate among commentators concerning which regulatory or statutory regime provides the so-called "correct" characterization of financial instruments as debt or equity.

[940] In fact, it has been observed that tiered preferred securities may already achieve effective equivalence in the tax treatment of interest and dividends under present law, which may explain the apparent preference of issuers for such securities over conventional preferred stock. *See* Victor Fleischer, *Enron's Dirty Tax Secret: Waiting For the Other Shoe to Drop*, 94 Tax Notes 1045, 1046 (Feb. 25, 2002) (noting that "Enron has engaged in a sort of self-help corporate integration, getting the equivalent of a dividends-paid deduction, which some reformers would want to give out anyway").

D. Investment Unit Securities

1. Brief overview

In 1995 and 1999, Enron raised over $470 million through the issuance of a different series of hybrid financial instruments. Whereas the tiered preferred securities combined features of both indebtedness and equity, these transactions combined characteristics of indebtedness and a forward contract for the sale of common stock in Enron Oil & Gas Company ("EOG"). By synthesizing these characteristics into a single financial instrument, Enron effectively was able to liquidate its investment in EOG common stock--and eliminate its risk of loss from future depreciation in the stock (along with reducing its opportunity for gain from future appreciation in the stock) -- without actually disposing of the stock.

2. Background

Reported tax and financial statement effects

For Federal income tax purposes, Enron treated the investment unit securities consistently with the terms of the indenture that was part of the securities offering. The indenture required Enron (as well as investors in the securities) to treat the investment unit securities as a combination of an undiscounted debt instrument with stated periodic interest and a forward purchase contract pursuant to which the holder was obligated to use the proceeds from the repayment of the debt instrument upon maturity to purchase EOG common stock based upon a specified exchange rate. Accordingly, Enron deducted the periodic yield payments on the investment unit securities as interest.

For financial accounting purposes, Enron reported the investment unit securities as long-term debt instruments. In addition, Enron reported as income or expense changes in the value of the investment unit securities based upon corresponding changes in the value of the underlying EOG common stock.[941]

As with several of the structured transactions entered into by Enron (e.g., Projects Teresa and Tomas), Enron reported the difference between the tax and financial statement effects of the investment unit securities as a component of its effective tax rate reconciliation under the caption "Asset[s] [or Basis] and Stock Sale Differences". Thus, when the 1995 investment unit securities issued by Enron matured in 1998, Enron reported an increase in financial statement

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[941] Specifically, increases in the value of the underlying EOG common stock would decrease the value of the investment unit securities (in particular, the imbedded forward contract on the EOG common stock) to Enron, and result in financial accounting expense. Conversely, decreases in the value of the underlying EOG common stock would increase the value of the investment unit securities to Enron, and result in financial accounting income. These adjustments produced differences between the financial reporting and tax reporting of the investment unit securities because the tax treatment of the securities did not take into account such changes in value until maturity.

earnings (i.e., earnings through a reduction in the provision for income tax expense) in the amount of $61 million.[942]

Development of investment unit securities

Over the past decade, several corporate taxpayers have issued certain financial instruments that are debt in form and provide regular, periodic payments of interest at a market rate. However, these instruments provide investors with a repayment at maturity that is not fixed in amount. Instead, the amount of the repayment at maturity varies based upon the value of stock other than stock of the issuing corporation (referred to as "reference stock"). Often, but not always, the issuing corporation owns the reference stock and issues the instrument in order to protect against a decline in the value of the reference stock.[943] In such cases, the financial instrument has the effect of monetizing the issuer's investment in the reference stock.[944]

In 1993, American Express Company issued the first such instruments, which are often referred to as debt exchangeable for common stock ("DECS").[945] In their original incarnation, DECS were structured as short-term or medium-term interest-bearing unitary debt instruments

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[942] Enron Corp. and Subs, 1998 Footnote, Detail of Assets and Stock Sales (Enron tax rate reconciliation workpaper). EC2 000036393.

[943] Typically, the issuing corporation issues one unit of the instrument for each unit of reference stock.

[944] More specifically, the investor bears the full risk of loss in the reference stock, but only limited opportunity for gain in such stock because the financial instrument typically provides that the investor is entitled to only a specified percentage of the appreciation in the stock upon maturity and only to the extent that the stock appreciation has exceeded a specified threshold amount. Because of this payout formula, some commentators have referred to these financial instruments as "kinky forward contracts". *See* Edward Kleinbard & Erika Nijenhuis, *Everything I Know About New Financial Products I Learned from DECS, reprinted in* 12 P.L.I. Tax Strategies 1171 (1999).

[945] American Express Company 6.25% exchangeable notes due October 15, 1996 (Oct. 7, 1993). The reference stock in the American Express DECS issuance was common stock of First Data Corporation. DECS is the service mark given these instruments by Salomon, Inc. (now Salomon Smith Barney, Inc.), which underwrote the American Express issuance. Similar instruments offered by other investment banks include yield enhanced equity linked debt securities ("YEELDS") offered by Lehman Brothers Holdings, Inc., stock appreciation income linked securities ("SAILS") offered by Credit Suisse First Boston Corporation, premium exchangeable participating shares ("PEPS") offered by Morgan Stanley & Co., Inc., provisionally redeemable income debt exchangeable for stock ("PRIDES") offered by Merrill Lynch & Co., and common-linked higher income participation securities ("CHIPS") offered by The Bear Stearns Companies, Inc. In general, the reference stock involved in DECS and their counterparts has been comprised of stock issued by a corporation in which the company issuing the DECS-type securities has only a so-called "portfolio", or non-controlling, ownership interest.

that the issuing corporation could repay either in cash (the amount of which was based upon the value of the reference stock) or by delivery of the reference stock itself. In general, DECS are offered at a price that is equal to the fair market value of the reference stock on the offering date.

Although DECS are offered as a single instrument, the economic substance of DECS is akin to a combination of a forward contract on the reference stock (i.e., a financial contract for the issuing corporation to sell the reference stock to the investor) and a conventional debt instrument.[946] However, these components are not independent as a practical matter because an investor in DECS is under an obligation to tender the securities in exchange for the reference stock (or its cash equivalent) upon maturity of the DECS. The tax treatment assigned to DECS by the market generally has been consistent with their substance -- a combination of a forward contract on the reference stock and a debt instrument.[947]

1995 issuance of Enron investment unit securities

In December 1995, Enron issued 10 million investment unit securities at an offering price of $21.75 each.[948] The Enron investment unit securities provided a stated interest rate of 6.25 percent payable quarterly. The stated maturity of the securities was December 13, 1998 and, upon maturity, the principal amount of the securities was to be mandatorily exchanged by Enron into common stock of EOG (or its cash equivalent) at a specified exchange rate.[949] Concurrently with the offering of the investment unit securities, Enron offered approximately 30 million shares of EOG common stock into the public U.S. and international stock markets in a separate public

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[946] In effect, an investor in DECS purchases a right to receive a series of noncontingent periodic payments (designated as stated interest under the terms of the DECS) and a "long" position in the reference stock, while the company issuing the DECS undertakes an obligation to make the periodic payments to the investor and acquires a "short" position in the reference stock.

[947] In the vernacular of a typical DECS prospectus or supplement tax disclosure, investors are "obligated (in the absence of contrary authority) to treat the DECS as a forward purchase contract that requires the holder to deposit the purchase price with the counterparty and to receive interest on that deposit."

[948] Enron Corp. 6.25 percent Exchangeable Notes due December 13, 1998 (December 8, 1995) [hereinafter "1995 Prospectus"]. The investment unit securities were approved for listing on the New York Stock Exchange under the symbol "EXG". 1995 Prospectus at 1. Enron referred internally to the 1995 investment unit securities as "ACES", presumably in reference to another structured finance product offered by Goldman, Sachs & Co. known as "automatic common exchange securities". In general, ACES are similar to DECS and the investment unit securities issued by Enron, except that the reference stock in ACES is the stock of the company issuing the securities rather than the stock of another company.

[949] The specified closing price of EOG common stock on the New York Stock Exchange at the time that Enron issued the investment unit securities was $21.75 per share, which also determined the $21.75 offering price of the investment units.

offering. This offering reduced Enron's stock ownership of EOG from 80 percent to approximately 54 percent.[950]

Typical of DECS offerings in general, the exchange rate specified by the Enron investment unit securities was equal to: (1) .8264 shares of EOG common stock (or the cash equivalent) per investment unit if the EOG common stock at maturity of the investment unit securities had appreciated to a value of $26.32 or more per share; (2) fractional shares of EOG common stock equal in value to $21.75 (or $21.75 in cash) per investment unit if the EOG common stock at maturity of the investment unit securities had appreciated up to $26.31 per share; or (3) one share of EOG common stock (or the cash equivalent) per investment unit if the EOG common stock had either not appreciated or had depreciated from a value of $21.75 per share.[951] Thus, whereas an actual purchaser of EOG common stock would bear the entire risk of loss and opportunity for gain, a purchaser of the Enron investment unit securities would bear the entire risk of loss but only a limited opportunity for gain from EOG common stock.[952] However, the 6.25 percent stated interest rate on the investment unit securities significantly exceeded the anticipated 0.6 percent anticipated dividend yield on the EOG common stock.[953]

The Enron investment unit securities were unsecured and ranked *pari passu* with all other unsecured and unsubordinated indebtedness of Enron. In addition, the securities did not restrict the ability of Enron to sell, pledge or otherwise dispose all or any portion of the EOG common held by it, and no shares of EOG common stock were pledged or otherwise held in escrow for use in satisfying Enron's obligations upon maturity of the investment unit securities. In the event of the bankruptcy of Enron, the investment unit securities provided for the acceleration of maturity upon the declaration of at least 25 percent of the holders of the securities.

The indenture for the Enron investment unit securities required both Enron and the holders of the securities to treat the securities as a combination of an undiscounted debt instrument with stated periodic interest and a forward purchase contract pursuant to which the holder agreed to use the proceeds from the repayment of the debt instrument upon maturity to purchase EOG common stock based upon the exchange rate described above.[954]

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[950] 1995 Prospectus at 1.

[951] 1995 Prospectus at 16. The price of the EOG common stock at maturity was based upon the average closing price per share of the stock for the 20 trading days immediately prior to (but not including) the maturity date. *Id.*

[952] To the extent that the closing price of the EOG common stock at maturity of the investment unit securities was $26.32 or more, the holders of the securities would be entitled to receive only 82.64 percent of the appreciation in the stock. 1995 Prospectus at 4.

[953] 1995 Prospectus at 4.

[954] 1995 Prospectus at 24.

Subsequent developments

Upon maturity of the 1995 Enron investment unit securities on December 13, 1998, the EOG common stock had depreciated to a price of 15.56 per share.[955] Pursuant to the terms of the securities and in accordance with the terms of the exchange rate specified by the securities, Enron retired the securities on December 14, 1998 by delivering one share of EOG common stock in exchange for each unit of the securities.

1999 issuance of Enron investment unit securities

In August 1999, Enron completed a new issuance of 10 million investment unit securities at an offering price of $22.25 each.[956] Structurally, these investment unit securities are similar to the 1995 Enron investment unit securities. The 1999 Enron investment unit securities provide a stated interest rate of seven percent payable quarterly. The stated maturity of the securities was July 31, 2002 and, upon maturity, the principal amount of the securities was to be mandatorily exchanged by Enron into common stock of EOG (or its cash equivalent) at a specified exchange rate.[957] Concurrently with the offering of the investment unit securities, Enron and EOG offered four million shares and 27 million shares, respectively, of EOG common stock in a separate public offering.[958] In conjunction with a separate split-off of a subsidiary of EOG to Enron occurring contemporaneously with the offering of the investment unit securities, this offering reduced Enron's stock ownership of EOG from approximately 53.5 percent (82.27 million shares) to approximately 9.7 percent (16 million shares).[959]

The exchange rate specified by the 1999 investment unit securities was equal to: (1) .8475 shares of EOG common stock (or the cash equivalent) per investment unit if the EOG common stock at maturity of the investment unit securities had appreciated to a value of more than $26.255 per share; (2) fractional shares of EOG common stock equal in value to $22.25 (or $22.25 in cash) per investment unit if the EOG common stock at maturity of the investment unit

[955] As noted above, the price of the EOG common stock at maturity was based upon the average closing price per share of the stock for the twenty trading days immediately prior to (but not including) the maturity date.

[956] Enron Corp. 7 percent Exchangeable Notes due July 31, 2002 (Aug. 10, 1999) [hereinafter "1999 Prospectus"]. The investment unit securities were approved for listing on the New York Stock Exchange under the symbol "EXG." 1999 Prospectus at 1. As with its 1995 investment unit securities, Enron referred internally to the 1999 investment unit securities as "ACES."

[957] The specified closing price of EOG common stock at the time that Enron issued the 1999 investment unit securities was $22.25 per share, which also determined the $22.25 offering price of the investment units.

[958] In addition, the underwriters of the offering had an option to purchase from Enron up to an additional 4.5 million shares of EOG common stock solely to cover over-allotments.

[959] 1999 Prospectus at 5-6.

securities had appreciated up to $26.255 per share; or (3) one share of EOG common stock (or the cash equivalent) per investment unit if the EOG common stock had either not appreciated or had depreciated from a value of $22.25 per share.[960] Again, whereas an actual purchaser of EOG common stock would bear the entire risk of loss and opportunity for gain, a purchaser of the Enron investment unit securities would bear the entire risk of loss but only a limited opportunity for gain from EOG common stock.[961] However, the seven percent stated interest rate on the investment unit securities significantly exceeded the anticipated 0.5 percent anticipated dividend yield on the EOG common stock.[962]

Subsequent developments

Upon the original maturity of the 1999 Enron investment unit securities on July 31, 2002, the EOG common stock had appreciated to a price of $34.88 per share.[963] However, the securities remain outstanding and in default because of the bankruptcy of Enron,[964] with the holders of the securities representing unsecured creditors of the bankruptcy estate pursuant to the terms of the securities. The New York Stock Exchange suspended public trading of the 1999 investment unit securities on January 15, 2002, and moved to delist the securities from the exchange.[965]

Role of outside advisers

Goldman, Sachs & Co. was the lead underwriter for both the 1995 and 1999 issuances of the Enron investment unit securities. For each transaction, Vinson & Elkins LLP provided an analysis of the tax consequences of the transaction but, because of the absence of direct authority addressing the characterization of the investment unit securities and the resulting uncertainty concerning their tax treatment, stated that it could not provide an opinion with respect to the tax consequences of owning or disposing the securities.[966] However, in order to bolster the characterization of the 1999 investment unit securities as a combination of a debt instrument and

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[960] 1999 Prospectus at 4.

[961] To the extent that the closing price of the EOG common stock at maturity of the investment unit securities was more than $26.255, the holders of the securities would be entitled to receive only 84.75 percent of the appreciation in the stock. 1999 Prospectus at 5.

[962] 1999 Prospectus at 5.

[963] As with the 1995 issuance, the price of the EOG common stock at maturity of the 1999 issuance was based upon the average closing price per share of the stock for the 20 trading days immediately prior to (but not including) the maturity date.

[964] EC2 000055434.

[965] New York Stock Exchange, *NYSE Suspends Trading in Enron Corp. and Related Securities and Moves to Remove from the List*, press release dated January 15, 2002.

[966] 1995 Prospectus at 24; 1999 Prospectus at 28.

a forward contract on EOG common stock, the discussion of Federal income tax considerations also specified certain terms of the ostensible forward contract:

(1) At the time of issuance of the investment unit securities, the holder of the securities irrevocably deposited with Enron a fixed amount of cash equal to the initial price of the securities to assure the fulfillment of the holder's purchase obligation at maturity of the securities;

(2) until maturity of the investment unit securities, Enron was obligated to pay interest at seven percent as compensation to the holder of the securities for Enron's use of the cash deposit during the term of the securities; and

(3) at maturity of the investment unit securities, the cash deposit unconditionally and irrevocably would be applied by Enron in full satisfaction of the holder's obligation under the forward contract, and Enron would deliver to the holder the number of shares of EOG common stock that the holder is entitled to receive at maturity of the securities.[967]

In addition, the discussion stated that Enron would not segregate the cash proceeds of the investment unit securities offering during the term of the securities but, instead, would commingle the cash with its other assets for use in retiring existing short-term debt of Enron with a weighted average interest rate of 5.15 percent per year.[968]

In connection with its 1995 and 1999 issuances of the investment unit securities, Enron paid fees in the amounts of $6.6 million and $6.675 million, respectively, to Goldman, Sachs & Co. as lead underwriter in the transactions. Enron also paid expenses in the amount of $425,000 in connection with the 1995 issuance. The Joint Committee staff was unable to determine the actual amount of expenses paid by Enron in connection with the 1999 issuance.[969]

3. Discussion

In general

While the tax consequences of tiered preferred securities transactions depend primarily upon whether the loan by the special purpose entity to the taxpayer (or, in the alternative, the preferred securities issued to investors by the special purpose entity) is respected as indebtedness for tax purposes, the intended tax treatment of investment unit securities, such as those issued by Enron, fundamentally hinges upon whether the imbedded components of the transaction -- the

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[967] 1999 Prospectus at 29. It is important to note that these terms actually do not change the structure or the economic substance of the investment unit securities.

[968] 1999 Prospectus at 14 (use of proceeds) and 29.

[969] This information is based upon a review of the prospectus for each issuance and information provided to the Joint Committee staff by Enron. Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, dated January 13, 2003.

undiscounted conventional debt instrument and the forward contract for the purchase of stock held by the issuer -- are respected as having independent economic substance.

The discussion of Federal income tax considerations that was included as part of the offering materials for the 1999 issuance of investment unit securities by Enron demonstrated a attempt to cosmetically reinforce the independence of the purported components of the securities. In similar transactions by other companies, structural variations on the basic DECS transaction primarily have involved the addition of features that are designed to ensure this intended tax result by incrementally de-linking the forward contract component from the debt instrument component. Such features have included, for example, acceleration and cancellation rights pertaining to the forward contract component, as well as resets on the stated overall yield and separation between the maturity dates of the forward contract and the rest of the transaction.

Investment unit characterization

In the absence of any definitive guidance concerning the tax treatment of DECS and other similar investment unit securities such as those issued by Enron in 1995 and 1999, it generally is believed that there are three potential alternative tax characterizations of such securities: (1) unitary contingent payment debt instruments; (2) unitary prepaid forward contracts; or (3) investment units consisting of a non-prepaid forward contract and a conventional undiscounted debt instrument with periodic stated interest.[970] The first two options view the securities as single instruments rather than investment units comprised of multiple components, while the third option views the securities as consisting of a combination of a debt instrument component and a forward contract component, each with independent significance. In this regard, the characterization of these financial instruments is critical because the alternative characterizations can result in drastically different tax consequences to both the issuer and holder of the financial instruments. However, each alternative characterization has shortcomings that preclude any of them from being the obvious candidate for the proper characterization of this genre of financial instruments.[971]

For instance, the unitary contingent payment debt instrument characterization is inadequate because DECS and other similar securities lack the quintessential feature of a debt instrument--an unconditional promise to pay a sum certain upon maturity--and, thus, cannot properly be characterized as a contingent payment debt instrument.[972] The prepaid forward

[970] *See* Garlock, Federal Income Taxation of Debt Instruments (2002) at sec. 9.09[A]; Schizer, *Debt Exchangeable for Common Stock: Electivity and the Tax Treatment of Issuers and Holders*, 13 J. Bank Tax'n 167 (Summer 2000).

[971] "The fact is that DECS simply do not fit as a whole into any of the traditional 'pigeonholes' of financial instruments, nor even into any of the modern categories that have been created to deal with more recent financial innovation (such as notional principal contracts)." Garlock, Federal Income Taxation of Debt Instruments (2002) at sec. 9.09[A].

[972] In two rulings concerning such financial instruments, the IRS has taken this view. Field Service Advice 199940007 (June 15, 1999); Field Service Advice 200131015 (May 2, 2001).

contract characterization is similarly deficient because, although it does not necessitate that such financial instruments be treated as indebtedness, it fails to account clearly for the periodic "interest" payments made to the holder by the issuer and the fact that (unlike true prepaid forward contracts) the initial investment by the holder is not discounted for present value to take into account the time value of money.[973] The investment unit characterization, although it perhaps most clearly reflects the underlying economics of the transaction and is the characterization that generally has been settled on by taxpayers, suffers from a general lack of authority for bifurcating a single financial instrument into its constituent components for tax purposes.[974]

Constructive sale treatment

Arguably, investment unit securities such as DECS and those issued by Enron properly should be treated as a taxable sale of the reference stock because the issuer of such securities has effectively liquidated or monetized its holdings in the reference stock and transferred substantial benefits and burdens of owning the reference stock to the holder of the securities.[975] In fact, the statutory constructive sale rules were enacted for the purpose of treating similar transactions as

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[973] "Were it not for the periodic payments, one might call the DECS a prepaid forward contract but, since the amount invested is not discounted to present value and the investor is paid a periodic return, the investor is clearly paying for something more than the right to receive the reference stock (or cash measured by the value of that stock)." Garlock, Federal Income Taxation of Debt Instruments (2002) at sec. 9.09[A]. However, it might be possible to view DECS as prepaid forward contracts by ignoring the specific cash flows and comparing the overall yield of an undiscounted prepayment with periodic payments over the term of the instrument to the overall yield of a discounted prepayment without such periodic payments.

[974] In discussing structural complexity relating to the taxation of financial products, the Joint Committee staff has stated that "[d]eveloping component-based rules would likely involve a considerable expansion of bifurcation principles that have previously been applied only in very narrow circumstances. *See, e.g.*, sec. 163(e)(5) (applicable high yield discount obligations); Treas. Reg. Sec. 1.1273-2(h) (investment units); *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (2d Cir. 1960) (debt instrument with equity rights); *Richmond, Fredericksburg & Potomac R.R. Co. v. Commissioner*, 529 F.2d 917 (4th Cir. 1975) ('guaranteed stock')." Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001 (vol. II at 338 n. 583).

[975] In fact, the 1995 and 1999 issuances of investment unit securities by Enron appear to have been part of an overall strategy to liquidate shares of EOG common stock. In late 1996, the Enron Board of Directors approved the monetization of 13 million shares of EOG common stock in a separate transaction involving an equity swap. Minutes, Meeting of the Board of Directors, Enron Corp., December 10, 1996, at 5-6 (approving "the monetization of [Enron's] ownership of [EOG] stock in the form of an economic equity swap which would entail [Enron's] sale of up to 13,000,000 shares of EOG"). EC 000045043 through EC 000045044.

taxable sales.[976] However, these rules only apply to forward contracts that provide for delivery (or cash settlement) of a substantially fixed amount of property and a substantially fixed price. The rules do not apply to forward contracts that provide for delivery of an amount of property that is subject to significant variation under the terms of the contract. Therefore, the payout pattern of a typical DECS transaction -- in which the amount of the repayment at maturity varies based upon the value of stock reference stock -- generally precludes such transactions from being treated as statutory constructive sales.

Nevertheless, the Treasury Department has the authority to define more precisely the circumstances under which a variable forward contract in general--and, thus, an issuance of investment unit securities such as DECS in particular--does result in a statutory constructive sale. Ideally, the Treasury Department will align the constructive sale treatment of investment unit securities with that of other transactions that transfer the economic risk of loss and opportunity for gain (such as collar transactions). However, the Treasury Department to date has not published such guidance.[977]

Disqualified indebtedness treatment

As noted above, treating investment unit securities such as DECS and those issued by Enron in 1995 and 1999 as unitary (contingent payment) debt instruments is probably inappropriate under general tax principles concerning the characterization of indebtedness because such securities lack the classic feature of a debt instrument -- an unconditional promise to pay a sum certain upon maturity. Consequently, taxpayers have taken the position that investment unit securities should not be subject to the interest disallowance rules for disqualified indebtedness because the securities, as a whole, do not constitute indebtedness and the debt instrument component (as opposed to the forward contract component) of such securities is not payable in equity. However, provided the issuer of investment unit securities owns more than 50 percent of the outstanding stock (in vote or value) that constitutes the reference stock, these interest disallowance rules can be applied to certain investment unit securities to the extent that the Treasury Department determines that the ostensibly imbedded debt instrument in such

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[976] Sec. 1259.

[977] In recent guidance relating to a particular taxpayer audit, the IRS National Office concluded that a transaction similar to DECS resulted in a constructive sale under common law tax ownership principles. However, the transaction at issue in the audit differed from DECS in that actual shares of the reference stock were pledged for delivery upon maturity of the instruments that the taxpayer issued in the transaction. Field Service Advice 200111011 (Dec. 6, 2000). In addition, the IRS recently issued generally applicable guidance in which it concluded that an unsecured prepaid forward sale of stock with a variable payout formula similar to DECS did not constitute either a common law constructive sale or a statutory constructive sale under section 1259. Rev. Rul. 2003-7, 2003-5 I.R.B. 1. However, while the ruling concluded that section 1259 did not apply because the number of shares to be delivered to close the transaction varied significantly, it did not provide a general framework for determining when a variable forward contract is subject to section 1259 by virtue of the amount payable at settlement not being subject to significant variation.

securities is part of an arrangement that is reasonably expected to result in the repayment of the debt instrument with or by reference to the reference stock underlying the accompanying forward contract.[978] To date, neither the Treasury Department nor the IRS has published guidance or rulings with precedent that would adopt this position.[979]

The 1995 issuance of investment unit securities by Enron predated the effective date of the disqualified indebtedness rules but, had these rules been in effect at the time of the issuance, it is possible that the issuance could have been considered an arrangement that was reasonably expected to result in the repayment of the securities with or by reference to the EOG common stock and, thus, treated as disqualified indebtedness.[980]

By contrast, the 1999 investment unit securities issued by Enron followed the effective date of the disqualified indebtedness rules. However, Enron apparently took into account the contemporaneous EOG subsidiary split-off transaction and/or the issuance of EOG common stock into the public stock markets, and thereby concluded that the disqualified indebtedness rules did not apply because Enron's stock ownership of EOG common stock had fallen below the 50-percent ownership threshold specified for Enron and EOG to be considered related parties under the disqualified indebtedness rules. Otherwise, it is possible that the 1999 issuance also could have been considered an arrangement that was reasonably expected to result in the repayment of the securities with or by reference to the EOG common stock and, thus, treated as disqualified indebtedness.

Straddle treatment

In recent years, it appears that the IRS position has been evolving toward a broader application of the straddle rules to investment unit securities such as DECS and those issued by Enron. In 1999, the IRS National Office issued guidance relating to an audit of a taxpayer that had issued equity-linked securities, and determined that the securities in question were not debt instruments but, rather, constituted a combination of put options and a call options (i.e., collars). Therefore, the National Office concluded that the taxpayer was subject to loss deferral under the straddle rules with regard to the reference stock underlying the securities because the issuance of

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[978] Sec. 163(l)(3)(C).

[979] As noted above, the reference stock involved in DECS and their counterparts generally has been comprised of stock issued by a corporation in which the company issuing the DECS-type securities has only a so-called "portfolio", or non-controlling, ownership interest. Therefore, the disqualified indebtedness rules do not apply to such transactions because the company and the corporation issuing the reference stock are not considered to be related parties under those rules.

[980] Even taking into account the concurrent issuance of EOG common stock into the public stock markets by Enron (which reduced Enron's stock ownership of EOG from 80 percent to approximately 54 percent), EOG would have been treated as a related party under the disqualified indebtedness rules because Enron would have held more than 50 percent of the outstanding stock of EOG.

the securities resulted in a substantial diminution of risk of loss attributable to the reference stock.[981] However, the National Office did not indicate in its guidance whether the taxpayer also was required to capitalize interest and carrying costs of the transaction under the straddle rules. Therefore, the guidance did not serve to either dispel or confirm the general view of taxpayers that the interest and carrying cost capitalization requirements of the straddle rules do not apply to payments of stated interest on DECS and similar securities because the debt component of such securities is not incurred to purchase or carry the reference stock.

With regard to applying the capitalization requirements of the straddle rules to DECS and similar securities, proposed regulations that the Treasury Department published in January 2001 would "clarify" its broad authority to require issuers of such securities to capitalize the stated interest payments that they make with respect to the securities. Under these rules, the IRS generally would have the authority to require issuers of DECS and similar financial instruments to capitalize (rather than deduct currently) the stated interest payments on the financial instruments.

Shortly after the publication of the proposed regulations, the IRS National Office provided guidance concerning a particular taxpayer audit that involved a financial instrument which appeared in all materials respects to be identical to DECS.[982] In this guidance, the National Office determined that the financial instrument in question did not provide for repayment of a sum certain upon maturity because the principal amount payable at maturity was contingent upon the value of the reference stock (as paid either in actual shares or their cash equivalent). Consequently, the National Office concluded that the financial instruments did not constitute indebtedness for tax purposes.[983] Instead, the National Office determined that the financial instruments constituted either: (1) a combination of put and call options comprising a "collar" on the reference stock; (2) a notional principal contract on the reference stock with the stated interest payments representing periodic payments; (3) a prepaid forward contract on the reference stock; or (4) a *sui generis* financial instrument subject to its own unique set of tax rules. In any case, the National Office concluded that the financial instruments in question were subject to the loss deferral provisions of the straddle rules because they provided the issuer with a substantial diminution in the risk of loss from holding an existing "long" position in the reference stock by reason of holding the "short" position in the reference stock through the issuance of the financial instruments in question.

In addition, the National Office concluded that, even though the issuer of the financial instruments did not actually pledge the reference stock to its obligation to deliver the reference stock (or its cash equivalent) to the investors upon maturity of the financial instruments, the issuer nevertheless intended to continue carrying (rather than actually disposing) the reference

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[981] Field Service Advice 199940007 (June 15, 1999).

[982] Field Service Advice 200131015 (May 2, 2001).

[983] The guidance stated that the taxpayer reported the financial instruments as a forward sale of the reference stock for (unspecified) regulatory purposes, but reported the instruments as indebtedness for financial accounting purposes.

stock by monetizing a significant portion of its economic interest in the reference stock through the issuance of instruments that included an obligation tied to the performance of the reference stock. Therefore, the National Office concluded that the financial instruments (and, in particular, the stated interest payments on the instruments) were subject to the capitalization requirements of the straddle rules.[984]

The recent guidance issued by the National Office suggests the IRS believes that, even if the deduction of stated interest payments on DECS and similar financial instruments is not disallowed altogether by the disqualified indebtedness rules (e.g., because the issuer does not have the requisite 50 percent stock ownership to be considered a "related party" to the issuer of the reference stock), such payments nevertheless must be capitalized under the present law straddle capitalization rules.

4. Recommendations

Unlike the constructive sale rules, the disqualified indebtedness rules 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.[985] It may be argued that the financing activities undertaken by Enron in 1995 and 1999 cast doubt upon the tax policy rationale for excluding from the application of these rules so-called "portfolio," or non-controlling, stock ownership interests of 50 percent or less. With regard to the investment unit securities issued by Enron during these years, the fact that Enron owned more than 50 percent of the EOG common stock at the time of the 1995 issuance but owned less than 50 percent of the EOG common stock at the time of the 1999 issuance (or shortly thereafter) had no discernible bearing on the intent or economic consequences of either transaction. In each instance, the securities had the purpose and effect of carrying out an equity transaction that involved the monetization of EOG common stock.

Therefore, the Joint Committee staff recommends that Congress eliminate the 50 percent related party threshold under the interest expense disallowance rules for disqualified indebtedness.

[984] Because the straddle capitalization regulations remain in proposed form and, in any case, would not apply to straddles created prior to January 17, 2001 (such as the financial instruments apparently at issue in the guidance), the National Office reached its conclusion without actually applying the proposed regulations. However, the National Office did apply principles similar to those set forth in the proposed regulations, thus confirming the view of the National Office that the proposed regulations would merely "clarify" the present-law application of the straddle capitalization rules.

[985] In this regard, the disqualified indebtedness rules also stand in contrast to the rules under section 1032 (providing for the non-recognition of gain or loss by a corporation with respect to certain transactions involving its own stock), which only apply to the taxpayer's own stock and not to any stock held by the taxpayer.

E. Commodity Prepay Transactions

1. Brief overview

Beginning in 1992, Enron entered into several structured financial transactions arranged by various financial institutions wherein Enron received upfront payments in exchange for the future delivery of a specified commodity such as crude oil or natural gas ("commodity prepay transactions").[986] Although such transactions are common in the energy industry in general, the Enron commodity prepay transactions were unique in that they involved a circular cash flow arrangement among Enron, the arranging financial institution, and a special purpose entity. The parties devised this circularity by engaging in multiple commodity transactions that involved a substantially identical amount of the underlying commodity. Upon termination of the overall transaction, no amount of the underlying commodity actually would be transferred. Rather, the initial cash flow to Enron that originated with the financial institution (or, in the case of some later transactions, outside investors) when the transaction was initiated essentially would be reversed when the transaction was terminated (i.e., Enron would return the funds to the financial institution or outside investors).

In general, the overall economic effect of the transactions was that Enron enjoyed the use of money provided to it during the pendency of the transactions, and returned the money (along with a premium) at the conclusion of the transactions. However, because of the way in which the transactions were structured, Enron portrayed its financial condition in a more favorable light -- from the standpoint of its credit rating and market valuation -- by reporting the transactions as part of its trading operations rather than as debt for financial accounting purposes.

The purposes for entering into most of these transactions apparently were twofold: (1) to accelerate the recognition of taxable income in order to utilize section 29 credits (relating to fuel production from nonconventional sources);[987] or (2) to generate cash flow, often immediately

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[986] September 22, 1999 memorandum from Morris R. Clark to Jordan Mintz, "Federal Income Tax Treatment of Prepayments" [hereinafter "Clark memorandum"]. EC2 000033005 through EC2 000033021. The structured financing materials in Appendix B contain the Clark memorandum. *See also The Role of the Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcommittee on Investigations of the Senate Comm. on Governmental Affairs* (July 23, 2002) (testimony of Robert Roach, Chief Investigator) [hereinafter "Roach testimony"].

[987] Clark memorandum (noting that Enron entered into three prepayment transactions in 1992 and 1993 "primarily as a means for generating taxable income in order to take advantage of [section] 29 credits generated by [Enron Oil and Gas] which, at that time, was part of Enron's consolidated group"). Section 29 credits may only be used against regular tax liability (secs. 29(b)(6)), and cannot be carried forward except as additional alternative minimum tax carryforward credits (sec. 53(d)(1)(B)). Consequently, Enron would not have been able to utilize its section 29 credits in 1992 and 1993 without the taxable income generated by the prepayment transactions because it otherwise would have been in an alternative minimum tax position.

preceding the close of a financial statement reporting period, that could be reported for financial accounting purposes as cash from trading operations rather than proceeds from debt financing.[988]

Enron entered into one or two commodity prepay transactions per year between 1992 and 1997, but entered into several more per year between 1998 and September 2001. Over this period of time, Enron entered at least 12 commodity prepay transactions with J.P. Morgan Chase & Co. ("J.P. Morgan"),[989] for an aggregate notional amount of approximately $3.7 billion, and at least 12 such transactions with Citigroup, Inc.,[990] for an aggregate notional amount of approximately $4.9 billion.[991]

2. Background[992]

Reported tax and financial statement effects

For financial accounting purposes, Enron treated the commodity prepay transactions as trading contracts.[993] Accordingly, Enron reported the proceeds from the transactions as cash flow from trading (or price risk management) operations and the obligation to close the

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[988] With regard to enhancing cash flow (as opposed to generating taxable income in order to utilize section 29 credits), the Roach testimony states that "Enron had two major reasons to reduce its balance sheet debt and increase cash flow from operations: 1) to improve Enron's credit rating and 2) to support and even boost Enron's share price." Roach testimony at A-2. Apparently, Enron entered into only one commodity prepay transaction for actual commercial purposes, which occurred in 1992 and involved a notional amount that was "considerably smaller than any of the other...prepayments." Clark memorandum.

[989] On December 31, 2000, The Chase Manhattan Corporation, the bank holding company of The Chase Manhattan Bank, N.A., merged with J.P. Morgan & Co., Inc. to become J.P. Morgan Chase & Co. All references herein to J.P. Morgan Chase & Co. include relevant constituent and predecessor firms.

[990] On October 8, 1998, Citicorp, the bank holding company of Citibank, N.A., merged with Traveler's Salomon-Smith Barney to become Citigroup. All references herein to Citigroup include relevant constituent and predecessor firms.

[991] Roach testimony at A-8. *See* Roach testimony at Appendix E for more details concerning the individual transactions (e.g., dates of the transactions, dollar amounts of the transactions, underlying commodities, and status at bankruptcy).

[992] The following description of the development and implementation of Enron's commodity prepay transactions is based in substantial part upon the Roach testimony, which provides a more comprehensive description and non-tax analysis of the transactions.

[993] Apparently, the commodity prepay contracts were treated in a similar fashion by the credit rating agencies. Clark memorandum ("The transaction is not treated as traditional debt for accounting and credit rating purposes, but rather, the prepayment is viewed as a part of Enron's overall price risk management activity.").

transactions as trading (or price risk management) liabilities.[994] In reporting its financial accounting income, Enron treated the proceeds from the transactions as deferred revenue, with income recognized over time as the underlying commodity was (or the cash proceeds from selling the commodity on behalf of the counterparty financial institution were) delivered by Enron pursuant to its obligations under the contract between Enron and the financial institution.

The Federal income tax treatment of the commodity prepay transactions by Enron depended upon Enron's objective for entering into the transaction. If Enron's objective was to generate immediate taxable income in order to utilize section 29 credits, Enron would treat the transaction as a sale of inventoriable goods under the applicable tax rules and would recognize the prepayment as taxable income in the year of receipt.[995] In order to characterize these transactions as a sale of goods for tax purposes, Enron structured the prepaid forward contracts to provide for settlement of the contracts by physical delivery of the underlying commodity (rather than non-physical cash settlement based upon the spot price of the underlying commodity on the settlement date of the contracts). However, because the counterparty financial institution presumably did not desire to take physical delivery of the underlying commodity, the parties structured the transactions to achieve the same practical effect as cash settlement by committing Enron to market or sell the underlying physical commodity at the spot price on behalf of the financial institution and remit the cash proceeds from such sale to the institution.[996]

By contrast, if Enron's intention was to generate cash flow for financial reporting purposes, but not recognize taxable income immediately, Enron initially relied upon the tax rules that provide for limited deferral of taxable income recognition with respect to inventoriable goods.[997] However, because such deferral constitutes a method of tax accounting, Enron had to

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[994] Roach testimony at A-2 to A-3; Clark memorandum. The decision by Enron to report these transactions as part of its trading activities, rather than as loan proceeds, has generated intense controversy and scrutiny. The Roach testimony concludes that "the basic transaction fails as a prepay and what remains is a loan to Enron using a bank and an obligation on Enron's part to repay the principal plus interest." Roach testimony at 1.

[995] Clark memorandum. Apparently, the need to utilize section 29 credits existed primarily during the time that Enron Oil & Gas was consolidated with Enron. *See The Role of the Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcommittee on Investigations of the Senate Comm. on Governmental Affairs* (July 23, 2002) (testimony of Jeffrey Dellapina, Managing Director, Credit and Rates Group, J.P. Morgan Chase & Co.: "Chase understood that the transactions originally had tax benefits to Enron. Later, Chase learned, Enron no longer received tax benefits from the transactions but chose to continue to engage in prepaid forward transactions for other corporation purposes."). However, consideration was given to using these transactions to generate immediate taxable income in order to absorb Enron's extensive and growing net operating losses. Clark memorandum.

[996] *Id.*

[997] Treas. Reg. sec. 1.451-5.

execute these transactions using entities that had not previously entered into transactions for the purpose of generating immediate taxable income to utilize section 29 credits.[998]

In later commodity prepay transactions, Enron structured the transactions with cash settled commodity contracts rather than physically settled contracts. Because Enron would market or sell the underlying commodity on behalf of the counterparty financial institution in the earlier transactions involving physical settlement, the use of cash settled contracts in the later transactions did not alter meaningfully the economic substance of the overall transaction. However, the change from physical settled contracts to cash settled contracts meant that the tax rules governing prepaid sales of goods no longer applied to the transactions. In addition, some of the commodity prepay transactions were funded by outside investors (rather than the financial institution arranging the transaction) through the issuance of so-called "credit-linked" notes. With regard to these transactions, Enron changed its characterization of the commodity prepay transactions for Federal income tax purposes and treated the transactions as loans for Federal income tax purposes, with the prepayment to Enron upon entering into the transaction treated as nontaxable loan proceeds and the termination of the transaction treated as a repayment of the loan.[999]

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[998] *Id.* The Enron entities that entered into the transactions for the purpose of generating immediate taxable income (and, thus, could not defer the recognition of taxable income from prepayments in subsequent transactions) included Enron Reserve Acquisition Corp., Enron Power Services, and EGS Hydrocarbon Corp. Enron Capital & Trade Resources Corp. ("ECT"), the predecessor to Enron North America, similarly was required to recognize immediate taxable income from these transactions because it had merged with some of the foregoing entities (and, thus, adopted their method of accounting for these transactions). Consequently, "although ECT may be the preferred entity to effectuate prepayment transactions from a commercial or legal perspective (since the counterparty may already have a master swap agreement in place with ECT or because the counterparty otherwise has familiarity with ECT from other commercial deals), ECT may not be the preferred entity from a tax perspective." *Id.* The Enron entities that entered into the transactions for the purpose of generating cash flow for financial reporting purposes without the immediate recognition of taxable income included Enron Hydrocarbons Marketing Corp., Enron Cushing Oil Marketing, Inc., and Enron Natural Gas Marketing. *Id.* Apparently, Enron formed a new entity every year from 1993 to 1996 in order execute new prepayment transactions that could achieve the desired tax results. *Id.*

[999] *Id.*; Roach testimony at 2; April 10, 2001 memorandum from AnnMarie Tiller and Brent Vasconcellos to Jim Sandt, "Enron Credit Linked Notes Due 2005" ("For book purposes, Enron will record the upfront payment under the Prepaid Swap in income and record Enron's obligation under the Prepaid Swap as a price risk management expense and liability. For tax purposes, these income and expense entries will be reversed with an M-1 adjustment.") [hereinafter "Tiller memorandum"]. EC 000850722 through EC 000850726. The structured financing materials in Appendix B contain this memorandum. The later commodity prepay transactions may have been restructured using cash settled contracts for tax purposes because it appears that the limited two-year deferral available for the recognition in taxable income of advance payments relating to inventoriable goods was considered insufficient for Enron's purposes inasmuch as the transactions (including the forward contracts) were structured to be

Development and implementation of Enron commodity prepay transactions

Basic structure

In general, these transactions involved a special purpose entity created by the financial institution that was arranging the transaction.[1000] The special purpose entity would enter into a prepaid forward contract with the financial institution providing for a cash payment by the financial institution to the special purpose entity in exchange for a promise by the special purpose entity to deliver to the financial institution a fixed quantity of a commodity (typically, crude oil or natural gas) on a specified future date.[1001] The amount of the cash payment made by the financial institution to the special purpose entity would equal the estimated future price ("forward price") of the reference commodity on the future delivery date.

Simultaneously, the special purpose entity would enter into an identical prepaid forward contract with Enron providing for a cash payment by the special purpose entity to Enron in exchange for a promise by Enron to deliver to the special purpose entity a fixed quantity of a commodity on a specified future date.[1002] The terms of this contract (e.g., the amount of the cash

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outstanding for three to six years. Clark memorandum ("[S]ince both natural gas and oil are carried in Enron's inventory, these prepayments fall under the inventoriable goods exception and, as such, gain recognition may only be deferred for a period of two years after the year of receipt.").

[1000] With regard to the transactions that Enron entered into with J.P. Morgan, the special purpose entity ("Mahonia Ltd.") was directly owned by the Eastmoss Charitable Trust, which J.P. Morgan formed in Jersey for the purpose of owning special purpose entities that J.P. Morgan would utilize in arranging financing transactions for its clients. Roach testimony at C-5. The Roach testimony concludes that, notwithstanding its formal ownership by a purportedly independent charitable trust, Mahonia Ltd. was controlled by J.P. Morgan to the point that it was "a non-substantive entity established for the benefit of [J.P. Morgan]." *Id.* at C-6. The Enron commodity prepay transactions that were arranged by Citigroup utilized a special purpose entity ("Delta Energy Corporation") that was incorporated in the Cayman Islands. *Id.* at D-6, fn. 9.

[1001] Although various media reports and congressional testimony have used the terms "forward contract" and "swap contract" somewhat interchangeably to describe Enron's commodity prepay transactions (perhaps to distinguish between physically and financially settled contracts), references herein to forward contracts refer only to contracts that do not provide for periodic payments, and references herein to swap contracts refer only to contracts that do provide for period payments.

[1002] Clark memorandum ("The [prepayment transactions intended to accelerate taxable income] were typically structured as forward oil sale contracts with a counterparty arranged by a financial institution (Chase Manhattan or Citibank), whereby the counterparty would make a significant upfront payment in exchange for Enron's obligation to deliver oil on a monthly basis over a 3 to 4 year period."), noting that the financial institution would not actually receive physical oil or gas from Enron pursuant to the transaction but, rather, Enron would sell the oil or gas on behalf of the financial institution and remit the proceeds from the sale to the institution.

payment by the special purpose entity to Enron, the quantity and type of the reference commodity, and the delivery date (and location) involved in the contract between the special purpose entity and Enron) all would mirror the terms of the contract between the special purpose entity and the financial institution.

Simultaneous with the execution of these prepaid forward contracts, Enron and the financial institution would enter into a commodity swap contract providing for the periodic payment of a fixed cash amount by Enron to the financial institution in exchange for the periodic payment of a variable, or floating, cash amount by the financial institution to Enron. The swap had the effect of eliminating the residual price risk that otherwise would be incurred by Enron from the transaction.

At the conclusion of the transaction, the special purpose entity would close the forward contract with Enron by taking delivery of the reference commodity from Enron, the financial institution would close the forward contract with the special purpose entity by taking delivery of the reference commodity from the special purpose entity (i.e., the same commodity delivered by Enron to the special purpose entity pursuant to their forward contract), and the financial institution would sell the commodity on the spot market (often to an Enron-affiliated entity).[1003] However, while some of the transactions provided for physical settlement through actual delivery of the reference commodity, many of the transactions provided for financial (or non-physical) settlement.[1004]

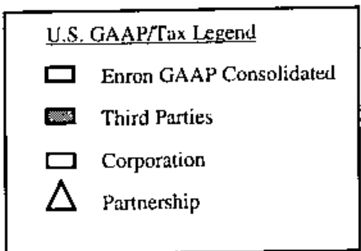
The diagram on the following page partially depicts a commodity prepay transaction that Enron entered into with Citigroup in August 2000 as an example of the basic structure of Enron's commodity prepay transactions.[1005]

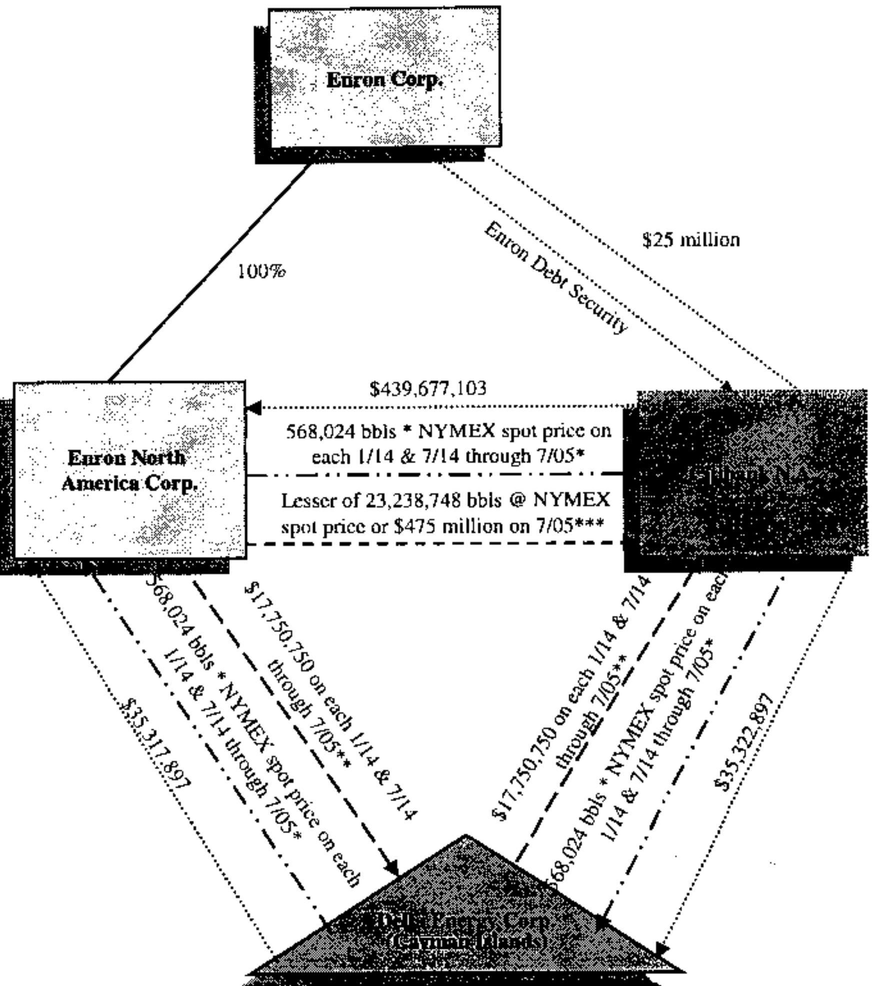
[1003] The particulars of the individual transactions often varied somewhat from the basic transactional structure. For example, prior to 1996 the special purpose entity and the financial institution would enter into a swap contract (rather than a forward contract), the special purpose entity (rather than the financial institution) would take ultimate delivery of the commodity pursuant to closing the forward contract with Enron and sell the commodity on the spot market, and the special purpose entity would hedge its price risk by entering into a futures contract. Roach testimony at C-3, fn. 3. In addition, the final commodity prepay transaction that Enron entered into involved three swaps rather than two prepaid forward contracts and one swap. *Id.* at C-9.

[1004] All but one of the transactions between Enron and J.P. Morgan involved physical settlement, while all but one of the transactions between Enron and Citigroup involved financial settlement. Roach testimony at A-8, fn. 33.

[1005] The diagram is only partial because it does not include the external financing obtained for this particular transaction from outside investors through the issuance of Enron credit-linked notes by an off-balance sheet trust (discussed below). *See* Diagram [2] below for a complete illustration of this particular transaction, including the issuance of Enron credit-linked notes.

ENA $475 Million Prepay Transaction
August 25, 2000
(Partial Diagram)





Prepay Legend

Initial Payments ....

Periodic Floating Payments — · · — ·

Periodic Fixed Payments — — —

Final Payment - - - - -

*As a result of the 8/25 closing date, the notional amount for the first periodic floating payment was 533,312 bbls

**As a result of the 8/25 closing date, the the first periodic fixed payment was $16,665,982

***Any shortfall below $475 million on the final payment to Citibank is made up through a final payment on the ENA/Delta Swap and Delta/Citibank Swap.

Credit-linked financial transactions

Whereas J.P. Morgan itself provided the funding for its commodity prepay transactions with Enron, several of the later commodity prepay transactions that Citigroup entered into with Enron were funded with the proceeds of notes that were issued through an off-balance sheet trust.[1006] Apparently, the financing of these transactions through the issuance of notes to investors who were otherwise external to the transaction was necessary because the internal credit policy of Citigroup precluded the extension of any additional credit to Enron.[1007] These transactions have become known publicly as the "Yosemite" transactions.

In the Citigroup transactions that involved external financing (i.e., the Yosemite transactions), the proceeds from the note issuances were loaned by the trust to the special purpose entity, which used the funds to make the prepayment as part of the prepaid forward contract entered into between the special purpose entity and Enron. The repayment of the notes by the trust was contingent upon (or "linked to") the credit rating of Enron.[1008] By issuing notes that were linked to Enron's creditworthiness, the exposure to a default by Enron on its

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[1006] Roach Testimony at D-1.

[1007] January 12, 2001 memorandum from AnnMarie Tiller to Dave Maxey, "Enron Credit Linked Notes Due 2005". EC 000850727 through EC 000850728. The structured financing materials in Appendix B contain this memorandum. According to an Enron internal communication, "Yosemite accomplished the following:

- Released bank capacity for future Enron deals by effectively refinancing the prepay structures into the bond market.
- Provided a longer-term financing option for our prepay structures (bond coupon could extend out to 10+ years)
- Provides for the ability to substitute transactions within Yosemite without having to prepay the bonds
- Provides for the ability to amend transactions within Yosemite through which is typically difficult in a bond transaction. Versus a bank deal, the Yosemite transaction allows for easier execution of an amendment because we only have to deal with Citibank versus a syndicate group.
- Retain the flexibility to sell Enron credit default swaps to the banks as an alternative method for freeing up their lending capacity."

Electronic mail message from Doug McDowell to Brent Vasconcellos, dated April 18, 2000. EC2 000033469.

[1008] These notes were designed to provide credit quality that was comparable to Enron senior unsecured obligations, and were referred to as Enron Linked Obligations ("LEOs"). Undated PowerPoint presentation, "Yosemite Securities Trust I: $750,000,000 Linked Enron Obligations (LEOs[SM])". EC2 000033095 through EC2 000033108.

obligations in the underlying commodity prepay transaction (i.e., the "credit risk") would be borne ultimately by the outside investors in the notes.[1009]

Yosemite transactions.–Between 1999 and 2001, Enron issued credit-linked notes for some of its commodity prepay transactions through four trusts known as Yosemite I, Yosemite II, Yosemite III, and Yosemite IV.[1010] In these transactions, Enron would enter into cash-settled commodity contracts (including the large initial premium payments to Enron) with Citigroup and a special purpose entity, similar to the basic commodity prepay transactions described above.[1011] In addition, Citigroup (through its special purpose entity) and the trust would enter into a credit default swap transaction whereby, in the absence of a credit event on the part of Enron (such as default of its obligations in the transaction or bankruptcy), the trust would make periodic (semi-annual) payments to Citigroup in an amount equal to the yield received by the trust on the loan to the special purpose entity that it made with the proceeds of credit-linked obligations that were issued by the trust to outside investors. In return, Citigroup would make periodic (semi-annual) payments sufficient for the trust to make yield payments on the credit-linked obligations and the trust certificates.

In the Yosemite transactions, the circular commodity prepay transactions among Enron, Citigroup, and the special purpose entity involved cash-settled commodity swaps, whereby Enron received an upfront payment from Citigroup (in the case of the swap between Enron and Citigroup) in exchange for an obligation to make periodic (semi-annual) floating payments (based upon the spot price for a notional amount of the underlying commodity) and a final payment at the end of the swap.[1012]

[1009] January 12, 2001 memorandum from AnnMarie Tiller to Dave Maxey, "Enron Credit Linked Notes Due 2005". EC 000850727 through EC 00085078.

[1010] *Id.* In general, credit-linked financial transactions typically involve some form of derivative, such as a total return swap, default swap, credit risk option, or credit-linked notes. Credit-linked notes generally are comprised of fixed or variable interest rate debt instruments issued by a party that is unrelated to the issuer of the underlying obligation(s) the repayment of which determines the repayment of the credit-linked notes. If no default (or other specified similar credit event) occurs with regard to the underlying obligation(s), the credit-linked notes are repaid at maturity. However, if a default (or other specified similar credit event) does occur with regard to the underlying obligation(s), the maturity of the credit-linked notes is accelerated but no amount is required to be repaid or a reduced amount is repaid by reference to the fair market value of the underlying obligations. *See* Nirenberg and Kopp, *Credit derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes*, 87 J. Tax'n 82, 94 (August 1997).

[1011] March 27, 2001 Electronic mail message from AnnMarie Tiller to Ryan Siurek (describing Yosemite III commodity prepay transaction). EC2 000033031. The structured financing materials in Appendix B contain this electronic mail message.

[1012] Roach testimony at D-3; Tiller memorandum. Because the funding for the commodity prepay transactions was channeled from the trust to Citigroup through its special

Initially, Enron and Citigroup owned equal shares of the equity certificates in Yosemite I in order to avoid financial statement disclosure of the trust (and the debt issued by the trust) by Enron and Citigroup.[1013] After Enron determined that its percentage of equity ownership in the trust would exceed the amount permissible to avoid financial statement disclosure, Enron sold the necessary portion of its equity ownership through LJM2 to a related entity, Whitewing.[1014] Similar events occurred with regard to Yosemite II.[1015]

The following describes, in general, the cash flows involved in some of these transactions:[1016]

Yosemite Trust Cash Flows

- The Yosemite trust receives $X billion from offering credit-linked notes.
- The trust loans the offering proceeds to the special purpose entity (which, in turn, transfers the proceeds to Citigroup through a prepaid commodity swap).[1017]
- The Yosemite trust pays the interest on the credit-linked notes from the yield on the loans made by the trust to the special purpose entity and the premium received from Citigroup for entering into the credit default swap.
- The Yosemite trust repays principal on the credit-linked notes from the proceeds of the repayment upon maturity of the loans made by the trust to the special purpose entity.

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purpose entity, Enron entered into the commodity contract directly with Citigroup rather than through the special purpose entity.

[1013] Roach testimony at D-10, fn. 39.

[1014] *Id.*

[1015] *Id.* at D-11, fn. 41.

[1016] Citibank/Salomon Smith Barney presentation to Enron, "The 'Next' Yosemite," dated May 2, 2000. EC2 000033439 through EC2 000033468.

[1017] With regard to the Yosemite III and IV transactions, the trust used the proceeds of the offering to acquire Citigroup certificates of deposit from the special purpose entity (rather than loaning the proceeds to the special purpose entity) as collateral for the funding provided by Citigroup to Enron through the contract between Citigroup and Enron. Roach testimony at D-11, fn. 41. As part of the collateral arrangement, the trust and Citigroup entered into a credit default swap that effectively permitted Citigroup to repay the certificates of deposit by delivering to the trust so-called "Enron Deliverable Obligations" in the event that Enron defaulted on its contract with Citigroup or became insolvent or bankrupt. The Enron Deliverable Obligations would be senior unsecured obligations of Enron and any amounts recovered by the trust from these obligations would be used to repay principal on the credit-linked notes issued by the trust. Tiller memorandum.

Credit Default Swap Cash Flows

- The Yosemite trust receives a premium from entering into the credit default swap with Citigroup.
- If a credit event on the part of Enron occurs (such as default on its obligations in the transaction or bankruptcy), the Yosemite trust transfers to Citigroup the notes on the loans that it has made to the special purpose entity and, in exchange, receives senior, unsecured obligations of Enron; in turn, the trust repays the credit-linked notes out of any proceeds received by the trust from the sale or workout of the Enron obligations received from Citigroup.

Enron Cash Flows

- Citigroup enters into a commodity swap contract with Enron that provides a prepayment by Citigroup to Enron in the amount of $*X* billion.
- Enron makes periodic (semi-annual) payments to Citigroup pursuant to the commodity swap contract.

The diagram on the following page depicts the commodity prepay transaction that Enron entered into with Citigroup in August 2000 as an example of an Enron commodity prepay transaction that included the issuance of credit-linked notes.

Confidential

ENA $475 Million Prepay Transaction
August 25, 2000

U.S. GAAP/Tax Legend
- Enron GAAP Consolidated
- Third Parties
- Disregarded Trust
- Corporation
- Partnership

Enron Corp.

100%

Enron Debt Security

$25 million

Enron North America Corp.

$439,677,103

568,024 bbls * NYMEX spot price on each 1/14 & 7/14 through 7/05*

Lesser of 23,238,748 bbls @ NYMEX spot price or $475 million on 7/05***

$50 million

Certificate

$549,135,000

Deposit

$499,135,000

$500 million notes

Rule 144A Note Holders

$35,317,897

568,024 bbls * NYMEX spot price on each 1/14 & 7/14 through 7/05*

$17,750,750 on each 1/14 & 7/14 through 7/05**

$17,750,750 on each 1/14 & 7/14 through 7/05**

568,024 bbls * NYMEX spot price on each 1/14 & 7/14 through 7/05*

$35,322,897

Prepay Legend
- Initial Payments
- Periodic Floating Payments
- Periodic Fixed Payments
- Final Payment

*As a result of the 8/25 closing date, the notional amount for the first periodic floating payment was 533,312 bbls

**As a result of the 8/25 closing date, the the first periodic fixed payment was $16,665,982

***Any shortfall below $475 million on the final payment to Citibank is made up through a final payment on the ENA/Delta Swap and Delta/Citibank Swap.

Role of outside advisors

The roles of J.P. Morgan and Citigroup in these transactions have been chronicled extensively.[1018] In general, it appears that Enron compensated these financial institutions for their involvement in the transactions primarily through spreads built into the circular contracts that were used in the transactions (rather than through explicit fees). For example, in a commodity prepay transaction entered into with Citigroup in June 1999, Enron essentially received approximately $250 million in net up-front payments upon entering into the transaction, and paid approximately $253 million in net payments when the transaction closed.[1019] Similarly, the Yosemite III transaction provided for Enron to receive net up-front payments in the amount of approximately $483 million at the initiation of the transaction, and provided for Enron to make a payment of approximately $492 million when the transaction terminated, thus resulting in compensation to Citibank in the approximate amount of approximately $9 million.[1020]

Enron apparently did not receive tax opinion letters in connection with the basic commodity prepay transactions. Rather, it appears that Enron tax personnel primarily developed the tax analysis of these transactions with some legal assistance provided by Vinson & Elkins LLP.

3. Discussion

In general

The primary tax policy issue surrounding the basic structure of the Enron commodity prepay transactions involves the selectivity that Enron exercised in determining the tax consequences of substantially similar transactions based upon the underlying objectives of Enron in executing the transactions.[1021] In earlier commodity prepay transactions, Enron treated the transactions as prepaid sales of goods. Within the tax rules governing the treatment of prepaid

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[1018] *See, e.g.*, *The Role of the Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcommittee on Investigations of the Senate Comm. on Governmental Affairs* (July 23, 2002); Peter Behr and Ben White, *J.P. Morgan Had Many Ties With Enron*, The Washington Post (Feb. 23, 2002) at E1; Kurt Eichenwald, *Questions Raised on Enron Offshore Gas Trades*, The New York Times (Feb. 19, 2002) at C1.

[1019] July 8, 1999 Memorandum from Michael L. Herman to R. Davis Maxey, "US$ 500 million Prepaid Forward and Swap Contracts with respect to Crude Oil, dated June 29, 1999". EC2 000033290 through EC2 000033294. Apparently, Enron also paid Citigroup a stated fee of $1 million in connection with the transaction. *Id.*

[1020] March 27, 2001 Electronic mail message from AnnMarie Tiller to Brent Vasconcellos (describing Yosemite III commodity prepay transaction). EC2 000033031.

[1021] For example, *see* RMTC Liquids (Prepay) 1999 and 2000 tax workpapers providing the tax return treatment of certain commodity prepay transactions entered into by Enron affiliate RMTC Liquids. EC2 000033554, EC2 000033529 and EC2 000033568. The structured financing materials in Appendix B contain these workpapers.

sales of goods, Enron essentially elected its tax treatment of these transactions (i.e., current recognition of prepayments from some transactions and limited deferral of prepayments from other transactions) by selecting the entity within the Enron consolidated group to execute the transaction based upon the entity's tax accounting method for prepaid sales of goods.

In later years, Enron exercised selectivity in the tax treatment of its commodity prepay transactions through the characterization of the transaction as a loan (resulting in no recognition of taxable income or subsequent offsetting deduction).[1022] Although these later transactions involved cash settled contracts (rather than physically settled contracts) and were funded by outside investors (rather than the arranging financial institution), they were no different economically from the earlier transactions in any material respect. However, their characterization as loans (specifically, loans from the Yosemite trusts to Enron) apparently provided certain timing and withholding tax advantages over alternative characterizations.[1023]

Because the commodity prepay transactions would generate an offsetting deduction when they closed (or would produce no deductions in the case of loan characterization), the transactions generally did not produce a permanent tax benefit. Rather, the selectivity that Enron exercised in the tax treatment of the transactions affected the timing of the recognition by Enron of taxable income.

Yosemite transactions

Enron's reliance upon credit-linked notes in the Yosemite transactions to effectively create credit capacity for additional commodity prepay transactions raises questions that are pertinent primarily to corporate governance and financial accounting. From the perspective of tax policy, the Yosemite transactions involve issues that are common to most credit-linked financial transactions. Because of their fairly recent advent, the overall tax treatment of the various types of credit-linked financial transactions remains uncertain. In substance, such transactions have been depicted in terms similar to the following description:

> In such transactions, a counterparty seeks to purchase protection against the default of a particular issuer. This protection can be most simply thought of as default insurance. This type of credit derivative is also most commonly thought

[1022] Electronic mail message from AnnMarie Tiller to Jill Erwin, Danny Wilson, and Kerrie Smith, dated January 11, 2000 ("Although [Yosemite I's] current investments are a complicated set of interests in debt and swaps, we are taking the position for tax purposes (given [Yosemite I's] current investments, at least), that [Yosemite I] owns a debt instrument issued by Enron with terms that match the aggregate payments due to the [Yosemite I] Certificateholders and the holders of the [credit-linked] Notes"). EC2 000033045 through EC2 000033047.

[1023] January 14, 2000 memorandum from Brent Vasconcellos to AnnMarie Tiller, "Yosemite I Withholding". EC2 000033237 through EC2 000033244. The structured financing materials in Appendix B contain this memorandum. October 28, 1999 Yosemite Financing outline of various tax issues. EC 000850764 through EC 000850773. The structured financing materials in Appendix B contain this outline.

of as a default or credit put option in which the holder of the put option holds the right to transfer obligations of the Reference Entity [i.e., the entity for which protection against default is being sought] to the credit derivative protection seller in exchange for either money or other value.[1024]

In effect, a credit-linked financial transaction brings together a party that desires to lend money without undertaking the associated credit risk and a counterparty that desires to undertake credit risk without lending money. Economically, these transactions can be described as synthetic loans in which the party that assumes the credit risk from the ostensible lender becomes the actual lender.

In characterizing a credit-linked note for Federal income tax purposes, it is not certain that repayment conditioned upon the non-occurrence of a credit event (such as default) constitutes the requisite promise to pay a specified amount at maturity that is necessary for a financial instrument to properly be characterized as indebtedness for Federal income tax purposes.[1025] In most transactions involving credit-linked notes, the classification of the notes as indebtedness for Federal income tax purposes can be critical because the loss of interest deductions that is occasioned by the loss of debt classification can destroy the economic rationale of the overall transaction.[1026]

[1024] *The Role of the Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcommittee on Investigations of the Senate Comm. on Governmental Affairs* (July 23, 2002) (testimony of Ronald M. Barone, Managing Director, Standard & Poor's Ratings Services). Actual default is only one of a variety of types of events (e.g., changes in credit ratings) that can be incorporated as a triggering event into the terms of a credit-linked obligation. *See* Kayle, *Will the Real Lender Please Stand Up? The Federal Income Tax Treatment of Credit Derivative Transactions*, 50 Tax Lawyer 569, 577 (Spring 1997) (citing imposition of exchange controls by borrower's home country as another example of "quasi-credit risks" that can be embedded into a credit-linked obligation or other security) [hereinafter "Kayle"].

[1025] *But see* Nirenberg and Kopp, *Credit derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes*, 87 J. Tax'n 82, 95 (August 1997) (arguing that credit-linked notes can be treated as indebtedness for tax purposes). As with many types of financial instruments for which questions concerning the proper tax treatment remain largely unanswered, commentators generally have analyzed credit-linked notes by analogy to other types of transactions of which the tax treatment is more clear, particularly with regard to the fundamental tax issues of timing, character, and source of payments and receipts pursuant to a financial transaction. *See* Kayle, at 577-578 (noting the resemblance of credit-linked notes to guarantees and letters of credit).

[1026] To the extent that the credit-linked notes are marketed to foreign investors, the loss of debt classification could upend further the overall economics of the transaction because the interest income that generally otherwise would be exempt from U.S. withholding tax under the portfolio interest exemption would also be recharacterized (e.g., as dividends on an equity interest) in a manner that would result in the imposition of U.S. withholding tax.

Even if credit-linked notes appropriately can be classified as indebtedness to some extent for tax purposes, questions similar to those involving DECS can be raised concerning the precise nature of credit-linked notes as indebtedness. Some commentators believe that credit-linked notes, like DECS, can be viewed as a combination of a standard noncontingent debt instrument and a swap that provides for payments based upon the specified credit events underlying the credit-linked notes (e.g., a credit default swap).[1027] However, this analysis merely shifts the unanswered questions regarding appropriate tax treatment to those involving credit default swaps and, more generally, the ability to "componentize" a financial instrument for tax purposes.[1028] The unsatisfactory state of affairs discussed above with regard to the tax treatment of hybrid financial instruments in general is particularly detrimental with regard to credit-linked transactions, as one commentator has described:

> Credit derivatives have proven themselves in the marketplace to be powerful and versatile tools for market participants to manage credit risk. Like other powerful tools, they have their dangers. In no small part, those dangers relate to their tax consequences. The dangers...are those for potential users of credit derivatives, but there are dangers for the Treasury as well, as taxpayers may resolve doubts in their own favor using the benefit of hindsight. Thus, uncertainty surrounding the tax treatment of credit derivative transactions is in the interest neither of the Treasury nor the public.[1029]

In the case of the Yosemite transactions, Enron evidently employed an economic substance analysis to arrive at a conclusion that these transactions constituted lending transactions for tax purposes, rather than prepaid sales of goods (as in the previous commodity prepay transactions). Beyond the characterization of the transactions as loans, determining which party should be treated as the lender was crucial to the feasibility of these transactions. Enron was concerned that treating the off-shore special purpose entity in the Yosemite transactions as the lender could have given rise to tax withholding obligations that would have made the transactions uneconomic. Therefore, Enron took advantage of this aspect of uncertainty in the treatment of credit-linked notes and treated the Yosemite trusts as the lender in these transactions.

<u>Selective tax treatment of Enron commodity prepay transactions</u>

The questions surrounding the Enron commodity prepay transactions can be analogized to the problems discussed above with regard to DECS financing transactions. Specifically, drastically different tax consequences can arise on the basis of different characterization of the same or substantially similar economic transactions. The sole reason that such a circumstance -- and the characterization selectivity that stems from it -- is even possible can be attributed to the

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[1027] Kayle, at 609-611.

[1028] *Id.* at 591 ("[T]he credit default swap is in many respects the most difficult of the genre [of credit-linked financial transactions] to analyze.").

[1029] Kayle, at 613.

fact that the tax consequences of a financial transaction are dictated largely by tax rules that traditionally have assigned labels to transactions that may not reflect in all cases the underlying economics of the transaction in question.

The effort that has been expended to differentiate among various types of financial transactions, and the analytical techniques (such as analogy, integration and bifurcation) that have been employed in such efforts, suggests that any structural differences among these transactions have largely been eliminated through modern financial engineering. The convergence of financial transactions -- and even some transactions that traditionally have been thought of a non-financial, such as prepaid sales of goods--suggests that the tax consequences of such transactions no longer can be based upon their assigned labels.

4. Recommendations

The commodity prepay transactions entered into by Enron demonstrate the convergence of traditionally dissimilar transactions that has occurred in recent years through financial engineering. This convergence presents increasing challenges to the rationality of certain tax rules that have been developed on the basis of categorical distinctions that may no longer reflect meaningful economic distinctions. In general, the tax rules should endeavor to reduce or eliminate the extent to which the tax consequences of economically similar transactions are impacted by their characterization.

Given the inherent complexity and customization of structured financial transactions such as those in which Enron engaged, the opportunities for tax-advantaged characterization of such transactions are particularly great and, to a certain extent, unavoidable. Nevertheless, in developing any new rules concerning the tax treatment of financial transaction and products, careful attention should be given to the potential for unintentionally creating new opportunities for *de facto* taxpayer electivity that, once recognized, might be considered unwarranted.[1030] For example, notional principal contracts with significant upfront nonperiodic payments, prepaid forward contracts, and secured lending transactions should all have the same or similar tax consequences to the extent that they all yield the same or similar economic results.

Similarly, greater attention should be paid to coordinating the tax rules governing financial transactions with those governing what have traditionally been thought of as non-financial (or physical) transactions, so that financial transactions cannot be restructured as economically similar non-financial transactions (and vice versa) simply for the purpose of accessing more favorable tax rules. For example, prepaid sales of goods should have the same or similar tax consequences as prepaid forward contracts and secured lending transactions to the extent that they yield the same or similar economic results.

[1030] *See* Notice 2001-44, 2001-30 I.R.B. 77 (noting that, "in the financial products area, it is particularly important to pay attention to the neutrality principle, i.e., consistent treatment of difference instruments with similar economic characteristics").

IV. USE OF FOREIGN ENTITIES BY ENRON

Enron owned interests in several hundred entities established in foreign jurisdictions that imposed no tax on such entities. Press reports have raised questions about the number and purposes of such entities. The discussion below begins with an overview of the relevant Federal international tax rules. The discussion then explains Enron's general posture under these rules and addresses Enron's use of the foreign entities. The discussion concludes with a Joint Committee staff recommendation.

A. Overview of Selected International Tax Rules

1. In general

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[1031] and the passive foreign investment company rules.[1032] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes.[1033]

2. Foreign tax credit

The United States generally provides a credit for foreign income taxes paid or accrued.[1034] In the case of foreign income taxes paid or accrued by a foreign subsidiary, a U.S. parent corporation is generally entitled to a "deemed paid" credit for such taxes when it receives an actual or deemed distribution of the underlying earnings from the foreign subsidiary.[1035] The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source

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[1031] Secs. 951-964.

[1032] Secs. 1291-1298.

[1033] Secs. 901, 902, 960, 1291(g).

[1034] Sec. 901.

[1035] Secs. 902, 960.

income, in order to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.[1036]

Due to this limitation, a taxpayer must allocate gross income and expenses between U.S. and foreign sources in order to determine the amount of allowable foreign tax credits. Under present law, interest expense that a U.S.-based multinational corporate group incurs in the United States is allocated to U.S. and foreign sources based on the gross assets located in the United States relative to those located abroad (measured either by basis or by fair market value).[1037] Thus, a U.S.-based multinational with a significant portion of its assets overseas must allocate a significant portion of its U.S. interest expense to foreign-source income, which reduces the foreign tax credits allowable (even though the interest expense incurred in the United States is not deductible in computing the actual tax liability under applicable foreign law).

The foreign tax credit limitation is applied separately to different types of foreign-source income, in order to reduce the extent to which excess foreign taxes paid in a high-tax foreign jurisdiction can be "cross-credited" against the residual U.S. tax on low-taxed foreign-source income. For example, if a taxpayer pays foreign tax at an effective rate of 45 percent on certain active income earned in a high-tax jurisdiction, and pays little or no foreign tax on certain passive income earned in a low-tax jurisdiction, then the earning of the untaxed (or low-taxed) passive income could expand the taxpayer's ability to claim a credit for the otherwise uncreditable excess foreign taxes paid to the high-tax jurisdiction, by increasing the foreign tax credit limitation without increasing the amount of foreign taxes paid. This sort of cross-crediting is constrained by rules that require the computation of the foreign tax credit limitation on a category-by-category basis.[1038] Thus, in the example above, the rules would place the passive income and the active income into separate limitation categories (or "baskets"), and the low-taxed passive income would not be allowed to increase the foreign tax credit limitation applicable to the credits arising from the high-taxed active income. Present law provides nine separate baskets as a general matter, and effectively many more in situations in which various special rules apply.[1039]

If a taxpayer generates an overall foreign loss ("OFL") for the year -- whether as the result of business losses or expense allocations under U.S. tax rules -- it will not be able to claim foreign tax credits for that year, since it will have no foreign-source income and thus will have a foreign tax credit limitation of zero. Moreover, if the taxpayer does generate foreign-source income in later years, some portion of such income will be "recaptured," or recharacterized as U.S.-source, thus reducing the foreign tax credit limitation in later years.[1040] The rationale for OFL recapture is that the foreign-source losses offset U.S.-source income in the year generated,

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[1036] Secs. 901, 904.

[1037] Sec. 864(e); Temp. Reg. sec. 1.861-11T.

[1038] Sec. 904(d).

[1039] *Id.*

[1040] Sec. 904(f). These rules also operate on a category-by-category basis.

thereby reducing the U.S. tax collected with respect to U.S.-source income. The U.S. fisc would not be made whole when the taxpayer subsequently earns foreign-source income if the U.S. tax on such income were completely offset by foreign tax credits.

3. Anti-deferral regimes

In general

Generally, income earned indirectly by a domestic corporation through a foreign corporation is subject to U.S. tax only when the income is distributed to the domestic corporation, because corporations generally are treated as separate taxable persons for Federal tax purposes. However, this deferral of U.S. tax is limited by anti-deferral regimes that impose current U.S. tax on certain types of income earned by certain corporations, in order to prevent taxpayers from avoiding U.S. tax by shifting passive or other highly mobile income into low-tax jurisdictions. Deferral of U.S. tax is considered appropriate, on the other hand, with respect to most types of active business income earned abroad.

Subpart F

Subpart F,[1041] applicable to controlled foreign corporations and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A controlled foreign corporation generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).[1042] Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation on their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.[1043]

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,[1044] insurance income,[1045] and certain income relating to international boycotts and other violations of public policy.[1046] Foreign base company income consists of foreign personal holding company income, which includes passive income (e.g., dividends, interest, rents, and royalties), as well as a number of categories of non-passive income, including foreign

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[1041] Secs. 951-964.

[1042] Secs. 951(b), 957, 958.

[1043] Sec. 951(a).

[1044] Sec. 954.

[1045] Sec. 953.

[1046] Sec. 952(a)(3)-(5).

base company sales income, foreign base company services income, foreign base company shipping income and foreign base company oil-related income.[1047]

In effect, the United States treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution out of the corporation's subpart F income. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's earnings invested in U.S. property.[1048]

Passive foreign investment companies

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies. A passive foreign investment company generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[1049] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a passive foreign investment company, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment companies that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[1050] A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[1051] A third set of rules applies to passive foreign investment company stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[1052]

Coordination

Detailed rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes. For example, a corporation generally is not treated as a passive foreign investment company with

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[1047] Sec. 954.

[1048] Secs. 951(a)(1)(B), 956.

[1049] Sec. 1297.

[1050] Sec. 1293-1295.

[1051] Sec. 1291.

[1052] Sec. 1296.

respect to a particular shareholder if the corporation is also a controlled foreign corporation, and the shareholder is a "U.S. shareholder" as defined in section 951(b). Thus, subpart F is allowed to trump the passive foreign investment company rules.

4. Transfer pricing

In general

Due to the variation in tax rates and tax systems among countries, a multinational enterprise may have an incentive to shift income, deductions, or tax credits among commonly controlled entities in order to arrive at a reduced overall tax burden. Such a shifting of items between commonly controlled entities could be accomplished by establishing artificial, non-arm's-length prices for transactions between group members.

Under section 482, the Secretary of the Treasury is authorized to redetermine the income of an entity subject to U.S. taxation when necessary to prevent an improper shifting of income between that entity and a commonly controlled entity. The statute generally does not prescribe any specific reallocation rules that must be followed, other than establishing the general standards of preventing tax evasion and clearly reflecting income. Treasury regulations adopt the concept of an arm's length standard as the method for determining whether reallocations are appropriate. Thus, the regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length.

Special transfer pricing rules apply to transactions involving intangible property and services. These transactions present particular challenges to the administration of the arm's length standard, since intangibles and services may be unique, thus rendering a comparison with third-party market transactions difficult or impossible.

Transactions involving intangible property

In the case of a related-party sale or license of an intangible, section 482 requires that the income with respect to such transfer or license be "commensurate with the income" generated by the intangible. Similarly, section 367(d) provides that, if an intangible is transferred to a related foreign corporation in a nonrecognition transaction (e.g., a transfer under section 351), the transaction is treated as a sale for contingent payments, resulting in the inclusion by the transferor of income "commensurate with the income" generated by the intangible. This approach seeks to avoid some of the difficulties of determining a single arm's length price at the time of the transaction by instead determining the appropriate income attributable to the intangible on an ongoing basis, as the intangible generates income.

In view of the uncertainty that this method may impose on taxpayers, regulations under section 482 provide an alternative method for allocating the income attributable to intangibles among the members of a group of related companies, in the form of "qualified cost-sharing arrangements."[1053] Under such an arrangement, if the parties share the costs of developing the

[1053] Treas. Reg. sec. 1.482-7.

intangible in proportion to their reasonably anticipated benefits, make arm's length buy-in payments with respect to any previously developed intangibles contributed to the arrangement, and otherwise comply with the terms of the regulation, then the IRS will not seek to make reallocations under the general rules of section 482.[1054]

Transactions involving services

In the case of services, the regulations under section 482 generally seek to distinguish between services that provide only incidental, or indirect and remote, benefits to a related party, in which case no arm's length charge is normally required, and services that provide more meaningful and direct benefits to a related party, in which case an arm's length charge is required.[1055] Even in the latter case, however, the requirement of an arm's length charge is generally considered met if the recipient of the services pays the provider's costs, unless the services constitute an "integral part" of the business of either the provider or the recipient of the services.[1056] Services are regarded as "integral" under this test if: (1) either the renderer or the recipient is in the trade or business of rendering the same or similar services to third parties; (2) providing services to related parties is one of the principal activities of the renderer; (3) the renderer is "peculiarly capable" of providing the services, the services are a principal element in the operations of the recipient, and the value of the services is substantially greater than the costs or deductions of the renderer; or (4) the recipient has received the benefit of a substantial amount of services from a related party or parties during the year.[1057]

5. Entity classification

Prior to 1997, entity classification for Federal tax purposes was determined on the basis of a multi-factor test provided in regulations under section 7701. In distinguishing between a corporation and a partnership, these regulations set forth four characteristics indicative of a corporation: continuity of life, centralization of management, limited liability, and free transferability of interests. If a business entity possessed three or more of these characteristics, then it was treated as a corporation; if it possessed two or fewer, then it was treated as a partnership.[1058] Thus, in order to achieve characterization as a partnership under this system, taxpayers needed to arrange the governing instruments of an entity in such a way as to eliminate two of these characteristics. For example, a taxpayer desiring partnership classification for an entity might include transferability restrictions and dissolution provisions in order to eliminate the characteristics of free transferability and continuity of life. Partnerships also needed to have at least two members, as the term suggests.

[1054] *Id.*

[1055] *See* Treas. Reg. sec. 1.482-2(b).

[1056] *Id.*

[1057] Treas. Reg. sec. 1.482-2(b)(7).

[1058] Treas. Reg. sec. 301.7701-2, as in effect prior to 1997.

Since January 1, 1997, new entity classification regulations have been in effect that generally allow taxpayers simply to elect the desired classification for many types of entities, including certain limited-liability entities available under the laws of many State and foreign jurisdictions.[1059] These regulations are commonly referred to as the "check the box" regulations. The regulations generally eliminate the need for modifications to the terms of governing documents in order to secure a particular entity classification, and they make it possible for a taxpayer to elect branch treatment for a single-member limited-liability entity, thus enabling the taxpayer to achieve both flow-through taxation and limited liability with respect to a foreign entity without adding a second member.

6. Treaties

In addition to the U.S. and foreign statutory rules for the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or eliminate withholding taxes imposed by a treaty country on certain types of income (e.g., dividends, interest and royalties) paid to residents of the other treaty country. Treaties also contain provisions governing the creditability of taxes imposed by the treaty country in which income was earned in computing the amount of tax owed to the other country by its residents with respect to such income. Treaties further provide procedures under which inconsistent positions taken by the treaty countries with respect to a single item of income or deduction may be mutually resolved by the two countries.

[1059] Treas. Reg. sec. 301.7701-1, *et seq.*

B. Enron's General International Tax Posture[1060]

1. Foreign tax credit problems arising from interest allocation rules

From the time that Enron began significant foreign expansion in the early 1990s, its tax posture in the international area was defined in large part by one major problem: as a result of large allocations of U.S. interest expense against foreign source income under section 864(e), Enron was persistently unable to use foreign tax credits. The company thus faced the possibility of significant double taxation of its foreign source income. This potential for unmitigated double taxation was of paramount concern in Enron's international tax planning and significantly influenced the structures of Enron's international operations and transactions.

Enron was not unique among companies of comparable size in facing foreign tax credit utilization problems arising from the interest allocation rules of section 864(e). U.S.-based multinational corporations have long complained about the impact of these rules on their capacity to use foreign tax credits, and legislation has been considered by Congress from time to time addressing this concern.[1061] In Enron's case, the adverse impact of the interest allocation rules was particularly acute as it expanded its activities abroad, due to Enron's high level of investment in foreign assets (e.g., power plants in foreign countries) and comparatively low level of foreign income. The high levels of foreign assets generated a large allocation of interest expense against relatively low levels of foreign source income, thus generating an ever expanding, and eventually nearly insurmountable, overall foreign loss account.[1062]

Enron's overall foreign loss account first arose in 1992 and grew at a rate of $20 million to $25 million per year.[1063] As early as 1993, Enron appears to have concluded that it would not be able to claim foreign tax credits at any time in the foreseeable future.[1064]

[1060] The information in this section of the report is based on documents provided by Enron and the IRS, and on interviews with Robert Hermann, James A. Ginty, Cullen A. Duke, Edward R. Coats, Leesa M. White, and Stephen H. Douglas.

[1061] *See, e.g.,* H.R. 285, 108th Cong., 1st Sess., sec. 310 (2003); H.R. 5095, 107th Cong., 2d Sess., sec. 311 (2002); Taxpayer Refund and Relief Act of 1999, H.R. Conf. Rep. No. 106-289, sec. 901 (1999) (vetoed by President Clinton).

[1062] For example, according to a company memorandum, EOG Canada's asset basis of $86 million attracted an allocation of U.S. interest expense of $7 million against income of only $400,000 for 1992. Memorandum, "Enron FTC Position," June 26, 1992, at EC2 000036091.

[1063] Enron Foreign Operations White Paper, June 28, 1996, at EC2 000036150.

[1064] Memorandum, "Structuring for Enron's Foreign Operations," Mar. 11, 1993, at EC2 000036120.

2. Planning techniques addressing the foreign tax credit problem

In general

Enron determined relatively early in its international expansion that it would not be feasible to attempt to eliminate the overall foreign loss account and thereby regain the ability to use foreign tax credits.[1065] Instead, the company accepted the fact that it would not be able to use foreign tax credits and sought to structure its international investments and activities in such a way as to minimize the impact of this problem. The company employed two main strategies in this regard: deferral and deconsolidation.

Deferral strategy

Under the deferral strategy, Enron conducted many of its international operations under a holding company and planned never to repatriate the earnings from a foreign project back to the United States. As long as the subpart F and passive foreign investment company rules did not apply to the earnings, U.S. tax on the foreign earnings generally could be deferred indefinitely, and double taxation would be avoided, albeit at the cost of losing the flexibility to repatriate funds to the United States.

Under applicable financial accounting standards, deferred U.S. taxes on foreign earnings need not be accrued for book purposes if the company has plans for permanently reinvesting the earnings offshore.[1066] In other words, to the extent that Enron could avoid actual or deemed repatriations of its foreign earnings, the company's inability to claim foreign tax credits would have no direct financial statement impact.

Thus, in Enron's case, the U.S. international tax rules (particularly the interest expense allocation rules), combined with the relevant financial accounting standards, created a significant incentive for the company not to repatriate foreign earnings to the United States. It is impossible to determine the extent to which this incentive may have caused the company to invest more heavily in foreign assets, and less heavily in U.S. assets, than its non-tax business strategy otherwise would have dictated. In this regard, it appears that the company anticipated major growth opportunities abroad, and that the foreign reinvestment encouraged by this incentive may not have been inconsistent with the company's non-tax business strategy -- indeed, it appears that the company's foreign investment plans called for more funds than the company was generating in its international operations.[1067] In addition, in cases in which the repatriation of funds was considered desirable, the company had the option of using the deconsolidation strategy.

[1065] *Id.*

[1066] *See Accounting Principles Board (APB) Opinion No. 23; Statement of Financial Accounting Standards (FAS) 109.*

[1067] Letter from Enron's counsel (Skadden, Arps) to Lindy L. Paull, Joint Committee on Taxation, Jan. 13, 2003, answer 133.

Deconsolidation strategy

Under the deconsolidation strategy, Enron was able in some cases to circumvent its foreign tax credit limitation problem by investing in a foreign project through a U.S. entity that was not a member of the Enron consolidated group. The interest allocation problem, large overall foreign loss account, and resulting inability to use foreign tax credits pertained only to the Enron consolidated group. In cases in which Enron was willing to allow an unrelated party to take an ownership interest exceeding 20 percent in the U.S. entity through which a foreign project was conducted, the entity's ability to use foreign tax credits would not be affected by the foreign tax credit problems of the Enron consolidated group.[1068]

The deconsolidation strategy entailed a number of costs to the company, however, which rendered the strategy unsuitable in many cases. First, it required significant equity participation on the part of an unrelated investor, which Enron may not have considered desirable from a non-tax perspective. Second, the strategy caused dividends paid by the deconsolidated entity to Enron to qualify for only the 80-percent dividends-received deduction under section 243, instead of the 100-percent deduction that would apply to dividends from an 80-percent-or-greater-owned company. Finally, the strategy involved greater transaction and compliance costs than comparable investments made in a more straightforward manner through the Enron consolidated group. In light of these considerations, Enron employed this strategy only in a few situations in which repatriation of earnings was considered highly desirable -- i.e., in connection with high-income projects in high-tax foreign jurisdictions, in which case substantial foreign tax credits would be generated, and any benefit of deferral would be small. Generally, however, the deconsolidation strategy was regarded as too costly and cumbersome, and thus the deferral strategy was by far more commonly employed.[1069]

[1068] For example, Enron held its interests in certain projects that were subject to higher rates of foreign tax through Enron Equity Corp. Enron held all of the common stock of Enron Equity Corp., and an institutional investor (John Hancock Insurance Co.) held all of the preferred stock, which carried sufficient voting power and value that the company was not a member of the Enron consolidated group for tax purposes. Enron Tax Deconsolidation and Foreign Tax Credit Planning Discussion Paper, April 30, 1998, at EC2 000036194.

[1069] Joint Committee staff interviews.

C. Proliferation of Foreign Entities in Enron's Ownership Structure[1070]

1. Background

Press reports have suggested that Enron employed an unusually large number of offshore entities, particularly in countries that impose no tax on such entities, in an effort to avoid taxes.[1071] Enron did in fact establish a complex entity structure that included a large number of foreign entities, including many entities in countries that imposed no tax on such entities. It is important to note, however, that the mere existence of a large number of entities, even entities formed in jurisdictions that do not impose an income tax, does not necessarily indicate that Enron was using these entities inappropriately from a U.S. Federal tax perspective. Moreover, the number of foreign entities established by a company does not necessarily bear a significant relationship to the amount of any reduction in U.S. Federal tax that the company might have achieved through the structuring of the company's international activities. In order to evaluate Enron's practices in this regard, the reasons behind its complex entity structure must be examined.

2. General reasons for complex entity structures

It is not uncommon for large multinational business enterprises to organize themselves into complex structures consisting of multiple domestic and foreign corporations, partnerships, and branch entities. Non-tax business considerations such as liability management, regulatory requirements, management accounting, and financing needs may influence the decision to conduct a particular operation or make a particular investment through a certain kind of entity or combination of entities. For example, the laws of a foreign country in which an enterprise wishes to do business may provide that certain activities may be conducted only by a corporation established under local law; or the involvement of a third-party foreign investor or partner in a project may necessitate the use of a certain combination of foreign business entities. Tax considerations generally also factor into the decision, both with respect to the choice of jurisdiction and the choice of entity within a particular jurisdiction. Jurisdictions differ in terms of overall tax burden, special tax rules applicable to certain types of income and activities, and tax treaty networks. Some entities are treated as separate taxable persons (e.g., corporations), some are not (e.g., branches), and some fall somewhere in between (e.g., partnerships). In structuring complex international investments and operations, prudent tax planning typically requires a U.S.-based multinational enterprise to use a combination of many different entities in

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[1070] The information in this section of the report is based on documents provided by the company and by the IRS, and on interviews with Robert Hermann, James A. Ginty, Cullen A. Duke, Edward R. Coats, Leesa M. White, and Stephen H. Douglas.

[1071] *See, e.g.*, David Cay Johnston, *Enron Avoided Income Taxes in 4 of 5 Years*, New York Times, Jan. 17, 2002 ("Enron paid no income taxes in four of the last five years, using almost 900 subsidiaries in tax-haven countries and other techniques, an analysis of its financial reports to shareholders shows"); Glenn R. Simpson, *Enron's Quest to Avoid Taxes Took the Firm to the Netherlands*, Wall Street Journal, Feb. 7, 2002 ("Enron's quest to avoid taxes by using offshore tax havens took the company to some unlikely places").

many different jurisdictions, even if the enterprise's tax planning goals are limited to the generally unobjectionable ones of deferring U.S. Federal income tax on active, non-subpart-F income until such income is repatriated, and mitigating the double taxation of foreign income to the extent allowable under the foreign tax credit and the U.S. tax treaty network.

For this combination of non-tax and tax reasons, a multinational business enterprise that conducts several lines of business in many different countries cannot avoid developing a somewhat complex organizational structure, as it seeks to manage the potential liabilities of the various businesses, satisfy all applicable local regulatory requirements, facilitate the evaluation of manager performance in the different businesses, arrange the desired mix of debt and equity financing from internal and external sources, and undertake sound tax planning measures with respect to all relevant jurisdictions.

3. The number of foreign entities in Enron's ownership structure

While the number and types of entities in the Enron ownership structure varied over time, as of the end of 2001, this structure included approximately 1,300 different foreign entities.[1072] The vast majority (approximately 80 percent) of Enron's foreign entities were "dormant" -- in other words, inactive shells that did not hold and were not engaged in or associated with any ongoing business, and that were therefore largely irrelevant for tax purposes.[1073] Approximately 20 percent of Enron's foreign entities were associated with ongoing businesses and thus had some potential relevance for tax purposes. Overall, leaving aside the dormant entities, Enron conducted its foreign operations during 2001 through a network of roughly 250 different foreign entities.

Enron created many entities in jurisdictions that imposed no tax on such entities. In particular, as of the end of 2001, the Enron ownership structure included 441 entities formed in the Cayman Islands, a country that has never imposed a corporate income tax.[1074] The majority of these entities were dormant.[1075] The role of the Cayman entities, and the reasons why so many were dormant, are explained in Part IV.C.4, below.

[1072] This figure includes foreign corporations and foreign partnerships that were controlled by Enron, as well as certain other entities in which Enron owned a significant stake (e.g., "noncontrolled section 902 corporations," in which Enron owned at least a ten percent stake). This figure does not include "branch" entities, which are disregarded for Federal tax purposes (e.g., pursuant to a "check the box" election) -- the activities, income, and deductions of branches are treated as those of their owners for Federal tax purposes. The inclusion of foreign branch entities would yield a total count of approximately 1,500 foreign entities for 2000. *See* Enron Presentation to Joint Committee staff, June 7, 2002, at 9 (Appendix B, Part I to this Report).

[1073] *Id.*; Joint Committee staff interviews.

[1074] Enron Submission to IRS Examination Team, Feb. 26, 2002.

[1075] *Id.*; Joint Committee staff interviews.

An article in the New York Times presented some figures in this regard that appear to reflect some confusion regarding certain information set forth the 2000 Form 10-K that Enron filed with the SEC. According to the article, Enron created "881 subsidiaries abroad, including 692 in the Cayman Islands, 119 in the Turks and Caicos, 43 in Mauritius and 8 in Bermuda."[1076] These figures appear to be based on Exhibit 21 of Enron's 2000 SEC Form 10-K, which lists subsidiaries of the filing company. In preparing this list, Enron used a somewhat confusing presentation format in which a single subsidiary would appear on the list multiple times if a number of other Enron subsidiaries held interests in it. Given this format, a simple line-by-line count of list entries would lead to substantial multiple-counting of certain entities, and thus to inflated numbers in some cases. For example, a review of Exhibit 21 of Enron's 2000 SEC Form 10-K suggests that multiple-counting of two Turks and Caicos companies (specifically Smith/Enron Cogeneration Limited Partnership and Smith/Enron O&M Limited Partnership) was largely responsible for the count of 119 Turks and Caicos companies reported in the article. According to materials submitted to the IRS by the company, Enron in fact established only 4 Turks and Caicos companies.[1077]

It is generally difficult to make useful tax inferences from the data that companies file with the SEC in this regard. Companies have considerable flexibility in determining the content and format of Exhibit 21, and the filing generally contains little or no information as to the various subsidiaries' assets, activities, tax treatment, and interrelationships. Moreover, different companies appear to have different standards as to the circumstances under which a subsidiary is regarded as "significant," and therefore required to be reported on Exhibit 21. Some companies may report relatively few of the overall entities in their structure on this form; others may report most or all of their entities. Ultimately, the only reporting regime that yields the information needed to determine the relevance of the various foreign entities to the administration of the Federal tax rules is the information reporting regime required under those rules.[1078]

Most importantly, regardless of the data source (whether it be SEC or IRS filings), it must be noted that relatively little can be inferred from a mere count of a company's foreign entities in various jurisdictions without examining why the entities were established and how they are used transactionally. On the one hand, it is possible for a company to own numerous foreign entities, even many formed in jurisdictions imposing no tax on such entities, without using these entities for any inappropriate Federal tax purposes. (And even if some entities are used for such inappropriate purposes, their sheer number does not necessarily bear a significant relationship to the amount of any reduction in U.S. tax that the company might be attempting to achieve.) On the other hand, it is possible for a company to employ a relatively simple entity structure, with no entities in jurisdictions typically regarded as tax havens, and yet attempt to

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[1076] David Cay Johnston, *Enron Avoided Income Taxes in 4 of 5 Years*, New York Times, Jan. 17, 2002.

[1077] Enron Submission to IRS Examination Team, Feb. 26, 2002.

[1078] Of course, the information provided under this regime generally is not made public. *See* sec. 6103.

achieve significant inappropriate reductions in Federal taxes through the use of its foreign entities.

Even with reference to Enron itself, it appears that the company's most aggressive tax-reduction strategy relating to the international tax rules was the Project Apache structured transaction, which did not require the involvement of any entity created in a jurisdiction generally regarded as a tax haven.[1079] The attempt to draw general conclusions about a company's international tax practices by simply following the trail of Cayman entities thus may focus attention on certain unexceptional practices and yet fail to reveal the company's most aggressive practices.

In sum, Enron undoubtedly had a complex entity structure, but the tax implications of that structure cannot be understood without examining the purposes and functions of the various entities comprising that structure.

4. Sources of complexity in Enron's ownership structure

Number of foreign infrastructure projects

One major component of Enron's international growth strategy over the 10-year period preceding the company's bankruptcy involved bidding for, constructing, and eventually selling foreign infrastructure projects, such as power plants and gas pipelines. Enron began developing its first major foreign project in 1991, which was a power plant project in the United Kingdom. By 1995, the company had undertaken project development activities in over 30 different countries.[1080] The Enron domestic affiliate primarily responsible for this line of business was Enron Development Corporation, which reorganized as Enron International in December 1997.

Foreign infrastructure development was a high risk business, in which each project opportunity represented a relatively small chance of generating very large returns. Enron pursued numerous project opportunities around the world, anticipating that most projects would fail but expecting that a few would be sufficiently profitable to make the overall line of business successful for the company.[1081] Each project, whether successful or not, typically had its own separate entity structure. In view of this practice, and the number of projects that the company initiated, the foreign infrastructure development business became the most significant contributor to the proliferation of entities within Enron's overall ownership structure.

[1079] *See* Part I.D.1, above, for a discussion of Project Apache.

[1080] Enron Foreign Operations White Paper, June 28, 1996, at EC2 000036151.

[1081] According to Enron, the company's success rate in winning project bids was "well under 20 percent." In addition, many projects that Enron pursued encountered serious difficulties or were abandoned either before submitting a bid or well after winning one. Letter from Enron's counsel (Vinson & Elkins) to IRS, Sep. 13, 2001, at EC2 000055688-689.

Multiple entities for each project

Enron generally formed a few separate entities for each foreign infrastructure project that it pursued. As explained in Part IV.B, above, Enron's dominant Federal income tax concern in the structuring of its foreign operations was its persistent inability to use foreign tax credits, and a deferral strategy was the company's principal response to this problem. Enron's typical deferral structure required that a few different entities be created for each project. In addition to a local project entity, the ownership of which might be divided between Enron and an unrelated co-venturer, Enron generally employed a tiered arrangement of foreign holding companies through which it held its own interest in the project entity. These tiered arrangements were established primarily to facilitate potential sell-downs of Enron's interests in the project entities, while to the extent possible maintaining deferral of U.S. taxes on any project earnings.[1082]

The nature of these arrangements changed over time in response to developments in U.S. tax law. In particular, as explained in further detail below, the issuance of the "check the box" entity classification regulations, effective at the beginning of 1997, enabled Enron to implement holding company structures that made use of fewer entities and offered greater flexibility without sacrificing U.S. tax deferral.[1083] Both before and after the issuance of these regulations, however, the practice of establishing multiple entities for each foreign project produced considerable complexity within the Enron ownership structure.

In a typical project structure established prior to the issuance of the "check the box" regulations, Enron would hold its interest in a project through three separate Cayman Islands holding companies, in addition to a project entity formed under local law in the project jurisdiction. The domestic Enron entity responsible for the project would own the stock of the first Cayman Islands holding company ("Cayman Parent"), which would be treated as a corporation for U.S. Federal tax purposes.[1084] Cayman Parent in turn would own all of the stock of a second Cayman Islands company ("Cayman Sub"), which also would be treated as a corporation for U.S. Federal tax purposes. Cayman Parent and Cayman Sub in turn would own 99 percent and 1 percent, respectively, of the ownership interests in a Cayman Islands Limited Life Company ("Cayman LLC"), which Enron would treat as a partnership for U.S. Federal tax purposes. Cayman LLC in turn would directly hold the Enron-side interest in the project entity. If Enron had a partner in the project venture, then that partner also would own an interest in the project entity. Cayman Sub, Cayman LLC, and the project entity typically would be dedicated exclusively to the particular project.

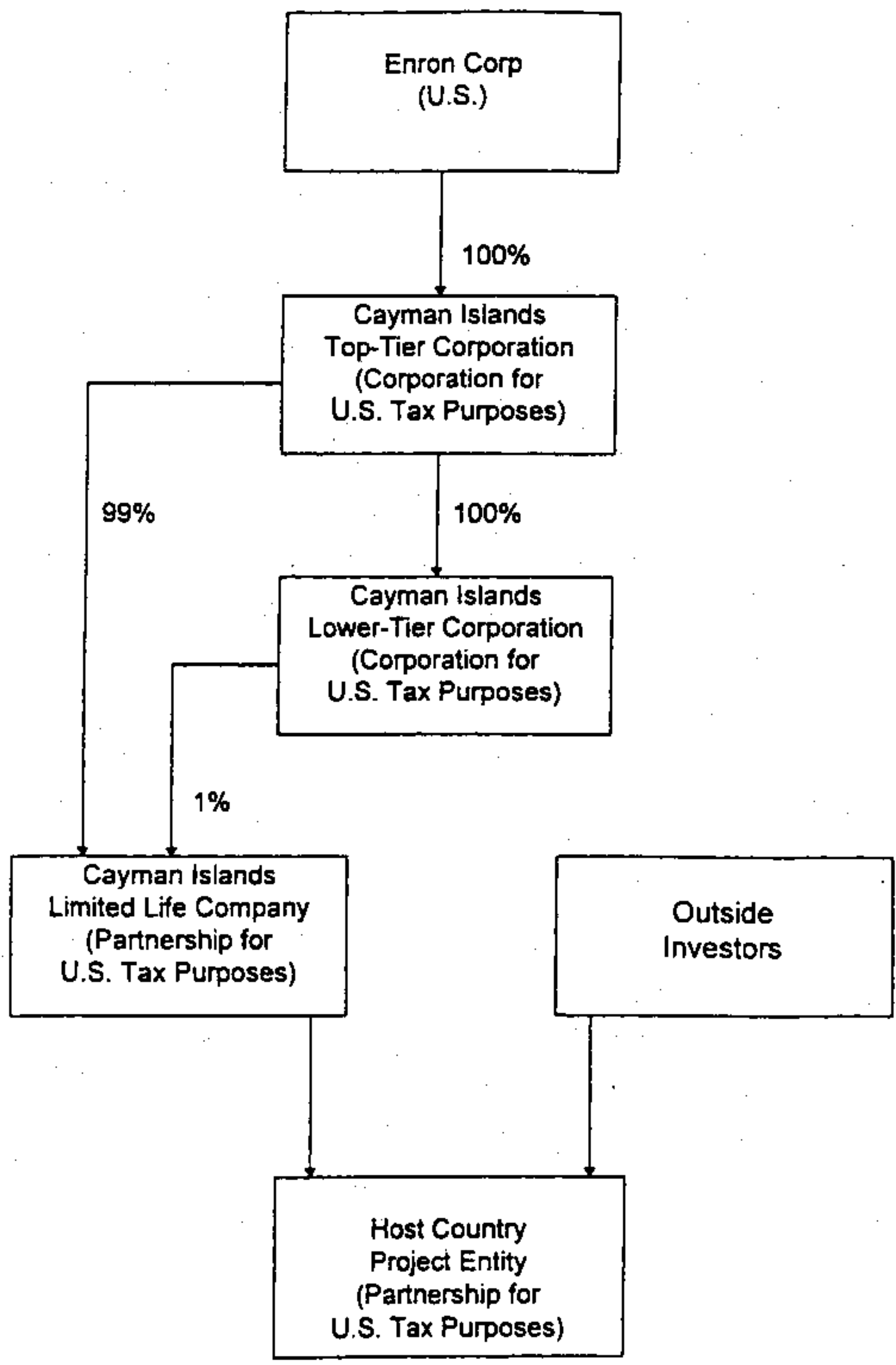
The diagram on the following page depicts this structure.

[1082] Enron Foreign Operations White Paper, June 28, 1996, at EC2 000036159; Joint Committee staff interviews.

[1083] Treas. Reg. sec. 301.7701-1, *et seq.*

[1084] Cayman Parent could also hold interests in lower-tier entities established in connection with other projects.

DIAGRAM OF TYPICAL CAYMAN ISLANDS MULTI-TIERED OWNERSHIP STRUCTURE



EC2 000036190

APPENDIX II

The project entity usually was an entity treated as a corporation in the project jurisdiction, due to regulatory requirements under local law, the needs of the venture partner, or both. For U.S. Federal income tax purposes, however, it was desirable to treat the project entity as a partnership, so that Enron's Cayman Islands holding companies could receive distributions of earnings from the project entity without generating subpart F income. Qualifying the project entity as a partnership enabled Cayman LLC to be treated essentially as if it had earned the project income itself. Thus, assuming that the project itself generated active type income that was not subject to subpart F, U.S. Federal taxes on project income generally could be deferred within the Cayman holding company structure until the earnings were repatriated to the United States.[1085]

In order to achieve characterization of the project entity as a partnership prior to the issuance of the "check the box" regulations, the entity could possess no more than two out of the four following corporate characteristics: limited liability, centralized management, free transferability of interests, and unlimited life.[1086] In view of the practical importance of limited liability and centralized management, Enron generally opted to eliminate the characteristics of free transferability of interests and unlimited life, by adding share transferability restrictions and dissolution provisions. Thus, for example, Cayman LLC typically would not be allowed to sell its interest in the project entity without the consent of the venture partner, and the organizing documents of the project entity would provide for dissolution in the event of the bankruptcy of Cayman LLC or the venture partner. The transferability restrictions added to the complexity of the project structure, since it required Enron to add a tier to its side of the structure in order to be able to sell its interest in the project without obtaining the consent of its venture partner.[1087]

The three Cayman Islands entities on the Enron side of the structure comprised a so-called "Cayman Triangle."[1088] The involvement of Cayman Sub, and its nominal level of ownership of Cayman LLC, was intended to ensure that Cayman LLC also would be treated as a partnership for U.S. tax purposes. Treatment of Cayman LLC as a partnership was important to avoid the creation of subpart F income on the distribution of earnings from the foreign project entity up through the Cayman holding company structure. If Cayman LLC were treated as a corporation, then distributions of project earnings from Cayman LLC to Cayman Parent

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[1085] Such deferral was not always possible, however, even with respect to active business income generated by a project. For example, certain income generated by the pipeline transportation of natural gas across national borders could be subject to subpart F as "foreign base company oil-related income." Sec. 954(g).

[1086] Treas. Reg. sec. 301.7701-2, as in effect before 1997.

[1087] In some instances there were other advantages to selling an interest in a Cayman holding company rather than an interest in a local project entity, including avoidance of project-country taxes, ownership registration requirements, and other regulatory or contractual restrictions on the transferability of interests under local law.

[1088] Joint Committee staff interviews; Enron Foreign Operations White Paper, June 28, 1996, at EC2 000036159.

generally would have been dividends treated as subpart F income.[1089] Characterizing Cayman LLC as a partnership for U.S. Federal income tax purposes made it possible for Cayman Parent and Cayman Sub to receive distributions from Cayman LLC without generating subpart F income.[1090]

The advent of the "check the box" entity classification regulations made it possible for Enron to plan for sell-downs and to achieve the desired deferral of U.S. taxes without using a "Cayman Triangle," since these regulations enabled taxpayers to treat eligible single owner entities as disregarded entities, and to elect to treat multi-owner entities as partnerships, without the need to contend with the four-factor test of the old entity classification regulations. Thus, as of 1997, Enron could achieve deferral of U.S. taxes on project earnings through a simpler structure in which Cayman Parent was the sole owner of the interest in Cayman LLC, which in turn held the Enron interest in the project entity. Cayman Sub could be eliminated, and there was no need to include transferability restrictions or dissolution provisions in the project entity's governing documents. In some cases, it might even have been possible for Cayman LLC to be eliminated, and to have Cayman Parent invest directly in the project entity, but project country tax considerations and regulatory or contractual transferability restrictions generally rendered it desirable to invest in the project entity through at least one project specific Cayman Islands entity underneath Cayman Parent.

Formation of project entity structures at early stage of project development

Another contributor to the proliferation of entities within the Enron ownership structure was the company's practice of establishing the separate entity structures described above at a very early stage in the evaluation, bidding, and development process. As a result of this practice, even those project opportunities that were abandoned before reaching any significant level of development would contribute a number of new entities to Enron's overall structure.

The principal reason that Enron established separate offshore entity structures so early in the project development process was a concern that the project opportunity (perhaps reflected in non-binding preliminary agreements, letters of intent, or "memoranda of understanding") could be found to constitute intangible property for tax purposes. Given this possibility, if preliminary project activities were undertaken directly by a U.S. entity, and then the project were later carried out by a foreign entity, the company was concerned that it might be deemed to have made an outbound transfer of the intangible property. Such a transfer would have been subject to the rules of section 367(d), which treat the transfer as a sale for contingent payments and require the U.S. entity to include in income a stream of payments from the foreign entity "commensurate with the income" generated by the intangible. By establishing a separate offshore entity

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[1089] The "same country dividend" exception of sec. 954(c)(3) requires that the dividend paying controlled foreign corporation be engaged in a trade or business in its country of incorporation, and thus would not have been available in the case of a holding company owning an interest in a project entity in another country.

[1090] The relatively small distributions from Cayman Sub to Cayman Parent, however, generally would generate subpart F income.

structure from the outset of a project, and having the project specific entities execute any preliminary agreements, the company sought to mitigate this risk.[1091]

The company recognized that there was a cost to this practice, in the form of the creation of multiple entities for projects that would never advance beyond the preliminary stages of development. These entities would be costly to establish and maintain, but ultimately would serve little or no purpose. Nevertheless, the company evidently concluded that the expected reduction of the company's exposure to IRS adjustments under section 367(d) outweighed these costs.

Retention of dormant entities

The considerations described above explain why Enron's infrastructure project development business, and the manner in which the company conducted this business, led to the creation of not just a large number of foreign entities, but also inevitably to a large number of foreign entities that would become dormant. Indeed, as noted in Part IV.C.3 above, the vast majority of foreign entities in Enron's corporate structure fit this description. This observation suggests that Enron could have achieved a great deal of simplification of its entity structure by eliminating these dormant entities, but that the company chose instead to maintain them.

According to Enron tax department personnel interviewed by the Joint Committee staff, the tax department consistently objected to the practice of maintaining dormant entities, and on several occasions recommended to Enron's legal and commercial groups that these entities be liquidated. The tax department argued that maintaining the dormant entities generally served little purpose other than to create unnecessary administrative and compliance costs for the company (e.g., annual filings of IRS Form 5471, "Information Return of U.S. Persons with Respect to Certain Foreign Corporations," under section 6038).

[1091] Enron also proposed legislation to eliminate this potential pitfall, but the company's efforts in this regard were not successful. *See* Enron "Non-binding Intent Agreements" Policy Memorandum, March 2000, Appendix B, Part XV to this Report.

The following table shows the number of Enron's filings of IRS Form 5471 by year:

Table 4.–Enron's Information Returns Relating to Controlled Foreign Corporations

Year	Number of Forms 5471 Filed
1992	84
1993	108
1994	128
1995	211
1996	247
1997	378
1998	491
1999	501
2000	564

In addition to controlled foreign corporations, Enron's ownership of other types of entities (e.g., controlled foreign partnerships) [1092] also entailed U.S. Federal tax information reporting on an annual basis, even if such entities were empty shells. On average, the tax department estimated that the company incurred $5,000 to $10,000 of administrative and compliance costs per entity per year.[1093] Given the number of dormant entities within the Enron ownership structure, these arguably unnecessary compliance costs would total several million dollars every year.

Notwithstanding these costs, and the recommendation of the tax department, the company for the most part chose not to unwind its dormant entities. According to the Enron tax department personnel interviewed, if there was even a remote chance that the project for which an entity was created might be revived, the commercial and legal groups preferred that the entity not be liquidated.[1094] This practice seems to have allowed the number of entities within the Enron ownership structure to grow beyond what the tax department viewed as the reasonable needs of the business, with little tax or non-tax effect other than for the company to incur additional compliance costs.

[1092] *See* sec. 6038(a), (e)(1), (e)(3).

[1093] *See* Enron "Non-binding Intent Agreements" Policy Memorandum, March 2000, Appendix B, Part XV to this Report.

[1094] In some cases there may have been a U.S. tax logic to this practice. For example, if the dormant entity had some sort of preliminary agreement relating to the project, then the section 367(d) concerns described above might weigh in favor of leaving that entity and its potential intangible property in place.

D. Transfer Pricing Issues

In general[1095]

For a multinational enterprise of its size, Enron's activities did not present an unusual level or range of transfer pricing issues. Unlike many other enterprises of its size (e.g., a typical globally integrated manufacturing enterprise), Enron's business generally did not rely on routine related party transactions. The nature of the company's business model thus limited somewhat the potential scope of the company's transfer pricing issues.

Performance of services for the benefit of related foreign entities

One aspect of Enron's business, however, did raise persistent and significant transfer pricing issues. These issues involved the treatment of services performed by Enron for the benefit of related foreign entities in connection with the foreign infrastructure development business.

Enron's foreign infrastructure projects generally were prospected and developed by personnel of Enron Development Corp. and Enron International, companies included in Enron's U.S. Federal consolidated tax return. These personnel identified the project opportunity, performed the financial analysis of the project's feasibility, and negotiated preliminary agreements with the relevant local authorities and other parties, among other development activities.[1096] As described in Part IV.C.4 above, at a very early stage in the project development process, the project typically was handed off to a local project entity that was owned by Enron (often jointly with a third-party co-venturer), with Enron's interest in the project entity typically held under two or more Cayman Islands holding companies. Thus, as of an early stage in the project development process, some portion of the services performed by personnel of Enron Development Corp. and Enron International could be regarded as performed on behalf of the project-specific entities.

Based on Joint Committee staff interviews with Enron and IRS personnel, as well as materials provided by the company, it appears that: (1) the company took the position that it was entitled to take deductions on its U.S. consolidated return for certain salary and other compensation related expenditures that were attributable to services provided by U.S. personnel in support of these foreign projects; and (2) the company did not always receive an adequate fee from either the project entity or the relevant foreign holding companies to reflect the benefit of

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[1095] The discussion in this section of the report is based on information and documents provided by the company and by the IRS, and on interviews with Robert Hermann, James A. Ginty, Cullen A. Duke, Edward R. Coats, Leesa M. White, Stephen H. Douglas, and IRS personnel.

[1096] In the heyday of Enron's foreign infrastructure project development business, these development activities were performed by a team of roughly 30 developers employed by Enron Development Corp. and Enron International, led by Rebecca Mark and Joe Sutton. Joint Committee staff interviews.

the services provided in connection with the foreign projects. In this manner, Enron arguably sought to shift offshore a portion of the income attributable to the services of its U.S. employees.

Enron generally did charge the project specific entities a fee reflecting the cost (with no mark-up) of providing some of these services. Enron did not include all compensation related expenditures relating to project personnel in this charge, however. In particular, the cost of bonuses provided to Enron Development Corp. and Enron International employees was not included in this charge, despite the fact that such bonuses were geared to the anticipated value of particular projects and to the achievement of certain milestones with respect to such projects.[1097] The cost of providing these bonuses was capitalized by Enron when awarded and then deducted on its U.S. Federal consolidated tax return when paid.[1098]

It should be noted that the IRS examination team identified these issues and proposed adjustments in this regard for every taxable year of the company since 1997. Thus, unlike the "structured transactions" discussed in Part I above, the arguably aggressive practices at issue here were readily detectable in the course of a normal audit and did not present the serious problems of tax administration that those transactions did.[1099] It also should be noted that the law in the area of transfer pricing for services and intangible property is unsettled, and that Enron's treatment of these expenditures, while arguably aggressive, was not entirely lacking support in the law. In this regard, the Treasury Department is currently working on a regulation project in an effort to provide more detailed and appropriate guidance in this area, with proposed regulations anticipated in 2003.[1100]

The current regulations under section 482 generally seek to distinguish between services that provide only incidental, or indirect and remote, benefits to a related party, in which case no arm's length charge is normally required, and services that provide more meaningful and direct benefits to a related party, in which case an arm's length charge is required.[1101] Even in the latter case, however, the requirement of an arm's length charge is generally considered met if the recipient of the services pays the provider's costs, unless the services constitute an "integral part" of the business of either the provider or the recipient of the services.[1102] Services are regarded as

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[1097] Joint Committee staff interviews. *See* Part Four, III.B.3, below, for a detailed discussion of the terms of these arrangements, the projects covered, and the compensation related issues that arose in connection with Enron's tax treatment of the arrangements.

[1098] Joint Committee staff interviews.

[1099] These taxable years and issues were still open as of early 2003. In order to avoid interfering with the IRS examination process, the Joint Committee staff provides only a general discussion of these issues in this Report, and does not reach specific conclusions as to particular projects.

[1100] *See, e.g.*, Bob Ackerman, *et al.*, "Global Transfer Pricing Update," 29 Tax Notes Int'l 375, Jan. 27, 2003.

[1101] *See* Treas. Reg. sec. 1.482-2(b).

[1102] *Id.*

"integral" under this test if: (1) either the renderer or the recipient is in the trade or business of rendering the same or similar services to third parties; (2) providing services to related parties is one of the principal activities of the renderer; (3) the renderer is "peculiarly capable" of providing the services, the services are a principal element in the operations of the recipient, and the value of the services is substantially greater than the costs or deductions of the renderer; or (4) the recipient has received the benefit of a substantial amount of services from a related party or parties during the year.[1103]

Enron generally had three main arguments supporting its tax treatment of the services performed by Enron Development Corp. and Enron International personnel. First, depending on the ownership percentages in a project conducted jointly by Enron and a co-venturer, Enron could take the position that the project-specific entities were not under Enron's "control," and that the fees reflected actual arm's length bargaining, rendering section 482 inapplicable.[1104] If that argument failed or could not be made, then Enron could take the position that Enron Development Corp., and later Enron International, was a venture-capital-type operation, and that the services performed by its personnel were in the nature of "stewardship" expenses to protect what was appropriately characterized as an investor's interest in the foreign projects, rather than expenses incurred on behalf of a particular project entity itself. On this theory, the services performed by Enron Development Corp. and Enron International personnel were performed primarily for the benefit of such companies, and not for the benefit of the project-specific entities. Under this theory, the regulations described above would not apply, and no charge at all would be required, since no substantial services would be regarded as provided for the direct benefit of related entities.[1105] If the services were regarded as performed for the direct benefit of a particular project entity, then Enron still could take the position in some cases that the services provided were not "integral," and thus that a fee reflecting cost was sufficient.

[1103] With respect to the second and fourth categories of integrality set forth above (i.e., the "principal activities" and "substantial amount" tests), cost-based safe harbors are available. Under the "principal activities" safe harbor, services generally are not treated as a principal activity of the renderer if the cost of providing such services does not exceed 25 percent of its total costs or deductions for the taxable year. Under the "substantial amount" safe harbor, a recipient of services generally is not treated as receiving a substantial amount of services if the cost of providing such services does not exceed 25 percent of the recipient's total costs or deductions for the taxable year. Manufacturing, production, extraction, and construction services are not eligible for the "principal activities" cost safe-harbor. Treas. Reg. sec. 1.482-2(b)(7).

[1104] Enron's contemporaneous transfer pricing documentation for 1995 through 2000, for example, makes this argument with respect to several different projects (EC2 000039103-39623). Of course, it has long been recognized that it is possible for two otherwise unrelated parties to act in concert to shift income to a jointly held entity, and that section 482 allocations may be made in such situations. *See, e.g., B. Forman Co. v. Comm'r,* 453 F.2d 1144 (2d Cir. 1972).

[1105] *See* Treas. Reg. sec. 1.482-2(b)(2)(i), (ii) (providing that no section 482 allocations are required in cases of certain "indirect or remote" benefits or cases in which the service merely duplicates a service that the renderer is performing for itself).

While the matter is not free from doubt, and cannot be conclusively determined without a detailed analysis of each individual project, on balance it appears that certain project-specific entities related to Enron for purposes of section 482 derived substantial and direct benefits from services provided by Enron Development Corp. and Enron International personnel. Thus, Enron Development Corp. and Enron International probably were required under section 482 to include in income a fee at least reflecting the full cost of providing such services. It also appears likely that in many cases the services provided by Enron Development Corp. and Enron International personnel were "integral" within the meaning of the applicable regulations,[1106] thus requiring an arm's length charge reflecting the value of such services.

[1106] Treas. Reg. sec. 1.482-2(b)(7). Enron's contemporaneous transfer pricing documentation for 1995 through 2000 conceded the "integrality" of the services in many instances, while taking the position that section 482 did not apply due to lack of common control (EC2 000039103-39623).

E. Recommendation: Information Reporting with Respect to Disregarded Entities

Present law requires no ongoing information reporting with respect to entities that are disregarded pursuant to a "check the box" election.[1107] 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. As a result, the IRS encounters considerable difficulty in keeping track of the various foreign entities in a company's structure and monitoring how these entities are being used in transactions. In Enron's case, the company filed 103 "check the box" elections in 1997, 191 in 1998, 151 in 1999, and 97 in 2000.[1108] After the year in which these elections were filed, the IRS would encounter great difficulty in monitoring how these entities were being used transactionally.

On the one hand, this lack of separate information reporting may be seen as appropriate, given that the entities are supposed to be "disregarded" for Federal tax purposes pursuant to the election. Nevertheless, it is also widely recognized that the application of the "check the box" regulations in the international setting has raised a number of issues that the IRS has an interest in monitoring. One example is the range of issues relating to the use of "hybrid entities" (foreign entities that are disregarded for U.S. Federal tax purposes but treated as separate taxable entities under foreign law).[1109] In addition, the IRS recently has focused some attention on the so-called "check and sell" practice, in which a "check the box" election is filed with respect to a lower-tier controlled foreign corporation in order to avoid the creation of subpart F income in connection with the sale of the stock of such corporation by a higher-tier controlled foreign corporation. The "check the box" election in these cases may convert what would have been a sale of stock (which generally creates subpart F income) into a sale of operating assets (which generally does not create subpart F income).[1110] Proposed regulations have been issued to restrict this practice, and the IRS appears to have been actively auditing the issue in the field.[1111] The existence of these and other issues relating to the use of "check the box" entities suggests that, although such entities are generally disregarded in terms of tax treatment, the IRS has an interest in monitoring their use.

The Joint Committee staff believes that a regime of annual information reporting with respect to entities disregarded pursuant to "check the box" elections would 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. The information to be reported could be similar to that required to be provided on Form 5471 with respect to controlled

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[1107] Treas. Reg. sec. 301.7701-1, *et seq.*

[1108] IRS Forms 8832 filed by Enron.

[1109] *See, e.g.*, Notice 98-11, 1998-6 I.R.B. 18; Notice 98-35, 1998-27 I.R.B. 35.

[1110] *See* sec. 954(c)(1)(B).

[1111] *See, e.g.*, Prop. Reg. sec. 301.7701-3(h) (Nov. 29, 1999); CCA 199937038; FSA 200046008; FSA 200049002.

foreign corporations, and thus could include income-statement and balance-sheet information, as well as such other information as the Secretary of the Treasury may require. The statement also should include information about the entity's classification and tax treatment under the law of its country of organization.

V. OFF-BALANCE SHEET TRANSACTIONS

A. Overview

1. Introduction to off-balance sheet transactions

Enron engaged in certain off-balance sheet partnership arrangements that were motivated by financial reporting objectives rather than by tax benefits. Three of these arrangements included Chewco Investments, LP ("Chewco"), LJM Cayman, LP ("LJM1"), and LJM2 Co-Investment, LP ("LJM2"). Enron did not own equity interests in Chewco or in the LJM partnerships. Ownership of those entities was held by certain Enron employees and, in the case of the LJM partnerships, outside parties.[1112] Enron employees, however, controlled Chewco and the LJM partnerships. In the cases of Chewco and LJM2, Enron owned interests in joint ventures in which Chewco and LJM2 participated. Further, in the case of LJM2, Enron entered into transactions using disregarded entities owned by Enron.[1113]

The participation of Enron and Enron employees in these off-balance structures raised issues regarding the appropriate accounting treatment of Chewco, the LJM partnerships, and their affiliates, and of Enron's transactions with those entities.[1114] These arrangements also provided significant financial benefits to certain Enron employees.[1115] Certain of the corporate

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[1112] In this sense, Enron used employees as accommodation parties in order for Enron to attain its financial statement objectives.

[1113] *See* Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, at 40 (June 7, 2002).

[1114] Enron's accounting treatment with respect to the Chewco, LJM1, and LJM2 arrangements was determined with significant assistance from its outside auditor, Arthur Andersen. On January 21, 2003, the Financial Accounting Standards Board ("FASB") issued guidance on special purpose entities and other types of "variable interest entities" which provides new accounting rules for off-balance sheet structures such as Chewco, LJM1, and LJM2, and nullifies certain accounting guidelines, including Emerging Issues Task Force Notice 90-15, that had served as the basis for the special purpose entity accounting treatment adopted by Enron with respect to these off-balance sheet partnerships. *See* FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an interpretation of ARB No. 51 (January 2003), generally effective after January 31, 2003.

[1115] For example, Enron reported to the Securities and Exchange Commission that it believed that Andrew S. Fastow earned in excess of $30 million relating to his LJM management and investment activities. Enron Corp., Form 10-Q filed with the Securities and Exchange Commission (November 19, 2001), at 19. Michael J. Kopper reportedly received at least $10 million from these arrangements. Powers Report at 3.

governance and management oversight issues relating to these transactions were discussed in the Powers Report and examined by other investigative bodies.[1116]

The Chewco, LJM1, and LJM2 structures were off-balance sheet arrangements involving ownership by Enron employees and outside parties and were not part of Enron's consolidated Federal income tax returns. For this reason, as well as the various ongoing law enforcement investigations into these structures, the Joint Committee staff was unable to investigate this area in detail. Accordingly, the following description, which relies heavily on the Powers Report, is necessarily incomplete.

2. Description of Chewco and JEDI I structure and transactions

JEDI I

Enron and the California Public Employees Retirement System ("CalPERS") formed JEDI I in 1993. JEDI I was not included in Enron's consolidated balance sheet for financial accounting purposes.

JEDI I's partnership agreement stated its purpose was to acquire, own, hold, make, participate in, exercise rights with respect to, and dispose of qualified investments, dispose of Enron stock and put options, and engage in any such other business purpose to accomplish the foregoing purposes.[1117] JEDI I's consolidated financial statements described its purpose as investing in and managing certain natural gas and energy related assets.[1118] At the end of 1996, JEDI I held interests in eight separate limited partnerships formed to acquire and develop oil and gas properties.[1119] JEDI I had contributed approximately $57.4 million to these eight partnerships and was committed to contributing an additional $32.2 million.[1120] JEDI I also held 12 million shares of Enron stock.[1121] As of September 30, 1997, JEDI's portfolio characteristics comprised the following based on total portfolio values: private equity: 41 percent; public equity:

[1116] Powers Report at 148-200. *E.g.*, Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate, *The Role of the Board of Directors in Enron's Collapse*, Report 107-70, at 77 (July 8, 2002).

[1117] Amended and Restated Partnership Agreement of JEDI. E48090.

[1118] *See* JEDI: limited partnership and subsidiaries- Consolidated Financial Statements as of December 31, 1996, together with Auditor's Report. E48322.

[1119] *See Id.*

[1120] *See Id.*

[1121] Powers Report at 59.

18 percent; Enron stock and put options: 26 percent; working interests: 2 percent; subordinated debt: 6 percent; partnerships: 4 percent; and loans: 4 percent.[1122]

Chewco

In 1997, Enron and CalPERS agreed to redeem CalPERS' interest in JEDI I. Because JEDI I had only two partners, a redemption of CalPERS' interest, without a substitute partner to replace CalPERS, would cause JEDI I to cease to be a partnership for State law purposes, and cause JEDI I to be consolidated with Enron in its financial statements. Enron employees formed Chewco to acquire and own the JEDI I investment previously held by CalPERS.[1123] CalPERS' 50 percent interest in JEDI I was redeemed in November 1997 and Chewco became JEDI I's limited partner. Chewco was structured as an unconsolidated special purpose entity to achieve off-balance sheet treatment with respect to Enron, and to preserve off-balance sheet treatment with respect to Enron's continued ownership in JEDI I.[1124]

As of its date of formation, Chewco had no equity. The parties put together the Chewco structure on short notice and arranged $383 million of bridge financing provided equally by Barclays Bank PLC ("Barclays") and Chase Manhattan Bank, and guaranteed by Enron, so Chewco could acquire CalPERS' interest in JEDI I.[1125] In November 1997, JEDI made a liquidating distribution to CalPERS of $383 million.[1126] Concurrently, Chewco purchased a

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[1122] JEDI, Quarterly Reporting Package to Pacific Corporate Advisors, Inc. (September 20, 1997). E73563.

[1123] Initially, Mr. Fastow intended to participate as an owner of Chewco. Mr. Fastow was advised by Vinson & Elkins that his participation in Chewco would require a proxy statement disclosure and approval from the Chairman and Chief Executive Officer under Enron's Code of Conduct of Business Affairs. Mr. Fastow arranged to have Mr. Kopper, an Enron Global Finance employee, become the owner and manager of Chewco. Although Mr. Kopper's participation would require approval under Enron's Code of Conduct of Business Affairs, Mr. Kopper was not a senior officer of Enron, and would not be subject to the proxy statement disclosure requirement.

[1124] Chewco was described as perhaps the first instance where "Enron's Finance Group (under Mr. Fastow) used a special purpose entity managed by an Enron employee to keep a significant investment partnership outside of Enron's consolidated financial statements." *See* Powers Report at 41. Enron had previously used off-balance sheet entities prior to the formation of Chewco, including JEDI I, to hold business investments, but the implication is that its prior arrangements involved investors and managers that were unaffiliated with Enron and with Enron's employees.

[1125] This reportedly was required to satisfy a closing deadline imposed by CalPERS. Criminal Complaint, *United States of America v. Andrew S. Fastow*, U.S. District Court, Southern District of Texas (Case No. H-02-8889-M), at 11.

[1126] Enron Corp., Form 8-K, filed with the Securities and Exchange Commission (November 8, 2001), at 18.

limited partner interest in JEDI I for $383 million.[1127] In November or December 1997, a longer term capital structure was created whereby three financing transactions took place: (1) a $240 million unsecured subordinated loan to Chewco was made by Barclays and guaranteed by Enron; (2) a $132 million advance from JEDI I to Chewco was made under a revolving credit agreement; and (3) $11.5 million in equity (representing 3 percent of Chewco's $383 million of assets) was provided by Chewco's general and limited partners.[1128] The sum of these amounts (i.e., $240 million, $132 million, and $11.5 million) equaled the $383 million CalPERS redemption price.

Mr. Kopper invested $115,000 in Chewco's general partner, and $10,000 in its limited partner. Mr. Kopper later transferred his limited partnership interest in Chewco to his acquaintance, Mr. Dodson. Barclays Bank provided "equity loans" in the amount of $11.4 million to Big River Funding, LLC ("Big River"), Chewco's sole limited partner, and to Little River Funding LLC ("Little River"), Big River's sole member. Barclays Bank characterized the advances as loans for business and regulatory purposes. Enron and Chewco characterized them as equity contributions for accounting purposes. In order to secure its repayment right, Barclays Bank required Big River and Little River to establish a cash reserve account funded with $6.6 million in cash at closing. The reserve account also had to be fully pledged to secure payment of the $11.4 million advance. JEDI I made a special $16.6 million distribution to Chewco, a portion of which was used to fund the reserve account.

Following Chewco's replacement of CalPERS as the limited partner of JEDI I, Enron continued to treat JEDI I as an unconsolidated affiliate for financial statement purposes, and engaged in a variety of transactions with Chewco and JEDI I designed to enable Enron to accelerate revenue for financial statement purposes. For Federal income tax purposes, Enron reported its pro rata share of income and losses.[1129]

<u>Specific transactions between Enron and Chewco or JEDI I</u>

<u>Overview</u>

Without a substantial outside investor in JEDI I such as CalPERS, Enron was able to enter into transactions with JEDI I and Chewco without having to obtain the consent of an unrelated third party. Enron repeatedly used Chewco and JEDI I to generate or accelerate financial reporting revenues through the use of loan guaranty fees, required payment management fees, and the reporting of appreciation of value in Enron stock held by JEDI I.[1130]

[1127] *Id.*

[1128] Powers Report at 49; *see also* Enron Corp., Form 8-K, filed with the Securities and Exchange Commission (November 8, 2001), at 18.

[1129] *See* Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, at 40 (June 7, 2002).

[1130] Powers Report at 56-60.

Enron's loan guaranty fee

Chewco had agreed to pay Enron a guaranty fee of $10 million in cash at closing, plus an additional 315 basis points annually on the average outstanding balance of the $240 million Barclays Bank loan provided to Chewco. In the 12 months that the Barclays Bank loan was outstanding, Chewco paid $17.4 million to Enron. Enron characterized these payments as structuring fees for financial statement purposes and reported income from the $10 million up-front guaranty fee in December 1997, rather than ratably over the 12-month term of the loan.[1131]

Enron's management fee

The December 1997 JEDI I amended partnership agreement provided that JEDI I would pay Enron an annual management fee equal to the greater of 2.5 percent of $383 million (less any distributions received by Chewco) or $2 million. The management services relating to the management fees would cover a five-year period, 1998 through 2003. In March 1998, Enron and Chewco amended the partnership agreement to convert 80 percent of the annual management fee to a "required payment" payable to Enron, and took the position for accounting purposes that Enron was entitled to recognize the entire "required payment" as revenue immediately.[1132] Consistent with this position, Enron immediately recognized, in its first quarter 1998 income, $25.7 million with respect to the required payment portion of the management fee.[1133]

Appreciation in Enron shares held by JEDI I

JEDI I held 12 million shares of Enron stock in its portfolio. JEDI I carried its assets at fair value, and Enron reported its investment in JEDI I under the equity method of accounting. Enron reported as income Enron's share of the increase in value of Enron stock held by JEDI I. Enron reported $126 million of income in Enron stock appreciation for shares held by JEDI I in the first quarter of 2000 alone.[1134] Enron's independent auditor informed Enron at some point during 2000 that Enron could no longer include in its financial statements its share of JEDI I's gain attributable to Enron stock. When Enron's stock declined in value during the first quarter of 2001, JEDI I's value of Enron shares declined by $94 million. Enron did not report its approximate $ 90 million share of this loss.[1135] This treatment had the effect of increasing Enron's earnings by $126 million in the first quarter of 2000 (when Enron's stock increased in value) without Enron reporting a loss when the value of the shares held by JEDI I declined in 2001.

Tax indemnity payment paid by Enron

[1131] *Id.* at 56-57.

[1132] *Id.* at 57-58.

[1133] *Id.* at 58.

[1134] *Id.* at 59.

[1135] *Id.*

In 1997, when Chewco purchased the JEDI I limited partnership interest, Enron and Chewco executed a tax indemnity agreement. This agreement reportedly compensated Chewco for the difference between Chewco's current tax obligations and its cash receipts during the term of the partnership. The tax indemnity agreement required Enron to make payments to Chewco for current tax obligations and cash receipts.[1136] In September 2001, Enron paid Chewco $2.6 million in connection with the March 2001 buyout of Chewco.[1137]

Other Chewco fees and payments

In December 1998, Chewco received a $400,000 payment from Enron in what has been described as a "restructuring," "amendment," or "nuisance" fee.[1138]

Subsequent developments and buyout agreement

In March 2001, Enron repurchased Chewco's limited partnership interest in JEDI I for $35 million and consolidated JEDI I into its consolidated financial statements for the first quarter 2001.[1139] The buyout contract price of $35 million was calculated by taking into account the following: (1) a $3 million cash payment that had been agreed to in the year 2000; (2) $5.7 million to cover the remaining required payments portion of the management fee due to Enron under the JEDI I partnership agreement (Enron reduced the $35 million purchase payment by this amount); and (3) $26.3 million to satisfy Chewco's outstanding $41.3 million obligation under the revolving credit agreement with JEDI I.[1140]

Accounting adjustments due to the unwind of Chewco

Enron and its independent auditor concluded in late 2001 that Chewco and JEDI I did not satisfy the non-consolidated special purpose entity accounting rules prior to Enron's buyout of Chewco and related consolidation of JEDI I in early 2001. In November 2001, Enron announced that it would consolidate Chewco and JEDI I retroactive to 1997. The retroactive consolidation reduced Enron's reported net income by $28 million (out of $105 million total) in 1997, by $133

[1136] *Id.* at 64-65.

[1137] *Id.* There apparently was a dispute between Enron and Chewco regarding whether the $2.6 million payment was required under the original tax indemnity agreement.

[1138] *Id.* at 55.

[1139] Enron Corp., Form 8-K, filed with the Securities and Exchange Commission (November 8, 2001), at 4, 19. JEDI I remained a wholly owned subsidiary of Enron. *Id.* at 19.

[1140] Powers Report at 62-63. Chewco was not required to pay off the entire $41.3 million obligation, and instead paid $26.3 million, with the remaining $15 million converted to a term loan due in January 2003.

million (out of $703 million total) in 1998, by $153 million (out of $893 million total) in 1999, and by $91 million (out of $979 million total) in 2000.[1141]

3. Description of LJM1 structure and transactions

LJM1 was formed as LJM Cayman, LP, a limited partnership registered in the Cayman Islands. Its initial partners consisted of LJM Partners, LP, the general partner, and ERNB Partnership, Limited ("ERNB") and Campsie Limited ("Campsie"), as limited partners. LJM Partners, LP was owned by Mr. Fastow and LJM Partners LLC, whose sole member was Mr. Fastow. ERNB and Campsie were entities controlled by Credit Suisse First Boston and National Westminster Bank, respectively, two banks with which Enron had banking relationships. Mr. Fastow controlled LJM1 through his control of the management duties possessed by the general partner. Enron did not own an interest in LJM1.[1142]

LJM1 was formed to provide Enron an accounting hedge against the decline in value of Rhythms Net stock. Enron purchased a put option provided by an LJM1 subsidiary that was designed to protect Enron against accounting risks relating to potential declines in value of the Rhythms Net shares. LJM1 also engaged in the purchase from Enron of a portion of Enron's interest in the Cuiaba, Brazil pipeline assets.

Overview of hedging transactions

The LJM partnerships engaged in transactions that involved the use of hedging. The definition of a hedging transaction varies widely depending upon the purpose for which the term is used. For example, a hedging transaction for Federal income tax purposes is defined as any transaction that is entered into in the normal course of a trade or business that is properly identified as managing the risk of price changes, currency fluctuations, interest rate changes, or any other risk prescribed in regulations with respect to ordinary property or borrowings.[1143] By contrast, a hedging transaction for financial accounting purposes is defined as a derivative that is designated as a hedge, but only to the extent that the changes in the value of the derivative are effective in offsetting changes in the fair value or cash flow of an exposure or changes in the value of net investment in a foreign operation.[1144] Hedging transactions typically involve contractual arrangements with a creditworthy third party who has the financial wherewithal to honor its obligations to the hedging party. Hedges may be effected through a variety of

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[1141] Enron Corp., Form 10-Q, filed with the Securities and Exchange Commission (November 19, 2001), at 16. Enron's reported debt also increased by $711 million in 1997, by $561 million in 1998, by $685 million in 1999, and by $628 million in 2000, reflecting both JEDI I's and Chewco's borrowings. *Id.*

[1142] The interests of ERNB and Campsie were subsequently purchased by Mr. Fastow and others in early 2000 through a partnership, Southampton, LP. Powers Report at 92-94. Criminal Complaint, *United States of America. v. Andrew S. Fastow*, at 31-32.

[1143] Sec. 1221(b)(2).

[1144] *See* Financial Accounting Standards Board Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

mechanisms, including the use of forward contracts, put and call options, short sales, and notional principal contracts such as swaps, caps, and floors.

In the LJM context, Enron was concerned with protecting itself against declines in the market value of certain of its portfolio investments in publicly traded stock. The LJM hedges were structured to protect Enron against financial accounting risks due to the volatility in value of equity positions Enron held in such investments.[1145] Although Enron retained the underlying investment, it would offset losses attributable to a decline in value of the underlying investment with the offsetting gain on the hedging position that Enron held with respect to that investment. Enron did not have to report losses attributable to the special purpose entity's exposure under the hedge as long as the special purpose entity could be treated as unconsolidated and had assets at least equal to its liabilities.

Enron provided the LJM special purpose entities those assets that were to be used to honor their contractual obligations to Enron in the event the hedged investments declined in value. In most of the LJM hedging transactions, Enron's hedge protection against the decline in value of its investment assets consisted of Enron stock or stock rights.

Rhythms Net hedge

In 1998, Enron acquired 5.4 million shares of Rhythms Net stock for $10 million.[1146] The value of the Rhythms Net shares increased to over $300 million during 1999, and Enron reported the appreciation as income for financial statement purposes under the mark-to-market method of accounting.[1147] Enron was concerned that the value of the Rhythms Net shares would decline and require Enron to report investment losses relating to the shares in such case. In 1999, Enron implemented a purported hedging transaction with LJM1 and an LJM1 subsidiary to address its accounting exposure concerns relating to the Rhythms Net stock.

To effect the hedge, Enron purchased a put option provided by an LJM1 subsidiary, LJM 1 Swap Sub, LP ("Swap Sub"), valued by the parties at $104 million.[1148] The put option obligated Swap Sub to purchase the 5.4 million Rhythms Net shares owned by Enron for a purchase price of $56 per share.[1149] In exchange for the put option and LJM1's promissory note

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[1145] *See* Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation at 39-40 (June 7, 2002). *See also*, Interoffice Memorandum dated April 19, 2000, from AnnMarie Tiller and Brent Vasconcellos to R. Davis Maxey ("The commercial purpose for the [Talon] transaction is to create a risk management program *to hedge from a financial accounting perspective the volatility in value of equity positions* Enron or its affiliates are expected to hold in various companies, both public and private, many or most of which are expected to be in the telecommunications and/or broadband communications areas.") (italics added). EC 000850875.

[1146] Powers Report at 77.

[1147] *Id.*

[1148] *Id.* at 81.

[1149] *Id.*

in the amount of $64 million, Enron transferred 3.4 million shares of its own stock to LJM1 to be used by LJM1 as credit support to honor any obligation LJM1 might incur under the hedge. The Enron shares had an unrestricted value at the time of the transfer of $276 million, but the parties discounted their value to $168 million because Enron prohibited LJM1 from selling the shares for four years.[1150] Thus, the parties treated the transactions as Enron providing $168 million of Enron stock to LJM1 in exchange for a put option valued at $104 million and a $64 million note.

Enron agreed in the first quarter of 2000 to provide LJM1 a put option that gave LJM1 the right to sell Enron shares to Enron at a price of $71.31 per share.[1151] In March 2000, Enron and LJM1 agreed to terminate the Rhythms Net hedge and related financial instruments. Pursuant to that agreement, Enron received the shares of Enron stock held by Swap Sub and paid LJM1 approximately $26.8 million.[1152] Enron treated the settlement of the put options as a realization event both for financial reporting and Federal income tax purposes.[1153]

Sale of Cuiaba assets

In September 1999, Enron transferred to LJM1 a 13 percent equity interest in a company owning a power project in Brazil for $10.8 million.[1154] This enabled Enron to take the position that it could recognize financial statement revenues of $65 million, $14 million, and $5 million from a commodity contract with the company owning the power project in 1999, 2000, and 2001, respectively.[1155] Enron paid LJM1 a marketing fee of $240,000 in May 2000.[1156] Enron

[1150] *Id.* at 79-82. LJM1 was not prohibited from pledging the Enron shares as collateral for a loan, however, which meant that LJM1 and Swap Sub could use the shares to obtain a loan to generate cash proceeds to honor the put obligation to Enron should Enron exercise the hedge. Powers Report at 80.

[1151] Enron Corp., Form 10-Q, filed with the Securities and Exchange Commission (November 19, 2001), at 17.

[1152] *Id.*

[1153] *See* Appendix B, Enron Corp., Presentation to the Joint Committee on Taxation, at 39-40 (June 7, 2002). Enron reported gain for book and tax purposes on the settlement of the put option of $104 million, and did not make a tax reporting change following the Form 8-K restatement that occurred in November 2001. *Id.*

[1154] Enron Corp., Form 10-Q, filed with the Securities and Exchange Commission (November 19, 2001), at 23. LJM1 also paid $500,000 to acquire redeemable preference shares in a related company. *Id.*

[1155] *Id.*

[1156] *Id.*

repurchased LJM1's interest in the Cuiaba assets and the preference shares for $14.4 million in 2001.[1157]

4. Description of LJM2 structure and transactions

In October 1999, Messrs. Fastow and Kopper formed LJM2 as a Delaware limited partnership. Enron described LJM2 as "a private investment company that primarily engages in acquiring or investing in energy and communications-related investments, primarily involving either assets Enron had decided to sell or risk management activities intended to limit Enron's exposure to price and value fluctuations with respect to various assets."[1158] LJM2 participated in various transactions pursuant to which it acquired from Enron or an Enron affiliate various assets, securities or other ownership interests involving Enron's energy or communications businesses.[1159] LJM2 is perhaps best known, however, for its four separate Raptors projects, which were variations of hedging transactions that are described below.

LJM2 was controlled by Messrs. Fastow and Kopper through their ownership and control of LJM2 Capital Management LP, the general partner of LJM2.[1160] The limited partners of LJM2 were approximately fifty investors who made their investments pursuant to a private placement.[1161]

Specific transactions between Enron and LJM2 or affiliated entities

The Raptors transactions

The LJM2 transactions that had the greatest impact on Enron's financial statements involved the hedging structures known as the "Raptors." The Raptors structures allowed Enron to avoid reflecting almost $1 billion of losses on merchant investments during their existence,

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[1157] *Id.*

[1158] Enron Corp., Form 14 Proxy, filed with the Securities and Exchange Commission (March 2, 2001), at 29.

[1159] *Id.* Enron's asset sales to LJM2 included (1) a 75 percent equity interest in a power project in Poland; (2) ownership rights to certain natural gas reserves; (3) an equity investment in a Nigerian barge company; (4) dark fiber optic cable; and (5) a contractual right to acquire a gas turbine. Enron Corp., Form 10-Q, filed with the Securities and Exchange Commission (November 19, 2001), at 23-24.

[1160] The general partner of LJM2 Capital Management LP was a limited liability company, LJM2 Capital Management LLC, of which Mr. Fastow was the sole member and Mr. Kopper was an authorized signatory. The limited partners were Mr. Fastow and a Mr. Kopper-controlled limited liability company (Big Doe LLC).

[1161] Hearings Before the Permanent Subcommittee of Investigations of the Committee on Governmental Affairs, United States Senate, 107th Cong. (July 23 and 30, 2002), *The Role of the Financial Institutions in Enron's Collapse* - Volume 2, at 2241, 2291.

including $501 million in 2000 and $453 million for 2001.[1162] In the last two quarters of 2000, Enron recognized revenues of $500 million on derivative transactions with Raptor entities, which offset losses in Enron's merchant investments, and recognized pre-tax earnings of $532 million (including net interest income).[1163] Enron reported that the combined notional principal amount of the derivatives transactions entered into between Enron and LJM2 was approximately $2.1 billion.[1164]

The Raptors were four separate and complex transactions that began in mid-2000 and ended in 2001. The first, Raptor I, involved the use of Enron Corp. stock and stock rights to hedge against the potential decline in value of certain Enron investments, including Internet company stocks. The second and fourth, Raptors II and IV, involved using Enron stock and stock rights to hedge other Enron investments. Raptor III involved a hedge relating to Enron's investment in New Power Holdings, Inc. ("NPW"), and differed from the other Raptors structures because it used NPW stock rather than Enron stock to effect the purported hedge.

Each of the Raptor structures involved a special purpose entity formed by an Enron wholly-owned limited liability company and LJM2. The Raptors structures were designed to permit Enron to (1) exclude LJM2 from both its consolidated financial statement balance sheet and consolidated Federal tax return; and (2) exclude the special purpose entity from Enron's consolidated financial statement balance sheet, but include the special purpose entity in Enron's consolidated Federal tax return.

Raptor I (Talon)

Raptor I was formed in April 2000 and used a special purpose entity named Talon I, LLC ("Talon"). Talon was created for the purpose of engaging in hedging transactions with Enron. Its investors were LJM2, through its affiliate LJM2-Talon, LLC, and Harrier I, LLC ("Harrier"), a wholly owned special purpose entity of Enron Corp. formed to participate in Raptor I. Talon's assets consisted of cash, a promissory note, and Enron stock and stock contracts. LJM2 invested $30 million cash, and Harrier invested a $50 million promissory note and Enron stock and stock contracts valued by the parties at approximately $537 million. Talon was prohibited from selling, pledging or hedging the Enron stock for three years, and the parties discounted the Enron stock by 35 percent from its unrestricted fair market value. Harrier received a membership interest and a $400 million revolving promissory note from Talon in exchange for the invested assets. LJM2 was the party responsible for managing Talon.

Under Talon's limited liability company agreement, both LJM2 and Harrier held membership interests in Talon for State law purposes. The parties treated LJM2 as an equity owner of Talon for financial accounting purposes but not for Federal income tax purposes. An

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[1162] Enron Corp., Form 10-Q, filed with the Securities and Exchange Commission (November 19, 2001), at 20-21.

[1163] *See* Powers Report at 14.

[1164] Enron Corp., Form 14 Proxy, filed with the Securities and Exchange Commission (March 2, 2001), at 30.

internal memorandum dated April 19, 2000, states that Enron treated LJM2's investment as debt, and Talon as a single member LLC which Enron regarded as its owner for Federal income tax purposes.[1165] The memorandum further stated that "[n]otwithstanding the legal form or title given to the interest LJM2 holds in Talon (which as described above was necessary solely for financial accounting purposes), Talon's [l]oan to LJM2 has all the important indicia of debt."[1166] As indicated above, the structure was designed to permit Enron to: (1) exclude LJM2 from both its consolidated financial statement balance sheet and consolidated tax return; and (2) exclude Talon from its consolidated financial statement balance sheet, but include Talon in Enron's consolidated Federal tax returns.

LJM2's economic rights differed from those of Harrier with respect to their Talon interests. The parties agreed that Talon would not engage in hedging transactions until it had distributed a minimum return from the income of Talon to LJM2, equal to the greater of $41 million or a 30 percent annualized return. By treating the minimum return as from Talon's income, rather than from Talon's capital, the parties determined they could treat the $30 million invested by LJM2 as capital for the 3 percent equity test applicable to related special purpose entities.[1167] After the minimum return was provided to LJM2, Harrier was entitled to all of any further distributions of Talon's income. Thus, for financial accounting purposes LJM2 was treated as an equity investor in Talon, though for Federal income tax purposes it was treated as the holder of a debt instrument issued by Talon (i.e., Talon's obligation to pay LJM2 the greater of $41 million or a 30 percent annualized return before any distribution could be made to Harrier).

Talon and Enron entered into numerous swaps pursuant to which Talon purportedly benefited from the upside, and was at risk for the downside, with respect to the underlying Enron investments. One such investment was stock in Avici Systems, Inc. ("Avici"), a public company in which Enron held a large stake.[1168] For financial statement purposes, Enron had accounted for its ownership of the Avici shares under the mark-to-market method, which meant that Enron

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[1165] Interoffice Memorandum from AnnMarie Tiller and Brent Vasconcellos to R. Davis Maxey (April 19, 2000) ("[i]n order for Talon to be viewed as an independent entity for financial accounting purposes, the $30 [million] that LJM2 transfers to Talon will be exchanged for what will legally be called a member interest in Talon."). EC 000850876. *See* Interoffice Memorandum from AnnMarie Tiller and Brent Vasconcellos to Ben Glisan (August 19, 2000) ("[o]ur earlier conclusion that we could treat LJM2's original investment in Talon as debt solely for tax purposes was in large measure based on Talon's capitalization or wherewithal to pay some few months after the closing.") EC 000850968.

[1166] *Id.* at EC 000850877.

[1167] This meant that Talon could be viewed, for financial accounting purposes, as off-balance sheet with respect to Enron, because LJM2 (a non-Enron entity) had provided outside equity of at least 3 percent of Talon's total assets.

[1168] Avici is a provider of carrier-class routing solutions for the Internet. Avici Systems Inc., Press Release dated December 11, 2002.

booked gain or loss on the 1.09 million shares[1169] of Avici stock it owned as Avici's stock price increased or decreased. Enron and Talon entered into a swap arrangement regarding the 1.09 million Avici shares effective as of August 3, 2000, the date on which Avici shares traded at its all-time high stock price ($163.50 per share). Under the swap arrangement, Enron retained outright ownership of the Avici shares, but shifted to Talon the upside and downside with respect to the Avici stock. Enron accounted for Talon on a cost basis, which meant Enron did not have to book any losses Talon realized on its swap position with respect to the Avici shares.[1170]

Raptor II (Timberwolf)

Raptor II was created in June 2000 through the formation of Timberwolf I, LLC, a Delaware limited liability company. Timberwolf's members were LJM2-Timberwolf, LLC, an LJM2 affiliate, and Grizzly I, LLC, a wholly-owned subsidiary of Enron Corp.[1171] The Raptor II hedging structure was similar to that of Raptor I, with Enron paying the special purpose entity $41 million to acquire a hedge against its investments, including certain assets in South America. Enron capitalized Timberwolf by contributing a restricted contingent forward contract for 7.8 million shares of Enron stock and a $50 million note payable.[1172]

Raptor III (Porcupine)

Raptor III was formed on September 27, 2000, to enter into hedging transactions with Enron with respect to NPW, a power delivery company created by Enron and in which Enron held a 75 percent ownership interest.[1173] Raptor III differed from the other Raptors in two respects: (1) it was formed to hedge a single Enron investment, NPW, rather than multiple Enron investments; and (2) it held the stock of NPW, the company whose stock it was intended to hedge, rather than Enron stock, for its credit support. Enron reportedly did not use its own stock to serve as the hedge because it did not have sufficient shares available to transfer to the structure without obtaining Board approval to issue additional common stock.[1174]

Raptor III was conducted through a special purpose entity, Porcupine I, LLC ("Porcupine"). Porcupine was a two-member limited liability company, with LJM2 holding one membership interest, through its affiliate LJM2-Porcupine, LLC, and Enron's wholly-owned

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[1169] Criminal Complaint, *United States v. Andrew S. Fastow*, at 27.

[1170] Interoffice Memorandum from AnnMarie Tiller and Brent Vasconcellos to R. Davis Maxey (April 19, 2000). EC 000850875.

[1171] Notes to Financial Statements, Timberwolf I, LLC, December 31, 2000. E100025.

[1172] *Id.*

[1173] NPW initially was a wholly owned subsidiary of Enron. Subsequently it included other investors, and in October 2000 it became a public company. Enron Corp., Form 8-K, filed with the Securities and Exchange Commission (November 8, 2001) at 13.

[1174] Powers Report at 116-118.

special purpose entity, Pronghorn I, LLC, holding the other. LJM2 contributed $30 million cash in exchange for its membership interest. Enron, through Pronghorn, transferred warrants for 24 million shares of NPW stock to Porcupine in exchange for Porcupine's promissory note in the amount of $259 million.[1175]

Porcupine's economic interests were structured in a manner similar to those of Raptor I, and provided LJM2 a minimum return prior to Pronghorn receiving any distributions. LJM2's minimum return was the greater of $39.5 million or a 30 percent annualized return. Enron, through Pronghorn, was to receive all Porcupine distributions after LJM2 received its minimum return.

On October 5, 2000, the day of the NPW initial public offering, Porcupine made a $39.5 million distribution to LJM2, the requisite minimum return, permitting Porcupine to commence hedging activities with Enron. On the same day, Enron and Porcupine entered into swaps with respect to NPW stock at $21 per share, pursuant to which Porcupine obtained the economic upside if NPW stock rose above $21, but became obligated to pay Enron when NPW stock fell below that price. Because Porcupine was treated as an unconsolidated special purpose entity, Enron did not have to book any of Porcupine's investment losses attributable to decreases in value of NPW shares.[1176]

Shortly after NPW's initial public offering, its stock declined in value to below $21 per share. This meant that Porcupine's swap obligation to Enron increased, which was designed to offset Enron's investment losses on the NPW shares it held outright. However, because Porcupine's only asset available to honor its obligation to Enron was NPW stock, Porcupine's ability to honor its swap obligation diminished at the same time (and to the same extent) that its obligation to Enron increased. This provided Enron no economic protection under the hedge, and required Enron to report as income for financial reporting purposes the excess of Porcupine's obligations over its assets (i.e., its negative credit capacity).[1177] By the end of December 2000, NPW's stock had dropped to below $10 per share, and Raptor III had a substantial negative credit capacity.

[1175] The documents recorded this transfer of NPW shares at $10.75 per share. The parties treated the transfer as a sale at $10.75 rather than a contribution of the shares. This apparently was done to enable the parties to take the position that Enron did not hold an equity stake in Porcupine for financial reporting purposes, so that Porcupine was not required to be included in Enron's consolidated financial statements. LJM2's $30 million cash contribution was intended to constitute equity for financial reporting purposes in order to satisfy the 3 percent outside equity requirement. Enron treated Porcupine as a disregarded entity of which Enron (through Pronghorn) was regarded as the owner of its assets. Notes to Financial Statements, Porcupine I, LLC, December 31, 2000. E100240.

[1176] Powers Report at 115-118.

[1177] This was required under the accounting principles applicable to unconsolidated special purpose entities, which permitted off-balance sheet treatment only if the special purpose entity had the financial wherewithal to honor its obligations.

Raptor IV (Bobcat)

Raptor IV was formed in August 2000. Its hedging structure replicated those of Raptors I and II, with Enron paying to acquire the hedge. Raptor IV was implemented through Bobcat I, LLC ("Bobcat"), a limited liability company with LJM2-Bobcat, LLC, an LJM2 affiliate, and Roadrunner I, LLC, a wholly owned subsidiary of Enron Corp., as its members. Although Raptor IV was capitalized, it was never used to engage in hedging transactions with Enron.[1178]

[1178] Instead its assets were used as credit support for Raptors I and III to address their respective negative credit capacities. *See* Notes to Financial Statements, Bobcat I, LLC, December 31, 2000. E 100330.